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FROM EMIR TO ETERNITY? THE EU FINANCIAL REGULATORY AGENDA INTO 2015 AND BEYOND

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This article provides a summary of some of the main developments during 2014 and the likely key areas of activity during 2015.

2014 was a very active year for financial regulation in the European Union (EU). There was a push to finalize much of the outstanding primary legislation on the regulatory reform agenda in advance of the European Parliamentary elections in May 2014. This resulted in the adoption of many EU Regulations and Directives in the first half of the year. However, much still remains in the in-box of EU legislators and regulators. Most of the legislation that has been adopted envisages a significant amount of further legislation and rulemaking regulation in the form of delegated regulations to be adopted by the EU Commission, much of it to comprise regulatory technical standards (RTS) and implementing technical standards (ITS) to be drafted by the European Supervisory Authorities (the ESAs), being the European Securities and Markets Authority (ESMA), the European Banking Authority (the EBA) and the European

Insurance and Occupational Pension Authority (EIOPA). Therefore, even though the EU regulatory reform program is now beginning the transition from legislation to implementation, a lot remains on the regulatory agenda into 2015 and beyond (with some measures not due to be implemented until 2025).

We have set out below a summary of some of the main developments during 2014 and the likely key areas of activity during 2015.

EMIR IMPLEMENTATION

The European Market Infrastructure Regulation (EMIR) [1] relating to the regulation of derivatives in the EU came into force in August 2012, but most of the relevant provisions require further delegated acts, RTS and ITS to be put in place before coming effective. That process continued during 2014. Some of the principal developments and expected further action in 2015 are set out below.

Reporting

After the commencement of the majority of EMIR's risk mitigation requirements in 2012, on 12 February 2014 [2] we finally saw the introduction of trade reporting, ensuring that all derivatives transactions (whether traded over the counter (OTC) or otherwise) entered into, modified or terminated by European counterparties are required to be reported to a trade repository within certain specified time limits. On August 11, 2014, the reporting regime was further expanded to include the reporting of collateral and valuation information, although this requirement only applies to financial counterparties and non-financial counterparties above the clearing threshold.

Almost immediately after the February reporting requirement became effective, concerns arose as to the ability and readiness of counterparties to provide the information required to complete the pro-forma trade reports. In its relevant ITS [3] , ESMA created 85 data fields for counterparty completion but provided minimal guidance on how to generate the required data. These difficulties were also compounded initially by a backlog of applications to the trade repositories, as well as difficulties in obtaining Legal Entity Identifiers (LEIs) (required to help identify a reporting entity and match up trades between counterparties). The reporting process does now appear to have settled down although in a consultation paper published on November 10, 2014 [4] , ESMA recognizes that the "*practical implementation of EMIR reporting showed some shortcomings*" and as such, recommendations have been made for changes to the relevant RTS [5] and ITS governing the application of the reporting obligation for counterparties and central counterparties

(CCPs). Once ESMA's final report is submitted to the EU Commission, the Commission will have three months to decide whether to endorse ESMA's proposed changes - it is therefore likely that there will be some technical amendments to the derivatives reporting regime in early 2015.

Clearing

As regards the clearing obligation, the implementation progress has been slower. As we reported in our recent article on the clearing of derivatives transactions in the EU, [6] between July and October of 2014, a number of consultations and reports have been published by ESMA, setting out the initial classes of derivatives likely to be subject to a clearing obligation. In particular, certain types of interest rate derivatives (fixed to floating rate swaps, floating to floating rate (or basis) swaps, forward rate agreements and overnight index swaps), credit derivatives (trades referencing certain untranched credit indices) and foreign exchange derivatives (non-deliverable forwards) are all likely to be covered.

These reports also provide detail on the likely phase-in schedule with respect to clearing. ESMA's proposals include sub-dividing market participants into different categories in order to ensure that the largest and most active market participants are required to clear first. In summary, Category 1 counterparties will be comprised of clearing members of an authorized CCP. Category 2 and 3 counterparties will include (non-clearing member) financial counterparties and alternative investment funds that trade above the clearing threshold. Category 4 counterparties include all other non-financial counterparties above the clearing threshold.

Given the categorization of a particular counterparty, it is possible to determine the applicable clearing obligation phase-in date, which is presently proposed to be six months for Category 1 counterparties, 12 months for Category 2, 18 months for Category 3 and three years for Category 4, in each case after the date the applicable RTS governing the clearing of a particular class of derivatives enters into force. When this date might be, however, remains unknown. As with the reporting consultation referred to above, as soon as ESMA submits the RTS proposals for each derivative class to the Commission, the Commission will have three months to decide whether or not to endorse them.

The first RTS in relation to Interest Rate Swaps (the IRS RTS) [7] was sent to the Commission on 1 October 2014. In a letter from the Commission dated 18 December 2014, it was confirmed that it intends to endorse the IRS RTS, subject to certain amendments. As a consequence, ESMA now has a period of six weeks to amend and re-submit the IRS RTS to the Commission. The required amendments have arisen as a result of a lack of certainty in respect of timing. In particular, ESMA had proposed that the frontloading requirement would commence from the date the technical standards are published in the Official Journal of the EU. However, concerns were raised by market participants that this would not allow enough time for Category 1 counterparties to implement the arrangements necessary for frontloading. Further, entities which could potentially fall into either Category 2 or 3 (depending on whether they are above or below a €8 billion threshold for the monthly average of non-centrally cleared derivatives over the three-month period prior to the relevant RTS coming into force) did not know when to begin the monitoring process for such three-month look-back period. As a consequence, the commencement of the frontloading requirement has been delayed for Category 1, until two months after entry into force of the applicable RTS and for Category 2, until five months after entry into force of the applicable RTS.

Collateral

In accordance with a requirement to develop technical standards governing the timely, accurate and appropriate segregation of collateral (under Article 11(15) of EMIR), in April 2014, the ESAs published RTS on risk mitigation techniques for the collateralization of uncleared derivatives transactions. [8] At the center of the ESA's proposals are requirements to (1) collect variation margin on a daily basis to cover the mark-to-market exposure of counterparties during the life of an existing trade and (2) collect initial margin upon inception of the trade, as calculated either in accordance with a model referred to as the Standardized Method (set out in such RTS) or another initial margin model acceptable to the regulators. Only certain assets may be posted for this purpose and a list of eligibility criteria must be satisfied. Once collected, the margin must be segregated from proprietary assets in the books and records of the custodian or third party that is holding it. Initial margin also cannot be rehypothecated.

