Friday, 18 January 2019

Financial services regulation 2019: New Year briefing

"In this briefing we summarise some of those key known knowns and known unknowns which should be the focus of attention for firms in the coming year and beyond. As for the unknown unknowns, who knows? And there is always next year's New Year briefing ..."

Travers Smith
New Year Briefing, 10 January 2018

Little did we imagine when we wrote those words a year ago that we would find ourselves in a position where, with only 10 weeks to go before the UK is scheduled to leave the EU on 29 March 2019, a number of different Brexit outcomes still remain possible: a "hard", no-deal Brexit; an agreement with the EU for a transitional period ending in December 2020 (what has become known as "Theresa May's deal") accompanied by a non-legally binding political declaration (that says little about financial services other than the parties will each have equivalence frameworks and they should start assessing equivalence as soon as possible); a postponement of the Article 50 period with an attempt to renegotiate a withdrawal deal in the interim; a second referendum; a general election; or a revocation of the Article 50 notification altogether.

The UK House of Commons rejected the EU Withdrawal Agreement on 15 January 2019; and the government survived a no confidence motion the day after. At the time of writing, cross-party talks are taking place and the government proposes to announce a "Plan B" on 21 January 2019. There will be a vote on this on 29 January 2019. Events are moving fast and it is still far from certain

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which of the outcomes outlined above will occur – some seem more likely than others.

The outcome which would be the most immediate in terms of impact is, of course, a "no deal" or "hard" Brexit: see Part 3 below which refers to the regulations and rules which H.M. Treasury and the regulators are making to apply in such an eventuality. Depending on events over the next days and weeks the measures summarised in Part 3 may become less relevant, totally irrelevant or supremely important!

By comparison with Brexit, the incoming SMCR regime for FCA-authorised firms towards the end of this year may be something of a relief for firms, at least insofar as it stands as something predictable and tangible for which they can - and must - prepare. The final rules have been made and firms will need to spend the coming months enhancing their systems, controls and procedures in preparation for December.

Despite the fact that Brexit has dominated the headlines, a steady stream of EU laws and proposals continues to come the UK's way. We cover those measures likely to be of most significance to firms. Many of them will be relevant, to a greater or lesser extent, even if there is a hard Brexit. The sustainability and green finance initiative has become a developing theme – at a global, European and UK level - which will have an impact on asset managers and other financial services providers one way or another – just how much remains to be seen. And in the coming year and beyond, there will be much more besides from the UK regulators to keep firms busy, Brexit or no Brexit.

Finally, as regards how the Brexit conundrum is finally resolved (assuming this is possible) and what the impact will be in the medium to long term for firms, we hesitate to say it again… but there is always next year's New Year briefing…

PART 1: EU MEASURES AND DEVELOPMENTS

1. EU SECURITISATION REGULATION AND CRR SECURITISATION AMENDMENTS – IN FORCE

INTRODUCTION

The EU Securitisation Regulation (Regulation (EU) 2017/2402) took effect on **1 January 2019**, alongside amendments to the CRR which introduced a revised regime for the regulatory capital treatment of securitisation positions. We summarised the key elements of these changes in section 8 of our previous New Year Briefing published in January 2018. Subordinate legislative rules relating to issuers concerning the obligation of an original lender, originator or sponsor to hold the risk retention stake in a securitisation (including expected provisions which narrow the scope of persons who can qualify as an originator) have yet to be adopted.

TRANSPARENCY: REPORTING TEMPLATE

Amongst other requirements, the EU Securitisation Regulation introduced a new transparency regime which requires originators, sponsors or securitisation special purpose entities (depending on which of these has been nominated to fulfil the transparency requirements) to make certain information available to investors and regulators. The EU Regulation envisages that ESMA (working together with the EBA and EIOPA) would have drafted new reporting templates for these purposes which would have been ready by the time that the new requirements entered into force. However, due to the complexity of creating templates suitable for different types of securitisations and ongoing differences of opinion with the European Commission about the proposed templates, ESMA has not yet completed its work.

On 30 November 2018, ESMA published a joint statement with the EBA and EIOPA which acknowledged that the relevant disclosure templates would not be completed in time. As a result, the default transitional arrangements in the EU Securitisation Regulation will apply instead, meaning that reporting for the purposes of the transparency requirements should take place using templates contained in Delegated Regulation (EU)

2015/3. That delegated regulation is a set of regulatory technical standards made under the Credit Rating Agencies Regulation (**CRA Regulation**) which contains disclosure requirements for structured finance instruments.

However, the joint statement notes that in practice, requiring reporting entities which do not already use the CRA Regulation templates to adopt them on a temporary basis (i.e. until ESMA publishes new, final templates) could be expensive and disproportionate. As a result, while acknowledging that national regulators do not have the legal power to disapply the default requirement to use the CRA Regulation templates, the joint statement advises regulators to apply day-to-day supervision and enforcement of the transparency rules in a "proportionate and risk-based manner". In particular, it suggests that national regulators should take into account the type and extent of information already being published by reporting entities when assessing whether they comply with the EU Securitisation Regulation requirements. However, the statement also emphasises that it is not recommending general forbearance by regulators, but a case-by-case assessment. In practice, it appears that where it would be impractical for a firm to implement the CRA Regulation templates on a temporary basis, the firm should instead consider whether it is providing the substantive information required by the EU Securitisation Regulation in its existing reports or whether additional information is required. In due course, once ESMA has confirmed the final versions of the new reporting templates, firms will need to implement those new requirements.

DUE DILIGENCE REQUIREMENTS FOR INSTITUTIONAL INVESTMENTS (INCLUDING UK OCCUPATIONAL PENSION SCHEMES)

As we reported in last year's New Year Briefing, the EU Securitisation Regulation contains new mandatory due diligence requirements on EU "institutional investors". Most institutional investors (e.g. banks, insurer, AIFMs, MiFID firms and UCITS management companies) were subject to similar requirements under the old rules. However, the term now includes institutions for occupational requirement provision (**IORPs**) and their investment managers or other authorised entities appointed by them under the IORP II Directive – i.e. UK occupational pension schemes fall within the new regulatory framework and this may be relevant for segregated investment management agreements or managed accounts with a mandate or strategy that includes investment in securitisations.

The EU Securitisation Regulation requires UK occupational pension schemes (like all other institutional investors which are not the originator, sponsor or original lender), in relation to any securitisation in which they invest, to:

- verify that the securitisation complies with the relevant risk retention requirements;
- verify that, if the originator or original lender is not an EU credit institution or an EU investment firm subject to CRR, it grants all credits giving rise to the exposures underlying the securitisation on the basis of "sound and well-defined criteria" and has clearly established processes for such purposes;
- carry out a due diligence assessment which permits them to understand:
  - the risks involved in the position(s) that they are taking in the securitisation and the relevant exposures underlying them;
  - the structural features of the securitisation that could materially impact the performance of the position(s) held, including payment priorities, credit and liquidity enhancements, market value triggers and transaction-specific definitions of default; and
  - if the securitisation is a "simple, transparent and standardised" (STS) securitisation, how the securitisation complies with the requirements in order to be classified as such (although they may rely on an STS notification and on the information provided by the originator, sponsor or securitisation vehicle "to the extent appropriate"); and

- establish appropriate and proportionate written procedures to ensure compliance with the above requirements, including requirements for regular stress testing and appropriate internal reporting.

The new due diligence requirements require the trustee of the OPS scheme to ensure that it has internal written policies and procedures which comply with the above requirements for verification, stress-testing and due diligence. Sanctions may be imposed for non-compliance (this will be the responsibility of the Pensions Regulator in the case of pension schemes). Where the OPS scheme has delegated authority to an investment manager to make day-to-day investment decisions in accordance with a mandate under which those decisions may expose the scheme to securitisations, or has invested in a managed account which may be similarly exposed, it may instruct that manager to fulfil the scheme's due diligence obligations (as summarised above) on its behalf. Where it does this, sanctions for non-compliance with the requirements of the Securitisation Regulation may be imposed on the manager.

On the face of the new rules, the likely practical effect is that a UK OPS scheme will not be able to invest in any securitisation (including a US or other non-EEA securitisation) that is not compliant with the requirements of the Securitisation Regulation – i.e. because the UK OPS scheme will not be able to fulfil its own verification and due diligence obligations in relation to the non-compliant securitisation. There may be a judgment to be made as to whether a particular securitisation is or is not compliant. To the extent that exposure to securitisations is or may be relevant to an investment strategy, OPS scheme trustees and their investment managers or fund managers should clarify the allocation of the institutional due diligence requirements as between them.

THE UK SECURITISATION REGULATIONS 2018 AND PRA/FCA JOINT STATEMENT ON "PRIVATE" SECURITISATIONS

The regulations

On 1 January 2019 the UK Securitisation Regulations 2019 came into effect. Amongst other things, the Regulations:

- designate the PRA as the competent authority for supervising compliance by PRA-authorised persons and which are not covered by certain specified directives (e.g. the IORP Directive, AIFMD and the UCITS Directive):

- designate the FCA as the competent authority for supervising:

  - whether persons selling a securitisation position to a retail client located in the UK are doing so in accordance with the conditions set out in Article 3 of the EU Securitisation Regulation;

  - whether a person established in the UK is complying with Article 4 of the EU Securitisation Regulation when establishing a securitisation special purpose entity (SSPE) in a third country;

  - whether a person is complying with the STS securitisation requirements set out in the EU Securitisation Regulation;

  - all originators, original lenders and SSEs which are not PRA-authorised persons;

- designate the FCA as the competent authority for authorising and supervising third party verifiers;

- ensure that the UK competent authorities have the necessary information-gathering, disciplinary and sanctions powers in order to enforce against breaches of the EU Securitisation Regulation regime;

- grant the PRA and FCA a power to direct, in the case of a securitisation in respect of which a prospectus has not been drawn up in compliance with the Prospectus Directive (referred to by the regulators as a 'private securitisation'), the manner in which the originator, sponsor or SSPE must make information available to the PRA or FCA.

PRA/FCA statement

In respect of the last point, in a statement published on 20 December 2018, the PRA and FCA jointly announced that they intend to exercise the power to direct that only a summary of the relevant information will need to be notified to the relevant UK competent authority, with the full set of information remaining available "on request". Although the statement covers new post-1 January 2019 securitisations, it appears that the new PRA/FCA reporting obligations will apply from **15 January 2019** catching new securitisations and other in scope events that occur on or after that date.

In terms of timing, the PRA and FCA will direct that notifications must be provided with the following frequency:

- for non-Asset Backed Commercial Paper (non-ABCP) securitisations, from 1 January 2019;
    - on each *issuance* of securities; or
    - for a non-ABCP securitisation which does not involve the issuance of securities, upon the *creation* of each new securitisation position;
- for ABCP securitisations:
    - upon the *first issuance* of securities at the programme level on or after 1 January 2019; and
    - thereafter, the first issuance of securities at the programme level following the inclusion of a new seller within the programme;
- for ABCP and non-ABCP securitisations alike, *upon any information being made available to holders of a securitisation position* in accordance with Article 7(1)(f) EU Securitisation Regulation (inside information relating to the securitisation that the originator, sponsor or SSPE is required to make public under Article 17 of the EU Market Abuse Regulation) or Article 7(1)(g) of the EU Securitisation Regulation (any other significant event (such as material breach of the obligations provided in the underlying documentation provided as being essential for the understanding of the transaction, a change in the structure features that can materially impact the performance of the securitisation, a change in the risk characteristics of the securitisation or of the underlying exposures that can materially impact the performance of the securitisation, (if relevant) where the securitisation ceases to meet STS requirements or where the competent authorities have taken remedial or administrative actions and any material amendment to the transaction documents)).

The joint PRA/FCA statement provides e-mail addresses at the PRA and/or the FCA to which relevant notifications should be sent, as applicable. The annex to the statement sets out the Excel template on which notifications should be made.

2. AIFMD - AIF AND UCITS DEPOSITARIES: DELEGATION RULES

In October 2018, two new delegated regulations were published in the EU's Official Journal. These amend the safekeeping requirements in Commission Delegated Regulation (EU) 2018/1618) (the **AIFMD Level 2 Regulation**) and Commission Delegated Regulation (EU) 2018/1619 (the **UCITS Level 2 Regulation**).

These new requirements will apply from **1 April 2020** and will directly impact depositaries when they are delegating their safekeeping functions to a third party custodian. However, AIFMs and UCITS managers should be aware of the changes, since they have an indirect impact. They may need to consider whether any amendments are required to their existing depositary agreements in order to reflect the revised obligations on their depositaries and they may need to be alive to attempts by depositaries to increase their fees because of their heightened obligations.

You can read our client briefing on the regulations here.

3. AIFMD: OMNIBUS REGULATION AND DIRECTIVE ON THE CROSS-BORDER DISTRIBUTION OF INVESTMENT FUNDS

INTRODUCTION

In March 2018, the European Commission published two new legislative proposals which amend the existing rules on the distribution of investment funds under AIFMD and the UCITS Directive – a Regulation on cross-border distribution of investment funds (commonly referred to as the "**Omnibus Regulation**") and Directive on cross-border distribution of investment funds (commonly referred to as the "**Omnibus Directive**") . We published a client briefing outlining the key elements of those changes at that time.

Negotiations have been taking place during 2018. The latest publicly-available compromise texts from the European Council are here and here) and the Parliament's ECON Committee adopted a report dated 6 December 2018 containing its proposed amendments on the directive (available here). Although negotiations are continuing and therefore the final rules have not yet been determined, these draft texts amend certain significant elements of the Commission's original proposal. We have therefore set out below certain key elements of the compromise texts which, if adopted, would be of particular relevance for AIFMs.

As set out in the current drafts, the proposed deadline for application of the measures is 24 months after the date of entry into force which, based on the current status of negotiations, would be at some point in **2021**.

DRAFT: NEW PRE-MARKETING REQUIREMENTS

Definition of pre-marketing

Both the Council and the Parliament are proposing to modify the new definition of "pre-marketing" in the Omnibus Directive in essentially the same terms as indicated in the following composite (with underlining indicating changes to the Commission proposal):

> " *'pre-marketing' means a direct or indirect provision of information <u>or communication</u> on investment strategies or investment ideas by an EU AIFM or on its behalf to <u>[potential]</u> professional investors domiciled or registered in the Union in order to test their interest in an AIF <u>or [in] a compartment of an AIF</u>, which is not yet established <u>or which is established, but not yet notified for marketing in accordance with Article 32, in that Member state where the [potential] investors are domiciled or have their registered office, and which in each case does not amount to an offer or placement to the investor to invest in the units or shares of that AIF or a compartment</u>.*"

This marks a significant departure from the Commission's original suggested definition, in so far as it would allow AIFMs to engage in pre-marketing where the AIF has already been established, whereas the Commission's text implied that where an AIF is already in existence, any promotional activities must amount to full AIFMD marketing, with all that that entails. Such an amendment would be welcomed by most market participants, as it would allow AIFMs to continue the common existing practice of establishing fund vehicles early in the process to deal with administrative issues, without requiring them to make AIFMD marketing notifications as a result.

It is clear from the suggested amended definition that once an EU AIFM has activated the AIFMD marketing passport into a jurisdiction, it can no longer be pre-marketing in relation to the passported AIF (although in practice, at the point at which most AIFMs would elect to activate the marketing passport, the envisaged promotional activities are likely in many cases to amount to full AIFMD marketing anyway).

In the conditions for pre-marketing originally proposed by the Commission, it had provided that promotional activity could not amount to pre-marketing where the information provided to potential investors includes a prospectus or other constitutional documents, offering documents, subscription forms or similar documents, whether in draft or final form. The Council and Parliament's compromise texts would narrow this requirement so that an AIFM would be able to provide draft constitutional documents (e.g. draft LPAs) or draft prospectuses or offering documents (e.g. pathfinder versions) to prospective investors without triggering full AIFMD marketing. When providing draft prospectuses or offering documents, the relevant documents must not contain "*all relevant information allowing investors to take an investment decision*" and must contain statements that they do not constitute an offer or invitation to invest and that the information contained in them must not be relied upon and may be subject to change. In practice, it is likely to be a question of degree as to whether a document contains the necessary information to permit investors to make an investment decision, but it is clear that the issue will be one of substance, not just form. Simply labelling a document as a "draft" version and stating that it does not constitute an offer or invitation does not necessarily mean that it has not crossed the line between pre-marketing and AIFMD marketing.

Both the Council and Parliament texts support the Commission position that AIFMs will not be able to provide draft subscription documents while pre-marketing. This might affect existing practices whereby certain managers send draft subscription forms to prospective investors for the purposes of indicating the types of warranties that investors will be asked to provide.

Need to notify intention to pre-market?

There is however a substantial point of difference between the Parliament and Council texts, which turns on whether an AIFM will need to notify its intention to engage in pre-marketing. The Council's text would, in line with the Commission proposal, expressly prohibit Member States from requiring notification as a pre-condition of pre-marketing in their jurisdictions. In contrast, the Parliament is proposing that the AIFM should submit a "simple, informal letter" to its Home State regulator, detailing the Member States in which it will be pre-marketing (but not the content of the pre-marketing or the identity of the intended addressees), with copies for the regulators in each of those Member States. If the Parliament position prevails, this is likely to mean that AIFMs would need to make both initial pre-marketing notifications for relevant jurisdictions and subsequent AIFMD marketing notifications when their promotional activities cease to constitute pre-marketing.

