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# Financial Services and Markets

## 2014 – The regulatory vortex

Earlier this month the US was hit by a polar vortex. Niagara Falls turned to ice. Planes were grounded. Hell finally froze over (at least a town of that name in Michigan did). For many of us on this side of the Atlantic, 2014 will see the regulatory vortex that has been intensifying over Europe for some time, hitting hard and bringing with it a chilling blast of mind-numbing requirements and a thick, compacted blanket of rules and regulations, making it ever more difficult to carry on working as normal.

In this briefing, we summarise the current status of some key provisions which are now in force or are in the process of being implemented in the immediate future. In the second part, we look at some other significant initiatives and developments which are still being discussed, or which will be implemented over the next year or so and which are likely to mean that the regulatory vortex will stay in place for the rest of this year and beyond.

**PART A: THE IMMEDIATE FUTURE**

**AIFMD: an update from the front line of the "phoney war"**

During the first few months of World War II, there was a period, referred to by some as the "phoney war" (and by Churchill, as the "twilight war") during which there were no major military engagements between the combatants (although that is not to say that nothing was happening). The implementation of AIFMD has had a similar feel to it: although the Directive came into force on 22 July 2013, many firms have taken advantage of the one year's transitional relief provided by the Directive, applications to competent authorities are still pending and certain measures and guidelines are only now in the process of being finalised.

We set out below a very brief update on some of the key issues for in-scope firms:

*When is a year not a year?*

While the Directive allows for a one year transitional period, starting from the date on which the Directive came into force, in which to submit an *application* for authorisation, the transitional arrangements, as transposed into UK law, had the effect that firms which were already managing AIFs as at 22 July 2013 had until 22 July 2014 at the latest in which to *obtain authorisation or registration*. The FCA said that this meant that such firms would have to submit their applications to the Financial Conduct Authority (FCA) no later than 22 January 2014 (for small authorised UK AIFMs and depositaries) or no later than 22 April 2014 (for full-scope UK AIFMs) in order to allow the FCA sufficient time to determine the application and to be certain therefore that approval would be granted in time. This had the effect of seriously curtailing the apparent one year's transitional relief provided for by the Directive.

However, as we reported in our email briefing of 19 December 2013 ("*A Christmas Present from HM Treasury*"), following representations made by the industry and the City of London Law Society, in which we were heavily involved, the Treasury announced a change in policy. The UK implementing legislation will be changed to provide that, if an application for authorisation or registration is submitted without sufficient time for the FCA to determine the application by 22 July 2014 (the end of the transitional year), the AIFM will be able to continue managing AIFs until the FCA has determined the application. However, while this will mean that firms relying on the transitional provisions will, in theory at least, have until 21 July 2014 to submit their applications for authorisation or variation of permission, they will nevertheless be required to comply with all relevant requirements of the Directive from 22 July 2014 even if their application has not yet been determined. Pending authorisation they would also not be entitled to exercise a passport to market fund interests across the EEA. For these reasons it is not a good idea to wait until July to submit the application.

At the time of writing, we are still waiting to see the details in the amending statutory instrument that will give effect to this policy change of heart. The FCA has said that it is aware of the Treasury's announcement and will make further announcements when further details are available but in the meantime encourages firms to submit their applications in accordance with the timelines stated on the FCA website (i.e. 22 January 2014 for small authorised UK AIFMs and depositaries and 22 April 2014 for full-scope UK AIFMs).

**ACTION POINT:** The message is, therefore, that while the 22 January 2014 may no longer be the deadline it previously was, firms must continue to work hard on submitting their FCA applications as soon as possible.

*Have passport, will travel*

Last August ESMA published an opinion ("*Practical arrangements for the late transposition of the AIFMD*" http://www.esma.europa.eu/content/Practical-arrangements-late-transposition-AIFMD) the effect of which is to recognise the right of duly authorised firms in Member States which have transposed the Directive (such as the UK) to be able to exercise their passport rights in those Member States that have not yet transposed the Directive.

This supports the argument that those UK firms that have been authorised by the FCA (see above) should be able to exercise their passporting rights throughout the EU including in those member states which have not fully transposed AIFMD (and also in the non-EU member states of the EEA (Norway, Liechtenstein and Iceland) once the EEA Agreement, to which those countries are signatories, has been updated to include the AIFMD within its scope). Nevertheless the firm's ability to exercise the passport will depend on the law of the jurisdiction into which they are marketing.

**ACTION POINT:** Firms should also note that some jurisdictions which have transposed AIFMD are charging fees upon receipt of an incoming AIFMD passport notification.

*A passport to Pimlico only?*

On a separate issue there is vexed question as to whether there is a passport for the MiFID "top up" services that a full scope UK AIFM is permitted to carry on in accordance with Article 6(4) of the Directive, allowing the firm to provide those MiFID services across the EEA alongside its collective portfolio management services. Both the Treasury and the FCA in the UK believe that there is and should be such a passport. The European Commission, however, is quite adamant that there is *not*. In its Q&A on AIFMD, the Commission says that the AIFM passport "only applies to management and marketing activities" and that an AIFM can only be authorised to provide the services listed in Article 6(4) through an AIFMD authorisation (and it cannot obtain a separate authorisation under MiFID for those activities). This would mean that a firm would not be able to provide MiFID services anywhere in the EEA other than the home state in which it is authorised.

The FCA's application forms have been drafted on the basis that the passport for MiFID services is available and it has said that, where a full scope UK AIFM so requests, it will notify the relevant supervisory authority of the firm's intention to provide MiFID services in the host state.

The FCA and HMT (along with a number of UK trade associations) are continuing their efforts to try to persuade the European Commission and ESMA that there should be a passport, but in the meantime the position is uncertain and highly unsatisfactory. As the FCA warns, however, although it will make passport notifications into host states, there is a risk that the host state authorities will turn down the notification as regards the MiFID activities.

**ACTION POINT:** Full scope UK AIFMs seeking to passport MiFID services alongside their AIFM management activities into other EEA states should consider what the impact to their business might be if one or more of those states turns down the notification.