Primarily impacting European financial counterparties and non-financial counterparties trading above the clearing threshold, the requirements are somewhat controversial in that they fail to exempt third-country entities trading below the clearing threshold (even though counterparties established in the EU with equivalent "NFC minus" status would be so exempt). Other exemptions are provided, however, including (but not limited to) where the total collateral exchanged between two counterparties at a group level would be equal to or less than €50 million, where trading is with an entity that is exempt from EMIR (such as an EU-based central bank), or where the relevant trade to be collateralized is a physically settled foreign exchange swap or forward.

The collateralization of uncleared trades will be phased in from December 1, 2015. However, only the largest market participants will be subject to initial margin collection requirements from that date (i.e., only those that trade non-centrally cleared derivatives in excess of €3 trillion in monthly aggregate notional amount). Counterparties trading non-centrally cleared derivatives in excess of €8 billion will be subject to the requirements by December 2019.

MiFID II IMPLEMENTATION

MiFID II is the overhaul of the Markets in Financial Instruments Directive which originally came into force in 2007. The primary MiFID II legislation comprises a Regulation (MiFIR) [9] and recast Directive [10] (together with MiFIR referred to as MiFID II). MiFID II was published in the Official Journal of the EU on June 12, 2014 and entered into force 20 days after that date. The provisions will not, however, become effective in the EU until January 2017.

MiFID II significantly expands the scope of the existing MiFID legislation, including:

- some amendments to the investor protection provisions including a narrowing of the execution-only exemption so structured UCITS are now outside the exemption, together with bonds or other forms of securitized debt that incorporate a structure which makes it difficult to understand the risk involved;
- structured deposits are now subject to a number of the provisions of MiFID II;
- the extension of many provisions of MiFID II to "organized trading facilities" or OTFs which will cover many forms of organized trading (not being regulated markets or multilateral trading facilities (MTFs)) of bonds, structured finance products and derivatives;
- requiring all derivatives, that are subject to the clearing obligation under EMIR and that ESMA determines to be sufficiently liquid, to be traded on a regulated market, MTF or OTF;
- extending the pre- and post-trade transparency regime (which currently only applies to shares) to bonds, structured finance instruments and derivatives traded on a trading venue;
- wider product intervention powers granted to ESMA and competent authorities including the ability to temporarily prohibit or restrict marketing of certain products in the EU;
- increased regulation of algorithmic and high-frequency trading;
- significantly expanding the scope of the regulation of commodities and commodity derivatives.

Although the primary legislation is now in place, a significant amount of detail still needs to be drafted. Much of this will be in the form of delegated acts of the EU Commission, mostly comprising regulatory and implementing technical standards to be drafted by ESMA and the other ESAs. In advance of the preparation of this secondary legislation, ESMA published in May 2014 a Consultation Paper [11] and a Discussion Paper [12] outlining its initial thinking in a number of respects. In addition, in August 2014 the European Banking Authority (EBA) published a consultation paper [13] containing draft technical advice to the EU Commission on delegated acts to be published in relation to intervention powers in respect of structured deposits.

On December 19, 2014, ESMA published its final technical advice to the EU Commission [14] and a second consultation paper on MiFID II [15] and is likely to spend much of 2015 engaged in the consultation process for MiFID II. It is expected to submit the bulk of the final regulatory technical standards to the EU Commission by the end of 2015 and the final implementing technical standards by 2016. Amongst the areas likely to be of key interest to market participants are ESMA's proposals as to which derivatives or classes of derivative will be regarded as sufficiently liquid to be subject to the trading obligation under MiFIR and its guidance as to the availability of waivers from the pre-trade transparency requirements for bonds, structured finance instruments and derivatives (with liquidity likely to be the key consideration). In its recent technical advice and consultation paper, ESMA undertakes a detailed consideration of what constitutes a liquid market for the purpose of granting waivers of pre-trade transparency requirements for bonds, structured finance instruments and derivatives. As required by MiFIR, it focuses on average frequency and size of transactions, number and type of market participants, and average size of spreads. It proposes determining liquidity by dividing each asset group into more granular classes that share largely homogeneous liquidity characteristics and then sub-divides such classes further by factors such as maturity, issue sub-type and issue size (for bonds) and derivative type, number of instruments, number of trades and total notional amount (for derivatives). Its conclusions for each sub-class are set out in detailed tables in the technical advice. In relation to determining whether a derivative is sufficiently liquid to be subject to the exchange trading requirement, ESMA considers similar factors and indicates in many cases the thresholds will be the same or very similar as in relation to the test for the transparency rules but this will not necessarily always be the case.

BRRD IMPLEMENTATION

The Bank Recovery and Resolution Directive (BRRD) [16] came into force in July 2014. The majority of the BRRD's provisions must be implemented into EU member states' national laws by January 1, 2015. The exceptions to this are the provisions relating to the bail-in tool, which are required to be implemented by January 1, 2016 at the latest. However, the UK Treasury has indicated that it will apply all of the provisions of the BRRD in the UK from January 1, 2015, including the bail-in requirements, with the exception of the minimum requirement for eligible (or bail-inable) liabilities (MREL), and the requirements for instruments governing bail-inable liabilities to contain contractual agreement/acknowledgement by the creditor that the liability could be subject to bail-in.

The BRRD requires EU credit institutions and certain investment firms to prepare recovery plans and for their relevant competent authorities to prepare resolution plans for such institutions based on information and other data provided to the authority by such firms. It also provides a mechanism for co-operation between resolution authorities in applying resolution tools and powers to cross-border groups. The BRRD also gives powers to competent authorities to take certain early intervention measures to seek to prevent a firm from going into resolution and, where a firm does need to be resolved, sets out resolution tools and powers available to authorities, namely the sale of business tool, the bridge institution tool, the asset separation tool and the bail-in tool. Various general principles are to govern the use of such bail-in powers, including that the firm's shareholders should bear the first loss, following which creditors should then bear losses in accordance with their order of priority, and no creditor should incur greater loss than would have been the case if the firm had been wound up under a normal insolvency.

