MORRISON | FOERSTER

# 2018: BUSINESS AS (UN)USUAL

## European Financial & Regulatory Developments Into 2018

FEBRUARY 2018

2017 in the UK and the rest of Europe seems to have been primarily a year devoted to implementation – both of political decisions already taken and of legislation that had already been enacted. On the political front, Brexit continued to dominate many conversations around EU financial services. Theories circulated that EU decisions on various equivalence and passporting provisions, intended to be based on regulatory system comparisons were being delayed for political reasons linked to the continued non-finalisation of a deal on the post-Brexit relationship between the UK and the rest of the EU. After Brexit, it is likely that UK financial services entities will lose the benefit of EU financial "passports" and may need to try and utilise the existing provisions on equivalence for non-EU countries. Equivalence is a recognition from the EU that the non EU country's financial regulations and supervision are of the same standard as those of the EU. Given that the UK, as a member state of the EU, already has such standards in place, granting equivalence status to the UK post-Brexit would be a logical step. However, politics and logic make strange bedfellows. UK financial services entities will be watching this area closely in 2018.

While UK politicians and civil servants were busy discussing the arrangements for "less EU" in UK life, the European Commission published its thoughts on "more EU" for those countries remaining in the EU, in the form of more direct supervision of EU financial markets by the European Securities and Markets Authority ("**ESMA**") and the other European Supervisory Authorities –the European Banking Authority ("**EBA**") and the European Insurance and Occupational Pensions Authority ("**EIOPA**").[1]

The European Commission also made proposals in relation to enhanced EU supervision (and possible EU relocation) of systemically important non-EU clearing counterparties ("**CCPs**"). If the proposals are finalised in the form proposed, they may help the EU realise its longed-for goal of relocating clearing of euro-denominated derivatives in the EU (rather than in London or New York), but at what price? The agreement between the Commodities and Futures Trading Commission in the U.S. ("**CFTC**") and the European Commission on the mutual recognition of CCPs took years to conclude and these new proposals could be regarded as "moving the goalposts." The CFTC has already expressed its annoyance at these proposals in very clear terms.

Much more negotiation and wrangling will ensue in 2018.

On the regulatory implementation front, most efforts were focused on the Markets in Financial Instruments Directive 2004/39/EC ("**MiFID II**") implementation, the biggest shake-up in EU financial services in a decade. Although the high level MiFID II provisions have been known for many years, the more technical details have emerged much more recently, and many financial market participants have struggled with the enormous technical and administrative changes required by certain parts of MiFID II. As we explain later, despite MiFID II having already been delayed by one year, not all of the MiFID II provisions were able to go live on 3 January 2018 as intended.

Below we set out our summary of the progress of some important areas of financial regulation in 2017 and look ahead to expected developments in 2018.

[1] See our earlier client alert, "The Rise of the ESAs: EU Proposals to Extend Direct Supervision of Financial Markets", https://goo.gl/89NEZH.

TABLE OF CONTENTS

# 1. BREXIT

Since 23 June 2016, the questions of what form Brexit will take and how it will affect the UK have dominated mainstream and financial press. The actual exit of the UK from the EU is planned for March 2019, with a two-year transitional period afterwards (the "implementation period"). The UK and the EU had planned to come to an agreement in the early part of 2018 on the areas of withdrawal, the implementation period and the future post-Brexit relationship. In October 2017, after five rounds of negotiations, the European Council was still awaiting clarification from the UK on the issues of citizens' rights, the UK's financial settlement with the EU and Republic of Ireland/Northern Ireland Border. However, after a sixth round of talks in November, December 2017 saw phase one of negotiations complete, and phase two "future relationship" negotiations will begin in early 2018. The UK currently remains a member of the EU and existing EU-derived laws and regulations continue to apply to the UK.

The pound continues to fluctuate in response to weekly developments in the "Brexit divorce negotiations." Whilst the drop in the value of the pound has resulted in inflation-driven growth of the economy and new record highs in the FTSE 100 (closing in 2017 on 7,687.77), the UK is also facing slower growth compared to global upticks. Whether or not the lack of clarity surrounding Brexit has contributed to this is hotly debated. However, one thing remains clear: UK markets are in need of some concrete facts.

In addition, the current lack of clarity surrounding the post-Brexit relationship also seems to have delayed the implementation of a number of decisions by the European Commission, such as in relation to equivalence and passporting under legislation such as MiFID II and AIFMD.

2017 saw a number of key milestones and announcements made. The Article 50 notice was served by the UK Prime Minister, Theresa May, on 29 March 2017. This letter notified the European Council in accordance with Article 50(2) of the Treaty on the European Union that the UK would be leaving the European Union, triggering an exit date of 29 March 2019. The European Union (Withdrawal) Bill[2] was introduced to the House of Commons on 13 July 2017. The aim of the bill is to make sure that the UK's laws continue to function coherently once Brexit has occurred, grandfathering existing EU law into UK law. A detailed overview of the UK government's proposal for legislation post-Brexit can be found in the Repeal Bill White Paper.[3] Over 300 amendments have been proposed, making the passing of this bill one of the key challenges in the legal and political process of Brexit. If the bill passes to the UK's upper house, the House of Lords, the Lords have the authority to send it back down with further amendments.

A key element of the Brexit process is determining the nature of the UK's post-Brexit trade relationship with the EU. If no agreement is reached by March 2019, then at the end of this period (assuming no extension is agreed) the UK will automatically leave the EU, and the terms of its trading relationship with the EU will default to World Trade Organisation ("**WTO**") rules. The UK seems to have ruled out membership of the European Free Trade Association ("**EFTA**"), as well as retaining membership of the European Economic Area ("**EEA**"), meaning the UK has to formulate an independent trade deal. As various trade agreement models based on those with other countries seem to have fallen away from consideration (for example the Norwegian and Swiss models), the UK is hoping to achieve a "bespoke" solution. A white paper titled "Preparing for our future UK trade policy" was published by the Department for International Trade[4] in October 2017, outlining its ambitious trade priorities. The Trade Bill 2017-2019 was introduced into UK Parliament in November 2017 and passed its second reading in January 2018.[5] It now passes to the Committee stage in the House of Commons on 23 January 2018. However, against this backdrop the EU has warned the UK that it cannot expect to stay in the single market and not back down on its ambitious trade agenda. Other free trade agreements entered into by the EU, including with Canada and South Korea, took many years to negotiate and did not cover financial services in any detail, so it seems ambitious that a comprehensive arrangement can be reached between the EU and the UK before the end of the post-Brexit transition period.

[2] https://goo.gl/oUWpkZ.
[3] https://goo.gl/6Xhjtc.
[4] https://goo.gl/wxXwPp.
[5] https://goo.gl/xUtUWM.

HM Treasury released a White Paper[6] in October 2017 detailing plans for a new Customs Bill that addresses key issues of VAT, customs and excise systems post Brexit. The paper outlines ways in which customs policies can be implemented to support the UK's vision for trade post Brexit and avoid a "cliff-edge" scenario. It outlines three strategic objectives that are key to the UK's customs regime: ensuring UK-EU trade is as frictionless as possible; avoiding a hard border between Ireland and Northern Ireland and establishing an independent international trade policy. The Taxation (Cross-border Trade) Bill[7] had its first reading in November 2017 and passed its second reading in January 2018. It will now be considered by a Public Bill Committee, which is scheduled to conclude by no later than 1 February 2018.

A major consideration for financial services businesses is whether to move personnel to another EU financial centre. Large investment banks are still yet to announce how many people they will need to move and where they will go. So far, major financial institutions have hinted at Dublin, Frankfurt and Paris being popular choices. On 31 May 2017, ESMA issued an opinion on the supervisory approach to Brexit-related relocation from the UK.[8] The opinion sets out nine principles for the regulatory authorities of the 27 remaining EU member states to follow, hoping to manage the risk of competition between regulators leading to "regulatory arbitrage" and a weakening of supervision and regulatory harmonisation.

To what extent the UK will be able to continue to benefit from the "single passport" for financial services that operates within EU member states is another topic under debate. Passporting is the name given to the process whereby a firm that obtains authorisation to carry out a particular financial activity or service in one EU member state can carry out that activity or service in other member states without further authorisation. Many pieces of EU financial legislation allow for passporting, including MiFID II, the Payment Services Directive, the Prospectus Directive and AIFMD (all discussed later). In December 2017, the UK Treasury, the Bank of England, the Financial Conduct Authority ("**FCA**") and the Prudential Regulation Authority ("**PRA**") made clear the intended approach of the UK to the operation of EU firms in the UK post-Brexit. EU-based banks should be able to apply for a temporary regulatory licence, similar to those used by the U.S. and Japan. This temporary permissions regime would allow for a smoother transition for banks after the planned 2019 exit. In terms of the post-Brexit period, it is likely that the UK will seek equivalence status (where available) from the EU if it cannot retain passporting. Equivalence is recognition from the EU that the UK's financial regulations are at the same standard as those of the EU. Given that the UK is already part of the EU and already has such standards in place, this would seem to be an easy decision for the EU, but the decision-making progress is fraught with politics.

The Bank of England also announced plans that banks will be able to apply for "third country branch status" from January 2018, so long as they do not plan to undertake significant retail banking activities in the UK. Branch status is considered more attractive to financial institutions as, unlike subsidiaries, branches do not require separate local capitalisation and are subject to only limited supervision by the local bank regulator. These announcements are subject to approval and cooperation with various UK government departments and more details are expected early in 2018.

What is clear from industry leaders, both within the UK and the EU, is that all stakeholders are working hard to prevent a "cliff-edge" scenario. 2018 will bring many new developments shaping how the UK/EU financial and regulatory landscape will look in the years to come.

## 2. MIFID II

In last year's edition, we reported the one year delay in the implementation of the MiFID II Directive[9] and the Markets in Financial Instruments Regulation[10] ("**MiFIR**") (together forming the legislative package known as MiFID II). As we write, MiFID II has finally become effective, but full compliance with the huge volume of new requirements by the required date of 3 January 2018 has proven to be a struggle for many financial market participants.

As an example, certain financial market infrastructures have had to avail themselves of the right to request transitional arrangements. MiFIR provides for central clearing counterparties ("**CCPs**") to provide

[6] https://goo.gl/VpY591.
[7] https://goo.gl/h8Fwiw.
[8] https://goo.gl/nCHJco.
[9] Directive 2014/65/EU, https://goo.gl/5tX5fn.
[10] Regulation (EU) No 600/2014, https://goo.gl/Yr626b.

open access to their services to all trading venues and for trading venues also to provide open access to their trade feeds to any EMIR-authorised or regulated CCP that wishes to clear instruments traded on that venue. In accordance with the transitional provisions of MiFIR, the trading venues ICE Futures Europe and the London Metal Exchange applied to the FCA in the UK to allow them to utilise MiFIR's transitional provisions. Similarly, the CCPs ICE Clear Europe Ltd. and LME Clear Ltd. applied to the Bank of England to allow them to utilise the transitional provisions. The above requests were granted, and, as a result, the two trading venues and the two CCPs are now not required to comply with the MiFIR open access provisions until 3 July 2020.

The use of the term "trading venue" throughout MiFID II now includes not only regulated markets ("**RMs**") and multilateral trading facilities ("**MTFs**") but also organised trading facilities ("**OTFs**"). These differ from RMs and MTFs in that the operator of an OTF does use discretion in matching orders received on the platform. However, the operator may not execute client orders against its own proprietary capital. By contrast, a systematic internaliser ("**SI**") i.e. a firm which, on an organised, frequent, systematic and substantial basis, deals on its own account when executing client orders outside a RM, MTF or OTF, without operating a multilateral system, which does execute using its own capital may not also be the operator of an OTF. This includes an SI being prohibited from facilitating back-to-back trades between clients in a "matched principal" capacity such that the SI takes no risk.

The definition of systematic internaliser has been made more objective by MiFID II, by reference to the number of over-the-counter (**"OTC"**) trades in the relevant instrument carried out by the firm on its own account when executing client orders and by the size of the OTC trading it carries out in that instrument. Being designated an SI has the effect of rendering an investment firm subject to obligations relating to pre-trade transparency, including an obligation to publish firm quotes in respect of specified financial instruments for which they are SIs and for which there is a liquid market. SIs also need to meet post-trade transparency requirements, as well as obligations regarding provision of data on execution quality under the best execution rules and provision of financial instrument reference data to their competent authorities. The SI regime has been extended from its pre-MiFID II scope to include not only shares traded on an RM, but also to other equity-like instruments such as exchange-traded funds, depositary receipts, certificates and similar instruments. It also applies for the first time to non-equity instruments, such as bonds, derivatives and structured finance instruments. The earliest mandatory date for firms to comply with the SI regime is 1 September 2018, although firms can opt in at any time before that.

The burden of administrative changes required by MiFID II (and in some cases the impossibility of meeting these requirements by the deadline) has been recognised by regulators, in particular in relation to the enhanced transaction reporting regime of MiFID II. MiFID investment firms and trading venues are obliged, when complying with their transaction reporting obligations, to identify clients who are legal persons, and (in the case of trading venues) issuers of financial instruments traded on their venue, by using a Legal Entity Identifier ("**LEI**"), and MiFIR provides that investment firms must refuse to provide to a client services that would trigger a transaction report until such client has a LEI. In December 2017, ESMA, having formally acknowledged that many clients of MiFID investment firms and many non-EU issuers of instruments traded on EU trading venues would fail to obtain LEIs by 3 January 2018, issued a statement of regulatory forbearance. Specifically, ESMA allowed for a 6-month transition period during which investment firms can continue to provide services to clients without LEIs, so long as the firm has obtained all necessary documentation from the client to apply for an LEI on the client's behalf and the firm applies for the LEI immediately. During the same period, ESMA stated that trading venues are permitted to report their own LEI codes, instead of the codes for non-EU issuers, while still applying pressure on the non-EU issuers to obtain their own LEI codes.

