Regulatory Developments Relevant to Structured Notes and Products in the EU and UK

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Regulatory Developments Relevant to Structured Products and Derivatives in the EU and UK

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Today’s Topics

- PRIIPs
- MiFID II / MiFIR
- Complex products
- Benchmark Regulation
- EMIR
- Prospectus Directive
- Proposed Capital Markets Union
- BRRD/Bail-in/TLAC
PRIIPs - Overview

• Initiative dates back to ECOFIN request to EU Commission in 2007
• Aim to seek greater consistency and more level playing field in regulation across different investment products in the EEA
• Increased focus on investor protection following financial crisis
• Point of sale issues are now largely dealt with in MiFID II / Insurance Mediation Directive
• Regulation on Key Information Documents for Packaged Retail and Insurance-based Investment Products (the “PRIIPs Regulation”) came into force on 29 December 2014:
  ➢ significant level 2 legislation still to be published
  ➢ Regulation will not become effective until December 2016
  ➢ Discussion Paper published by ESAs in November 2014
  ➢ further consultation papers and draft technical standards expected to be published during 2015
PRIIPs - Scope

• Regulation applies to packaged retail and insurance-based investment products or “PRIIPs”, being either of:
  ➢ packaged retail investment products (“PRIPs”), being “an investment … where, regardless of the legal form of the investment, the amount repayable to the investor 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”
  ➢ insurance-based investment products, defined as “an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations”

• Certain categories of product are expressly excluded:
  ➢ deposits other than structured deposits (as defined in the MiFID II Directive)
  ➢ certain “vanilla” securities that are exempted from the scope of the Prospectus Directive
  ➢ life insurance contracts where the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or infirmity
  ➢ non-life insurance products listed in Annex I to the Solvency II Directive
  ➢ many occupational pension schemes and pension products which, under national law, have the primary purpose of providing the investor with an income in retirement
PRIIPs – KID

• Regulation applies to manufacturers of, and persons advising on or selling, PRIIPs and provides that where a PRIIP is to be made available to retail investors a Key Information Document (“KID”) must be prepared:
  ➢ retail investor comprises retail clients under MiFID II

• Generally, a person advising on or selling a PRIIP to retail investors must provide a KID in good time (free of charge) before he is bound by any contract of offer relating to the PRIIP

• Must be provided to the retail investor or to someone with written authority to make relevant investment decisions on behalf of the retail investor

• Primary responsibility to draw up KID is on the PRIIP manufacturer
  ➢ definition includes any entity that manufactures PRIIPs or that makes changes to an existing PRIIP including altering its risk and reward profile or the costs associated with an investment in a PRIIP
• KID requirements as to form and content are detailed:
  
  ➢ intended to create standardised format of KID to aid comparability of pre-contractual information across different types of product
  
  ➢ stand-alone document separate from any marketing materials
  
  ➢ must provide key information and be consistent with the contractual documents, relevant parts of the offer documents and the terms and conditions of the PRIIP
  
  ➢ to be clearly titled “Key Information Document” at the top of the first page
  
  ➢ drawn-up in (or translated into) one of the official languages of the member state where the product is being sold
  
  ➢ KID should be written in a concise manner, promoting comparability and be a maximum of 3 sides of A4 paper
can be provided on website of product manufacturer with paper copy to be produced if requested

over-arching requirement to be “accurate, fair, clear and not misleading” and for language to be “clear, succinct and comprehensible” supplemented by detailed content requirements with mandatory headings in a specified order

KID must contain details of the PRIIP manufacturer, including contact details

KID must, where applicable, contain a “comprehension alert” i.e. a warning that the investor is about to purchase a product that is not simple and may be difficult to understand
PRIIPs – KID (cont.)

• Required sections of KID include:
  ➢ “What is this product?”
  ➢ “What are the risks and what could I get in return?”
  ➢ “What happens if [the PRIIP manufacturer] is unable to pay out?”
  ➢ “What are the costs?”
  ➢ “How long should I hold it and can I take my money out early?”
  ➢ “How can I complain?”
PRIIPs – KID (cont.)

• ESAs must develop various draft regulatory technical standards ("RTS") including:
  ➢ further details of the presentation and content of the various mandated sections of the KID outlined above
  ➢ the methodology underpinning the summary risk indicator and performance scenario sections
  ➢ the methodology for the calculation of costs

• Draft RTS expected to be published during 2015
• PRIIP manufacturer must review the KID regularly and revise the document promptly where the review indicates that changes should be made:
  ➢ ESAs to produce RTS setting out further details of these requirements
PRIIPs – Liability

• Liability and sanctions provisions:
  
  ➢ PRIIP manufacturer will not incur civil liability based solely on the KID, unless it is misleading, inaccurate or inconsistent with the legally binding contractual and pre-contractual documents or with the detailed KID content requirements.
  
  ➢ Regulation provides that where a retail investor can demonstrate a loss resulting from its reliance on information in the KID that is misleading, inaccurate or inconsistent (as above), the investor can claim against the manufacturer damages for loss in accordance with applicable national law.
  
  ➢ Liability cannot be waived or limited.
PRIIPs – Other Relevant Provisions

- UCITS management and investment companies and persons selling or advising on UCITS will be exempt from the PRIIPs Regulation for a transitional period of five years.
- PRIIPs regulation requires member states to set down sanctions for breaches of the Regulation including possible suspension of marketing of a product or public warning:
  - aimed at a more harmonised approach to sanctions across EEA member states.
- EU Commission to review PRIIPs Regulation after four years:
  - review must include the possible extension of scope of the PRIIPs Regulation to other financial products.
PRIIPs – What Was Not Included?

- No complexity label – instead a “comprehension alert” is required
- No product intervention powers (except in relation to insurance-based PRIIPs) or governance requirements – dealt with in MiFID II
- No reversal of burden of proof in relation to liability provisions
- No prohibition on preparation of KID for certain types of complex products (effectively banning such products for retail investors)
- No on-line calculator
- Some of these issues may be re-visited during PRIIPs review
MiFID II / MiFIR – Overview

- Markets in Financial Instruments Directive (MiFID) came into force in November 2007
- MiFID II is an overhaul of MiFID comprising a Regulation (MiFIR) and a recast Directive (MiFID II)
  - entered into force in July 2014
  - rules will begin to apply in January 2017
  - considerable number of technical standards to be published by ESMA
- ESMA has issued a number of discussion and consultation papers:
  - initial Consultation Paper and Discussion Paper issued in May 2014
  - second Consultation Paper published in December 2014 seeking views on draft technical standards
  - Technical Advice to EU Commission published in December 2019 on content of delegated acts to be implemented under MiFID II
  - further Consultation Paper published in February 2015 on implementation of transparency provisions for certain derivatives
- UK FCA published Discussion Paper in March 2015 on its approach in implementing MiFID II conduct of business and organisational requirements
MiFID II / MiFIR - Overview (cont.)

• MiFID II / MiFIR make fundamental changes to MiFID including:
  ➢ greater emphasis on product governance and investor protection
  ➢ increased regulatory capture for products and entities
  ➢ more intrusive regulation of products and entities
  ➢ major extension of transparency rules including to debt and structured products
  ➢ focus on enforcement and supervision

• Many provisions have particular relevance for structured products
MiFID II / MiFIR – Investor Protection

• Investor protection:
  ➢ some narrowing of client categorisations
  ➢ firms must inform clients whether advice is being provided on an independent basis and whether it is based on a broad or more restricted analysis of different types of instruments
  ➢ prohibition on firms providing independent investment advice from receiving third party inducements
  ➢ best-execution rules enhanced
  ➢ execution-only exemption retained (enabling non-advisory execution-only sales of non-complex products to customers with no suitability or appropriateness assessment) but narrowed so structured UCITS funds are now outside exemption together with bonds or other forms of securitised debt that embed a derivative or incorporate a structure which makes it difficult to understand the risks involved

• ESMA consultation states for a financial instrument to be non-complex it must not (a) incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay-out profile and (b) include any explicit or implicit charges that will have the effect of making the instrument illiquid

• ESMA will need to produce RTS on what constitutes a “structure which makes it difficult to understand the risks involved” – Consultation Paper published in March 2015 (see below)
MiFID II / MiFIR – Investor Protection (cont.)

- MiFID II sets out detailed requirements on product governance
- Enhanced organisational requirements for investment firms:
  - manufacturers of financial instruments must undertake a product approval process for each product before it is marketed or distributed
  - manufacturers must ensure products are designed to meet the needs of an identified target market
  - strategy for distribution must be consistent with such target market
  - manufacturers must take reasonable steps to ensure the product is distributed to the target market
- Firms must regularly review the products they offer and consider whether they remain consistent with the needs of the target market and whether the distribution strategy remains appropriate
- Manufacturers must make available to distributors all appropriate information on the product and the product approval process including the target market
Distributors must have in place arrangements to obtain relevant information for products they have not manufactured and to understand the characteristics and identified target market of products they distribute.

