TRAVERS SMITH

Financial Services and Markets

2015 - a year of change and planning for change

In 2015, firms will continue to be affected by significant changes to the FCA's rules as part of its domestic agenda and by a number of European legislative initiatives. Although some of these initiatives, such as the extensive changes that will be introduced by MiFID II or the update to the market abuse regime contained in MAD II, will not take effect this year, the importance of advance planning and preparation for all firms cannot be over-emphasised. At the same time, there may be some positive developments for alternative investment fund managers, with the potential for further progress on the passporting and infrastructure fund regimes. As a result, 2015 looks set to be another year of obligations and opportunities, permeated throughout by that familiar mantra – if you fail to prepare, you prepare to fail.

This briefing covers the following issues:

UK developments

- The new CASS rules which come into effect on 1 June. A more detailed explanation including a list of suggested action points is available to clients on request to carol.durndell@traverssmith.com.
- The proposals for a permanent ban on the retail distribution of contingent convertible instruments in the UK.
- The proposed new regime for the regulation of individuals who work in the banking sector.

European developments

- A very brief overview of the next stages in the implementation of EMIR - i.e. the phased introduction of (i) mandatory central clearing in respect of certain OTC derivatives transactions and (ii) requirements for the exchange of collateral in relation to non-cleared OTC derivatives. Although all but the very largest of in-scope firms will have until 2016 at the earliest until the new rules take effect, a great deal of preparation will be required in the coming months of this year. The FCA has said it expects firms to have "robust and specific plans in place" to be able to comply with these requirements as they come into force.
- The current state of play in relation to MiFID II, MAD II, the ELTIF Regulation, AIFMD and the EuVECA and EuSEF regimes, so that firms can consider whether to engage with their trade associations in relation to outstanding consultations and also start their preparations for implementation, as appropriate.

CASS - significant changes take effect in June 2015 - will you be ready?

In June 2014, the FCA announced a major overhaul of the existing client assets rules in a policy statement (PS 14/9). An initial set of changes to CASS came into force on 1 July 2014, followed by a second set on 1 December 2014, subject to transitional relief in certain circumstances. We published a client briefing on those amendments and the related key action points, which is available at http://www.traverssmith.com/media/1439199/cass_recast_in_time_for_christmas.pdf

Countdown to the third and final phase of CASS reforms

On 1 June 2015, the final set of revisions to the CASS rules will take effect. They will make a number of important changes which will impact the substantive manner in which firms operate their businesses and the way in which they deal with their clients. A

number of transitional reliefs for previous amendments will also cease to apply as from that date. In addition, there will be a general re-ordering of the format of the CASS sourcebook, resulting in some provisions moving to new locations.

The June 2015 changes are likely to require a very detailed review of many aspects of a firm's operations and may require new contractual arrangements with existing clients and third parties. The FCA views the changes to CASS as critical investor protection measures and will expect firms to be compliant on time.

We provide a short summary of these changes and their potential impact on firms below. A more detailed explanation which includes suggested action points is available to clients on request to carol.durndell@traverssmith.com

Firms should not underestimate the significance of some of the changes or the time and effort that will be needed to comply with them.

The paragraphs below detail the key changes to the CASS rules that will take effect on 1 June 2015. In order to view these changes in the online FCA Handbook, firms should use the "time travel" facility at the top of the screen at http://fshandbook.info/FS/html/FCA/, selecting 1 June 2015 from the drop-down dates and clicking the "Set" button, before navigating to the desired part of the CASS sourcebook.

Changes to existing agreements/terms of business by 1 June 2015 – a summary

Changes which may require re-papering of, or amendments to, a firm's existing agreements or terms of business include:

- A firm's ability to register legal title to client assets in the name of a third party or in the name of the firm itself will be subject to additional restrictions, as will the circumstances in which a firm can use the same name to register title to its own assets as well as client assets.
- Payments of client money must be received directly into a client bank account, rather than paid into the firm's account and then segregated.
- Money arising in connection with client custody assets (e.g. dividends on shares or coupons on bonds) must be treated as client money subject to the segregation requirement.
- New notification requirements will apply to firms when they receive requests from clients to terminate existing title transfer collateral arrangements.
- Prior written client agreement is required if a firm wishes to rely on the delivery-versus-payment exemption for transactions relating to units in regulated collective investment schemes.
- Firms must provide a client upon request with a statement of any client assets or client money balances held for the client.

