Shining a Light on the SFT Regulation and an Update on Shadow Banking Reform

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1. Presentation

2. Morrison & Foerster User Guide:
   “The Long Long Game: The EU Financial Regulatory Agenda into 2016 and Beyond”

3. Morrison & Foerster Client Alert:

4. Morrison & Foerster Client Alert:
   “Possible Worlds Versus Probable Worlds – the Metaphysics of Systemic Risk: FSOC Revisits Asset Managers”

5. Fund Board Views Article:
   “Derivatives Rule Proposal: More Work for Overburdened Fund Directors”

6. Morrison & Foerster Client Alert:
   “SEC Proposes Rules to Require Funds to Adopt Liquidity Risk Management Programs; Allow ‘Swing Pricing’”
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24 May 2016

Presented by:
Peter Green
Jeremy Jennings-Mares

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A Brief History of Shadow Banking Reform

- Financial crisis and concerns that crisis was partly caused and/or exacerbated by banking activities carried out by non banks:
  - securitisation/CDOs
  - SIVs/ABCP conduits
  - credit derivatives
- Potential systemic risks arising from such activities
- G20 summit at Seoul in 2010 mandated FSB to develop oversight and regulation of shadow banking system
- Various background papers, consultative documents and related papers published by FSB
- FSB work now focussed on five workstreams
- Legislation in place or being developed in many areas
What is “Shadow Banking”?

• FSB background note – 12 April 2011:
  ➢ no clear definition
  ➢ activities outside the regular banking system that involve bank-like functions
  ➢ non-bank credit intermediation
  ➢ focus on activities that give rise to systemic risks, in particular through maturity or liquidity transformation, leverage and flawed credit risk transfer

• FSB, EU Commission and other regulators have stressed that any definition should not be rigid and should be capable of adapting to changes and developments in the financial markets
What is “Shadow Banking”? (cont.)

- EU Commission Green Paper published in March 2012 approved FSB definition and set out non-exhaustive list of entities and activities it believes fall within the ambit of shadow banking

**Entities**
- Special purpose entities performing liquidity and/or maturity transformation (e.g. ABCP conduits, securitisation SPVs, SIVs)
- Money market funds and similar vehicles with deposit-like characteristics making them vulnerable to runs
- Investment funds providing credit or that are leveraged (e.g. ETFs)
- Finance companies / securities entities providing credit or guarantees or unregulated liquidity / maturity transformation
- Insurance / reinsurance undertakings issuing or guaranteeing credit products

**Activities**
- Securitisation
- Securities lending and repos
In conjunction with the G20 leaders, the FSB has adopted a two-pronged strategy to address financial stability risks in shadow banking:

1. First, it has created a system-wide monitoring framework to track developments in shadow banking and to identify the build up of systemic risks with a view to taking necessary corrective action.

2. Secondly, it has developed five workstreams to strengthen the oversight and regulation of shadow banking:
   - Dampening procyclicality and other financial stability risks in securities financing transactions such as repos and securities lending.
   - Reducing the susceptibility of money market funds to runs.
   - Mitigating risks in banks’ interactions with shadow banking entities.
   - Improving the transparency and aligning the incentives in securitisation.
   - Assessing and mitigating financial stability risks posed by other shadow banking entities and activities.
FSB acknowledges securities and repo markets are vital in supporting secondary market liquidity for many securities:

- central to financial intermediaries’ ability to make markets and facilitate risk management and collateral management strategies
- core funding markets for some financial institutions
- key to money market and refinancing operations in many jurisdictions
- can, however, lead to bank-like activities including maturity and liquidity transformation and leverage
FSB’s specific concerns include:

- ensuring competent authorities have sufficient visibility on the build-up of leverage and illiquidity
- extent of reinvestment of cash collateral given for securities lending (and the potential for maturity and liquidity transformation)
- potential for securities financing to cause pro-cyclicality in the banking system
- tendency of creditors in repo and securities lending sectors to sell collateral securities immediately upon a counterparty default, potentially causing a downwards spiral
- possibility of re-hypothecation of client assets causing risks to financial stability if there is uncertainty as to the treatment of re-hypothecated assets in the event of an insolvency
Regulation of Securities Lending and Repos (cont.)

• FSB developed 11 policy recommendations for this workstream, including:
  - improving regulatory reporting to obtain more granular information on exposures
  - improving collection of trade level data and regular snapshots of outstanding balances for repo markets (particularly through trade repositories)
  - total national and regional data for repos and securities lending should be aggregated by FSB
  - improving reporting by fund managers to end-investors
  - limiting risks associated with cash collateral reinvestment
  - addressing risks associated with re-hypothecation of client assets
  - strengthening collateral valuation and management practices
  - evaluating the establishment or wider use of central clearing
  - changing bankruptcy law treatment of repos and securities lending transactions
FSB Framework for Haircuts on Non-centrally cleared SFTs

- FSB proposals for consultation on minimum standards for methodologies in calculating haircuts and for a minimum haircut framework
- In November 2013, FSB launched quantitative impact study on detailed proposals for the haircut framework
- In October 2014 the FSB published its regulatory framework for haircuts on non-centrally cleared securities financing transactions
  - contains FSB’s final recommendations on qualitative standards for methodologies used by market participants to calculate haircuts
  - sets out numerical haircut floor framework
- FSB regulatory framework was revised in November 2015
Haircut methodologies:

- Framework sets out qualitative standards to be incorporated by regulatory authorities.
- Haircuts to be based on market risk of assets used as collateral and calibrated over sufficiently long historical period (including at least one stress period).
- Regulatory authorities should set qualitative standards for methodologies used in calculating collateral margins or haircuts, whether on an individual transaction or portfolio basis, and should review those standards against FSB guidance by the end of 2017.
• The FSB sets out a table of numerical haircut floors:

<table>
<thead>
<tr>
<th>Residual maturity of collateral</th>
<th>Haircut level</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Corporate and other issuers</td>
</tr>
<tr>
<td>≤ 1 year debt securities, and floating rate notes (FRNs)</td>
<td>0.5%</td>
</tr>
<tr>
<td>&gt; 1 year, ≤ 5 years debt securities</td>
<td>1.5%</td>
</tr>
<tr>
<td>&gt; 5 years, ≤ 10 years debt securities</td>
<td>3%</td>
</tr>
<tr>
<td>&gt; 10 years debt securities</td>
<td>4%</td>
</tr>
<tr>
<td>Main index equities</td>
<td></td>
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<tr>
<td>Other assets within the scope of the framework</td>
<td></td>
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</tbody>
</table>
• FSB specific recommendations in relation to numerical floor are:
  ➢ BCBS should review its capital treatment of non-centrally cleared securities financing transactions and incorporate the framework of numerical framework floors in the Basel framework by the end of 2015 (BCBS published a consultative document in this regard on 5 November 2015)
  ➢ national authorities should implement such framework of numerical haircut floors by the end of 2018 (delay from previous recommendation of 2017)
  ➢ national authorities should also introduce a framework of numerical haircut floors on non-bank to non-bank transactions by the end of 2018. For jurisdictions with larger securities financing activities this should be done using market regulation or an entity-based approach (ideally market regulation in jurisdictions with the very largest securities financing activities)
  ➢ an initial assessment of the need and the implementation approach for introducing the framework of numerical haircut floors on non-bank to non-bank transactions should be conducted by national authorities by the end of 2018
FSB Standards for Data Collection and Aggregation

• In addition to its work on haircuts, the FSB has also developed standards and processes for global securities financing data collection and aggregation
• Finalised standards published in November 2015
  ➢ implementation timetable aims at launching global data and aggregation in 2018
EU Regulation on SFTs - Overview

- European Commission Regulation on reporting and transparency of securities financing transactions (SFTs) came into force on 12 January 2016
- Draft Regulation first proposed by EU Commission in January 2014
- Regulation focuses on transparency, disclosure and rehypothecation (reuse of securities)
- Effective date for implementation of provisions is staggered as set out further below
EU Regulation on SFTs - Scope

• Regulation applies to:
  - any counterparty to a SFT that is established in the EU or established outside the EU if the SFT is concluded by a branch of that counterparty located in the EU
  - UCITS management companies and investment companies
  - managers of alternative investment funds authorised under the AIFMD
  - counterparties to “reuse” arrangements which are either established in the EU or in a non-EU jurisdiction if the reuse is effected in the course of the operations of an EU branch or the reuse concerns financial instruments provided as collateral by a counterparty established in the EU or by an EU branch of a counterparty established outside the EU
EU Regulation on SFTs – Scope (cont.)

• There is an exemption from the provisions of the Regulation relating to the reporting and safeguarding obligations and the reuse of financial instruments under a collateral arrangement for:
  ➢ members of the European System of Central Banks and member state bodies performing similar functions
  ➢ EU public bodies charged with or intervening in the management of public debt
  ➢ the Bank for International Settlements
The Regulation defines a SFT under Article 3(11) as:

- a repurchase transaction (including reverse repo transactions);
- securities or commodities lending or borrowing;
- a buy-sell back transaction or a sell-buy-back transaction; or
- a margin lending transaction.
• Article 4 of the Regulation provides that counterparties to a SFT must report, to a registered or recognised trade repository, the details of any SFT that they have concluded, modified or terminated
  ➢ reporting must be no later than the working day following the conclusion, modification or termination of a transaction
  ➢ details to be included in the reporting are to be specified in further RTS to be developed by ESMA and adopted by the EU Commission (see further below)
  ➢ the Regulation provides that reportable information must at least include details of the parties to the SFT (and any beneficiaries), principal amount, currency, details of collateral (including type, quality and value), whether the collateral is available for reuse, repurchase rate, lending fee, margin lending rates, haircuts, value date and maturity date
EU Regulation on SFTs – The Reporting Obligation (cont.)

• Both counterparties have an obligation to report the details of a SFT
• A financial counterparty is responsible for reporting on behalf of both counterparties where the other counterparty is:
  ➢ a non financial counterparty
  ➢ whose balance sheet does not exceed two of (i) EUR20m balance sheet total, (ii) EUR 40m net turnover, (iii) 250 employee average during financial year

• Financial counterparty includes credit institutions, investment firms authorised under MiFID, insurance undertakings authorised under Solvency II, UCITS funds and an AIF whose manager is authorised or registered under the AIFMD

• If a UCITS fund or AIF is the counterparty to a SFT, the UCITS manager or the AIFM is responsible for reporting on behalf of the UCITS fund or AIF

• Counterparties may delegate their reporting obligations but remain liable in respect of the obligation
• Reporting is required to be made to a trade repository that is either:
  ➢ located in the EU and registered under Article 5 of the Regulation or
  ➢ located outside the EU and recognised under Article 19 of the Regulation
  ➢ in either case, the relevant repository must meet the criteria for regulation specified under EMIR
  ➢ in the absence of a registered or recognised trade repository, reporting can be made to ESMA

• Counterparties must keep records of any SFT they have concluded, modified or terminated for least five years following termination of the transaction
• The reporting requirement is to be phased in after adoption of the relevant RTS
• The reporting requirement will apply on or after the relevant “phase-in” date which will occur a specified number of months after the RTS are adopted and enter into force – the number of months will vary depending on the nature of the relevant counterparty:
  ➢ 12 months for EU investment firms or credit institutions or equivalent non-EU entities
  ➢ 15 months for central counterparties and central securities depositories authorised in the EU or equivalent non-EU entities
  ➢ 18 months for insurance and reinsurance undertakings, UCITS funds, AIFs, institutions for occupational retirement provision and central counterparties, in each case authorised in the EU (or equivalent non-EU entities)
  ➢ 21 months for non-financial counterparties established either in the EU or in a non-EU jurisdiction
• In addition to SFTs traded on or after the applicable phase-in date, back-loaded reporting of transactions will apply to transactions in existence prior to the phase in date where:
  ➢ the applicable SFT has a remaining maturity on the phase-in date of more than 180 days or
  ➢ the applicable SFT has an open maturity and remains outstanding for 180 days after the phase in date

• Back-loaded transactions shall be reported within 190 days of the applicable phase-in date
EU Regulation on SFTs – Investor Transparency

- The Regulation contains provisions relating to transparency similar to those contained in the UCITS V Directive and the AIFMD
- To enable investors to be made aware of the risks associated with the use of SFTs, Articles 13 and 14 of the Regulation require fund managers to provide pre-contractual and periodical information to investors
EU Regulation on SFTs – Investor Transparency (cont.)

• In the case of UCITS or AIF funds, pre-contractual information must be provided to investors in either a UCITS prospectus or an AIF disclosure, including:
  ➢ a general description of the SFTs and total return swaps used by the fund and the rationale for their use
  ➢ in relation to each type of SFT and total return swaps used by the fund, data relating to the types of assets subject to such transactions and the maximum and expected proportion of assets under management to be the subject of such transactions
  ➢ criteria used to select counterparties (including legal statutes, country of origin and minimum credit rating)
  ➢ acceptable collateral
  ➢ collateral valuation
  ➢ a description of the risks linked to SFTs and total return swaps
  ➢ specification of how assets subject to SFTs and total return swaps and collateral received are kept safe
  ➢ specification of any restrictions (regulatory or self-imposed) on the re-use of collateral
• In relation to such funds, periodical information must be provided in a UCITS half-yearly and annual reports and an AIF’s annual report:
  ➢ global data relating to the amount of securities and commodities on loan as a proportion of total lendable assets and the amount of assets engaged in each type of SFT and total return swaps in absolute terms and as a proportion of funds under management
  ➢ concentration data relating to the top ten collateral issuers across all SFTs and total return swaps and the top ten counterparties of each type of SFT and total return swap
  ➢ aggregate transaction data for each type of SFT and total return swap including type and quality of collateral, maturity tenor of collateral and SFTs in specified maturity buckets, currency of collateral and country of domicile of counterparty
  ➢ data on the reuse of collateral, including the share of collateral received that is reused compared to the maximum amount specified in pre-contractual information provided to investors
• Obligation on UCITS and AIFMs to disclose their use of SFTs and total return swaps in financial reports becomes effective 12 months after the Regulation comes into force
• Obligation on UCITS and AIFMs to disclose use of SFTs and total return swaps in prospectuses/pre-investment disclosure becomes effective 18 months after the Regulation comes into force for AIFs and UCITS funds that are constituted prior to the Regulation coming into force
• Reuse of collateral is defined as:
  ➢ the use of financial instruments by an entity receiving such instruments under a collateral arrangement in its own name and on its own account, or on the account of another counterparty, including a natural person (the “receiving counterparty”)

• The use can comprise transfer of title or exercise of a right of use in accordance with a security financial collateral arrangement:
  ➢ does not include the liquidation of a financial instrument in the event of default of the entity providing the collateral

• Rules on re-use of collateral become effective 6 months after the Regulation came into force (so 12 July 2016)
• Article 15 of the Regulation specifies certain conditions that must be complied with if a receiving counterparty has a right to reuse financial instruments it receives as collateral:

- the providing counterparty must be informed in writing of the risks and consequences in (i) granting consent to a right of collateral under a security financial collateral arrangement or (ii) concluding a title transfer collateral arrangement

- the providing party must (i) grant its prior express signed consent to the applicable security financial collateral arrangement containing a right of use of collateral or (ii) expressly agree to provide collateral by way of a title transfer collateral arrangement

- the reuse must be carried out in accordance with the terms of the applicable collateral arrangement

- the financial instruments received by the receiving counterparty must be transferred from the account of the providing counterparty
EU Regulation on SFTs – Administrative Sanctions

- Member states are required to provide their competent authorities with the power to impose administrative sanctions and other administrative measures in respect of breaches of the reporting and reuse obligations under the Regulation

- Sanctions available to competent authorities include:
  - cease and desist orders
  - public censure
  - withdrawal or suspension of authorisation
  - temporary banning orders
  - administrative fines
The EU Commission may adopt implementing acts determining the equivalence of non-EU reporting regimes:

- such rules must ensure secrecy of information and be applied and enforced in a manner commensurate with the rules under the Regulation
EU Regulation on SFTs - RTS

• On 11 March 2016, ESMA published draft RTS relating to the Regulation
• RTS cover principally technical areas, including:
  ➢ technical standards regarding the registration of trade repositories in respect of the reporting obligation
  ➢ the format of reports to be made under the Regulation including the content and structure of the report
  ➢ operational standards for data collection by trade repositories and data to be provided to competent authorities
• RTS were open for consultation until 22 April 2016
• ESMA expect to produce a final report on the RTS by Q3 2016 for endorsement by the EU Commission by 13 January 2017
Regulatory Reform of Money Market Funds

• FSB has stated that MMFs are an important element of the shadow banking system:
  ➢ provision of maturity and liquidity transformation
  ➢ important source of short-term funding for banks

• Historically MMFs have been regarded as a safe investment with a stable NAV

• During financial crisis some MMFs suffered large losses due to holdings of ABS and other financial instruments:
  ➢ significant drop in NAVs of some funds
  ➢ prompted investor redemptions and instability
  ➢ in 2008, the Prime Reserve Fund in the US “broke the buck” due to large holdings in Lehman Brothers paper

• IOSCO Reports: April 2012 and October 2012
Regulatory Reform of Money Market Funds (cont.)

- IOSCO identified ongoing vulnerabilities of MMFs which could destabilise the financial system:
  - Stable NAV features give impression of safety but MMFs are subject to credit, interest rate and liquidity risk.
  - “First mover advantage” for investors who redeem MMF shares at first sign of market distress – stable NAV feature means losses are borne by remaining shareholders.
  - Discrepancies between published NAV and realisable value of assets.
  - Implicit support from sponsors results in investors perceiving MMFs as less risky than they are.
  - Importance of ratings in MMF regulations.
Regulatory Reform of Money Market Funds (cont.)