*Periodic reporting*

Amongst other things, AIFMD (Articles 3(3)(d) and Article 24(1), (2) and (4)) and its implementing legislation requires authorised EEA AIFMs to comply with a range of detailed regulatory reporting obligations. Regulatory reporting obligations also apply to non-EEA AIFMs seeking to market their funds to professional investors in those Member States that have retained their national private placement regime for the time being.

The details of the reporting requirements are beyond the scope of this brief round-up – but, broadly, AIFMs will be required to make periodic reports to relevant competent authorities in accordance with the Directive's requirements using a set of prescribed template forms as stipulated in Commission Delegated Regulation (EU) No 231/2013 (the "Delegated Regulation") and in accordance with final guidelines published by the European Securities and Markets Authority ("ESMA") on 15 November 2013 http://www.esma.europa.eu/content/Guidelines-reporting-obligations-under-Articles-33d-and-241-2-and-4-AIFMD-revised. Those guidelines (which, broadly, confirmed some improvements to what had previously been proposed in relation to the initial reporting date and the first reporting period) were accompanied by a number of electronic reporting templates in XML format, together with IT guidance to assist in the preparation of reporting systems capable of generating XBRL reports. In addition to annual reports in respect of each managed AIF (where required and requested by the competent authority), firms will have to provide periodic reports on prescribed forms relating to the AIFM itself and in respect of each of the AIFs that it manages (including information in relation to investment strategies, main instruments traded, principal exposures, risk profile and (where relevant) leverage).

In addition to its final guidelines, ESMA also published an opinion (the "Opinion") on 1 October 2013 http://www.esma.europa.eu/cs/node/67757. In the Opinion ESMA encouraged Member States to exercise their discretion under the Directive to require AIFMs to report certain additional information over and above the requirements of the original reporting templates set out in the Delegated Regulation. ESMA's reporting templates, as published, included additional fields in this regard (marked with an asterisk).

The ESMA reporting guidelines will be translated into the official languages of the EU: national competent authorities will then have two months from the date of the publication of the translations on ESMA's website to confirm to ESMA whether they comply or intend to comply with the Guidelines. As of 30 January 2014 the translated versions of the guidelines do not appear to have yet been published on ESMA's website and, therefore, technically the two month period has not yet started. However, the FCA has said that it will consult "in due course" on integrating the ESMA material into the FCA Handbook (implying that it will be complying with the Guidelines).

Firms that will be subject to the reporting obligations but unsure as to when the first report will become due and/or as to the periodic frequency that will apply (i.e. annual, half-yearly or quarterly) should take advice. For instance, firms that are already authorised as UK AIFMs will, in certain circumstances, find themselves having to provide AIFMD regulatory reports to the FCA in the first quarter of 2014 (and the FCA has asked those firms to submit completed returns using the XML v1.1 reporting template published by ESMA). However, firms currently relying on the transitional provisions will not have to start complying with the periodic reporting obligations until they are authorised or registered (the ESMA guidelines provide clarification as to when authorised and registered AIFMs should first start reporting).

**ACTION POINT:** Authorised AIFMs, or those in the process of applying for authorisation, should ensure that they are suitably prepared to be able to report using the XML v 1.1 template as and when the first report becomes due. Any doubts as to *what* will need to be reported and/or by when must be resolved in good time. The reporting Guidelines from ESMA, together with the IT guidance, should be worked through carefully, taking into account the AIFs under management, to ensure correct reporting. The guidance is complex and not always clear.

*Remuneration*

In CP13/9 Quarterly Consultation Paper No.2 (September 2013) the FCA published for consultation draft amendments to its AIFM Remuneration Code (in SYSC 19B) and draft supplementary guidance. The draft guidance was intended to cover certain issues in greater depth than the ESMA Guidelines on sound remuneration policies under the AIFMD (which had been published on 11 February 2013) and focused in particular on the application of the proportionality principle on remuneration – i.e. the circumstances in which it would be disproportionate for an authorised AIFM to have to comply with aspects of the AIFM Remuneration Code. For more details see our briefing paper on the consultation http://www.traverssmith.com/media/1348388/ts4-_21126624-v2-aifmd_fca_consultation_on_proportionality_under_the_aif....pdf. The FCA consultation closed on 6 November 2013. The FCA published in final form its General Guidance on the AIFM Remuneration Code on 31 January 2014. We will issue a brief report on this shortly.

**EMIR: reporting deadline is imminent and mandatory central clearing draws near**

The long-drawn out, phased implementation of the European Markets Infrastructure Regulation is continuing in fits and starts. By way of brief summary:

*In force: risk mitigation techniques in respect of non-centrally cleared OTC derivatives:*

In our *End of Summer Postcard* we summarised:

- the obligations that have been in force since 15 March 2013 - timely confirmation of trades, marking-to-market/marking-to-model and the requirement for non-financial counterparties to notify their competent authority (and ESMA) if they exceed the clearing threshold); and
- the additional risk mitigation obligations that have been in force since 15 September 2013 - reconciliation, portfolio compression, dispute resolution procedures.

See our *End of Summer Postcard* http://www.traverssmith.com/media/1348610/end_of_summer_postcard_2013.pdf for more details.

*Imminent: Reporting*

See our recent flyer *EMIR: are you ready to report?* which summarises the requirement under EMIR to report all derivatives transactions (OTC and exchange-traded) to a registered or recognised trade repository, starting from 12 February 2014 http://www.traverssmith.com/media/1368769/emir_are_you_ready_to_report.pdf. Since that note, on 13 January 2014, ISDA and the FOA jointly published the ISDA/FOA EMIR Reporting Delegation Agreement. The document has been drafted as a template contract under which a counterparty with a reporting obligation may appoint a third party to report to a trade repository on its behalf. It should be noted that, while the document was prepared by a working group with representatives from both buy-side and sell-side firms at the two trade associations, the document should not be considered as non-negotiable and firms may wish to consider amendments. The template document is available for download from the ISDA website at: http://www2.isda.org/emir/

*Expected later this year: mandatory clearing*

It is expected that the first mandatory clearing obligations will become operational in the second half of this year. We are awaiting the publication of the draft regulatory technical standards which will specify which classes of derivative will be subject to the obligation and the date from which the clearing obligation will become effective in respect of those classes.