Appropriate information must be provided in good time to clients including in relation to the product, investment strategies, execution names and costs and related charges.

ESMA’s May 2014 Consultation Paper and December 2014 Technical Advice conclude that the product governance rules should be construed broadly and apply generally to all investment services including vanilla products.

- measures should be applied in appropriate and proportionate manner.

ESMA sets out detailed requirements for product manufacturers and distributors.
Structured deposits will now be subject to a number of provisions of MiFID II:

- must be (i) a deposit and (ii) involve payment of interest according to a formula, e.g. index, commodity or fx rate
- structured deposit provisions apply to EU credit institutions authorised under CRDIV and to investment firms authorised under MiFID II which sell or advise clients in relation to structured deposits
- many of MiFID II conduct of business rules will apply to structured deposits including provisions relating to governance, conflicts of interest and client order handling
- European Banking Authority (“EBA”) will have product intervention powers in relation to structured deposits under MiFIR – EU Commission has instructed ESMA and the EBA to work together when providing technical advice on product intervention powers
MiFID II / MiFIR – Transparency

• Pre- and post-trade transparency for derivatives and structured products:
  ➢ EU Commission basic principle in relation to MiFID II is that the same pre- and post-trade transparency requirements should apply to regulated markets, MTFs and organised trading facilities (OTFs)
  ➢ calibration for different types of instrument and trading
  ➢ MiFID already provides for transparency requirements for shares traded on a regulated market
  ➢ MiFIR will extend regime including to bonds, structured finance instruments and derivatives traded on a trading venue
  ➢ obligation to make publicly available current bid and offer prices and depth of trading interest
  ➢ rules to make public firm quote to apply to systematic internalisers where there is a liquid market and they agree, following a client request, to provide a quote
competent authorities will have powers to grant waivers from requirements – ESMA to be notified of waivers and will give opinion as to compatibility of waiver with MiFIR:

- use of waivers is more limited than was previously the case
- available for non-equity instruments for (i) orders large in scale (ii) indications of interest in request for quote and voice trading systems above a specified size if liquidity providers would otherwise be subject to undue risk and (iii) derivatives not subject to the trading obligation and any instruments for which there is not a liquid market
- in December 2014 paper, ESMA considers meaning of a “liquid market” for the purpose of granting waivers for pre-trade requirements - each asset group is divided into more granular classes that share largely homogenous liquidity characteristics
- each class is sub-divided further by factors such as maturity, issue sub-type, issue size, derivative type and notional amount
- conclusions for each sub-class are set out in detailed tables
- in February 2015, ESMA published an additional Consultation Paper on MiFID II setting out its analysis on what constitutes a liquid market for certain non-equity instruments not covered in its December 2014 papers including fx derivatives, credit derivatives and contracts for difference
- the February 2015 paper also sets out ESMA’s calculations on the “large in scale” and “size specific” thresholds to determine whether a waiver from the pre and post trade transparency requirements should be available
MiFID II / MiFIR – Exchange Trading of Derivatives

• Exchange Trading of OTC derivatives:

- MiFIR provides that all derivatives subject to a clearing obligation under EMIR and determined to be subject to a trading obligation under MiFIR should be traded on a regulated market, MTF or OTF or third country venue meeting equivalence and other requirements

- ESMA to develop technical standards (and consult) in relation to classes of derivatives to be subject to the trading obligation

- ESMA must consider the class to be “sufficiently liquid” taking into account factors such as average frequency, average size and number of trades, average size of spreads and profile of market participants

- In relation to determining whether a derivative will be determined sufficiently liquid to be subject to the exchange trading requirement, ESMA considers similar factors to those relevant to the transparency rules and indicates in many cases the thresholds will be the same or similar as for those rules but this is not necessarily the case
MiFID II / MiFIR – Product Intervention

- Product intervention powers granted to ESMA and competent authorities.
- ESMA can take action to temporarily prohibit or restrict marketing, distribution or sale of certain financial instruments or financial instruments with certain features if addressing a threat to:
  - investor protection OR
  - the orderly functioning and integrity of financial markets OR
  - the stability of all or part of the EU financial system AND
  - existing regulatory obligations do not address the relevant threat and the relevant competent authorities have not taken appropriate action to deal with the threat.
- ESMA must take into account possible detrimental effect on the efficiency of markets and potential for regulatory arbitrage.
- Ban may be up to 3 months but can be renewed.
- ESMA must give prior notification to competent authorities and publish details on its website.
• Competent Authorities will have power to restrict marketing or sale of financial instruments on the same grounds as ESMA (subject to requirement of proportionality and consultation with other affected competent authorities)

• ESMA consultation paper sets out list of factors to be considered in determining whether product intervention powers should be used including:
  - degree of complexity of financial instrument or type of financial activity
  - the type of clients to whom the relevant instrument will be marketed or sold
  - the features of the product including any leverage
  - degree of innovation

• On 5 August 2014, EBA published draft technical advice relating to intervention powers for structured deposits - it considers relevant factors to include degree of complexity of product, the size of the deposit, growth of the market and whether deposit is insured
MiFID II / MiFIR – non-EEA Firms

- MiFID currently has no harmonised regime for non-EEA firms to access EEA markets – left to individual member states
  - no passport is therefore currently available to non-EEA firms
- MiFID II will permit a third country firm to provide investment services or activities to eligible counterparties and professional clients in any EU member state without the need to establish an EEA branch if the EU Commission has determined the third country’s legal and supervisory regime is broadly equivalent to MiFID II
  - appropriate co-operation arrangements must also be in place with the third country
- An EEA member state may require that a third country firm establishes a branch and obtains authorisation in that member state to be able to provide services to retail clients or opted-up professional clients
  - no passporting available for these types of client
- If a third country firm establishes an authorised branch in an EEA member state and its home jurisdiction is recognised by the Commission as having requirements broadly equivalent to MiFID II, it will be able to passport activities to eligible counterparties and professional investors across the EEA
Complex Products

• Significant regulatory focus on complex products and their sale and distribution to retail clients

• IOSCO final report on suitability requirements with respect to the distribution of complex financial products, January 2013
  - nine key principles in relation to distribution of complex financial products
  - definition of complex product does not seek to be exhaustive but includes any product whose terms, features and risks are not likely to be understood by a retail customer because of their complex structure (including credit and equity-linked notes and ABS/MBS)
  - principles focus on understanding of product by intermediaries, advice, understanding of customer’s categorisation, financial sophistication, risk appetite and ability to absorb losses but does not seek to impose rigid rules on products that may or may not be sold to retail customers

• In December 2013 IOSCO published final report on regulation of retail structured products:
  - sets out toolkit with regulatory options that members can consider in regulation of structured retail products
Complex Products (cont.)

- February 2014 ESMA opinion on regulation of structured products with particular focus on the sale of complex instruments:
  - reminder to competent authorities of existing duties and obligations
  - does not define ‘complex product’ but provides examples of complex products and product types including products that:
    - are or embed derivatives
    - incorporate opaque indices
    - effectively lock investors in for a fixed period
    - are subject to complex pay-off formulae
  - ESMA sets out various requirements for internal controls and processes
  - competent authorities should ensure firms assess whether each complex product should be sold on an advised or non-advised basis to target clients
  - contains guidance on disclosure, particularly in ensuring clients are fully aware of total costs and charges for a complex product
  - ESMA also published a “Risk Warning” to be provided to market participants including need to understand key features of the product
Complex Products (cont.)

- UK FCA published thematic review on product development and governance in relation to structured products on 5 March 2015
- FCA stresses need for firms to identify a target market and design products to meet the needs of customers in such target market:
  - need for a robust approval process for new products
  - appropriate information to be provided to distributors and end-customers
  - product should be monitored through its life cycle
- FCA research concluded that retail customers continue to struggle to understand complex features common to many structured products and often overestimate potential returns
- FCA is concerned that many firms are not following its previous guidance:
  - not defining clear target market at products design stage
  - not conducting sufficiently robust analysis and stress-testing
  - not properly assessing whether products are likely to represent value for money to end customers
Complex Products (cont.)

- FCA specifies six key messages
  - retail customers struggle to understand relative merits to structured products and factors driving potential returns – firms should seek to bridge this knowledge gap
  - senior management should put customers at the forefront of their approach to product governance starting with identification of a clear target market
  - structured products should have a reasonable prospect of delivering economic value to customers in the target market – stress testing should be used to help meet this objective
  - firms should provide customers with clear and balanced information on each product and any risks
  - manufacturers should strengthen the monitoring of their products, ensure distributors have sufficient information on the product and check each product is being distributed to its target market
  - firms should do more to ensure fair treatment of customers throughout the lifecycle of a structured product
Complex Products (cont.)

• On 24 March 2015 ESMA published a Consultation Paper on complex debt instruments and structured products

• Paper relates to MiFID II and the execution-only exemption. ESMA is required to develop technical standards by 3 January 2016 as to the requirement that the exemption is not available to:
  
  - bonds or other securitised debt incorporating a structure which makes it difficult for the client to understand the risks involved
  - structured deposits which incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before its term
Complex Products (cont.)