It was not only investment firms that struggled to prepare in time for the 3 January 2018 deadline. The European Commission and the U.S. Commodities and Futures Trading Commission narrowly avoided disaster by finally agreeing mutual recognition principles in relation to derivatives trading venues in each other's jurisdiction. MiFID II requires that cleared derivative contracts that are declared subject to the trading obligation by the European Securities and Markets Authority ("**ESMA**") can no longer be traded by EU firms on OTC basis and must be traded only on one of the three types of EU trading venue or on a third-country trading venue established in a jurisdiction in respect of which the European Commission has adopted an equivalence decision. On 9 January 2018, ESMA published a Public Register for the Trading

Obligation[11] for derivatives under MiFIR, which lists those classes of derivatives that are subject to the trading obligation and the dates from which the trading obligation takes effect for different counterparties, as well as the EU trading venues on which those derivatives are available for trading and those third-countries deemed equivalent for the purpose of the trading obligation. Before 5 December 2017, no such equivalence decision had been adopted by the European Commission and, similarly, the CFTC had not exempted any EU trading venues from the requirement to become registered as a Swap Execution Facility in order for U.S. entities to trade derivatives on them. The European Commission and the CFTC on 5 December 2017 published a joint decision, specifying that U.S. exchanges would be considered equivalent for the EU trading obligation and that EU trading venues would be exempted from registration as SEFs, which averted the possibility of EU entities and U.S. entities being able to trade derivatives only on trading venues in their own jurisdictions, and the ensuing fragmentation of liquidity that would follow from that.

MiFID II has also substantially amended the provisions relating to the ability of non-EEA firms to provide investment services in the EEA. Where the non-EEA firm wishes to provide services in an EEA member state to retail clients and elective professional clients (i.e., clients who would be retail clients but who have been "opted-up" at their request to the status of professional client) that member state can require the non-EEA firm to establish a branch, which is required to be authorised and supervised by the competent authority in that member state.

The non-EEA firm would only be able to obtain authorisation to provide services that it is authorised to provide by its home regulator, and cooperation arrangements must be in place between the home country supervisor and the supervisor in the relevant members' state. In addition, the home country and the relevant member state must have signed a tax co-operation agreement. The branch itself would be subject to requirements as to initial capital and as to the competency of its management and must belong to an EU investor compensation scheme authorised or recognised under the Investor Compensation Scheme Directive (97/9/EC).

Such a branch, although established primarily for business with retail/elective professional clients, could then be used also to provide services to professional clients and eligible counterparties. However, establishing such a branch in one EEA member state would not entitle the non-EEA firm to transact business in any other member state.

By contrast, a non-EEA firm proposing to provide investment services only to professional clients and eligible counterparties may now become permitted to provide those services on a cross-border basis, throughout the EEA, without establishing a branch. This would require the European Commission to adopt a decision that the third country's legal framework and prudential and business conduct requirements are equivalent to those of the EU. No third country has yet been declared equivalent by the European Commission under these provisions.

MiFID II also increased the powers of supervisors to ban the distribution of specific products, services or practices, where such action is justified by threats to investor protection, financial stability or the orderly functioning of markets. On 15 December 2017, ESMA announced that it was considering the possible use of its product intervention powers under Article 40 of MiFIR to address investor protection risks in relation to speculative products, such as contracts for difference ("**CFDs**") and binary options being sold to retail investors. ESMA stated that it was considering measures to prohibit the marketing, distribution or sale to retail clients of binary options and to restrict the marketing, distribution or sale to retail clients of CFDs, including rolling spot foreign exchange contracts. Subsequently, on 18 January 2018, ESMA published a call for evidence,[12] detailing the restrictions that it is considering imposing on CFDs, specifically, leverage limits, a margin close-out rule, negative balance protection (to provide a guaranteed limit on client losses), a restriction on benefits incentivising trading and a standardised risk warning. The call for evidence also invited views on how CFDs on cryptocurrencies fit within the MiFID II regulatory framework as financial instruments. Comments on the call for evidence can be made up to 5 February 2018. Following its consideration of any comments, it may adopt one or more product intervention measures, which can have an initial duration of up to three months, but which are renewable.

[11] https://goo.gl/R6sBTd.
[12] https://goo.gl/6frPcr.

MiFID II's new product governance obligations are also now in force, in relation to measures to be taken by MiFID firms who are manufacturers and/or distributors of financial instruments. These obligations affect the creation, development, issuance, design, offer and sale of financial instruments and include:

(a) enacting measures to ensure that the manufacture of financial instruments complies with conflicts of interest management requirements;

(b) ensuring that the firm's management body has effective control over the firm's product governance process;

(c) identifying, at a sufficiently granular level, the potential target market for each financial instrument; and

(d) ensuring that the target market assessment is communicated to all distributors and that the distribution strategy for each financial instrument is consistent with its target market assessment.

The new product governance rules have involved big procedural and administrative changes for EU manufacturers and distributors of products and also some changes for non-EU manufacturers/distributors who, though they may not be directly subject to these MiFID II obligations, find that they need to provide information and co-operation to MiFID firms in the distribution chain who are subject to those requirements.

Although not financial instruments, the product governance obligations also cover structured deposits, i.e. bank deposits under which the interest or principal payable or repayable is exposed to movements in underlying indices, exchange rates, commodities or financial instruments. In addition to product governance, for the first time, other investor protection provisions also apply to structured deposits, such as conflicts of interest and client order handling rules.

MiFID II also provides more protection to municipalities and local authorities by excluding them from the list of entities considered to be eligible counterparties or "per se" professional clients. Therefore such entities will now need to be classified as retail clients and hence be entitled to a higher standard of investor protection from investment firms, unless they meet the criteria to be "opted up" to the category of professional client.

MiFID II has also enhanced the obligations of MiFID firms in relation to conflicts of interest, in particular in relation to inducements. Firms providing independent investment advice or portfolio management services are prohibited from accepting or retaining fees, commissions or benefits (monetary or non-monetary) from a third party, except in the case of minor non-monetary benefits that are capable of enhancing the quality of the service to the client, are of a scale/nature such that they could not impair compliance with the duty to act in the best interest of the client and are clearly disclosed to the client.

For other MiFID services, firms may not pay or receive any fee or commission, or provide or receive any non-monetary benefit, other than from the client, unless such payment or benefit is designed to enhance the quality of the relevant service to the client and does not impair the duty to act fairly, honestly and professionally in accordance with the best interest of its clients. In addition, such payment or benefit needs to be clearly disclosed to the client.

In this context, the provision of research by third parties to MiFID firms providing portfolio management services can potentially be regarded as an inducement. In order to conclude that it will not be regarded as an inducement, the research must either be paid for by the firm out of its own resources or must be paid from a separate research payment account controlled by the firm and funded by specific research charges to the clients.

This provision of MiFID II has proven particularly problematic for U.S. broker-dealers who were prohibited from receiving "hard dollars" in return for providing research, threatening to deprive investors of access to research. On 26 October 2017, the U.S. Securities and Exchange Commission issued a "no-action" letter, effectively allowing SEC-registered broker-dealers, on a temporary basis, to receive research payments from money managers in hard dollars or from research payment accounts.

The above areas represent just some of the changes brought in by MiFID II as from 3 January 2018, and we expect a large part of 2018 to be taken up by firms in continuing to digest the finer points of these obligations and continuing adapting their business models to ensure compliance.

## 3. MAR IMPLEMENTATION

The majority of the Market Abuse Regulation (Regulation 596/2014) ("**MAR**")[13] came into effect and repealed and replaced the Market Abuse Directive (2003/6/EC) ("**MAD**") and its implementing legislation on 3 July 2016. The aim of the new legislation was to strengthen the market abuse regulatory framework and bring the instruments and markets within its scope into line with the MiFID II regime.

However, certain provisions relating to OTFs (see "**MiFID II**"), SME growth markets, emission allowances and related auctioned products have only applied as from 3 January 2018 when MiFID II became applicable.

## 4. BRRD AND TLAC/MREL

The Bank Recovery and Resolution Directive[14] ("**BRRD**"), having been required to be fully transposed into national laws by 1 January 2016, has created a framework in which (in theory) a bank can be allowed to fail, with the minimum of public sector support and the minimum of disruption to the broader financial system. One of the most important "resolution tools" that BRRD gives to resolution authorities (especially in terms of resolving systemically important banks) is the "bail-in tool." This tool allows national resolution authorities to convert liabilities of the failing bank into equity or to write down the principal amount of those liabilities, so that in this way those liabilities can be forced to absorb some of the losses of the bank entering into resolution.

Crucial to the successful employment of the bail-in tool is ensuring that the bank will have sufficient liabilities that can be bailed in if it enters resolution. BRRD addresses this in the form of obligations to maintain Minimum Required Eligible Liabilities ("**MREL**"). MREL can be viewed as the European version of the total loss absorbing capacity ("**TLAC**") rules referred to below (in that they provide for each EU national resolution authority to prescribe, for each bank under its jurisdiction, a minimum level of loss-absorbing capital and liabilities to be held by the bank that can credibly be bailed-in in a bank resolution situation). These MREL provisions will apply to EU banks on top of the minimum regulatory capital requirements and capital buffer requirements that have been prescribed by the CRR.

Article 55 of BRRD requires that for most liabilities that can be bailed-in, where the contract for the liability is governed by a non-EU law, the party subject to BRRD must ensure that, in that contract, the beneficiary of the liability acknowledges that the liability can be bailed-in and agrees to be bound by any such bail-in action. This contractual bail-in recognition requirement applies unless it can be shown that the EU bail-in action can be put into effect by the laws of the non-EU jurisdiction or by binding agreement with that jurisdiction.

More than a year after the European Commission introduced it, its package of proposed legislative reforms to the BRRD has still not been finally agreed by the various EU legislative bodies. The package of reforms focused primarily on the setting of MREL for global systemically important institutions ("**GSIIs**") and for non-GSIIs, but also proposed changes to Article 55 of BRRD and new pre-resolution powers of suspension. These proposals consist of a draft Regulation[15] to amend the CRR ("**CRR2**"), a draft directive amending the BRRD in relation to MREL[16] ("**BRRD2**"), a draft second directive amending BRRD in respect of the insolvency ranking of certain liabilities[17] ("**Insolvency Hierarchy Directive**") and a draft regulation[18] amending the SRM Regulation ("**SRM2**"). The Insolvency Hierarchy Directive has now been agreed at EU level. It will come into force on the day following its publication in the Official Journal of the EU and is to be implemented by EU member states into their national laws with 12 months thereafter.

The SRM Regulation,[19] which constitutes the Single Resolution Mechanism ("**SRM**"), mirrors the resolution tools and options available under the BRRD in order to apply a uniform resolution process to all banks established in EU member states that are participating in the Single Supervisory Mechanism

13 https://goo.gl/Lxj1MF.
14 https://goo.gl/V6nHMk.
15 https://goo.gl/NsEoMk.
16 https://goo.gl/9SAUfr.
17 https://goo.gl/bEh7mj.
18 https://goo.gl/onLxEa.
19 https://goo.gl/6er1hT.

("**SSM**"), in other words all banks in the Eurozone and other member states that are participating in the SSM. Under the SSM, the European Central Bank acts as the ultimate supervisor for all the banks subject to the SSM. Under the SRM, a Single Resolution Board ("**SRB**") is appointed to perform most of the functions that are performed by national resolution authorities according to the BRRD.

In relation to Article 55, and in response to the difficulties facing banks in complying with this Article, the European Commission proposes that a bank need not comply with Article 55 so long as (i) the EU bail-in action will be recognised by the non-EU law that governs the relevant liability or by a binding agreement of that non-EU country, (ii) it is legally, contractually or economically impracticable to include such a contractual agreement in the relevant liability and (iii) a waiver of Article 55 in respect of such liability would not impede the resolvability of the bank. This proposed waiver would not apply to liabilities counting towards MREL – only those ranking senior to MREL liabilities.

In addition to Article 55 and the MREL provisions, the European Commission also proposed an additional power for resolution authorities to intervene early in a bank's decline, in the form of the ability to suspend any payment or delivery obligation of a bank for up to five working days, where necessary either to assess whether the bank is likely to breach applicable EU legislation (for the purpose of Article 27(1) BRRD), such as required capital notices, or whether the bank is "failing or likely to fail" (for the purpose of Article 32 BRRD). However, excluded from this power are obligations owed to central clearing counterparties, payment and securities settlement systems and deposits covered by a deposit guarantee scheme, as well as eligible claims under investment compensation schemes.

On 11 July 2017, the EBA published three sets of guidelines on bail-in under the BRRD on its official website that are intended to complement existing regulation and guidance to facilitate the use of the bail-in power as a way of absorbing losses and recapitalising banks in resolution:

(a) *Guidelines* on the interrelationship between the BRRD sequence of writedown and conversion and the CRR, clarifying the treatment of instruments that meet the criteria for recognition as AT1 under the CRR;

(b) Guidelines on the rate of conversion of debt to equity in bail-in, which clarify when and how different conversion rates from debt to equity should be set for different types of liability; and

(c) Guidelines on the treatment of shareholders in bail-in or the writedown and conversion of capital instruments, which clarify the circumstances under which it is appropriate to cancel, transfer or severely dilute shares or other instruments of ownership when applying the bail-in tool or the writedown or conversion of capital instruments power provided for in the BRRD.

The EBA addressed the guidelines to resolution authorities, and the guidelines should be implemented by resolution authorities by 11 January 2018. National competent authorities will need to confirm their compliance status to the EBA, and this will be disclosed on the EBA's website.

The above insolvency hierarchy directive was published in the Official Journal on 27 December 2007 and is required to be implemented into member states' national laws by 29 December 2018.

On 30 November 2017, the Council of the EU published a Presidency compromise proposal (dated 27 November 2017) on BRRD2 and SRM2.

Political agreement on BRRD2, SRM2 and CRR2 is expected in the first half of 2018, and CRR2 is required to enter into force by 1 January 2019, in order for the EU to stick to its G-20 commitments regarding implementation of the Financial Stability Board's TLAC principles.

## 5. EU DEPOSIT INSURANCE REGULATION

As part of plans for the European Banking Union, currently consisting of the SSM and the SRM, the European Commission published a draft Regulation to establish the European Deposit Insurance Scheme ("**EDIS**").[20] The draft Regulation envisages that the EDIS will be operated by the Single Resolution Board and will provide additional funding for national deposit guarantee schemes established in member states participating in the SRM.