The bail-in power gives resolution authorities the power to determine when the firm has reached the point of non-viability and enables them to impose losses on certain creditors by writing their claims down or off or converting them into equity. The power is applicable to a wide range of unsecured liabilities of the firm with certain limited exceptions. The BRRD also requires firms to maintain a minimum amount of own funds and "eligible liabilities" (being liabilities that can be bailed-in under the bail-in tool) and referred to as the MREL. The EBA must produce RTS in respect of the criteria to be used by competent authorities for determining the MREL for individual firms, and it produced a consultation paper setting out draft RTS in this respect in November 2014. [17]

The EBA's draft RTS were based in part on recommendations published by the Financial Stability Board (FSB) in November 2014 [18] on the adequacy of the loss-absorbing capacity of global systemically important banks (G-SIBs). The FSB's proposals include that the minimum total loss-absorbing capital (TLAC, which is broadly equivalent to the MREL) to be held by a G-SIB should be in the region of 16 to 20% and at least twice the Basel III tier 1 leverage ratio requirement.

In relation to the provisions regarding contractual recognition of bail-in, the EBA must develop draft RTS to determine the contents of the required contractual term, and these must be submitted to the EU Commission by July 3, 2015. It produced a consultation paper with draft RTS in this regard in November 2014. [19] The EBA has also produced various other draft RTS required under the BRRD to be delivered to the EU Commission during 2015, and work will continue on finalizing these in 2015. In the UK, we expect to see the Treasury's proposals on the required levels of MREL in the first half of 2015, in order that these can be implemented by the end of 2015, as required. In the meantime, it is proposed in the draft version of the UK Bank Recovery and Resolution Order 2014, [20] published in November 2014 that, as from January 1, 2015, the Bank of England will be empowered to set a minimum requirement for own funds and eligible liabilities on an institution-by-institution basis. The Prudential Regulation Authority (the PRA) in the UK is currently considering whether the provisions on contractual recognition of the bail-in tool should be implemented with effect from January 2015 for contracts such as regulatory capital and other debt market instruments, and as from January 2016 for all other relevant liabilities. It acknowledges, though, that the publication of the final draft RTS by the EBA by July 2015 may entail some changes to its rules in this regard.

SRM IMPLEMENTATION

Closely coupled with the BRRD is the European single resolution mechanism (SRM) established by the SRM Regulation. [21] The SRM applies to all banks that are subject to the Single Supervisory Mechanism (SSM), and the SSM applies to all banks in the Eurozone and in certain other participating member states - around 6,000 of them - and establishes the European Central Bank (the ECB) as the single bank supervisory authority. The SRM further develops the "single rulebook" concept of the SSM. It does this by adopting recovery and resolution mechanisms that essentially mirror those in the BRRD and by establishing a Single Resolution Board (SRB) as the main resolution authority for all banks subject to the SSM. As the UK has opted out of the SSM, banks established in the UK will not be subject to the SRM.

The SRB (which will consist of a member appointed by each SSM member state, as well as an Executive Director, Deputy Executive Director and a member appointed by each of the EU Commission and the ECB) will determine whether the conditions for resolution of an individual bank have been met, and if so will recommend to the EU Commission that the bank be put into resolution, as well as the resolution tools that should be applied, and how the Single Bank Resolution Fund (SBRF) should be used. The EU Commission will then have the final decision as to whether or not to place the bank into resolution and what tools to use.

The SBRF will be funded by bank contributions in a similar way to the national resolution funds under the BRRD, with a similar target fund level and time frame for reaching it.

In terms of the interaction between the BRRD and the SRM, where a resolution procedure would affect only banks governed by the SSM, then the SRM would apply. Where a resolution procedure would affect only banks outside the scope of the SSM, then the BRRD would apply. Where a resolution procedure would affect both banks within and outside the scope of the SSM, then the BRRD will apply, with the SRB representing the national resolution authorities of the SSM-participating member states.

The majority of the provisions of the SRM Regulation will apply from January 1, 2016. From November 1, 2014, the EU Commission and the EU Council have had the power to adopt delegated and implementing acts, respectively, in relation to contributions to the funding of the SBRF. The SRB became fully operational on January 1, 2015, and the EU Commission is required to publish an evaluation report by December 31, 2018, and every five years after that, on the application of the SRM Regulation.

EU BANKING STRUCTURAL REFORM PROPOSALS

January 2014 saw the publication by the EU Commission of a draft Regulation [22] mandating structural separation of certain EU banking activities. This draft Regulation is a culmination of the initiative started by the establishment of a high-level expert group and the resulting Liikanen report [23] in 2012, although this legislative proposal has moved a long way from that original initiative.

The draft Regulation is intended to apply to the largest 30 or so banking groups in the EU, those designated as global systemically important institutions (G-SIIs) under the CRD IV legislation, and will catch EU credit institutions and their parent companies, and branches and subsidiaries of these entities, wherever they are located in the world.

It will also apply to certain non-G-SIIs if they have had, for a period of three consecutive years, total assets of at least €30 billion and trading activities amounting to at least €70 billion or 10% of total assets. This will include the EU branches of US and other non-EU banks and also the non-EU subsidiaries of EU parent companies, unless those branches and subsidiaries are subject to regulations deemed equivalent to those in the EU.

The Regulation will firstly prohibit proprietary trading (defined as using capital or borrowed money to take a position in a financial instrument or commodity for the sole purpose of making a profit for own account (i.e., excluding activities connected to actual or anticipated client activities)) by in-scope entities.

It will also prohibit in-scope entities from investing capital or borrowed money in a hedge fund (or fund-linked instrument) or other entity that engages in proprietary trading or itself invests in hedge funds, again where the sole purpose of the investment is making a profit for own account.

In-scope entities are also subject to the possibility that a national competent authority may force them to separate off one or more of their trading activities where these are considered to pose a threat to the institution's financial stability or that of the EU financial systems as a whole. "Trading activities" are defined as meaning any activities other than a list of permitted activities, such as taking deposits, lending, payment services, custody and safekeeping services, etc., but specifically included as trading activities are market-making, sponsoring securitizations and trading in derivatives (other than a narrow range of permitted hedging instruments).