- IOSCO final report made 15 policy recommendations, which have been endorsed by the FSB, including:
  - MMFs should be explicitly defined in regulation of collective investment schemes
  - need for compliance with general principles of fair value when valuing securities in portfolio
  - holding of a minimum amount of liquid assets to meet redemptions and prevent fire sales
  - MMFs that offer a stable NAV should be subject to measures designed to reduce specific risks associated with the stable NAV feature
  - MMF regulation should strengthen internal credit risk assessment practices
  - documentation should disclose the absence of a capital guarantee
  - regulators should, where necessary, develop guidelines strengthening the framework applicable to the use of repos by MMFs
In July 2014, following a consultation on previous proposals, the SEC voted 3-2 to adopt amended rules relating to MMFs. Rule amendments comprised of two principal components:

- floating NAV requirement for MMFs other than retail and government funds
- liquidity fees and gates
• Floating NAV:
  - institutional MMFs (other than government MMFs) must fix NAV based on the current market value of their underlying securities rounded to four decimal places
  - funds may value fixed income securities with remaining maturity of 60 days or less at amortised cost (rather than current market value) when the fund can reasonably conclude, each time it makes a value determination, that amortised cost is approximately the same as the fair value of the security as determined without the use of amortised cost valuation
  - retail MMFs may continue to use amortised cost
  - retail MMFs are defined as funds that limit beneficial owners to natural persons
  - retail MMFs must adopt policies reasonably designed to enforce limitation to natural persons
  - governmental MMF is one that invests at least 99.5% of its total assets in cash, government securities and/or repurchase agreements collateralised by cash or government securities
Liquidity fees and redemption gates:

• Liquidity fees:
  - if non-government MMF’s “weekly liquid assets” fall below 30% of total assets, the fund board has discretion to impose a liquidity fee of 2% on all redemptions if it determines that fee is in the best interests of the MMF
  - the fund board can impose a lesser or no fee if determined to be in the fund’s best interests
  - all non-government MMFs must impose a liquidity fee of 1% if weekly liquid assets fall below 10% of total assets unless the board determines such a fee is not in the MMF’s best interests - fund directors may impose fees of up to 2% on redemptions

• Redemption gates:
  - if weekly liquid assets fall below 30%, the board may also suspend redemptions for up to 10 days in any 90 day period

• Government MMFs are not bound by fee and gate requirements but could impose them if disclosed in the prospectus
SEC Regulation of Money Market Funds (cont.)

- Other requirements of the amended rules include:
  - enhanced registration statement and website disclosure about any financial support provided by fund’s sponsor or an affiliate and daily reporting of NAV per share
  - additional disclosure requirements re net inflows and outflows and daily and weekly liquidity levels
  - new form N-CR which must be filed within one business day of certain events, e.g. imposition or lifting of redemption gates, defaults in an underlying security and decline in NAV below $0.9975 for stable NAV fund
  - removal of 25% bucket for guarantees or demand features from a single institution. Up to 15% of a tax-exempt MMF’s total assets may be subject to guarantees or demand features from a single institution provided that any demand feature or guarantee acquisition in excess of 10% of fund’s total assets must be a demand feature or a guarantee issued by a non-controlled person
  - other amendments which promote greater diversification
  - additional stress testing requirements
SEC Regulation of Money Market Funds (cont.)

• Effective date of SEC Amendments:
  - floating NAV fees and gates: October 14, 2016 (2 years after the Effective Date)
  - reporting requirements: July 14, 2015 (9 months after the Effective Date)
  - diversification, stress testing etc: April 14, 2016 (18 months after the Effective Date)

• Fall out from new MMF regulations:
  - some observers believe that fees and gates will increase the likelihood of pre-emptive runs
  - will federal banking regulators, through FSOC, require additional protections?
• In December 2012 the European Systemic Risk Board published four broad recommendations in relation to MMFs:
  ➢ a mandatory move to variable NAV in most cases
  ➢ greater requirements for monitoring of liquidity risks and having measures in place to deal with liquidity constraints
  ➢ greater public disclosure of absence of capital guarantee, valuation practices and redemption procedures
  ➢ enhanced reporting requirements
Draft EU Money Market Fund Regulation

- Draft Regulation published by EU Commission on 4 September 2013
- Departed from a number of the ESRB recommendations
- Draft Regulation proposes to limit investment by MMFs to:
  - money market instruments (with high internal credit rating)
  - deposits of no more than 12 months (or on demand) with eligible credit institutions
  - financial derivatives (for hedging maturity and fx risks only)
  - reverse repos (maximum close-out facility of two working days)
- Subsequent negotiation during EU legislative process has been detailed and time consuming:
  - concerns in particular raised by EU parliament over requirement that constant NAV MMFs should have a 3% capital buffer in place
  - concerns also on restrictions on permitted investments
- EU parliament has voted in favour of amendments to the draft Regulation and the EU Council of Ministers subsequently published a comprise proposal on 10 May 2016
- Following slides reflect current Council Compromise proposal
Current compromise draft envisions that MMFs may be established in the EU as either:

- Variable Net Asset Value MMF (VNAV)
- Constant Net Asset Value MMF (CNAV)
- Low Volatility Net Asset Value MMF (LVNAV)

CNAV must:
- seek to maintain an unchanging NAV per unit or share
- accrue income in the fund to either be paid to the investor or be used to purchase more fund units or shares
- generally value assets according to the amortised cost method and/or round the NAV to the nearest percentage point
- invest at least 99.5% of its assets in specified assets and cash (see below)
• LVNAV MMFs must comply with specific requirements including:
  ➢ LVNAV may be valued using the amortised cost method only if it has a residual maturity up to 75 days (and provided such value does not deviate from a mark to market or mark to model valuation by more than 10 basis points)
  ➢ calculate a constant NAV per share on at least a daily basis on the basis specified in the Regulation
  ➢ the LVNAV must also calculate a mark to market or mark to model valuation and continuously monitor the difference between such value and the constant NAV value
  ➢ the units or shares of a LVNAV may be issued or redeemed at a price equal to the constant NAV provided such value does not deviate from the NAV per share or unit calculated on a mark to market or mark to model valuation by more than 20 basis points
  ➢ potential investors must be clearly warned of the circumstances in which shares or units will not be redeemed on a constant NAV basis
• Investment restrictions provide that a MMF may only invest in:
  - high quality money market investments (“high quality” is to be assessed by an internal credit quality procedure in accordance with the Regulation)
  - eligible securitisations and asset backed commercial paper (ABCP)
  - financial derivative instruments
  - repurchase agreements and reverse repurchase agreements
  - units or shares of other MMFs

• Eligible securitisations and ABCP comprise:
  - securitisations eligible to be included in the LCR under CRD IV
  - an ABCP which is fully supported by a credit institution under CRD IV that covers all liquidity, credit and material dilution risks as well as transaction and programme wide costs
  - securitisations designated as a “simple, transparent and standardised” securitisations under the forthcoming Securitisation Regulation
Further criteria are specified for the other categories of permitted investments.

Certain investment activities are expressly prohibited by the Regulation:

- short-selling
- taking direct or indirect exposure to equity or commodities, including through derivatives or indices
- entering into securities lending or borrowing agreements or other agreements that would encumber the assets of the MMF
- borrowing and lending cash
• The Regulation imposes diversification requirements on an MMF:
  - maximum 5% issuer limit for money market instruments (for VNAV MMFs the limit is 10% provided the aggregate value of instruments held above 5% in any instrument does not exceed 40%)
  - 10% limit on deposits with a single credit institution
  - aggregate 15% limit on permitted securitisation exposures
  - cap on value of assets transferred under permitted repurchase agreements of 10% of MMF’s assets
  - maximum risk exposure to same counterparty in respect of OTC derivatives of 5%
  - aggregate cash provided to same counterparty to reverse repos not to exceed 20% of MMF’s assets

• In addition to limits above, a MMF may not combine investments in money market instruments, deposits and OTC derivative exposures to the same body if that would exceed 20% of the MMFs assets

• A MMF must not hold more than 10% of the money market instruments issued by a single body
Draft EU Money Market Fund Regulation (cont.)

• The Regulation will also impose portfolio rules for standard MMFs (does not include CNAV or LVNAV MMFs):
  ➢ portfolio not to have a weighted average maturity (WAM) of more than 6 months
  ➢ portfolio to have a weighted average life (WAL) of no more than 12 months at any time
  ➢ at least 10% of assets to be comprised of daily maturing assets (including reverse repos that can be terminated on one business day’s notice)

• Different rules for short-term MMF portfolios (which must have a legal or residual maturity of 397 days or less and meet other criteria specified in the Regulation):
  ➢ WAM of no more than 60 days
  ➢ WAL of no more than 120 days
Draft EU Money Market Fund Regulation (cont.)

- Regulation imposes specific rules relating to liquidity fees and/or redemption gates and/or suspension of redemptions for CNAV and LVNAV MMFS
- Manager of a CNAV or LVNAV MMF must establish, implement and consistently apply prudent and rigorous liquidity management procedures for controlling the weekly liquidity thresholds applicable to such funds
- Where the proportion of weekly maturing assets falls below a 30% threshold of the assets of the MMF, the manager must inform the Board of the MMF which must make a “documented and well-reasoned” assessment of the situation and, acting in the best interests of investors, decide whether to apply one more of the following measures:
  - liquidity fees on redemptions up to 2%
  - redemption gates limiting the amount of shares or units to be redeemed on any dealing day to a maximum of 10% (for up to 15 dealing days)
  - suspension of redemptions for up to 15 days
• If the proportion of weekly maturing asset falls below 10% of total assets, the manager shall inform the Board which, following a documented and well-reasoned assessment of the situation, shall, acting in the best interests of investors, impose
  ➢ liquidity fees of at least 1% (not exceeding 2%) on redemptions
  ➢ suspension of redemptions for any period up to 15 days

• If within a period of 90 days, aggregated suspensions exceed 15 days, a CNAV or LVNAV MMF shall automatically cease to be a CNAV or LVNAV MMF and shall be prohibited from using the amortised cost or rounding method
The Regulation imposes various transparency and reporting obligations:

- MMF must indicate what type of MMF it is and whether it is a short-term or standard MMF
- MMF must report information to its competent authority on at least a quarterly basis
- Documents used for marketing purposes must contain certain statements including that the MMF is not a guaranteed investment, that it does not rely on external support for guaranteeing the liquidity of the MMF or stabilising the NAV per unit or share and that the risk of loss of the principal has to be borne by the investor
• The Regulation provides that a MMF shall not receive external support

• External support is stated to be any direct or indirect support offered by a third party that is intended for or in effect would result in guaranteeing the liquidity of the MMF or stabilising the NAV per unit or share including:

  ➢ cash injections
  ➢ purchase of assets at an inflated price
  ➢ purchase by a third party of units or shares of the MMF
  ➢ issuance of any kind of explicit or implicit guarantee, warranty or letter of support for the benefit of the MMF
• Previous proposal for a 3% capital buffer is removed from the latest compromise draft

• Existing MMFs will have 2 years to comply with the Regulation after it comes into force

• Regulation is still subject to further negotiation and change
Interaction of Regular Banking System with Shadow Banking

• Various amendments have been made to banks’ capital requirements under Basel II.5 and III. Measures that have been or are in the process of being adopted include:
  ➢ increased capital requirements for banks’ exposures to resecuritisations and liquidity facilities provided to securitisation vehicles
  ➢ increased capital requirements under the IRB approach for exposures to regulated financial institutions whose total assets are equal to or greater than US$100bn and to unregulated financial institutions
  ➢ enhanced banks’ internal capital adequacy process under Pillar 2 for securitisation risk, reputational risk and implicit support
  ➢ enhanced Pillar 3 disclosure requirements in relation to securitisation

• BCBS is continuing to develop guidance to improve international consistency of consolidation for prudential regulatory purposes
• In December 2013, BCBS published final policy framework for calculating capital requirements for banks’ equity investments in funds held in their banking book:
  ➢ financial standard will apply from 1 January 2017
  ➢ BCBS aims for consistent approach between banking book and trading book
• In April 2014, BCBS published its final standards for the framework for measuring and controlling banks’ large exposures seeking to take account of risks arising from shadow banking:
  ➢ to apply from 1 January 2019
  ➢ overall limit on large exposures of 25% of Tier 1 capital (15% for G-SIBs)
  ➢ EBA published Guidelines on exposures to shadow banking entities in December 2015
Regulation of other Shadow Banking Entities

• FSB has examined the extent to which non-bank financial entities (other than MMFs) pose systemic risks:
  ➢ policy framework published in August 2013

• Focus on economic functions carried out by relevant entities rather than focussing purely on legal names or forms

• FSB recommends that regulatory authorities identify shadow banking risks in non-financial entities by focussing on a framework of five economic functions:
  ➢ management of cash pools with features making them susceptible to runs
  ➢ loan provision that is dependent on short term funding
  ➢ intermediation of market activities dependent on short term funding or on secured funding of client assets
  ➢ facilitation of credit creation
  ➢ securitisation and funding of financial entities
• FSB has launched an information-sharing exercise among all its member jurisdictions to exchange information on the status of national authorities’ implementation of the framework
• In July 2015 the FSB also launched a thematic peer review to evaluate progress in implementing the policy framework
Regulation of other Shadow Banking Entities (cont.)

• In January 2014 FSB/IOSCO published a consultation paper on assessment methodologies for identifying non-bank, non-insurer Global SIFIs:
  ➢ basic set of impact factors included size, interconnectedness, substitutability, complexity and cross-jurisdictional activities
  ➢ assessment methodologies to measure impact of entity’s failure on global financial system and wider economy
  ➢ establishment of international oversight group
  ➢ sector-specific methodologies
• Further FSB/IOSCO consultation paper expected shortly
• In US under Dodd-Frank, FSOC has already designated four non-banks as SIFIs: GE Capital, AIG, Prudential and Met Life
  ➢ on March 30, 2016 – US federal court overturned FSOC’s designation of Met Life including calling such designation “arbitrary and capricious”.
Regulation of other Shadow Banking Entities (cont.)

• FSOC has, with SEC, considered whether asset management firms could pose a systemic risk and potentially be designated as SIFIs
  ➢ SEC consultation in 2013
• In December 2014 the SEC chair outlined three initiatives for the investment management industry:
  ➢ expanded data reporting for registered investment companies and investment advisers
  ➢ enhanced controls on risks relating to portfolio composition
  ➢ improved transition planning and stress testing
• In December 2014 the FSOC issued a public consultation on whether asset management products and activities may pose potential risks to the US financial system:
  ➢ liquidity and redemptions – FSOC asks whether pooled investment vehicles that provide for liquidity (e.g. mutual funds) have a greater incentive to redeem in times of market stress than if investors held the underlying securities directly
Regulation of other Shadow Banking Entities (cont.)

- whether leverage by pooled investment vehicles increases the potential for forced asset sales or exposes lenders or other counterparties to losses or unanticipated market risks and the potential impact for US financial stability
- potential risks to the US financial system resulting from operational risks
- the extent to which the failure or closure of an asset manager, fund counterparty or financial intermediary could have an adverse impact on financial markets or the economy

- September 2015, SEC proposed rules to require investment companies to adopt comprehensive liquidity risk management programmes which would include among other things:
  - classification of the liquidity of fund portfolio assets
  - assessment, periodic review and management of a fund’s liquidity risk
  - establishment of a three day liquid asset minimum
  - board approval and review
  - proposal would also allow funds to use “swing pricing” to add on the cost of large purchases and redemptions to shareholders that create costs
• December 2015, SEC proposed rules to limit investment company use of derivatives and leverage

• Funds would be required to comply with one of two tests:
  ➢ exposure-based portfolio limit – fund’s aggregate exposure to derivatives cannot exceed 150% of net assets
  ➢ risk-based portfolio limit – fund could limit exposure to 300% of net assets, provided investments are subject to less market risk than if the fund did not use derivatives, evaluated using a valuation at risk (VAR) analysis

• Funds must segregate cash to cover obligations from derivative transactions

• Funds that use more than a limited amount of derivatives would be required to implement a derivatives risk programme and designate a derivatives risk manager
Securitisation and Excess Leverage

• FSB has accepted that securitisation can have benefit to real economy:
  ➢ resumption of orderly securitisation markets stated to be a goal of the wider financial reform programme

• Concerns, however, that certain complex structures gave rise to various risks:
  ➢ misaligned incentives as between originators and investors
  ➢ imperfect credit risk transfers leading to concentration of risk in banking system
  ➢ opaqueness of structures led to lack of transparency
  ➢ some structures were specifically designed to circumvent Basel capital requirements

• BCBS/IOSCO undertook investigation of requirements relating to transparency and risk retention

• IOSCO policy recommendations published in November 2012
• IOSCO recommendations include:
  ➢ enhanced monitoring of incentives / retention requirements and the impact of
differences in approach, particularly between EU and US
  ➢ improving disclosure by issuers on stress testing and scenario analysis of pooled
assets
  ➢ encouraging standardisation of securitisation products, particularly in relation to
disclosure templates
• In July 2015, BCBS/IOSCO published criteria for identifying simple, transparent and comparable securitisations
• In the EU, in September 2015, the EU Commission published a draft Securitisation Regulation with a view to setting out common rules on securitisation and creating on EU framework for “simple, transparent and standardised” securitisations which would attract preferred regulatory capital treatment for institutional investors
THE LONG LONG GAME:
THE EU FINANCIAL REGULATORY AGENDA INTO 2016 AND BEYOND

FEBRUARY 2016

A pig in a poke. Whist, whist' (Sir Joseph Mawbey, 1st Bt), by James Gillray, publisher Samuel William Fores (floruit 1841), published 1788.
2016 will mark the eighth anniversary of the collapse of Lehman Brothers and the raft of regulatory reforms introduced in the aftermath of that event and the wider financial crisis will continue to be implemented during the year and in the coming years. Although many of these reforms have now been in the pipeline for a number of years, some new regulation does however continue to be worked on. In particular, in 2015, we saw the initiative to develop a Capital Markets Union (“CMU”) in the European Union (“EU”) which focused on a number of issues including reform of the Prospectus Directive and the introduction of a new regime for simple, transparent and standardised securitisations. Some major pieces of legislation, including the Market Abuse Regulation and the PRIIPs Regulation (both referred to in more detail below), will come into effect during or at the end of 2016 and this coming year will see the finalisation of many regulatory technical standards (“RTS”) and Implementing Technical Standards (“ITS”) in connection with such legislation. Although it looks like implementation of MiFID II will be delayed from 2017 to 2018 (as described more fully below), work will continue in relation to developing the vast number of RTS and ITS that need to be prepared in connection with this legislation.