- For debt instruments incorporating a structure that makes it difficult to understand the risk, ESMA states this should be interpreted as a structure and related risks that a retail client would be unlikely to readily understand. Non-exhaustive examples include:
  - ABS/ABCP
  - subordinated debt instruments
  - certificates
  - debt instruments that give the issuer rights to significantly modify cash flows
  - perpetual bonds
  - debt instruments with an unfamiliar or unusual underlying
  - debt instruments that may not repay principal in full
  - “packaged products” under the PRIIPs Regulation
  - debt instruments issued by a SPV
  - debt instruments with complex guarantees
  - debt instruments with leverage features
Complex Products (cont.)

- ESMA believes the following instruments should generally be regarded as non-complex
  - simple step-up notes
  - floating rate notes
  - covered bonds

- ESMA gives following, non-exhaustive examples of structures where it is likely to be difficult for the average retail client to understand the risk of return:
  - where more than one variable affects the return received
  - complex relationship between relevant variable and the return
  - an unfamiliar or unusual variable is involved in the calculation of the return

- ESMA considers the following factors could make it difficult for a client to understand the cost of exiting a structured deposit before maturity:
  - an exit penalty that is not a fixed sum or a percentage of the original sum invested

- Consultation is open until 15 June 2015
Benchmark Regulation

• Use of benchmarks in financial transactions has been the subject of focus from international regulations in recent years:
  ➢ LIBOR setting
  ➢ Wheatley Review
  ➢ UK Banking Reform Act 2013
  ➢ FCA consultation on additional benchmarks (March 2015 Policy Statement)

• July 2013 – IOSCO General Principles for Financial Benchmarks
  ➢ endorsed by FSB and G20

• EU Commission published draft Regulation in September 2013 in relation to indices used as benchmarks in financial instruments and contracts
  ➢ aim is to improve governance and controls applicable to financial benchmarks, the quality of data used in setting benchmarks, methodologies used by benchmark administrators and ensuring that contributors to benchmarks are subject to adequate controls
Benchmark Regulation (cont.)

- Draft regulation imposes various obligations on benchmark administrators, contributors and users
- Definition of benchmark is wide:
  - any index by reference to which the amount payable under a financial instrument is determined or an index that is used to measure the performance of an investment fund
- Index:
  - any figure that is published or made available to the public that is regularly determined, entirely or partially, by the application of a formula or any other method of calculation, or by an assessment where the determination is made on the basis of the value of one or more underlying assets or prices or other values
- Most significant obligations apply to benchmark administrators:
  - if located in EU, will be subject to authorisation and supervision by competent authority
  - need robust governance requirements, oversight function in relation to the benchmark and establishment of control and accountability frameworks
Benchmark Regulation (cont.)

- required to ensure there are adequate and effective systems and controls to ensure the integrity of input data
- appropriate monitoring to be in place
- code of conduct for each benchmark
- input data to be published immediately after publication of benchmark (delay permitted if there would otherwise be serious adverse consequences for the contributors or publication would adversely affect the reliability or integrity of the benchmark)

- Benchmark users:
  - entity subject to supervision in EU can only issue or own a financial instrument or be party to a financial contract that references a benchmark or use a benchmark that measures the performance of an investment fund if the benchmark is provided by an EU-authorised administrator or a non-EU administrator registered by ESMA
  - non-EU administrator can only be registered if relevant jurisdiction is recognised as having equivalent benchmark regulation and co-operation arrangements are in place between ESMA and the relevant competent authorities
Benchmark Regulation (cont.)

• Contributors:
  ➢ supervised entity that contributes input data to a benchmark administrator is subject to various governance and control requirements

• Due to systemic importance of certain benchmarks, EU Commission will 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 various powers including requiring selected supervised entities to contribute input data

• Regulation still going through EU legislation process
  ➢ compromise drafts published
  ➢ concerns over breadth of definition of index
  ➢ concerns over effect on non-EU benchmarks
  ➢ ECON has published draft report on Regulation which includes amendments relating to critical benchmarks and application of regulation to non-EU benchmarks
• EMIR came into force in August 2012
  ➢ most relevant provisions require further delegated acts to become effective

• Trade reporting:
  ➢ obligations started becoming effective on 12 February 2014
  ➢ all derivative transactions (OTC and exchange traded) entered into, modified or
terminated by EU counterparties must be reported to trade repositories (TRs)
within specified time limits
  ➢ in August 2014, the reporting regime was further expanded to include reporting of
collateral and valuation information (for financial counterparties and NFC+s only)
  ➢ concerns arose as to ability and readiness of counterparties required to complete
the pro forma reports (which contain 85 data fields)
  ➢ backlog in firms obtaining legal entity identifiers (LEIs)
  ➢ process has now settled down but in November 2014, ESMA published
recommendations to amend existing technical standards relevant to reporting to
address various concerns raised by market participants
  ➢ EU Commission must approve amendments – if it does they are likely to take
effect during 2015
• Clearing obligation:
  ➢ no clearing obligation is yet in effect in EU
  ➢ ESMA published consultation papers in July 2014 in relation to clearing of interest rates and fx transactions and in October 2014 in relation to fx derivatives
  ➢ draft RTS relating to interest rate derivatives covers fixed to floating swaps, basis swaps, forward rate agreements and overnight index swaps
  ➢ draft RTS relating to credit derivatives covers trades referencing certain untranched CDS indices
  ➢ commencement of clearing obligation also depends on type of market participant – four categories are specified with the clearing obligation applying first to clearing members of CCPs
  ➢ ESMA initially suggested clearing obligations could commence by February 2015
  ➢ delay has occurred due to suggested amendments proposed by the EU Commission, largely due to lack of certainty over timing relating to frontloading – EU Commission proposes frontloading requirements should be phased-in and only be effective from 2 months after the relevant RTS come into force
  ➢ in February 2015 ESMA confirmed the clearing obligation will not apply for the time being to fx derivatives until it has had time to address concerns raised by market participants
  ➢ on 11 May 2015 ESMA published further consultation paper on establishing a clearing obligation for further fixed to floating rate swaps and forward rate agreements in various currencies
• Collateral:
  - in April 2014, the ESAs published drafts RTS on risk mitigation techniques for the collateralisation of uncleared derivative transactions
  - it is proposed that counterparties be required to collect (1) variation margin on a daily basis to cover the mark-to-market exposure of counterparties during the life of a transaction and (2) initial margin on trade inception
  - eligibility criteria to apply to collateral
  - initial margin must be segregated from proprietary assets in the books and records of the custodian or third party holding it
  - initial margin cannot be rehypothecated
  - exemptions apply including where total collateral exchanged between two counterparties at a group level would not be greater than €50 million or where one party is exempt from EMIR
draft RTS envisage requirements will be phased in from 1 December 2015 – initially only to apply to counterparties that trade non-centrally cleared derivatives in excess of €3 trillion in monthly aggregate notional amount

requirements to apply to all counterparties trading non-centrally cleared derivatives in excess of €8 billion by December 2019

in March 2015, the BCBS and IOSCO updated their recommendations as to margin requirements for non-centrally cleared derivatives – recommendations included delaying the commencement of the obligations to 1 September 2016
Prospectus Directive - Overview

• Prospectus Directive ("PD") first came into force at the end of 2003 and sets out the requirements (in terms of both form and content) for issuers to produce a prospectus.

• Prospectus Regulation provides detailed prospectus contents requirements

• PD was amended by Directive 2010/73/EU (the "Amending Directive") which came into force on 1 July 2012 and two Commission Delegated Regulations of 30 March 2012 and 4 June 2012

• Omnibus II Directive requires ESMA to draft RTS in relation to prospectus approval, incorporation by reference, prospectus publication and dissemination of advertisements – draft RTS published in September 2014
Prospectus Directive – Summary of Amendments

- Amending Directive made a number of important amendments to the PD
- Exemptions from requirement to produce a prospectus were amended including:
  - number of non-qualified investors to whom an offer can be made in any member state increased to 150
  - minimum total consideration per denomination exemption increased to €100,000
  - amendments will have limited relevance to structured products, particularly those aimed at retail investors
- Position for “retail cascades” clarified so financial intermediaries are under no obligation to create a new prospectus on the resale or final placement of securities provided that:
  - there is available a valid PD compliant prospectus, approved no earlier than 12 months prior to the resale or placement; and
  - the person responsible for creating the prospectus consents to its use in writing
Prospectus Directive – Summary of Amendments (cont.)

• March 2012 delegated regulation categorised information to be included in base prospectus and final terms into:
  
  ➢ **Category A** – items that must be included in full in the base prospectus and cannot be left in blank for later insertion in the final terms (e.g. risk factors, governing laws and issuer credit ratings)
  
  ➢ **Category B** – items where the general principles must be included in the base prospectus and only details not known at the date of approval of the base prospectus can be left blank for insertion in the final terms
  
  ➢ **Category C** – items where the base prospectus can contain a reserved space for later insertion in the final terms, relating to information not known at the date of approval of the base prospectus

• Final terms are now much more restricted on what can be included:
  
  ➢ has had a particular impact on structured products
Prospectus Directive – Summary of Amendments (cont.)