Subject to the exemptions referred to below, in relation to those derivatives or classes of derivative specified by ESMA, the clearing obligation will apply to transactions between any combination of financial counterparties and non-financial counterparties above the clearing threshold (NFC+) in respect of OTC derivatives that are declared by ESMA to be subject to the clearing obligation.

The mandatory clearing obligation will also apply in relation to relevant OTC derivatives transactions where at least one of the counterparties is established in the EU and is a financial counterparty or NFC+; and the other counterparty established outside the EU would be a financial counterparty or NFC+ if it were established in the EU.

Generally, the clearing obligation will not apply where two counterparties that are both established outside the EU (in a "third country") enter into an OTC derivative transaction declared subject to the mandatory clearing obligation unless (a) both parties would be subject to the clearing obligation if they were established in the EU (i.e. they would be a financial counterparty or an NFC+) and (b) the contract has a "direct, substantial and foreseeable effect in the EU".

On 15 November 2013, following a consultation process, ESMA published its Final Report setting out draft technical standards on contracts with a direct, substantial and foreseeable effect within the Union and non-evasion http://www.esma.europa.eu/content/Draft-technical-standards-under-EMIR-contracts-direct-substantial-and-foreseeable-effect-wit. In the draft RTS, ESMA has recommended that a contract will have a direct, substantial and foreseeable effect within the Union if:

- at least one third country counterparty benefits from a guarantee provided by a financial counterparty established in the EU which covers all or part of its liability resulting from the OTC derivative contract, to the extent that the guarantee meets certain quantitative thresholds; or

- two counterparties established in a non-EU country enter into an OTC derivative contract through their EU branches and they would both qualify as financial counterparties if they were established in the EU (e.g. because they are banks, investment firms, insurers etc).

The European Commission has until 15 February 2014 (i.e. three months from submission of ESMA's Final Report) in which to decide whether to endorse the draft regulatory technical standards.

There is an exemption from the clearing obligation for intra-group transactions, subject to the satisfaction of certain conditions. Prior FCA consent is required. The FCA has started accepting applications from firms wishing to rely on the intra-group exemption, although currently only notifications for exemptions in relation to transactions between two group entities which are both established in the UK can be submitted to the FCA via the EMIR Web Portal – the FCA has 30 calendar days to consider applications. See http://www.fca.org.uk/firms/markets/international-markets/emir/emir-notifications-and-exemptions for further details. Details as to how and when submissions will be accepted in relation to derivatives transactions between UK firms and non-UK counterparties appear on the EMIR Web Portal Q&As webpage at: http://www.fca.org.uk/firms/markets/international-markets/emir/web-portal-qas?category=clearing-exemption-for-intragroup-transactions.

Finally, there is a temporary exemption from the clearing obligation for pension scheme arrangements (although they are not exempt from the risk mitigation obligations in respect of non-centrally cleared trades nor from the reporting obligation (see above)). Broadly, the clearing obligation will not apply to such schemes until 15 August 2015, although there are provisions within the legislation to extend that temporary exemption until August 2018. In order to benefit from the exemption a notification will be required: the FCA says that it is expecting to grant exemptions on an industry-wide basis for a type of entity or arrangements and is currently in the process of discussing the matter with the relevant UK trade associations to facilitate this.

*Expected 1 December 2015: margin requirements for non-centrally cleared OTC derivative contracts*

Under EMIR, financial counterparties are required to have risk management procedures that require the timely, accurate and appropriate segregation of collateral in relation to OTC derivative contracts entered into on or after 16 August 2012. Non-financial counterparties are required to have such procedures with respect of OTC derivatives entered into on or after the date on which they exceed the clearing threshold.

These margin requirements will be phased in over a four year period: subject to the implementation of draft technical standards (which are currently being drafted by ESMA) variation requirements for non-centrally cleared trades would apply from 1 December 2015 and initial margining requirements would be phased in between 1 December 2015 and 1 December 2019.

*Miscellaneous EMIR publications:*

Publications of note relating to EMIR that have recently appeared include the following:

On 20 December 2013 ESMA published an updated version of its Questions and Answers on the implementation of EMIR. Amongst other things, this included specific Q&A in relation to the obligation for counterparties to report exchange traded derivativeshttp://www.esma.europa.eu/content/EMIR-QA.

- On 18 December 2013, the European Commission published an updated version of its Frequently Asked Questions on EMIR http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/emir-faqs_en.pdf. This included the Commission's views on the interpretation of the concept of an "undertaking established in the Union" for the purposes of the definition of a non-financial counterparty and the circumstances in which EMIR could apply to municipalities.

## New Year, New Approach

Our recent experiences with the FCA indicate that they are taking a much stricter approach in respect of a number of clearance and approval processes than was the case with the Financial Services Authority. This change of approach has not been publicly announced, but is evident from the way in which the regulator is dealing with applicants for various forms of approval. Firms should bear this mind when applying for approvals from the FCA.

## New Year, New Rules (1): Promotion of non-mainstream pooled investments

By way of reminder (rather than news we hope), on New Year's Day the FCA's new rules and guidance regarding the promotion to retail investors of "non-mainstream pooled investments" finally came into force, having first been consulted upon by the Financial Services Authority back in August 2012 and finalised in June 2013. The new rules and guidance appear in COBS 4.12, as amended http://fshandbook.info/FS/html/FCA/COBS/4.

The term "non-mainstream pooled investment" is used by the FCA to catch not only unregulated collective investment schemes but also what it referred to in its consultation paper as "close substitutes" – i.e. products which provide access to the same kind of investment strategies that are often pursued by unregulated collective investment schemes. The FCA's collective definition therefore captures units in unregulated investment schemes, units in qualified investor schemes, securities (other than "excluded securities") issued by special purpose vehicles, traded life policy investments and rights to or interests in any of those things. The definition of "special purpose vehicle" is broad but, helpfully, "excluded securities" include shares in investment trusts, VCTs and REITs and so the marketing restriction do not apply to them.