The draft Regulation is currently scheduled to be considered by the European Parliament during its plenary session in April 2015, and the Commission intends for the Regulation to be adopted by June 2015 and for the secondary rule-making to be completed by the end of 2015. It intends that a list of in-scope banking groups would be published by July 1, 2016, and annually thereafter. The proprietary trading prohibition is intended to become effective from January 1, 2017, and the provisions on potential separation of trading activities from July 1, 2018. It should, however, be noted that the provisions remain controversial in many member states with many differing views as to how structural reform of banks should be effected. There are concerns in some quarters that the proposals are too narrow compared with provisions in other jurisdictions, including the Volcker Rule in the US. Other jurisdictions are concerned as to the effect of the prohibition on proprietary trading on banks in their jurisdiction. The final outcome is therefore far from certain.

IMPLEMENTATION OF BANKING REFORM ACT IN THE UK

The UK Financial Services (Banking Reform) Act 2013 (the Banking Reform Act) [24] enacts a number of changes to the UK banking system, in particular in relation to the requirement to ring-fence retail banking services. As expected, the main provisions as to the excluded activities and prohibitions applying to ring-fenced banks will come into force on January 1, 2019.

As mentioned in relation to the BRRD above, the bail-in stabilization option under the Banking Act 2009 largely came into force on December 31, 2014. However, the provisions relating to the primary loss-absorbing capacity of ring-fenced banks and UK global systemically important banks have been delayed, as these overlap with the provisions regarding MREL under the BRRD (see above).

The provisions relating to giving preference to depositors, to the extent their deposits are covered by insurance under the Financial Services Compensation Scheme, came into force on December 31, 2014.

The new senior persons regime, licensing regime and banking standards rules all came into force in July 2014. However, the new criminal offence of reckless misconduct in the management of a bank, which will potentially apply to individuals who are covered by the senior persons regime, has not yet had a date announced for its commencement. When this commences, the maximum sentence for individuals found guilty of the offence will be seven years in prison and/or an unlimited fine.

It currently looks likely that ring-fenced banks (broadly, banks engaging in significant non-institutional deposit-taking) will not be permitted to sell structured products or derivatives unless they fall within a specified range of hedging transactions for customers. In addition, it seems that neither their subsidiaries, nor their parent companies, will be able to engage in such activities, and banking groups that contain a ring-fenced bank will need to engage in these activities through "sibling" entities. These proposals are controversial and likely to be subject to further debate into 2015. The ring-fence will not come into force until 2019, but banks are already planning the transition to the new regime.

PRIIPS REGULATION

On December 9, 2014, the final text of the EU Regulation on key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs) was published in the Official Journal of the EU [25] and came into force on December 29, 2014. The provisions of the Regulation will not, however, become effective until two years later (so December 29, 2016).

Under the Regulation, when a person is advising on or selling a PRIIP to retail investors, a KID must be provided to the investor prior to any contract being concluded. The primary obligation to draw up the KID will be on the manufacturer of the PRIIP (including any entity that makes significant changes to an existing PRIIP). The Regulation contains detailed requirements as to the form and content of the KID, which must be a maximum of three sides of A4 paper. The KID should be a "stand-alone" document separate from marketing materials and contain key information relating to the product. Although "key information" is not defined, an explanatory statement to be included in the KID will state that the information is intended to help the investor understand the nature, risks, costs and potential gains and losses of the product, and to help comparison with other products.

On November 17, 2014, the ESAs released a joint discussion paper [26] in relation to the KID. The paper sets out their thoughts as to the presentation and content of each element of the required KID content, the methodology underpinning the presentation of risk and reward, such as the risk indicator and performance scenarios and the methodology for calculation of costs including the specification of summary indicators. The risk and reward section of the discussion paper focuses on issues such as defining risk and reward; defining market, credit and liquidity risk; and the different possible measures and ways of presenting each type of risk. These include various possible presentations of a summary risk indicator in pictorial form. In relation to the costs section, the paper discusses different types of costs and the scenarios in which they can occur in relation to different types of PRIIP. It also explores different possible options for presenting costs, including different visual ways of presenting a summary costs indicator.

The ESAs invite comments to be submitted by February 17, 2015, and they will use the feedback on the discussion paper to prepare draft regulatory technical standards. They expect to publish a consultation on these technical standards in the autumn of 2015. However, before this, there will be a consumer testing exercise organized by the EU Commission to assist the ESAs in developing the standards. It is also expected that a further technical discussion paper on the KID will be published in the first half of 2015.

AIFMD

The Alternative Investment Fund Managers Directive (the AIFMD) [27] came into effect in the EU on July 22, 2013 and governs the management and marketing within the EU of alternative investment funds (AIFs) by alternative investment fund managers (AIFMs). The definition of an AIF is very broad, being a collective investment undertaking which is not a UCITS fund but which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors. However, AIFs categorized as "small AIFs" are exempted from the majority of the provisions of the Directive. An AIFM is defined simply as a legal person whose regular business is the managing of one or more AIFs. Managing an AIF involves performing portfolio management activities and/or risk management activities for an AIF.

The AIFMD creates a harmonized set of rules in the EU for the supervision of AIFMs and requires AIFMs to be authorized and subject to supervision by their home competent authority. It also imposes a capital requirement of at least €125,000 on AIFMs. The AIFMD sets out various requirements as to governance and conduct of business, including rules relating to remuneration policies and practices. AIFMs are also subject to various transparency obligations requiring financial reports and information to be submitted to the relevant competent authority.

There is no requirement for a fund or a manager to be established or based in the EU in order to fall within the remit of the AIFMD. Non-EU AIFMs marketing one or more AIFs to professional investors in an EU country are currently required to comply with that country's AIFMD implementing legislation irrespective of the domicile of such AIFs. However, such non-EU AIFMs cannot benefit from the AIFMD marketing passport across the EU until the EU Commission implements delegated legislation extending the passporting regime to non-EU AIFMs (following a positive opinion from ESMA). This is expected to be in place by the end of 2015, but until then non-EU AIFMs can only actively market AIFs to professional investors in an EU jurisdiction in accordance with that jurisdiction's national private placement regime.

After the passporting regime becomes available to non-EU AIFMs, they can either seek authorization under the AIFMD (and benefit from the pan-European marketing passport) or continue to rely upon those national private placement regimes that continue to exist, although it is currently expected that all national private placement regimes in the EU will be abolished from 2018, subject to an opinion of ESMA.