Who can undertake pre-marketing?

The Parliament text also provides that pre-marketing activities can only be undertaken by the following types of entities on behalf of an EU AIFM:

- MiFID investment firms;
- CRD IV credit institutions;
- UCITS managers;
- AIFMs; or
- Tied agents.

Although not entirely clear, the intention appears to be that only certain third parties that are authorised in the EU would be permitted to pre-market on behalf of an EU AIFM if the AIFM were not engaging in direct pre-marketing itself. The Council has not proposed a similar express restriction.

Impact of pre-marketing on reverse solicitation

Both compromise texts, although worded slightly differently in each case, provide that where an investor has been contacted as part of pre-marketing it must not subsequently acquire units or shares in an AIF otherwise than through AIFMD-compliant marketing (and therefore by extension, the acquisition cannot be deemed to have occurred through reverse solicitation). However, in each case, this wording has been narrowed considerably from the Commission's original version, which extended to prohibiting reverse solicitation in cases where the AIFM which had pre-marketed established a new AIF with "similar features". This had previously caused considerable concern about the extent to which engaging in the pre-marketing of one fund would effectively preclude reliance on reverse solicitation in relation to a later fund with a similar investment strategy.

Both texts would, however, introduce a presumption that an investment in an AIF by a person who was subject to pre-marketing in relation to that AIF that is made within 18 months of the pre-marketing occurring will be deemed to have occurred due to AIFMD marketing. This appears designed to operate as an additional anti-avoidance provision, preventing the AIFM from relying reverse solicitation arguments in this context.

Impact on national private placement regimes

Although the revised definitions of pre-marketing are still expressed in the texts to apply only to EU AIFMs, in reality it nonetheless seems likely that EU Member States which operate national private placement regimes (**NPPRs**) would adopt a similar approach to the promotional activities of non-EU AIFMs under those NPPRs. As a result, these changes are likely to be relevant to UK AIFMs, whether they are treated as EU AIFMs or non-EU AIFMs as a result of Brexit.

DRAFT: DISCONTINUATION OF MARKETING

Condition regarding number of investors in jurisdiction

The Omnibus Directive will also introduce new restrictions on when an AIFM can discontinue marketing after having exercised the AIFMD marketing passport into another EU Member State. The Commission originally proposed that, amongst other conditions, this should only be possible where no more than 10 investors in the relevant jurisdiction collectively hold units which in total represent less than 1% of the assets under management of the relevant AIF that was marketed.

The Council text would revise this condition so that discontinuance of marketing would still be possible where any number of investors who are domiciled in the relevant Member State in the relevant jurisdiction, hold, in total, less than 5% of the AIF's assets under management. The Parliament text proposes deleting this requirement entirely.

Public offer to repurchase units?

In addition, the Commission originally proposed requiring any EU AIFM which was proposing to discontinue marketing under the passport to make a blanket public offer to repurchase the units in the AIF held by investors in the relevant Member State. Both the Council and the Parliament are proposing to exempt closed-ended AIFs and ELTIFs from this requirement, which is likely to be welcomed by the managers of such funds, given the general impracticality of redemption in relation to vehicles which are closed-ended and/or invest in illiquid underlying assets.

Periodic reports after discontinuation

The Council and Parliament texts maintain the Commission position that AIFM will be under an obligation to continue providing investors who remain invested in the AIF after marketing activities have been discontinued, with the periodic reports required under AIFMD. However, in addition, the Parliament text provides that the AIFM must also provide the investor information to its home Member State supervisor and also to the competent authorities of the Member State where the marketing has been discontinued, along with the Annex IV marketing information; and that the relevant national regulator in that jurisdiction may continue to charge fees for exercising continuing supervisory activities, notwithstanding that the AIFM has deactivated the marketing passport. Since avoiding ongoing fees charged in some jurisdictions may have been one of the key incentives to discontinue marketing, if the Parliament's text is accepted, this may raise questions about the attractiveness of discontinuation.

DRAFT: REQUIREMENTS FOR MARKETING TO RETAIL INVESTORS

Both the Parliament and the Council have retained the Commission's proposed requirement in their respective texts for AIFMs that market to retail investors to make available facilities in the relevant Member State to process investors' orders and to provide investors with information. The Commission had previously required that these facilities be provided in the official language (or languages) of the relevant Member State, raising concerns that this could require expensive translations of information when investors might be content to receive communications in a customary language of international commerce. The Parliament and Council's revised texts would allow information to be provided either in an official language of the Member State or otherwise in a language approved by the relevant regulator in the jurisdiction. If that drafting is adopted in the final legislation, market participants are likely to hope that individual Member States exercise that discretion to allow information to be provided in a customary business language such as English, in order to reduce the need for separate (and potentially expensive) translations, although clearly there is no guarantee that this will be the case.

4. AIFMD 2: KPMG REPORT ON THE OPERATION OF AIFMD

INTRODUCTION

The EU Alternative Investment Fund Managers Directive (**AIFMD**) contains provisions requiring the European Commission to start a review of the application and scope of the AIFMD by 22 July 2017. The review must include a general survey of the application and scope of AIFMD and how all of its rules function in practice, looking at the impact on investors, AIFs and AIFMs and the extent to which the objectives of the directive have been met. Following its review, the Commission is permitted to propose appropriate legislative amendments to the AIFMD to address any identified issues - such revisions are commonly referred to as "AIFMD 2".

For the purposes of assisting in the review, the Commission appointed KPMG Law Rechtsanwaltsgesellschaft mbH (**KPMG**) to conduct the market study and impact assessment. On 10 January 2019 the firm's 427-page Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD) was finally published, having been submitted to the European Commission a month earlier. The report represents the first step in the Commission's review process. It will continue its review and said in its press release accompanying the publication of the report that it will report to the European Parliament and the Council "next year" – i.e. 2020. The timeline for any subsequent legislative proposals therefore remains uncertain for the time being and any concrete changes that may result and impact upon firms is (compared to other things) likely to be some considerable way off. As referred to above, more immediate amendments to the AIFMD regime will apply from 1 April 2020 as regards to depositaries when delegating their safekeeping duties and, at some point in 2021, amendments made to the marketing provisions of AIFMD by virtue of the Omnibus measures are likely to apply.

A summary of the key observations in the KPMG report is set out below. It remains to be seen to what extent the report's various findings and observations are translated into concrete proposals under a forthcoming AIFMD 2 directive.

MARKETING PASSPORTS AND NPPR

Evidence indicates that the EU *management* passport is working well. However, the EU *marketing* passport is "lagging behind" and is suffering due to the different approaches adopted by different competent authorities. In this regard:

- Member States have adopted different approaches as to which activities constitute "marketing";
- there is a lack of transparency with regards to the differing national rules and regulatory processes, which results in additional costs for industry participants and investors alike.

The Omnibus proposals had already identified these problems and have sought to address them (see above).

As regards non-EU AIFs and non-EU AIFMs, the current lack of a passport leaves Member States with discretion and approaches vary markedly. Respondents and interviewees observed that national private placement regimes (NPPRs) are to the benefit of the EU. Some called for non-EU passports to be introduced, but a significant number – from both Member States and third countries – called for the NPPRs to be retained even if the non-EU passports are introduced.

REPORTING TO REGULATORS

Large volumes of data are submitted to national competent authorities under the AIFMD reporting requirements. However, not all the data may be essential, some of it may be insufficient and some of it may be duplicative: other EU legislation (as firms will be well aware) imposes overlapping reporting requirements. Given these overlaps and duplication, asset and fund managers in particular called for a more holistic approach to reporting and the use of new technology. This desire for change seems to be tempered by the fact that survey respondents and interviewees asked for any future amendments to the reporting requirements to take into account the fact that firms have sunk significant costs into implementing their reporting systems and that any changes would incur additional costs, particularly if they were made on a piecemeal basis.

Differences in national interpretation and filing procedures further exacerbate costs for the industry, which are not compensated for by the publication of aggregate data which would provide the industry and investors with useful market information: most national competent authorities said that they do not generally make reported data publicly available and there is a lack of data collation and analysis at the EU level.

INVESTOR DISCLOSURES

There was a strong reaction to the current Article 23 AIFMD disclosure requirements which respondents felt are unduly onerous: the number of disclosures means that investors either simply ignore them or cannot obtain from them a clear understanding of the AIF's investment proposals. However, some institutional investor representatives specifically voiced a concern about the lack of sufficient or standardised disclosures of *all* fees, costs and charges – the particular example of private equity investment was cited.

More generally, the AIFMD disclosure rules are inconsistent with other EU disclosure regimes and give rise to duplicative (and potentially inconsistent) disclosures.

LEVERAGE

The use of high leverage is rare in AIFs. It would be helpful to harmonise the calculation methodologies for leverage across the AIFMD, the UCITS Directive and other relevant legislation. In the light of IOSCO's work on common leverage measures, it would be more efficient for AIFMs, regulators and investors alike if any changes to EU requirements are considered only after IOSCO's work is complete and are then introduced simultaneously for AIFs and UCITS.

VALUATION

The fact that AIFMD presents a binary choice in the valuation rules between using an internal or external valuer, combined with the differing legal interpretations of the liability of external valuers, is seen as having impaired the effectiveness of the rules for some asset classes and in some Member States. In some Member States there are fewer available external valuers than in others, meaning a lower level of competition and potentially higher fees for AIFs/AIFMs. There has been more focus on internal processes.

REMUNERATION

There are questions about how the AIFMD remuneration rules fit (or do not fit) with other pieces of legislation and guidelines – this is especially the case for AIFMs that are part of corporate groups where more than one regulatory remuneration regime will apply. The potential efficiency of the regime may be harmed by a lack of coherence.

DEPOSITARY REQUIREMENTS

Overall, the depositary rules tend to adopt a one-size-fits-all approach, which does not take account of different asset classes or geographical considerations.

Some of the AIFMD depositary rules are interpreted differently in different Member States. For example, there are differing national approaches to the total look-through provision (under which, broadly, depositaries are required to look-through certain legal or financial structures to the underlying assets in order to ensure that they those assets are subject to appropriate safekeeping requirements) and also to the cash monitoring duties. However, it is not clear whether and to what extent these different approaches have impaired the effectiveness of the provisions.

In relation to the specific rules requiring asset segregation throughout the custody chain, there was a perception that the requirement to operate different omnibus accounts at every level of a sub-custody chain was unnecessary and burdensome, without providing enhanced investor protection. The amendments to the Level 2 requirements on depositaries of AIFs taking effect on 1 April 2020 will include provisions on asset segregation.

INVESTMENTS IN NON-LISTED COMPANIES

Particular criticism was levelled against the AIFMD requirements on notifying competent authorities of investments in non-listed companies with a recommendation that the rules should be re-assessed:

- the requirements, which go beyond those of the Second Company Law Directive, are not seen as useful or essential and are overly burdensome – especially since many private equity/venture capital AIFMs are smaller companies for whom the administrative burdens are disproportionately great;
- it is not clear what use (if any) the competent authorities make of the information reported to them;
- the information provided to controlled companies has not been improved;
- the requirements have not had a positive impact on the relationship between AIFs/AIFMs and the target/investee companies;
- there is a lack of clarity as to the meaning of "non-listed company";
- there is lack of clarity as to how the rules apply to investments in unlisted special purpose vehicles and unlisted UCITS or AIFs.

RISK AND PORTFOLIO MANAGEMENT

Generally, AIFMD has had a positive effect on limiting micro-prudential risks as regards conflicts of interests and risk management. However, concerns were raised, in particular from the private equity and real estate sectors, about the requirement for a full functional and hierarchical separation of risk and portfolio management, especially for smaller AIFMs.

5. EUROPEAN SUPERVISORY AUTHORITIES: JOINT CONSULTATION PAPER ON AMENDMENTS TO PRIIPS KID

INTRODUCTION

On 8 November 2018, ESMA, EBA and EIOPA, through the Joint Committee of the European Supervisory Authorities, published a Joint Consultation Paper concerning amendments to the PRIIPs KID. The consultation closed on 6 December 2018.

The Regulation on packaged retail and insurance-based investment products (the **PRIIPs Regulation**) provides for a temporary exemption for UCITS managers from the requirement to prepare a PRIIPs-compliant key information document (**PRIIPs KID**). This is on the grounds that the existing UCITS key investor information document (**UCITS KIID**) which UCITS managers must provide will be given to investors instead. This exemption will expire on 31 December 2019, the effect of which will be (absent an effective change to the legislation beforehand) that from 1 January 2020 onwards UCITS managers will technically be required to prepare both a PRIIPs KID and the UICTS KIID.

The three ESAs wrote to the European Commission on 1 October 2018, expressing their concern that following the expiry of the exemption there would likely be duplicative information requirements in both sets of documents. According to the ESAs, potential legislative changes to the Level 1 UCITS Directive and the PRIIPs Regulation are currently being discussed between the EU co-legislators, but these will not be agreed until later in 2019.

AMENDMENTS TO THE PRIIPS KID: EXPIRY OF THE TEMPORARY EXEMPTION FOR UCITS MANAGERS

In the meantime, and as trailed in the letter to the Commission, the ESAs proposed in the consultation paper a number of targeted amendments to Commission Delegated Regulation (EU) 2017/653 (the **PRIIPs KID Regulation**) to incorporate certain requirements of Commission Regulation (EU) No 583/2010 (the **UCITS KIID Regulation**). They presumably did this on the assumption that the EU co-legislators will in turn amend the relevant *Level 1* legislation to disapply the requirement for a UCITS manager to provide a UCITS KIID provided that a modified PRIIPs KID, containing the additional UCITS information, has been given to the relevant investors. The proposed amendments will be effected by way of draft regulatory technical standards (**RTS**) although in the consultation paper these were described in narrative form only, without specific textual amendments being appended. This was because of the timing constraints referred to below.

AMENDMENTS TO THE PRIIPS KID: ADDRESSING OTHER CONCERNS

In addition, the ESAs proposed a number of other amendments to the PRIIPs KID requirements relating to issues where concerns have been raised by the industry and regulators that elements of the existing PRIIPs KID may be misleading to investors: these include concerns that past and future performance scenarios may be giving investors inappropriate expectations about possible returns, uncertainty over the market risk measure calculation for regular investment or premium PRIIPs and the fact that the prescribed Summary Risk Indicator in isolation and without explanatory text could be misleading.

TIMING

The ESAs intend to submit the RTS to the European Commission for endorsement during January 2019. A final report containing feedback on the consultation will be published at the same time. The intention is that, subject to endorsement by the European Commission, the amendments to the PRIIPs KID Regulation would be effective as from 1 January 2020 following the expiry of the temporary exemption for UCITS managers. Following endorsement by the Commission, the European Parliament and Council have a period in which to express objections – in light of the European Parliament elections in May 2019, the legislative process will need to have been completed in Q2 2019 at the latest in order for the RTS to take effect on 1 January 2020 as intended. It is for these reasons that the consultation was shorter than usual and the ESAs decided that they would not consult again on the legislative *text* of the RTS.

If the RTS were finalised within the tight timeframe PRIIP manufacturers and distributors would have to review the proposed changes and implement them into their procedures and document production in as little as six months.

UCITS managers will clearly be interested to see whether, as hoped, they will be relieved from having to issue duplicative information to investors on expiry of the temporary exemption.

6. EU SECURITIES FINANCING TRANSACTIONS REGULATION – REPORTING

INTRODUCTION

The EU Securities Financing Transactions Regulation (**SFTR**) has applied from 12 January 2016, although certain requirements under the SFTR have been entering into force on a phased basis.

By way of recap:

- *Disclosure*: The pre-investment disclosure requirements in relation to the use of securities financing transactions (**SFTs**) by AIFs or UCITS have applied since 12 January 2016, except for any funds constituted prior to that date, in which case the requirements took effect on 13 July 2017;

- *Reuse of collateral*: the requirements relating to reuse of financial instruments under a collateral arrangement have applied since 13 July 2016;

- *Reporting by AIFs or UCITS*: the requirements relating to the reporting of the use of SFTs by AIFs or UCITS in their annual (and for UCITS, half-yearly) reports have applied since 13 January 2017.

The last set of substantive obligations under the SFTR which have yet to enter into force are those which relate to the requirement for counterparties to SFTs to *report details of those transactions to a trade repository*. Legislation has now been adopted meaning that **reporting will start in 2020** (see below).

REPORTING SFTS TO TRADE REPOSITORIES

ESMA was responsible for providing draft technical standards to the Commission setting out the proposed reporting requirements. It did this on 30 March 2017, but it was not until 24 July 2018 that the European Commission wrote back to ESMA notifying its intention to adopt the draft RTS and ITS submitted by ESMA *with amendments*. In turn, ESMA wrote an opinion on 4 September 2018 stating why it declined to amend the draft technical standards as proposed by the European Commission.