Although the EU continues to push through its regulatory reform agenda, the cumulative effect of all the new regulation on the financial markets remains uncertain and there are some concerns that there may be unintended and unforeseen consequences arising from the reform agenda. On 20 January 2016, the European Parliament published a resolution on stocktaking and challenges of EU financial regulation.1 The resolution calls on the EU Commission to pursue an integrated approach to the CMU, pay attention to other relevant policy agendas including the development of a digital single market and threats to cyber security and provide regular (at least annual) “coherence and consistency” checks on a cross-sectoral basis on draft and adopted legislation. The resolution also calls on the EU Commission to publish a green paper exploring new approaches to promoting proportionality in financial regulation and to provide, at least every five years, a comprehensive qualitative and quantitative assessment of the cumulative impact of EU financial services regulation on financial markets and participants, both at EU and member state level. The EU Commission has yet to formally respond to this resolution but the points raised by the EU Parliament in the resolution echo many concerns already raised by market participants.

We have set out below a summary of some of the main regulatory developments we expect to see in the EU during 2016.

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I. EMIR Implementation

The European Market Infrastructure Regulation (“EMIR”)\(^2\) regulating derivatives transactions in the EU entered into force on 16 August 2012, but some of its requirements have yet to come into effect. Further delegated acts, RTS and ITS are required for many of EMIR’s provisions to be effected.

**Reporting**

Although the trade reporting regime was introduced in February 2014 and expanded in August 2014, recommendations for changes to the RTS and ITS have been made to address practical implementation concerns. In November 2015, the European Securities and Market Authority (“ESMA”) published a Final Report\(^3\) setting out new draft RTS and ITS on data reporting under Article 9 of EMIR.

The RTS include a list of reportable fields with prescriptions of what the content should include. The RTS explain how to report in the situation when one counterparty reports on behalf of the other counterparty to the trade, the information required for the reporting of trades cleared by a CCP and the conditions and start date for reporting valuations and information on collateral.

The ITS include a list of reportable fields prescribing formats and standards for the content of the fields. The ITS define the frequency of valuation updates and various modifications that can be made to the report and a waterfall approach to the identification of counterparties and the product traded. Finally, they describe the timeframe by which all trades should be reported (including historic trades that will need to be backloaded). ESMA has sent the final draft technical standards to the EU Commission for endorsement, which is likely to occur in early 2016.

ESMA published a Consultation Paper\(^4\) in December 2015 on draft RTS relating to data access, and aggregation and comparison of data. It proposed amendments to the current RTS\(^5\) on data access. The draft RTS aim to allow the authorities to better fulfil their responsibilities, in particular in the context of monitoring systemic risk and increased OTC derivatives transparency.

**Clearing**

The implementation of clearing requirements continues to be progressed. After some back and forth between ESMA and the EU Commission at draft stage, the first RTS on clearing Interest Rate Swaps was published in the Official Journal of the EU on 1 December 2015.\(^6\) The classes of interest rate swaps that will need to be cleared are:

- fixed-to-float (Plain Vanilla) swaps denominated in Euro, GBP, JPY and USD;
- float-to-float (Basis) swaps denominated in Euro, GBP, JPY and USD;
- forward rate agreements denominated in Euro, GBP and USD; and
- overnight index swaps denominated in Euro, GBP and USD.

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The RTS divide market participants into categories in order to ensure the most active market participants are required to clear first. The phase-in schedule is as follows:

- 21 June 2016 - Category 1: counterparties that are clearing members of an authorised CCP.
- 21 December 2016 - Category 2: financial counterparties and alternative investment funds ("AIFs") that belong to a group that exceeds a threshold of EUR 8 billion aggregate month-end average outstanding gross notional amount of non-centrally cleared derivatives.
- 21 June 2017 - Category 3: financial counterparties and other AIFs with a level of activity in uncleared derivatives below the threshold of EUR 8 billion aggregate month-end average outstanding gross notional amount of non-centrally cleared derivatives.
- 21 December 2018 - Category 4: non-financial counterparties above the clearing threshold.

The contract date against which the minimum remaining maturity is calculated for Category 1 and Category 2 counterparties was adjusted to allow counterparties time to determine their categorisation and make any necessary arrangements.

ESMA published a Final Report\(^7\) setting out final draft RTS in November 2015 establishing a mandatory clearing obligation on two further classes of interest rate swaps, being:

- fixed-to-float interest rate swaps denominated in CZK, DKK, HUF, NOK, SEK and PLN; and
- forward rate agreements denominated in NOK, SEK and PLN.

As with the first RTS, these RTS propose that the clearing obligation will be phased in depending on counterparty category.

**Risk Mitigation – Collateral**

Article 11(3) of EMIR requires financial counterparties to adopt procedures with respect to the timely, accurate and appropriately segregated exchange of collateral with respect to non-cleared derivatives. The European Supervisory Authorities (“ESAs”) (being ESMA, the European Banking Authority (“EBA”) and the European Insurance and Occupational Pensions Authority (“EIOPA”)) are required to develop RTS as to the necessary procedures, levels and type of collateral and segregation arrangements. In April 2014, the ESAs published their first joint consultation on draft RTS\(^8\) and their second Consultation Paper on draft RTS\(^9\) was published in June 2015 which, among other provisions, prescribed the regulatory amount of initial and variation margin to be posted and collected, and the methodologies by which that minimum amount would be calculated.

The ESAs propose that variation margin be collected over the life of the trade to cover the mark-to-market exposure of OTC derivative contracts. For initial margin, counterparties will be able to choose between a standard pre-defined schedule based on the notional value of the contracts and a more complex internal approach, where the initial margin is determined based on the modelling of the exposures. Assets provided as collateral are subject to eligibility criteria. Once received, margin must be segregated from proprietary assets of the relevant custodian, and initial margin cannot be rehypothecated.

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The second consultation revised the phase-in schedule so that variation margin requirements for uncleared trades are expected to come into effect from 1 September 2016 for major market participants (market participants that have an aggregate month-end average notional amount of non-centrally cleared derivatives exceeding EUR 3 trillion) and on 1 March 2017 for all other counterparties. Initial margin requirements are expected to be phased in between 1 September 2016 and 1 September 2020.

II. Capital Markets Union

In September 2015, the EU Commission launched its Capital Markets Union ("CMU") Action Plan\(^{10}\), intended to cover the 28 EU member states. The CMU initiative was first suggested in response to concerns that, compared with the US and other jurisdictions, capital markets-based financing in Europe is fragmented and underdeveloped, with significant reliance on banks to provide sources of funding. For example, compared with the US, European small and medium-sized enterprises ("SMEs") receive five times less funding from capital markets.

The hope is that this single market for capital will unlock more investment from the EU and the rest of the world by removing barriers to cross-border investment, whilst channeling capital and investment from developed capital markets into smaller markets with higher growth potential. It is intended to provide more options and better returns for savers and investors through cross-border risk-sharing and more liquid markets, with the ultimate aim of both lowering the cost and increasing the sources of funding available.

Based on consultations which began in February 2015, the EU Commission has confirmed that, rather than establishing the CMU through a single measure, it will be achieved through a range of initiatives. These will be targeted towards specific sectors, as well as more generally towards the EU supervisory structure, in each case with the aim of removing the barriers which stand between investors' money and investment opportunities.

The following measures have been designated as priorities: providing greater funding choice for Europe's businesses and SMEs; ensuring an appropriate regulatory environment for long-term and sustainable investment and financing of Europe’s infrastructure; increasing investment and choice for retail and institutional investors; enhancing the capacity of banks to lend; and bringing down cross-border barriers and developing markets for all 28 member states.

The EU Commission declares this to be a long-term project, with its ultimate goal being a fully functioning CMU by 2019. In order to achieve this, the Action Plan provides that the EU Commission will continuously work to identify the main inefficiencies and barriers to deeper capital markets in Europe and, alongside the annual reports it intends to publish, the EU Commission is also proposing to do a ‘comprehensive stock-take’ in 2017 to decide whether any further measures are required.

The next stage of the CMU implementation will occur in early 2016 when the EU Commission receives responses to two public consultations on (1) access to European venture capital and social entrepreneurship funds and (2) the creation of a pan-European covered bonds market. Also during the course of 2016, the European Parliament and the EU Council of Ministers will consider amendments to the Solvency II Delegated Regulation, as well as proposals for a Securitisation Regulation creating an EU framework for simple and transparent securitisation (see section on EU Securitisation Regulation) as described further below.

III. PD III (Prospectus Regulation)

As part of its implementation of the CMU Action Plan, on 30 November 2015, the EU Commission published a legislative proposal\(^{11}\) for a new Prospectus Regulation ("PD III") which will repeal and replace the current Prospectus Directive 2003/71/EC and its implementing measures. As set out in the EU

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\(^{11}\) [http://eur-lex.europa.eu/resource.html?uri=cellar:036c16c7-9763-11e5-983e-01aa75ed71a1.0006.02/DOC_1&format=PDF](http://eur-lex.europa.eu/resource.html?uri=cellar:036c16c7-9763-11e5-983e-01aa75ed71a1.0006.02/DOC_1&format=PDF)
Commission’s Consultation Document\textsuperscript{12} published in February 2015, the EU Commission concludes that the barriers to accessing capital in the EU need lowering and the mandatory disclosure requirements under the Prospectus Directive are particularly burdensome. Therefore, the hope is that implementation of PD III will make it easier and cheaper for SMEs to access capital markets, whilst also simplifying the process for all companies wishing to issue debt or shares.

The key proposals involve the following:

- introducing a higher threshold for determining when a prospectus is required for smaller capital raisings (proposed to be increased from €100,000 to €500,000, with the ability for member states to increase the threshold further in their domestic markets);
- doubling the firm size threshold under which SMEs are allowed to submit a ‘lighter’ prospectus (to include SMEs with a market capitalisation of up to €200 million);
- a simpler prospectus for secondary issuances by listed companies to reflect the reduced risk posed by such issuances;
- shorter, clearer prospectus summaries emphasising only material risk factors;
- fast-track approvals for frequent issuers via a ‘Universal Registration Document’ (the “\textit{URD}”) (similar to a shelf registration concept); and
- the creation of a free searchable online portal which will act as a single access point for all prospectuses approved in the EEA.

Most other exemptions from the requirement to produce a prospectus, such as for offerings to qualified investors only and to fewer than 150 persons per member state, are proposed to remain unchanged.

As we move further into 2016, the draft PD III will be reviewed by the European Parliament and the EU Council of Ministers. Once approved by all relevant EU institutions, several delegated acts will need to be adopted and ESMA will need to publish draft RTS and guidance. This timetable process is uncertain and it is therefore not presently known when PD III will take effect. The current draft of PD III contemplates that ESMA will produce annual reports on its impact and, in particular, the extent to which the simplified disclosure regimes for SMEs and secondary issuances and the \textit{URD} are used. The new rules will be evaluated five years after they enter into force.

\textbf{IV. EU Securitisation Regulation}

Securitisations have continued to be criticised in some quarters for the product’s perceived role in causing and/or exacerbating the effects of the recent financial crisis. However during the last couple of years, there have been increasing signs that the securitisation market is viewed by EU regulators as having an important part to play in creating well-functioning capital markets. This is principally due to the role such structures can play in diversifying funding sources and allocating risk more efficiently within the financial system.

On 30 September 2015, the EU Commission published a legislative proposal for a “Securitisation Regulation”\textsuperscript{13} with a view to setting out common rules on securitisation and creating an EU framework for simple, transparent and standardised (“STS”) securitisations. In effect, these are securitisations that satisfy certain criteria and are therefore able to benefit from the resulting STS label (for example, through reduced capital charges). This concept is not dissimilar to the idea that a fund might qualify for the

\textsuperscript{13} http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015PC0472&from=EN
UCITS label. According to the EU Commission, the development of a STS market is a key building block of the CMU and contributes to the priority objectives of supporting job creation and sustainable growth. At the same time, the EU Commission also published a draft Regulation to amend the CRR (referred to and defined below) to provide more favourable regulatory capital treatment for STS securitisations.

The draft Securitisation Regulation has two main goals, the first being to harmonise EU securitisation rules applicable to all securitisation transactions, while the second is to establish a more risk-sensitive prudential framework for STS securitisations in particular. The first goal is to be achieved through repealing the separate, and often inconsistent, disclosure, due diligence and risk retention provisions found across EU legislation, such as the CRR, the Alternative Investment Fund Managers Directive and the Solvency II Directive, and replacing them with a single, shorter set of provisions consisting of uniform definitions and rules which will apply across financial sectors.

The second part of the Securitisation Regulation is focused on the objective of creating the framework for STS securitisations and aims to provide clear criteria for transactions to qualify as STS securitisations. These include RMBS, auto loans/leases and credit card transactions, whereas actively managed portfolios (for example, CLOs), resecuritisations (for example, CDOs and SIVs) and structures which include derivatives as investments have been specifically prohibited. Those transactions which qualify as STS securitisations will result in preferential regulatory capital treatment for institutional investors. The EU Commission’s hope is that in recognising the different risk profile of STS and non-STS securitisations, investing in safer and simpler securitisation products will become more attractive for credit institutions established in the EU and will thus release additional capital for lending to businesses and individuals.

However, market concern exists in relation to the classification of STS securitisations. This, in part, arises as a result of the lengthy list of STS criteria which need to be satisfied and which may be interpreted in different ways. The burden of such interpretation is currently proposed to reside with the issuers and investors, which may introduce uncertainty and a lack of clarity that could ultimately defeat the purpose of the exercise. Some commentators have suggested that a third-party approval mechanism may be beneficial, although it remains to be seen who would be willing to assume this role and whether it is something that EU regulators wish to pursue.

The proposed Securitisation Regulation has been sent to the European Parliament and the EU Council of Ministers who need to agree and approve a final text. It is likely to be subject to considerable debate and scrutiny and it is therefore unlikely to become effective before the end of 2016. That said, market participants are likely to start responding to the proposal by considering whether their transactions fit the criteria for preferential regulatory capital treatment in time for when the Regulation does become effective.

V. **MiFID II Implementation**

MiFID II is the commonly used term for the overhaul of the Markets in Financial Instruments Directive which originally came into force in 2007. The primary MiFID II legislation comprises a Regulation ("MiFIR") and recast Directive (together with MiFIR referred to as "MiFID II"). MiFID II was published in the Official Journal of the EU on 12 July 2014 and entered into force 20 days after that date.

MiFID II currently provides that its provisions will start to become effective in the EU in January 2017. However, during 2015, concerns increased as to the work required in relation to the implementation of MiFID II, both in terms of finalising the vast number of delegated acts, RTS and ITS required to be published under MiFID II and in relation to firms putting in place the necessary systems to comply with all of the requirements. ESMA has recommended a delay in the implementation of MiFID II. In November 2015, the European Parliament announced that it is prepared to accept a one-year delay to MiFID II, subject to certain conditions. It is expected that the EU Commission will shortly make a formal legislative proposal to defer the date of implementation to January 2018 but this has not yet been published. It is

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not clear whether the EU Commission will also propose a deferral of the deadline for member states transposing relevant parts of MiFID II into their national laws. This deadline is currently 3 July 2016.

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

- some amendments to the investor protection provisions including a narrowing of the execution-only exemption so that structured UCITS are now outside the exemption, together with bonds or other forms of securitised debt that incorporate a structure which makes it difficult to understand the risk involved;

- structured deposits are now subject to a number of the provisions of MiFID II;

- the extension of many provisions of MiFID II to “organised trading facilities” or “OTFs” which will cover many forms of organised trading (not being regulated markets or multilateral trading facilities (“MTFs”)) on which bonds, structured finance products and derivatives are traded;

- requiring all derivatives that are subject to the clearing obligation under EMIR, and that ESMA determines to be sufficiently liquid, to be traded on a regulated market, MTF or OTF;

- extending the pre- and post-trade transparency regime (which currently only applies to shares) to bonds, structured finance instruments and derivatives traded on a trading venue;

- wider product intervention powers granted to ESMA and competent authorities including the ability to temporarily prohibit or restrict marketing of certain products in the EU;

- increased regulation of algorithmic and high frequency trading; and

- significantly expanding the scope of the regulation of commodities and commodity derivatives.