2015 is expected to bring about the culmination of the work of ESMA further to its call for evidence in November 2014 [28] relating to the functioning of (i) the passport for EU AIFMs managing and marketing EU AIFs under the AIFMD and (ii) the national private placement regimes. This is to consider whether the passport should be extended to the management and marketing of AIFs by non-EU AIFMs and to the marketing of non-EU AIFs by EU AIFMs. ESMA is due to provide an opinion and advice to the European Parliament, the Council and the Commission in July 2015, and in October 2015 the Commission will, subject to a positive ESMA opinion, adopt a delegated act to specify when such passport will become available. In addition in 2015, ESMA will continue its consultation in relation to asset segregation by depositaries holding assets for AIFMs. [29]

SHADOW BANKING REFORMS

The "shadow banking" sector continues to be an area of key regulatory focus. This has been spearheaded at international level by the FSB following a mandate at the G20 leaders' meeting in St. Petersburg in November 2010. The FSB has avoided giving a specific definition of shadow banking but has focused on non-bank intermediation which it regards as credit intermediation involving entities and activities fully or partially outside the regular banking system. The FSB has stressed that any definition by national regulators should be capable of adapting with changes and developments in the financial markets. [30]

The FSB's work has focused on five workstreams: (a) interaction of the regular banking system with shadow banking, (b) the regulation of shadow banking entities, (c) securitization and excess leverage, (d) regulation of securities lending and repos and (e) money market regulation. It has, together with the International Organization of Securities Commissions (IOSCO) in some cases, published a number of reports and policy recommendations covering these areas.

In the EU, the EU Commission in its March 2012 Green Paper [31] on shadow banking approved the FSB's general definition of shadow banking and sought to give a non-exhaustive indication of the types of entities and activities that it believes fall within the scope of shadow banking. Activities comprise primarily securitization and securities lending and repos. Entities include SPVs (such as ABCP conduits) performing liquidity and/or maturity transformation, money market funds, leveraged investment funds (including ETFs) and finance companies and insurance/reinsurance undertakings issuing or guaranteeing credit products. It subsequently published a Communication on shadow banking in September 2013 [32] setting out more detail on priority areas where it believes further work and legislation is needed.

The existing regulatory reform program in the EU has already led to many of the proposals from the FSB workstreams being implemented in the EU. CRD IV (and previous amendments to the Capital Requirements Directive) has implemented Basel III including increased capital requirements for banks' exposures to resecuritizations and liquidity facilities provided to securitization vehicles and enhanced disclosure requirements. As described above, the AIFMD has imposed a harmonized EU regulatory regime for alternative investment funds. EMIR has also imposed a comprehensive reporting regime for OTC derivatives. Two areas where there is ongoing work in the EU, which will continue into 2015, are the regulation of securities financing transactions and money market funds. The current status of each is as follows:

a.Securities Financing Transactions: Although the securities lending and repo markets are vital in meeting many financial institutions' financing needs, supporting market liquidity and facilitating market-making, the FSB believes that many transactions are entered into by non-banks, giving rise to maturity and liquidity transformation risks. Concerns raised by the FSB include potential build-up of leverage, liquidity risks, the extent of reinvestment of cash collateral, potential pro-cyclicality due to the relationship between funding levels and fluctuating asset values and volatility caused by valuation haircuts and risks relating to rehypothecation of collateral. It has developed 11 policy recommendations [33] including minimum regulatory standards for cash collateral reinvestment and new regulatory requirements relating to rehypothecation including sufficient disclosure to enable clients to understand their potential exposure in the event of a failure of the intermediary. In October 2014 the FSB published a Regulatory Framework for haircuts on non-centrally cleared securities financing transactions including proposed numerical floors for haircuts. [34]

In January 2014, the EU Commission published a draft Regulation [35] on reporting and transparency of securities financing transactions which focuses on transparency, disclosure and rules relating to rehypothecation. The draft Regulation provides for EU entities (whether or not financial entities) to report details of securities financing transactions to a trade repository similar to the reporting requirements for OTC derivatives under EMIR. For these purposes, the definition of securities financing transactions is wide and includes repos, reverse repos, securities borrowing and lending transactions and equivalent financing structures. The draft also contains additional disclosure requirements for managers of UCITs funds and alternative investment funds including criteria for counterparties and collateral and valuation methodologies and details of rehypothecation policies. In relation to rehypothecation, the draft Regulation proposes that the client or counterparty must consent in writing to an asset being rehypothecated, the risks of rehypothecation must be explained in writing to the collateral provider and assets received as collateral must be transferred to an account in the name of the receiving counterparty.

The EU Council recently announced that it has agreed its negotiating position in relation to the draft Regulation, and discussions between the EU Commission, EU Parliament and EU Council are expected to progress in the early part of 2015. It is therefore possible that the Regulation may be adopted at some time during 2015.

b.Money Market Funds: The FSB has acknowledged that MMFs are an important source of credit and short-term funding for the regular banking system and provide maturity transformation and leverage. It also expressed concern, however, that some MMFs suffered large losses during the financial crisis, often due to ABS holdings, leading to significant redemptions, runs and subsequent bail-outs for some funds. IOSCO has driven much of the work on this workstream and published a final report in October 2012 [36] setting out 15 policy recommendations for a common approach in relation to MMF regulation, including that MMFs offering a stable NAV should be subject to measures designed to reduce specific risks related to this feature. Other recommendations included a requirement for fair value principles for portfolio valuations and requirements for MMFs to hold a minimum amount of liquid assets to meet redemptions.

The EU Commission published a draft Regulation relating to money market funds in September 2012. [37] This draft contains provisions limiting investments by MMFs to certain low-risk investments, including money market instruments with high internal credit ratings and deposits with eligible credit institutions with a maximum maturity of 12 months. It also proposes stricter diversification and concentration limits. The draft Regulation does not seek to abolish constant NAV MMFs but proposes they be subject to a capital buffer of at least 3% of total assets. Concerns have been raised that this buffer may make such funds uneconomical. It also proposes minimum average maturity and weighted average life requirements and a prohibition on external credit ratings.

The draft Regulation differs in a number of important respects from the approach taken by the SEC in the US in adopting new rules for MMFs which came into force in October 2014. The new SEC rules impose a floating NAV requirement for non-retail and non-governmental MMFs. The draft Regulation also provides for liquidity fees and gates to be imposed in certain circumstances where the fund's board determines it is in the fund's best interests to do so.