[20] https://goo.gl/QabJm1.

More than two years later, the proposed regulation still remains unagreed. Most recently, on 24 November 2017, the Council of the EU published a progress report[21] on the EDIS Regulation, which flagged a number of issues under consideration within the Council, including the following main issues:

(a) Risk-based contributions methodology;

(b) Alternative measures to prevent the failure of credit institutions that EDIS could potentially deploy, assessing some features of the U.S. system;

(c) The scope of EDIS and the expected treatment of third-country branches and non-CRD/CRR entities;

(d) Non-compliance by, and the procedure for the disqualification of, a national deposit guarantee scheme;

(e) The administrative provisions on EDIS, particularly the national guarantee schemes; and

(f) The design of EDIS, including the merits of the full insurance and reinsurance models.

The establishment of EDIS is hoped to occur in 2019, although this part of the EU Banking Union remains the most politically controversial, and as such, timing is highly uncertain.

## 6. UK RING-FENCING

The UK's Financial Services (Banking Reform) Act 2013 requires retail banking services to be ring-fenced from other bank activities. The base legislation has now been in force for some time in the UK, but the precise details of exactly what will be required to comply with the new ring-fencing regime, by its proposed implementation date of 1 January 2019, are to be provided by secondary legislation to be passed by the UK Treasury.

Over the course of 2017, there were various developments in such secondary legislation, some of which are intended to assist UK banks in making more definitive plans as to how to reorganise their businesses. Furthermore, the PRA and Bank of England were particularly active in 2017 in publishing consultation papers and statements relating to ring-fencing.

What is known is that the ring-fenced retail entity can remain as part of the broader banking group, so long as it is functionally and legally separated. The legislation will catch firms that, on a three-year average period, hold more than GBP25 billion worth of core deposits, meaning all deposits other than from financial institutions, large to medium sized companies and high net worth individuals. In order to be able to survive the failure of another member of the banking group, the ring-fenced banks ("**RFBs**", each a "**RFB**") will be subject to stand-alone prudential rules, including minimum capital requirements, leverage ratios, liquidity ratios and risk buffers.

Such banks will be prevented from undertaking certain excluded activities, such as dealing in investments as principal and commodities trading, although it is possible that further activities may in the future be specified as excluded for this purpose. Generally, they will not be able to engage in investment banking activities, but they will be able to offer limited types of derivatives to their customers, such as derivatives commonly used to hedge currency and interest rate risk.

The PRA published an Occasional Consultation Paper in October 2016 ("**OCP**"),[22] in which it proposed changes to certain parts of the PRA Rulebook, in particular proposals for consequential amendments to the ring-fencing rules and amendments to the reporting templates and instructions for monitoring the use of permitted exceptions.

The PRA published a policy statement in February 2017 (PS3/17 – "The implementation of ring-fencing: reporting and residual matters – responses to CP25/16 and Chapter 5 of CP36/16") setting out changes to reporting requirements and incorporating the amendments discussed at Chapter 5 (pertaining to the Ring-Fenced Bodies Part) of the OCP into the final rules and reporting templates.[23]

[21] https://goo.gl/NVEmTB.
[22] https://goo.gl/7LoZdn.
[23] https://goo.gl/6FHePD.

Also in February 2017, the PRA published the Occasional Consultation Paper CP2/17, setting out proposed changes to residual reporting requirements for ring-fenced bodies.[24] In July 2017, the PRA published its responses to CP2/17 in PS19/17.[25]

The PRA published the public working draft of its standalone ring-fencing taxonomy on 18 September 2017. Software firms were invited to provide feedback, and it is anticipated that v3.0 of the Bank of England Banking XBRL taxonomy will be published in spring 2018.[26]

The PRA published PS29/17[27] ("Recovery Planning") on 11 December 2017, which follows CP9/17. This policy statement appends SS9/17[28] (the supervisory statement on Recovery Planning) as well as an update to SS8/16 (the supervisory statement on Ring-Fenced Bodies). This policy statement outlines "the PRA's final expectations on the content of recovery plans and on the approach to recovery planning for groups containing a ring-fenced body."[29]

Ring Fencing Transfer Schemes ("**RFTS**") (a scheme allowing a bank to transfer all or part of its business to another body, in order to comply with the ring-fencing regime) require the PRA (after consultation with the FCA) to (i) approve the skilled person who is appointed to make a related scheme report and (ii) approve the scheme report itself. Bank court directions hearings began in 2017, during which the court considers a bank's proposed RFTS communications. During 2018, each bank will also attend a sanction hearing, during which the court will decide whether the bank can implement its specific RFTS.[30]

Without discounting the possibility of any surprises in 2018, most major banks in the UK appear to be on track to comply with the ring-fencing deadline of 1 January 2019.

## 7. CAPITAL MARKETS UNION

When it was launched by the European Commission in September 2015, the aims of the Capital Markets Union ("**CMU**") Action Plan included providing greater funding choice for Europe's businesses and small and medium-sized enterprises ("**SMEs**"); ensuring an appropriate regulatory environment for long-term and sustainable investment and financing of Europe's infrastructure; increasing investment and choice for retail and institutional investors; enhancing the capacity of banks to lend; and bringing down cross-border barriers and developing markets for all EU member states.

Specific measures under the CMU banner have included:

(a) creating a framework for simple, transparent and standardised securitisations (see further below) to support bank financing of the wider economy and to open up investment opportunities for a wider set of non-bank investors;

(b) reducing the costs for companies accessing capital markets by overhauling the legislation relating to prospectuses for offerings of securities (see further below);

(c) work in relation to crowdfunding;

(d) work to strengthen venture capital markets and support for small high-growth firms;

(e) supporting market-led initiatives on the development of private placements of corporate debt;

(f) a further review of the covered bonds markets in the EU (see further below); and

(g) work on encouraging finance for sustainable and green investments (see further below).

Following the Brexit vote, a Mid-Term Review of the CMU Action Plan was carried out by the EU Commission in June 2017 with the aim of reframing the importance of the CMU in the wake of Brexit and emphasising such emerging areas as sustainable investment and environmental, social and corporate governance, as well as the rise of FinTech.

[24] https://goo.gl/kiFBsu.
[25] https://goo.gl/fBR6EZ.
[26] https://goo.gl/qVzirC.
[27] https://goo.gl/ms1TE8.
[28] https://goo.gl/v3ZQbx.
[29] https://goo.gl/rrbNxf.
[30] https://goo.gl/JfBxYu.

Nine new priority measures were highlighted in the review. These include:

(a) amending the functioning of ESMA and the other ESAs to promote the effectiveness of consistent supervision across the EU and beyond. In targeted areas, the Commission will strengthen ESMA's powers including, where warranted, granting direct supervision to support a functioning CMU;

(b) exploring whether targeted amendments to relevant EU legislation could deliver a more proportionate regulatory environment to support SME listing on public markets. This could lead to targeted changes in sectoral legislation in Q2 2018;

(c) a legislative proposal to review the prudential treatment of investment firms. The European Commission introduced legislative proposals in December 2017 for a directive and a regulation. The new legislation is aimed at creating a more effective prudential and supervisory framework for investment firms that is calibrated to their size and the nature of their business. This legislation would be coupled with the removal of investment firms from the scope of the Capital Requirements Directive (Directive 2013/36/EU) and the Capital Requirements Regulation (Regulation (EU) No. 575/2013), which currently provides the prudential requirements for many EU investment firms, as well as for EU banks;

(d) as part of a comprehensive approach to enable FinTech, assessment of the case for an EU licensing and passporting framework for FinTech activities in Q4 2017. It is now proposed that a FinTech action plan will be published in early 2018, covering such issues as crowdfunding, peer-to-peer lending, privacy and cyber-security;

(e) measures to support secondary markets for non-performing loans. The Commission will also launch an impact assessment with a view to considering a possible legislative initiative to strengthen the ability of secured creditors to recover value from secured loans to corporates and entrepreneurs (Q1 2018);

(f) possible follow-up on the recommendations of the High Level Expert Group on Sustainable Finance, in particular, measures to improve disclosure and better integrate sustainability in rating methodologies and supervisory processes, as well as in the investment mandates of institutional investors and asset managers. It will also develop an approach for taking sustainability considerations into account in upcoming legislative reviews of financial legislation;

(g) a possible legislative proposal to facilitate the cross-border distribution and supervision of UCITS and AIFs in Q1 2018;

(h) guidance on existing EU rules for the treatment of cross-border EU investments; and an adequate framework for the amicable resolution of investment disputes; and

(i) by Q2 2018, a comprehensive EU strategy on steps that can be taken at EU level to support local and regional capital market development across the EU.

In addition, the Commission set out that it would put forward three legislative proposals:

(a) a legislative proposal on a pan-European personal pension product;

(b) a legislative proposal specifying conflict of laws rules for the effects on third parties of transactions in securities and claims; and

(c) a legislative proposal for an EU-framework for covered bonds.[31]

The proposal for an EU framework for covered bonds, as well as another CMU hot topic – the combined impact of financial regulation – are discussed in more detail below. However, the Commission currently appears to be on track to achieve its goal of having a fully functioning CMU by 2019.

Further to the EU Commission's September 2015 Consultation Document,[32] assessing the merits of a potential harmonised EU covered bond framework, in April 2017, the Commission published the report

[31] https://goo.gl/aB7VwE.
[32] https://goo.gl/gBhwkS.

"Covered Bonds in the European Union: Harmonisation of legal frameworks and market behaviours." This report both assesses "the functioning and performance of the European covered bonds market to identify improvements deliverable through EU intervention without harming the market" and "the costs and benefits of potential EU action (in the form of a dedicated legislative framework for covered bonds) against a 'no EU policy action' scenario, i.e. a baseline scenario involving no EU intervention, but considering market developments such as the covered bonds label."[33]

The report acknowledged the costs involved in harmonisation, but concluded that creation of an overall harmonised covered bond framework was a positive step forward.

In June 2017, the Commission published an impact assessment and request for feedback regarding three possible ways forward in the creation of a European covered bond framework. These options were to:

(a) "build on the current system and try to improve it by promoting market led-initiatives or national regulatory action";

(b) "recognise the fact that the current EU rules outline only a few high-level principles and contain several loopholes that would need to be filled in order to reach an effective and necessary level of harmonisation"; or

(c) "fully harmonise both the structural and prudential aspects of covered bond regulation in order to ensure that only covered bonds complying with these detailed standards could be qualified as covered bonds and receive preferential treatment."[34]

The impact assessment itself did not, however, recommend a particular way forward.

The Commission now plans to set forth a legislative proposal for a covered bonds framework in the first quarter of 2018[35] (it is set to be published on 7 March 2018) and it is anticipated it will follow the EBA's recommendations, which call for a loose, high-level and principle-based framework, rather than a full harmonisation (the European Parliament supports this way forward as well).

The Mid-Term Review also discussed the possibility of an overarching framework for European Secured Notes ("**ESNs**"). These would be similar to covered bonds except they would apply only to SME bank loans and infrastructure bank loans.[36] In October 2017, the European Commission sent a call for advice to the EBA regarding ESNs. This report requested that the EBA examine the effects of ESNs on banks, possible best practices with regards to ESNs and any risk treatment issues. It is anticipated this report will be ready by spring 2018.

In September 2015, the EU Commission launched a public consultation in the form of a Call for Evidence[37] relating to the EU regulatory framework for financial services. It stated that in view of the huge amount of financial legislation put in place since the crisis, it wanted to understand the combined impact of such legislation and identify any unintended consequences. In particular, the EU Commission sought views on areas of regulation that firms regard as imposing excessive burdens, costs or complexity out of proportion with the intended policy objectives.

Several themes came out of the responses to the Call for Evidence, including:

(a) there has been a significant increase in compliance costs due to the scale and pace of regulatory change and a perceived overlap of different layers of regulation. Concerns were raised as to poorly aligned and tight timelines for implementation and the complexity of the overall framework;

(b) the need for improvements in financing conditions for SMEs;

(c) possible adverse consequences of the LCR and its potential negative impact on corporates' cash management;

[33] https://goo.gl/geuxbs.
[34] https://goo.gl/23k4tD.
[35] https://goo.gl/Ud6KbX.
[36] https://goo.gl/6XMKxE.
[37] https://goo.gl/xawmPf.

(d) specific pieces of legislation and the cumulative effect of certain rules have given rise to a detrimental impact on market liquidity, particularly in corporate bond markets; and

(e) disclosure rules are seen as inconsistent across different pieces of relevant legislation.

In November 2016, the EU Commission published a communication stating that, having regard to the responses received to its earlier consultation, its view was that overall the financial services framework is working well. Follow-up action would include:

(a) reducing unnecessary regulatory constraints on financing the economy – in this regard it notes the importance of retaining banks' ability to finance the wider economy and to ensure SME financing;

(b) enhancing the proportionality of rules without compromising prudential objectives;

(c) reducing undue regulatory burdens (of which the proposed EMIR II focus on reducing reporting burdens for non-financial counterparties is an example); and

(d) making the regulatory framework more consistent and forward-looking.

In December 2017, the EU Commission published a report on the follow-up to the Call for Evidence. This report sets out progress made on the above commitments, items that have been delivered with regard to these commitments and work that is still ongoing.

The report notes that the follow-up actions discussed in the November 2016 Communication have led to the following:

(a) reviews of individual pieces of legislation;

(b) implementation of ongoing policy work;

(c) the calibration of "level 2" technical standards and upcoming "level 1" regulations and directives; and

(d) the EU's input in global fora.[38]

The report states that "the Commission has been active in tackling the issues identified by stakeholders in the Call for Evidence process and continues to do so to ensure that EU legislation remains fit for purpose" and "the Commission is working to ensure that the regulatory compliance framework is fit for the digital age, where possible through automation and standardization…this should ultimately lead to reducing the burden for industry and result in better financial supervision."[39]

The report also detailed the Commission's follow-up measures to the Supervisory Reporting Framework, such as a proposal for a reduction in the "frequency with which smaller and less complex banks are required to report" and a proposal to "reduce the reporting burden on non-financial corporations."[40]

## 8. PD III

Following consultation by the European Commission to identify the shortcomings in the last Prospectus Directive as part of its Capital Markets Union Action Plan, the new Prospectus Regulation (Regulation (EU) 2017/1129) ("**PD III**") was adopted by the European Commission and entered into force in July 2017,[41] with a majority of its provisions to take effect from 21 July 2019. The aim of PD III is to (a) make it easier and more cost-effective for smaller companies to access the capital markets through the prospectus regime, (b) simplify the prospectus disclosure requirements, particularly for secondary market and frequent issuers, and (c) improve the readability of prospectuses to enhance disclosure and investor protection.