In addition to the level 1 legislation referred to above, MiFID II requires a significant number of delegated acts of the EU Commission to be prepared, mostly comprising RTS and ITS to be drafted by ESMA and the other ESAs. This has resulted in a significant number of consultation papers and discussion papers to be published, including:

(a) in May 2014, a Consultation Paper\textsuperscript{16} and a Discussion Paper\textsuperscript{17} from ESMA outlining its initial thinking on many aspects of MiFID II;

(b) in December 2014, Technical Advice from ESMA to the EU Commission\textsuperscript{18} and a second Consultation Paper on MiFID II\textsuperscript{19} dealing principally with regulation of secondary markets (including a detailed consideration of what constitutes a liquid market for the purpose of granting waivers of pre-trade transparency requirements for bonds, structured finance instruments and bonds and derivatives);

(c) in February 2015, an Addendum Consultation Paper from ESMA\textsuperscript{20} relating to MiFID II, dealing in particular with the transparency rules for non-equity financial instruments including the specification of thresholds for large-in-scale and size-specific waivers for pre- and post-trade transparency requirements for certain derivative transactions;

\textsuperscript{17} ESMA 2014/548, \url{http://www.esma.europa.eu/system/files/2014-548_discussion_paper_mifid-mifir.pdf}
\textsuperscript{18} \url{http://www.esma.europa.eu/system/files/2014-1569_final_report__esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf}
\textsuperscript{19} \url{http://www.esma.europa.eu/system/files/2014-1570_cp_mifid_ii.pdf}
(d) in April 2015, a Consultation Paper from ESMA on draft guidelines for the assessment of knowledge and competence of persons in investment firms providing investment advice or information about financial instruments, investment services or ancillary services to clients under Article 24 and 25 of the MiFID II Directive;

(e) in June 2015, an ESMA Final Report on draft ITS and RTS relating to authorisation, passporting, registration of third-country firms and co-operation between competent authorities;

(f) in August 2015, an ESMA Consultation Paper on various ITS and RTS to be published under MiFID II that it had not previously consulted on, including the suspension and removal of financial instruments from trading on a trading venue and notification and provision of information for data reporting services providers;

(g) in September 2015, an ESMA Final Report setting out the final versions of ITS and RTS it consulted on pursuant to its May 2014 papers referred to above;

(h) in November 2015, an ESMA Final Report setting out Guidelines on complex debt instruments and structured deposits in respect of the MiFID II “execution only” exemption;

(i) in December 2015, Final Reports from ESMA on Guidelines for cross-selling practices under the MiFID II Directive and on draft ITS relating to various matters including position reporting and format and timing of weekly position reports; and

(j) in December 2015, a Consultation Paper from ESMA on Guidelines on its draft RTS on transaction reporting, reference data, order record keeping and clock synchronisation.

It is expected that the EU will move to adopt the various delegated acts necessary in connection with the relevant ITS and RTS detailed above. It was expected that this would occur before the July 2016 transposition deadline. As mentioned, if the MiFID II timetable is delayed, it remains to be seen if the transposition deadline is also amended.

In the United Kingdom, on 15 December 2015, the FCA published the first of two Consultation Papers on changes to its Handbook necessary to implement MiFID II. This first consultation focused on secondary trading of financial instruments including the rules relating to pre- and post-trade transparency. This consultation is open until 8 March 2016, following which the FCA will publish a Policy Statement. The FCA’s second Consultation Paper on changes to its Handbook dealing with other relevant matters under MiFID II is expected during the first half of 2016.

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29 https://mifid.the-fca.org.uk/
VI. PRIIPS Implementation

The Regulation on key information documents (“KIDs”) for packaged retail and insurance-based investment products (“PRIIPs”)30 (“the PRIIPs Regulation”) is set to become effective on 29 December 2016, having come into force in December 2014. The two-year delay was deemed necessary in order to give PRIIPs manufacturers, advisors and sellers sufficient time to prepare for the practical application of the Regulation.

The main aim of the PRIIPs Regulation is to introduce a KID into pre-contractual disclosure, thus enabling retail investors to compare products and make a more informed investment choice when considering buying PRIIPs. The current EU-level regulation of pre-contractual product disclosures is uncoordinated and member states’ application of it has become more divergent which, according to the EU Commission, has created an “unlevel playing field between different products and distribution channels, erecting additional barriers to an internal market in financial services and products”. The worry is that this has led to retail investors making investments without full appreciation of the risks involved and subsequently suffering unforeseen losses.

Therefore, in order to improve the transparency of PRIIPs for investors, the PRIIPs Regulation obligates the manufacturer of a PRIIP (including entities which make significant changes to PRIIPs) to produce a KID which must be provided to each retail investor prior to any contract being concluded. The Regulation contains detailed requirements as to the form and content of the KID, as the aim is for all KIDs to be comparable side-by-side; for example, the KID must be a ‘stand-alone’ document separate from marketing materials, must be a maximum of three sides of A4 paper and the order of items and headings should be consistent throughout all of the documentation. The KID must contain all the information which could be material to an investor, such as the nature, risks, costs, potential gains and losses of the product, but must also be short, concise and avoid financial jargon.

On 11 November 2015, the ESAs released a joint Consultation Paper31 setting out draft RTS relating to presentation, review and provision of the KID. In terms of presentation and content, the draft RTS include a mandatory template to be used for each KID along with the permitted adaptations to the template, a risk indicator scale from 1 to 7 on which PRIIPs must be ranked and the methodology by which to calculate their ranking, a ranking for performance scenarios (unfavourable, moderate and favourable) for the PRIIP and various requirements regarding the presentation of costs. The draft RTS also provide that the KID be reviewed by the PRIIP manufacturer at least every 12 months to ensure it is accurate, fair, clear and not misleading and that the KID is provided in ‘good time’ so that the investor has time to fully consider it.

The ESAs invite comments on the RTS to be submitted by 29 January 2016 and this feedback will be submitted to the EU Commission, along with the final RTS, for endorsement by the end of March 2016. From January 2017, PRIIPs manufacturers and those selling or advising on PRIIPs will need to ensure they provide retail investors with a PRIIPs Regulation compliant KID before entering into any binding contracts.

VII. EU Benchmark Regulation

The integrity of benchmarks used in financial transactions has been the subject of increasing focus from regulators since the investigations into the manipulation of LIBOR and EURIBOR among other benchmarks. It is against this background that the Commission has proposed the Benchmark Regulation32, the draft of which was first published in September 2013.

On 19 May 2015, the EU Parliament agreed to a negotiating mandate on the Benchmark Regulation. Trialogue discussions began in June 2015 with the intention to agree a final version of the Regulation by the end of 2015. On 25 November 2015, the EU Council of Ministers and the European Parliament

reached preliminary political agreement on the proposed Benchmark Regulation. The agreement was
formalised by member states at a meeting of the Council’s Permanent Representatives Committee
("COREPER") on 9 December 2015. The proposed Benchmark Regulation will now be submitted to the
European Parliament for a vote at first reading, and to the Council for final adoption. Once adopted, it will
apply 12 months from publication in the Official Journal of the EU, and is unlikely to be in force until early
2017, at the earliest.

The proposed Benchmark Regulation aims to improve the governance and controls applicable to financial
benchmarks (including proper management of conflicts of interest), improve the quality of input data and
methodologies used by administrators and ensure that contributors to benchmarks are subject to
adequate controls. The proposed Benchmark Regulation will impose various obligations on benchmark
administrators, contributors (including submitters) and users.

The initial draft of the Benchmark Regulation distinguished between critical and non-critical benchmarks
and fewer requirements will apply in relation to a non-critical benchmark. If a competent authority
considers that the representativeness of a critical benchmark is at risk, the relevant competent authority
has the power to take various actions, including requiring selected supervised entities to contribute input
data; extending the period of mandatory contribution; determining the form in which, and the time by
which, any input data must be contributed; and changing the code of conduct, methodology or other rules
of such benchmark. The current political agreement reached in Trialogue between the EU Commission,
the EU Council of Ministers and the European Parliament is that there will be three categories of
benchmark: critical benchmarks (generally those used as a reference for financial instruments or financial
contracts or for the determination of the performance of investment funds having a total value of at least
EUR500 billion), significant benchmarks (based on the same criteria as critical benchmarks but with a
threshold of EUR50 billion) and non-significant benchmarks (those benchmarks that are not critical or
significant on the previous criteria). Obligations under the Regulation will be applied proportionally by
reference to these categorisations. There will also be specific regimes distinguishing between commodity
benchmarks (based on IOSCO’s principles for oil price reporting), interest rate benchmarks (which include
additional requirements relating to input data and contributors) and regulated data benchmarks (which,
due to their perceived lower risk of manipulation and conflicts of interest, will be exempt from some
requirements).

The proposed Regulation imposes strict control standards and oversight requirements on benchmark
administrators. Administrators will need to put in place procedures for controlling input data and reporting
infringements. There are also requirements on the transparency of the work undertaken by the
administrators in relation to the benchmark. Administrators of critical benchmarks will require
authorisation, while administrators of non-critical benchmarks will need to register with ESMA, who will
maintain a public register.

In relation to benchmark users, the initial draft Regulation provides that an entity that is subject to
supervision in the EU will only be permitted to issue or own a financial instrument or be party to a financial
contract which references a benchmark or a combination of benchmarks or use a benchmark that
measures the performance of an investment fund if the benchmark is provided by an administrator
authorised under the Regulation or is an administrator located outside the EU that is registered by ESMA
subject to specified criteria. Concern was raised as to the scope of these provisions, having regard to the
fact that no other major jurisdiction outside the EU currently has proposed benchmark regulation as
extensive as that proposed in the draft Regulation. Following the Trialogue discussions, the current
agreed position is that non-EU indices will be able to continue to be used through a recognition or
endorsement regime.

VIII. BRRD Implementation

Having come into force in July 2014, the Bank Recovery and Resolution Directive ("BRRD") was required
to be implemented into EU member states' national laws by 1 January 2015, except for the provisions
relating to the bail-in tool, which should have been implemented by each EU member state by 1 January
2016.
The main aim of the BRRD is to create a framework in which a bank can be allowed to fail, with the minimum of public sector support and the minimum of disruption to the broader financial system. Therefore, in addition to provisions relating to formulating recovery plans, resolution plans and provisions relating to the transfer of businesses and liabilities, the BRRD for the first time in EU law created an additional 'resolution tool' for EU national resolution authorities, in the shape of the 'bail-in tool'. This tool allows national resolution authorities to convert liabilities of the failing bank into equity or to write down the principal amount of those liabilities, so that in this way those liabilities can be forced to absorb some of the losses of the bank entering into resolution.

In addition to the resolution tools, the BRRD also introduced an additional prudential measure, in the form of an obligation to maintain Minimum Required Eligible Liabilities ("MREL"). MREL can be viewed as the European version of the TLAC rules referred to below (in that they provide for each EU national resolution authority to specify, for each bank under its jurisdiction, a minimum level of loss-absorbing capital and liabilities that can credibly be bailed-in in a bank resolution situation). These MREL provisions will apply to EU banks on top of the minimum regulatory capital requirements and capital buffer requirements that have been prescribed by the CRR.

Article 55 of BRRD requires that for most liabilities that can be bailed-in, where the contract for the liability is governed by a non-EU law, the party subject to BRRD must ensure that, in that contract, the beneficiary of the liability acknowledges that the liability can be bailed-in, and agrees to be bound by any such bail-in action.

This Article also became effective from 1 January 2016 and is giving rise to a flurry of activity for EU banks in explaining this obligation to their non-EU counterparties and obtaining their agreement to the inclusion of appropriate wording in the contract. Given that the scope of bail-inable liabilities is so broad, including not only purely 'financial liabilities', the intensive efforts needed for banks to comply fully with Article 55 will continue well into 2016 and beyond, until counterparties become familiar with the requirement and its implications.

IX. TLAC/MREL

On 9 November 2015, the Financial Stability Board ("FSB") published its final principles on the amount of loss absorption capacity to be held by global systemically important banks ("GSIBs")\(^33\). The principles were endorsed at the November 2015 meeting of the G20 nations in Antalya, Turkey. As such, they are now expected to be implemented into the national laws of the G20 nations, although the principles will have no binding effect on any GSIB until its home nation has in fact implemented the principles.

The FSB maintains a list of global banks that it considers to be GSIBs, and updates this list periodically. Currently, the list consists of 30 banks from around the globe.\(^34\) For each bank that is contained on the list, the TLAC principles will establish minimum levels of capital and liabilities that are able to absorb losses in the event of the GSIB’s failure. Those banks that were designated as GSIBs before the end of 2015 and that are not established in an emerging market economy must meet a minimum TLAC requirement, as from 1 January 2019, of at least 16% of their risk-weighted assets, and at least 6% of the denominator for the Basel III leverage ratio. For such firms, these minimum requirements will increase, as from 1 January 2022, to at least 18% of risk-weighted assets and at least 6.75% of the Basel III leverage ratio denominator. For those GSIBs that are currently headquartered in an emerging market economy (which currently encompasses only banks in the People’s Republic of China), these two pairs of minimum figures must be complied with by 1 January 2025 and 1 January 2028, respectively.

Any Tier 1 or Tier 2 capital held towards a GSIB’s minimum capital requirements can also be counted by it towards its TLAC requirements. However, the figures above are exclusive of capital maintained to meet


the various buffer requirements under the Basel III framework, which buffers must be maintained on top of the minimum TLAC requirement.

In terms of eligibility for TLAC, a liability that does not count as Tier 1 or Tier 2 capital must be unsecured, and must be perpetual in nature or not be redeemable at the instigation of the holder within one year. It must also be subordinated to liabilities that are expressly excluded from counting towards TLAC and must absorb losses prior to such excluded liabilities in insolvency, without giving rise to legal challenge or compensation claims. In addition, such liability cannot be hedged or netted in a way that would reduce its ability to absorb losses in a resolution.

The TLAC principles include a list of liabilities that are excluded from TLAC, on the basis that they may be difficult in practice to bail-in in a resolution, or where there are policy reasons why they should not be bailed-in. These include:

- deposits with an original maturity of less than 1 year;
- liabilities arising from derivatives or instruments with derivative-linked features (such as structured notes);
- liabilities that arise other than through a contract (such as tax liabilities);
- liabilities which are preferred to normal senior unsecured creditors; and
- any other liabilities that are excluded from bail-in under the resolution entity’s national laws, or cannot be bailed-in without risk of a successful legal challenge or compensation claim from the relevant creditor.

2016 will see the beginning of efforts to implement the TLAC principles into national legislation, and this is already evident in Europe in relation to the MREL provisions of the BRRD. The MREL provisions, although they address the same risk as the TLAC principles, differ in certain respects from the TLAC principles. For instance, they apply to all EU banks and not just GSIBs and are to be set on an entity-by-entity basis. They also are intended to be set by national resolution authorities as a percentage of the bank’s own funds and eligible liabilities, on a non-risk-weighted basis. However, sufficient flexibility is built into the MREL provisions that they are expected to meet the TLAC requirements when applied to European GSIBs.

The levels of MREL set by Europe’s national resolution authorities (“NRAs”) will be of significant impact to the European banking industry because, unlike the TLAC principles, a level of MREL must be set for every single European bank, not just GSIBs. Since this is set on an entity-by-entity basis, NRAs will have to apply a certain amount of discretion and judgment in setting the relevant levels. However, each NRA will be required to comply with the RTS (currently still in draft form) prescribed by the European Banking Authority (EBA) in respect of the setting of MREL. These standards provide that a bank’s MREL must consist of both an amount necessary for loss absorption prior to and during resolution, as well as an amount necessary for the subsequent recapitalisation of the bank. The loss absorption amount will have to at least equal the minimum capital requirement prescribed by the EU’s Capital Requirements Regulation (defined below), together with any applicable leverage ratio requirement that is set by the relevant national competent authority.

In the United Kingdom, the Bank of England has already set out its proposals as to the principles it will apply in setting MREL for each bank under its auspices. In particular, it has stated that it intends to use its MREL-setting powers to reflect the FSB’s TLAC principles in relation to UK-based GSIBs.

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36 http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf
The Bank of England has stated that for the biggest/most complex UK banks, it intends to set MREL at a level equivalent to twice the bank’s current minimum capital requirements – once for the loss absorption portion and once for the recapitalisation portion. Although not strictly required by the BRRD, the Bank of England also proposes that MREL liabilities should be subordinated to senior operating liabilities of the relevant bank.

The issue of subordination of certain liabilities, in the context of MREL and TLAC, is and will remain throughout 2016, a controversial subject. MREL – or TLAC – eligible liabilities are required to be subordinated to other unsecured liabilities that cannot be bailed-in or are unlikely to be bailed-in in a resolution situation. This subordination is required in order to prevent a myriad of claims that might arise from bailed-in creditors in circumstances where other equal-ranking unsecured liabilities, in particular deposits, have not been bailed-in, and the bailed-in creditors have suffered detriment as a result.

However, different EU member states are using different methodologies to achieve this subordination. For instance, the United Kingdom has enacted legislation which bestows a priority status on bank deposits of individuals and micro and small and medium enterprises. In contrast, Germany proposes to enact legislation which will provide that certain bank bonds are automatically subordinated to depositors and other unsubordinated liabilities. However, the precise methodology and wording used to achieve subordination of certain bail-inable liabilities could have a huge impact on the market for senior unsecured bank bonds and other liabilities, and we expect many developments in this regard during 2016.

X. CRD IV/Basel III

The Basel III reforms, in the form of the Capital Requirements Regulation (“CRR”)\(^37\) and the CRD IV Directive\(^38\) (together with the CRR referred to as “CRD IV”), largely came into effect on 1 January 2014 in Europe. This included the revised requirements in relation to minimum capital requirements for firms and the introduction of new capital buffers. These requirements are now being phased in in accordance with the terms of CRD IV.