In very broad outline, COBS 4.12 as amended:

- extends the pre-existing marketing restriction (which applied solely to the promotion of unregulated collective investment schemes) to cover the additional categories of NMPI outlined above; and

- removes some of the pre-existing exemptions from the marketing restriction, amending others and creating some new exemptions. In addition, new guidance has the effect of imposing a greater administrative burden and risk on the regulated firm seeking to rely on the exemptions. However, exemptions remain in place allowing promotions of NMPIs to non-retail clients (i.e. eligible counterparties or professional clients (which will include retail clients who have been opted up to elective professional status)) and also to employees (which should generally make it possible for private equity/venture capital firms to continue to offer co-investment and carried interest schemes to their staff).

**ACTION POINT:** Firms should ensure that their compliance manuals are updated to take account of the changes, together with financial promotion approval procedures.

## New Year, New Rules (2): Implementation of CRD IV

On 1 January 2014, new and amended PRA and FCA rules came into force in implementation of the Fourth Capital Requirements Directive (2013/36/EU) and the Capital Requirements Regulation (No. 575/2013) (collectively referred to as "CRD IV"). This note focuses exclusively on the FCA changes.

Although the Prudential sourcebook for Investment Firms (IFPRU) is up and running, as at 30 January 2014 the FCA had still not managed to consolidate many of the other significant changes into its Handbook Online. Except in the case of IFPRU therefore, firms should exercise extreme caution when referring to the rules online (many of which will be out of date) and, as unsatisfactory as it is, should cross-refer to the relevant legal instruments (copies of which appear in the final Policy Statement (PS13/10) http://www.fca.org.uk/your-fca/documents/ps13-10-crd-iv-for-investment-firms published on 13 December 2013, a matter of two weeks before the transposition date of 1 January).

The revised rules – and the provisions of the CRR, which has direct application to relevant firms in the UK – are complex. The precise application of the requirements to individual firms – including those relating to remuneration and reporting - depends upon a number of factors. If firms are unsure of how the rules affect them, they should seek specific advice.

In terms of the FCA Handbook:

- there is a new **Prudential Sourcebook for Investment Firms (IFPRU)** – as stated above, this is now live on the Handbook Online. IFPRU applies to those investment firms which are subject to the full CRD IV requirements and which are categorised as "IFPRU investment firms" (they are no longer subject to BIPRU or GENPRU). Such firms are sub-categorised into "full-scope IFPRU investment firms", "IFPRU limited activity firms" and "IFPRU limited licence firms" (broadly replicating the BIPRU sub-categories that had previously existed), as well as Exempt IFPRU commodities firms (a partial extension of requirements to commodities derivatives specialist firms).

- a former BIPRU limited licence firm will be classified as an IFPRU limited licence firm if it holds client money or provides safekeeping and administration services or if it carries on the MiFID activity of placing of financial instruments on a firm commitment basis. A full-scope UK AIFM with an Article 6(4) AIFMD MiFID "top up" (i.e. a "collective portfolio management investment firm") which is authorised to provide safekeeping and administration services or hold client money in connection with its MiFID business will be an IFPRU firm. The FCA has broadly copied the CRD III Pillar 2 regime (from the previous versions of BIPRU and GENPRU) into IFPRU. However, subject to that, such firms are subject to a substantially revised set of rules on regulatory capital and pay regulation and, in particular:

    - new "COREP" financial reporting requirements, with the first reports due by the end of May 2014 in respect of Q1 2014;

    - new "FINREP" financial reporting requirements, where the firm is subject to International Accounting Standards;

    - new rules on what may be included in and what must be deducted from regulatory capital;

    - new rules on the risk weighting of any derivative exposures on the firm's balance sheet, including "credit valuation adjustments"; and

    - new CRD IV requirements in relation to remuneration – IFPRU firms are subject to the Remuneration Code in SYSC 19A which include a 1:1 bonus cap (which can be increased to 2:1 but only with shareholder approval). The UK has challenged this bonus cap in the European Court of Justice. IFPRU limited licence firms and some others will generally be permitted to disapply the new bonus cap rules on the basis of the FCA's revised proportionality guidance.

- **BIPRU** and **GENPRU** (as revised) now generally apply to a newly-defined category of "BIPRU firms". These are MiFID firms which are only authorised to perform the MiFID activities of executing orders on behalf of clients and/or carrying on portfolio management (and which may also provide reception and transmission of orders and/or investment advice) and which are not authorised to provide safekeeping and administration services and do not hold client money or assets. A full-scope UK AIFM (or incoming EEA AIFM branch) with an Article 6(4) AIFMD MiFID "top up" (i.e. a "collective portfolio management investment firm") which is not authorised to provide safekeeping and administration services or hold client money in connection with its MiFID business will be a BIPRU firm and be subject to BIPRU and GENPRU. Note that:

    - FCA has exercised its right of derogation (under Article 95(2) CRR) to maintain the *status quo ante* rules in CRD III – i.e. the rules which applied as at 31 December 2013 (so in practice BIPRU firms are not subject to CRD IV). These include the pre-1 January 2014 rules on pay regulation, which are now set out in SYSC 19C (the BIPRU Remuneration Code). Firms within this category will continue to submit their regulatory returns as before and will not be subject to COREP and FINREP. However, where these firms form part of a consolidation group with an IFPRU investment firm, the IFPRU group capital rules will apply in place of the BIPRU rules;

    - the FCA contacted a number of BIPRU firms in the Autumn of 2013 asking them to consider whether they would be entitled to remain on the BIPRU (CRD III) treatment after 1 January 2014 or not they would become subject to the CRD IV http://www.fca.org.uk/static/documents/faqs-firms-remaining-on-bipru.pdf. As the FCA explained, a firm would only be able to remain subject to the CRD III treatment if (in addition to not being permitted to carry out dealing on own account, underwriting/placing financial instruments on a firm commitment basis and/or operating a Multilateral Trading Facility) it did not carry on the MiFID service/activity of placing of financial instruments without a firm commitment basis. Firms were asked to respond to the FCA by 20 November 2013 confirming whether or not they carried on this activity (since the MiFID activity does not have a direct or identically-worded equivalent in the regulated activities/Part 4A permissions regime and so would not appear on the Register). In December 2013 the FCA sent letters to all CRD firms confirming its understanding of their status as either CRD III or CRD IV.