As we move into 2015, there is likely to be considerable activity in the EU to seek to reach agreement on the draft MMF Regulation referred to above, and it will be interesting to see if the proposals move closer to the SEC position as the Regulation goes through the EU legislative process. The EU Council of Ministers has proposed a compromise draft which would bring the Regulation more in line with the new SEC rules, including eliminating the proposed buffer for retail and small professional constant NAV funds and requiring the board of such funds to consider imposing redemption gates and fees when the proportion of weekly maturing assets falls below 30% of net assets. The draft report of the European Parliament's Committee on Economic and Monetary Affairs (ECON) also proposes amendments to the Regulation, although it takes a different approach to the EU Council. In relation to constant NAV funds, ECON is still exploring various options. Including: (i) maintaining the proposed capital buffer, (ii) developing a system based on liquidity fees and redemption gates, (iii) developing a European variation on the SEC rules with a carve-out for governmental MMFs or (iv) developing a system of low-volatility NAV funds. Negotiations are likely to continue through 2015, and it remains to be seen if political agreement can be reached to enable the Regulation to be finalized in the coming year.

BENCHMARK REGULATION

The use of benchmarks in financial transactions has been the subject of focus from international regulators in recent years following investigations of a number of financial institutions for alleged misconduct in relation to the setting of LIBOR as well as other financial benchmarks. In the UK, following a review by Martin Wheatley, CEO of the Financial Conduct Authority, a number of reforms have been made in relation to the setting of LIBOR in the Banking Reform Act 2013. In September 2014, following a review by the Bank of England, HM Treasury published a consultation paper recommending that additional financial benchmarks be subject to regulation in the UK. [38] In December 2014, HM Treasury confirmed that the UK government would implement the recommendations in respect of seven benchmarks. [39] At the same time, the FCA published a consultation paper on bringing additional financial benchmarks under its supervision. [40] On a global level, IOSCO published principles for financial benchmarks in July 2013 [41] which have been endorsed by the FSB and the G20 setting out a framework of standards in relation to issues of governance, benchmark quality and calculation methodology.

In September 2013, the EU Commission published a draft Regulation [42] in relation to indices used as benchmarks in financial instruments and contracts with the stated aim of improving the governance and controls applicable to financial benchmarks (and in particular the avoidance or appropriate management of conflicts of interest), the quality of data used in setting the benchmark and methodologies used by benchmark administrators and ensuring that contributors to benchmarks are subject to adequate controls. The draft Regulation imposes various obligations on benchmark administrators, contributors and users.

Benchmark administrators located in the EU will be subject to authorization and supervision by their competent authorities including detailed governance requirements. A benchmark administrator will also be required to ensure that the input data is sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure and is responsible for ensuring that there are adequate and effective systems and controls to ensure the integrity of input data and to put appropriate monitoring in place. The administrator is also required to publish relevant input data immediately after publication of the benchmark, although it may delay publication where there would otherwise be serious adverse consequences for the contributors or if immediate publication would adversely affect the reliability or integrity of the benchmark.

In relation to benchmark users, an entity that is subject to supervision in the EU will only be permitted to issue or own a financial instrument or be party to a financial contract which references a benchmark or use a benchmark that measures the performance of an investment fund if the benchmark is provided by an administrator authorized under the Regulation or is an administrator located outside the EU that is registered by ESMA subject to specified criteria.

Having regard to the systemic importance of certain benchmarks, the EU Commission will be required to maintain a list of critical benchmarks. If at least 20% of the contributors to a critical benchmark cease or are likely to cease to make contributions, the relevant competent authority has the power to take various actions, including requiring selected supervised entities to contribute input data; determining the form in which and the time by which any input data must be contributed; and changing the code of conduct, methodology or other rules of such benchmark.

The draft Regulation is still going through the EU legislative process. ECON largely welcomed the draft Regulation but expressed concerns as to the breadth of the scope of the definition of "index," suggesting that the scope be narrowed to benchmarks in certain specified categories of financial index. It also recommended that national competent authorities be given more powers to ensure mandatory contributions to critical benchmarks and further consideration be given to the treatment of benchmarks administered outside the EU - many benchmarks used in financial instruments, including derivatives, originate from outside the EU and it would cause considerable disruption to financial markets if many of these could not continue to be used. The EU Council has also published compromise drafts of the Regulation. Discussions will continue into 2015 and there are likely to be considerable efforts to have the text of the Regulation agreed and finalized during 2015.

CRD IV IMPLEMENTATION

The Basel III reforms, in the form of the new Capital Requirements Regulation (CRR) [43] and the CRD IV Directive [44] (and, together with the CRR referred to as CRD IV), largely came into effect on January 1, 2014 in Europe. This included the revised requirements in relation to minimum capital requirements for firms and the introduction of new capital buffers. These requirements are now being phased in in accordance with the terms of CRD IV. CRD IV also provides for a significant number of RTS and ITS to be drafted, principally by the EBA. This process is now well underway, with many of these already having been adopted by the EU Commission through delegated acts.

Certain provisions of CRD IV were always intended to take effect at a later date. In particular, the Liquidity Coverage Ratio (LCR) provisions are to become effective from 2015. The EU Commission in October 2014, adopted a delegated Regulation [45] in relation to the LCR, containing detailed provisions for the ratio. The delegated Regulation generally followed the Basel III LCR standard, with certain amendments, including in relation to giving certain covered bonds extensive recognition and also including, as part of the permitted liquid assets, certain types of securitized asset, such as securities backed by auto loans. The LCR is to be phased in from October 1, 2015, commencing at 60% of the full requirement and rising to 100% of the full requirement by 2018.

The CRR provides for the European Banking Authority to report to the EU Commission by December 31, 2015 on whether the Net Stable Funding Ratio (NSFR) prescribed by Basel III should be introduced and on appropriate methodologies and definitions for calculating the ratio. The EU Commission is required by December 31, 2016, if appropriate, to submit a legislative proposal to the European Parliament and the

Council, with the aim of the NSFR applying, if at all, by January 1, 2018.