Although the principal minimum regulatory capital requirements started to apply from 1 January 2014, a number of the other provisions take effect at a later date, in particular those relating to the liquidity coverage and stable funding ratios, leverage ratio and systemic buffers referred to below.

**Liquidity Coverage Ratio (“LCR”)**

In October 2014, the EU Commission adopted a delegated Regulation\(^39\) in relation to the LCR mandated by the Basel III framework, containing detailed provisions for the ratio which requires firms to hold an adequate level of high-quality liquid assets to meet net cash outflows over a 30 day stress scenario period. The delegated Regulation generally followed the Basel III LCR standard, with certain amendments, including in relation to giving certain covered bonds extensive recognition and also including, as part of the permitted liquid assets, certain types of securitised assets, such as securities backed by auto loans. The LCR started to be phased in from 1 October 2015, commencing at 60% of the full requirement and rising to 100% of the full requirement by 1 January 2018 unless the EU Commission exercises its power to delay full implementation until 1 January 2019.

**Net Stable Funding Ratio (“NSFR”)**

The NSFR is also prescribed by the Basel III framework and provides for a longer term amount of stable funding to be available. A bank must have “available stable funding” to meet 100% of its “required stable funding” over a one-year period. There are, as yet, no binding requirements as to the NSFR in CRD IV. However, as required by the CRR, in December 2015, the EBA published a Report\(^40\) in relation to the


introduction of the NSFR in the EU. In the Report, the EBA recommends the introduction of the NSFR in the EU and concludes there is likely to be no need to exempt certain banks from the NSFR requirements, although it states that it will explore further the costs for smaller banks in implementing the requirements. The EU Commission is now required to submit a legislative proposal in relation to the introduction of the NSFR in the EU by 31 December 2016. The Basel III framework envisages the introduction of the NSFR by 1 January 2018. This timetable is also envisaged by the recitals to the CRR but further details on timing will be included in the draft legislation to be published by the EU Commission.

**Leverage Ratio**

The ratio also forms part of the Basel III framework and is a measure of a firm’s Tier I capital divided by the non-risk weighted values of its assets. Basel III provides for such ratio to be a minimum of 3%. Following the current period of bank-level reporting of the leverage ratio and its components to national supervisory authorities, the Basel Committee on Banking Supervision (“BCBS”) intends to make any final calibrations and amendments to the requirements by 2017 with the intention that a minimum leverage ratio requirement will become effective from 1 January 2018. Title VII of the CRD IV Directive contains some measures implementing the Basel III leverage ratio requirements. In addition, in October 2014, the EU Commission adopted a delegated Regulation 41 making changes to the calculation of the leverage ratio by amendments to the capital measure and the total exposure measure. These included provisions to address the treatment of the exposure values of derivatives and securities financing transactions.

The EBA is required to publish a report on the impact and effectiveness of the leverage ratio by 31 October 2016. The EBA has indicated that it intends to publish the report by July 2016 at the earliest. Following publication of such report, the EU Commission is required to submit its legislative proposal, if appropriate, for a delegated act implementing the leverage ratio.

**Systemic Buffers**

In addition to the minimum capital requirements, Basel III also introduced capital buffers which apply to credit institutions and certain investment firms. These comprise (i) a capital conservation buffer of 2.5% of risk weighted assets (“RWAs”) comprised of common equity tier 1 capital (“CET1”) (which if not met, will result in a limitation of the maximum amount of profits that be distributed by the firm), (ii) a countercyclical buffer that can be set by national supervisory authorities of up to 2.5% of RWAs and must again comprise only CET1 and (iii) systemic risk buffers referred to below. The capital conservation buffer and the countercyclical buffer started to be phased in on 1 January 2016 and will be fully implemented by 1 January 2019. In December 2015, the EBA published an Opinion 42 on the interaction of Pillar 1 and Pillar II requirements under Basel III / CRD IV and the combined buffer requirements and restrictions on distributions. In the Opinion, the EBA recommended, among other things, that competent authorities ensure that the CET1 capital taken into account for calculating the maximum distributable amount where the capital conservation buffer is not met should be limited to the amount not used to meet the Pillar 1 and own funds requirements of the firm. It also recommended that authorities consider requiring firms to disclose their MDA-relevant capital requirements.

Under CRD IV, national competent authorities must assess global systemically important institutions (“G-SIIs”) and other systemically important institutions (“O-SIIs”). Each G-SII will be placed into one of five sub-categories. CRD IV imposes an additional buffer for each G-SII of between 1% and 3.5% of RWAs. Competent authorities will also have the discretion to impose a buffer on O-SIIs of up to 2.5% of RWAs. In each case, these buffer requirements must be met by CET1 capital and are in addition to a firm’s minimum capital requirements and capital conservation and countercyclical buffers. Member states will also have the power to introduce a systemic risk buffer, comprised of CET1 capital, which can be applied to the financial sector (or subsets of such sector). These buffers can be up to 3% of RWAs for all exposures and up to 5% of RWAs for domestic and third country exposures. These buffers are not intended to be cumulative with the G-SII buffer and the O-SII buffer. Only the highest will apply to a firm.

The EBA published a Consultation Paper\(^43\) in April 2015 in relation to a draft Regulation amending the RTS on the identification methodology for G-SIIs, which Regulation had previously been published in October 2014 and a draft Regulation amending the ITS on uniform format and dates for the disclosure by G-SIIs. In January 2016, the EBA published a Final Report\(^44\) on final draft RTS in relation to such amendments.

**Remuneration**

CRD IV also contains provisions relating to firms’ remuneration policies. These require firms to ensure that their remuneration policies make a clear distinction between criteria for setting basic fixed remuneration and variable remuneration. CRD IV also sets out a number of principles on variable remuneration, most controversially that a person’s variable remuneration should not exceed the amount of fixed remuneration (with the possibility of it being 200% of fixed remuneration only with shareholder approval (66% majority required with a minimum quorum of 50%)). This has been referred to as the “bonus cap”. Variable remuneration must also be subject to clawback arrangements. The bonus cap will therefore continue to be applicable into 2015. Concerns were raised by the EBA and the EU Commission during 2014 as to the practice by some firms of redesignating some variable pay into allowances. Their view was that in many cases, the allowances would still be regarded as variable pay. In October 2014, the EBA published an Opinion\(^45\) outlining what sort of pay structures it would consider to be variable pay. However, the paper has no binding force in the EU, and it is therefore possible that some firms could press ahead with allowance-type arrangements, leaving open the possibility of competent authorities seeking to impose sanctions and possible future legal action in this area.

In May 2015, the EBA published correspondence between it and the EU Commission as to the interpretation of the proportionality principle set out in Article 92(2) of the CRD IV Directive that states that the remuneration principles should be applied to firms in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities. The EU Commission’s view is that the remuneration principles under CRD IV have to be applied to each firm and any discretion those provisions may leave to member states and competent authorities have to be exercised in accordance with the proportionality principle. Therefore, the EU Commission is of the view that the proportionality principle does not disapply any of the remuneration principles and that requirements on deferral and payment in instruments have to be applied to all institutions.

In December 2015, the EBA published an Opinion\(^46\) on the application of the proportionality principle. It also published a Final Report on its Guidelines in relation to the CRD IV remuneration requirements.\(^47\) The revised Guidelines will come into force on 1 January 2017 and will apply on a “comply or explain” basis so that national competent authorities will have to state whether they intend to comply with the Guidelines and, if not, the reason for not doing so. In the Opinion, the EBA repeats its view in relation to the proportionality principle stated above. It also proposes amendments to CRD IV that would permit smaller and less complex firms to disapply the requirements in relation to deferral and payment in instruments. It does not propose any amendment to the bonus cap. This would mean that all CRD IV firms would have to apply the bonus cap from 1 January 2017 (including all asset managers and investment firms coming under CRD IV). At present, the UK FCA only requires CRD IV firms in levels 1 and 2 of its proportionality framework to apply the bonus cap.

It is expected that the EU Commission will publish its report on the application and impact of the CRD IV remuneration rules in the first half of 2016 which will address the issues raised by the EBA, including possible amendments to the relevant provisions of CRD IV.

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XI. UK Ring-fencing

Since this time last year, there have been very few developments in the implementation of the UK’s Financial Services (Banking Reform) Act 2013. This Act requires retail banking services to be ring-fenced from other bank activities. Although the base legislation has now been in force for some time in the UK, the precise details of exactly what will be required to comply with the new ring-fencing regime, by its proposed implementation date of 1 January 2019, are to be provided by secondary legislation to be passed by the UK Treasury. However, there has so far been no sign of any further draft legislation in this regard, making it very difficult for UK banks to make definitive plans as to how to reorganise their businesses.

What is known is that the ring-fenced retail entity can remain as part of the broader banking group, so long as it is functionally and legally separated. The legislation will catch firms that, on a three-year average period, hold more than £25 billion worth of core deposits, meaning all deposits other than from financial institutions, large to medium sized companies and high net worth individuals. In order to be able to survive the failure of another member of the banking group, the ring-fenced banks will be subject to stand-alone prudential rules, including minimum capital requirements, leverage ratios, liquidity ratios and risk buffers.

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

At the end of January 2016, the Financial Policy Committee of the Bank of England (the “FPC”) published a Consultation Paper on its proposals for a framework for the systemic risk buffer that it is required to develop pursuant to the Capital Requirements (Capital Buffers and Macro prudential Measures) Regulations 2014. This systemic risk buffer (“SRB”) is intended to apply, inter alios, to ring-fenced banks and is part of the UK’s framework for identifying and setting higher capital requirements for domestic systemically important banks.

The FPC proposes that each ring-fenced bank will be required to hold a certain amount of Tier 1 capital in addition to its minimum capital requirements, its capital conservation buffer and any countercyclical capital buffer. The amount of required additional Tier 1 capital will range from 1% of RWAs for banks with total assets of £175 billion or greater to 3% of RWAs for banks with total assets of £755 billion or greater (although the FPC expects that the largest ring-fenced banks will have an initial SRB rate of 2.5%).

The SRB is proposed to apply in tandem with the implementation date for the ring-fencing regime, and the consultation will remain open for comments until 22 April 2016.

UK banks will need to see many more details of the ring-fencing regime during the course of 2016, in order that they can make necessary preparations in time for the proposed implementation date of 1 January 2019.

XII. Possible EU Banking Reform

As we noted in last year’s “From EMIR To Eternity?” the draft Regulation on EU-level bank structural reform published by the EU Commission had been expected to be considered by the European Parliament during its April 2015 session, and adopted by June 2015. That has not happened.
Currently, the EU Council of Ministers and the European Parliament are considering the EU Commission’s legislative proposal. It is now expected that the European Parliament will decide on its negotiating position on the legislative proposal during the first half of 2016, and will attempt to reach political agreement with the Council in the latter part of 2016. However, even those estimates are very tentative, bearing in mind the history of this draft Regulation so far, and the fact that this topic remains highly politically sensitive.

It was originally proposed that the provision in the Regulation as to prohibition of proprietary trading would become effective on 1 January 2017 (six months after the publication of a list of covered and derogated banks), and the provisions regarding potential separation of trading activities would become effective on 1 July 2018. Given the delay in the progress of this Regulation, these timings will almost certainly need to change.

XIII. FCA Senior Managers Regime

The Approved Persons Regime (the “APR”) which has, up to the start of 2016, applied in the UK was set up with the objective of ensuring the quality of individuals working in certain roles within the financial services industry, and thereby providing protection of consumers and the UK financial system. Under the Financial Services and Markets Act 2000 (“FSMA”), only persons classified as “approved persons” by either the FCA or the PRA were permitted to perform certain key functions, known as “controlled functions”, for authorised firms. Such approval could only be granted if the candidate was a “fit and proper” person to perform the function to which the application relates.

The APR, however, came under considerable criticism from the Parliamentary Commission on Banking Standards (the “PCBS”) in its June 2013 Final Report titled ‘Changing Banking for Good’ in which the APR was described as a “complex and confused mess” which has created “a largely illusory impression of regulatory control over individuals”. The report made several recommendations which resulted in amendments being made to FSMA to replace the APR for banks, building societies, credit unions and investment firms (through the Financial Services (Banking Reform) Act 2013).

In July 2014, the FCA and the PRA published a joint Consultation Paper on a new framework for individual accountability, with proposals for a Senior Managers’ Regime (“SMR”) and a Certification Regime (“CR”) (collectively the “SMCR”) in line with the PCBS’s recommendations. From 7 March 2016, these two new regimes, along with revised Conduct Rules, will replace the APR for banking sector firms (this includes UK banks (including UK branches of foreign banks), building societies, credit unions and PRA-approved investment firms), and new senior managers will appear on the FCA register from that date. The UK government has also confirmed that, following the Fair and Effective Markets Review (“FEMR”) report’s recommendations, the new framework will be extended to all UK authorised financial institutions from 2018.

Broadly, the SMR’s aim is to ensure that senior managers who are recognised as performing a senior management function (“SMF”) can be held accountable for any misconduct that falls within their areas of responsibilities. This is done by requiring firms to allocate SMFs to their senior managers and then assigning prescribed responsibilities to these SMFs to ensure that there is an individual accountable for every aspect of a regulated activity within a firm. The CR applies to other staff who could pose a risk of significant harm to the firm or any of its customers and firms will need to ensure they have procedures in place for assessing the fitness and propriety of staff, for which they will be accountable to the regulators.

Individuals who are currently approved under the APR need to be ‘grandfathered’ into relevant SMR roles via a notification, the submission deadline for which is 8 February 2016, accompanied by corresponding statements of responsibility for each individual and the firm’s responsibilities map.

53 http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx
In relation to insurers, the Solvency II Directive mandated regulators to update the existing APR and so the PRA introduced the Senior Insurance Managers Regime ("SIMR"). The SIMR aims to ensure that all insurance firms and groups have a clear and effective governance structure, and to clarify and enhance the accountability and responsibility of individual senior managers and directors. The elements of the SIMR which needed to be in force for the UK to implement Solvency II entered into force on 1 January 2016, whilst the remaining elements will enter into force alongside the SMCR on 7 March 2016. As the SMCR is set to be extended to insurers as of 2018, it is likely that the SIMR will only be operational for a short time.

XIV. AIFMD

The Alternative Investment Fund Managers Directive54 (the "AIFMD") and its supplementary Regulation came into effect in the EU in July 2013 and introduced a centralised rulebook for the management and marketing of alternative investment funds ("AIFs") by alternative investment fund managers ("AIFMs") within the EU.

The concept of an AIF is fairly broad and is defined as a collective investment undertaking (including investment compartments thereof) which is not a UCITS fund but which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors. However, certain entities and arrangements are expressly excluded, such as segregated managed accounts, family offices, joint ventures, insurance contracts and certain special purpose vehicles. Furthermore, AIFs which are categorised as ‘small AIFs’ are exempted from many of the provisions of the AIFMD and where the aggregate assets of all AIFs under an AIFM’s management do not exceed the relevant thresholds, that AIFM will only have basic obligations in relation to registration and notification of certain information.

An AIFM is a legal person whose regular business is the managing of one or more AIFs by, for example, performing portfolio or risk management activities. Each AIF within the scope of the AIFMD must have a single authorised AIFM for AIFMD purposes, although it can continue to utilise the services of multiple entities for management and administration activities. Aside from having to be authorised, AIFMs are subject to supervision by their home competent authority, must meet capital requirements of at least €125,000 and meet various additional requirements such as having appropriate governance and conduct of business standards and systems in place to manage risks, liquidity and conflicts of interest. The AIFMD also aims to enhance the transparency of AIFMs and the funds they manage by imposing on them various transparency requirements, including reporting obligations (to the relevant competent authorities) and detailed disclosures in annual reports.

The AIFMD does not only apply to funds and managers based in the EU. Any non-EU AIFMs that market one or more AIFs managed by them to professional investors in the EU are currently subject to the national private placement regime of each of the member states where the AIFs are marketed or managed.

The AIFMD provides for the possibility in the future of an ‘AIFMD passport’ by which a non-EU AIFM that has complied with the full rigour of the AIFMD’s requirements can market its funds throughout the EU following a simplified regulatory notification process. A similar passport regime is already in place for EU AIFMs. It was hoped that the passporting regime for non-EU AIFMs would come into play during 2015. However, despite a positive recommendation from ESMA in July 2015 (for extension of the passport regime to Guernsey, Jersey and, with certain amendments, Switzerland) the EU Commission has not adopted the delegated act specifying when the passporting regime will become effective. It is unclear how long it will be before the regime comes into effect, as ESMA is conducting a country-by-country analysis of whether the AIFMD passport should be extended to each jurisdiction and has recommended that the extension of the passport be deferred until it has delivered positive recommendations for a sufficient number of non-EU countries. It is expected that ESMA will deliver its Opinions on the second group of non-EU jurisdictions (amongst them the Cayman Islands, Australia, Canada and Japan), along

with a final conclusion on those it was considering in its first recommendation (Hong Kong, Singapore and the USA) by March 2016. Aside from this, there is also a concern that the delay may be extended further as it is unclear whether (under the AIFMD itself) it is possible to extend the passport on a country-by-country basis.

In addition to the passporting developments, in 2016, ESMA is expected to publish revised guidelines on sound remuneration policies and finalise its guidelines on asset segregation under the AIFMD. By July 2017, the EU Commission is expected to start a review on the application and scope of the AIFMD as a whole.