[38] https://goo.gl/C7cHbw.
[39] https://goo.gl/egLSC5.
[40] https://goo.gl/hMVQCB.
[41] https://goo.gl/YJWEHF.

The main changes under PD III are:

(a) **Expansion of exemptions** – the PD III will not apply at all to an offer of securities to the public with a total consideration of less than EUR1 million over a 12-month period. Such amount may be increased, up to a maximum of EUR8 million, by each member state in its national laws. The "wholesale denomination" exemption for offers of securities to the public with a minimum denomination of EUR100,000 will continue to apply.

(b) **Expansion of wholesale disclosure regime** – the wholesale disclosure regime, including the summary exemption, has been expanded and will now apply not only to high-denomination securities (i.e., EUR 100,000) that are admitted to trading on a regulated market, but also to other non-equity securities that are to be traded only on markets (or segments thereof) to which only qualified investors have access. In these cases, lighter (proportionate) disclosure requirements are envisaged, and no prospectus summary will be required.

(c) **Changes to summary requirements** – a number of changes have been introduced in respect of the summary contained in a prospectus. The prospectus summary must be no longer than seven pages of A4-sized paper, must be presented and laid out in a way that is easy to read, with characters of readable size and written in a style and language that facilitates the understanding of the information. It may contain no more than the 15 most significant risk factors specific to the issuer and the securities offered. A summary will no longer be required in the base prospectus itself, but the final terms for each issuance of securities must include, as an annex to the final terms, a summary of that issuance.

(d) **Presentation of risk factors in the prospectus** – risk factors will be required to be presented in a limited number of categories, depending on their nature, and must be ranked by materiality, based on both the probability of their occurrence and the expected negative impact if the relevant risk occurs.

(e) **Incorporation by reference** – the requirement that a document to be incorporated by reference shall be approved by or filed with a competent authority has been removed, and a greater range of documents that have been previously or simultaneously published electronically may now be incorporated by reference.

(f) **Universal registration document** – a new universal registration document ("**URD**") regime is available under PD III, similar to the U.S. shelf registration system. Issuers with a URD will benefit from a faster approval process, and after having had a URD approved by the relevant competent authority for two consecutive years, it will be allowed to file further URDs without prior approval, although they will still be subject to review by the authority.

(g) **Notification portal** – the European Securities and Markets Authority ("**ESMA**") shall establish a notification portal into which the competent authority of the home member state shall upload the certificates of approval and electronic copies of any documents it has approved, the final terms and any translation of the prospectus and any summary thereof, at which time the competent authority of any host member state should also be informed of any such approval. This will be a significant development as this will mean that market participants will, for the first time, be able to search in one centralised location for all EU-approved prospectuses.

ESMA is empowered (and in some cases, required) under PD III to develop various draft RTSs to facilitate the implementation of the regulation, on topics such as technical arrangements for the notification portal, when a supplement is required to be published, dissemination of advertisements and relating to the publication of prospectuses. ESMA is required to submit the RTSs that are mandated by PD III by 21 July 2018, one year before PD III comes into effect. On 15 December 2017, ESMA published a consultation paper,[42] setting out draft regulatory technical standards in relation to provisions such as content and presentation, format of key financial information, the data necessary for classification of prospectuses, provisions concerning advertisements, situations requiring a prospectus supplement and requirements as to publication. The deadline for responses to the consultation is 9 March 2018.

[42] https://goo.gl/xyjNHA.

## 9. EU SECURITISATION REGULATION

As part of the CMU Action Plan, on 30 September 2015, the EU Commission published a legislative proposal for a "Securitisation Regulation"[43] with a view to setting out common rules on securitisation and creating an EU framework for simple, transparent and standardised ("**STS**") securitisations. In effect, these are securitisations that satisfy certain criteria and are therefore able to benefit from the resulting STS label (for example, through reduced capital charges). At the same time, the EU Commission published a draft Regulation to amend the CRR (referred to and defined below) to provide more favourable regulatory capital treatment for STS securitisations.

In terms of products, the Securitisation Regulation is focused on residential mortgage backed securities ("**RMBS**"), auto loans/leases and credit card transactions, whereas actively managed portfolios (for example, CLOs), resecuritisations (for example, CDOs and SIVs) and structures, which include derivatives as investments, have been specifically prohibited.

During the EU legislative process, many amendments were proposed by the European Parliament, some of which would, if implemented, have been quite onerous on issuers, such as the proposal to increase the minimum level of risk retention to either 7.5% or 10%, with a possibility for further increases up to a maximum level of 20%.

However, in June 2017, a broad political agreement on the nature of the regulation was agreed in trilogue among the European Parliament, European Council and the European Commission. To the relief of market participants, this agreement retained the 5% risk retention requirement already in place.

The European Parliament approved the proposed Securitisation Regulation and Securitisation Prudential Regulation on 26 October 2017. The Council approved the Securitisation Regulation on 20 November 2017.[44] On 28 December 2017, the Securitisation Regulation and the CRR Amendment Regulation were published in the Official Journal of the EU. These entered into force on 17 January 2018 and will apply from 1 January 2019. The EBA is currently consulting on draft regulatory technical standards related to the criteria for homogeneity of underlying exposures for STS and related to providing further clarity on the risk retention requirements.

The Securitisation Regulation sets out several changes to the existing regime, and some key points covered in the new Securitisation Regulation include:

(a) Maintaining the existing 5% risk retention, as agreed in the trilogue in June;

(b) Prohibition of re-securitisations and RMBS backed by unverified loans; and

(c) STS designation will apply only when the Issuer, originator and sponsor are each established in the EU.[45]

Overall, market participants are relatively pleased with the legislative outcome, especially compared to some of the more restrictive measures originally proposed by the European Parliament, such as a much higher percentage of risk retention. However, it is anticipated that the new rules for STS will lead to higher compliance costs than for other securitisations and this may prove a barrier to entry for some participants.

## 10. EMIR IMPLEMENTATION

The European Market Infrastructure Regulation (Regulation (EU) No. 648/2012) ("**EMIR**"), which regulates derivatives transactions in the EU, entered into force on 16 August 2012. However, much of the relevant rule-making under EMIR was introduced by regulatory technical standards ("**RTS**") and implementing technical standards ("**ITS**") through delegated legislation. The fundamental pillars of EMIR include reporting, clearing, exchange of margin and other risk mitigation for non-cleared trades, as well as the regulation of central clearing counterparties ("**CCPs**").

[43] https://goo.gl/is8aEr.
[44] https://goo.gl/5sNA4Q.
[45] https://goo.gl/R2B95z.

One of the central limbs of EMIR is the requirement for mandatory central clearing for derivatives entered into by financial counterparties ("**FCs**") and certain significant non-financial counterparties ("**NFCs+**"), and their non-EU equivalents, where ESMA has mandated that the relevant class of derivatives should be subject to the clearing obligation. Subsequent RTS have specified which derivatives are to be subject to the clearing obligation and the dates on which the clearing obligation is to apply to different categories of a counterparty, with the most active counterparties becoming subject first.

For G4 current interest rate swaps[46] that are subject to the clearing obligation, the following dates apply:

(a) 21 June 2016 – Category 1: counterparties that are clearing members of an authorised or recognised CCP.

(b) 21 December 2016 – Category 2: FCs and AIFs which do not fall within Category 1, which are not non-financial counterparties ("**NFCs**") and which belong to a group whose aggregate month-end average outstanding gross notional amount ("**AMEANA**") of non-centrally cleared derivatives exceeds EUR8 billion.

(c) 21 June 2019 – Category 3: FCs and AIFs that are NFCs and which are not included in Categories 1 or 2.

(d) 21 December 2018 – Category 4: NFCs which do not fall within Categories 1, 2 or 3.

For those EEA currency interest rate swaps and index credit default swaps[47] ("**CDS**") that are subject to the clearing obligation, the following dates apply:

(a) 9 February 2017 – Category 1: counterparties that are clearing members of an authorised or recognised CCP.

(b) 9 July 2017 (9 August 2017 for CDS) – Category 2: FCs and AIFs which do not fall within Category 1, which are not Non-Financial Counterparties ("**NFCs**") and which belong to a group whose AMEANA of non-centrally cleared derivatives exceeds EUR 8 billion.

(c) 21 June 2019 – Category 3: FCs and AIFs which are NFCs and which do not fall in Categories 1 or 2.

(d) 9 August 2019 (9 May 2019 for CDS) – Category 4: NFCs which do not fall into Categories 1, 2 or 3.

Article 11(3) of EMIR requires financial counterparties and NFCs+ to adopt procedures with respect to the timely, accurate and appropriately segregated exchange of collateral with respect to non-cleared derivatives. The 3 European Supervisory Authorities ("**ESAs**") (being ESMA, EBA and EIOPA) were required to develop RTS as to the necessary procedures, levels and type of collateral and segregation arrangements and the EU Commission adopted a final version of the relevant RTS[48] (the "**Risk Mitigation RTS**") on 4 October 2016. The Risk Mitigation RTS only directly affect financial counterparties and NFCs+ that are established in the EU. However, non-EU entities that trade with EU entities that are subject to the margin requirements are likely to be obliged to put collateralization procedures in place in order to allow their EU-established counterparties to comply with EMIR. The Risk Mitigation RTS require the posting of Initial Margin ("**IM**") and Variation Margin ("**VM**"). They also set out eligibility criteria for assets that may be used as collateral, designed to ensure that the collateral is sufficiently liquid, not exposed to excessive credit, market or FX risk and holds its value during times of financial stress. The margin requirements apply to all new OTC derivative contracts that are not cleared through a central counterparty. There are some exemptions from the collateral requirements for transactions below certain financial thresholds and intragroup transactions complying with specified criteria.

Collateral collected as IM must be segregated from the other assets of the third party or custodian that is holding it. Counterparties that collect IM are forbidden from re-hypothecating, re-pledging or otherwise re-using the collateral. The margin requirements have been gradually phased in since 4 January 2017. Categories for margin requirements are calculated by the Average Notional Amount ("**ANA**") at group

[46] As to which, see Commission Delegated Regulation (EU) 2015/2205, https://goo.gl/s6qFjP.
[47] As to which, see Commission Delegated Regulation (EU) 2016/1178 and 2016/592, https://goo.gl/UXZdJ5.
[48] https://goo.gl/LguZoM.

level with category 1 being the highest (at ANA ≥ EUR3 trillion) and category 5 being the lowest (at ANA ≥ EUR8 billion). The Risk Mitigation RTS came into force on 4 January 2017 and currently VM has been phased in for all counterparties and products, with IM currently phased in for categories 1 and 2. By September 2020, all in-scope entities trading such derivatives in excess of EUR8 billion will be subject to the requirements. IM is not required to be exchanged for physically-settled foreign exchange forwards ("**FX forwards**") but in addition, on 18 December 2017, the Joint Committee of the three ESAs published draft regulatory technical standards to amend the existing Risk Mitigation RTS in relation to physically-settled FX forwards. According to these draft standards, if either counterparty to the FX forward is an entity who is neither (a) an EU credit institution or EU MiFID investment firm (each, an "institution"), nor (b) a non-EU entity that would be an institution if it were established in the EU, then no variation margin will need to be exchanged.

The new standards will only become effective the day after they are published in the Official Journal, and therefore the above changes were not effective by 3 January 2018 (the date on which the variation margin requirements for physically-settled FX forwards came into force).

Consequently, the ESAs have stated that, for institution-to-non-institution transactions, competent authorities should apply the EU framework in a risk-based and proportionate manner until the amended RTS enter into force. In practice, this is expected to mean that competent authorities will not seek to enforce variation margin arrangements for trades that will not require variation margin when the amended RTS eventually become effective.

Between 2015 and 2016, the European Commission carried out an extensive review of EMIR and this resulted in a legislative proposal by the European Commission on 4 May 2017 to amend EMIR in many respects,[49] intended to streamline or reduce the regulatory burden on derivatives counterparties. However, it also proposed to broaden the definition of "financial counterparty" in order to include central securities depositaries and most securitisation special purpose entities ("**SSPEs**"), as well as all AIFs. In response to negative reactions to these proposals, two compromise proposals were issued which suggested not classifying SSPEs as financial counterparties and also restricting the range of AIFs that would constitute financial counterparties to those that are established in the EU or whose manager is authorised or registered under the EU's AIFM Directive. If these compromise proposals are ultimately agreed, it will mean that SSPEs and a large proportion of alternative investment funds will (as is currently the case) not be subject to EMIR's clearing and margin provisions, unless they constitute NFC+ entities.

EMIR provides a mechanism for recognising non-EU CCPs, and currently recognition decisions have been provided for 14 countries.[50] The effect of these recognition decisions is that such non-EU entities will be eligible as CCPs under EMIR, without further authorisation or supervision from EU authorities. However, on 13 June, the European Commission released a separate legislative proposal on the recognition and the supervision of non-EU central counterparties.[51] The proposal introduces a new two-tier system for classifying third-country CCPs, dividing them into "Non-systemically important CCPs" or Tier 1 CCPs and "Systemically important CCPs" or Tier 2 CCPs. Tier 1 CCPs will continue to be able to operate under the existing EMIR equivalence regime. Tier 2 CCPs will be subject to enhanced supervisory requirements which would need to be complied with, in order to benefit from a recognition decision. The European Commission also proposed that, if ESMA decided, together with the relevant EU central bank, that a particular CCP posed risks to the EU's financial stability that could not be sufficiently mitigated by any enhanced supervisory measures, they can recommend to the European Commission that such CCP should not be recognised. This would mean that the CCP would have to relocate to an EU member state and become authorised there as an EU CCP. This final provision is widely viewed by the financial markets as a means for the EU to appropriate the UK's euro-denominated clearing business when the UK finally leaves the EU. The proposal is now being considered by the European Parliament and Council.