- Amending Directive substantially amended summary requirements:
  - a prospectus summary is required except for non-equity securities with a denomination of at least €100,000
  - must provide “key information” to investors in a concise non-technical manner
  - must be in the order / format prescribed in the Prospectus Regulation
  - must be no longer than 7% of the prospectus or 15 pages (whichever is greater)
  - must not cross-reference other parts of the prospectus
- Amending Directive provides for an issue-specific summary to accompany final terms for securities with a denomination of less than €100,000
- The individual issuance summary is additional to the PRIIPs KID requirement and must contain:
  - information from the base prospectus summary relevant only to that issuance;
  - the options from the base prospectus which are only relevant to that issuance; and
  - relevant information in the final terms left blank in the base prospectus
Prospectus Directive – Review

• Amending Directive requires EU Commission to undertake review of certain aspects of PD by 1 January 2016 including:
  - liability regarding the summary with key information
  - proportionate disclosure regime
  - electronic publication of prospectuses
  - rules on determination of home member state for non-equity securities with a denomination below €1,000
  - definition of “public offer”
  - need to define the terms “primary market” and “secondary market”

• On 18 February 2015, the EU Commission issued a Consultation Paper setting out a broad ranging review of the PD going well beyond the matters it is required to review
Prospectus Directive – Review (cont.)

• Consultation Paper asks a number of questions related to when a prospectus should be required and when an exemption should apply including:
  ➢ the automatic exemption for higher denomination securities (currently €100,000)
  ➢ the lighter disclosure regime for a listing on an EU regulated market
  ➢ should a prospectus be required if securities are listed on a MTF?
  ➢ should the obligation to prepare a prospectus be mitigated for secondary sales?

• Consultation Paper also considers the contents of prospectuses including short form disclosure and interaction with the KID under the PRIIPS Regulation

• Approval process across EU member states – should the review and approval process be streamlined?

• Possibility of maximum length for Prospectus or specific sections of the Prospectus

• Should current one year validity period be extended?
EU Capital Markets Union

• Aim is to lower cost of funding in the EU and increase sources of funding for business:
  ➢ priorities include widening investor base to SMEs, building sustainable securitisations, boosting long-term investment and developing European private placement markets
  ➢ concerns raised that compared with US and other jurisdictions, capital markets based financing in Europe is relatively underdeveloped
  ➢ capital markets union should be based on principle of creating a single market for capital for all EU member states by removing barriers to cross-border investment in the EU
  ➢ further consultation paper to be published on covered bond market and the possibility of a more integrated EU covered bond market
BRRD/Bail-in

• BRRD finally entered into force on 2 July 2014
• Most complex and controversial provisions for legislators to agree on were bail-in provisions
• Member States must implement into national laws by 1 January 2015, except for bail-in provisions which must be implemented by 1 January 2016
• UK enacted legislation to implement most bail-in provisions by 1 January 2015
• Each member state must appoint a national resolution authority
BRRD/Bail-in (cont.)

• Recovery plan to be prepared by each institution and submitted to national competent authority for review

• Resolution authority must draw up resolution plan for each institution in consultation with national competent authority and other relevant resolution authorities

• Resolution plan must assess resolvability of institution without extraordinary public support (other than permitted resolution financing) or central bank liquidity assistance

• Resolution action can only be taken by an authority where it has determined that the institution is failing or likely to fail and other requirements are satisfied including resolution action being necessary in the public interest
• Resolution authorities must ensure resolution action taken in accordance with following principles:
  ➢ the shareholders of the institution must bear first losses
  ➢ creditors of the institution bear losses after the shareholders in accordance with the priority of their claims under normal insolvency proceedings, except as expressly provided otherwise
  ➢ the management body and senior management of the institution are replaced except where their retention is considered necessary to achieve the resolution objectives
  ➢ except where otherwise provided, creditors of the same class are treated in an equitable manner
  ➢ no creditor shall incur greater losses than they would have incurred under normal insolvency proceedings
  ➢ covered deposits are fully protected
• Resolution tools available to resolution authorities (which can be applied individually or in combination) are:
  - sale of business tool
  - bridge institution tool (transfer to publicly-owned bridge institution)
  - asset separation tool
  - bail-in tool
• Bail-in is the imposition of losses on liabilities owed by a financial institution where such liabilities would not, by their terms, be required to absorb such losses
• Loss absorption can be by:
  - conversion of the liability into a common equity instrument – the most loss-absorbent instrument
  - writing down/off the principal amount of the liability
• Resolution action can only be taken once valuation of assets and liabilities of institution are carried out by independent valuer – will be used, among other things, to determine extent to which capital instruments are to be written down or converted under the bail-in tool
• All liabilities that are not expressly excluded from the scope of bail-in are potentially bail-inable

**Express Exclusions**
- covered deposits – up to the amount covered by a deposit guarantee scheme
- liabilities in respect of holding client assets or client money or from a fiduciary relationship
- liabilities to other financial institutions (outside its group) with an original maturity of less than seven days
- employee remuneration or benefits (other than variable remuneration)
- secured liabilities – expressly including covered bonds and hedging instrument liabilities of the covered bond issuer

• Resolution authority can wholly or partially exclude liabilities from the scope of bail-in in limited circumstances including where it is not possible to bail-in the liability in a reasonable timeframe

• Structured notes are therefore potentially subject to bail-in provisions
BRRD – Bail-in of Derivatives

- A derivative liability can only be bailed-in once the derivative contract has been terminated and closed out.

- Where subject to a netting agreement (e.g. ISDA Master), the liability should be valued (for the purpose of the resolution valuation) on a net basis.

- EBA to develop (in consultation with ESMA) draft regulatory technical standards by 3 January 2016 on the methodologies and principles for valuing derivatives liabilities:
  - consultation paper with draft RTS published by the EBA on 13 May 2015.

- Where subject to a netting agreement, EBA “shall take into account the methodology for close-out set out in the netting agreement.”
BRRD – Bail-in of Derivatives (cont.)

- Article 71 BRRD gives resolution authority power to suspend termination rights of parties to contracts with institution under resolution, until midnight on the business day following official notice of the resolution action, so long as obligations regarding payments/deliveries/collateral exchange are kept current.

- FSB and other regulators concerned that powers such as these might not be enforceable against third country counterparties, where contract governed by the domestic law of the relevant court.

- Strongly encouraged derivatives industry to take steps to insert termination suspension provisions into the contracts governing derivatives. In November 2014 ISDA launched a protocol for parties to be able to modify terms of their ISDA Master Agreement.

- Also intended to be in sufficiently generic language that it would be used for other arrangements such as securities repo contracts.

- FSB will recommend that national regulators require regulated entities to adopt similar contractual language.
Each Member State must set a minimum requirement for eligible (loss-absorbing) liabilities (“MREL”) expressed as percentage of the aggregate of an institution’s own funds (capital) and total liabilities.

Minimum own funds are already established by Capital Requirements Regulation by reference to risk-weighted assets.

Where liability is governed by law of a non-EU country, it will only count towards minimum bail-inable liabilities if resolution authority is satisfied that the non-EU country would give effect to a decision to bail-in that liability:

- EBA published draft RTS on minimum list of factors that must be present in November 2014.
Total Loss Absorbing Capital ("TLAC")

- Financial Stability Board Proposal for Comment issued in November 2014; comment period closed in February 2015
- Intended to be effective by January 2019
- Designed to facilitate orderly resolution of G-SIBs
  - 30 banks globally including 8 US banks
- Two elements: Risk-weighted TLAC Ratio and a TLAC Leverage Ratio
- Minimum total loss absorbing capital of 16-20% of risk weighted assets excluding buffers
  - Tier 1 and Tier 2 Capital
  - other eligible TLAC that is not regulatory capital
- Minimum of a 6% leverage ratio: ratio of TLAC to total leverage exposure must equal at least 2 times bank’s leverage ratio
- Additional TLAC may be required for individual G-SIBs based on risk factors
TLAC Eligible Securities:

- issued and maintained by each resolution entity (on a consolidated basis) within a G-SIB group
- unsecured
- remaining maturity of at least one year

• **Excludes**
  - insured deposits
  - any liability callable on demand without supervisory approval
  - liabilities funded by the issuer or a related party
  - liabilities arising from derivatives or debt instruments with derivative-linked features—e.g., structured notes
  - non-contractual liabilities, such as tax liabilities
  - preferred liabilities
  - other liabilities that cannot be written down or converted to equity by resolution authorities
TLAC Term Sheet (cont.)