Finally, on 13 December 2018, the European Commission adopted a Commission Delegated Regulation and a Commission Implementing Regulation relating to reporting SFTs to trade repositories under Article 4 SFTR:

- RTS specifying the details of SFTs to be reported to trade repositories, together with an Annex describing the relevant reporting fields (the **reporting RTS**);

- ITS with regard to the format and frequency of reports on the details of SFTs to trade repositories, together with Annexes (which set out the required reporting format for each field identified in the Annex to the RTS)(the **reporting ITS**);

Other measures relating to the reporting of SFTs to trade repositories (but which are less directly relevant to those firms which will be required to report as counterparties) were also adopted on 13 December 2018:

- RTS on access to details of SFTs held in trade repositories;

- RTS specifying the details of the application for registration and extension of registration as a trade repository;

- Delegated Regulation amending Delegated Regulation (EU) No 151/2013 (which relates to EMIR) with regards to access to the data held in trade repositories;

- Delegated Regulation amending Delegated Regulation (EU) No 150/2013 (which also relates to EMIR) with regards RTS specifying the details of the application for registration as a trade repository;

- RTS on the collection, verification, aggregation, comparison and publication of date on SFTs by trade repositories, together with Annexes;

- Delegated Regulation supplementing the SFTR with regard to fees charged by ESMA to trade repositories;

The various Delegated and Implementing Regulations will now enter into force on the twentieth day following their publication in the Official Journal.

This suggests that, in line with SFTR and assuming publication in the Official Journal shortly, SFT reporting to trade repositories will commence as follows:

- For CRD IV credit institutions and MiFID investment firms (and their respective third country equivalents where concluding an SFT through the operations of an EU branch) – **early 2020** (12 months after the RTS enters into force);

- For AIFMs and UCITS managers (and their respective third country equivalents where concluding an SFT through the operations of an EU branch) – early **Q3 2020** (i.e. 6 months after reporting goes live for credit institutions and investment firms);

- For other persons not covered above, reporting will commence either:

  - in **Q2 2020** for certain specified entities (including, for instance, EMIR central counterparties); or

  - in **Q4 2020** for any other persons to subject to the Q2 2020 start date.

The precise date in each case will depend on the date on which the RTS are published in the Official Journal.

PREPARING FOR SFT REPORTING

The above means that firms will have to start making preparations to be able to report SFTs by the relevant start date. The key headlines to note from the SFTR reporting requirement, the RTS and the ITS are as follows:

- The reporting requirement will apply to the principal counterparty to that transaction where it is established in the EU, or where it is an EU branch of a non-EU entity and is concluding the transaction through that branch;

- Reportable SFTs will include repos, securities and commodities lending transactions/securities and commodities borrowing transactions, buy-sell backs and sell-buy backs and margin lending transactions – a recital to the reporting RTS clarifies that only transactions that serve the same purpose as repos, securities/commodities lending/borrowing transactions or buy-sell backs/sell-buy backs will be caught and other loans, such as loans for corporate restructuring purposes, will not be caught and will therefore not be reportable;

- Reporting will have to be made to the trade repository by T+1;

- A reporting counterparty may delegate responsibility to a third party – it may even be possible for a "buyer" of an SFT to delegate the reporting obligation to the "seller" if that party is willing to report on the other's behalf;

- The ITS includes methodologies for determining whether a counterparty is the "collateral taker" or the "collateral provider" in any given SFT and for determining which counterparty is responsible for generating a "Unique Trade Identifier" for the relevant SFT.

7. CRD V AND CRR II: AN UPDATE – FORMAL ADOPTION SOON

INTRODUCTION

The European Commission published two legislative proposals in November 2016: one was a proposed directive amending the existing CRD IV Directive (**CRD V**) and the other was a proposed regulation amending the existing CRR (**CRR II**). As we reported last year, the proposed rules in CRD V will be of particular interest to firms, given that they include, amongst other elements, provisions which:

- amend the current CRD IV remuneration rules by altering the application of the proportionality test and setting specific quantitative thresholds for the disapplication of certain remuneration requirements (which will not include the so-called "bonus cap" relating to a maximum ratio of 2:1 variable to fixed remuneration, so that this could not be disapplied on proportionality grounds); and

- require two or more EU institutions that form part of the same third country group to have a single intermediate parent undertaking established in the EU, which would need to be authorised by the appropriate national regulator. However, this would only apply if the relevant group has balance sheet assets in the EU above a certain threshold (being EUR 40 billion in the case of the last-published Council compromise text, or EUR 30 billion in the case of the European Parliament's report). Assuming a threshold of such magnitude is maintained following trilogue, therefore, the intermediate EU parent undertaking obligation is only likely to be relevant to firms within groups containing banks or investment banks which are either based in the EU or have significant branches in the EU.

CRR II contains a number of detailed amendments to the CRR in areas such as the standardised approach under the credit risk rules, market risk requirements, the leverage and net stable funding ratio requirements, total loss absorbing capacity (**TLAC**), large exposures and regulatory reporting.

See below as regards the status of negotiations. Subject to the final agreed, adopted text, Member States would have to transpose CRD V's provisions within 12 months of the publication of the directive in the Official Journal and apply the majority of its provisions the day after that deadline – i.e., at some point in **mid-to-late 2020**.

Note that CRD V and CRR II are "in flight" EU legislative measures expressly referred to in the draft Financial Services (Implementation of Legislation) Bill currently before the UK Parliament (see Section 3: A Hard Brexit below) meaning that, if enacted, H.M. Treasury will have a temporary power following a "hard" Brexit to make regulations implementing and amending those measures in the UK.

STATUS OF NEGOTIATIONS

The Council of the European Union published compromise proposals of CRR II and CRD V on 22 and 23 May 2018 respectively and announced that the Economic and Financial Affairs Council (ECOFIN) had agreed its general approach. The European Parliament agreed its position on the two measures in June 2018. The institutions then entered into trilogue discussions in the second half of the year.

On 4 December 2018 the Parliament announced that their negotiators had reached agreement with the Council's negotiators. However, a letter from John Glen, the Economic Secretary to the Treasury, to the Chair of the European Scrutiny Committee on 17 December 2018 suggested that it was anticipated that trilogies on outstanding technical issues and legal drafting would continue into January 2019 with a view to submitting the package of measures (including CRD V and CRR II) for a final agreement at the January ECONFIN meeting.

On that basis, final agreement is close.

8. NEW PRUDENTIAL REGIME FOR MIFID FIRMS: INVESTMENT FIRMS REGULATION AND DIRECTIVE

INTRODUCTION

On 20 December 2017, the European Commission published a legislative proposal containing a new Directive (referred to as the Investment Firms Directive (**IFD**)) and a new Regulation (referred to as the Investment Firms Regulation (**IFR**)) which together will introduce a new prudential regime for MiFID investment firms. This followed earlier advice from the EBA. We published a client briefing in December 2017 which discussed the most significant aspects of the drafts as proposed by the Commission at that time.

As currently drafted, the IFR will apply **18 months after the Regulation is published** in the Official Journal and Member States should apply the IFD from the same date. It is not clear at this stage how long trilogue negotiations (see below) will last.

"HARD" BREXIT

As with CRD V and CRR II, IFD and IFR are "in flight" EU legislative measures expressly referred to in the draft Financial Services (Implementation of Legislation) Bill currently before the UK Parliament (see Section 3: A Hard Brexit below) meaning that, if enacted, H.M. Treasury will have a temporary power following a "hard" Brexit to make regulations implementing and amending those measures in the UK.

CURRENT STATUS

Since December 2017 the technically complex legislative measures have been considered by the Council of the EU and the European Parliament who have now established their respective negotiating positions:

- The Committee on Economic and Monetary Affairs of the European Parliament (ECON) adopted reports on the IFD and on the IFR on 27 September 2018;
- The Council's negotiation position is represented by two compromise proposals – for the IFD and for the IFR - which were published on 4 January 2019 and endorsed by the Permanent Representatives Committee on 7 January 2019.

The institutions will now enter into trilogue negotiations *so changes are likely* as they seek to find a compromise.

SIGNIFICANT ASPECTS OF THE MEASURES - OUTLINE

However, going into those negotiations at least, and as outlined in our December 2017 briefing on the Commission proposals, the most significant aspects of the IFD/IFR measures in broad outline include the following elements:

- Initial capital requirements will increase, compared to now, and will become a "floor" so that a firm will always have to hold regulatory capital of at least that amount on an ongoing basis;
- There will be detailed criteria for classifying firms according to their complexity which then impacts on their capital treatment:
  - The majority of MiFID investment firms – *and the vast majority, if not all, MiFID portfolio managers* – will be what the EBA in its original proposals called "Class 2 firms", being neither "small and non-interconnected" (which the EBA termed "Class 3 firms") nor sufficiently large and systemically important to be classified as "credit institutions" under a revised definition (which the EBA termed "Class 1 firms")(however the legislative drafts do not use the EBA's terms);
  - "Class 2" firms (and therefore most portfolio managers and other MiFID investment firms) will be subject to the higher of a fixed overheads requirement (i.e. 1/3 fixed overheads), the permanent initial

capital floor or a capital requirement based on the aggregation of a number of applicable capital requirement "K-factors", detailed metrics based on the particular activities undertaken by the relevant firm;

- the Parliament proposes that competent authorities should be given the discretion to apply CRR requirements to an investment firm which satisfies certain size and systemic significance criteria

- New liquidity requirements will apply to "Class 2" investment firms, which will be based on a month's worth of the firm's fixed overheads;
- New remuneration requirements will apply to "Class 2" investment firms which will share similarities with those in CRD IV but:
  - without a bonus cap (although it should be noted that Parliament in its draft has proposed that Member States should be granted the discretion to impose such a bonus cap in relation to firms that deal on own account or carry out underwriting and/or placing of financial instruments on a firm commitment basis);
  - with less room to manoeuvre under the proportionality principle meaning that firms will not be able to disapply as many of the remuneration requirements as they do now; and
  - with a move on the part of both the institutions towards aligning the requirements for investment firms more closely to those which apply under AIFMD;
- "Class 2" firms will be subject to governance and country-by-country reporting requirements similar to some of those in CRD IV;
- Transitional provisions will apply for five years from the date of application of IFD/IFR which will limit the amount of capital requirements
- Some of the third country equivalence provisions under MiFIR governing the provision by non-EU firms of services on a cross-border basis will be amended (which is almost certainly Brexit-driven).

Firms should continue to monitor for further developments giving a clearer indication as to when the new regime will apply and also a settled picture of what the final rules will look like once agreed between the Council and the European Parliament. Whatever is agreed, the IFD and IFR will introduce significant changes for all MiFID investment firms when they finally take effect which will result in them having to maintain more regulatory capital.

9. PROPOSED CREDIT SERVICERS AND PURCHASERS DIRECTIVE

INTRODUCTION

In March 2018, the European Commission published a proposal for a new directive governing credit servicers, credit purchasers and the recovery of collateral in connection with loans (Credit Servicers and Purchasers Directive (**CSPD**)). This was accompanied by an additional proposal amending the provisions in the current CRR which govern minimum loss coverage requirements for non-performing loans (**NPLs**). The combined legislative package is sometimes referred to as the "NPL Directive", but aspects of the proposals apply to both performing and non-performing loans.

TIMING

Under the drafting of the Commission's proposals, the majority of the rules in the CSPD would apply from **1 January 2021**, although certain provisions that are relevant to credit servicers would apply from **1 July 2021**. This timescale is dependent upon legislative progress, particularly if the CSPD is not finalised before the next elections for the European Parliament in May 2019.

In July 2018, the UK announced that while it is broadly supportive of the CSPD's aims to reduce levels of NPLs in the UK, it is nonetheless in the UK's interest *not* to opt in to the Justice and Home Affairs obligations within the CSPD "as the provisions introduce an unnecessary level of administration to the UK's existing collateral enforcement mechanisms, which are sufficiently robust and fit for purpose".

THE IMPACT OF A "HARD" BREXIT

The CSPD is <u>*not*</u> currently specified for the purposes of the FSCR (see *Section 3: A Hard Brexit* below): it is not on the list of proposals adopted before, on or after exit day. On the face of it, unless the FSCR is amended to include the proposal, H.M. Treasury would therefore not have power to make provisions and amendments.

POLICY AIMS AND SCOPE OF THE CSPD

Broadly, the overall policy aims of these proposals are to:

- require EU banks to allocate sufficient resources to NPLs at an early stage, thereby encouraging them to take steps to address NPLs more quickly (which may include the sale of those NPLs to a third party);
- encourage the development of more active secondary markets for NPLs, which will in turn allow banks to reduce their balance sheet exposures by selling NPLs to other parties who may be more willing to manage, or have greater expertise in managing, the associated risks; and
- introduce more efficient collateral enforcement mechanisms for secured loans in order to increase the efficiency of debt recovery procedures.

Although the explanatory text to the proposed CSPD primarily discusses NPLs, the legislation has a much wider scope and, broadly, **applies to all credit agreements that are originally issued by EU credit institutions or EU subsidiaries of non-EU credit institutions ("credit agreements")**. This means that, as mentioned above, in addition to affecting NPL markets, the legislation as proposed will also have an impact on markets for *performing* loans.

The CSPD will impose new requirements on credit servicers and certain creditors. We are aware that a number of industry bodies are actively lobbying on these proposals and also, given that they are subject to further negotiation at a European level, material amendments cannot be ruled out.

Meaning of "creditor"

For these purposes, a "creditor" is any of the following:

- a credit institution;
- any other legal person which has issued credit in the course of its trade, business or profession; or
- a credit purchaser, which is defined as any natural or legal person (other than a credit institution or subsidiary of a credit institution) who purchases a credit agreement in the course of that person's trade, business or profession.

Meaning of "credit servicer"

A "credit servicer" is any natural or legal person (other than a credit institution or the subsidiary of a credit institution) which carries out <u>one or more</u> of the following activities on behalf of a creditor:

- monitoring the performance of a credit agreement;
- collecting and managing information about the status of a credit agreement, the borrower and the collateral (if any) used to secure that agreement;

- informing the borrower of any changes in interest rates, charges or payments due under the credit agreement;
- enforcing the rights and obligations under the credit agreement on behalf of the creditor (including administering repayments);
- renegotiating the terms and conditions of the credit agreement with borrowers (except where the person is acting as a mortgage intermediary or credit intermediary under EU law); and/or
- handling complaints by the borrower.

The very wide scope of these activities means that asset managers could easily fall within the definition of a credit servicer – for example, where a fund manager monitors the performance of, and collects and manages information relating to, loans that have been purchased by a fund that it manages.

However, the CSPD limits the scope of requirements for credit servicers and credit purchasers to the servicing or purchase of credit agreements originally issued by an EU credit institution (or an EU subsidiary of a non-EU credit institution). This means that, for example, where a firm is servicing loans that were originally advanced by a credit fund or certain shareholder loans made in the context of a private equity deal, rather than an EU bank, that activity will fall outside the scope of the CSPD.

AUTHORISATION REQUIREMENTS FOR CREDIT SERVICERS

Credit servicers that fall within the scope of the CSPD (i.e. which provide relevant services in relation to in-scope credit agreements) will be required to obtain authorisation in the EU, but once authorised, will be able to provide their services across all EU Member States on a passported basis. Credit services are required to be authorised in their "home Member State", which is defined as the Member State in which the credit servicer is domiciled or established. This suggests that non-EU entities - including UK firms, after a "hard" Brexit or on the expiry of any transitional period - cannot act as credit servicers in the EU. Unless prescribed, it is possible there will varying outcomes across Member States.

Credit servicers must satisfy other threshold conditions in order to be authorised, including the following:

- the members of the firm's management body and any persons with significant holdings in the firm must be of sufficiently good repute, have clean criminal records in relation to serious property or financial offences and not be subject to insolvency procedures or previously have been declared bankrupt (unless discharged in accordance with national law);
- the firm must have appropriate governance arrangements and controls to ensure compliance with any rights of borrowers under the credit agreements and any applicable data protection requirements;
- the firm must operate an appropriate policy to ensure the fair treatment of borrowers, including, where available, the need for such borrows to be referred to debt advice or social services; and
- the firm must have adequate internal procedures to ensure the recording and handling of borrowing complaints.

Where fund managers are acting as credit servicers, the CSPD is therefore likely to require them to implement new policies and procedures to satisfy these conditions.

It is still unclear whether AIFMs and UCITS managers who act as credit servicers for funds which they manage could be authorised as a credit servicers. The CSPD, as currently drafted, does not amend AIFMD or the UCITS Directive to permit AIFMs or UCITS managers to carry on the relevant credit servicing activities as part of their permitted activities, but it also does not exempt fund managers from the CSPD authorisation requirement. The interaction between the various legislative provisions will therefore require further clarification.

OBLIGATIONS OF CREDIT SERVICERS

Under the CSPD, a number of new obligations will apply to credit servicers, including the following:

- the relevant credit services must be provided on the basis of a written agreement between the credit servicer and the relevant creditor, which must contain certain minimum content (e.g. a description of the services and the extent to which the credit servicer is permitted to represent the creditor in connection with dealings with the borrower);
- new record keeping rules will require the credit servicer to retain records of all correspondence with the creditor and the borrower for at least 10 years; and
- where a credit servicer outsources credit servicing activities to a third party, additional conditions must be met. These include information access rights, a requirement for the credit servicer to impose an obligation on the third party to comply with any relevant EU law applicable to the credit agreement and for the credit servicer to ensure that it retains the expertise and resources to be to provide the outsourced activities after the termination of the outsourcing agreement.

REQUIREMENTS APPLICABLE TO CREDIT PURCHASERS

Territoriality

The CSPD definition of a credit purchaser does not include any territorial limitation. As a result, where a non-EU person purchases a credit agreement originally issued by an EU credit institution (or the EU subsidiary of a non-EU credit institution) that person will still be classified as a credit purchaser.