Changes to policies, procedures etc. by 1 June 2015 – a summary

Changes that may require firms to revise and amend their existing internal systems and controls include:

- The additional restrictions on registration of client assets in the name of the firm or third parties and associated due diligence requirements.
- The requirement to keep written records of the required periodic reviews of custody arrangements when firms are depositing client assets with third party custodians.
- The requirement for client money to be received directly into a client bank account.
- The requirement for physical receipts of client money such as cash, cheques or other physical payment orders to be paid into a client bank account promptly and in any case generally by no later than the next business day and to be kept physically secure in the intervening period.
- New rules governing the treatment of client money arising in connection with client custody assets.
- New due diligence requirements which will apply prior to the opening of client bank accounts and new requirements for periodic review of that due diligence.
- The availability of "prudent segregation" of the firm's money into a client bank account (which will be treated as client money in the event of the firm's insolvency) and the requirement for a clear documented policy on the risks that such segregation is designed to mitigate.

- The requirement that a firm must ensure that cleared funds are used for client transactions, so that one client's money is not being used to fund another client's transactions.
- The rule (previously guidance) requiring payment of any money due to a client promptly, and in any event by no later than the business day after the money has become due and payable.
- New and detailed record keeping and reconciliation requirements relating to client money.
- New guidance clarifying the record-keeping requirements for non-written client mandates.
- New reporting requirements for client assets and client money statements.

Further potential changes to documents and practices as a result of the expiry of transitional reliefs

A range of transitional reliefs (explained in our previous client briefing which is accessible via the link above) are due to expire from 1 June 2015, so firms which relied on the relief will need to have changed their procedures, documents and practical arrangements by then. These reliefs affect the following areas:

- The requirement for acknowledgement letters for client bank accounts to be in the FCA's standard form.
- The revised rules applicable to firms that operate the alternative approach to client money segregation.
- The new required content for title transfer collateral arrangements.
- The requirement for firms relying on the banking exemption to notify clients that the firm will be holding their funds as banker and not as a trustee under the client money rules.
- The new disclosure requirements for client asset protection arrangements in relation to non-retail clients.
- The requirement for third party custody agreements to be in written form, covering a minimum range of issues.
- The narrowing of the DvP exemption for transactions effected through commercial settlement systems.
- The revised requirements for firms using the non-standard method of client money reconciliation.
- The requirement for auditor assurances to be provided by firms operating the alternative approach to client money segregation and the non-standard method of internal client money reconciliation.

FCA decides that CoCos may leave a bitter aftertaste in the retail market

The FCA introduced a temporary ban (subject to limited exceptions) on the retail distribution of contingent convertible instruments ("**CoCos**") from 1 October 2014 for 12 months. CoCos are debt/equity hybrid instruments which are designed to assist in absorbing losses incurred by the entity which issues them. The contractual terms provide that if the issuer's regulatory capital falls below a specified level, this will activate the loss absorbency features in the CoCos (e.g. a write-down of the principal amount of the instruments).

On 29 October 2014, the FCA published a consultation paper (CP 14/23) containing its proposals for a permanent restriction on the retail distribution of CoCos. The consultation period closes on **29 January 2015**. The FCA is also proposing to expand the restriction to include the promotion of units or beneficial interests in so-called "CoCo funds", which are unregulated collective investment schemes, qualified investor schemes or special purpose vehicles under which returns are wholly or predominantly linked to, contingent upon, highly sensitive to or dependent upon the performance of, or changes in, the value of CoCos.

UK reform of bank senior management accountability and employee certification

In July 2014, the FCA and the PRA published a joint consultation paper (FCA CP14/13 / PRA CP14/14) on their proposals to increase individual accountability in the banking sector through the introduction of new senior management function and certification regimes.

The consultation closed on 31 October 2014 and the industry is now awaiting the final policy statement. The summary below is based on the consultation paper. A more detailed note on the proposals may be found here.

Senior management functions ("SMFs")

The SMF regime will (at least as proposed) only apply to deposit-taking banks, building societies or very large investment banks which are regulated by the PRA.

Those persons who are allocated a senior management function (as defined by PRA/FCA) will become subject to the "presumption of responsibility". This means that if a contravention of a regulatory requirement occurs in the area of the firm's activities for which (s)he is responsible, the relevant individual may be held accountable for that breach if (s)he is unable to demonstrate that (s)he has taken reasonable steps to prevent that breach. In addition, (s)he may also be subject to criminal prosecution for the new offence of recklessly causing a financial institution to fail.