- Junior to excluded liabilities on the balance sheet of the resolution entity
- No set-off
- No redemption without supervisory approval
- Resolution entity must maintain “External TLAC”
- Material subsidiaries in jurisdictions outside of bank’s home country must have “Internal TLAC”
  - each material subsidiary must have 75-90% of the amount that would be required if they were the resolution entity
  - for this purpose, a “material subsidiary” is one that is not itself a resolution entity and that: (1) has more than 5% of consolidated RWAs of the G-SIB group; (2) generates more than 5% of consolidated RWAs of the G-SIB group; (3) has total leverage exposures that are more than 5% of the G-SIB group’s total leverage exposure; or (4) has been identified as material to the firm’s critical functions
TLAC Term Sheet (cont.)

- **Tier 2**
  - Additional Tier 1 Equity
  - Common Equity Tier 1

- **Unsecured, subordinated and other eligible debt**
  - Likely to be greater than 33% of overall TLAC

- **Capital Conservation, Countercyclical and other G-SIB buffers**
  - Unsecured, subordinated and other eligible debt

**Basel Capital Requirements**

**TLAC Requirements**

**TLAC Requirements & Capital Buffers**

- TLAC must be greater than 16-20% RWA, 6% leverage assets
Difficulty in Understanding? ESMA Consultation Paper on Complex Debt Instruments and Structured Deposits

On 24 March 2015, the European Securities and Markets Authority (ESMA) published a Consultation Paper setting out draft guidelines on complex debt instruments and structured deposits.¹

Background

The Consultation Paper is focussed on a relatively narrow (but important) aspect of the MiFID II legislation, namely the “execution-only exemption”. This is already part of the existing MiFID regime and relates to the level of diligence that firms are required to carry out on their clients before providing financial services to such clients. For investment advisory and portfolio management services, a full “suitability” assessment is required under which the firm must obtain sufficient information regarding the client’s knowledge and experience, financial situation and investment objectives. For other financial services, including execution-only services, a less stringent “appropriateness” assessment is permitted, which is limited to considering the client’s relevant knowledge and experience to enable the firm to assess whether the service or product is appropriate for the client. However, where an execution-only service relates to non-complex financial instruments specified in Article 19(6) of MiFID and certain other conditions apply, the investment firm can provide the service to the client without having to carry out the appropriateness assessment. The Article 19(6) list of instruments includes bonds and similar debt instruments admitted to trading on a regulated market or equivalent third country market but specifically excludes any such bond or other instrument that embeds a derivative.

The execution-only exemption was carefully considered as part of the MiFID II consultation process. The conclusion of the EU Commission was that the exemption should stay but that it should be narrowed by excluding further instruments. Article 19(6) of MiFID will be replaced by Article 25(4) of MiFID II. In addition to the exclusion of debt and other instruments embedding derivatives, it also now excludes (i) bonds or other securitised debt incorporating a structure which makes it difficult for the client to understand the risk involved and (ii) structured deposits which incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before its term. ESMA is required under MiFID II to develop technical standards by 3 January 2016 as to how these additional provisions should be assessed. The ESMA Consultation Paper is the first step in this process.

² MiFID II refers to the overhaul of the Markets in Financial Instruments Directive (MiFID) comprising the Markets in Financial Instruments Regulation (MiFIR) and a recast MiFID.
What is in the Consultation Paper?

Although MiFID II does not require ESMA to give guidance on the type of instruments that will be regarded as embedding derivatives (which as noted above are already automatically “complex” under MiFID), ESMA believes it is necessary for it to set out guidelines on this issue as well as the “difficult to understand” issue, for the proper understanding of the MiFID II criteria and the proper classification of an instrument as complex or non-complex.

In relation to an embedded derivative, ESMA approves previous definitions that it is a “component of a host contract or instrument—such as a debt instrument—that causes some or all of the cash flows that otherwise would result from the contract or instrument to be modified according to a defined variable, such as the price of a security or the level of a market index or an interest rate or foreign exchange rate”. ESMA provides non-exhaustive examples of instruments it believes come within this definition including:

- convertible and exchangeable bonds;
- indexed bonds and turbo certificates;
- contingent convertible bonds (cocos);
- inflation indexed bonds;
- callable or puttable bonds;
- credit-linked notes; and
- warrants.

In relation to debt instruments incorporating a structure making it difficult to understand the risk, ESMA believes this should be interpreted as meaning a structure (and the related risks) that an average retail client would be unlikely to readily understand. ESMA provides non-exhaustive examples of instruments it believes come within this definition including:

- asset-backed securities (ABS) and asset-backed commercial paper (ABCP);
- subordinated debt instruments;
- certificates;
- debt instruments that give the issuer rights to significantly modify the cash-flows;
- perpetual bonds;
- debt instruments with unfamiliar or unusual underlying securities;
- debt instruments structured in a way that may not provide for a full repayment of principal;
- debt instruments that are “packaged products” under the PRIIPs Regulation;
- debt instruments issued by an SPV, in circumstances in which the denomination of the debt instrument or the legal name of the SPV may mislead the investor as to the identity of the issuer or guarantor;
• debt instruments with complex guarantees; and

• debt instruments with leverage features.

ESMA also gives examples of instruments that it would normally not regard as difficult to understand for this purpose (so long as they don't include any of the features listed previously) including (i) step-up notes (which provide for an increasing rate of interest over time), (ii) floating rate notes and (iii) covered bonds.

In relation to structured deposits incorporating a structure making it difficult to understand (a) the risk of return or (b) the cost of exiting before term, ESMA states that the key consideration for (a) is whether the average retail client could reasonably be expected to understand the circumstances in which a return will be paid on the structure and the way in which it will be calculated. It again gives a non-exhaustive list of structures it believes will make it difficult to understand the risk of return including:

• more than one variable that affects the return received;

• a complex relationship that exists between the relevant variable and the return; or

• a variable involved in the calculation of the return that is unusual or unfamiliar to the average retail investor.

For (b), ESMA gives further non-exhaustive examples, including (i) an exit penalty that is not a fixed sum or a fixed rate and (ii) an exit penalty that is not a fixed percentage of the original sum invested.

Effect of Consultation Paper

The execution-only market is still important in financial markets and there are concerns that a significant narrowing of the exemption could have a big impact on the market and impact investor choice and market liquidity. Therefore it is likely that the consultation will be carefully reviewed by market participants. There are probably no huge surprises in the types of instruments that ESMA considers will be included in the “difficult to understand” categories but there may be concerns that ESMA's overall guidance is still very general. Although it gives specific examples of instruments that will be regarded as difficult to understand, it expressly states that these are non-exhaustive and there is likely to be careful thought and analysis given as to other types of instruments that may fall within the exemptions. Although ESMA does give some examples of instruments that will not usually be regarded as “difficult to understand” for this purpose, notably covered bonds, the list is short and it would not be surprising if in the consultation there is a push for ESMA to expressly specify other instruments that it regards as non-complex for this purpose. There will also inevitably be some push-back on some of the instruments ESMA regards as being difficult to understand—for example, it is somewhat baffling as to how the denomination of a debt instrument issued by an SPV could possibly mislead an investor as to the identity of the issuer or guarantor. One wonders whether ESMA is using the term “denomination” to mean the “name” or “designation” of the instrument, rather than the face or nominal value of the debt instrument.

Although the Consultation Paper is focussed on a relatively narrow aspect of MiFID II, it is also likely to have wider significance. The sale and distribution of complex products, particularly to retail investors, is coming increasingly under the microscope of regulators in the EU and elsewhere with various consultation papers on the issue having been published in recent years at the national and international level. Although ESMA's definition of a complex product for the purpose of the MiFID II execution exemption is not necessarily one that will be carried over across the board for other regulation impacting on complex products, its thinking is likely to be very relevant in this area.

The consultation is open for comments until 15 June 2015.
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A European Prospectus Revolution?

The EU prospectus regime, based on Directive 2003/71/EC (the “Prospective Directive”) as amended, has been in place now for nearly 10 years and was due to be reviewed by the European Commission by 1 January 2016. However, the European Commission has moved forward its review, and on 18 February 2015 released a consultation¹ on possible reform of the current regime, in conjunction with its Green Paper on a possible EU Capital Markets Union, released on the same date.

The main focus of the proposed EU Capital Markets Union is on improving the access to capital markets for smaller business entities (“SMEs”), in order to broaden the range of funding without the need for bank intermediation. The European Commission considers that the review of the EU prospectus regime is a vital part of developing a Capital Markets Union and, as such, has accelerated the timing of the review by launching its consultation now.

Background

The prospectus regime review is driven by the European Commission’s belief that there are many shortcomings in the current prospectus framework, such as the expense and complexity of preparing a prospectus, getting it approved, and the time-consuming nature of that process. It considers that these factors act as a barrier for many smaller-sized business entities that wish to access the capital markets. The stated aim of the review is therefore to reform the current regime to make it easier for companies to raise capital throughout the EU, at a lower cost, whilst still maintaining an effective level of investor protection. It also aims to update the regime to adapt to market and regulatory developments, including the prevalence of securities trading via multilateral trading facilities and organised trading facilities, the creation of SME growth markets, and also to reflect the upcoming introduction of Key Information Documents for packaged retail investment products under the new PRIIPs Regulation.²

The consultation takes the form of a number of questions, on which the European Commission invites the submission of on-line responses by 13 May 2015 at the latest. From the very first question, “should a prospectus be necessary for admission to trading on a regulated market, or an offer of securities to the public?”, it is clear that no part of the current prospectus regime is off-limits for discussion purposes – this is a “root and branch” review.