Non-EU credit purchasers (which would include those in the UK after a "hard" Brexit or on the expiry of any transitional period) are required to designate an EU representative which will be fully responsible for compliance with the credit purchaser obligations under the CSPD. If the relevant credit agreement was concluded with a consumer, non-EU credit purchasers must also appoint an authorised credit servicer or an EU credit institution (or EU subsidiary of a credit institution) to perform credit servicing activities in relation to that agreement.

This highlights a potential inconsistency in the CSPD. It is clear that a non-EU credit purchaser must appoint an EU credit servicer to service an EU loan agreement where the borrower is a consumer. However, the CSPD requires any person carrying out credit servicing activities in relation to an in-scope credit agreement to be authorised and authorisation is only possible if the relevant person is established or domiciled in the EU. Therefore, it would appear that even EU loan agreements with non-consumer borrowers would still require EU credit servicers. It is possible that further details on these issues might emerge during the process of lobbying and negotiations on the draft text at the EU level, and these might clarify the scope of credit services that a non-EU firm can perform outside of the EU in its own right or on an outsourced delegated basis on behalf of a licensed EU credit servicer.

Information which creditors must provide to credit purchasers

The CSPD requires creditors to provide all necessary information to a credit purchaser prior to entering into a contract to transfer a credit agreement in order to enable the credit purchaser to assess the value of the agreement and the likelihood of recovering the value under that agreement.

Under the CSPD, credit purchasers (or in the case of non-EU purchasers, their nominated EU representatives) must:

- inform the relevant national regulator in the EU Member State in which they (or for non-EU purchasers, their representatives) are domiciled or established of the identity and address of any credit servicer which they have engaged to perform credit servicing activities for relevant credit agreements;

- if there is a change in the identity of the credit servicer, inform the relevant national regulator at least two weeks in advance of that change, providing details of the new credit servicer;

- when it intends to take direct enforcement action in relation to a credit agreement, provide information to the relevant national regulator about the agreement, the borrower and any assets securing the agreement, as well as confirming whether the agreement was concluded with a consumer; and

- when it transfers a credit agreement to a new credit purchaser, inform the relevant national regulator of the identity and address of the new purchaser or its representative.

Impact on asset managers

In practice, agency asset managers are unlikely to act as principal credit purchasers. However, they may purchase in-scope credit agreements as agent on behalf of the funds or segregated managed accounts for whom they are acting and therefore may in practice be required to discharge the above obligations on behalf of underlying clients.

ACCELERATED EXTRA-JUDICIAL COLLATERAL ENFORCEMENT

Introduction

The CSPD also introduces a new accelerated extra-judicial collateral enforcement (**AECE**) procedure, which is designed to make it easier for creditors to enforce rights over collateral in connection with NPLs. The Commission hopes that this will make the purchase of NPLs more attractive to third parties, which, in turn, could make it easier for banks to offload NPLs from their balance sheets.

Conditions

The AECE procedure can only apply under credit agreements which have been concluded with business (i.e. non-consumer) borrowers, where the agreement has been secured by a mortgage, charge, lien or other similar security right. Broadly, in order for the AECE to be available, the following conditions must be satisfied:

- there must be a written agreement between the creditor and business borrower which states that the AECE may apply when an enforcement event arises under the relevant credit agreement and specifies the period of time in which the borrower must make payment to prevent the AECE process – in other words, AECE is voluntary and cannot apply if either party does not agree;

- the business borrower must be clearly informed of the application and consequences of the AECE process;

- within 4 weeks of any enforcement event (or such later time as the parties may agree in the written agreement), the creditor must notify the business borrower in writing of its intention to use the AECE procedure, the time period for payment before the AECE will be used and the relevant default amount due; and

- the business borrower has failed to make payment within the time permitted to prevent the application of the AECE procedure.

Where a third party acquires the relevant credit agreement, it will also acquire the right to apply the AECE on the same terms and conditions as applied to the original creditor.

Requirement for Member States to provide for AECE

The CSPD requires each EU Member State to provide for at least one of the following mechanisms for enforcement under the AECE procedure:

- a public auction procedure, under which the collateral is auctioned (subject to certain minimum substantive and procedural requirements); or

- a private sale procedure, under which public advertising is used to attract potential buyers for the collateral (again, subject to certain minimum substantive and procedural requirements).

Where the AECE procedure used by the creditor does not comply with the CSPD requirement as implemented by the Member State, the borrower will have the right to challenge the creditor's use of AECE before the national courts.

Reaction to the AECE proposals

To date, there has been a mixed reaction to the AECE proposals. While some market participants have broadly welcomed the Commission's suggestions, noting that they may give additional certainty to banks and third parties purchasing banks' credit exposures, there has also been some concern that the introduction of the AECE should not otherwise interfere with established and trusted existing rules for collateral enforcement.

In July 2018, the UK announced that while it is broadly supportive of the CSPD's aims to reduce levels of NPLs in the UK, it is nonetheless in the UK's interest *not* to opt in to the Justice and Home Affairs obligations within the CSPD *"as the provisions introduce an unnecessary level of administration to the UK's existing collateral enforcement mechanisms, which are sufficiently robust and fit for purpose"*.

10. EUROPEAN COMMISSION LEGISLATIVE PROPOSALS ON SUSTAINABLE FINANCE

INTRODUCTION

On 24 May 2018, as part of its wider action plan on financing sustainable growth (which is in itself part of global initiatives), the European Commission published a package of legislative proposals (see below for the individual components).

At the same time, the Commission published its Feedback statement on the public consultation on institutional investors and asset managers' duties regarding sustainability following its November 2017 consultation on how institutional investors and asset managers could include ESG factors when taking decisions.

Aims of the package

The package includes three broad proposals, represented by a number of legislative proposals:

- The introduction of a unified classification system of sustainable economic activities – a "taxonomy" (see the "Sustainability Taxonomy Regulation" in the "Package of Legislative Proposals" below);

- The imposition of enhanced disclosure requirements on how managers and other institutional investors integrate environmental, social and governance (**ESG**) factors in their risk processes (see the "Disclosure Regulation" in the "Package of Legislative Proposals" below); and

- The introduction of a new category of low carbon and positive impact carbon benchmarks.

The concept of "sustainability" within the package as a whole is not clearly or consistently defined. For instance, the Sustainability Taxonomy Regulation will seek to set out, in complicated detail, a criteria for determining whether an economic activity is "*environmentally* sustainable" for the purposes of establishing the degree of environmental sustainability of an investment – i.e. the "E" in "ESG". Under the Disclosure Regulation "sustainable investments" are, essentially, defined as investments in an economic activity that contributes to an environmental or social objective, or companies following good governance practices – i.e. ESG. However, "sustainability" – e.g. in the context of sustainability risk policies that firms will be required to publish - is not specifically defined.

Reaction

Generally, the reaction from the asset management industry has been that, while the promotion of sustainable finance is meritorious, the often quite granular approach adopted in the draft legislation risks being inflexible and overly prescriptive, potentially resulting in unlooked for economic consequences and less choice for clients and investors.

Status and timing

The intended timetable for the proposals to enter into force is unclear. As drafted, the majority of the substantive rules would take effect between 12 to 18 months after the final text is published in the Official Journal and so, depending on how the EU legislative process unfolds, it is possible that many of the changes could come into force around mid-2020 – 2021.

It is likely that the Disclosure Regulation will be adopted this year. The European Parliament's Economic & Monetary Affairs Committee (ECON) adopted its position on the proposed Disclosure Regulation on 9 November 2018 and the European Council is expected to adopt its approach this month (January 2019). It is understood that the aim to reach agreement before the dissolution of Parliament in April 2019. As drafted, the Disclosure Regulation would apply 12 months following the date of publication in the Official Journal.

The UK and Brexit

None of the sustainable finance legislative proposals is mentioned in the Financial Services (Implementation of Legislation) Bill (see above). On 15 January 2019, the House of Commons European Scrutiny Committee published its Fiftieth Report of Session 2017-19 referring to documents considered by the Committee on 9 January 2019. In *Chapter 10: Green finance: sustainability disclosure requirements for investment advisors and asset managers,* the Committee considered the Disclosure Regulation. It noted that neither of the Disclosure Regulation nor the Taxonomy Regulation are covered by the Bill and such omission *"suggests the Government's support for the proposal is lukewarm, and that the Treasury is not in fact persuaded that regulatory action is the "best method" to achieve the aims of the disclosure requirements, nor that the Sustainability Taxonomy offers sufficient added value for it to be copied into UK law"*. However, despite this, the Committee concluded that Disclosures Regulation could impact the UK financial services industry directly and indirectly for a number of years. (The Committee cleared the proposal from scrutiny on the grounds that the EU legislative process is likely to be finalised in the coming months.)

See also item 21 below, on the FCA's independent initiative as set out discussion paper on climate change and green finance.

REGULATION ON DISCLOSURES RELATING TO SUSTAINABLE INVESTMENTS AND SUSTAINABILITY RISKS

This proposed Regulation was subject to a fast-track consultation period with feedback requested by 16 August 2018 consistent with the expectation that its provisions will come into force earlier than the other proposals, possibly even during the course of 2019.

In terms of broad application, the Regulation will apply to any "financial market participant" which is defined as any of the following:

- an AIFM;
- a MiFID investment firm providing portfolio management services or investment advice;
- a UCITS management company;
- a EuVECA or EuSEF manager;
- an institution for occupational retirement provision (an **IORP**) or provider of a pension product;

- an insurer making available insurance-based investment products (**IBIPs**).

In addition, some requirements will also apply to MiFID investment firms which provide investment advice and to insurance intermediaries which provide advice on IBIPs.

Sustainability risk policies

Each financial market participant (and each MiFID firm which provides investment advice and insurance intermediary which provides advice on IBIPS) will be required to establish a written policy on the integration of sustainability risks in its investment decision-making or advisory process and will have to publish that policy on its website. Asset managers will therefore have to develop such a policy against the backdrop of their business model and investment strategies and mindful of the fact that the policy will be publicly-available.

Pre-contractual disclosures

A financial market participant will also be required to include the following descriptions in its pre-contractual disclosures to clients:

- the procedures and conditions applied by the firm for integrating sustainability risks into its investment decisions;
- the extent to which sustainability risks are expected to have a relevant impact on the returns of the financial products that the firm makes available; and
- how the firm's remuneration policy is consistent with the integration of sustainability risks into investment decision making and is in line, where relevant, with the sustainable investment target of the financial product.

Similar pre-contractual disclosure requirements apply to investment firms which provide investment advice and insurance intermediaries which provide insurance advice with regard to IBIPs.

These pre-contractual disclosures will have to be made within the existing pre-contractual disclosure requirements set out in relevant sectoral legislation so, for instance:

- for an AIFM, in the Article 23 AIFMD investor disclosures;
- for a MiFID investment firm, in the ex-ante client disclosures required by MiFID II;
- for a UCITS manager, in the prospectus.

Where the financial product has a sustainable investment target set by reference to a benchmark, the pre-contractual disclosures must also include information about how the designated index for that benchmark is aligned with the relevant investment target together with an explanation as to why the weighting and constituents of the designated index differ from a "broad market index" (which presumably means an index which reflects the wider market and is not specifically tied to sustainability).

Where the financial product has as its target sustainable investments (or investments with similar characteristics) but does not reference a benchmark, the pre-contractual disclosures must explain how the target is reached.

There are specific, additional requirements if the financial product has as its target a reduction in carbon emissions.

ESMA, the EBA and EIOPA will, through the Joint Committee of the European Supervisory Authorities, develop draft regulatory technical standards to specify further details on the presentation and content of the prescribed pre-contractual disclosures.

Periodic disclosures

Where financial market participants make available financial products that target sustainable investments or reductions in carbon emissions, they must include the following information in a relevant periodic report (see below):

- the overall sustainability-related impact of the financial product, by means of relevant sustainability indicators; and
- where an index has been designed as a reference benchmark for the product, a comparison between the overall impact of the financial product with the designated index and with a broad market index in terms of weighting, constituents and sustainability indicators.

The relevant periodic reports for these purposes include:

- for an AIFM, the AIF annual report;
- for a MiFID portfolio manager, the periodic statements required by MiFID II; and
- for a UCITS manager, the half-yearly and annual report for the UCITS.

As with the pre-contractual disclosures, ESMA, the EBA and EIOPA will, through the Joint Committee of the European Supervisory Authorities, develop draft regulatory technical standards to specify further details on the presentation and content of the information required in periodic reports.

Website publication requirements

As mentioned above, financial market participants (and MiFID firms which provide investment advice and insurance intermediaries which provide advice on IBIPS) will be required to publish their sustainability risk policies on their websites.

In addition, financial market participants will be required to publish and maintain on their websites, for each product that targets sustainable investments, the following information:

- a description of the relevant sustainable investment target (following regulatory technical standards developed by ESMA, the EBA and EIOPA);
- information on the methodologies used to assess, measure and monitor the impact of the sustainable investments that have been selected for the relevant financial product, including its data sources, screening criteria for the underlying assets and relevant sustainability indicators used to measure the overall sustainable impact of the financial product (following regulatory technical standards developed by ESMA, the EBA and EIOPA);
- the pre-contractual disclosures referred to above; and
- the periodic disclosures referred to above.

Firms will have to disclose the information in a clear way and in a prominent area of the website, and will therefore not be able to "bury" the information in a difficult-to-access part of the website. The information must be kept up-to-date and any amendments to the information must be explained on the website.

It is unclear as to precisely how firms will be required to satisfy the publication requirements in relation to pre-contractual and periodic disclosures (since some of these may be specific to individual clients rather than being generic) or, for that matter, why website disclosure is required at all if the sectoral disclosure requirements are being complied with.

Marketing communications

Financial market participants (and MiFID investment firms providing investment advice and insurance intermediaries providing advice on IBIPs) will be required to ensure that their marketing communications do not contradict any of the information required to be disclosed under the Regulation. ESMA, the EBA and EIOPA will, through the Joint Committee of the European Supervisory Authorities, develop draft regulatory technical standards to determine the standard presentation on information on sustainable investments in marketing communications.

Industry reaction

Generally, there is concern that seeking to drive sustainability requirements into firms' policies, procedures and disclosures by way of hard-wired regulatory requirements in all cases, including where a client does not have ESG preferences and the firm does not specifically market its investments and services as sustainable, risks distorting the market and potentially reduces investor choice. It should remain open for firms to decide not to incorporate ESG factors into its portfolio offerings, provided that it is clear in their disclosures to potential clients that this is the case. However, as currently drafted, the Regulation on disclosures does not operate in this way.

REGULATION AMENDING THE MIFID ORG REGULATION – INFORMATION TO CLIENTS AND SUITABILITY

The Commission package includes a proposal to amend the MiFID Org Regulation to include references to the ESG preferences of clients and ESG considerations which firms should build into their suitability assessments and in the provision of information to clients.

In outline, the proposed amendments to the MiFID Org Regulation would have the following effects:

- MiFID portfolio managers will be required, when providing information to their clients and describing the types of financial instrument that may be included in the client portfolio, to base that on the client's investment objectives, *including any ESG preferences*;
- when providing clients or potential clients with a general description of the nature and risks of financial instruments, firms should take into account in particular ESG considerations;
- when providing information about their investment advisory services, firms shall (amongst other things) provide the factors taken into consideration in the selection process used by the firm to recommend financial instruments and these must include, where relevant, ESG considerations
- for the purpose of suitability assessments investment advisers and portfolio managers will need to:
  - collect information on any ESG preferences of the client and ensure that the transaction to be recommended or entered into meets those preferences, in addition to the client's investment objectives more generally;
  - include within the requisite policies and procedures designed to ensure that they understand the nature, features, risks of investment services and financial instruments selection for the clients, an express consideration of the ESG factors relevant to the client; and
- where an investment advisory firm is providing a suitability report to a retail client, it must ensure that the report includes ESG preferences, if any.

OTHER PROPOSALS IN THE COMMISSION'S LEGISLATIVE PACKAGE

In brief, the Commission's legislative package also included the following:

- a new Regulation setting out a framework of criteria to define when investments will constitute "sustainable investments" – this is referred to commonly as the Taxonomy Regulation since it aims to establish a unified EU classified system of sustainable economic activities. Industry reaction has focused on the risk of the taxonomy becoming an inflexible and exhaustive determinant of what sustainability means, with the consequence that some investments become "non-sustainable" by omission;
- a Regulation amending the EU Benchmark Regulation to add two new categories of benchmark:
  - a low carbon benchmark: a benchmark where the underlying assets are selected so that the resulting benchmark portfolio has lower carbon emissions when compared to assets comprising a standard benchmark; and
  - a positive carbon impact benchmark: a benchmark where the underlying assets are selected on the basis that their carbon emissions savings exceed the asset's carbon footprint;
- a Regulation amending the IBIP Regulation so that when a firm is providing advice in relation to an IBIP it must, when performing the requisite suitability assessment:
  - obtain sufficient information from the customer to ensure that the investment is consistent with that customer's ESG objectives; and
  - ensure that the suitability statement provided by the firm includes an explanation of how the IBIP meets the customer's investment objectives, including any ESG objectives.