Certification regime

This is a wider system of "licensing" of individuals working within banks that extends beyond the proposed senior manager regime. The FCA and the PRA have the ability to specify functions that require a firm to certify that any person carrying them out is a "fit and proper person" to perform those functions.

Individuals who are subject to the requirement for certification do not need to be approved by the relevant regulator – it will instead be the bank itself that is required to take reasonable care to ensure that no person performs a certification function unless the firm has certified that individual as fit and proper to do so. The certification must then be renewed annually.

New conduct rules

The PRA and the FCA are each proposing to issue a new set of "Conduct Rules" that will replace the current Statements of Principle and Code of Practice for Approved Persons for firms falling within the new rules. The FCA proposes a broad scope, stating that the only individuals who will not be subject to the FCA Conduct Rules will be those persons whose role would be fundamentally the same if they worked in a non-financial services firm. It has produced a definitive list of persons who are not within scope, which includes receptionists, security guards, print room staff, facilities management, cleaners, personal assistants, HR administrators and IT technology support workers.

Application of the new regime to UK branches of foreign banks

On 17 November 2014, HM Treasury published a consultation paper which proposed to extend the ambit of the Senior Manager regime and certification requirements to UK branches of non-UK banks, although individuals holding SMFs in such branches cannot be liable to prosecution for the new criminal offence of recklessly causing a financial institution to fail.

The deadline for responding to HM Treasury's consultation paper is **30 January 2015**.

EMIR – more pieces of the jigsaw

Mandatory central clearing

The European legislators are adopting a phased approach to the introduction of mandatory central clearing of certain OTC derivatives through a CCP. The publication in the Official Journal of what will be the first of a series of technical standards in this regard is expected soon. These will relate to specified types of interest rate OTC derivatives and will specify when the clearing obligation in respect of those types of derivative will first apply to different categories of in-scope firms. Further RTS are being developed in relation to other classes of OTC derivatives.

We have drafted a note containing a more detailed explanation of this issue, which is available to clients on request to carol.durndell@traverssmith.com.

Exchange of collateral for non-cleared OTC derivatives

Over the coming weeks we expect to see the publication in the Official Journal of technical standards on the final set of risk-mitigation techniques for OTC derivative contracts not cleared by a CCP. Central to these will be measures prescribing the minimum amount of initial and variation margin to be posted and collected by counterparties and the methodology for the calculation of that amount, together with an outline as to the types of eligible collateral.

ESMA consultation on the review of the technical standards on reporting under Article 9 of EMIR

On 10 November 2014, ESMA published a consultation paper on the review of the technical standards on reporting under Article 9 of EMIR. The consultation is here: http://www.esma.europa.eu/consultation/Consultation-Review-technical-standards-reporting-under-Article-9-EMIR

Firms which report to trade repositories under EMIR should consider ESMA's proposed changes to the RTS and ITS carefully, particularly in the light of the practical difficulties they may have faced in reporting under the existing regime. They should consider responding to ESMA's consultation either in their own right or through their trade association.

The consultation closes on **13 February 2015**.

EMIR and the FCA's supervisory priorities for 2015

On 17 December 2014, the FCA updated its webpage on its supervisory priorities for 2015 in relation to EMIR.

Areas of focus will include:

- Compliance with trade reporting requirements, including (i) having established connectivity or appropriate delegated reporting arrangements, (ii) having internal systems to ensure the accuracy of reports and (iii) the acquisition and annual renewal of Legal Entity Identifiers (LEIs).
- NFCs and their assessment and monitoring of their status against the EMIR clearing threshold; and
- Readiness of FCs and NFC+s for the clearing obligation (to be phased in by asset class in accordance with RTS) and for collateralisation of non-centrally cleared OTC derivatives (to be phased in from 1 December 2015).

In relation to the new EMIR obligations coming into force from 2015 onwards referred to in the last bullet point (i.e. the phased introduction of the clearing obligation and the requirements for exchange of segregated collateral), the FCA expects firms to have "robust and specific plans in place to comply with them as they come into force". If there is a reason why full compliance cannot be achieved by the relevant date, a firm should prioritise and have a detailed and realistic plan to achieve compliance within the shortest possible timeframe. However, the FCA warns, this does not prejudge its approach to any instances of non-compliance.

MiFID II – All eyes on ESMA as the new regime starts to take shape

The **MiFID II Directive** and the Markets in Financial Instruments Regulation ("**MiFIR**"), which together constitute the MiFID II legislative package, were published in the EU Official Journal on 12 June 2014. With some minor exceptions, these revised rules will take effect on **3 January 2017**.