- **IPRU(INV)** continues to apply to exempt CAD firms – i.e. firms whose MiFID activities are limited to investment advice and/or reception and transmission of orders and which are not authorised to provide safekeeping and administration of assets and which do not hold client money or assets in connection with their MiFID business. These will not be subject to CRD IV requirements.

- **Chapter 11 of IPRU(INV)** applies to collective portfolio management firms (i.e. full-scope UK AIFMs without an Article 6(4) MiFID "top up") and collective portfolio management investment firms (i.e. full-scope UK AIFM or incoming EEA AIFM branches with an Article 6(4) MiFID "top up" and UCITS investment firms). Note that a collective portfolio management investment firm will also be subject to the requirements of either (i) GENPRU and BIPRU (if it is a BIPRU firm) or (ii) IFPRU (if it is an IFPRU investment firm) – see above.

- A small authorised UK AIFM that is not also a UCITS management company will be subject to **IPRU(INV) 5** if it is an investment management firm, **GENPRU** and **BIPRU** if it is a BIPRU firm or IFPRU if it is an IFPRU investment firm.

A table setting out a brief overview of main types of firm and relevant FCA Rules following the CRD IV changes is attached in the Annex (this has been updated from the one which appeared in our End of Summer Postcard).

## Dealing commission: FCA consultation still open

There is still time for investment managers to make submissions, either direct or through their trade association, to the FCA's consultation paper on the use of dealing commission (CP13/7). Consultation closes on **25 February 2014**. Our briefing paper on the consultation is here http://www.traverssmith.com/media/1365595/dealing_commission_consultation.pdf.

## Consumer credit: transfer to FCA

On 1 April 2014 the FCA will take over regulation of consumer credit from the Office of Fair Trading. Affected firms will be subject to new requirements from 1 April 2014.

Any firm which currently holds a valid OFT consumer credit licence and which intends to continue carrying on consumer credit activities on and after 1 April 2014 must register for interim permission with the FCA by 31 March 2014 at the latest (although a firm which is granted a new OFT licence between 18 March 2014 and 31 March 2014 will have a little longer - until 14 April 2014 - in which to make its interim permission registration). Any firm which carries on consumer credit activities after 1 April 2014 (or, if relevant, 14 April 2014) without having obtained interim permission will commit an offence.

Applying for interim permission is not a full authorisation process. It involves registering on the FCA website http://www.fca.org.uk/firms/firm-types/consumer-credit/consumer-credit-interim - the fee is £350. Interim permission will only be effective if the OFT licence is valid as at 31 March 2014. The FCA has produced a step-by-step guide to assist firms in making their registrations http://www.fca.org.uk/your-fca/documents/interim-permission-registration-step-by-step-guide.

Under the interim permission regime firms will be subject to a "light touch" regime whereby, broadly, they will be able to continue carrying on their consumer credit activities as before for a period. Firms will not, during the interim permission period, be required to comply with new consumer credit FCA rule requirements including those regarding approved persons, requirements regarding controllers (and change of control), periodic reporting to the regulator and compliance with complaints rules.

This "business as usual" approach will be complemented by a six-month transitional period, starting on 1 April 2014, during which if a firm can demonstrate that it has acted in accordance with the requirements of the Consumer Credit Act 1974 as they applied on 31 March 2014 and also with the associated OFT guidance, the FCA will not take action against the firm in relation to those corresponding new rules that are substantially the same.

However, it is important to understand that some FCA rules **will apply from 1 April 2014** despite the interim permission regime and the six-month transitional period. These are:

- the FCA's new rules on risk warnings for **on-line** and **other electronic financial promotions;**

- the FCA's high level rules in PRIN, SYSC and GEN:

  - in this regard note that all letters to customers and electronic equivalents will have to carry the statutory status disclosure – i.e. "**Authorised and regulated by the Financial Conduct Authority**". This obligation applies to letters delivered by hand, sent by post or fax and also electronic mail. However, it does not apply to text messages, account statements, business cards or compliments slips (used as such);

  - the FCA's new rules for debt-management firms to indicate the availability of free independent debt advice and to ensure that fees for debt plans are spread so that customers begin paying their lenders from the start.

In addition, additional rules for payday lenders come into effect on 1 July 2014 and the new FCA rules for peer-to-peer lenders come into force on 1 October 2014.

Firms subject to interim permission will be required at some stage to apply for full or limited authorisation from the FCA. The FCA will operate this process on a phased basis between 1 October 2014 and 1 April 2016. In this regard (and as regards the eventual application of the FCA rules), firms will be split into two categories: higher-risk and lower-risk:

| Higher-risk | Lower-risk |
|---|---|
| Consumer credit lending<br><br>Including personal loans, credit card lending, overdrafts, pawnbroking, hire purchase, conditional sales etc. | Consumer credit lending<br><br>Lending activities where main business is selling goods and non-financial services and there is no interest or charges (and not under hire purchase or conditional sale agreements). For example, a sports club that allows payment by instalment for membership, without any additional charge. |
| | Consumer hire<br><br>Hiring goods to consumers, such as tool and car hire |
| Credit brokerage<br><br>Including introducing consumers to lenders; and brokerage services carried on in a consumer's home on more than an occasional basis – e.g. double-glazing sellers selling credit to the consumer in their home. | Credit broking<br><br>Broking where main business is selling goods and non-financial services and broking is a secondary activity. For example, a car dealership that introduces customers to lenders. Also includes green deal broking and broking of vehicle lease contracts. But excludes brokerage carried on in the consumer's home on more than an occasional basis. |
| Debt adjusting<br><br>Helping people with their debt problems by taking over their debts or negotiating on their behalf (where a profit is made by the debt adjuster) | Not-for profit debt adjusting<br><br>Including helping people with their debt problems by taking over their debts or negotiating on their behalf, where carried out by a non-for-profit organisation. |
| Debt counselling<br><br>Including advising people on discharging specific debts (where a profit is made by the debt counseller) | Not-for-profit debt counselling<br><br>Including advising people on discharging specific debts where carried out by a non-for-profit organisation. |
| Debt collection<br><br>Collecting debts due to others under credit or hire agreements. | |
| Debt administration<br><br>Carrying out activities relating to consumer credit agreements on behalf of a lender | |
| Credit information services<br><br>Obtaining information about someone's credit record or helping them change their credit record (by a profit making organisation). | Not-for-profit credit information services<br><br>Obtaining information about someone's credit record or helping them change their credit record, where carried out by a not-for-profit organisation |
| Credit reference agency<br><br>Collecting information about consumers' financial standing to inform the decisions of consumer credit firms. | |
| Peer-to-peer lending<br><br>The new regulated activity | |

So, firms carrying on higher-risk activities are likely to have to start applying for full FCA authorisation as from 1 October 2014. Firms carrying on lower-risk activities only will be able to apply for a limited permission instead of full authorisation and will be subject to less intensive supervision and fewer rules requirements.

Any firm which intends to carry on new consumer credit activities after 1 April 2014 will have to apply for full authorisation or limited permission as applicable. This will be true of a firm that has interim permission as from 1 April 2014 but wishes to carry on additional credit activities that were not covered by its OFT licence as of 31 March 2014.

**ACTION POINTS:** Firms with existing OFT licences wishing to carry on consumer credit activities on and after 1 April 2014 must ensure that they have submitted their interim permission registration by 31 March 2014 at the very latest. Despite the interim permission regime and the six-month transitional period during which, broadly, compliance with the Consumer Credit Act rules and OFT guidance will be treated as compliance with corresponding FCA rules, firms must (a) ensure that all letterheads and emails contain the FCA statutory status disclosure from 1 April 2014 and (b) all online and other electronic financial promotions issued on or after 1 April 2014 comply with the FCA's risk warnings rules.

## PART B: THE FORECAST: GLOOMY, WITH CONTINUING UNSETTLED CONDITIONS

### MiFID 2/MiFIR – Informal political agreement reached in trilogue

On 14 January 2014 (apparently after an "all-nighter") the European Council, under the Greek Presidency, and the European Parliament reached an informal political agreement in trilogue on the "MiFID II" legislative proposals, bringing a close to the first stage of the political process. During the coming year, ESMA has the heavy task of consulting on and drafting a large number of "Level 2" measures in relation to MiFID II – without minimising some of the more contentious arguments that there have been within the Level 1 legislation, not least in relation to market structure and the third country provisions, past experience has tended to show that much of the devil ends up in the detail of Level 2.

At the time of writing the legislative text has not yet been published.

### MAD 2: Final adoption draws near

On 20 December 2013, the Council approved a compromise with the European Parliament on the draft directive on criminal sanctions for market abuse (CSMAD) which, alongside the Market Abuse Regulation (MAR), will replace the current Market Abuse Directive.

The political agreement means that both CSMAD and MAR can be adopted at first reading. Some amendment to MAR will be required in order to align it with MiFID II (which, as reported above, has now been agreed in trilogue) – the scope of MAR extends to cover the new markets and trading venues and the regulation of commodity derivatives as encompassed by MiFID II. These aligning amendments are scheduled to be considered by the Parliament in its 4 February 2014 plenary session.

Following adoption, the MAR will apply, and the CSMAD must be transposed by Member States, 24 months after they enter into force (which will be on the twentieth day after they are respectively published in the Official Journal). Note that at the time of writing the UK government has not reversed the decision it took in February 2012 not to opt into CSMAD at this stage. As an EU Regulation MAR will apply directly in the UK, without any requirement for transposition.

In common with the MiFID II process, a number of MAR implementing measures will be required on a number of technical issues. Again, ESMA will be busy in consulting on and drafting these – in parallel with the MiFID II implementing measures – during the course of 2014.

On 14 November 2013, ESMA published a discussion paper http://www.esma.europa.eu/content/ESMA%E2%80%99s-policy-orientations-possible-implementing-measures-under-Market-Abuse-Regulation setting out in detail its policy orientations and its initial proposal for MAR implementing measures. This is open for comments until **27 January 2014**.

### Other European legislation expected to be finalised soon

Other important pieces of European legislation which are nearing finalisation and which are therefore likely to be in force over the next couple of years or so are set out below. We will provide further details as and when final text becomes available.

- **The Fourth Money Laundering Directive (MLD4)** – this is currently being considered by Parliament and Council, with the aim of adopting the Directive at first reading. ECON and LIBE are expected to vote on joint draft report on 22 January 2014. The European Parliament has an indicative plenary sitting date of 2 April 2014. Subject to the legislative process, the Directive is likely to come into force in 2016 (2 years after adoption of Directive).

- **The recast Insurance Mediation Directive (IMD2)** – The European Parliament is to consider the Directive at its plenary session of 24 to 27 Feb 2014. Level 2 measures/Level 3 guidelines are expected this year and (again subject to the legislative process) the new regime likely to come into force in 2016 (two years after adoption of the Directive).

- **ELTIF Regulation** – proposal for a Regulation on European Long-Term Investment Funds (ELTIF Regulation). An ELTIF is a proposed type of collective investment vehicle that will allow institutional and private investors to invest, via the fund, in companies and projects needing long-term capital (such as infrastructure projects). A cross-border passport would be available for an ELTIF, provided it complies with specific rules.

  The European Parliament is due to vote on the Regulation in its 14-17 April 2014 plenary session. Depending upon how the legislative process unfolds, the Regulation could be in force in early 2015. For more details on the ELTIF Regulation, see the summary in the Annex of our *End of Summer Postcard:*
  http://www.traverssmith.com/media/1348610/end_of_summer_postcard_2013.pdf.