Other starter questions in the consultation include whether there should be a different treatment for a prospectus used for admission to trading compared to one used for an offer to the public. The consultation also asks for details of the costs of producing different types of prospectuses, in different circumstances, and a breakdown of how those costs are constituted. It also seeks views as to whether the costs of producing a compliant prospectus are justified by the major benefit provided to issuers by the Prospectus Directive – that of the “passport”, which permits the issuer access to all EU member states and regulated exchanges, without the need for any additional prospectus approvals.

The consultation is then broken up into separate sections.

**When Should a Prospectus Be Required?**

*Exemptions*

This section focuses particularly on the existing exemptions from the need to publish an approved prospectus and whether those existing exemptions are appropriate or should be amended.

It also focuses on the fact that, for small offerings (i.e., below EUR 5 million), the Prospectus Directive does not mandate the production of a prospectus, but leaves it open to individual member states as to whether a prospectus should be required in such circumstances, and whether there should be a harmonised approach across the EU to the question of prospectuses for small offerings.

*Secondary Issuances*

It also asks the question whether there should be a general prospectus exemption for secondary issuances of a class of securities that is already admitted to trading on a regulated market. Currently there is a limit of 10 percent per annum for an admission to trading without a prospectus of a secondary issuance of securities that are already listed, and the European Commission invites views as to whether that exemption should be extended or whether there should be instead be a more general, lighter (or proportionate) disclosure regime for secondary issuances of securities that are already listed.

*Trading Venues*

It considers whether the current requirement for publication of a prospectus for admission to trading on a regulation market should be extended also to admission to trading on a multi-lateral trading facility, and if so, whether there should be a differentiation between different types of multi-lateral trading facilities (including SME growth markets).

*Investment Funds*

In relation to investment funds, the Prospectus Directive currently provides that open-ended collective investment schemes are outside of its scope, but closed-ended collective investment schemes marketed to non-professional investors are potentially within scope. The European Commission invites views on whether certain types of funds, such as European long-term investment funds, European social entrepreneurship funds, and European venture capital funds, should be exempted from the prospectus requirement (even though they may remain subject to any bespoke disclosure requirements imposed by their sectoral regulation and/or by the PRIIPs regulation).
Share Schemes

In relation to employee share schemes, currently an exemption is granted for offers of securities by a firm to its employees, though this applies only where the issuer has its head office or registered office in the EU, or if it is a non-EU company whose securities are admitted to trading on a regulated market or on a third-country market. Views are invited as to whether this exemption should be extended also to employee share schemes of private non-EU companies.

Wholesale Denomination

Currently, a prospectus is not required in relation to debt securities with a denomination of at least EUR 100,000. The original reason behind this exemption was that it was considered that private or retail investors (who were the primary focus of the investor protection provisions of the prospectus regime) were less likely to invest in high-denomination debt (and in fact, this exemption is commonly known as the “wholesale exemption”). In terms of what was considered high-denomination, the amendments made to Prospectus Directive in 2010 increased that amount from EUR 50,000 to EUR 100,000. However the European Commission is now asking the question as to whether this exemption is still appropriate or whether having a high threshold may create an incentive to issue in larger denominations and so limit the issuance of debt securities in smaller denominations.

The other benefits to issuing in higher denominations are lighter disclosure requirements for such high-denomination securities where they are to be admitted to trading on a regulated market (and therefore still require an approved prospectus). Issuers of high-denomination securities are also not required to provide a prospectus summary, and in addition, under the Transparency Directive (Directive 2004/109/EC), an issuer of exclusively high-denomination debt securities, that are admitted to trading on a regulated market, is exempted from the obligation to publish annual and semi-annual financial statements. Views are now invited as to whether the high-denomination exemption may be detrimental to liquidity in corporate bond markets, and if so, whether the EUR 100,000 threshold should be lowered and whether some or all of the benefits of issuing in high denominations should be removed. It even asks whether the threshold should be removed altogether, with the effect that the current exemptions and benefits should be granted to all debt issuers, regardless of the denomination of those securities.

Prospectus Contents

The next section considers the information that a prospectus should contain.

Proportionate Disclosure

Firstly, it focuses on the proportionate disclosure regime that was introduced in 2010 for SMEs and companies with “reduced market capitalisation”. The Commission’s concern is that the proportionate disclosure regime has not delivered on its intended effect and is still not widely used, as it is still perceived as too burdensome by smaller entities. It asks whether the regime should be modified to improve its efficiency and whether it should be extended to other types of issuers not yet covered. It also asks whether respondents would support the creation of a simplified prospectus regime for SMEs admitted to trading on an SME growth market.

Incorporation by Reference

The Prospectus Directive allows for prospectuses to incorporate certain information by reference only, where that information has been published and approved or filed with the relevant authority. The Commission invites responses on whether the provisions on incorporation by reference should be recalibrated to achieve more flexibility and allow other documents to be incorporated by reference, including (but not limited to) documents already required pursuant to other financial regulation, such as the Transparency Directive and the Market Abuse Directive.
Directive. This reference to flexibility is interesting, given that one of the criticisms by market participants of the approach of the European Securities and Markets Authority (“ESMA”) to implementing the amendments made to the prospectus regime by the Omnibus II Directive is its overly restrictive interpretation of the Prospectus Directive provisions on incorporation by reference.

Short-Form Disclosure

One of the key criticisms of the approach to the recent PRIIPs regulation is the fact that, for a packaged retail product in the form of a security, when the PRIIPs regulation comes into force there will be a need to provide a key investor document ("KID") summarising the essential features of the product, in addition to the separate prospectus summary required in relation to debt securities with denominations below EUR 100,000. There will be a large degree of overlap in the information required for these two documents, yet there is no proposal in either the PRIIPs regulation or the Prospectus Directive to address this overlap in an efficient manner. The European Commission now asks whether there is a need to reassess the rules regarding the prospectus summary (for instance, regarding the concept of key information and its usefulness for retail investors, regarding the comparability of summaries of similar securities and regarding the interaction of the prospectus summary with final terms for securities issued under a base prospectus). It also asks for views as to how the overlap of information between the PRIIPs KID and the prospectus summary should best be addressed - whether that may be by providing for information already contained in the KID not to be duplicated in the prospectus summary, or by eliminating the need for a prospectus summary for such securities altogether. Another suggested alternative is the alignment of the format and content of the prospectus summary with that of the PRIIPS KID, with the view to minimising costs and promoting comparability of products.

Length

The European Commission is concerned about the trend towards overly long prospectuses – in Europe, base prospectuses for structured products, for example, may often exceed 1000 pages. The European Commission asks whether respondents would support the concept of introducing a maximum length for a prospectus, or a maximum length for certain specific sections of the prospectus. Many would say that this is not an issue that can properly be considered without at the same time considering the current liability standards for prospectuses, given that it is the latter that primarily drives the level of disclosure that the issuers feel is necessary to minimise their liability – that and, in the case of the base prospectuses, the regulatory changes that were introduced by the European Commission in the last few years, restricting the amount and type of information that can be included in final terms for programme issuances.

Liability

The Prospectus Directive does not currently provide any harmonised liability regime, and it is largely left to individual member states to prescribe criminal sanctions and a civil liability regime. The European Commission is now asking for comments as to whether the current provisions, requiring member states to ensure that appropriate administrative sanctions can be imposed against responsible persons, are adequate or should be improved.

Approval of Prospectuses

The final section of the consultation focuses on the issue of how prospectuses are approved. It invites views on how the approval process by national competent authorities can be streamlined and made more consistent between different jurisdictions. In particular it asks what the involvement of national competent authorities should be in relation to prospectuses, including whether there should any longer be a requirement (as currently) to review all prospectuses before the relevant offer or admission to trading, or whether authorities should review only a sample of prospectuses beforehand, with other prospectuses being reviewed only after the offer or the
admission to trading has commenced. It also asks whether the EU passporting mechanism is functioning in an efficient way or whether improvements could be made, such as whether the approval notification procedure between home and host member states could be simplified.

*Base Prospectuses*

Base prospectuses are currently only available for the issuance of debt securities for up to 12 months after the approval. However, views are now sought by the European Commission as to whether base prospectuses should be able to be used for all types of issuers and issues (including equity securities) and whether the base prospectus should remain valid for more than one year.

*Miscellaneous*

Other questions asked include whether the current distinction as to the home member state for non-equity securities above EUR 1000 denomination and non-equity securities with a denomination below EUR 1000 is a relevant distinction, or whether it should amended. It also asks whether member states should move to an all-electronic system for the filing and publication of prospectuses.