We would expect the shape of the proposed EMIR II regulation to become clearer in the coming months. Certainly it will streamline certain EMIR obligations, such as reporting of trades, even though it will not

[49] https://goo.gl/WCY7wr.
[50] https://goo.gl/gPr5Ri.
[51] https://goo.gl/QUTScU.

remove the requirement for bilateral reporting, and it seems that the unwise reclassification proposal contained in the original draft from the European Commission will not reappear in the final version.

The fate of the proposed regulation to enhance supervision of so-called Tier 2 CCPs is much less certain. The proposed changes to the system of recognition of non-EU CCPs are highly politically controversial in the context of the Brexit negotiations, and the regulation may not advance far until there is much more clarity on how these will turn out. In addition, certain provisions of the proposed regulation have elicited strong adverse reactions from the U.S., with the CFTC Commissioner Giancarlo, in October 2017, stating that the U.S. is a "rule maker" and not a "rule taker."

## 11. BENCHMARKS REGULATION

Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "**Benchmarks Regulation**" or "**BMR**")[52] came into force on 30 June 2016, and the vast majority of the provisions came into effect on 1 January 2018.

The BMR is a new regime for the authorisation and supervision of administrators of financial benchmarks that are used in the EU. It is particularly significant for financial securities sold in the EU, as supervised entities will only be able to use a benchmark in the EU (including referencing the benchmark in a financial instrument it issues) if the benchmark is provided by an administrator authorised or registered under the BMR. Benchmark administrators will be required to comply with a number of obligations including governance, oversight and control requirements and requirements relating to benchmark methodology. Benchmark administrators located outside the EU will also be subject to the BMR if a benchmark they administer is used within the EU.

Under the Benchmarks Regulation, a "benchmark" is defined as "any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument, is determined, or an index that is used to measure the performance of an investment fund with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees." The definition of "index" is wide and covers any figure that is published or made available to the public and that is regularly determined by reference to a formula or other method of calculation and on the basis of the value of one or more underlying assets or prices, including actual or estimated interest rates.

There are broadly three categories of benchmarks under the BMR – critical benchmarks (including benchmarks used as a reference for financial instruments having a total value of at least EUR500 billion), significant benchmarks (including benchmarks used as a reference for financial instruments having a total value of at least EUR50 billion but less than EUR500 billion) and non-significant benchmarks (those which are neither critical nor significant). There are also some specific provisions relating to regulated-data benchmarks, commodity benchmarks and interest rate benchmarks.

The BMR requires administrators of benchmarks that are located in the EU to be authorised or registered by their relevant competent authority. Such benchmark administrators are subject to a number of obligations, including governance requirements, oversight function obligations and record-keeping. Additional requirements apply to administrators of commodity and interest rate benchmarks. Critical benchmarks are subject to additional requirements, particularly where the administrator of such benchmark intends to cease to provide such benchmark.

The BMR is likely to have a particular impact on structured products offerings within the EU as many of these are likely to come within the BMR definition of "financial instrument" and incorporate a benchmark within the scope of the BMR. There are, however, significant transitional provisions that will enable many existing benchmark administrators to continue to provide benchmarks in the EU until 1 January 2020 even without authorisation or registration under the BMR.

For index providers located in the EU, the BMR provides that any index provider that was already providing a benchmark in the EU on 30 June 2016 (the date the BMR came into force) must apply for authorisation or registration under the BMR by 1 January 2020. In a Technical Advice and in a Q&A

[52] https://goo.gl/mRJxyb.

document dated 8 November 2017,[53] ESMA has confirmed that EU-based index providers that were providing benchmarks in the EU on or before 30 June 2016 may continue to provide benchmarks in the EU (including new benchmarks developed after 1 January 2018) up until 1 January 2020 unless and until the authorisation or registration of the index provider under the BMR is refused.

However, in relation to EU index providers that only commenced providing a benchmark in the EU between 30 June 2016 and 31 December 2017, ESMA construes the transitional provisions as meaning that in relation to benchmarks that such administrator started providing between 1 July 2016 and 31 December 2017, it can continue to provide such existing benchmark (i.e., those existing on or before 1 January 2018) up until 1 January 2020 or unless and until the authorisation or registration of such index provider is refused. However, any such index provider cannot provide any benchmark created on or after 1 January 2018 in the EU unless it first obtains authorisation or registration under the BMR.

Different provisions apply in respect of non-EU administrators. There are three routes by which such administrators can have their benchmarks used in the EU:

(a) **Determination of equivalence**: the non-EU administrator is located and subject to supervision in a jurisdiction that the EU Commission has determined has equivalent regulation to the BMR (no such determination has yet been made in respect of any jurisdiction).

(b) **Recognition**: the non-EU administrator is recognised by its EU member state of reference as complying with the majority of the provisions of the BMR (to be determined by specified criteria).

(c) **Endorsement by EU supervised entity**: an authorised/registered EU administrator, or any other supervised entity in the EU which has a clear and well-defined role within the control or accountability framework of a non-EU administrator, and which is able to monitor the provision of the relevant benchmark, may apply to the relevant competent authority to endorse a benchmark or a family of benchmarks provided in a non-EU country for their use in the EU.

Transitional provisions under the BMR state that any benchmark provided by a non-EU administrator can still be used in the EU after 1 January 2018 if such benchmark is "already used" in the EU as a reference for financial instruments. Under the Q&A document dated 8 November 2017, ESMA states that for the purpose of the transitional provisions relating to non-EEA benchmarks, the term "already used" should be interpreted as meaning where the benchmark is already used in the EU on or before 1 January 2020. This means any non-EU administrators are able to continue to administer both existing and new benchmarks in the EU up until 1 January 2020. The revised ESMA guidance in the Q&A is considered surprising by many market participants as it puts non-EU administrators in a better position than EU administrators who were not providing an index in the EU as of 30 June 2016. The Q&A is, however, intended to operate as "level 3" guidance under the BMR and market participants should therefore be able to rely on ESMA's revised guidance.

Although this gives immediate relief to non-EU benchmark administrators in respect of both existing and new benchmarks to be used in financial instruments, we would recommend that such administrators start giving consideration to whether an application for recognition or endorsement of relevant benchmark(s) should be made. It should be noted that (in contrast to the position for EU administrators) even if such an application is not successful, the benchmark can still benefit from the transitional provisions up until 1 January 2020.

On 28 December 2017, LIBOR was added to the list of critical benchmarks under the BMR by the European Commission pursuant to the Commission Implementing Regulation (EU) 2017/2446. This brings the list of critical benchmarks to a total of three benchmarks to date (together with EURIBOR® and EONIA®). Under Article 23 of the BMR, where an administrator has given notice that it intends to cease contributing input data to a critical benchmark, the relevant competent authority has the power to require supervised contributors of such benchmark to continue contributing input data for a period of no more than four weeks, without imposing an obligation on supervised entities to either trade or commit to trade.

[53] https://goo.gl/zwqqxX.

This comes after the Chief Executive of the UK FCA announced in July 2017 that it will no longer compel panel banks to continue to contribute data for LIBOR after 2021. Whilst the designation of "critical benchmark" means that the FCA can continue to compel contribution of data to LIBOR after 2021 pursuant to its power under the BMR, it is only a temporary measure, which the FCA acknowledged as much in its July 2017 speech, and in any case the FCA had made clear that it would prefer not to do so. Since the July 2017 speech, the market has largely prepared itself for a move away from the use of LIBOR, and there has been much discussion as to what would be the most appropriate alternative rate. The Loan Market Association noted that there is considerable pressure from regulators for the market to move to risk-free rates, a move that is recognised also by ISDA, which announced in November 2017 that it has started preparing a comprehensive analysis for the issues and potential solutions relating to transitioning existing and new financial contracts and practices to alternative risk free rates, including the feedback from all sectors of the market on this matter. The ISDA report is due to be published in Q1 2018.

## 12. PRIIPS REGULATION

The EU Packaged Retail Products and Insurance-based Investment Products Regulation (the "**PRIIPs Regulation**") became effective on 1 January 2018.

The range of products that are within the scope of the PRIIPs Regulation is very broad and the vast majority of structured products are captured. Products where the amount repayable to investors is subject to "fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor" will fall within scope, whilst simple instruments such as "vanilla" fixed rate notes will not. The position with "vanilla" floating rate notes, i.e., notes repaying 100% of the invested principal on maturity and with interest rate payments linked only to a standard reference rate such as LIBOR, is less clear. While it could be argued that such a note falls within the above description, there are also arguments supporting the view that it does not, including the clear intention of the PRIIPs initiative, as reflected not just in the PRIIPs Regulation, but also in the MiFID II Directive. While the PRIIPs Regulation provides some lists of some instruments that are within scope and some that are outside scope, these lists are not exhaustive and no further guidance has yet been issued for those products that appear on neither list.

The PRIIPs Regulation requires that whenever an in-scope product is offered to an EU retail investor (including a retail client under MiFID II), an additional short form disclosure document, called a Key Information Document ("**KID**"), must be provided to that investor before they make their investment decision. The obligation to prepare the KID falls on the product manufacturer (the person who manufactures the product or makes changes to an existing product, including its risk/reward profile or the associated costs of investing in the product), even if the manufacturer is located outside the EU, whereas the obligation to provide or deliver the KID to the EU retail investor rests with the person who is selling or advising on the product to the investor, again even if such seller/advisor is located outside the EU. On the other hand, no KID needs to be provided to any investors located outside the EU even where the manufacturer or seller/advisor is located in the EU.

In March 2017, the European Commission adopted the revised regulatory technical standards ("**RTS**") for the PRIIPs Regulation after the initial draft of the RTS was rejected in September 2016 due to various deficiencies raised by a number of market participants. The revised RTS apply from 1 January 2018, in line with the application of the PRIIPs Regulation. The RTS set out the prescriptive criteria for the information to be included in the KID, including without limitation:

(a) The presentation, content and format of KIDs, such as:

   (i) each KID shall not exceed three sides of A4-sized paper;

   (ii) it shall contain a summary risk indicator scale from 1 to 7 for ranking the relative risk of the relevant product;

   (iii) it will need to include four performance scenarios – favourable, moderate, unfavourable and stress scenarios, including formulae for the calculation of scenario values for the recommended holding period;

(iv) specific requirements for multi-option products (i.e., products which have two or more underlying investment options).

(b) The review, revision and republication of KIDs:

(i) product manufacturers shall review the information in a KID at least once every 12 months following the initial date of publication, and every time there is a change that significantly affects (or is likely to significantly affect) the information contained in the KID, and revise the KID accordingly without undue delay; and

(ii) all revised KIDs will have to be published on the manufacturer's website.

(c) Meeting the requirement to provide the KID in good time: KIDs have to be provided to investors sufficiently early to enable them to have enough time to consider the documentation before being bound by the contract, regardless of any cooling down period. Whether this condition is satisfied will depend upon the knowledge and experience of the retail investor, the complexity of the product and the urgency to conclude the proposed sale (where the advice or sale is at the instigation of the retail investor).

In July and August 2017, the Joint Committee of the European Supervisory Authorities ("**ESAs**") published the "level 3" Q&As to further clarify upon the implementation of the PRIIPs Regulation and the RTS, and a flow diagram setting out the detailed calculation steps for the risk and reward calculations in a KID.

Issuers of in-scope products should continue to be aware that, although the obligation to provide or deliver a KID to an investor lies with the seller/advisor who faces the investor, the issuer still has the obligation to prepare the KID if its products are to be sold to EU retail investors. Therefore, issuers should always ensure that it is clearly understood between it and its distributors whether their products are permitted to be distributed to EU retail investors or not, and they should give careful thought as to both the contractual restrictions to be agreed between them in that respect, as well as any legends and disclosures in the disclosure documents. Issuers should also ensure that the distribution strategy of its distributors is in line with any such distribution restrictions.

Under the current RTS, for multi-option products, manufacturers are required to provide information on each investment option underlying the product, including information on investment objectives, summary risk indicator and narrative, performance scenarios, a presentation of costs and, where relevant, a comprehension alert. Where at least one of the underlying investment options is either a UCITS or non-UCITS fund, manufacturers may use the key information document that it has prepared in respect of such investment option in accordance with the UCITS Directive (2009/65/EC) instead, pursuant to the derogation under Article 14(2) of the RTS. However, this derogation will only apply until 31 December 2019, which means that after that date, manufacturers will need to provide the same information in respect of any UCITS or non-UCITS fund underlying investment option, in the same way it does for the other underlying investment options.

Given the short time in which the PRIIPs Regulation has been in force, market practice in relation to KIDs for different products, as well as distribution arrangements, contractual restrictions and disclosures will continue to evolve throughout 2018. It is possible that further PRIIPs guidance from the ESAs and national regulators may be developed, and financial participants will be grateful for any further regulatory clarifications.

## 13. AIFMD

The Alternative Investment Fund Managers Directive[54] (the "**AIFMD**") and its supplementary Regulation came into effect in the EU in July 2013 and introduced a centralised rulebook for the management and marketing of alternative investment funds ("**AIFs**") within the EU by alternative investment fund managers ("**AIFMs**").

[54] https://goo.gl/o9hfDh.

One of the main benefits for an AIFM from being subject to the full onerous requirements of AIFMD is the managing and marketing passport. Once an AIFM has obtained authorisation in an EEA member state, it may market units or shares of any EU AIF that it manages to professional investors in any other member state, once it has complied with certain additional conditions, such as notifying the competent authorities of its home member state in respect of the EU AIF that it intends to market.

In addition, an EU AIFM that is authorised in one EU member state may manage an AIF established in another member state either directly or by establishing a branch, provided that the AIFM is authorized to manage that type of AIF.

Currently, the AIFMD passport can be used in the following combinations of circumstances:

(a) an EU AIFM managing one or more EU AIFs, but not marketing AIFs in other member states;

(b) an EU AIFM managing one or more EU AIFs and marketing one or more EU AIFs in other member states; and

(c) an EU AIFM managing one or more non-EU AIFs which are not marketed in any EEA member state.