THE PACKAGE OF LEGISLATIVE PROPOSALS

The European Commission's package of legislative proposals consists of the following components:

- a proposed regulation on the establishment of a framework to facilitate sustainable investment (the "Sustainability Taxonomy Regulation");
- a proposed regulation on disclosures relating to sustainable investment and sustainability risks and amending Directive (EU) 2016/2341 (the "Disclosures Regulation");
- a proposed regulation amending Regulation (EU) 2016/11 on low carbon benchmarks and positive carbon impact benchmarks;
- a draft delegated regulation amending Delegated Regulation (EU) 2017/2359 with regard to environmental, social and governance preferences in the distribution of insurance-based investment products;
- a draft delegated regulation amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU as regards organisational requirements and operating conditions for investment firms and defined terms of the purposes of that directive.

11. ESMA CONSULTATION ON SUSTAINABILITY RISKS AND FACTORS

INTRODUCTION

As set out above, the European Commission published an action plan on sustainable finance and an accompanying series of legislative proposals in May 2018. At the same time, the Commission indicated that it would clarify how certain types of entities, including asset managers and investment advisers, should integrate sustainability risks and factors into their organisational structures, risk management obligations and product governance target market. As part of that process, the Commission sent a formal request to ESMA and EIOPA for technical advice on this proposed integration. For these purposes, the concept of sustainability is broadly defined and covers ESG factors.

On 19 December 2018, ESMA published three consultation papers, including draft technical advice (see the links to the documents under the heading "ESMA consultation papers" below).

Firms have until **19 February 2019** to submit responses to the CPs on MiFID II and the UCITS Directive and AIFMD to ESMA. ESMA will consider the responses it receives in relation to each of the CPs and expects to publish its final reports and its finalised draft technical advice on the UCITS/AIFMD/MiFID II measures by 30 April 2019; the European Commission will consider the adoption of potential delegated acts although timing is unclear at this stage. The deadline for comments on the credit ratings CP is 19 March 2019 and ESMA expects to publish a final report by 30 July 2019.

ESMA states that, at this stage, it prefers a high-level principles-based approach which refers to sustainability risks and factors in general terms, rather than seeking to provide more granular definitions, which it considers could lead to gaps or regulatory arbitrage.

Therefore, for the purposes of its amendments to the AIFMD and UCITS Level 2 measures, ESMA is proposing to work to a general understanding of "sustainability risk" which refers to the risk of fluctuation in the value of positions in the fund's portfolio due to ESG factors and in the case of the MiFID II measures refers in simple terms to "environmental, social and governance" risks, factors, considerations or preferences, without further definition. This means that these proposed amendments taken alone are, for the most part, very light, and, in time, consequential amendments to firms' policies and procedures to reflect the changes may in turn be relatively minimal. Clearly, however, ESMA's proposals are part of a much bigger picture represented by the European Commission's *Action Plan: Financing Growth* and its detailed sustainable finance legislative proposals published on 25 May 2018 (see item 16 above) and firms are therefore likely to need to consider more substantively the relevance of ESG issues to their business models.

A high-level summary of the key proposals in ESMA's technical advice in relation to the UCITS Directive, AIFMD and MiFID II is set out below.

PROPOSED AMENDMENTS TO AIFMD AND UCITS LEVEL 2 MEASURES

General organisational requirements

AIFMs are currently subject to general organisational rules under the AIFMD Level 2 Regulation (Delegated Regulation (EU) No. 231/2013), which require them to establish and implement internal decision-making processes, internal control mechanisms, effective reporting and adequate record keeping. In addition, they must ensure that their directors, partners, managers and employees are aware of procedures to be followed to ensure the proper discharge of their responsibilities. There are very similar requirements in the UCITS Delegated Directive (Commission Directive 2010/43/EU).

ESMA is proposing that these requirements should be updated so that AIFMs and UCITS managers have to take into account sustainability risks and factors when implementing them – the objective (as the Commission made clear in its request) is to explicitly require the integration of sustainability risks into the *investment decision process*. However, this will remain subject to general proportionality principles, so that fund managers can take into account the size and complexity of their operations when incorporating sustainability concepts into their internal systems and controls. In addition, AIFMs and UCITS managers must also ensure that their senior management is responsible for the integration of sustainability risks and factors within their organisations.

In its narrative analysis, although not in the amended draft text, ESMA says that firms should carefully consider whether they have sufficient human and technical resources for the assessment of sustainability risks within their organisation and governance structure and that it is important that firms employ individuals with the relevant skills, knowledge and expertise in sustainability risks. ESMA goes on to say that the overriding requirement for AIFMs and UCITS managers to take into account sustainability risks and factors as part of the general organisational requirements means that "it would also be expected" that both the Compliance function and internal audit incorporate issues related to the integration of sustainability into their control programs. Although this expectation is not immediately manifest from the draft amendments to the legislation, it is justified on the basis that both Compliance and internal audit would be responsible for monitoring the firm's internal policies and procedures and assessing their compliance with regulatory requirements, and the effect of the amendments will be to embed sustainability risks and factors into such policies and procedures.

Operating conditions (due diligence)

AIFMs and UCITS managers are currently subject to a number of broadly identical due diligence requirements. ESMA is proposing that amendments are made to each of the AIFMD Level 2 Regulation and the UCITS Delegated Directive (by way of a new recital and a new operative provision) requiring the AIFM or UCITS manager, when identifying the type of conflicts of interest whose existence may damage the interests of the AIF or UCITS, to include those that may arise in relation to the integration of sustainability risks and factors and to take those risks and factors into account when complying with their due diligence obligations.

Risk management

AIFMs and UCITS managers are required to establish, implement and maintain an adequate and documented risk management policy which identifies the risks the AIFs or UCITS they manage are or might be exposed to. The risk management policy must comprise such procedures as are necessary to enable the AIFM or UCITS manager to assess the exposure of the AIF or UCITS to market, liquidity and counterparty risks, and the exposure to all other risks, including operational risks, which may be material.

A minor amendment will expressly add "sustainability" to the list of risks which the AIFM or UCITS manager must assess.

PROPOSED AMENDMENTS TO MIFID ORG REGULATION AND MIFID DELEGATED DIRECTIVE

ESMA's general approach

As with its proposals in relation to AIFM and UCITS managers, ESMA prefers sustainability risks to be integrated into MiFID II requirements by way of a high-level, principles-based approach. In accordance with this principle-based approach, the proposed textual amendments are light.

General organisational requirements

In its draft technical advice, ESMA suggests an amendment to the general organisational requirements in Article 21 of the MiFID Org Regulation to provide that, where environmental, social and governance (**ESG**) considerations are relevant for the provision of services to clients, firms should take those considerations into account when complying with the requirements (so, for instance, in terms of the firm's systems and procedures and the skills, knowledge and expertise of its personnel).

Risk management

Firms will also be required to take into account ESG factors when establishing, implementing and maintaining risk management policies and procedures designed to identify and manage the firm's risks under Article 23 MiFID Org Regulation.

In its narrative analysis ESMA says that it believes that sustainability risks impact upon "some" of the services offered by investment firms and specifically cites the example of portfolio management, "whereby an investment policy that ignores environmental considerations leaves the possibility for clients to invest in stranded assets".

Again, the expectation is that Compliance and internal audit will consider sustainability as part of their monitoring of the firm's risk management policies and procedures.

Conflicts of interest

A new recital will state that firms should include consideration of ESG factors when identifying conflicts of interest which may damage the interests of clients but this is qualified and tempered by a requirement for firms to have in place appropriate arrangements to ensure that the inclusion of ESG considerations in the advisory process and portfolio management does not lead to mis-selling practices.

Product governance

ESMA is proposing amendments to Commission Delegated Directive (EU) 2017/593 (the **MiFID Delegated Directive**) and, correspondingly, to its own *Guidelines on MiFID II product governance requirements*. As a general principle, ESMA's position is that both the manufacturer and distributor must take ESC preferences or considerations into account during the process of identifying target markets. In keeping with the high-level approach favoured by ESMA generally, the amendments to the MiFID Delegated Directive as regards product governance are light so that firms will be required to:

- take into account ESG preferences (where relevant) of client types when considering their needs, characteristics and objectives for the purposes of identifying a potential target market; and

- consider whether a financial instrument's ESG characteristics (where relevant) are consistent with the needs, characteristics and objectives of the target market.

Manufacturers and distributors will have to take account of ESG preferences (where relevant) of the target market in the reviews they are required to conduct to ensure ongoing compatibility of a product or service.

The fact that the suggested amendments referring to ESG preferences or characteristics are all qualified by the words "where relevant" reflects the fact that not all investment products will need to have a reference in their target market as to whether the product fulfils ESG preferences or not. Rather, the obligation on firms will be to assess, in all cases, *whether* ESG preferences are relevant to the needs, characteristics and objectives of the target market clients, but if they are not it is not necessary for the target market to make any reference to ESG characteristics. ESMA considers that this will generally result in two types of target market: "ESG positive products", being target markets in which certain ESG characteristics are specified and "non ESG products" being target markets without any reference to ESG characteristics.

ESMA has also proposed a minor, corresponding change to paragraph 18 of its *Guidelines on MiFID II product governance requirements* so that, in specifying the investment objectives and needs of target clients that a product is designed to meet, a manufacturer is required to include their ESG preferences *where relevant*. It has also drafted an entirely new case study on the target market for a "green" investment fund (a UCITS) which invests in renewable energy, organic farming, sustainable real estate, nature and landscape projects and environmental technology. The client objectives and needs in the case study includes specific ESG preferences and how the product can help fulfil specific objectives. This reflects ESMA's intention that manufacturers and distributors should "specify with a meaningful level of granularity" which ESG preferences a particular product fulfils and that it would not be sufficient to simply specify that a product has as its target market clients who are interested in environmentally sustainable, social and good governance investments.

THE ESMA CONSULTATION PAPERS

The three consultation papers published by ESMA on 19 December 2018 were:

- On integrating sustainability risks and factors in MiFID II;

- On integrating sustainability risks and factors in the UCITS Directive and AIFMD; and

- Guidelines on Disclosure Requirements Applicable to Credit Ratings (which includes a section on environmental, social and governance factors under the CRA Regulation).

12. EU CENTRAL SECURITIES DEPOSITORIES REGULATION: AN UPDATE

INTRODUCTION

As we have previously reported, the Regulation on improving securities settlement in the European Union and on central depositories (Regulation (EU) No 909/2014) (the EU **Central Securities Depositories Regulation** or **CSDR**)), came into force on 17 September 2014 and has been subject to a lengthy (and still ongoing) process of phased, piecemeal implementation over a number of years.

The CSDR broadly divides into two parts:

- The first part addresses the process of securities settlement and applies broadly to market operators and so-called "settlement internalisers" (as defined in Article 2(11) CSDR) – the overriding policy aim is to improve settlement efficiency and safety.

- The second part focuses on the regulation of the central securities depositories (**CSDs**) themselves, imposing among other things specific conduct of business and prudential requirements.

The CSDR is directly applicable in EU member states, and is subject to a number of Level 2 implementing measures by way of regulatory and technical implementing standards and delegated acts.

RTS ON SETTLEMENT DISCIPLINE

Section 18 of our New Year briefing last year contained a summary of the status of CSDR implementation although at that time we were still awaiting finalisation of the last set of implementing measures, regulatory technical standards on settlement discipline. These provisions will impact not only CSDs, but also trading venues and investment firms. On 13 September 2018 Commission Delegated Regulation (EU) 2018 of 25 May 2018, the RTS on settlement discipline, was finally published in the Official Journal. The RTS will come into effect on **13 September 2020**.

All the Level 2 measures implementing CSDR have now been published in the Official Journal. A list of them, with links to the underlying documents, is available on the ESMA website here.

EU Q&A ON CSDR

ESMA published the most recent update of its Questions and Answers on CSDR implementation on 12 November 2018. The update includes new Q&A on the calculation of cash penalties in the context of settlement fails.

13. MLD 5: A REMINDER

On 19 June 2018, Directive (EU) 208/843 was published in the Official Journal, a Directive which amends the Fourth Money Laundering Directive (**MLD 4**), which is commonly known as the Fifth Money Laundering Directive (**MLD 5**). We summarised the key changes likely to be of most relevance to firms in our briefing on 29 June 2018.

MLD 5 came into effect on 9 July 2018. It must be transposed by Member States on **10 January 2020**. As we noted, this would be after exit day but within the transitional period currently envisaged in the draft EU withdrawal agreement (if agreed).

The government has issued a draft Exit SI, The Money Laundering and Transfer of Funds (Information)(Amendment)(EU Exit) Regulations 2018 which would make deficiency correcting amendments to the current UK Money Laundering Regulations 2017 in the event of a "hard" Brexit.

14. EMIR 2.1

We published our briefing on the approval by the European Parliament of a revised proposal to the European Commission's proposed amendment to the terms of EMIR, referred to as "EMIR 2.1", part of the "EMIR Refit Regulation".

At the time of writing, trilogue discussions behind closed doors are still taking place between the European Parliament, the Council and the Commission.

PART 2: UK DEVELOPMENTS

15. SENIOR MANAGERS AND CERTIFICATION REGIME

With less than 11 months remaining until **9 December 2019** when the Senior Managers and Certification Regime (**SMCR**) will be extended to FCA-regulated firms, firms should now be making preparations in earnest.

Our client briefing which summarised the (then near-final) rules made in July 2018 (and which included links to our previous briefings published in July 2017 and December 2017) is here. We have a fuller guide for clients, setting out a summary of the final rules and proposals which is available on request.

To help clients in streamlining the process of implementation, we have jointly developed an **SMCR Essential Toolkit** for clients. Aimed at "core firms", the Toolkit consists of a number of template documents designed to be compliant with the new regime, but also adaptable and easy-to-use for Compliance and HR departments.

Further details are available from any of the Partners listed at the end of this briefing.

16. BEIS PROPOSALS ON REFORM OF UK LIMITED PARTNERSHIP LAW

INTRODUCTION

On 10 December 2018, the UK government's Department for Business, Energy and Industrial Strategy (**BEIS**) published a response to its consultation on potential reforms to UK limited partnership law which it originally published in April 2018. The consultation had contained a number of proposals generally aimed at improving the UK regulatory regime governing limited partnerships and preventing their misuse.

The government response sets out BEIS's broad conclusions on the aspects of limited partnership law that it identified as potentially meriting revision in the original consultation. However, it does not contain specific draft legislation to demonstrate how its proposed changes might be given effect. Instead, BEIS states that the UK government will bring forward legislation "*when Parliamentary time allows*". This means that the timescale for the introduction of the proposed new requirements is currently unclear.

The intention is that this legislation will apply across the whole UK. The summary of the proposals below therefore applies to any limited partnership which is registered in any part of the UK (i.e. including both English and Scottish limited partnerships).

REGISTRATION REQUIREMENTS

In the original consultation, BEIS had proposed that it should be mandatory for any person registering a limited partnership to be supervised under money laundering legislation and to provide evidence of such supervision.

In the response, BEIS has confirmed that it is will proceed with that proposal and therefore that any person who wishes to register a limited partnership will need to provide appropriate evidence of AML supervision on the application form. In the UK, this means that the relevant person will need to be subject to the domestic money laundering regulations; BEIS states that overseas persons will need to demonstrate that they are supervised in accordance with "*equivalent standards*". The response indicates that BEIS is still considering how those equivalent standards would be determined (e.g. whether registration would be limited to entities supervised under equivalent EEA legislation), although any list of equivalent overseas jurisdictions would be kept under periodic review. As a result of the new requirement for AML supervision, it will no longer be possible in the UK for unregulated persons (e.g. private individuals) to register limited partnerships.

PRINCIPAL PLACE OF BUSINESS AND SUFFICIENT CONNECTION TO THE UK

Originally, BEIS had also proposed that limited partnerships could be required to have a principal place of business (**PPoB**) in the UK, which would effectively prevent the use of migrated limited partnerships (i.e. those which are registered in the UK, but move their PPoB to another jurisdiction). This would have had important implications for fund structures which have been migrated to offshore jurisdictions such as the Channel Islands, as it would in effect require those partnerships to be domiciled in the UK and therefore treated as EU AIFs.

Following feedback from respondents to the consultation (including a sizeable number of responses from the fund management industry arguing that the proposal would have had a detrimental impact on the private equity/venture capital industry and make LPs unattractive to investors), BEIS has concluded that it will not be proceeding with this element of the proposal. This means that limited partnerships may continue to have PPoBs in jurisdictions outside the UK. However, the government still believes that LPs registered in the UK must have some demonstrable link to the UK. Therefore, the limited partnership will need to have, at the time of its application for registration, a proposed PPoB in the UK (which, it appears, may subsequently be migrated); and on an ongoing basis, it will need to demonstrate a connection to the UK through at least one of the following:

- retaining the PPoB in the UK;
- demonstrating that the limited partnership continues to carry on a legitimate business activity at a UK address; or
- engaging the ongoing services of an agent that is registered with a UK anti-money laundering supervisory body which has agreed to provide its address as a service address for the limited partnership. (This reflects another proposal from the original consultation paper that limited partnerships could be required to maintain a service address in the UK.)

BEIS is still considering the relevant information that the limited partnership will need to provide in order to demonstrate that these conditions are satisfied. It is also considering how these requirements should apply to limited partnerships that have already been established and whether transitional arrangements will be required in such cases.

If the limited partnership ceases to retain its PPoB in the UK, it will have to notify the Registrar of that fact. In addition, if there is a change to the way in which the limited partnership evidences its ongoing connection to the UK because it changes to a different option set out above, it must also notify the Registrar.