MIFID II will result in significant changes to the ways in which firms do business and will have considerable implications for their policies, procedures, systems and controls. Firms should already be starting to identify the ways in which it may impact their business models and the possible implementation steps that will need to be taken. They should also consider whether to engage with their trade associations in making representations on any current and future consultations.

MiFID II builds on the existing MiFID regime in areas such as best execution, inducements and organisational requirements. It also significantly expands the provisions relating to the financial markets, providing in particular for the following:

- more detailed regulation of activities such as algorithmic trading and high frequency trading
- increased transaction reporting requirements both in terms of the firms affected, the instruments concerned and the information required
- greater market transparency, by enhancing transparency requirements for equity markets and subjecting a range of non-equity markets to equivalent rules
- the regulation of a new type of trading venue, known as an "organised trading facility"
- new requirements for third country firms operating in the EU
- product governance rules which will require manufacturers and distributors of investment products to identify target markets for those products and to tailor their distribution strategies and product design to the needs of those markets.

ESMA is currently consulting on the detailed Level 2 legislative measures that will ultimately be adopted by the European Commission. Further important details on the scope and operation of the new regime will continue to emerge throughout 2015.

ESMA has issued the following documents in connection with Level 2 measures under MiFID II:

- a discussion paper (ESMA/2014/548) and a consultation paper (ESMA/2014/549) published in May 2014 containing proposed measures in relation to a number of key areas contained in the MiFID II Directive and MiFIR, including investor protection,

inducements, organisational requirements for firms, product governance requirements, transparency, data publication and transaction reporting;

- a consultation paper (ESMA/2014/1570) published in December 2014 containing ESMA's concrete proposals resulting from the May 2014 discussion paper, including a cost-benefit analysis of the final proposed measures and the text of the proposed regulatory technical standards; and

- a final report containing ESMA's technical advice to the European Commission (ESMA/2014/1569) in connection with the areas raised in the May 2014 consultation paper.

The deadline for responding to the December 2014 consultation paper is **2 March 2015** and a pro forma response form has been published on ESMA's website. The final technical advice published by ESMA in December 2014 will now be considered by the European Commission.

We will be publishing a series of client briefings on MiFID II in 2015 in order to explain the key aspects of the new rules and the resulting implications for firms. In addition, we will be inviting clients to seminars designed to assist firms with their preparations for the implementation of the new regime.

MAD II – Originally MARred by delays, but finally heading on to consultations for Level 2 measures

The Criminal Sanctions for Market Abuse Directive ("**CSMAD**") and the Market Abuse Regulation ("**MAR**"), which together form the "**MAD II**" package, were both published in the EU Official Journal on 12 June 2014. The new regimes introduced by these measures will apply from **3 July 2016**.

From a UK perspective, CSMAD is currently of limited relevance because the UK government chose to exercise an opt-out from the criminal component of the MAD II regime and therefore is not currently bound to implement it. HM Treasury has indicated that it will continue to review the situation and may opt-in to CSMAD at a future date.

By contrast, MAR, by virtue of its status as a European regulation, will apply directly in the law of each Member State, including the UK, although further implementation work will need to be undertaken by ESMA and the European Commission prior to the regime entering into force in mid-2016.

In summary, MAR will amend the current market abuse regime in the following ways:

- The market abuse regime will expand to cover instruments traded on a multilateral trading facility or on the new category of organised trading facility introduced by MiFID II, and any other financial instruments the price or value of which depends upon, or has an effect on the price or value of, instruments listed on those trading venues. This has the potential to result in a significant increase in the scope of instruments covered, including non-EEA financial instruments;

- The market manipulation provisions will be expanded to include spot commodity contracts (except wholesale energy contracts) where the relevant behaviour has, or is likely to have or is intended to have, an effect on the price of a financial instrument which is within scope of the general MAD II market abuse regime;

- MAR will introduce prohibitions on manipulative behaviour relating to benchmarks and will supplement the European Commission's separate workstream on the proposed Benchmark Regulation, which will regulate the quality of benchmark determination;

- MAR explicitly recognises that algorithmic, HFT and other electronic forms of trading may be used for the purposes of market manipulation (although the current Market Abuse Directive may capture certain forms of behaviour using those techniques); and

- Attempted market manipulation will be prohibited, in order to capture situations where a person starts manipulative activities but does not complete them - for example, because there is a technological failure or broker oversight which prevents an order from being acted upon.