Therefore, at the moment, an EU AIFM wishing to market non-EU AIFs, or a non-EU AIFM wishing to market any AIF, may only do so in accordance with the national private placement regime ("**NPPR**") of each EEA member state in which marketing is to take place. In this case the AIFM must comply with the rules specified for each relevant NPPR, and these rules may differ as between member states.

The AIFMD envisages that the AIFMD passport can be extended to non-EU AIFMs/AIFs at the decision of the European Commission, having received an opinion from ESMA.

However, the Commission has so far remained silent on this matter for over two years despite positive recommendations by ESMA for extension of the passport to entities from the following countries (in some cases minor regulatory changes would be required): Australia, Canada, Guernsey, Japan, Jersey and Switzerland. Hong Kong and Singapore were also recommended, although it was noted that they have regimes which limit the access of UCITs from some EU member states to retail investors in their jurisdictions, and Bermuda, Cayman Islands and Isle of Man were given no current indication.[55] The question of whether third country passporting rights should be granted to the United States is more complex. In terms of investor protection and monitoring systemic risk, ESMA found no significant obstacles in extending the passport to the United States and ESMA noted that it did not find any significant obstacles for funds marketed by managers to professional investors so long as they do not involve any public offering. However, to the extent that funds are marketed by managers to professional investors which do involve a public offering, ESMA concluded that there would be a risk of an "un-level playing field" between EU and non-EU AIFMs if such passport were extended, due to the stringent U.S. registration requirements for public offerings.

Since the UK is set to be a non-EU country after March 2019, and since the question of its post-Brexit rights of access to the EU market for financial services is such a politically sensitive topic, it is not expected that the Commission will make any decisions on third-country passports until more is known about the nature of the UK's exit from the European Union.

The consequences of the United Kingdom's vote to leave the EU ("**Brexit**") on 23 June 2016 may (depending on the United Kingdom's future post-Brexit relationship with the EU) mean that United Kingdom-based AIFMs will be treated as those of the same as AIFMs from any other non-EU country. Therefore, UK AIFMs may, post-Brexit, be required to (a) use individual national private placement regimes ("**NPPRs**") of EU member states (if NPPRs for such member state(s) is/are still available by then); (b) become authorised in a (non-UK) member state of reference to be eligible for the passport, if the passport is extended to the UK as a non-EU country; or (c) if the passport is not extended to the UK as a non-EU country, have a registered office in a (non-UK) member state to be authorised as an EU AIFM.

[55] https://goo.gl/nF8DAi.

In terms of non-passport related developments, in June 2017 the FCA's updated reporting requirements came into effect in the UK. These extended Annex IV reporting under AIFMD to include a requirement for non-EEA AIFMs to report on their feeder funds in the UK as well as the feeder fund's master AIF (where both AIFs have the same AIFM).

Following on from its June 2016 Call for Evidence[56] in relation to asset segregation and custodial services under UCITS V and AIFMD, on 20 July 2017, ESMA released its opinion in relation to these matters.[57] The opinion addresses two main areas:[58]

(a) The optimal approach to asset segregation under the framework under AIFMD and UCITS. To achieve this, ESMA proposed the model: own account; client account; fund account-allowing for segregation of accounts and recognition of omnibus structures. It is noted that regulatory authorities can apply different standards.

(b) Clarification on how the depositary delegation rules should apply to central securities depositaries ("**CSDs**") ensuring a consistent approach across the EU. The opinion highlights the AIFM definition in relation to CSDs, solving the conflict as to whether the use of CSDs constitutes a delegation by the depositary (it does not). ESMA differentiates between the role of CSD as "agent" and the role of CSD as "intermediary/ investor."

Over the course of 2017, ESMA responded to a number of questions in their AIFMD Q&A document.[59] These answers provided further clarity on the following topics under AIFMD:

**April 2017**

AIF marketing passport may only be used to market to "professional investors" (i.e. professional clients under MiFID II). Any other marketing to other categories of investors whose definitions share characteristics of professional investors must be notified and carried out under NPPRs.

**May 2017**

How AIFMs should report when information is not available for the split between retail and professional investors

Article 4(2) of EMIR (the exemption for intragroup transactions) should be construed narrowly, and in most cases, it will not be possible to be used. It will only be granted if the AIF is established to form part of the same group as the counterparty to the OTC derivative contract and if it fulfils all the criteria under certain sub-paragraphs of Article 3(2) of EMIR. This will be a case-by-case assessment.

In a case where an AIFM wants to manage AIFs domiciled in another member state under the management passport, and specific AIFs cannot be identified at the time of notification, the AIFs to be managed may be identified by their investment strategy. Where an AIFM is able to specify AIFs, these should be identified in the programme of operations by their name and national identifier (if available).

**July 2017**

How to convert the total value of assets under management into Euros to address reporting requirements.

How an AIF should measure its exposure to a purchase of a loan in a secondary market.

The NAV of the AIF should be reported in the base currency of the AIF on the consolidated reporting template.

[56] https://goo.gl/cx1yXo.
[57] https://goo.gl/CPAjYC.
[58] https://goo.gl/cxb6Ed.
[59] https://goo.gl/jGeDPD.

**October 2017**

Remuneration-related disclosure requirements under Article 22(2) of the AIFMD do apply to staff of an entity to whom portfolio management or risk management activities have been delegated by the AIFM.

Information mentioned under Article 22(2)(e) and (f) of the AIFMD should be disclosed in the annual report and not with a link to a different document.

How Section A of the Annex to the Securities Financing Transactions Regulation ("**SFTR**") is properly used to present data, in relation to the obligation of AIFs to inform investors on the use they make of SFTs and total return swaps in their annual reports.

In a speech given in December 2017,[60] Verena Ross, ESMA Executive Director, addressed the future of the AIFMD in the context of Brexit. She said that ESMA was aware of the concern that market participants had in relation to the effect of a possible "cliff edge" Brexit, where the UK leaves the EU without any political agreement having been reached and that "cooperation arrangements" would need to be in place in case portfolio or risk management is delegated to an entity in a third country. She suggested that ESMA take an active role in coordinating agreements on behalf of the national regulators in the EU27.

By July 2017, the EU Commission was expected to start a review on the application and scope of the AIFMD as a whole. Though now delayed, in April 2017, the Commission issued a tender[61] for a market study to take place. It is possible that such a review might result in an AIFMD II.

## 14. UCITS

Undertakings for Collective Investment in Transferable Securities ("**UCITS**") funds (mutual funds) in the EU are currently regulated pursuant to the existing UCITS Directive ("**UCITS IV**")[62] as amended by an amending Directive[63] ("**UCITS V**"). The original focus of UCITS was on funds which deal with "transferable securities", but it also covers a broader range of funds, such as closed-ended funds and structured financial instruments, when they fulfil certain requirements.

The principal amendments made by UCITS V seek to make some of the rules for UCITS funds more consistent with those applicable to alternative investment funds under the AIFMD. These include changes to the provisions relating to the appointment of a depositary in respect of a UCITS fund, rules setting out the terms on which the depositaries' safekeeping duties can be delegated and a revision of the eligibility criteria for depositaries.

In April 2016, a Delegated Regulation[64] came into force which provided, among other things:

(a) minimum requirements to be included in the contract between the depositary and the management/investment company;

(b) certain duties and obligations on the depositary including safe-keeping, custody and ownership verification, oversight and record-keeping;

(c) provisions relating to insolvency protection of the assets of the UCITS, including due diligence and asset-segregation obligations when appointing delegates to perform safe-keeping duties; and

(d) liability of the depositary in circumstances where custody assets are lost by the depositary or a third party.

Following on from its June 2016 Call for Evidence[65] in relation to asset segregation and custodial services under UCITS V and AIFMD, on 20 July 2017, ESMA released its opinion in relation to these matters.[66]

[60] https://goo.gl/prPdme.
[61] https://goo.gl/8X8VwJ.
[62] Directive 2009/65/EC, https://goo.gl/ajdVSF.
[63] Directive 2014/91/EC, https://goo.gl/rDPaGG.
[64] https://goo.gl/9PGZnq.
[65] https://goo.gl/8LUsnm.
[66] https://goo.gl/2rrfYH.

The opinion addresses two main areas:[67]

(a) The optimal approach to asset segregation under the framework under AIFMD and UCITS. To achieve this, ESMA proposed the model: own account; client account; fund account-allowing for segregation of accounts and recognition of omnibus structures. It is noted that regulatory authorities can apply different standards.

(b) Clarification on how the depositary delegation rules should apply to central securities depositaries ("**CSDs")** ensuring a consistent approach across the EU. The opinion highlights the AIFM definition in relation to CSDs, solving the conflict as to whether the use of CSDs constitutes a delegation by the depositary (it does not). ESMA differentiates between the role of CSD as "agent" and the role of CSD as "intermediary/ investor."

A further opinion was issued in January 2017 by ESMA in relation to UCITS share classes,[68] following on from the previous discussion papers.[69] The UCITS Directive recognises the possibility for UCITS to offer different share classes to investors, but it does not prescribe whether, and to what extent, share classes of a given UCITS differ from one another. ESMA has now set out the following high-level principles to be followed when setting up different share classes:[70]

(a) Common investment objective – Share classes of the same fund should have a common investment objective reflected by a common pool of assets;

(b) Non-contagion – UCITS management companies should implement appropriate procedures to minimise the risk that features that are specific to one share class could have a potentially adverse impact on other share classes of the same fund;

(c) Pre-determination – All features of the share class should be pre-determined before it is set up; and

(d) Transparency – Differences between share classes of the same fund should be disclosed to investors when they have a choice between two or more classes.

In addition to the above principles, share classes should never be set up to circumvent the rules of the UCITS Directive, particularly those on diversification, derivative eligibility and liquidity.

The UCITS Q&A document was updated a number of times in 2017[71] resulting in clarifications on the following topics:

**April 2017**

A UCITS management company can notify cross-border activities without having to identify a specific UCITS.

**May 2017**

Article 4(2) of EMIR (the exemption for intragroup transactions) should be construed narrowly. It will only been granted if the UCITS is established to form part of the same group as the counterparty to the OTC derivative contract and if it fulfils all the criteria under certain sub-paragraphs of Article 3(2) of EMIR. This will be a case-by-case assessment, and in most cases, it will not be possible to be used.

**July 2017**

The 40% limit set out in Article 52(2) of the UCITS Directive is not applicable to the index-tracking UCITS that comply with the requirements set out in Article 53.

A person who served in the management body or supervisory body of an entity or was otherwise employed by such an entity should be deemed to fulfil the independence requirement only after

[67] https://goo.gl/WZPB6T.
[68] https://goo.gl/QsjvjL.
[69] https://goo.gl/xwNAi9.
[70] https://goo.gl/ogsRuf.
[71] https://goo.gl/kf36td.

an appropriate cooling-off period following the termination of his/her relationship with the relevant entity.

**October 2017**

How Section A of the Annex to the Securities Financing Transactions Regulation ("**SFTR**") is properly used to present data in relation to the obligation of UCITS management companies to inform investors on the use they make of SFTs and total return swaps in their annual and half-yearly reports.

Two speeches by ESMA in late 2017 addressed the future of UCITS. In October 2017, Steven Maijoor, Chair of ESMA gave a speech[72] on the challenges facing European financial markets. He outlined that ESMA would focus on the cost and performance of UCITS funds as part of their large-scale assessment of costs and past performance of retail investment products. He drew particular attention to differences between active and passive investment, and the impact on costs and charges, and long-term return. In a speech given in December 2017,[73] Verena Ross, ESMA Executive Director, addressed the future of the UCITS Directive in the context of Brexit. She said that ESMA was aware of the concern that market participants had in relation to the effect of a possible "cliff-edge" Brexit, where the UK leaves the EU without any political agreement having been reached and that "cooperation arrangements" would need to be in place in case portfolio or risk management is delegated to an entity in a third country. She suggested that ESMA take an active role in coordinating agreements on behalf of the national regulators in the EU27.

## 15. ICOS/VIRTUAL CURRENCIES/BLOCKCHAIN

2017 was a blockbuster year for blockchain, the technology which allows information to be recorded on a ledger that is linked and secured by means of digital cryptography. The use of decentralised and distributed ledger technology has the potential to disrupt or reform the way transactions are conducted and verified. Although the use of blockchain technology is still being explored in various forms, virtual currencies and initial coin offerings ("**ICOs"**) have experienced rapid growth and are being carefully considered by regulators.

*Virtual Currencies/Distributed Ledger Technology.* 2017 has seen the price of Bitcoin, the most prominent and first virtual currency ("**VC**"), chart a volatile course to record highs. Correspondingly, there has been significant interest in the underlying innovation of distributed ledger technology ("**DLT**") in recent years. The European Parliament's Committee on Economic and Monetary Affairs ("**ECON**") described DLT as being "set to have a significant impact on the financial sector and beyond." DLT, which enables a decentralized, rapid, resilient and relatively secure means of recording transactions together with the history of previous transactions, presents considerable opportunities and risks.

While there is currently no UK or EU legislation specifically addressing virtual currencies or DLT, several regulatory bodies of the UK and EU have published reports or opinions that provide some insight on the regulatory horizon. We have summarised them below.

On 12 December 2013, the EBA issued a warning[74] to consumers to highlight the possible risks arising from buying, holding or trading virtual currencies. It highlighted various risks to consumers, including risk of loss of money (resulting from the lack of regulation for trading platforms for VCs, theft from digital wallets, lost passwords, among others), lack of consumer protection, potential that networks may be associated with criminal activities, volatility and potential tax implications.

On 4 July 2014, the EBA then published an opinion on virtual currencies.[75] In the opinion, the EBA advised national supervisory authorities ("**NSAs**") to discourage credit institutions, payment institutions and e-money institutions from buying, holding or selling VCs. It also recommended that EU legislators consider requiring market participants at the direct interface between conventional (fiat) currencies and VCs (such as VC exchanges) to observe anti-money laundering ("**AML**") obligations.

---

[72] https://goo.gl/H3axU6.
[73] https://goo.gl/2Ppcyy.
[74] EBA/WRG/2013/01, https://goo.gl/n3Da6R.
[75] EBA/Op/2014/08, https://goo.gl/nKiayz.