## Financial stability: into the shadows

It seems that every other major regulatory initiative these days was prompted, in some way, by the financial crisis of 2007/2008. The international initiatives regarding the so-called "shadow banking system" certainly were (despite the pejorative overtones of the term, it seems that it is here to stay). Back in November 2010 the G20 instructed the Financial Stability Board, together with other international bodies, to develop recommendations to strengthen the oversight and regulation of the shadow banking system. The aim has been to reach into the "shadows" of the financial sector – beyond the orthodox banking sector - and to extend regulation and oversight to all "systemically important financial institutions, instruments and markets" which perform bank-like functions.

The overriding supervisory concern has been that, as an alternative to the orthodox banking system, the shadow banking system allows the accumulation of large amounts of debt within the financial sector on an unregulated, or at least a less regulated basis. Furthermore, although there is no empirically-certain data, it is also estimated (by the FSB in its Global Shadow Banking Monitoring Report 2012) to be large, potentially half the size of the regulated banking system and because it is inextricably linked to the rest of the financial sector – including, significantly, the regulated banking system – the risk of a failure within that system causing systemic failures throughout the whole financial sector through a "wave of contagion" is considered to be high. In short, it is considered to be another financial crisis waiting to happen.

In terms of the international initiatives, the FSB has been involved since its mandate in 2010 in a pursuing a number of pieces of work, including a public consultation process, culminating in the publication on 29 August 2013 of the following policy documents:

- *FSB: Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* http://www.financialstabilityboard.org/publications/r_130829c.pdf

- *FSB: Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* http://www.financialstabilityboard.org/publications/r_130829b.pdf

- *FSB: An Overview of Policy Recommendations* http://www.financialstabilityboard.org/publications/r_130829a.pdf

These policy recommendations were endorsed by the G20 leaders in September 2013. The international work is ongoing. For instance, as part of the overall package of measures, the FSB was asked in 2011 to prepare, in consultation with IOSCO, methodologies to identify systemically important non-bank non-insurer financial entities. The FSB and IOSCO's work has resulted, most recently, in the publication on 8 January 2014 of a *Consultative Document: Assessment Methodologies for Identifying Non-bank Non-insurer Global Systemically Important Financial Institutions*
http://www.financialstabilityboard.org/publications/r_140108.htm

The consultation paper sets out the proposed assessment methodologies for identifying non-bank non-insurer globally systemically important financial institutions (snappily abbreviated as "NBNI G-SIFIs"), extending the systemically important financial institutions framework that currently covers banks and insurers to all other financial institutions. In addition to a high-level framework for identifying NBNI G-SIFIs, the document includes some sector-specific methodologies in respect of finance companies, broker-dealers and investment funds (including money market funds, ETFs, hedge funds and private equity/venture capital funds). It notes that more work is required to determine whether *separately managed accounts*, while not collective investment schemes, should be included. The "default" indicator for assessing systemic importance is that of net assets under management or the net asset value for the fund. However, in the specific case of hedge funds, the consultation paper suggests that size and significance could be measured by reference to gross assets under management (i.e. including leverage), measured by using the gross notional exposure method; and that hedge funds with either $100 billion (or more) in net assets under management or a value set between $400-600 billion (or more) in gross notional exposure would be subject to an assessment by national authorities. The consultation closes on **7 April 2014**.

The European Commission has contributed to the international initiatives but has also been pursuing its own review of the shadow banking sector.

*Communication from the Commission – Addressing new sources of risk in the financial sector*

On 4 September 2013, the European Commission published a Communication http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0614:FIN:EN:PDF , following up on its Green Paper on shadow banking of March 2012. It says its proposals are fully in line with the recommendations issued so far at international level.

Shadow banking (for the purposes of the European Commission's initiatives) is defined as "a system of credit intermediation that involves entities and activities outside the regular banking system". It includes entities which, although not regulated like banks, are "bank like" in their operations by:

- taking in funds with deposit-like characteristics;

- performing maturity and/or liquidity transformation – i.e. lending over long periods and taking in deposits that are available immediately;

- allowing credit risk transfer – by assuming the risk that a "borrower" will not be able to repay;
- using direct or indirect leverage.

This broad description is capable of capturing a wide range of entities, such as securitisation vehicles, money market funds and institutions that provide credit or credit guarantee. Investment funds are also caught to the extent that they provide credit or are leveraged and therefore many private equity funds and hedge funds will be within the European Commission's "shadow banking" sector. The proposals in relation to shadow banking must therefore watched closely by the asset management sector. The biggest risk is that some asset managers or even funds themselves – which are alleged to be "bank-like" in their activities but are, after all, already subject to heavy regulation - end up being *prudentially* supervised as if they are banks.

A number of EU measures to regulate shadow banking sector participants are already in place or are in the place of being implemented. These cover hedge funds, private equity funds and real-estate funds under AIFMD, derivatives counterparties under EMIR, insurers under Solvency II (which includes more stringent requirements in relation to securitisation arrangements) and managers under the UCITS Directive.

Amongst the future measures recommended by the Communication, the following are notable:

- A proposal for a **Regulation on Money Market Funds** – this has been adopted by the Commission and was published on the same day as the Communication. It defines a money market fund (MMF) as a mutual fund that invests in short-term debt such as money market instruments issued by banks, governments or corporations. MMFs provide a source of short-term financing for financial institutions, corporate bodies (as part of their treasury function) and governments. Money market instruments traditionally include treasury bills, commercial paper or certificates of deposit. Under the Regulation, rules will be applied to the operation of an MMF, including with regards to prescribed levels of daily and weekly liquidity within an MMF. MMFs are defined as a short-term MMF (holding short-term money market instruments with a residual maturity not exceeding 397 days) or a standard MMF (holding short-term money market instruments with a residual maturity not exceeding two years). "Constant Net Assets Value Money Market Funds" (i.e. broadly, funds which maintain an unchanging value NAV per unit or share) must maintain a 3% capital cushion or buffer (i.e. a capital reserve amounting to 3% of assets under management to support a stable NAV in circumstances where the underlying assets of the MMF are subject to negative price movements). An MMF will have to be authorised under the Regulation before it can be established, marketed or managed in the European Union over and above the obligations under the UCITS Directive or the AIFMD. The proposal for the MMF Regulation has been sent to the European Council and Parliament, and so will be discussed during the coming months. Once agreed (which could be during the course of 2014) it will be directly applicable in the UK on the twentieth day following its publication in the Official Journal. See: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52013PC0615:EN:NOT.