XV. Shadow Banking

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

Most recently, in November 2015, the FSB published various reports, including on transforming shadow banking into resilient market-based finance, the Global Shadow Banking Monitoring Report for 2015 (part of its annual shadow banking monitoring exercise) and a Report finalising recommendations on a regulatory framework for haircuts on non-centrally cleared securities financing transactions (referred to below). The FSB has also updated its roadmap, which outlines certain specified tasks for IOSCO, the Basel Committee on Banking Supervision and the FSB itself.

The EU Commission has also identified resolving the issues surrounding shadow banking as a priority and published its “Communication” on shadow banking in September 2013 as a roadmap for the EU Commission’s future work in the area. The EU Commission has endorsed the FSB’s general definition of shadow banking and given an indication of the activities (primarily securitisation, securities lending and repos) and entities (including SPVs performing liquidity and/or market transformation and money market funds) which it believes fall within the definition.

Two areas highlighted in both the FSB’s workstreams and in the EU Commission’s Communication for specific regulatory developments are securities financing transactions and money market funds. The current status of each is as follows:

(a) Securities Financing Transactions: One of the FSB’s main priorities has been assessing financial stability risks and developing policy recommendations to strengthen regulation of securities lending and repos, as it believes that the majority of such transactions are entered into by non-banks, thus giving rise to maturity and liquidity transformation risks outside the banking sector. These are of particular concern, as the securities lending and repo markets are vital for facilitating market-making, supporting secondary market liquidity and meeting many financial institutions’ financing needs.

On 12 November 2015, the FSB published a Report finalising its policy recommendations on a regulatory framework for haircuts on non-centrally cleared securities financing transactions (to apply numerical haircut floors to non-bank-to-non-bank transactions). The framework is intended

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to limit the build-up of excessive leverage outside the banking system and to help reduce procyclicality of that leverage.

In November 2015, the EU Council of Ministers adopted the EU Commission’s proposed Regulation on transparency of securities financing transactions (“SFT Regulation”), and the final text was published in the Official Journal of the EU on 23 December 2015. The SFT Regulation provides for details of all SFTs to be reported to trade repositories, similar to the reporting requirements for OTC derivatives under EMIR, and imposes additional disclosure requirements on managers of UCITS and AIFs. Furthermore, in relation to rehypothecation, the SFT Regulation’s “reuse” arrangements require that counterparties must consent in writing to an asset being rehypothecated in the case of a security financial collateral arrangement, the risks of rehypothecation must be explained in writing to the collateral provider and assets received as collateral must be transferred to an account opened in the name of the receiving counterparty.

The SFT Regulation entered into force on 12 January 2016 and the vast majority of its provisions have applied from that date.

(b) Money Market Funds (“MMFs”): Historically MMFs have been regarded as a safe investment with a stable net asset value (“NAV”). The FSB considers MMFs to be an important element of the shadow banking system, both as a source of short-term funding for banks and for provision of maturity and liquidity transformation. It notes, however, that during the financial crisis, some MMFs suffered large losses due to holdings of ABS and other financial instruments, leading to significant investor redemptions and instability. IOSCO published two reports in April and October 2012 setting out policy recommendations for a common approach to MMF regulation, including the need for compliance with general principles of fair value when valuing securities in a portfolio, the requirement to hold a minimum amount of liquid assets to meet redemptions and prevent fire sales and the requirement that MMFs offering a stable NAV should be subject to measures designed to reduce the specific risks associated with this feature. In accordance with these recommendations, the SEC adopted new rules on MMFs (which were established after October 2014), resulting in the imposition of a floating NAV requirement for non-retail and non-governmental MMFs.

The EU Commission has supported the FSB’s analysis of the importance of MMFs and agreed that they need to become more resilient to crises. As a result, the EU Commission has proposed a Regulation (“MMF Regulation”) which will introduce a framework of requirements to enhance the liquidity and stability of MMF funds. Key provisions in the MMF Regulation include:

- prescribed levels of daily and weekly liquidity; the requirement to clearly indicate whether an MMF is a short-term MMF (those holding assets with a residual maturity of 397 days or less) or a standard MMF;
- the imposition of a capital buffer of 3% for constant NAV funds;
- the requirement that some internal credit risk assessment is carried out by the MMF manager to avoid over-reliance on external credit ratings; and
- the introduction of customer profiling policies in order to anticipate large-scale redemptions.

TheEuropean Parliament approved amendments to the MMF Regulation during a plenary session on 29 April 2015 and the MMF Regulation is currently with the European Parliament and the EU Council of Ministers for negotiation and adoption. The capital buffer referred to above is a particularly contentious issue. There is, as yet, no clear timetable for the MMR Regulation to be approved and adopted during 2016.

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XVI. MAR / MAD II Implementation

From 3 July 2016, the Market Abuse Regulation (Regulation 596/2014) (“MAR”) will repeal and replace the existing Market Abuse Directive (2003/6/EC) (“MAD”) and its implementing legislation. MAR was part of a revised legislative package governing market abuse adopted by the EU Council of Ministers in April 2014 along with the Criminal Sanctions for Market Abuse Directive (“CSMAD”) (together known as “MAD II”). The aim of these changes is to strengthen the market abuse regulatory framework and bring the instruments and markets within its scope into line with the proposed new MiFID II regime. With the objectives of enhancing market integrity and investor protection, the new regime will, among other things, bring the manipulation of benchmarks within the scope of the legislation and make the manipulation of markets a criminal offence.

The UK has exercised its powers under the Lisbon Treaty to opt out of measures governing EU criminal law and thus has not signed up to CSMAD. All other member states (with the exception of Denmark, who also opted out) must transpose the CSMAD provisions into national law by 3 July 2016. UK firms operating across member states’ borders should be aware of the provisions since they could incur liability in those jurisdictions subject to CSMAD.

The principal changes that will be brought into effect under MAR include an extension of scope to cover a broader range of securities than is presently covered under MAD. Whereas MAD regulates derivatives traded on the EU’s primary investment exchanges (or regulated markets), MAR will borrow the definition of ‘financial instruments’ introduced by the MiFID II Directive and thereby include instruments traded on MTFs and OTFs, as well as those that may be traded off-market but can have an effect on such instrument. The scope of regulatory coverage for the following instruments is also extended: emission allowances and related auctioned products, commodity derivatives and related spot commodity contracts and benchmarks.

MAR also introduces a new offence of ‘attempted’ insider dealing and market manipulation, and includes a prohibition on certain automated trading methods using algorithmic trading or high-frequency trading strategies which can be used to manipulate markets. Further, market participants subject to MAR will need to adjust their internal compliance procedures to ensure they comply with the new requirements on insider lists, notification obligations and directors’ dealings, amongst other changes. Although the bulk of MAR provisions will automatically apply to all member states on 3 July 2016, certain provisions relating to OTFs, SME growth markets, emission allowances and related auctioned products will not apply until 3 January 2017, when MiFID II becomes applicable. It is not yet clear how the proposed delay in MiFID II referred to above will impact this timetable.

On 28 September 2015, ESMA published a final report containing draft RTS and ITS on MAR and, in response, the European Commission adopted a Delegated Regulation supplementing MAR on 17 December 2015. This Delegated Regulation covers rules regarding indicators of market manipulation, minimum thresholds for exemption of certain participants in the emission allowance market from the requirement to publicly disclose inside information, the competent authority for notifying delays in disclosures, permission for trading during closed periods, types of notifiable managers’ transactions and exemption from MAR for certain third countries’ public bodies and central banks. The Regulation will come into force along with MAR in July 2016.

On 28 January 2016, ESMA published a Consultation Paper on draft Guidelines under MAR relating to persons receiving market soundings and on the legitimate interests of issuers to delay insider information and situations in which the delay of disclosure is likely to mislead the public. This consultation is open until 31 March 2016.

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In the UK, there are several ongoing consultations related to MAR. Responses to the FCA’s November 2015 Consultation on delaying disclosure of inside information under the Disclosure and Transparency Rules69 must be submitted by 20 February 2016, and the deadline for responses to its consultation titled ‘Policy proposals and Handbook changes related to the implementation of the Market Abuse Regulation’70 is 4 February 2016. HM Treasury is also consulting on the Financial Services and Markets Act 2000 (Market Abuse) Regulations 2016, a draft statutory instrument which would implement MAR into UK legislation. Comments on this draft statutory instrument are due by 4 February 2016, and it will then be subject to further policy and legal review.

XVII. UCITS V

The UCITS V Directive was published in the Official Journal of the EU on 28 August 201471 and makes various changes to the existing UCITS Directive (“UCITS IV”).72 It came into force on 17 September 2014, and EU member states have until 18 March 2016 to transpose it into their national laws. The principal amendments made by UCITS V seek to make some of the rules for UCITS funds more consistent with those applicable to alternative investment funds under the AIFMD and include:

- changes to the provisions relating to the appointment of a depositary in respect of a UCITS fund;
- rules setting out the terms on which the depositaries’ safekeeping duties can be delegated;
- revision of eligibility criteria for depositaries so that only credit institutions and investment firms will be able to act as depositaries;
- clarification of scope of a depositary’s liability in the event of losses relating to an asset held by the depositary;
- the requirement that UCITS management companies put in place remuneration policies and practices for senior management and persons whose professional activities have a material impact on the risk profile of the management company or the UCITS;73 and
- imposition of minimum harmonisation rules to seek to provide more consistency in sanctions provisions in member states.

UCITS V requires the EU Commission to publish and implement various delegated acts and technical standards and guidance. In particular, the EU Commission has to set out various requirements as to the rules relating to depositaries. ESMA published a Consultation Paper in September 201474 in relation to such delegated acts. Following this consultation, the EU Commission adopted a Delegated Regulation on 17 December 2015 which included:

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

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

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

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

(e) requirements relating to the independence of management companies, investment companies, depositaries and third parties to whom the safekeeping function has been delegated.

The Delegated Regulation is still subject to approval by the European Parliament and the EU Council of Ministers. It is expected this process will be completed during the early part of 2016, following which it will be published in the Official Journal of the EU and come into force on the 20th day following such publication. Its provisions will become effective six months after it comes into force.

In addition, on 23 July 2015, ESMA published a Consultation Paper on proposed Guidelines\(^{75}\) on sound remuneration policies under UCITS V and the AIFMD. These Guidelines aim to clarify the specific provisions in UCITS V in relation to remuneration to ensure a consistent application with the equivalent provisions in the AIFMD and to provide guidance on certain provisions, including those relating to proportionality, the governance of remuneration, risk alignment and disclosure. Provisions in the guidelines which are consistent with the approach in relation to the AIFMD include:

(a) only certain remuneration principles may be disapplied if proportionate to do so, including payment of variable remuneration in instruments, deferral of payments of variable remuneration, the clawback provisions and the requirement to establish a remuneration committee;

(b) requirements in relation to staff to which investment management activities have been delegated, including a requirement that delegates are subject to remuneration requirements at least as effective as those under the remuneration Guidelines referred to above, and there are appropriate contractual arrangements to ensure there is no circumvention of the remuneration rules; and

(c) certain disclosure requirements in relation to remuneration in the UCITS prospectus and annual report.

ESMA is expected to publish its final Guidelines in the first half of 2016 although it is not clear that these will be published before 18 March 2016 when member states are required to transpose UCITS V into national laws. This would mean UCITS managers would be subject to the UCITS V remuneration rules but without having the benefit of the Guidance.

Many member states are in the process of ensuring compliance with the 18 March 2016 transposition requirement. In the UK, in October 2015 HM Treasury published an open consultation in relation to the implementation of UCITS V in the UK.\(^{76}\)

**XVIII. SRM Regulation**

Closely linked to the BRRD is the Single Resolution Mechanism (“SRM”), which forms part of the European Banking Union. The aim of the SRM is to apply a uniform resolution process to all banks established in EU Member states that are participating in the Single Supervisory Mechanism (“SSM”), in other words all banks in the Eurozone and other member states that are participating in the SSM. Under the SSM, the European Central Bank acts as the ultimate supervisor for all the banks subject to the SSM.

The SRM (which is constituted by the SRM Regulation\(^{77}\)) is extremely closely related to the BRRD and mirrors the resolution tools and options available under the BRRD. The important difference is that a Single Resolution Board (“SRB”) is appointed to perform most of the functions that are performed by


national resolution authorities according to the BRRD. The SRM Regulation came into full effect on 1 January 2016.

The SRB consists of a full-time Chair, four full-time members and one member appointed by each member state participating in the SSM, to represent that member state’s national resolution authority. In December 2015, an agreement between the SRB and the European Parliament came into force, in relation to procedures relating to the accountability of the SRB to the European Parliament. In addition, the SRB and the European Central Bank have concluded a memorandum of understanding relating to cooperation and exchange of information, in their respective roles of Single Resolution Authority and Single Supervisor for the SSM.

The SRM Regulation also established a Single Resolution Fund (“SRF”), with a target size of 1% of the amount of the deposits of all SSM banks that are guaranteed under the Deposit Guarantee Schemes Directive. The initial target date for such a figure to be reached is 1 January 2024. The purpose of the SRF is the same as that of a national resolution fund under the BRRD, namely to support a resolution under the SRM, if necessary by making loans or providing guarantees, purchasing assets and making contributions to a bridge institution or asset management vehicle or paying compensation to shareholders or creditors who end up worse off in the resolution than they would have in an insolvency procedure.

The SRF is funded by contributions from the banking industry, including by ex ante contributions. The implementing Regulation in relation to the SRF, which harmonises the methodologies for raising ex ante contributions with those in the BRRD, became effective from 1 January 2016. A separate delegated Regulation, dealing with the criteria for calculating ex ante contributions and the deferral of ex post contributions to the SRF, was adopted by the European Commission in December 2015. However, the EU Council of Ministers and the European Parliament are yet to consider the delegated Regulation. Assuming they have no objections, it is expected to enter into force in the first half of 2016.

While the SRF is building up its resources, it will require bridge financing, and the EU Council of Ministers in November 2015 published details of the work in progress for an agreement on such bridge financing. It envisaged that it would consist of national credit lines from the participating member states, and these national credit lines are presumably in place, given that the SRF became operational on 1 January 2016.

Looking further into the future, the European Commission is required to publish a report by 31 December 2018, and once every five years thereafter, on the application of the SRM Regulation, dealing with how it is functioning and its cost efficiency, including particularly how effective the co-operation and information sharing arrangements have been between the SRB and the European Central Bank and between the SRB and national resolution authorities and national competent authorities.

XIX. EU Deposit Insurance Regulation

The recast Deposit Guarantee Schemes Directive\(^\text{78}\) protects EU deposits up to EUR100,000 through national Deposit Guarantee Schemes (“DGS”) throughout the EU and requires each credit institution authorised in the EU to become a member of its home state’s DGS. The Directive imposes various obligations on the establishment, supervision and operation of DGSs.

In connection with the establishment of the SSM and the SRM, it was originally envisaged by the EU Commission that a single deposit guarantee scheme for member states participating in the SRM/SSM would be one of the main elements of the banking union established thereby. Although these proposals were deferred, in June 2015, in the “Five Presidents” report on completing monetary union within the Eurozone, Jean-Claude Juncker, President of the EU Commission, proposed the launch of a European Deposit Insurance Scheme (“EDIS”).

On 24 November 2015, the EU Commission published a draft Regulation to amend the Regulation for the SRM to establish the EDIS.79 The draft Regulation envisages that the EDIS will be operated by the Single Resolution Board and will provide additional funding for DGSs established in member states participating in the SRM. The draft Regulation envisages EDIS being established in three successive stages:

- Reinsurance – for the first three years, EDIS will reinsure participating DGSs and cover a limited share of the loss of a participating DGS and will provide funding in the event of a liquidity shortfall at a DGS;
- Co-insurance – for four years after the reinsurance period, participating DGSs will be co-insured by the EDIS. The percentage of loss covered by the EDIS under such co-insurance will commence at 20% and rise by 20% each subsequent year; and
- Full insurance – after the co-insurance period, participating DGSs will be fully insured by the EDIS. It is intended that this will occur by 2024.

It is likely that the draft Regulation will continue to be debated during 2016. There is currently no clear timetable for finalisation of the Regulation.

XX. PSD II

The Payment Services Directive (“PSD”) became law in most of the EU in 2009 and aimed to harmonise the regulatory regime for payment services across the EU by enabling a new type of regulated financial institution (a “payment institution”) to compete with banks in the provision of payment services. It established an EU-wide licensing regime for payment institutions, as well as harmonised conduct of business rules.

The EU Commission published proposals for an amended payment services Directive in July 2013 and the final approved text of such Directive (referred to as “PSD2”)80 was published in the Official Journal of the EU on 23 December 2015 and entered into force on 12 January 2016. EU member states are required to transpose PSD2 into national laws by 13 January 2018.

PSD2 makes certain extensions to the geographical scope and the currencies covered by the PSD. The PSD is limited to payment services provided in the EU where both the payer’s and payee’s payment service provider are located in the EU. Under PSD2, certain provisions (primarily in respect of transparency of terms and conditions and information requirements) will apply to transactions where only one of the payment service providers is located in the EU. PSD2 will also now apply the provisions relating to transparency and information requirements to all currencies, not only EU currencies, as is currently the case.

The definition of payment services will also be widened to cover (i) payment initiation services enabling access to a payment account provided by a third-party payment service provider, where the payer can be actively involved in the payment initiation or the third-party payment service provider’s software or where payment instruments can be used by the payer or payee to transmit the payer’s credentials to the account servicing payment service provider and (ii) an account information service where consolidated and user-friendly information is provided to a payment service user on one or several payment accounts held by the payment service user with one or several account servicing payment service providers.