On 23 February 2016, the ECON published a draft report on virtual currencies,[76] calling for a proportionate regulatory approach so as not to stifle innovation at an early stage, while also discussing the serious regulatory challenges that the widespread use of VCs and DLT might pose. It welcomed the European Commission's suggestions for including virtual currency exchange platforms in the Fourth Money Laundering Directive[77] ("**MLD4**") as well as recommended a review of EU legislation on payments, including PSD2 and the second Electronic Money Directive[78] ("**2EMD**"), in the light of new possibilities afforded by technological developments, including virtual currencies and DLT.

On 26 May 2016, the European Parliament published a provisional edition of the text of a non-legislative resolution it has adopted on VCs, building on the proposed motion in ECON's report. It recommended, among other things, that:

(a) government agencies and competent authorities that are tasked with analysing large quantities of data explore the use of real-time DLT-based supervision with reporting tools as part of a RegTech agenda in the financial services sector;

(b) the Commission draw up a comprehensive analysis of VC and, on the basis of this assessment, considers, if appropriate, revising the relevant EU legislation on payments, including the Payment Accounts Directive[79] ("**PAD**"), PSD2 and 2EMD; and

(c) the Commission to set up a taskforce to monitor VC.

On 5 July 2016, the European Commission published its legislative proposal[80] for a Directive amending the MLD4 ("**MLD5**"), which included an amendment to bring virtual currency exchange platforms and custodian wallet providers within the scope of MLD4. These entities would then have to apply customer due diligence controls when exchanging virtual for traditional (fiat) currencies, ending the anonymity associated with them and thus preventing the misuse of virtual currencies for money laundering and terrorist financing purposes. MLD5 is expected to be adopted by the European Parliament in its 16 to 19 April 2018 plenary session. Once adopted, the final MLD5 text will be published in the Official Journal and will enter into force 20 days later. Member States will then have 18 months to implement it into their national laws.

In the UK, the FCA published a feedback statement[81] (FS17/4) in December 2017 on its April 2017 discussion paper on DLT, as part of a dialogue on the regulatory implications of current and potential developments of DLT in the financial market. The feedback indicated that the FCA's current rules were sufficiently flexible to deal with DLT without requiring any specific rule changes. The FCA concluded that overall it is open to all forms of deployment of DLT (including both permissioned and permissionless DLT networks) provided the operational risks are properly identified and mitigated.

The FCA said that it will continue to monitor DLT-related market developments and keep its rules and guidance under review in the light of those developments. It expects to work collaboratively with industry, HM Treasury, the Bank of England, the Office of the Information Commissioner and other UK regulatory authorities to ensure a co-ordinated approach towards DLT in the UK. At an international level, the FCA said it would also work closely with national and international regulatory bodies to shape regulatory developments and standards.

*Initial Coin Offerings.* ICOs are a form of fundraising in which digital tokens are generated and then sold in exchange for other virtual currencies or traditional (fiat) currency (legal tender issued by a central bank) in unregulated public offerings. ICOs vary widely by design. The issuers are often early stage start-ups who use the proceeds to fund projects. There has been a rapid growth in ICOs over the course of 2017, with a reported USD2 billion in funds having been raised in total by ICOs.

[76] 2016/2007(INI), https://goo.gl/vS4VKk.
[77] (EU) 2015/849, https://goo.gl/e6TGz9.
[78] 2009/110/EC, https://goo.gl/r8fr4A.
[79] 2014/92/EU, https://goo.gl/oWFkg5.
[80] COM(2016) 450 final, https://goo.gl/N7ar7H.
[81] FS17/4, https://goo.gl/dL4eBQ.

In the UK, the FCA issued a consumer warning on 12 September 2017[82] about the risks of ICOs, highlighting the following risks:

(a) Potentially unregulated space (the FCA indicated that it will determine whether a specific ICO falls within its boundaries on a case-by-case basis);

(b) No investor protection, such as the Financial Services Compensation Scheme;

(c) Price volatility;

(d) Potential for fraud, in terms of issuers not using the funds raised in the manner stated during marketing;

(e) Inadequate information – typically ICOs only produce a "white paper", rather than a regulated prospectus; and

(f) ICOs are typically early stage of the majority of such projects with a high risk of an investor losing its investment.

The FCA recommended that consumers should only invest in an ICO project if they are an experienced investor, confident in the quality of the ICO project itself (e.g., business plan, technology, people involved) and prepared to lose their entire stake.

On 15 December 2017, the FCA's Feedback Statement on Distributed Ledger Technology announced that the FCA would gather further evidence and conduct a deeper examination of the fast-paced developments on the ICO market, with a view to determining whether or not there was need for further regulatory action in this area beyond the September consumer warning.

On 13 November 2017, ESMA issued two statements on initial coin offerings: one to firms[83] and one to investors.[84] In the statement for firms, ESMA highlighted that firms should give careful consideration as to whether their activities constitute regulated activities and ensure that they comply with relevant applicable EU legislation.

Where ICOs qualify as financial instruments, it is likely that the firms involved in ICOs will be conducting regulated investment activities and therefore need to comply with the relevant applicable legislation, including, but not limited to, the Prospectus Directive, PD III, MiFID II, Alternative Investment Fund Managers Directive and MLD4. ESMA reminded firms that where their activities constitute regulated activities, any failure to comply with the applicable rules will constitute a breach.

In the statement for investors, ESMA alerted investors of the high risk of losing all of their invested capital as ICOs are highly speculative investments. Where an ICO is structured so as to fall outside of regulation, ESMA warns that investors have no protection. In a similar vein to the FCA's consumer warning, ESMA highlighted the following risks that investors are exposed to:

(a) Lack of regulation, depending on structure;

(b) Vulnerability to fraud or illicit activities owing to their anonymity, amongst other factors;

(c) High risk of losing all invested capital;

(d) Lack of exit options and extreme price volatility;

(e) Inadequate information being provided; and

(f) Flaws in technology.

[82] https://goo.gl/ytFWHM.
[83] ESMA50-157-828, https://goo.gl/X1GzHc.
[84] ESMA50-157-829, https://goo.gl/EjntKt.

## 16. PAYMENT SERVICES DIRECTIVE II

The initial Payment Services Directive was introduced in 2007 (and implemented in EU member states in 2009) ("**PSD**") to harmonise the regulatory regime for payment services across the EU, by enabling a new type of regulated financial institution (a "**payment institution**") to compete with banks in the provision of payment services. It established an EU-wide licensing regime for payment institutions, as well as harmonised conduct of business rules.

The new Payment Services Directive (Directive (EU) 2015/2366)[85] ("**PSD2**") was published in the Official Journal of the EU in November 2015, and was to be implemented into national laws by each EU member state on 13 January 2018. The aims of PSD2 include, amongst others, increasing payment security, promoting lower cost for payments, enhancing efficiency in the EU payments market and consumer protection. PSD2 widens the definition of payment services to cover (i) payment initiation services, which enable a user to initiate a payment order in their payment account with another payment service provider; and (ii) an account information service, which provides consolidated information on one or more payment accounts held by the user with one or more other payment service providers.

In addition, a number of the exemptions that were available under the PSD are narrowed or removed (and now called "exclusions"). Various amendments are also made to the conduct of business requirements. The exemptions affected include:

(a) the "commercial agent" exemption under the PSD was relied upon by some marketplaces, for example, to process payments and the related funds as agent for both payer and payee. The exclusion under PSD2 only applies to payment transactions from the payer to the payee through a commercial agent authorised via an agreement to negotiate or conclude the sale or purchase of goods or services on behalf of only the payer or only the payee, but not both parties;

(b) the "limited network" exclusion is available for services based on payment instruments that can be used only in a limited way and:

    (i) allow the holder to acquire goods or services only in the premises of the issuer or within a limited network of service providers under a direct commercial agreement with a professional issuer; or

    (ii) can be used only to acquire a very limited range of goods or services; or

    (iii) are valid only in a single Member State and provided at the request of an undertaking or a public sector entity and regulated for specific social or tax purposes for the purpose of acquiring specific goods or services from suppliers having a commercial agreement with the issuer.

(c) Even if the service meets the exemption, however, it will need to be registered with the local supervisory authority if the total value of payment transactions executed over the preceding 12 months exceeds EUR1 million, and the authority must assess whether the service satisfies the exemption; and

(d) the exemption under the PSD for digital content or telecom payments applying to payments executed through mobile phones and the internet is, under PSD2I, limited to ancillary payment services carried out by providers of electronic communication networks or services:

    (i) for purchase of digital content and voice-based services, regardless of the device used for the purchase or consumption of the digital content and charged to the related bill; or

    (ii) performed from or via an electronic device and charged to the related bill within the framework of a charitable activity or for the purchase of tickets.

(e) The exclusion is only available for individual transactions that do not exceed EUR50 and is subject to an overall limit of EUR300 per month. A firm must notify the relevant

[85] https://goo.gl/zQKube.

supervisory authority that it is relying on this exclusion, and submit an annual audit opinion that the service complies with the limits.

PSD2 also prohibits a payee from adding a charge based on which payment instrument is used by a payer, where the instrument is a card covered by the Interchange Fee Regulation (Regulation (EU) 2015/751) or a credit transfer or direct debit in euros. However, the UK, for example, has extended this ban to every type of consumer payment method. So, any contract term requiring such a "surcharge" will not be enforceable, and there will be an implied requirement to refund the excess. The payer could also initiate a chargeback via the issuer of an affected debit or credit card (or make a claim against the credit card issuer under section 75 of the UK Consumer Credit Act 1974). In addition, any extra charge for using a commercial payment method must be limited to the supplier's cost of accepting that type of payment.

A number of other conduct of business requirements have been changed under PSD2 and some provisions aim to increase competition by facilitating the use of the new payment initiation services and account information services offered by third-party payment service providers ("**TPPs**"). PSPs who offer payment accounts cannot deny TPPs access to their users' payment accounts or discriminate against TPPs.

The territorial scope of PSD2 is wider than the PSD. Certain provisions (mainly in respect of transparency of terms and conditions, and information requirements) will now apply to all transactions of any currency so long as at least one of the payment service providers (a "**PSP**") is located in the EU in relation to the parts of the payment transaction carried out in the EU.

PSD2 empowers host Member States to require passporting firms operating through branches or agents under the right of establishment to appoint a central point of contact to report to them on the activities carried out in the host territory by the firm's agents or branches. The EBA is to specify the functions of the central point of contact and will hold a central register of information that is entered on each Member State register that the national regulators will have to ensure is accurate and up to date. Host states may then contact the passporting firm's home state regulator with any allegations of non-compliance.

PSD2 provides that PSPs must "only access, process and retain personal data necessary for the provision of their payment services, with the explicit consent of the payment service user." PSPs must also comply with the General Data Protection Regulation[86] from 25 May 2018.

Under PSD2, the EBA is empowered to develop RTS and/or guidelines to facilitate the implementation of PSD2. Following the publication of consultation papers by the EBA on various aspects of PSD2, a number of level 2 and level 3 measures have been published:

(a) Delegated Regulation (EU) 2017/2055[87] – RTS for the cooperation and exchange of information between competent authorities relating to the exercise of the right of establishment and the freedom to provide services of payment institution, to facilitate an efficient and consistent notification process for PSPs wanting to passport their authorisation under PSD2, and including various notification templates as annexes thereto. This RTS entered into force on 1 December 2017.

(b) Final draft RTS on strong customer authentication and common and secure open standards of communication were published by the European Commission on 27 November 2017.[88] The RTS include details such as the security measures for the application of strong customer authentication ("**SCA**") that should be applied for each access to a payment account or any payment transaction, the exemptions from applying strong customer authentication and confidentiality obligations on PSPs in relation to personalised security credentials of its users. The RTS also specify requirements for common and secure standards of communication between banks and TPPs, whereby consumers and companies can consent to allow payment accounts and payment data to be accessed by TPPs. These RTS are currently expected to be published in the Official Journal of the EU early 2018, and the requirements specified therein will

[86] Regulation (EU) 2016/679, https://goo.gl/bixcbG.
[87] https://goo.gl/AGFs6r.
[88] https://goo.gl/qrqi3F.

become applicable 18 months thereafter, to allow market participants sufficient time to transition their systems.

(c) A number of final reports by the EBA containing PSD2 guidelines have also been published in 2017, each to apply from 13 January 2018, including guidelines on (i) the information to be provided for the authorisation of payment institutions and e-money institutions and for the registration of account information service providers,[89] (ii) the security measures for operational and security risks of payment services under PSD2[90] (iii) major incident reporting under PSD2[91] and (iv) procedures for complaints of alleged infringements of PSD2.[92]

The EBA has also published draft RTS on the appointment and functions of central contact points,[93] draft RTS setting technical requirements on the development, operation and maintenance of the electronic central register and on access to the information therein and draft implementing technical standards ("**ITS**") on the details and structure of the information entered by competent authorities in their public registers and notified to the EBA pursuant to PSD2,[94] and a consultation on draft guidelines on fraud reporting requirements.[95]

In the UK, the Financial Conduct Authority ("**FCA**") published a policy statement on 19 September 2017 on the implementation of PSD2,[96] following two consultations which took place during April and July 2017, including a revised Approach Document[97] setting out the FCA's approach to applying the Payment Services Regulations 2017 (the legislation by which PSD2 has been primarily implemented in the UK) and the amended E-Money Regulations 2011.

## 17. GREEN AND SOCIAL BONDS

The green bonds market has been one of the fastest developing sectors in recent years, as environmental initiatives and concerns over climate change around the world gain momentum. June 2017 marked the 10th anniversary of the first ever green bond issuance – a EUR600 million climate awareness zero coupon bond issued by the European Investment Bank ("**EIB**"). The green bonds market has developed significantly since then, with approximately USD120 billion issuance in 2017, up from USD81.60 billion in 2016.[98] Related to this, there has also been an increase in the assets under management of dedicated green bond funds.[99] The EIB remains the largest issuer of green bonds in the market, now along with many corporate issuers both in and outside of Europe wishing to take advantage of the boom in this market to expand their sources of funding. In particular, outside of EMEA, China has emerged as one of most active countries in the issuance of green bonds in the last couple of years, although some questions remain as to whether all green bonds issued are truly "green", as further explained below.