The other major part of the CRD IV package which has not yet entered into force is in relation to the leverage ratio. The ratio, which is a measure of a firm's Tier I capital, compared to the non-risk weighted values of its assets, is required to be disclosed publicly by each firm as from January 1, 2015. In October 2014, the EU Commission adopted a delegated Regulation [46] making changes to the calculation of the leverage ratio by amendments to the capital measure and the total exposure measure. These included provisions to address the treatment of the exposure values of derivatives and securities financing transactions. By the end of December 2016, the EU Commission is required to submit a report on the impact and the effectiveness of the leverage ratio, and this will be accompanied by a legislative proposal, introducing the leverage ratio as a binding measure, if the EU Commission decides this is appropriate. The binding leverage ratio is intended to be applicable from 1 January 2018 onwards.

An area of CRD IV that has been controversial is that concerning provisions relating to firms' remuneration policies and, in particular, the requirement that a person's variable remuneration should not exceed the amount of fixed remuneration (with the possibility of it being 200% of fixed remuneration only with shareholder approval (66% majority required with a minimum quorum of 50%)). Variable remuneration must also be subject to clawback arrangements. The UK launched a legal challenge to the cap on variable remuneration on the grounds that it fell outside the powers of the EU. However, following an adverse opinion from the advocate general of the European Court of Justice, the UK abandoned its challenge in 2014. The "bonus cap," as it has been referred to, will therefore continue to be applicable into 2015. Concern was raised by the EBA and the EU Commission during 2014 as to the practice by some firms of redesignating some variable pay into allowances. Their view was that in many cases, the allowances would still be regarded as variable pay. In October 2014, the EBA published an opinion [47] outlining what sort of pay structures it would consider to be variable pay. However, the paper has no binding force in the EU, and it is therefore possible that some firms could press ahead with allowance-type arrangements, leaving open the possibility of competent authorities seeking to impose sanctions and possible future legal action in this area.

FINANCIAL TRANSACTIONS TAX

Initially based on a set of failed EU-wide proposals in relation to a tax on financial transactions (the FTT) dating back to September 2011, the current revised proposals for the FTT [48] are now intended to be applied in just 11 member states [49] (the FTT Zone) based on a principle of enhanced cooperation which allows a subset of member states that wish to continue to work more closely together to do so, while respecting the legal framework of the Union. In short summary, the purpose of the FTT is to harmonize legislation on the indirect taxation of financial transactions. Specifically, proposals are to impose a tax of 0.1% on all transactions relating to financial instruments other than derivatives (such as options, futures, contracts for difference or interest rate swaps), which will attract a tax rate of 0.01% on the notional amount of the transaction. Under the proposals a tax would be imposed, broadly, where at least one party to a transaction was a financial institution in a participating member state. However, it also sought to impose the FTT on transactions relating to an instrument issued by an entity incorporated or registered in a participating member state even if the parties to the transaction were both outside the FTT zone (e.g. a put option between UK and US banks over shares in a French entity would be potentially subject to the FTT - referred to as the "issuance principle").

Opting to remain firmly outside of the FTT Zone, the UK has argued strongly that the implementation of the FTT would, when coupled with existing EU tax legislation on mutual assistance and administrative cooperation, result in negative extraterritorial effects for itself and other non-participating states. In April 2014, the UK lost its legal challenge in the European Court of Justice to the granting of authorization to use enhanced cooperation. While clearly a blow to the UK's attempt to stop the revised FTT proposals in their tracks, it should be understood that the UK was not (at that stage) taking steps to challenge the implementing measures which will ultimately be adopted by the FTT Zone states. Whether it does so in the future remains to be seen.

On October 31, 2014, the Italian Presidency of the EU published a report on the status of the revised FTT proposals. [50] The report confirms that efforts have continued to clarify two "*key open issues,*" being (i) the need to define the scope of the transactions which shall form part of the "*first phase*" of implementation and (ii) the basic "*principle of taxation*" that should apply to the levy of the FTT and distribution of income across the FTT Zone. In respect of the scope of transactions, it is stated that most participating member states are in favor of taxing transactions in derivatives linked to an underlying that itself falls under the scope of the FTT (e.g. equity derivatives, where transactions relating to the underlying shares will be within the scope of the FTT). As regards the principal of taxation, it is suggested that either a "residence" or an "issuance" principle shall apply (or some combination of the two), meaning that it is yet to be decided whether the appropriate taxing authority should be (a) that of the place of establishment of the parties to the taxable transaction (residence) or (b) that of the place of the establishment of the issuer (issuance) or both.

In a press release of the European Council on November 7, 2014, [51] it is stated that work shall be intensified in order to enable an agreement in the near future, with the aim of implementing the first phase of the FTT by January 1, 2016. Given the relatively limited amount of detail currently available and the possibility of another legal challenge from the UK, we are likely to see plenty of further activity on the proposed FTT during 2015.

MAD IMPLEMENTATION

On April 16, 2014, the revamped legislative package governing market abuse, consisting of the Market Abuse Regulation (MAR) [52] and the Criminal Sanctions for Market Abuse Directive (CSMAD), [53] was formally adopted by the Council of the European Union. As a result of the UK's special position under the Lisbon Treaty, it has powers to opt out of measures governing EU criminal law and as such has not signed up to CSMAD. MAR, however, will apply automatically in all EU states (including the UK) when it becomes effective in July 2016.

The principal changes that will be brought into effect under MAR include an extension of scope to cover a significantly broader range of securities than are presently covered under the existing Market Abuse Directive (MAD). [54] MAD regulates derivatives traded on the EU's primary investment exchanges (known as regulated markets). However, in order to take account of the significant amount of off-market trading, MAR will also cover instruments traded on MTFs and OTFs as well as OTC transactions. Commodity derivatives (and related spot commodity contracts), emission allowances and benchmarks will also receive greater regulatory coverage.

Other changes brought about by the introduction of MAR include the regulation of market soundings (discussions with investors, prior to commencement of an actual transaction, to gauge their interest and determine pricing), a new offence of attempted insider dealing and market manipulation, and the prohibition of algorithmic or high-frequency trading strategies where they are used to manipulate markets. The initial proposals to expand the scope of inside information to cover that which a reasonable investor would be likely to consider as part of the basis of his/her investment decision, was not retained in the adopted version of MAR. [55]

On July 15, 2014, ESMA initiated the consultation process for preparing RTS and ITS in relation to MAR. [56] These technical standards will cover a variety of areas, including (amongst other things) (i) the conditions that buy-back programs and stabilization measures must meet (such as conditions for trading, restrictions regarding time and volume and disclosure and reporting obligations); (ii) appropriate arrangements, procedures and record-keeping requirements for persons to comply with the new market soundings requirements; and (iii) appropriate public disclosure of inside information (as well as rules governing any necessary delay). The deadline for responses to the consultation closed on October 14, 2014. ESMA has indicated that it will finalize the technical standards for submission to the Commission no later than 12 months after the entry into force of MAR [57] (i.e., by July 2015). In the coming year, we therefore expect to see continued development of ESMA's technical proposals as we head closer towards implementation in 2016.