In addition, a number of the existing exemptions available under the PSD are narrowed or removed, and various amendments are made to the conduct of business requirements. The exemptions affected include:

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the “commercial agent” exemption relating to payment service providers acting as a commercial agent. This exemption will now only apply where the agent is acting solely for either the payer or payee, but not both parties;

the “limited network” exemption where a payment instruction can only be used to purchase a limited range of goods or services within a limited network of service providers. Under PSD2, any services relying on the exemption must be based on specific instruments designed to address precise needs that can only be used in a limited way. Also, if the monthly volume of transactions exceeds EUR1 million, the payment service provider must obtain clearance from its competent authority to be able to utilise the exemption; and

the exemption under the PSD for digital content or telecom payments applying to payments executed through mobile phones and the internet is, under PSD2, limited to ancillary payment services carried out by providers of electronic communication networks or services. The exemption is also no longer available for any individual transaction exceeding EUR50 and is subject to an overall limit of EUR300 in a billing month.

A number of other conduct of business requirements are amended by PSD2 and it contains some provisions aimed at increasing competition by facilitating the use of third-party payment service providers (“TPPs”). PSPs will be prohibited from denying TPPs access to bank accounts and PSPs, which provide account servicing cannot discriminate against TPPs.

The PSD2 requires the EBA to develop RTS and/or guidelines in relation to information to be provided to competent authorities in respect of an application for authorisation, the requirements for authentication and communications and the development, operation and maintenance of the electronic central register. These are required to be finalised by 13 January 2017, and consultation drafts are therefore expected to be published by the EBA during 2016.

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Casting Light on Shadows: New Transparency Rules for Securities Finance Transactions

This article summarises potential new European regulatory obligations that may arise for any financial entity, whether located inside or outside of the European Union, that regularly or occasionally enters into securities finance transactions (including repurchase agreements, securities / stock lending or borrowing or margin lending).

On 3 November 2015, the Council of the European Union (the “Counsel”) adopted the European Commission’s proposal for a regulation on reporting and transparency of securities financing transactions (the “Proposed Regulation”).

Background

The roots of European regulatory focus on securities finance transactions (“SFTs”) extend to the aftermath of the recent financial crisis and the search for causes of instability in global financial markets. Following reports by the Financial Stability Board (“FSB”), the European Commission and the review led by Erkki Liikanen, each covering (amongst other things) the key role of financial intermediaries that are not credit institutions (but which offer bank-like credit intermediation services) and their interconnectedness with the regular banking system, the realm of so-called “shadow banking” was highlighted as a source of potential systemic risk and concern.

In August 2013, the FSB adopted a policy framework entitled “Strengthening Oversight and Regulation of Shadow Banking” (the “FSB Framework”), which was subsequently endorsed by the G20. One of the five key areas highlighted by the FSB as requiring legislation to mitigate potential risks associated with shadow banking, concerns “pro-cyclical incentives associated with securities financing transactions such as repos and securities lending that may exacerbate funding strains in times of market stress”. The Proposed Regulation seeks to address some of the FSB’s recommendations by enhancing transparency and regulating securities financing, thereby strengthening the oversight and regulation of shadow banking.

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Scope of the Proposed Regulation

The Proposed Regulation applies to any “counterparty” to an SFT that is either established in the EU, or in a third country in circumstances where the SFT is concluded by a branch of that counterparty which is located in the EU. Accordingly, the regulation’s scope is intentionally broad, covering both regulated and unregulated entities, in a way that is similar to the application of the reporting requirement in the European Market Infrastructure Regulation (Regulation No. 648/2012, “EMIR”). EMIR reporting also applies generally to “counterparties” and does not distinguish between financial (i.e., regulated) and non-financial (unregulated) entities.

The Proposed Regulation also applies to management companies in undertakings of collective investment in transferrable securities (“UCITS”), managers of alternative investment funds (“AIFs”) and to counterparties engaging in “reuse” arrangements. In the latter case, such a counterparty is caught by the Proposed Regulation if it is in the European Union. A counterparty established outside the EU would also be caught when acting through a branch of that counterparty located in the EU, or where the reuse concerns financial instruments provided under a collateral arrangement by a counterparty established in the Union (or an EU branch of a counterparty established in a third-country).

As with EMIR, certain exemptions apply to EU-based central banks (and other public bodies performing similar functions) and the Bank for International Settlements. In addition, provision is made for extending the central-bank exemption to cover those managing the public debt of third-countries, although such an exemption would depend upon the outcome of a comparative analysis of the treatment of central banks within the framework of various third-countries. Noticeably, however, multilateral development banks have not been exempted.

Reporting Obligation

An SFT includes:

- a repurchase transaction;
- securities or commodities lending or borrowing;
- a buy-sell back transaction or a sell-buy back transaction; or
- a margin lending transaction.

Article 4 of the Proposed Regulation states that counterparties to SFTs are required to report to a registered or recognised trade repository the details of any SFT that they have concluded, modified or terminated. The nature of such details shall be set out in regulatory technical standards (“RTS”) prepared by the European Securities and Markets Authority (“ESMA”) and adopted by the European Commission. However, the Proposed Regulation provides that reportable information shall include (amongst other items) details of the parties to the SFT (and any beneficiaries), principal amount, currency, collateral (type, quality, value etc.), whether collateral is available for reuse or has been reused, repurchase rate, lending fee, margin lending rate, haircuts, value date and maturity date.

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6 Although it is worth noting that, unlike the Proposed Regulation, the reporting obligation under EMIR does not have extra-territorial application.
7 Authorised in accordance with Directive 2009/65/EC.
8 Authorised in accordance with Directive 2011/61/EU.
9 It remains open to the European Commission to expand the list of SFTs by delegated act.
10 Such repository must meet EMIR’s criteria for registration. In the absence of such a trade repository, reporting can be made to ESMA.
Reporting should take place no later than the working day following such conclusion, modification or termination.

In addition, counterparties are required to keep records of any SFT that they have concluded, modified or terminated for at least five years following termination of the transaction.

**Phase-In of Reporting Obligations**

The reporting requirement in Article 4 is to be phased in after adoption of the RTS. Reporting requirements will apply on or after a date (the “Phase-in Date”) occurring a certain number of months after the RTS are adopted. The applicable number of months depends upon the type of counterparty that has entered into the SFT:

<table>
<thead>
<tr>
<th>Number of Months After RTS Adoption</th>
<th>Type of Entity</th>
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<tbody>
<tr>
<td>12 months</td>
<td>Investment firms or credit institutions (in each case authorised in accordance with EU legislation) or third-country entities which would require authorisation or registration as investment firms or credit institutions if they were established in the EU</td>
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<tr>
<td>15 months</td>
<td>Central securities depositories (authorised in accordance with EU legislation) and third-country entities which would require authorisation as central securities depositories if they were established in the EU</td>
</tr>
<tr>
<td>18 months</td>
<td>Insurance and re-insurance undertakings, UCITS funds, AIFs, institutions for occupational retirement provision and central counterparties (in each case authorised in accordance with EU legislation) or third-country entities which would require authorisation as such entities if they were established in the EU</td>
</tr>
<tr>
<td>21 months</td>
<td>Non-financial counterparties established in either the EU or in a third-country</td>
</tr>
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</table>

In addition to SFTs traded on or after the applicable Phase-in Date, back-loading of transactions will apply to transactions in existence prior to the Phase-in Date where:

- the applicable SFT has a remaining maturity, on the Phase-in Date, exceeding 180 days; or
- the applicable SFT has an open maturity and remains outstanding for 180 days after the Phase-in Date.

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11 There appears to be an error in the current draft legislation, which makes reference to a missing Article 33(a)(j). Accordingly, it may be intended that there is another type of entity that will be phased in at 15 months after the adoption of the RTS, although this is presently unclear.
Such back-loaded transactions shall be reported within 190 days of the applicable Phase-In Date.

**Reuse Provisions**

A “reuse” is defined as the use of financial instruments by an entity receiving such instruments under a collateral arrangement in its own name and on its own account, or on the account of another counterparty, including a natural person (the “receiving counterparty”). Such use can comprise transfer of title or exercise of a right of use in accordance with a security financial collateral arrangement, but does not include the liquidation of a financial instrument in the event of default of the entity providing the collateral (the “providing counterparty”).

Article 15 of the Proposed Regulation states that if a receiving counterparty has a right to reuse financial instruments it receives as collateral, then such right of reuse is subject to the following conditions:

- the providing counterparty is informed in writing of the risks and consequences in (1) granting consent to a right of use of collateral under a security financial collateral arrangement, or (2) concluding a title transfer collateral arrangement;
- the providing party (1) grants its prior express signed consent (in writing or other legally equivalent manner) to the applicable security financial collateral arrangement containing a right of use of collateral or (2) has expressly agreed to provide collateral by way of a title transfer collateral arrangement;
- the reuse is carried out in accordance with the terms of the applicable collateral arrangement; and
- the financial instruments received by the receiving counterparty are transferred from the account of the providing counterparty.

In discussions of previous drafts of the Proposed Regulation, a number of trade associations (including the International Securities and Derivatives Association (“ISDA”) and the International Securities Lending Association (“ISLA”)) and other interested parties lobbied the European Commission extensively in an attempt to have title transfer collateral arrangements removed from Article 15. The reason for this was that you cannot restrict the reuse rights of a collateral receiver in these circumstances, given that (by virtue of the legal transfer of title that characterises a title transfer transaction) the collateral receiver becomes the legal owner of the collateral. It therefore makes little sense that, in order for the collateral receiver to use its own collateral, it must receive the express consent of the providing counterparty.

Nevertheless, in the adopted draft of the Proposed Regulation, a requirement remains for receiving counterparties to ensure that, in order to use collateral received under a title transfer collateral arrangement, they must ensure that the providing counterparty is aware of the risks of that arrangement and must receive the providing counterparty’s consent to the provision of collateral in this way. By suggesting that such consent be provided in writing or other legally equivalent manner, ISDA appears to hold the view that documenting relevant transactions under standard documentation (such as the ISDA Master Agreement) will be sufficient to comply with this obligation.

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12 A title transfer financial collateral arrangement is one where the collateral provider transfers full ownership of the financial collateral to a collateral receiver, for the purpose of covering the performance of relevant financial obligations. The collateral provider, in turn, typically receives a contractual claim against the collateral receiver for the delivery of financial instruments that are equivalent to those which were initially posted.

13 See Article 5 of Directive 2002/47/EC (the “Financial Collateral Directive”), which introduced a framework to simplify the taking of collateral in the EU. Article 5 relates to a “right of use” for financial collateral under a security financial collateral arrangement. This is an arrangement under which a collateral provider provides financial collateral by way of security in favour of, or to, a collateral taker but where full ownership of the financial collateral remains with the collateral provider.
Equivalence

As is the case with EMIR, the European Commission has the ability to adopt implementing acts which determine that the legal, supervisory and enforcement arrangements of a third-country are equivalent to certain aspects of the Proposed Regulation, including with respect to the Article 4 reporting requirements.

Sanctions

Member States are required to provide their competent authorities with the power to impose administrative sanctions and other administrative measures in respect of infringements of Article 4 (Reporting) and Article 15 (Reuse). These include cease and desist orders, public censure, withdrawal or suspension of authorisation, temporary banning orders or administrative pecuniary sanctions with statutory minimums applied.

In respect of an infringement of the reporting requirements, Article 22(5) of the Proposed Regulation makes clear that such infringement shall not affect the validity of the terms of the SFT or the possibility that the SFT can be enforced. This should provide some certainty of enforceability with respect to parties entering into SFTs to the extent that they fail to comply with their reporting obligations. However, the position with respect to a breach of the reuse conditions is not quite as clear. This is because there is no provision that is equivalent to Article 22(5). Instead, counterparties are forced to rely upon the effect of Article 15(4). This states that Article 15 shall not affect national law concerning the validity or effect of a transaction. This suggests that if a transaction is otherwise valid under national law, it should not be invalidated as a consequence of a breach of Article 15. For example, in the UK, Article 16(1) of the Financial Collateral Regulations provides that if a security financial collateral arrangement provides for a collateral taker to use and dispose of financial collateral as if it were the owner of it, the collateral taker may do so in accordance with the terms of the arrangement. This would suggest that, provided the reuse conditions of the contractual arrangement are complied with, it should remain enforceable, even if Article 15 were breached.

Next Steps

The Proposed Regulation will come into force on the 20th day after its publication in the Official Journal of the European. It is expected that this will happen in early 2016. However, the application of certain provisions (such as Article 4(1) as described above) will not become effective until the relevant time as stated in the Proposed Regulation’s text.

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15 This provision tracks Article 5 of the EU Financial Collateral Directive, which requires that Member States ensure that collateral takers are entitled to exercise rights of use in relation to financial collateral provided under security financial collateral arrangements.
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On April 18, 2016, the Financial Stability Oversight Council (FSOC) again warned that asset managers present systemic risk to financial stability in five key areas:

- liquidity and redemptions;
- leverage;
- operational functions;
- securities lending; and
- resolvability and transition planning.

In a 27-page statement, FSOC detailed its concerns and how regulators should respond to those risks.

In response, SEC Chair Mary Jo White, who also serves as a member of FSOC, said she supported FSOC’s efforts, which she characterized as “complementary” to the SEC’s current regulatory initiatives. She noted that the SEC evaluates systemic risks in reliance on its own studies by its Division of Economic and Risk Analysis (DERA) and has responded with its own rule proposals independent of FSOC’s analysis. “Today’s FSOC update thus should not be read as an indication of the direction that the SEC’s final asset management rules may take,” she said in a public statement.


FSOC maintains that its review, consistent with its Dodd-Frank mandate, focuses on “identifying potential risks to financial stability, rather than investment risk.” The review, it says, seeks to assess whether asset management products or activities “could create, amplify or transmit risk more broadly in the financial system in ways that could affect U.S. financial stability.”

We summarize FSOC’s five areas of focus here, primarily as they affect private funds and registered investment companies.
LIQUIDITY AND REDEMPTION RISK

Mutual funds. FSOC notes that mutual funds, in particular, create “liquidity transformation” because they offer daily liquidity while investing in less-liquid assets. During a “stress event,” illiquid assets held by mutual funds may fall rapidly when shareholders redeem large amounts of their holdings. This daily liquidity thus creates “first-mover advantage” when remaining shareholders bear the bulk of the risks because funds sell more liquid assets to pay off early redeemers.

This risk is particularly acute for mutual fund investors, FSOC says, because transaction costs associated with meeting redemptions generally are passed on to remaining investors. While mutual funds may not invest more than 15 percent of their assets in illiquid securities, this limit “does not take into account the size of a fund’s position or potentially lengthy settlement times, which could delay a fund’s ability to convert securities into cash,” and may also invest in less-liquid securities that are not subject to this limit. FSOC is also focusing on whether fund borrowings through lines of credit or inter-fund lending could transmit liquidity stress to other entities or markets during times of market stress.

ETFs. Exchange-traded funds (ETFs) are not subject to the same types of liquidity risks, FSOC said, because generally they redeem in kind. But, FSOC cautioned, ETF arbitrage mechanisms may “break down in times of severe market stress,” in which case bid-ask spreads may widen, creating a divergence between ETF share prices and net asset values.

Hedge funds. FSOC noted that hedge funds restrict investors’ ability to redeem and thus are not subject to the same kinds of liquidity risks that mutual funds experience. But, during times of stress, hedge funds may experience liquidity issues when they are forced to sell illiquid assets.

FSOC’s views. Among other things, FSOC believes that mutual funds should adopt “robust liquidity risk management practices” and guidelines for limiting investment in illiquid securities, coupled with enhanced reporting and steps to remove “first-mover advantages.”

LEVERAGE RISK

Hedge funds. FSOC helpfully notes that leverage involves risk because it can magnify potential direct or indirect losses. These risks “may have implications for U.S. financial stability.” The relationship between a hedge fund’s level of leverage, and the potential financial stability implications “is highly complex.” While FSOC has found available data contained in Form PF are helpful, it believes that available information is not adequate to fully assess these risks and potential mitigants.

Mutual funds and ETFs. FSOC notes that some “alternative strategy funds,” particularly highly leveraged funds do not represent a large part of total assets under management but have experienced significant growth and have received “a disproportionate share of industry net inflows.”

FSOC’s views. Citing “a need for further analysis,” FSOC is creating an interagency working group to analyze and better understand whether hedge funds pose potential risks to financial stability. FSOC “welcomes the SEC’s efforts to limit the amount of leverage that registered investment companies” can use through derivatives and will monitor the effects of the SEC’s regulatory changes.
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OPERATIONAL RISK

FSOC is concerned that a disruption or failure of a large service provider could transmit risk to the broader financial system. Reliance on technology by the asset management industry “calls for greater understanding of potential risks.”

SECURITIES LENDING RISK

FSOC believes that reinvestment of cash collateral by securities lenders (generally excluding mutual funds) creates a potential risk to financial stability. FSOC “encourages enhanced and regular data collection and reporting” in this area.

RESOLVABILITY AND TRANSITION PLANNING

FSOC believes that “the rapid failure or closure of a large, global asset manager,” particularly during times of market stress, could create potential challenges and risks to financial stability. FSOC welcomes the SEC’s efforts to propose a rule to address transition planning.

OUR TAKE

The Dodd-Frank Act created FSOC to identify and control systemic risks to the U.S. financial system. But the Dodd-Frank Act does not clearly define systemic risk, and FSOC has not addressed this uncertainty.