Economically, green bonds provide financial returns similar to traditional bonds, but the proceeds from the issuance are to be used for "green projects", such as low carbon projects, renewable energy, energy efficiency, pollution prevention, climate change and sustainable transportation. However, there is currently no single global standard on what projects may be classified as "green", and participants have found that the boundaries have at times been pushed in certain jurisdictions. Nevertheless, the following international bodies have developed guidelines and standards, which seek to address this lack of international standard:

---

89 https://goo.gl/yXNDPv.
90 https://goo.gl/YCtjpJ.
91 https://goo.gl/S1uBAc.
92 https://goo.gl/WMtUSN.
93 https://goo.gl/hN8nBJ.
94 https://goo.gl/at6UG8.
95 https://goo.gl/78Fas4.
96 https://goo.gl/bU8JNY.
97 https://goo.gl/etJun4.
98 Climate Bonds Initiative, https://goo.gl/nMnYZ4 (last accessed 22 December 2017).
99 Fitch Ratings, https://goo.gl/wobk2G (last accessed 22 December 2017).

(a) *The Green Bond Principles* ("**GBP**") *by the International Capital Markets Association* ("**ICMA**")[100] – ICMA developed the GBP as voluntary process guidelines to promote integrity, transparency and disclosure in the development of the green bond market. The GBP have four main components: (i) use of proceeds; (ii) process of project evaluation and selection; (iii) management of proceeds; and (iv) reporting. ICMA recommends issuers to engage an external reviewer to confirm that any proposed green bonds to be issued conform with the GBP, including certification and rating as appropriate, and encourages public disclosure of this information.

To further promote its international application, the GBP has been translated into 18 languages in 2017.

(b) *The Climate Bonds Standard* ("**CBS**") *by the Climate Bonds Initiative* ("**CBI**") – the CBS includes a certification process, pre-issuance requirements, post-issuance requirements and a suite of sector-specific eligibility and guidance documents. As a sign of co-operation between the different bodies, the principles from the 2016 GBP have been integrated into the CBS.

In terms of classification, CBI distinguishes the issuances as being "certified green bonds" (where the bonds issued are certified by a third-party verifier as being in compliance with the CBS for the relevant sector, with a final confirmation issued by the Climate Bonds Standards Board) and "labelled green bonds" (representing "self-labelled" green bonds where proceeds from the issue are to be used for climate or environmental projects labelled as "green" by the issuer), further divided into those which align with the CBI definitions and those that do not (and therefore excluded from the amount of green bonds issuance tracked by the CBI). It is interesting to note that labelled green bonds which do not comply with the CBI definitions amount to some USD10.2 billion for 2017,[101] highlighting the disparity in the use of the definition in the market.

(c) *The Green Bond Assessment* ("**GBA**") *by Moody's*[102] - Moody's defines green bonds as those which raise capital for use in projects or activities with environmental benefits, and the GBA has been set up with the goal of standardising the framework for the evaluation of green bonds. Its assessment methodology comprises five elements: (i) organisation, (ii) use of proceeds, (iii) disclosure on the use of proceeds, (iv) management of proceeds and (v) ongoing reporting and disclosure on environmental projects financed or refinanced with such securities. As part of the assessment process, Moody's will calculate a score for the relevant bond issue based on an assessment of each of the five elements, weighted to reflect its relative importance.

In addition, government entities such as the People's Bank of China ("**PBOC**") and the Japanese Ministry of the Environment ("**MoE**") have also published their own green bonds guidelines, in order to promote the development of their respective local green bonds market. The PBOC first published its guidelines in 2015, whilst the Japanese MoE published its inaugural Green Bonds Guidelines in March 2017. Both the PBOC and the MoE have considered the principles of the GBP in the development of its guidelines. This is certainly a positive step forward for the market. There however remains a difference in opinion as to the inclusion of "clean coal" projects, which are eligible green bond uses under the Chinese Green Bond Endorsed Project Catalogue published by the PBOC, but excluded under the CBI definitions.[103] As the market continues to develop, it will hopefully not be long before a single set of internationally-recognised standards is adopted to ensure consistency of application of "green bonds" uses in the global market.

In a similar vein, albeit at a slower pace of growth compared with the green bonds, is the development of the social and sustainable bonds market, being part of the "use of proceeds" bonds market. The generally accepted principle is that the proceeds from issuance of social bonds will be used for projects with social objectives, such as affordable housing, vocational training and affordable social infrastructure, whereas proceeds from sustainable bonds will be used for a combination of green and social initiatives or projects, although again there is no single market definition for these. As of 2017, Germany, France, Spain, the Netherlands and the U.S. are the top active markets in this area. In order to align the approach in these different markets, ICMA has also developed the Social Bond Principles[104] and the Sustainability Bond

[100] ICMA, https://goo.gl/PHPJin (last accessed 22 December 2017).
[101] Climate Bonds Initiative, https://goo.gl/jM31jQ (last accessed 22 December 2017).
[102] Moody's, https://goo.gl/HDk5Sa (last accessed 22 December 2017).
[103] Climate Bonds Initiative, https://goo.gl/6V2v1m (page 4) (last accessed 22 December 2017).
[104] https://goo.gl/urHWtA.

Guidelines,[105] utilising the same approach as the GBP. Although the market is still relatively small, the figures show that year on year the market continues to grow. As this segment gains wider recognition by investors, and as the base of investors who wish to engage in socially beneficial investment increases, it is likely that the social and sustainability bonds market will continue to enjoy growth.

## 18. SHADOW BANKING

The FSB has been spearheading a review of "shadow banking" since the financial crisis in light of concerns that shadow banking entities and activities contributed to the crisis and subsequent concerns that increased regulation in the banking sector since the crisis could push certain banking activities into the less regulated sectors. The FSB refers to "shadow banking" as a system of credit intermediation that involves entities and activities that are outside the regular banking system, although it has stressed that this is not a rigid definition and should be adapted according to the financial markets.[106] The FSB has been coordinating various international workstreams and has, together with IOSCO, developed a package of policy recommendations which have been endorsed by the G20 leaders.

On 3 July 2017, the FSB published an assessment of progress in transforming shadow banking into resilient market-based finance. This assessment included an assessment of the evolution of shadow banking activities since the global financial crisis and related financial stability risks and whether the policies and monitoring put in place by FSB members since then are adequate to address these risks. The assessment "highlights that the aspects of shadow banking activities generally considered to have made the financial system most vulnerable and that contributed to the financial crisis have declined significantly and are generally no longer considered to pose financial stability risks."[107] It further notes that, "since the financial crisis, policies have been introduced at the international level, and both regulatory reforms and new policy tools have been introduced at national/regional levels to address financial stability risks from shadow banking that have materialised to date."[108] These policies include:

(a) establishing system-wide oversight and monitoring frameworks to assess the financial stability risks from shadow banking, so that appropriate policy measures can be taken;

(b) taking steps to address banks' involvement in shadow banking;

(c) acting to reduce liquidity and maturity mismatches, and also leverage in the shadow banking system; and

(d) alongside increases in capitalisation of banks' securitisation-related exposures, undertaking national and regional reform to address incentive problems and opaqueness associated with securitisation.[109]

Overall, the report is very positive about the steps being taken to mitigate shadow banking and risks associated with it. It does, however, highlight its views that "the size and considerable growth of collective investment vehicles, where accompanied by significant liquidity transformation, could prove disruptive in market stress."[110]

The EU Commission has endorsed the FSB's general definition of shadow banking and has given an indication of the activities (primarily securitisation, securities lending and repos) and entities (including SPVs performing liquidity and/or market transformation and money market funds) which it believes fall within the definition.

Two shadow banking areas in respect of which there has been considerable work in the EU legislative context during the last three years or so have been securities financing transactions and money market funds. The current status of each is as follows:

[105] https://goo.gl/usLsft.
[106] See "Shadow Banking: Scoping the Issues", https://goo.gl/HnMtTm.
[107] https://goo.gl/kBSyxK.
[108] https://goo.gl/DypMVD.
[109] https://goo.gl/wDERBA.
[110] https://goo.gl/EaQKE8.

The EU's regulation on transparency of securities financing transactions (the "**SFT Regulation**")[111] came into force on 12 January 2016. It provides for details of all SFTs to be reported to trade repositories, similar to the reporting requirements for OTC derivatives under EMIR, and imposes additional disclosure requirements on managers of UCITS and AIFs. Furthermore, in relation to rehypothecation, the SFT Regulation's "reuse" arrangements require that counterparties must consent in writing to an asset being rehypothecated in the case of a security financial collateral arrangement the risks of rehypothecation must be explained in writing to the collateral provider and assets received as collateral must be transferred to an account opened in the name of the receiving counterparty.

ESMA published its final report regarding technical standards under the SFT Regulation in March 2017. This report sets out the final text of the regulatory technical standards ("**RTS**") and implementing technical standards ("**ITS**"), policy decisions, as well as provisions on SFT reporting and data collection.[112] The Commission will decide whether to endorse these standards by early 2018, and the reporting obligations would not come into force until late 2018 at the earliest.

On 4 October 2016, ESMA recommended in a Report[113] on securities financing transactions and leverage in the EU, inter alia, that the FSB qualitative standards[114] on the methodology used to calculate haircuts in non-centrally cleared SFTs should be introduced to improve the transparency and stability of haircuts and the resilience of financial institutions.

However, on 19 October 2017, the European Commission published a report, stating that it considered that the FSB recommendations on SFTs have been largely addressed in the EU and therefore there did not seem to be a need for further regulatory action at this stage. However, it intends to monitor developments in SFT markets and will reassess the added value of qualitative standards and haircut floors on the basis of a report, which it intends that ESMA will prepare once comprehensive SFT data is available.[115]

Money Market Funds ("**MMFs**"): Historically MMFs have been regarded as a safe investment with a stable net asset value ("**NAV**"). The FSB considers MMFs to be an important element of the shadow banking system, both as a source of short-term funding for banks and for provision of maturity and liquidity transformation. It notes, however, that during the financial crisis, some MMFs suffered large losses due to holdings of ABS and other financial instruments, leading to significant investor redemptions and instability. IOSCO published two reports in April[116] and October[117] 2012 setting out policy recommendations for a common approach to MMF regulation, including the need for compliance with general principles of fair value when valuing securities in a portfolio, the requirement to hold a minimum amount of liquid assets to meet redemptions and prevent fire sales and the requirement that MMFs offering a stable NAV should be subject to measures designed to reduce the specific risks associated with this feature.

Back in 2013, the European Commission proposed a regulation on MMFs ("**MMF Regulation**"). After years of negotiation and discussions between the EU legislative bodies, the MMF Regulation was published in the OJ on 20 June 2017. It entered into force on 20 July 2017 and, with the exception of certain articles, will apply from 21 July 2018. After the Regulation comes into force, existing MMFs will have 18 months to comply with the Regulation.

The key elements of the MMF Regulation are:

(a) MMFs will be permitted to be established in the EU as either (i) a Variable Net Asset Value MMF ("**VNAV**"), a Constant Net Asset Value MMF ("**CNAV**") or (iii) a Low Volatility Net Asset Value MMF ("**LVNAV**");

[111] https://goo.gl/C9wrnP.
[112] https://goo.gl/Zn3jGs.
[113] https://goo.gl/4pJQ3e.
[114] https://goo.gl/JXbz1o.
[115] https://goo.gl/kX6wW5.
[116] https://goo.gl/s1Eiig.
[117] https://goo.gl/bvQXTP.

(b) CNAVs will be required to seek to maintain an unchanging NAV per unit or share and must invest at least 99.5% of its assets in specified assets and cash, such as public debt securities and cash;

(c) LVNAVs must comply with specific requirements and may be valued using the amortised cost method only if the fund has a residual maturity up to 75 days and provided such valuation does not deviate from a mark to market or model valuation by more than 10 basis points. Units or shares in the LVNAV may be issued or redeemed at a price equal to the constant NAV provided such valuation does not deviate from the NAV per share or unit calculated on a mark to market or model valuation by more than 20 basis points;

(d) CNAVs and LVNAV MMFs will be subject to liquidity requirements including a minimum 10% portfolio investment in daily maturing assets and a minimum 30% portfolio investment in weekly maturing assets. VNAVs must have a minimum 7.5% portfolio investment in daily maturing assets and a minimum 15% portfolio investment in weekly maturing assets; and

(e) MMFs will be subject to diversification requirements including a 17.5% limit on investments in other MMFs and a 15% limit on cash provided to the same counter-party under reverse repos.

ESMA submitted its final technical advice in relation to the MMF Regulation to the European Commission in November 2017.[118] Following this, the European Commission published a "roadmap" in January 2018. It explains how the MMF Regulation empowers it to adopt three delegated acts – the first two in relation to the conditions for granting a favourable credit risk assessment by the MMF manager before investing in an asset or receiving collateral under a reverse repo agreement, and the third relates to establishing a cross-reference for the MMF manager to use criteria for investing in STS securitisations (because the Securitisation Regulation was not finalized before the MMF Regulation was adopted). The roadmap closes to comments on 12 February 2018.

118 https://goo.gl/iNWqPa.

## Contacts


| | | | |
|---|---|---|---|
| Peter Green<br>London<br>+44 (20) 7920 4013<br>pgreen@mofo.com | Jeremy Jennings-Mares<br>London<br>+ 44 (20) 7920 4072<br>jjenningsmares@mofo.com | Clara Wong<br>London<br>+ 44 (20) 7920 4148<br>clarawong@mofo.com | Isabelle Lee<br>London<br>+ 44 (20) 7920 4049<br>ilee@mofo.com |
| Thomas Drake<br>London<br>+44 (20) 7920 4073<br>tdrake@mofo.com | Isabel Janssen<br>London<br>+44 (20) 7920 4164<br>ijanssen@mofo.com | Simon Deane-Johns<br>London<br>+44 (75) 3984 8096<br>sdeanejohns@mofo.com | |


## About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We've been included on The American Lawyer's A-List for 13 years, and Fortune named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients while preserving the differences that make us stronger. This is MoFo.



For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*

MORRISON | FOERSTER

@ThinkingCapMkts

www.mofo.com