- In order to increase transparency the communication suggests amongst other things:

    - developing *central* repositories for reporting of derivatives under EMIR and other instruments under the revised Markets in Financial Instruments Directive (MiFID II);
    - implementing the Legal Entity Identifier (LEI). While a global governance body – the LEI Regulatory Oversight Committee – is in place and operating, the Commission says it will consider the possibility of preparing a legislative proposal mandating the use of the LEI;
    - increasing the transparency of securities financing transactions (e.g. securities lending and repurchase agreements) – see also, the FSB's Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos. The Commission is following an initiative from the ECB to establish a central repository for the collection of data on repos in the EU and will monitor this work in the light of the FSB's Policy Framework.

- The Commission is also considering legislating in relation to securities financing transactions, following its work into the potential problems caused by "chains" of collateral and the lack of transparency as to the ownership of property.

- A review is being carried out into the way that Member States interpret the definition of "credit institution" in order to determine whether there are differences in interpretation amongst Member States of concepts such as "repayable funds from the public" or even the concepts of "credit" and "deposits" and if there are (and entities are not prudentially regulated as credit institutions when they should be) the Commission may seek to clarify the definition of credit institution within the Capital Requirements Regulation. In addition to the proposal on money market funds, the communication indicates that an enhanced framework for certain investment funds could be implemented by strengthening the UCITS framework. There are currently significant differences of views across the EU as to whether non-bank funds can originate loans without a banking licence. This is an area debt funds should monitor closely.

- The Commission urges Member States to ensure that the risks associated with the shadow banking sector are identified and monitored at national level. It notes that this task is often performed by bodies in charge of the macro-prudential supervision of the financial sector (in the UK, this is the Bank of England's Financial Policy Committee – see the item below). The Commission will "pay attention" to the quality of this national monitoring and whether there is close cooperation between the other national bodies.

For further information on any of the issues discussed above, please contact any of the financial services partners named below.

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## ANNEX

### CRD IV: Brief overview of main types of firm and relevant FCA Rules

| Firm type | Basic definition | Application of CRD IV regime | Sourcebook(s) |
|---|---|---|---|
| Full-scope IFPRU investment firm | MiFID investment firms excluding limited activity firms and limited licence firms | Subject to full CRD IV regime, except for:<br>• FCA derogation from liquidity requirements (until 2015), but liquidity reporting requirements will apply from 2014 to firms classified as significant firms which have balance sheet sizes equal to at least £50 million; and<br>• possible FCA derogation from capital conservation buffer and countercyclical capital buffer requirements for small and medium sized investment firms (dependent upon which UK authority is designated by HM Treasury as having such discretion) | IFPRU |
| IFPRU limited activity firm | Equivalent to pre-1 January definition of BIPRU limited activity firm | Benefit from the following exemptions from the CRD IV regime:<br>• proposed derogations applicable to full-scope IFPRU investment firms above;<br>• exempt from leverage requirements on an individual basis;<br>• parent investment firm may choose not to apply leverage requirements on a consolidated basis where all entities in a group of investment firms are exempt from leverage requirements on an individual basis;<br>• rules on large exposures do not apply; and<br>• potential FCA waiver of own funds requirements on a consolidated basis for groups of investment firms | IFPRU |
| IFPRU limited licence firm | Equivalent to pre-1 January 2014 definition of BIPRU limited licence firm, except that it only covers such firms which:<br>• hold client money; or<br>• provide safekeeping and administration; or<br>• place financial instruments without a firm commitment.<br>Also now includes former exempt CAD firms carrying out the ancillary service of safekeeping and administration of financial instruments for the account of clients | Benefit from the following exemptions from the CRD IV regime:<br>• proposed exemptions applicable to IFPRU limited activity firms above;<br>• exempt from liquidity requirements;<br>• exempt from capital buffer requirements; and<br>• exempt from regime permitting branches of firms to be classified as significant branches | IFPRU (and if a full scope UK AIFM, IPRU(INV)11) |
| BIPRU firm | MiFID investment firms that are authorised to provide one or more of the following MiFID services:<br>a) execution of orders on behalf of clients; or<br>b) portfolio management,<br>and may provide one or more of the following investment services:<br>c) reception and transmission of orders in relation to one or more financial instruments;<br>d) investment advice;<br>but which are not permitted to provide safekeeping and administration of financial instruments for the account of clients and therefore are not permitted to | Not subject to CRD IV in practice because they benefit from FCA exercise of a CRR derogation allowing to carry forward the CRD III rules as at 31 December 2013, providing a less onerous definition of own funds and simplified credit risk calculation and reporting under GABRIEL (not COREP) | GENPRU and BIPRU (and if a full scope UK AIFM, IFPRU(INV)11) |

| | | | |
|---|---|---|---|
| | hold money or securities belong to their clients and may not at any time place themselves in debt with those clients (and excluding the firms listed in BIPRU 1.1.7R) | | |
| Exempt CAD firm | MiFID investment firms that are authorised to provide **only** one or more of the following MiFID services:<br>a) investment advice; or<br>b) reception and transmission of orders in relation to one or more financial instruments,<br>but which are not permitted to provide safekeeping and administration of financial instruments for the account of clients and therefore are not permitted to hold money or securities belong to their clients and may not at any time place themselves in debt with those clients. | Subject to CRD IV base capital requirement, but otherwise outside CRD IV regime | IPRU(INV) |