While an ongoing analysis of systemic risks is important to the stability of the U.S. financial system, FSOC should distinguish between analysis and recommendations for action. That is, it is not useful to discuss the possibilities of what could happen without discussing the probability that those events may occur.

Thus, FSOC should determine the likelihood that a destabilizing event will occur before it recommends actions to correct those events. Without this determination, FSOC will require the financial system to undertake changes that could be costly and which could even increase, rather than decrease, the likelihood of destabilization.

Nowhere is this dilemma more evident than in the area of asset management. It should come as no surprise that the SEC’s recent regulatory initiatives address FSOC’s enumerated concerns about potential risks to financial stability. The SEC’s proposed rules and statements concerning liquidity risk management, limits on investment company use of derivatives, enhanced reporting by private fund advisers, and transition planning appear designed to head off potential regulation from empowered bank regulators who are not as well positioned as the SEC to regulate those risks.

The SEC appears to be gradually shifting toward prudential regulation in response to pressure from FSOC.

On a positive note, the FSOC paper did not suggest that it should move toward regulating funds or asset managers as “systemically important financial institutions,” or SIFIs. Perhaps this omission suggests that FSOC is moderating its approach and applying a kinder, gentler approach in the road to promoting financial stability, rather than wielding a club and insisting that everyone should be regulated as a bank. Or, more likely, it is simply reacting to the United States District Court’s decision to overturn FSOC’s decision to designate MetLife as a SIFI.
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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.
The Securities and Exchange Commission’s proposals to modernize its regulation of fund use of derivatives and leverage again increase the scope and complexity of the responsibilities of investment company fund directors. If you’re a fund director, here’s what you need to know about the SEC’s proposals and how they could affect you:

**What did the SEC propose?**
The SEC proposed rules that would substantively limit the amount of leverage that investment companies could obtain through use of certain types of derivative instruments. Among other things, the rules would broaden the role of directors who oversee funds that make extensive use of derivatives or that invest in certain “complex derivatives.”

**What exactly is a derivative?**
A derivative generally is a financial instrument that derives its value from another reference asset. Reference assets can include, among other things, stocks, bonds, currencies, interest rates, market indices or other assets. Some types of derivatives involve leverage, which magnifies the amount of gains or losses on an investment.

**Would the rule apply to all types of derivatives?**
No. The rule would apply only to derivatives that involve a continuing obligation of a fund to pay anything during the life of the instrument or at maturity or early termination, as would typically be the case with derivatives involving explicit leverage. The proposed rule would not affect the ability of a fund to invest in securities providing indirect or “economic” leverage that do not involve an ongoing potential obligation to pay money to a counterparty.
Why did the SEC propose these rules?
In a nutshell, the SEC is concerned that the growing use of derivatives by investment companies may involve degrees of leverage that create the potential for speculation and abuses that Congress wanted to prevent when it designed the Investment Company Act of 1940.

Of course, prior to 1940, no one ever heard of derivatives. It should come as no surprise, then, that the ‘40 Act, as amended, does not refer to derivatives or prohibit their use by funds. Rather, back then, leverage came in the form of capital structures that allowed funds to borrow money without limitation, either from banks or through issuing debt securities.

So, to address the concerns about protecting investors from excessive leverage, Section 18 of the ‘40 Act included a prohibition on investment companies from issuing “senior securities.” A senior security includes “any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness,” but does not include borrowing from a bank.

Nearly 40 years later, derivatives, as we know them today, had not yet been invented. But, funds were obtaining de facto leverage through certain investment techniques, including “reverse repurchase agreements,” firm commitment agreements and standby commitment agreements.

In 1979, the SEC issued guidance for funds that use these investment techniques. The SEC said at the time that while these techniques may not be securities for purposes of the federal securities laws, they may be “evidence of indebtedness” that Section 18 was designed to prevent. Recognizing that these investment techniques may benefit investors, however, the SEC said that it would not consider funds in violation of Section 18 if the funds segregated liquid assets to “cover” potential obligations created by these would-be senior securities. The 1979 guidance, Release No. 10,666 (affectionately referred to as “Release Ten-Triple-Six”) contained no mention of derivatives.

Alas, the ‘40 Act and its rules could not keep up with changes in the market and the innovation of new investment techniques. So, in the years following 1979, the staff of the SEC published a string of “no-action” letters and other guidance that effectively extended the scope of Release Ten-Triple-Six to include modern-day derivatives. The SEC now believes that the resulting confusing mish-mash of staff interpretations went too far, and allows funds to obtain more leverage than Congress originally intended when it adopted the ‘40 Act.

What did the SEC propose?
On Dec. 11, 2015, the SEC proposed Rule 18f-4. While the proposed rule is only 11 double-spaced pages long, the proposing release included more than 400 pages and 864 footnotes of background, commentary and economic analysis, and is accompanied by a 97-page white paper authored by the SEC’s Division of Economic Risk Analysis (DERA). The SEC also proposed further amendments to two forms that require investment companies to report information about their portfolios and operations.
Substantive Limitations
As proposed, Rule 18f-4 would limit the ability of investment companies (including open-end, closed-end and exchange-traded funds) and business development companies (BDCs) to enter into “derivatives transactions”—meaning any swap, futures contract, forward contract, option under which the fund is or may be required to make payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination. The rule refers to these types of instruments as “derivatives instruments.”

Rule 18f-4 would allow funds to enter into “derivatives transactions” if they comply with three conditions:

1. **Alternative portfolio limitations.** Funds would be required to comply with one of two alternative portfolio limitations designed to impose limits on leverage that funds may obtain through derivative transactions, financial commitment transactions and senior securities transactions:
   - **Exposure-based portfolio limit.** A fund’s “aggregate exposure” to a derivative instrument may not exceed 150% of the fund’s net assets immediately after entering into a derivative transaction or financial commitment transaction. The exposure-based limit is designed to impose an overall limit on the amount of exposure, and thus limit a fund’s potential leverage, through derivatives and other senior securities transactions, including borrowing and other indebtedness.
   - **Risk-based portfolio limit.** A fund would be able to limit exposure under derivatives transactions, financial commitment transactions and other senior securities transactions to 300% of the fund’s net assets, provided its investments are subject to less market risk than if the fund did not use those derivatives, evaluated using valuation at risk (VaR). VaR attempts to quantify the amount an investor can lose over a period of time, based on historical probability levels. The proposed rule defines it as “an estimate of the potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level.”

2. **Asset segregation requirement for derivatives transactions.** Rule 18f-4 would require funds that enter into derivatives transactions to manage associated risks by maintaining an amount of “qualifying coverage assets” to allow the fund to cover obligations arising from those transactions. Funds would be required to segregate amounts, to be determined at least once a day, with a value equal to at least the sum of the fund’s aggregate mark-to-market coverage amounts and a “cushion” of risk-based coverage. Fund directors would be required to approve asset segregation policies and procedures. The requirement is designed to “address the undue speculation” concern reflected in the ‘40 Act.

3. **Derivatives risk management program.** Funds that use more than a limited amount of derivatives transactions would be required to establish a formalized derivatives risk management program and designate a derivatives risk manager approved by fund directors. Generally, this requirement would apply to funds that exceed a 50% threshold of notional derivatives exposure.

Risk Management
Of course, the SEC notes, all funds that enter into derivatives transactions (even a single transaction) in reliance on the proposed rule would be required to manage risks. This program would be in addition to the requirements related to risk management that already apply to funds, including determination of risk-based coverage amounts and monitoring of compliance with portfolio limits.
A fund would not need a formalized program if the board determines that the fund will comply and monitor compliance with a portfolio limitation under which the fund limits its aggregate exposure to derivatives transactions to no more than 50% of its net asset value and does not use any “complex derivatives” without regard to the 50% threshold.

Specifically, the derivatives risk management program would require a fund to have policies and procedures reasonably designed to:

- Assess the risks associated with the fund's derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity, and operational risks, as applicable, and any other risks considered relevant;
- Manage the risks of the fund's derivatives transactions, including by (i) monitoring the fund's use of derivatives transactions to ensure they are consistent with the fund's investment guidelines and portfolio restrictions, and (ii) informing portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions; and
- Reasonably segregate the functions associated with the program from the portfolio management of the fund.

The derivatives risk management program would be administered by a designated derivatives risk manager, who may be an officer or employee of the fund or the fund's investment adviser (but who may not be a portfolio manager). The SEC contemplates that the derivatives risk manager could also wear the hat of a chief compliance officer or chief risk manager.

Financial Commitment Transactions

The rule also would limit a fund's ability to enter into reverse repurchase agreements, short sale borrowing, or firm or standby commitment agreements, known as “financial commitment transactions.” Funds can enter into these types of arrangements provided that they segregate an amount equal to the fund's aggregate financial commitment.

How would Rule 18f-4 affect fund directors?

To be sure, Rule 18f-4 would increase the role of fund directors and add to the complexity of the issues that fund boards must consider. For example, if adopted, the rule would impose requirements on fund directors in the following areas:

- **Approval of portfolio limitation amounts.** The rule would require fund directors, including a majority of the disinterested directors, to approve the particular portfolio limitation under which a fund would operate. That is, the board must determine whether the fund will comply with the 150% exposure-based limit or the alternative 300% risk-based portfolio limit.
- **Determination of risk-based coverage amounts for each derivatives transaction.** The SEC has adopted a principles-based approach that would require fund directors to approve a risk-based coverage amount for each derivatives transaction. Directors would be required to take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset, and “any other relevant factors” in determining a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions. This may include, for example, an assessment of the derivative's terms and the fund's intended use of the
derivative in connection with the investment strategy. With the board's approval, directors could adopt policies that include stress testing or use a “stressed VaR model to estimate potential loss the fund would incur.”

- Derivatives risk management program. The adopting release flags derivatives use as an area of potential conflicts between investment managers and funds, requiring scrutiny by fund directors. Thus, the rule would require fund directors, including a majority of the disinterested directors, to approve the fund's derivatives risk management program, any material changes to the program, and the designation of the fund's derivatives risk manager. The proposing release includes a laundry list of specific factors that fund directors should consider when approving a derivatives risk management program. The SEC said fund directors could satisfy their obligations with respect to initial approval by reviewing summaries of the derivatives risk management program prepared by the derivatives risk manager, legal counsel, or other persons familiar with the program. The rule would require fund directors to review and update the program at least annually, including any models (such as VaR calculation models used by the fund during the period in question). Fund directors would be required to review at least quarterly, written reports prepared by the derivatives risk manager, to review the adequacy of the fund's derivatives risk program and its effectiveness. Fund directors, including a majority of the disinterested directors, would be required to approve the derivatives risk manager. Unlike Rule 38a-1, however, Rule 18f-4 would not provide that the derivatives risk manager is removable only by the board, nor would the board need to approve the derivative risk manager's compensation.

- Financial commitment transactions. For funds that enter into financial commitment transactions, the fund's directors, including a majority of the disinterested directors, would be required to approve policies and procedures designed to provide for the fund's maintenance of “qualifying coverage assets.”

What are the implications for fund directors?
If a fund invests in derivatives, said Commissioner Luis Aguilar at the Dec. 11 open meeting, “it is only appropriate to require that its board also take on the responsibilities” outlined in the proposed rule. But, he said he “consider[s] whether boards are prepared and equipped to take on those added responsibilities, which seem only to increase in number and complexity over time.”

The SEC’s proposing release reminds directors that investments in derivatives are not for the faint of heart or for the uninitiated. “As the spectrum of risk increases, the overall supervision of risk management will become even more crucial to fulfilling a board’s obligations,” Aguilar said.

For example, the rule would require fund directors to approve a derivatives risk management program, unless the fund limits its aggregate exposure to derivatives transactions to no more than 50% of its NAV and does not use “complex derivatives” without regard the 50% threshold. In order to carry out this responsibility, a director must know whether the fund invests in “complex derivatives.” The rule would define complex derivatives, generally, as any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise (i) depends on the value of the underlying reference asset at multiple points in time during the term of the transaction, or (ii) is a “non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.”

Say what?
This is not your father’s (or grandfather’s) mutual fund. Rather, this proposed definition underscores how the role of fund directors has quickly and dramatically evolved to require directors to grasp complex concepts before they can delegate responsibilities to investment advisers and derivatives risk managers. It may not be long before “vega notional” measures of volatility will join liquidity and fair valuation as dinner topics of conversation.

In any event, the proposed rules on derivatives risk illustrate that fund directors will see their responsibilities grow over the coming months as the SEC continues down the path of increased prudential regulatory proposals.

“Accordingly, I urge fund boards to be proactive in foreseeing the challenges and opportunities that lie ahead, and to how best to navigate them,” Commissioner Aguilar said. “To this end, fund boards must continue to evaluate—such as through periodic reviews—whether its members, collectively, have the requisite skills, experience, time, and resources that are needed as a fund’s operations, objectives, and investment strategies change over time.”

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Client Alert

September 22, 2015

SEC Proposes Rules to Require Funds to Adopt Liquidity Risk Management Programs; Allow “Swing Pricing”

By Jay Baris

At an open meeting today, the SEC proposed new rules and amendments to existing rules to require open-end investment companies to adopt comprehensive liquidity risk management programs. The rules would also allow funds to use “swing pricing” to pass on the cost of large purchases and redemptions to the shareholders that cause those costs.

The SEC also proposed rules that would require funds to categorize the liquidity of each portfolio holding, and to report to the SEC the category assigned to each portfolio security.

Chair Mary Jo White said that the Commission’s purpose in adopting the proposals is to enhance management of liquidity risks of registered open-end investment companies, including mutual funds and exchange-traded funds.

Here is a brief summary of the proposals.

Liquidity risk management programs

In establishing liquidity risk management programs, funds (other than money market funds) would be required to assess their liquidity risk. The program would be tailored to the individual needs and risks of each fund. The rules would require a liquidity risk management program to include several elements, including:

- Classification of the liquidity of fund portfolio assets;
- Assessment, periodic review and management of a fund’s liquidity risk;
- Establishment of a three-day liquid asset minimum; and
- Board approval and review.

Classification of liquidity risks. The rules would require funds to assign liquidity risks of individual portfolio securities to one of six liquidity categories. The classification would be based on the number of days in which a fund could convert the security to cash at a price that does not materially affect the value of the asset immediately prior to sale. In categorizing the liquidity of a particular security, funds would be required to consider all relevant liquidity factors, including trading frequency, volume, bid/ask spread and position size, among others. Funds could characterize a particular security in multiple categories, depending on its liquidity and the ability of the fund to sell that security without moving the market.
Assessment, periodic review and management of a fund’s liquidity risk. Funds would be required to assess and periodically review their liquidity risk, based on specific factors. Liquidity risk means the risk that a fund could not meet expected liquidity risks under normal conditions or stressed conditions without materially affecting the fund’s net asset value (NAV) per share.

Three-day liquid asset minimum. Based on this assessment, the rules would require a fund to determine a minimum amount of its portfolio to be held in cash or instruments that could be converted to cash within three days. This is the so-called “three-day liquid asset minimum.” Fund boards would be required to approve the liquidity risk management programs and the three-day liquid asset minimum.

15 percent limit on investments in illiquid securities. The SEC would codify its long-standing policy to limit funds’ investments in illiquid securities to 15 percent of net assets. Generally, a security is illiquid if it cannot be sold within seven days at approximately the price at which it has been valued.

Board approval and review. A fund’s board, including a majority of the independent board members, would be required to approve the fund’s liquidity risk management program, including the fund’s three-day liquid asset minimum. The board would also be responsible for ongoing reviews of the program’s adequacy.

Swing pricing option

Proposed amendments to Rule 22c-1 would allow, but not require, funds to use swing pricing under certain circumstances. That is, funds could adjust their NAV upward or downward when purchases or redemptions exceed a designated “swing threshold.” The adjustment would be the “swing factor.” Fund boards would approve the methodologies for calculating the swing threshold and swing factor. The goal is to ensure that large purchases and redemption requests are met in a timely manner while also minimizing shareholder dilution. The option would not be available to money market funds or ETFs.

Disclosure and reporting

Form N-1A. Proposed amendments to Form N-1A would require funds to disclose swing pricing, if applicable, and the methods used by funds to meet redemptions.

Form N-PORT. New Form N-PORT would require mutual funds and ETFs to report information about liquidity and the liquidity categories assigned to portfolio securities, including the fund’s three-day liquid asset minimum.

Form N-CEN. Proposed amendments to the census reporting form would require funds to disclose information regarding committed lines of credit, interfund borrowing and lending, and swing pricing, among other things.

The Commissioners

Commissioner Kara Stein said that she was concerned that the proposed rules do not go far enough in certain areas. She implied that the Commission should consider tailoring regulation to specific funds that present the most concern from a redeemability perspective.

Commissioner Michael S. Piwowar generally supported the proposals, but expressed concern about the proposed
Client Alert

three-day liquid asset minimum requirement. He said that he preferred that the rule track the statutory requirement that funds make payment on redemptions within seven days.

Outgoing Commissioner Daniel M. Gallagher generally supported the proposals, but expressed reservations about the three-day liquid asset minimum and the use of swing pricing. Swing pricing, he said, could cause disproportionate harm to retail investors.

What’s next?

Investment company use of derivatives. Chair White said that she expects the Commission’s staff to finalize recommendations related to the use of derivatives by funds by the end of 2015. The recommendations may address specific limits on leverage.

Request for comments. The SEC is asking for comments on whether more substantive regulation is needed for certain types of investment companies that may present greater liquidity risks. The comment period will be 90 days after publication in the Federal Register.

* * *

This summary is based on information made available at the Commission’s open meeting. We will update this report as more information becomes available.

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