REPORTING AND TRANSPARENCY

In the consultation paper, BEIS had suggested that limited partnerships could become subject to the same requirements to file accounts and submit other periodic filings as currently apply to limited companies.

In its response, however, BEIS has confirmed that it will not extend all of these requirements to limited partnerships. Instead, it has stated that "*where there are any gaps in the requirements for partnerships to file basic accounts with the UK government, the Government will close those gaps in a way that is not* *burdensome or duplicative*". It is not immediately clear precisely what this statement means in practical terms, although it may imply that rather than requiring limited partnerships to file public accounts and reports, it may be sufficient that they provide the necessary information to a government department or agency (e.g. HMRC). Fund managers and other users of limited partnerships will need to watch closely for the detail of BEIS's draft legislation in this regard.

ANNUAL CONFIRMATION STATEMENTS

In the original consultation, BEIS suggested that limited partnerships could be required to file an annual statement which would confirm that all information about the partnership on the register remained correct (a requirement which already applies to Scottish limited partnerships).

In its response, BEIS has confirmed that annual confirmation statements will be required in respect of all other UK limited partnerships. These statements will be an expansion of the information which is already required in relation to new registrations (the new requirements are emboldened):

- the name of the partnership;
- the general nature of the partnership's business, **including a standard industrial classification (SIC) code, identifying the nature of the LP's business**;
- the address of the PPoB;
- the term, if any, for which the partnership has been entered into;
- the names and signatures of each general partner;
- the names, amounts contributed and signatures of each limited partner;
- **contact information for each general partner and limited partner;**
- **the date of birth and nationality of all limited partners and general partners who are natural persons;**
- the name of the person registering the partnership and that person's reference; and
- **how the limited partnership satisfies the requirement to have sufficient connection to the UK** (see above).

BEIS states that it will introduce a transitional period and a new mechanism for all existing limited partnerships to submit the additional information above that they have not already provided to the Registrar.

BEIS also indicates that it will be undertaking further work to determine whether it should require additional beneficial ownership information from corporate limited partners or general partners who do not maintain a register of persons with significant control (e.g. because they are incorporated outside the UK).

STRIKE-OFF OF LIMITED PARTNERSHIPS

BEIS will proceed with its original proposals in the consultation paper to grant powers to the Registrar to strike off limited partnerships from the register when they have been dissolved or when the Registrar otherwise concludes that they are no longer in operation.

Responses to the consultation highlighted concerns that accidental strike-off might affect the limited liability of limited partners or might otherwise lead to considerable legal and practical difficulties. BEIS acknowledges these concerns and has stated that it will continue to discuss the precise legal mechanisms for strike-off with stakeholders so that it can design a process that ensures, as far as possible, that limited partners and general partners are given due notice that the relevant limited partnership may be struck off the register. In addition, BEIS states that it is considering the circumstances in which it may be possible to restore a limited partnership to the register and the necessary procedure for doing so. Fund managers and other interested parties will need to wait to see the detail of precisely what is proposed in the relevant legislation to assess the potential impact in this area.

17. #US TOO: THE FCA APPROACH TO FITNESS AND PROPRIETY

On 28 September 2018, Megan Butler, the FCA's Executive Director of Supervision (Investment, Wholesale and Specialists Division), sent a letter to Maria Miller, Chair of the House of Commons Women and Equalities Committee, responding to questions raised by Ms Miller about the FCA's approach to sexual harassment in regulated firms.

Ms Butler confirms in her letter, as she had done when she had previously given evidence to the Committee, that the FCA views sexual harassment as misconduct which falls within the scope of the FCA's regulatory framework.

She makes a number of observations about the FCA's fitness and propriety requirements and the transparency obligations to which firms and their Senior Managers are subject:

- the SMCR – which will apply to all FCA firms from December 2019 - requires the FCA to assess the fitness and propriety of senior managers and this will include a consideration of any past criminal convictions, sanctions for discrimination, harassment or sexual misconduct;

- FCA regulated firms within the scope of SMCR will also need to perform a similar assessment for their certified staff and will be required to take into account similar factors;

- regulatory references under the SMCR will need to include relevant circumstances behind an individual's departure from a previous employer and therefore information about harassment or discrimination may need to be disclosed;

- the fact that the SMCR does not yet apply makes no difference – FCA firms are currently subject to the approved persons regime and during the approval process the FCA will determine an applicant's fitness and propriety - similar factors will be taken into account by the FCA;

- sexual harassment and other non-financial misconduct may amount to a breach of the SMCR Code of Conduct and may be notifiable to the FCA;

- firms are subject to Principle 11 of the FCA's Principles for Businesses which requires them to be open and cooperative with the FCA and to disclose appropriately anything relating to the firm of which the FCA would reasonably expect to be notified – this includes any potentially serious misconduct involving employees. Senior Managers are subject to a similar obligation;

- firms are expected to have internal whistleblowing and complaints procedures in place for non-financial misconduct; individuals can raise sexual harassment or other issues directly with the FCA through its whistleblowing procedures;

- the FCA's whistleblowing rules do not allow firms to use "gagging orders" to prevent disclosure to the FCA; and

- sexual harassment is misconduct and tolerance of such behaviour can lead to a poor culture within the firm generally. The FCA's continuing focus on culture within firms, alongside the implementation of the SMCR, means than non-financial misconduct will continue to be a key area of focus.

The letter highlights that non-financial misconduct can be just as relevant as financial misconduct in terms of assessing the fitness and propriety of employees and the culture of firms. Firms should ensure that their policies and procedures acknowledge this and that it is clear that such misconduct will not be tolerated.

18. AUTHORISED FUND MANAGERS: ASSET MANAGEMENT MARKET STUDY - 'PHASE 1' REMEDIES

INTRODUCTION

New rules will be introduced for managers of authorised funds (i.e. open-ended collective investment schemes) resulting from the FCA's 2016/2017 asset management market study (the final report for which together with its associated consultation paper (CP17/18), setting out proposals on part of the package of proposed remedies, were both published in June 2017). The FCA published the final rules on the first package of remedies in April 2018 in PS18/8: Asset Management Market Study remedies and change to the handbook – Feedback and final rules to CP17/18. At the same time it published a second consultation paper relating to remainder of the proposed remedies (see next item).

THE NEW RULES

In outline, the new rules, set out in the FCA's Collective Investment Schemes sourcebook (**COLL**) and guidance will address the areas set out below.

Governance

- *Value assessments*: Authorised fund managers will have to assess annually whether the charges taken from a fund are justified in the context of the overall value provided by the fund (the final rules do not use the term "value for money" which feedback to the consultation paper had suggested was too focused on the costs of the authorised fund manager). There are detailed minimum considerations which must be taken into account by the authorised fund manager including quality of service, performance, costs of providing the service, benefits from economies of scale, comparable market rates for services and charges for comparable services. Information about the assessment of value must be provided to investors in the fund's annual reports. These requirements will come into force on **30 September 2019** and the reporting obligation will apply to annual reports for accounting periods ending on or after that date.

- *Independent directors/members*: at least 25% of the board (or equivalent governing body) of the authorised fund manager will have to comprise independent directors/members, with a minimum of 2 independent directors/members. This requirement will also come into force on **30 September 2019**.

Allocation of responsibility and SMCR

- Authorised fund managers must allocate responsibility for compliance with the new governance requirements to an approved person (usually the chair of the governing body) by **30 September 2019**.

- There will be a new prescribed responsibility under SMCR: a senior manager (usually the chair of the board) must take reasonable steps to ensure that the firm complies with the obligation to carry out the assessment of value, the duty to recruit independent directors and the duty to act in the best interests of the fund investors. This will come into force along with the rest of the SMCR regime on **9 December 2019**.

Box profits

- Authorised fund managers will no longer be able to retain risk-free box profits and instead the profits will have to be repaid to the fund, with flexibility as to how they should be allocated provided it is fair to investors. These rules come into effect on **1 April 2019**.

Share classes

- Revised guidance recommends that authorised fund managers make a one-off, one-way notification to investors before a mandatory conversion to a cheaper but otherwise identical share class – this should be made at least 60 days before the mandatory conversion. This revised guidance is included in FG18/3: Changing clients to post-RDR unit classes and **was effective as from April 2018** to coincide with the publication of the policy statement.

19. AUTHORISED FUND MANAGERS: ASSET MANAGEMENT MARKET STUDY – 'PHASE 2' REMEDIES

INTRODUCTION

On 5 April 2018, the FCA published CP18/9: Consultation on further remedies – Asset Management Market Study. It has not yet published a policy statement setting out its feedback on the consultation and its final rules but this is **expected in Q1 2019**.

Broadly, the consultation paper addresses the FCA's concerns that fund objectives are not as clear or specific as they should be and that benchmarks (if used) are not always presented consistently or appropriately.

GUIDANCE ON FUND OBJECTIVES

General

The FCA decided not to change the rules regarding disclosure of objectives in the prospectus, but instead proposes new *guidance* on how fund managers should make fund objectives more useful to investors. Generally, the proposed guidance will set out what the regulator expects when funds disclose their objectives.

The UCITS KID or PRIIPS KIID

Specifically, the draft guidance will set out expectations as to what should be included in the objectives section of the relevant key information document – for instance, the UCITS KID or the PRIIPS KIID should:

- avoid jargon and legalese and be in user-friendly language but at the same (even if the wording is not identical) be consistent with the prospectus;
- include elements of the investment strategy in order to explain how the fund will achieve its aims;
- disclose where the authorised fund manager is using a particular strategy;
- be updated whenever necessary to reflect changes of substance (e.g. change of investment strategy/manager).

"Internal" restrictions relative to a benchmark

The guidance will also explain when authorised fund managers should disclose that the portfolio construction of a fund is *in practice* constrained or limited relative to a benchmark. This is getting not at an explicit restriction, as in the case of index tracking and partly active funds (which is disclosable under the rules), but at "internal" restrictions which limit how far a fund can differ from the composition of a benchmark . These types of internal ties to a benchmark are not always made clear to investors. Examples of such constraints that the guidance gives include: the risk management process of a fund causing it to be monitored and controlled relative to a benchmark, individual managers being remunerated by reference to the fund's performance relative to a benchmark and the portfolio management system restricting transactions using hard or soft limits relative to a benchmark.

Non-financial objectives

If authorised fund managers set out non-financial objectives for the fund (including ESG objectives), high-level guidance will provide these objectives should be set out. Broadly, they should be set out in a way that is fair, clear and not misleading and there should be a clear indication as to how the fund/manager will measure whether or not the objective is being met on an ongoing basis and provide periodic information to investors.

BENCHMARKS

The concern

In relation to benchmarks, the FCA is seeking to address a concern that authorised fund managers do not often explain to investors why they have selected a particular benchmark and they use the term "benchmark" inconsistently and with different meanings in different contexts as regards the same fund.

The rules and guidance

The FCA therefore proposes introducing rules and guidance that would, in outline, require authorised fund managers:

- to explain in the fund's prospectus and other customer-facing documentation why they have set one or more benchmarks and to disclose what category of benchmark it is, i.e.:
  - a "target benchmark" – i.e. where a target for the fund's performance has been set, or payment out of scheme property is permitted, by reference to a comparison of one or more aspects of the scheme property or price with fluctuations in the value or price of an index or similar factor – in other words, a target the authorised fund manager has set for the fund to match or exceed in terms of performance, including anything used for performance fee calculation;
  - a "constraint benchmark " – i.e. where, without being a target benchmark, there are arrangements in respect of which the composition of the portfolio is, or is implied to be, constrained by reference to the value, the price or the components of an index or other similar factor; or
  - a "comparator benchmark" – i.e. where, without being either a target benchmark or a constraint benchmark, the fund's performance is compared against the value or price of an index or similar factor;
- to be consistent in the way they refer to a benchmark in a fund's prospectus and other relevant documentation relating to that fund;
- to require that any presentation of past performance must only be compared against any constraint or target benchmark which has been adopted (but not a comparator benchmark) and this should be shown in the UCITS KID/PRIIPS KIID;
- where a comparator benchmark is used in presentations of past performance, the authorised fund manager must, in most situations, be consistent in suing the same comparator benchmark and no other benchmark in every subsequent communication made for a prescribed period;
- where the authorised fund manager has *<u>not</u>* set a benchmark:
  - to explain how investors should assess a fund's performance instead; and
  - to be consistent in not referring to a benchmark.

Transition

As from the effective date of the new rules, authorised fund managers will have to comply with the new rules and guidance within:

- **three months** for new funds; or
- **six months** for existing funds.

PERFORMANCE FEES

FCA guidance currently provides that an authorised fund manager should not charge performance fees based on gross performance – i.e. before other charges such as the manager's fees have been deducted. The FCA proposes to elevate this ban to the status of a rule.

As from the effective date of the new rules, authorised fund managers will have within **six months** in which to comply with the new rule.

20. FCA CP18/27: CONSULTATION ON ILLIQUID ASSETS AND OPEN-ENDED FUNDS

INTRODUCTION

On 8 October 2018 the FCA published CP18/27: Consultation on illiquid assets and open-ended funds and feedback to Discussion Paper 17/1. The consultation paper was the culmination of the regulator's supervisory work carried out in response to the various property fund suspensions which had occurred in the immediate aftermath of the Brexit referendum in June 2016 and the subsequent discussion paper, DP17/1: Illiquid assets and open-ended investment funds that it published in February 2017.

Broadly, while the FCA concluded that a major overhaul of the regulatory framework was not needed, the consultation paper nonetheless proposes a number of specific proposals that will be relevant to managers and depositaries of non-UCITS retail schemes investing in illiquid assets which are generally designed to:

- reduce the risk that some investors lose out because units in a fund become incorrectly priced as a result of the assets of the fund becoming difficult to value;
- improve liquidity management in the fund through the use of better planning and depositary oversight; and
- improve disclosures to investors about how liquidity management tools used by the manager may impact them.

These proposals will be primarily relevant to managers and depositaries of non-UCITS retails schemes that are likely to hold illiquid assets but there are some elements of broader application (see "*Limited broader application*" below).

The proposals should be seen against the global backdrop of IOSCO's Recommendations on Liquidity Risk Management for Collective Investment Schemes which were originally published in 2013 and revised on 1 February 2018.

The consultation closes on **25 January 2019**.

FUNDS INVESTING IN INHERENTLY ILLIQUID ASSETS

The majority of the FCA's proposals in the consultation paper are applicable to a new category of "funds investing in inherently illiquid assets" (**FIIA**s).

Application to NURSs

An FIIA is, broadly, a non-UCITS retail scheme (**NURS**) which either:

- has an investment policy – as evidenced by the investment objectives and policy published in the instrument constituting the fund and the prospectus – which aims to invest at least 50% of the value of the scheme property in "*inherently illiquid assets*" (see below); or

- has in fact invested at least 50% of the value of the scheme property in inherently illiquid assets for at least three continuous months in the last twelve months.

However, a NURS which meets one of the above conditions will not be an FIIA if the instrument constituting the fund and the prospectus provide for *limited redemption arrangements* that reflect the typical time needed to liquidate the inherently illiquid assets held by the NURS. Limited redemption arrangements are defined in the FCA Glossary as the arrangements operated by an authorised fund manager for the redemption of units in an authorised fund where the authorised fund manager holds himself out to redeem units in that scheme less frequently than twice in a calendar month in accordance with COLL 6.2.19R. A NURS will also not be an FIIA if the fund is in the process of winding up or termination.

For these purposes, an "inherently illiquid asset" will be defined as an asset which is:

- an immovable;

- an investment in an infrastructure project;

- a transferable security (as defined in COLL 5.2.7R) that is not a readily realisable security;

- any other security or asset which is not listed or traded on an eligible market and which exhibits one or more prescribed indicators of illiquidity (e.g. transactions are negotiated on a one-off basis, valuation of the sale price is typically complex and may require specialist advice);

- a unit in another FIIA;

- a unit in a qualified investor scheme (**QIS**) which is not in the process of winding up or termination and which satisfies one of the limbs of the definition of FIIA (see above – i.e. it would be an FIIA if it were a NURS) and broadly allows redemptions on timescales that do not reflect the typical time need to sell;

- a unit in an unregulated scheme where the scheme is not in the process of winding up or termination and aims to invest at least 50% of the value of the property of the scheme in any of the above assets and permits redemptions on timescales which do not reflect the typical time needed to sell, liquidate or close out those assets.

No general extension to QISs

The majority of the new requirements proposed by the consultation paper will apply to the managers of NURS that satisfy the above definition of FIIA. The FCA considered, but decided against, extending the requirements to QIS – it did not consider that the mischief which the amendments are designed to address and the overall aim of retail investor protection necessitated this.

Limited broader application

Despite the general application to managers of NURS that are FIIAs, it should be noted that:

- the requirements to suspend dealings in the case of funds holding immovables where there is a material uncertainty about the value of scheme property apply to NURS regardless of whether or not they amount to FIIAs;

- depositaries of FIIAs are subject to specific liquidity management oversight duties;
- all firms subject to COBS will be required to give a prescribed risk warning in financial promotions to retail clients that are not the prospectus or KIID; and
- UCITS will be subject to specific guidance on the use of liquidity buffers.

These exceptions are noted again below.

DISCLOSURE REQUIREMENTS FOR FIIAS

Promotion of FIIAs

Where a *firm* is communicating a financial promotion to a retail client relating to an FIIA outside the prospectus or the NURS's key investor information document (KIID), it must give a standardised risk warning to the client using wording specified by the FCA.