On 15 July 2014, ESMA published two consultation papers in connection with MAD II: the first (ESMA/2014/808) related to draft technical advice on possible delegated measures under MAR while the second (ESMA/2014/809) related to draft technical standards under MAR. The deadline for responding to both consultation papers expired on 15 October 2014.

The industry now awaits the final ESMA technical advice and technical standards on the above measures, which, subject to their approval and subsequent adoption by the European Commission, will provide the detailed basis for the operation of the MAD II regime.

AIFMD – Non-EU managers still waiting at passport control, but the gates may be about to open

At present, non-EU AIFMs may only market AIFs in the EU under the national private placement regimes of individual Member States. Similarly, individual EU Member States may permit EU AIFMs to market non-EU AIFs (and EU feeder AIFs of master AIFs which are not EU AIFs managed by an EU AIFM) to professional investors under national private placement regimes. In both cases the relevant firms are therefore subject to multiple varying regimes where seeking to market on a pan-European basis.

ESMA has now started the process which may ultimately result in a "marketing passport" for non-EU AIFMs and for non-EU AIFs managed by EU AIFMs. On 7 November 2014, ESMA published a call for evidence on the AIFMD passport and third country AIFMs (ESMA/2014/1340) in connection with its preparation of advice and an opinion to the European Commission on matters which are relevant to the extension of the current passport arrangements.

The consultation closed on 8 January 2015 and ESMA must now issue the opinion and advice by 22 July 2015. If ESMA's advice recommends the extension of the passport regimes, the Commission has three months to specify a date for the activation of the passporting rules for non-EU AIFMs and non-EU AIFs. Member States would need to implement this in their national legal systems by that deadline.

Member States will retain the ability to operate national private placement regimes for at least three years following the introduction of the passport, after which ESMA will produce advice on terminating the existence of individual national regimes. The earliest date by which national private placement regimes may be terminated is 2018.

European Long Term Investment Funds Regulation

On 5 December 2014, the Council of the European Union published a note (16386/14) indicating that it had reached provisional agreement with the European Parliament on the text for the European Long Term Investment Funds Regulation ("**ELTIF Regulation**"). Subsequently, on 10 December 2014, the Council also issued a press release stating that agreement with the European Parliament had been confirmed.

It currently appears likely that the ELTIF Regulation will become effective at some point in mid-2015. We will be publishing a separate note shortly.

EuVECA and EuSEF Regulations

The European Venture Capital Funds Regulation ("**EuVECA Regulation**") and the European Social Entrepreneurship Funds Regulation ("**EuSEF Regulation**") both came into effect on 22 July 2013.

The EuSEF Regulation is designed to encourage the financing of social businesses within the EU (i.e. businesses whose primary aims are to achieve social goals, rather than to generate profits for their owners).

The EuVECA Regulation is designed to support venture capital activity by encouraging easier cross-border fundraising which will eventually be invested in the real economy.

Both EuSEF and EuVECA managers benefit from a marketing passport provided that they register with an EU competent authority and meet the conditions set out in the relevant Regulations.

Although the EuVECA Regulation and EuSEF Regulation are already applicable in EU Member States, they each contain provisions requiring ESMA / the European Commission to provide further clarification on certain issues such as conflicts of interest, information requirements and the definition of "qualified portfolio undertakings" in which EuSEFs may invest. ESMA published a consultation paper (ESMA/2014/1182) on 26 September 2014 setting out its proposals in this regard. The consultation closed on 10 December 2014. Firms that are considering establishing EuSEFs or EuVECAs will find these proposals of interest, since they are likely to have a direct impact on the operational requirements for such firms and, in the case of EuSEFs, the scope of investments that they may make.

In addition, on 11 November 2014, ESMA published a short Q&A document providing additional guidance on the application of the EuSEF and EuVECA Regulations, which may assist firms in interpreting the registration requirements and the operation of the passporting regime.

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

Travers Smith LLP
10 Snow Hill
London EC1A 2AL

T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

Jane Tuckley
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238

Mark Evans
mark.evans@traverssmith.com
+44 (0)20 7295 3351

Phil Bartram
phil.bartram@traverssmith.com
+44 (0)20 7295 3437

Margaret Chamberlain
margaret.chamberlain@traverssmith.com
+44 (0)20 7295 3233

Tim Lewis
tim.lewis@traverssmith.com
+44 (0)20 7295 3321

Stephanie Biggs
Stephanie.biggs@traverssmith.com
+44 (0)20 7295 3433