UCITS V / VI

The UCITS V Directive was published in the Official Journal of the EU on August 28, 2014 [58] and makes various changes to the existing UCITS Directive (UCITS IV). [59] It came into force on September 17, 2014, and EU member states have until March 18, 2016 to transpose it into their national laws. 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 and include:

- changes to the provisions relating to the appointment of a depositary in respect of a UCITS fund, including new rules relating to duties of oversight, cash monitoring, custody duties and conflicts management;
- rules setting out the terms on which the depositaries' safekeeping duties can be delegated;
- revision of eligibility criteria for depositaries so only credit institutions and investment firms will be able to act as depositaries;
- clarification of scope of a depositary's liability in the event of losses relating to an asset held by the depositary;
- the requirement that UCITS management companies put in place remuneration policies and practices for senior management and persons whose professional activities have a material impact on the risk profile of the management company or the UCITS; the policies and practices must be consistent with, and promote, sound and effective risk management and discourage disproportionate risk taking;
- imposition of minimum harmonization rules to seek to provide more consistency in sanctions provisions in member states.

UCITS V requires the EU Commission to publish and implement various delegated acts and technical standards and guidance. In particular, the EU Commission has to set out various requirements as to the rules relating to depositaries. ESMA published a consultation paper in September 2014 [60] in relation to such delegated acts, focusing on insolvency protection of the assets of a UCITS, where the depositary has delegated safekeeping duties to a third party and the requirements on the management company and depositary to act independently. Following the end of the consultation process, ESMA's final technical advice was published in November 2014. The EU Commission is likely to publish the delegated acts based on this advice during 2015.

In July 2012, the EU Commission published a consultation paper seeking views on possible further changes to the UCITS regime - such possible changes have been generally referred to as UCITS VI. The Commission did not make specific proposals but outlined possible areas to be covered by further legislation, including eligible assets and the use of derivatives, efficient portfolio management techniques, extraordinary liquidity management rules, the possibility of a depositary passport, money market funds and long-term investments.

In November 2014, Steven Maijoor, the chairman of ESMA, indicated that many of the major issues that could have been the subject of specific UCITS VI legislation have been or are in the process of being dealt with in other legislation, including the draft Regulation on money market funds and the draft Regulation on European long-term investment funds (ELTIFs). [61] It therefore currently seems unlikely that the EU Commission will make any further proposals for amendment of the UCITS regime during 2015.

CENTRAL SECURITIES DEPOSITARIES REGULATION

The Central Securities Depositaries Regulation (CSDR) came into force on September 17, 2014 [62] and imposes a new regulatory regime on central securities depositaries and securities settlement in the EU. Provisions requiring the recording of securities in book-entry form, where the trade takes place on a regulated venue, and general requirements to settle transactions in specified financial instruments on the intended settlement date are already in force. Provisions requiring transactions in securities to be executed on trading venues not later than the second business day after the trade is executed apply from January 1, 2015. Other provisions requiring EU issuers to arrange for specified securities to be represented in book-entry form do not come fully into force until January 1, 2025. ESMA is required to draft various technical standards and guidelines under the CSDR and to deliver the draft technical standards to the EU Commission by June 18, 2015. In March 2014 ESMA published a Discussion Paper setting out draft proposals in relation to most of the required RTS and ITS. [63]

PAYMENT SERVICES DIRECTIVE

The Payment Services Directive (PSD) became law in most of the EU in 2009 and aimed to harmonize 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 harmonized conduct of business rules. In July 2013, the EU Commission published a draft Directive which amends the PSD and other relevant EU legislation (referred to as PSD2). [64] The draft Directive will update the existing framework relating to payment services and expand the scope of regulated payment institutions. New transparency requirements will also apply.

PSD2 will expand the scope of the current Directive by also applying certain provisions when only one payment service provider in a transaction is located in the EU. PSD2 will also now apply the provisions relating to transparency and information requirements to all currencies, not only EU currencies, as is currently the case. The definition of payment services will also be widened to cover services provided in the form of payment initiation services or account information services. A number of the existing exemptions available under the PSD are narrowed or removed, and various amendments are made to the conduct of business requirements.

The EU Council has proposed compromise drafts of the draft PSD2 Regulation, and the EU Parliament has also proposed amendments. Negotiations will continue into 2015. If PSD comes into law, it will be required to be transposed into national law in EU member states within two years of its coming into force.

1

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This was the reporting start date for trades entered into (1) on or after August 16, 2012 and still outstanding as of February 12, 2014, or (2) on or after February 12, 2014. For those trades entered into prior to August 16, 2012 that were not outstanding as of August 16, 2012, there is no trade reporting obligation. For those trades entered into either (1) prior to August 16, 2012 that were still outstanding as of August 16, 2012 or (2) on or after August 16, 2012 but in each case where such trade was not outstanding as of February 12, 2014, the trade reporting date is February 12, 2017. For those trades entered into prior to August 16, 2012 that were still outstanding as of February 12, 2014, the trade reporting start date was May

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[3] Commission Implementing Regulation (EU) No. 1247/2012.

[4] http://www.esma.europa.eu/system/files/esma-2014-1352_consultation_paper_on_the_review_of_emir_reporting_standards_under_article_9_0.pdf.

[5] Commission Delegated Regulation (EU) No. 148/2013.

[6] http://www.mofo.com/~/media/Files/ClientAlert/2014/10/141015ClearingDerivativeTransactionsintheEU.pdf.

[7] http://www.esma.europa.eu/system/files/esma-2014-1184_final_report_clearing_obligation_irs.pdf.

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[16] Directive 2014/59/EU, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN.

[17] https://www.eba.europa.eu/documents/10180/911034/EBA+CP+2014+41+(CP+on+draft+RTS+on+MREL).pdf.

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