It should be noted that the above requirement applies to *all* firms subject to the FCA's conduct of business rules (**COBS**) on the communication and approval of financial promotions, not only the authorised fund manager. This means that intermediaries and platforms that make financial promotions in the course of distributing FIIAs to retail clients will need to ensure that they include the necessary risk warning disclosure.

Disclosure in Fund Prospectus

In addition, authorised fund managers of FIIAs will be required to include additional information in the fund prospectus:

- an explanation of the risks involved in the fund investing in inherently illiquid assets and how those risks might crystallise;
- a description of the tools and arrangements the manager would propose to use, including those required under the FCA rules, to mitigate such risks (e.g. typically, suspension of dealing, fair value pricing adjustment, fair and reasonable valuation of an immovable and anti-dilution measures such as a dilution levy); and
- an explanation of the circumstances in which the manager would typically deploy such tools and arrangements and the likely consequences for investors.

Written communications and naming requirement

- The authorised fund manager of an FIIA must include the words: "a fund investing in inherently illiquid assets" in the final part of the scheme's name at least once in any written communication provided to or seen by retail clients.

SUSPENSIONS OF DEALINGS

- A NURS manager of funds investing in property will have to suspend dealings in the fund's units if the standing independent valuer has expressed "material uncertainty" (in accordance with the Red Book) about the value of one or more "immovables under management" and that uncertainty applies to at least 20% of the value of the scheme property, or if at least 20% of the value of the scheme property is invested in other authorised funds where dealing has been suspended for the same reason.
- The depositary must be *notified* of the suspension (currently, the depositary's consent is required before a temporary suspension).

- The suspension must cease as soon as reasonably practicable after the standing independent valuer's material uncertainty assessment applies to less than 20% of the value of the scheme property and the depositary has given its approval for the removal of the suspension.
- It should be noted that these provisions apply to NURSs (i.e. regardless of whether or not it satisfies the definition of FIIA).

CONTINGENCY PLANNING

- A new rule will require FIIA managers to implement liquidity management contingency plans which set out how they will respond when a liquidity risk crystallises, which tools they may deploy and how they will work with depositaries and other relevant third parties and a communication plan.
- FIIA managers will be required to obtain written confirmation from any third parties identified in their contingency plans that those parties are themselves able to implement any relevant part of the liquidity plan and/or communicate with unitholders as soon as reasonably practicable.

RAPID SALES OF IMMOVABLE PROPERTY

- Before agreeing to sell immovable property quickly to meet redemption requests, an authorised fund manager of a NURS must agree a fair and reasonable value with the fund's standing independent valuer (they may agree between themselves beforehand a methodology that they will apply when carrying out such rapid sale valuations).
- Rapid sales may only take place if the fund prospectus has explicitly included the possibility of using such a tool.

LIQUIDITY BUFFERS

- New guidance, which will be applicable to UCITS as well as NURS, will state that cash or near cash in the scheme property should not be accumulated or held for a "significant duration" in anticipation of unusually high and unpredictable volumes of requests for redemptions.

DEPOSITARY'S OVERSIGHT DUTIES: LIQUIDITY MANAGEMENT

- The depositary of an FIIA will be required to regularly make its own assessment of the liquidity profile of the FIIA in order to devise its own procedures for overseeing the manager's liquidity management.
- The depositary will have to take reasonable care to oversee the authorised fund manager's liquidity management systems and procedures on an ongoing basis to ensure that the FIIA is being managed in accordance with specified FCA rules and provisions in the AIFMD level 2 regulation and must have a clear escalation procedure for raising cases of potential non-compliance which must be made available to the FCA on request.
- The depositary will not be able to delegate the above functions (although administrative support will be permissible).

21. FCA DISCUSSION PAPER ON CLIMATE CHANGE AND GREEN FINANCE

INTRODUCTION

On 15 October 2018, the FCA published *DP 18/8: Climate change and green finance* setting out the FCA's proposed approach to climate change and green finance issues in the financial markets and explaining how climate change-related matters are relevant to its statutory objectives (i.e. to ensure that the UK financial markets work well (the market integrity objective) and promoting effective competition in the interests of consumers in the markets (the competition objective)).

The FCA seeks feedback on its discussion paper by **31 January 2019**.

CONTEXT IN WHICH THE DP IS PUBLISHED

The discussion paper is coloured by, but independent of, the wider sustainable finance initiatives that are taking place both domestically and internationally, in respect of which the FCA has been working with UK, EU and international regulators, the government and industry. For instance, the paper mentions, but is separate from, the European Commission's Action Plan and its May 2018 proposals for legislation requiring disclosures on sustainable investments and the establishment of a new EU taxonomy to define such investments (see above).

The discussion paper therefore explores in domestic terms how the different aspects of climate change could impact the FCA's objectives, some of the opportunities and risks which will affect the financial markets in the move to a low carbon economy and also some tentative proposals on the specific action the FCA might take.

KEY OBSERVATIONS

The FCA's key observations and proposals in the discussion paper include the following:

- *pension funds*: climate change may be particularly relevant to entities that are responsible for long-term investment – for example pension funds (particularly workplace personal pension schemes whose members are in a default strategy) – since climate change is likely to be a material factor in the performance of those funds and has therefore become a practical concern, not just an ethical one;
  - the FCA will publish a package of proposed changes relating to the remit of the Independent Governance Committees (which oversee workplace pension schemes) in Q1 2019, which will include proposals in relation to environmental issues and climate change;
  - the FCA will consult on introducing guidance for providers of workplace personal pension schemes clarifying how providers should consider financial and non-financial factors, such as ESG and climate changes risks/opportunities and members' concerns and preferences) when making investment decisions;
- *innovation in financial services*: the FCA's "Innovate" programme has supported firms looking to provide innovative green finance products has also led to the creation of the Global Financial Innovation Network (**GFIN**), which is designed to provide a more efficient way for firms to interact with regulators across jurisdictions when developing new ideas for financial products and which could be used to help develop green finance products;
- *disclosure in the capital markets*: the regulatory environment should support asset buyers in making informed risk assessments on green finance products by ensuring that they have the relevant information necessary for valuation and transparent price formation – and in this context, the disclosures made by investee companies are relevant;
  - in this regard, the FCA will be consulting, not on specific changes to the existing regulatory regime which apply to issuers (at the outset at least), but on guidance to issuers about how that regulatory regime might be *interpreted* to apply to climate change-related risks -
  - in order to encourage greater comparability between issuers' products, the FCA is considering whether it would be helpful to introduce a more standardised framework for green finance disclosures;
  - the FCA is seeking industry input on whether any new framework should be structured as a set of voluntary "comply or explain" principles or whether another approach may be required;

  - there is an observation (nothing more at this stage) that minimum disclosure standards will help investors understand the products that they are buying and will prevent so-called “green-washing”, whereby a provider may market products as producing positive environmental outcomes when this is not in fact the case;

- *public reporting by financial services firms*: the FCA is also seeking feedback on whether it should introduce a new requirement for financial services firms to report publicly on how they manage climate change risks to their customers and their operations – by way of example, a report by an asset manager would be required to explain how it is managing the risks to long-term investments, such as pension fund assets, which climate change presents; and

- *Climate Financial Risk Forum*: the FCA and PRA are jointly establishing a Climate Financial Risk Forum which is designed to share knowledge and best practice in this area. This will include industry representatives, technical experts and other stakeholders and is expected to have its first meeting in early 2019.

As with all discussion papers, the Climate Change and Green Finance paper is exploratory in nature and while there are some outline proposals, it falls short of specific, rule changes that will affect financial services firms in the near future. However, firms should keep an eye on how the FCA's domestic initiatives proceed, particularly in the context of the EU's wider proposals and against the backdrop of Brexit.

PART 3: A "HARD" BREXIT

22. ONSHORING EU LEGISLATION

INTRODUCTION

As we have previously reported, under the European Union (Withdrawal) Act 2018 (**EUWA**) as currently enacted, all EU law will, through a process of automatic domestication or "onshoring", be preserved and retained as of "**exit day**" – **11:00 p.m. on 29 March 2019**. All EU regulations which are currently directly applicable will be incorporated into UK domestic law. However, EUWA also gives H.M. Treasury the power to correct "deficiencies" in the "onshored" legislation in order to ensure that it works and makes sense once the UK is no longer a member of the EU. It has been publishing drafts of various "Exit SIs" over recent months. A number of these have now become made instruments; but many are still in draft form, either going through the relevant legislative procedure or still yet to be laid.

As regards all binding technical standards made under UK legislation, H.M. Treasury has delegated its deficiency-correcting power to the UK regulators. The FCA, PRA and the Bank of England have recently published drafts of various amending instruments – see, by way of example, our section on FCA CP18/28 below.

It should be stressed that EUWA, the Exit SIs and the regulators' instruments amending binding technical standards are all predicated on there being a hard, no-deal Brexit – i.e. the UK leaves the EU on 29 March 2019 without agreeing any transitional deal with the EU and absent any postponement or revocation of the Article 50 notice. If there is a deal, amendments will be required to postpone the process of onshoring EU legislation until the expiry of the transitional period, which is currently defined as 31 December 2020 in the draft EU Withdrawal Agreement.

Put another way, all of these legislative and regulatory measures as drafted are contingencies which *may* not come into effect on 29 March 2019 (or at all).

EXIT STATUTORY INSTRUMENTS RELEVANT TO FINANCIAL SERVICES

Principally relevant to fund managers

The Exit SIs that are principally relevant to fund managers are as follows:

- The Alternative Investment Fund Managers (Amendment)(EU Exit) Regulations [2018] (**AIFM Exit SI**);
- The Collective Investment Schemes (Amendment, etc.)(EU Exit) Regulations [2018] (**CIS Exit SI**); and
- The EEA Passport Rights (Amendments etc. and Transitional Provisions)(EU Exit) Regulations 2018 (**EEA Passport Rights SI**)(made instrument).

Our October 2018 briefing summarised the impact of the above Exit SIs on investment funds, and that of the FCA's consultation paper *CP18/29: Temporary permissions regime for inbound firms and funds*. Since that briefing the EEA Passport Rights SI has now been made, but at the time of writing the AIFM Exit SI and the CIS Exit SI have not yet been made.

Made instruments

Other Exit SIs relevant to financial services which have been ***made*** so far include the following.

- The Markets in Financial Instruments (Amendment)(EU Exit) Regulations 2018
- The Central Counterparties (Amendment, etc., and Transitional Provision)(EU Exit) Regulations 2018*
- The Financial Regulators' Powers (Technical Standards etc.)(Amendment etc.)(EU Exit) Regulations 2018
- The EEA Passport Rights (Amendment, etc., and Transitional Provisions)(EU Exit) Regulations 2018*
- The Electronic Money, Payment Services and Payment Systems (Amendment and Transitional Provisions)(EU Exit) Regulations 2018*
- The Short Selling (Amendment)(EU Exit) Regulations
- The Central Securities Depositories (Amendment)(EU Exit) Regulations 2018
- The Trade Repositories (Amendment and Transitional Provision)(EU Exit) Regulations 2018*
- The Bank Recovery and Resolution and Miscellaneous Provisions (Amendment)(EU Exit) Regulations 2018
- The Capital Requirements (Amendment)(EU Exit) Regulations 2018

Although the above instruments have now been made, those marked with an asterisk will be subject to further amendments in due course to give effect to the government's Financial Services Contracts Regime (see below).

H.M. Treasury maintains a webpage with a list of made financial instruments statutory instruments here (at the time of writing this was last updated on 21 December 2018).

Draft instruments

A large number of other EU Exit SIs relevant to financial services are still in ***draft*** form at different stages in the consultative and legislative process (some have been laid). These include:

- The Financial Services and Markets Act 2000 (Amendment)(EU Exit) Regulations 2019

- The Transparency of Securities Financing Transactions and of Reuse (Amendment)(EU Exit) Regulations 2019
- The Securitisation (Amendment)(EU Exit) Regulations 2019
- The Financial Services Contracts (Transitional and Saving Provision)(EU Exit) Regulations 2019 (see the section on the Financial Services Contracts Regime below)
- The Financial Services (Distance Marketing)(Amendment and Savings Provisions)(EU Exit) Regulations 2019
- The Packaged Retail and Insurance-based Investment Products (Amendment)(EU Exit) Regulations 2018
- The Long-term Investment Funds (Amendment)(EU Exit) Regulations 2018
- The Social Entrepreneurship Funds (Amendment)(EU Exit) Regulations 2018
- The Venture Capital Funds (Amendment)(EU Exit) Regulations 2018
- The Insurance Distribution (Amendment)(EU Exit) Regulations 2018
- The Solvency 2 and Insurance (Amendments)(EU Exit) Regulations 2018
- The Money Laundering and Transfer of Funds (Information)(Amendment)(EU Exit) Regulations 2018
- The Market Abuse (Amendment)(EU Exit) Regulations 2018
- The Financial Markets and Insolvency (Amendment and Transitional Provision)(EU Exit) Regulations 2019
- The Over-the-Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision (EU Exit) Regulations 2018

As regards the last item, which would onshore the European Markets and Infrastructure Regulation (**EMIR**), our Derivatives and Structured Products group published a client briefing on 16 January 2019: UKMIR and what a "no-deal" Brexit means for users of derivatives in the UK.

23. INCOMING EEA FIRMS - TEMPORARY PERMISSIONS REGIME (TPR)

Our October briefing summarising the impact of the fund-specific Exit SIs covered the temporary permissions regime (**TPR**) which would enable EEA AIFMs to market and/or carry on management activities in the UK following exit day.

The notification window for the TPR opened on 7 January 2019 and will **close at the end of 28 March 2019** (i.e. the day before exit day). Firms will need to notify the FCA that they wish to enter the TPR using the FCA's Connect system. They will also need to notify the FCA which of their currently passported funds they wish to continue to market in the UK via the Connect system.

The FCA's webpage on the notification window contains details on how EEA firms should notify the FCA for the purposes of the temporary permissions regime. Given that many EEA firms may not have previously registered for Connect, this page contains two helpful guides showing how to use Connect to submit an application for firms and for funds.

24. INCOMING EEA FIRMS – THE FINANCIAL SERVICES CONTRACTS REGIME

INTRODUCTION

For those firms and funds currently passporting into the UK which fail (through choice or otherwise) to notify under the TPR before the notification window closes – and for firms which *did* enter the TPR but did not get a UK authorisation at the end of the transitional period - the government has introduced draft legislation establishing The Financial Services Contracts Regime (**FSCR**). The FSCR will provide run-off mechanisms for EEA firms that exercise their rights of passport pursuant to a single market directive, i.e.:

- those which passport under e.g. MiFID II or AIFMD and which gain authorisation under the FSMA regime;
- those which passport under the Payment Services Directive (**PSD II**) which are authorised or registered under Payment Services Regulations 2017; and
- those which passport under the Electronic Money Directive and which are authorised under the Electronic Money Regulations 2011.

The FSCR is also available for non-UK central counterparties and EEA trade repositories.

The FCA webpage on the FSCR is here.

AIM: ORDERLY WIND DOWN OF PRE-EXISTING BUSINESS – NO NEW BUSINESS/CONTRACTS

The FSCR is intended to allow such incoming EEA firms which are outside the TPR to wind down their business in the UK in an orderly fashion. Firms in the FSCR will not be permitted to undertake any new business. They will be restricted to regulated activities which are necessary:

- for the performance of a contract entered into before exit day (or, where the firm enters the FSCR after exit from the TPR, before entry into that regime);
- to transfer property, rights or liabilities under a pre-existing contract;
- for the undertaking of certain activities in relation to managing financial risk.

Although not clear, this arguably means that, for example, a portfolio manager *would* be able to continue exercising discretion to enter into transactions under the terms of a pre-existing investment management agreement and mandate for as long as the period of wind-down with a view to ultimately exiting the UK market. However, by way of contrast, a broker, which executes individual (new) contracts, albeit under the terms of pre-existing terms of business, would likely not be covered. EEA firms will need to consider, in contemplation of a potential, "hard" Brexit, whether to enter into the TPR (and therefore make a notification to the FCA before 29 March 2019) or whether the FSCR approach to winding-down their business is appropriate.

AVAILABLE FOR LIMITED PERIOD ONLY

Firms within the FSCR will be able to continue to perform contracts entered into prior to exit day (or prior to exiting the TPR) for up to **5 years** starting from the day they enter into the regime without breaching the UK regulatory perimeter. For insurance contracts only the period will be 15 years. H.M. Treasury will have the power to extend those periods,

AUTOMATIC APPLICATION

No notification is required. The FSCR will apply automatically to all incoming EEA firms which have not notified under the TPR but which would otherwise require a UK licence in order to perform their pre-existing contracts (as above new contracts will not be covered by the FSCR).

WHO THE FSCR IS NOT FOR

At first blush, the FSCR might appear to be a broad "safety net" for those firms which fail to make a TPR notification in time. However, in *CP 19/2: Brexit and contractual continuity*, published on 8 January 2019 (see below for further details), the FCA was at pains to make it clear who the FSCR is not relevant for:

- EEA-domiciled investment funds which are currently marketed into the UK – any operator who wishes to market such a fund into the UK after exit day will have to notify under the TPR;
- UK firms that passport into the EEA;
- an EEA-based manager of a UK authorised fund (i.e. an authorised unit trust scheme, an authorised contractual scheme or an authorised open-ended investment company) that wishes to continue to manage such a fund after exit day – such manager will need to establish a UK incorporated entity for these purposes although it may obtain temporary permission under the TPR to do so.