*Equivalence of Non-EU Prospectus Regimes*

Most importantly for non-EU issuers is the question that the European Commission asks in relation to a possible equivalence regime. Currently, the prospectus regime does not provide for a single equivalence regime for prospectuses drawn up under the legislation of non-EU countries, and assessments of equivalence are currently made by each individual national authority. The European Commission is seeking feedback on whether an equivalence regime could be developed and applied for all non-EU countries, such that a general equivalence decision could be taken by the European Commission for each non-EU country, based on an assessment as to whether the requirements of the non-EU country’s prospectus regime are equivalent to those of the Prospectus Directive in terms of investor protection.

*Definitions*

Finally, the consultation invites views as to whether there is a need for certain terms to be better defined, including the term “offer of securities to the public” (which is fundamental to the current prospectus regime) as well as the terms “primary market” and “secondary market”.

This review of the prospectus regime, and the ensuing regulation, will test the European Commission’s appetite for reform. The current prospectus regime took many years to develop, and it took many more years for participants and regulators to work through the finer details of compliance. Depending upon which approach the European Commission chooses to take, following the outcome of the consultation, the enormous scope of the potential changes could lead to many more years of work yet.

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Safe to Fail?

On 10 November 2014, the Financial Stability Board (FSB) launched a consultation on the adequacy of the loss-absorbing capacity of global systemically important banks (G-SIBs) in resolution. The Basel III minimum capital requirements for banks have already been implemented in many jurisdictions, including in Europe by virtue of the Capital Requirements Regulation and in the United States in July 2013. These rules require banks to hold certain amounts of different types of loss-absorbing capital, expressed as a percentage of their total risk-weighted assets – common equity Tier 1 capital of at least 4.5%, total Tier 1 capital (common equity Tier 1 + additional Tier 1) of 6% and total combined Tier 1 and Tier 2 capital of 8%.

On top of these minimum capital requirements, Basel III also prescribed the maintenance of capital buffers – a capital conservation buffer and, in certain circumstances, a counter-cyclical capital buffer. Failure to maintain the required levels of buffers leads to restrictions on payments of dividends and discretionary remuneration. The capital conservation buffer must be at least 2.5% of risk-weighted assets, the counter-cyclical capital buffer can be up to 2.5% of risk-weighted assets, and both buffers must consist of common equity Tier 1 capital.

In addition to the Basel III minimum capital and capital buffer requirements, the FSB has prescribed additional common equity Tier 1 capital requirements for those banks considered to be G-SIBs in a range of between 1% and 3.5% of risk-weighted assets. In its latest list of banks considered to be G-SIBs as of November 2014, 30 global banks are named and assigned to various different levels (or “buckets”) of required additional capital. This additional loss absorbency is to be implemented by way of an extension of the normal capital conservation buffer of 2.5% that applies to all internationally active banks. In the United States, the largest banks also are subject to a supplemental leverage ratio.

Total Loss-Absorbing Capacity (TLAC)

However, the FSB remains concerned that bank supervisors and markets need to have confidence that systemically important banks are truly no longer “too big to fail” and are resolvable without the use of public funds. It considers that, in order to have confidence that these firms have sufficient capacity to absorb losses, before and during resolution, there needs to be an internationally-agreed standard on an appropriate level of total loss absorbing capacity for G-SIBs.

The FSB’s consultation paper contains a set of principles intended to ensure that there is sufficient loss-absorbing capacity available in a bank’s resolution, such that the resolution authority can minimise any impact on financial stability, ensure the continuity of critical functions and avoid exposing tax payers to loss. It also contains a term sheet with more detailed proposals for implementing those principles in the form of an internationally-agreed standard.

Although maintaining adequate levels of loss-absorbing capacity cannot by itself guarantee either the non-failure of the bank or that a bank resolution would be effective, it is recognised as a vital piece of the framework for ensuring a successful resolution of a failing bank. In Europe, the Bank Recovery and Resolution Directive (BRRD) has now come into force and is to be implemented into national laws of EU member states by 1 January 2015, except for the bail-in provisions which are to be implemented by 1 January 2016. The BRRD includes a requirement for national authorities to establish minimum requirements for own funds and other liabilities that can be “bailed in” to absorb losses. The concept is that a bank should be funded by a minimum level of liabilities that are either designed by their terms to absorb losses, or can be made to absorb losses, in each case either by way of conversion of the liability into an equity instrument or by the permanent writing down of the principal amount of the liability.

In the United States, the Federal Deposit Insurance Corporation (FDIC), in December 2013, also published a notice on its approach to single-point-of-entry (SPOE) resolution, in which it sought comments on the amount and characteristics of loss-absorbing capacity that should be required to be held at the bank’s holding company level in order for this approach to be successful.

Under the SPOE approach in the United States, the bank holding company of a systemically important financial institution (SIFI) would be placed into FDIC receivership. The FDIC would then transfer the SIFI’s assets, including any investments in its subsidiaries, to a newly formed bridge financial company. The failed holding company’s secured liabilities and possibly limited unsecured liabilities would also be transferred to the bridge financial company. Shareholders’ equity, senior unsecured debt and subordinated debt of the failed holding company would not be transferred to the bridge financial company and would remain as claims of the failed bank. In order to ensure the effectiveness of the SPOE approach, the Federal Reserve has for some time been working with the FDIC to formulate a long-term debt requirement at the bank holding company level. Federal Reserve Governor Tarullo has explained that, “while minimum capital requirements are designed to cover losses up to a certain statistical probability, in the even less likely event that the equity of a financial firm is wiped out, successful resolution without taxpayer assistance would be most effectively accomplished if a firm has sufficient long-term unsecured debt to absorb additional losses and to recapitalize the business transferred to a bridge operating company. The presence of a substantial tranche of long-term unsecured debt that is subject to bail-in during a resolution and is structurally subordinate to the firm’s other creditors should reduce run risk by clarifying the position of those other creditors in an orderly liquidation process.”

How Much Loss-Absorbing Capital?

The proposed approach of the FSB is to require a minimum level of capital that can absorb losses on both a going concern and a gone concern basis. This will include the capital that is held to satisfy the Basel III minimum capital requirements, but will exclude capital held as part of the Basel III capital buffers, such as the capital conservation buffer (and the G-SIB extension of this buffer) as well as the counter-cyclical capital buffer.

The FSB proposes, firstly, that the minimum Pillar 1 TLAC requirement should be in the range of 16 to 20% of risk-weighted assets. This would mean that a global bank that falls in the 2.5% bucket of the G-SIB buffer would have to hold TLAC of between 21% and 25% of its risk-weighted assets, assuming no counter-cyclical buffer applied. Authorities would also be free to set additional, institution-specific Pillar 2 requirements on top of these.
Secondly, the Pillar 1 requirement should also be at least twice the Basel III Tier 1 leverage ratio requirement. The Basel III leverage ratio requirement, instead of looking at a ratio of capital to risk-weighted assets, measures an institution’s Tier 1 capital against its total (non-weighted) assets and off balance sheet exposures. As currently proposed by Basel, between 1 January 2015 and 1 January 2017, a leverage ratio of 3% will be tested, with a view to the final, calibrated leverage ratio being in full effect from 1 January 2018. Therefore, if the leverage ratio remains at the proposed 3%, the FSB’s proposals will mean that, in addition to the G-SIB holding TLAC of between 16 and 20% of its risk-weighted assets, capital would also need to be at least equal to 6% of the G-SIB’s total non-risk-weighted exposures plus off balance sheet exposures.

The FSB intends that a breach of the minimum TLAC requirement should be dealt with by bank supervisors as severely as a breach of minimum regulatory capital requirements.

As stated above, the required minimum levels of TLAC will include capital that already counts towards the G-SIB’s minimum Tier 1 and Tier 2 capital requirements, but the FSB has stated that it expects that at least 1/3 of the minimum Pillar 1 TLAC requirement will be satisfied in the form of debt capital instruments and other TLAC-eligible liabilities that are not regulatory capital. The FSB’s reason for this specification is not immediately clear. These kinds of liabilities are no more loss-absorbing than other TLAC. In fact those that do not constitute regulatory capital are likely to rank senior to regulatory capital in the statutory insolvency pecking order.

**Location of TLAC Within Group Structures**

The financial crisis demonstrated the truth of the maxim “global in life, national in death”, when applied to international banking groups, or in other words that, in contrast to the international nature of its operations, the responsibility for its failure falls on the authorities in its home state. This can create an incentive for regulators in the jurisdiction of incorporation of a material foreign bank subsidiary to require as much capital as possible to be held locally by that foreign subsidiary, so as to be available to ensure a successful resolution of that entity in the event of its failure.