THE DRAFT LEGISLATION

The proposed legislation that will establish the FSCR is available on H.M. Treasury's website. As it is still in draft form it could be subject to further changes. It is two parts and, to complicate an already complicated picture, will make amendments to relevant Exit SIs which are currently going through the parliamentary process:

- The Financial Services Contracts (Transitional and Saving Provision)(EU Exit) Regulations 2019 – these Regulations (which were laid before Parliament on 15 January 2019) make amendments to the EEA Passport Rights (Amendment, etc., and Transitional Provisions)(EU Exit) Regulations 2018, the Central Counterparties (Amendment, etc., and Transitional Provision)(EU Exit) Regulations 2018 and the Trade Repositories (Amendment and Transitional Provision)(EU Exit) Regulations 2018; and
- The Financial Services Contracts (Transitional and Saving Provision)(EU Exit)(No.2) Regulations 2019 – these make amendments to the Electronic Money, Payment Services and Payment Systems (Amendment and Transitional Provisions)(EU Exit) Regulations 2018,

collectively, the **FSCR Regulations**.

The H.M. Treasury page also includes some supporting, background documentation:

- an explanatory memorandum on the FSCR legislation;
- an annex explaining the run-off regime for EEA firms that currently passport into the UK under FSMA;
- an annex explaining the run-off regime for EEA firms that currently passport into the UK under the Payment Services Regulations 2017 and the Electronic Money Regulations 2011; and
- an annex explaining the run-off regime for services provided by non-UK CCPs and trade repositories.

FCA CONSULTATION

As mentioned above, on 8 January 2019 the FCA published *CP19/2: Brexit and contractual continuity* in which it is consulting on the proposed application of its rules to firms in the FSCR. Consultation is open until **29 January 2019**.

The two FSCR mechanisms

The FSCR will have two mechanisms, supervised run-off (**SRO**) and contractual run-off (**CRO**):

- *SRO firms*: broadly speaking, SRO will apply to EEA firms providing services through a branch or with top-up permissions in the UK. They:
  - will be deemed to have Part 4A permission for the purposes of servicing their pre-existing contracts and winding down their UK regulated activities in respect of them;
  - will appear on the Financial Services Register;
  - will be subject to regulation and supervision by the relevant UK regulator and, broadly, will be subject to all the FCA rules which currently apply to them, all FCA rules which implement a requirement of an EU directive which are currently reserved to the firm's home state;
  - will be subject to FSCS cover (unless they are EEA authorised payment institutions (**PIs**), EEA Registered Account Information Service Providers (**RAISPs**) and EEA authorised e-money institutions (**EMIs**)) and will have to pay FSCS fees; and
  - will be required to pay fees to the FCA.
- *CRO firms*: CRO will essentially be for all other incoming EEA firms not covered by the SRO (but excluding those firms for which the FSCR is not relevant – see above). They will:
  - be exempt from the general prohibition in section 19, FSMA (or, in the case of PIs, RAISPs and EMIs, the relevant prohibitions in the Payment Services Regulations 2017 (**PSRs**) and the Electronic Money Regulations 2011 (**EMRs**) as applicable);
  - *not* be authorised persons (or otherwise subject to any relevant authorisation or registration requirement under the PSRs or EMRs;
  - *not* be subject to FCA/PRA supervision or to the FSCS;
  - *not* be required to pay periodic fees (but may face a "Special Project Fee" where the regulator is required to undertake work exercising its powers under the FSCR Regulations, but only where the costs of doing this exceed a £5,000 threshold for any individual firm);
  - *not* have FSCS cover (and so will not have to pay FSCS fees);
  - be required to notify the FCA as soon as practicable that they are carrying on regulated activities in the UK; and
  - be required to maintain their home-state authorisation (and to notify the FCA is such authorisation is subsequently varied or cancelled).

25. FCA CONSULTATION PAPER ON PROPOSED BREXIT CHANGES TO THE FCA HANDBOOK

INTRODUCTION

As mentioned, H.M. Treasury has delegated its deficiency-correcting power under the European Union (Withdrawal) Act 2018 (**EUWA**) to the UK regulators as regards all binding technical standards (i.e. the **RTS** and **ITS** made under EU legislation).

On 10 October 2018, the FCA published *CP 18/28: Brexit: proposed changes to the Handbook and Binding Technical Standards – first consultation*. Consultation closed on 7 December 2018.

In the consultation paper, the FCA consulted on changes to a limited number of RTS and ITS including those relating to the AIFMD and UCITS regimes (but not, at that time, EuVECAs, EuSEFs or ELTIFs), MiFID II/MiFIR, capital requirements, short selling requirements and credit rating agencies.

GENERAL APPROACH

In keeping with the approach under EUWA, the proposed changes under the CP are designed only to correct deficiencies in the rules which arise from Brexit and are not designed to make broader policy changes. Consequently, many proposed amendments to technical standards are relatively minor and include:

- the removal of references to EU legislation, replacing them with references to equivalent "onshored" UK legislation (except where a continuing reference to UK legislation is appropriate);
- removing references to passporting and associated terms;
- removing references to EU institutions and supervisory authorities (except where it is appropriate to retain them);
- amending references to EU Member States and EEA Member States in contexts which imply that the UK continues to be an EU or EEA member; and
- removing references to obligations on the FCA to share information with other EU/EEA competent authorities.

AIFMD

In terms of AIFMD the FCA identified only one technical standard which required onshoring and amendment: Commission Delegated Regulation (EU) No. 694/2014 with regard to regulatory technical standards determining types of alternative investment fund managers – i.e. to determine whether an AIF is open- or closed-ended.

MIFID II

Under the MiFID II regime, of the 44 RTS and ITS identified by the FCA, the regulator has decided that 9 of them can be revoked on the basis that they relate to obligations that would no longer apply after exit day. Of the remaining technical standards the amendments will, again, be relatively minor. Generally, these relate to standard forms relating to the submission of information to regulators and requirements for the sharing of data between national regulators.

However, the FCA did identify a number of issues of substance in relation to the MiFID II regime, including the following on trading:

- after exit day, UK trading venues would need to start transaction reporting for trades entered into through their systems by EEA firms, since such firms will have become third country firms;
- however, UK trading venues would not be required to transaction report for UK branches of EEA firms, as those should report to the FCA directly – this means that the UK trading venue will need to be able to determine whether a trade is being executed by a UK branch of an EEA firm or by the EEA firm from overseas;
- a UK branch of an EEA firm will therefore need to ensure that it has appointed an ARM (or has otherwise connected to the FCA's Market Data Processor) before exit day in order to be in a position to report;
- a UK firm which transmits orders to an EEA firm will no longer be able to rely on "transmission" to relieve it from the obligation on its part to transaction report.

Also on MiFID II, the FCA is proposing to amend its conduct of business rules so that:

- a UK firm will only be allowed to rely on suitability and appropriateness assessments carried out by an instructing firm where that firm carries out the assessment *in compliance with the COBS rules* (currently firms which receive instructions from another EEA MiFID firm can rely on a suitability or appropriateness assessment performed by that firm in accordance with equivalent requirements in that EEA State);

- for the purposes of the MiFID client categorisation rules, the quantitative test (if any) for categorisation of an EEA local public authority as applied by the EEA State in which it is established will no longer be relevant – instead, FCA firms will need to apply the FCA's test (which is the current approach for local public authorities established in non-EEA jurisdictions.

STATUS OF EUROPEAN GUIDANCE

In addition to the FCA's proposed amendments to (and revocations of) EU technical standards, the consultation paper addressed the regulator's approach to Level 3 guidance published by one or more of the European Supervisory Authorities and other non-legislative materials (such as opinions from the ESAs or European Commission Q&As). Such materials will not be onshored under EUWA. The FCA's proposed approach is to issue non-Handbook guidance which, in outline, will state that:

- the FCA considers that firms should continue to have regard to the Level 3 materials after exit day on the grounds that the EU-derived law to which those material relate will have been retained under UK legislation;
- the FCA will not re-issue amended Level 3 materials to correct deficiencies in the way that it has done in relation to the technical standards and therefore firms will need to apply a sensible interpretation;
- where the FCA has previously notified the ESAs that it will not comply with one or more elements of Level 3 materials (for example, the proportionality guidance under the CRD IV remuneration rules), firms should continue to apply to FCA's approach to the relevant text after exit day;
- where the ESAs produce new materials, or amend existing materials, after exit day, the FCA will set out its expectations as to how firms should treat such materials.

If the EU Withdrawal Agreement were to be agreed between the UK and the EU with a transition period to 31 December 2020, the proposed amendments in CP 18/28 would not come into effect on 29 March 2019 and would need to be subject to further review, amendment and consultation to take account of any final arrangements regarding financial services agreed with the EU.

26. UK REGULATORS: TEMPORARY TRANSITIONAL POWERS

On 8 October 2018, H.M. Treasury published its proposal to grant temporary transitional powers to the FCA, PRA and Bank of England to assist with "no deal" Brexit planning – i.e. where the UK leaves the EU on 29 March 2019 without a withdrawal agreement and without a transition period. While the various Exit SIs (see above) will address the necessary amendments to EU legislation to reflect the UK's position outside the EU, in some cases there will be a knock-on effect as regards firms' regulatory obligations. However, this may not become manifest until very near exit day itself, meaning that firms would have very little, if any, time to prepare. H.M. Treasury recognises that it might be "challenging" for firms to make the changes necessary to comply with their changed regulatory obligations in a short timeframe.

The regulators' temporary powers – which would last for 2 years following exit day - would therefore essentially enable the regulators to waive or modify firms' regulatory obligations and grant them transitional relief where those obligations have changed as a result of the "onshoring" process for EU legislation. The powers will be extensive and will apply to any changes made under EUWA which have resulted in modified regulatory requirements for UK firms, including under any of the following:

- FCA or PRA rules made under FSMA;
- any onshored RTS or ITS;

- any onshored EU regulations or delegated regulations relating to financial services; and
- any relevant UK primary or secondary legislation derived from EU law.

The regulators will be able to exercise the powers in relation to particular firms, classes of firms or all firms affected by a particular change. This could include EEA firms that are subject to the temporary permission regime or non-UK CCPs that are subject to the temporary recognition regime.

The Treasury will be publishing a draft statutory instrument addressing the temporary powers in due course.

27. FINANCIAL SERVICES (IMPLEMENTATION OF LEGISLATION) BILL – "IN FLIGHT" EU LEGISLATION

INTRODUCTION

On 22 November 2018, the Financial Services (Implementation of Legislation) Bill was introduced into the House of Lords, together with a policy note from H.M. Treasury.

The Bill will give H.M. Treasury a temporary power to make regulations after exit day to implement and amend certain "in flight" EU legislation – i.e. EU financial services legislation that:

- has been published in the Official Journal of the EU but are not in effect immediately before exit day and so will not be automatically onshored by EUWA; or
- is in the process of being negotiated by the EU and which may be adopted and published in the Official Journal of the EU within the two years following exit day.

RATIONALE FOR THE POWER

The stated rationale for the power is that the UK played a leading role in shaping these laws during its membership of the EU, and therefore the UK will have an interest in them. The overall effect of the Bill, therefore, is to grant the Treasury the power to make regulations which, by way of corresponding or similar provisions and with such adjustments as the Treasury considers appropriate, implement the EU legislative provisions into UK law.

EU LEGISLATION IN RESPECT OF WHICH THE POWER MAY BE EXERCISED

However, as wide as this power is, it can only be exercised in relation to "specified EU financial services legislation" – i.e. ***EU legislative provisions expressly referred to in the Bill***. This includes:

- Article 37 (non-discriminatory access to benchmarks), MiFIR and article 38(2) MiFIR (CCPs);
- Article 4(1) of the Securities Financing Transactions Regulation (relating to reports of securities financing transactions);
- Articles 6 and 7 of the Central Securities Depositaries Regulation (CSDR) (relating to measures to prevent and address settlement fails);
- the Delegated Cash Penalties Regulation made under CSDR; and
- the EU Prospectus Regulation and any delegated acts made under it;

It also includes any other EU Directive or EU Regulation adopted before, on or after exit day ***as a result of any of the proposals expressly listed in the Schedule to the Bill***, which includes the following:

- the CRD V and CRR II proposals;

- the proposed Investment Firms Regulation and Directive;
- the proposed "Omnibus" Directive and Regulation relating to the cross-border distribution of collective investment funds; and
- the proposed amendment to EMIR – the so-called EMIR REFIT Regulation (which includes EMIR 2.1).

The fact that the Treasury's power will only be exercisable in relation to EU provisions expressly referred to on the face of the Bill means that there may be debate, during the passage of the Bill through Parliament, as to what appears in the Schedule.

CONDITIONS AND RESTRICTIONS ATTACHING TO THE POWER

Other conditions and restrictions attached to the power are as follows:

- H.M. Treasury's power will be subject to the same limitations which apply to the deficiency correcting power under EUWA – i.e. it cannot be used to create, impose or increase taxation; make retrospective provision; create a criminal offence punishable by longer than 2 years in prison; establish a public authority; implement a withdrawal agreement from the EU; or amend the Human Rights Act 1998 or the devolution settlements;
- the power does not extend to "in flight" RTS or ITS (a concern that has been identified by the Financial Markets Law Committee);
- any regulations made by the Treasury pursuant to the Bill would be subject to the affirmative resolution procedure in Parliament;
- the power is subject to a "sunset clause" of two years following exit day (consistent with EUWA itself); and
- H.M. Treasury will be required to publish an annual report before the end of April in each of those two years explaining how it has used the relevant powers (and, in the first year, explaining how it proposes to use them in the coming year).

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GLOSSARY OF ABBREVIATIONS USED IN THIS BRIEFING

AECE	Accelerated extra-judicial collateral enforcement
AIF	Alternative investment fund
AIFM	Alternative investment fund manager
AIFMD	Alternative Investment Fund Managers Directive
BEIS	Department for Business, Energy and Industrial Strategy
CP	Consultation paper
COBS	FCA's Conduct of Business sourcebook
COLL	FCA's Collective Investment Scheme sourcebook
CRA Regulation	EU Credit Rating Agencies Regulation
CRD IV	EU Fourth Capital Requirements Directive
CRD V	Proposed EU Directive amending CRD IV
CRO	Contractual run-off under the FSCR regime
CRR	EU Capital Requirements Regulation
CRR II	Proposed EU Regulation amending the CRR
CSD	Central securities depository
CSDR	Central Securities Depositories Regulation
CSPD	Proposed EU Credit Servicers and Purchasers Directive
EBA	European Banking Authority
EC	European Commission
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ELTIF	A European long-term investment fund as defined in the ELTIF Regulation
ELTIF Regulation	EU Long-term Investment Fund Regulation
EMI	E-money institution
EMIR	European Market Infrastructure Regulation
EMRs	Electronic Money Regulations 2011
ESAs	European Supervisory Authorities (EBA, EIOPA and ESMA)
ESG factors	Environmental, social and governance factors
ESMA	European Securities and Markets Authority
EU	European Union
EuSEF	A qualifying social entrepreneurship fund as defined in the EuSEF Regulation

EuSEF Regulation	EU Social Entrepreneurship Regulation
EuVECA	A qualifying venture capital fund as defined in the EuVECA Regulation
EuVECA Regulation	EU Venture Capital Fund Regulation
EUWA	European Union (Withdrawal) Act 2018
Exit day	29 March 2019, 11:00 p.m. GMT
Exit SI	Statutory instrument under EUWA correcting deficiencies in EU law
FCA	Financial Conduct Authority
FIIA	Fund investing in inherently illiquid assets
FSCR	Financial Services Contracts Regime
FSCR Regulations	The draft Financial Services Contracts (Transitional and Saving Provision)(EU Exit) Regulations 2019; and The draft Financial Services Contracts (Transitional and Saving Provision)(EU Exit)(No.2) Regulations 2019
FSMA	Financial Services and Markets Act 2000
IBIP	Insurance-based investment product
IORP	Institution for occupational retirement provision
IFD	Proposed EU Investment Firms Directive
IFR	Proposed EU Investment Firms Regulation
ITS	Implementing technical standard
MiFID II	Recast Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MLD 4	Fourth Money Laundering Directive
MLD 5	EU directive amending MLD 4
NURS	Non-UCITS retail scheme
Omnibus Directive	Proposed EU Directive on Cross-border Distribution of Funds
Omnibus Regulation	Proposed EU Regulation on Cross-border Distribution of Funds
PRIIP	Packaged retail investment or insurance-based product
PRIIPs KID	Key information document required by PRIIPs Regulation regime
PRIIPs Regulation	EU PRIIPs Regulation
NPPR	National private placement regime
NPL	Non-performing loan
NURS	Non-UCITS retail scheme
PPoB	Principal place of business
PSRs	Payment Services Regulations 2017

QIS	Qualified investor scheme
RAISP	Registered Account Information Service Provider
RTS	Regulatory technical standard
SFT	Securities financing transaction
SFTR	Securities Financing Transactions Regulation
SMCR	Senior Managers and Certification Regime
SRO	Supervised run-off under the FSCR regime
TPR	Temporary permissions regime
UCITS	Undertaking for collective investment in transferable securities