The FSB’s consultation therefore also sets out proposals for where TLAC should be held within the group structure of a G-SIB. Firstly, relevant authorities should determine their preferred resolution strategies and identify which entity within the G-SIB group their resolution tools would be applied to (a “resolution entity”). This may be the top-level parent, an intermediate holding company or a subsidiary operating company. Whichever it may be, a resolution entity and its direct and indirect subsidiaries are considered to form a “resolution group” within the G-SIB group. The FSB also acknowledges that within a G-SIB group there may in fact be more than one resolution group. It therefore proposes that the minimum TLAC requirement will apply to each resolution entity within a G-SIB group and will be set in relation to the consolidated balance sheet of each resolution group.

In terms of where within the resolution group the TLAC should be held, the FSB proposes that the foreign subsidiaries of the resolution entity that are material (i.e., that constitute at least 5% of the G-SIB group by risk-weighted assets, revenues or total leverage, or that are otherwise material to the group’s critical functions), but are not themselves resolution entities, should be subject to an internal TLAC requirement in proportion to the size and risk of their exposures. The FSB intends that this “pre-positioning” of TLAC within foreign subsidiaries should reassure host authorities that there will be sufficient capital available to allow them to implement their resolution strategy and allow them to ensure continuity of critical functions and maintenance of financial stability.

It therefore proposes that the amount of internal TLAC to be pre-positioned in material subsidiaries should be equivalent to between 75% and 90% of the TLAC requirement that would apply to that material subsidiary on a stand-alone basis. This figure, however, is a tentative figure and will be the subject of a quantitative impact study in early 2015, which is intended to assist in the calibration of the Pillar 1 minimum TLAC requirements.
TLAC-Eligible Instruments

The FSB has not been prescriptive as to what instruments should be eligible to count towards TLAC, but has expressly excluded certain liabilities. It expects minimum maturity restrictions to be applied, to ensure that resolution loss absorbency will not be diminished by the withdrawal of short-term funding to an institution in the lead-up to its failure. It therefore proposes excluding all liabilities of less than one year’s maturity or that are callable on demand. In addition, the FSB has excluded the following from the list of eligible liabilities:

- insured deposits;
- liabilities funded directly by the issuer of the liability or a related party (unless relevant home and host authorities waive this exclusion);
- liabilities under derivatives, including securitised derivatives such as structured notes;
- secured or insolvency-preferred liabilities;
- tax and other non-contractual liabilities; and
- any other liabilities that cannot effectively be written down or converted under the laws governing the issuing entity.

The FSB’s proposed exclusion from TLAC of structured notes and other securitised derivatives should prove controversial, especially for those containing a prescribed level of principal protection, and European banks would have been expecting to be able to count such liabilities towards their minimum loss-absorbing liabilities requirements under BRRD. Given that such securities can, in principle, be bailed-in in a resolution, it seems difficult to justify not being allowed to count them as bail-inable for the purpose of calculating TLAC.

The FSB states that operational liabilities to providers of critical services should not be included within TLAC, and in the EU, the BRRD also expressly excludes such liabilities from eligibility for bail-in.

Characteristics of TLAC-Eligible Liabilities

The FSB also stresses that authorities need to possess the necessary legal powers to impose losses on TLAC-eligible liabilities, without fear of legal challenge or compensation costs. In Europe, the BRRD implements this requirement by providing resolution authorities with a “bail-in” tool to require conversion or write-down of bail-inable liabilities, and also enshrines in statute the power of resolution authorities to write down or convert Tier 1 or Tier 2 capital at the point of the bank’s non-viability.

In order to be eligible for TLAC, an instrument must be either:

- contractually subordinated to all excluded liabilities on the resolution entity’s balance sheet, although it may rank senior to Tier 1 and Tier 2 capital; or
- junior in the statutory creditor hierarchy to all such excluded liabilities; or
- issued by a resolution entity that has no excluded liabilities on its balance sheet, e.g., a holding company.

However, the above does not apply for those jurisdictions in which all of the liabilities excluded from being TLAC, as discussed above, are excluded from the scope of any bail-in tool and therefore cannot legally be written down or converted to equity.
In addition, where a liability eligible for TLAC is subject to set off or netting rights, the FSB states that only the net amount of the liability should be counted towards the TLAC requirement.

In the same way as for minimum regulatory capital, the FSB states that institutions should require prior supervisory approval before redeeming eligible TLAC instruments, unless they are being replaced with instruments of the same or better loss-absorbing capacity and the liability replacement will not impose unsustainable conditions on the bank.

TLAC-eligible instruments should be governed by the law of the resolution entity’s jurisdiction of incorporation, or should contain legally enforceable contractual bail-in provisions that recognise the home state bail-in action, unless appropriate statutory cross-border bail-in recognition provisions apply.

**Transparency**

The FSB also mandates adequate disclosure, for each material legal entity, on the hierarchy of its different legal liabilities, so that creditors, investors, depositors, counterparties and customers will have as much clarity as possible as to whom losses would be absorbed by, and in what order.

**Financial Contagion**

Due to the interconnectedness of the financial system, the failure of a major financial institution can cause severe financial stress to other participants in the system and, as a result, the FSB proposes that bank supervisors should place prudential limits on the ability of banks to invest in liabilities that are eligible for a G-SIB’s TLAC. The BRRD in Europe similarly prescribes that resolution authorities shall have the power, as part of an EU bank’s resolution planning, to limit that bank’s investment in liabilities eligible to be bailed-in.

**Resolution Funds**

The consultation proposes that, subject to certain conditions, including the agreement of the relevant authorities, if there exist “credible ex ante commitments” from resolution funding schemes to recapitalise a G-SIB in resolution as necessary to facilitate an orderly resolution, then such commitments may be counted towards the G-SIB Pillar 1 TLAC. The BRRD in Europe provides for each member state to establish a national resolution fund, funded mainly from ex ante contributions from its banks. However, the precise circumstances surrounding the permitted use of this fund, including the minimum levels of other loss absorption that must have first been effected, proved very controversial during the law-making stage of the BRRD, since this question is linked very closely to the ability of EU resolution authorities to exempt, on an ad hoc basis, a class of liabilities from being bailed-in. It remains to be seen to what extent this provision is of assistance to EU G-SIBs.

**Emerging Markets**

G-SIBs that are headquartered in emerging market jurisdictions are stated not to be subject, initially, to the minimum TLAC requirements. The FSB has not offered any reasoning for this stance, but based on the most recent list of G-SIBs, it will mean that the three largest Chinese banks will be exempt from these requirements.

**United States**

In the United States, as discussed above, the Federal Reserve has been studying a long-term unsecured debt requirement for some time. In speeches and in testimony, various Federal Reserve representatives have described it as a “requirement that large financial institutions have minimum amounts of long-term unsecured debt that could be converted to equity” and as “gone concern” capital. Already, in public remarks, Federal Reserve Governor Tarullo has noted that the U.S. TLAC requirements are likely to be more rigorous and may permit a
more limited number of instruments to be issued. This would be consistent with the “super-equivalency”
approach that the U.S. banking agencies have taken in implementing Basel III requirements for U.S. banks. Also,
under the capital rules adopted in July 2013, U.S. banks have far fewer options than do their European
counterparts in terms of the types of financial instruments that are considered eligible for Additional Tier 1 (AT1)
capital.

Europe

The European Banking Authority, on 28 November 2014, released a consultation on its draft regulatory technical
standards (RTS), specifying further criteria to be applied by EU member states in determining a minimum level of
own funds and bail-inable liabilities for each institution under the BRRD. These RTS firstly consider the
relationship between the institution’s going concern capital requirements, on the one hand, and on the other hand
the resolution authority’s assessment of the amount of loss that the bank should be able to absorb (which may be
the same as the overall capital requirements, including buffers, Pillar 2 requirements and backstop capital
measures, prescribed by the bank’s supervisor).

Secondly, they go on to consider how to determine the amount of recapitalisation that would be necessary to
implement any preferred resolution strategy. This may be zero if the bank can be liquidated, or if the bank is to
continue as a going concern, it will include the minimum capital amount necessary to meet the conditions for
continuing authorisation, plus an additional amount determined by the resolution authority to be necessary to
maintain sufficient market confidence in the recapitalised institution.

Market Impact

Although it may be premature, it seems reasonable that market participants may be concerned about the potential
impact of the TLAC requirement on bank securities. For example, just as European investors in the securities of
banks reacted sharply in 2011 when the bail-in regime first took shape, one might anticipate that investors in
senior bank debt might be more focused on spreads. Perhaps the more noticeable impact may be on contingent
capital AT1 instruments given that it may be more difficult to price differences between AT1 securities in a new
capital structure that includes TLAC. Finally, if one considers that the Basel III requirements (both regulatory
capital and the liquidity requirements) are already causing banks to reconsider their capital structures, the
introduction of TLAC and possibly some new measure to reduce reliance on short-term wholesale funding will
certainly lead to a shift in funding costs and in investor behavior.

Timing

Banks would be required to comply with the minimum TLAC requirements as from 1 January 2019, and would be
subject to earlier reporting and monitoring provisions. This timing would coincide with the date on which the
minimum capital, liquidity and leverage requirements of Basel III should be fully in effect. Comments on these
policy proposals of the FSB can be made until 2 February 2015.

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