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U.S. and Other Non-EU Issuers Offering Securities in Europe: Update on Legal and Regulatory Developments

Teleconference

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2. **"PRIIPS Update: EU Commission Adopts Revised RTS"**
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Peter Green

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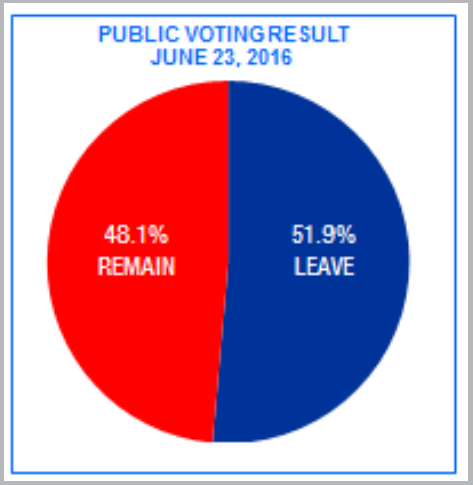
Today's Topics

- Brexit
- Proposed Prospectus Regulation (PDIII)
- Market Abuse Regulation (MAR)
- Benchmark Regulation
- PRIIPs

Brexit – Overview

- UK Referendum: Narrow majority voted to leave EU on 23 June 2016
- Advisory only
- UK government has indicated intention to give effect to Brexit vote
- Presently, UK remains an EU member
- Existing EU-derived laws and regulations continue to apply to UK



- To commence exit, UK is required to serve notice of its intention to leave the EU under Article 50 of the EU Treaty
- Once Article 50 Notice is served, UK has 2-year period to negotiate and agree Brexit terms
- Terms need to be approved by a qualified majority of the European Council (excluding UK), and the consent of the European Parliament
- If no agreement is reached within 2-year period, or any extended period agreed by all members of the European Council, the UK would automatically cease its membership of EU
- Following a recent decision of the UK Supreme Court and the enactment of the European Union (Notification of Withdrawal) Act 2017 by the UK Parliament, the UK Government served the Article 50 Notice on the European Council of Ministers on 29 March 2017

Brexit – Overview, cont'd.

Brexit – Article 50 Notice

- In addition to giving formal notice of the UK's intention to leave the EU, the Article 50 notice letter set out a summary of the UK's objectives and its approach to negotiation with the EU
- The objectives set out in the letter were consistent with the UK government's White Paper on Brexit published in February 2017 which set out principles to guide the UK government in giving effect to Brexit:
  - the UK government will not seek to retain the UK's membership of the European Economic Area (EEA) and the UK will not continue to be a member of the EU single market
  - the UK will "take control of its own affairs" and the European Court of Justice will cease to have jurisdiction in the UK
  - the UK will "design its immigration system to ensure it controls the numbers of people that come to the UK". The EU Free Movement Directive will cease to apply to the UK and the migration of nationals from the EU and elsewhere will be subject to UK laws

- The Article 50 Notice and the White Paper also state that:
  - a key aim is to seek an early agreement as to the rights of citizens of the other EU member states residing in the UK and vice versa
  - although the UK Government will not seek membership of the EU single market, it will seek access to the single market through a "new, comprehensive, bold and ambitious Free Trade Agreement"
  - the new relationships should aim for the freest possible trade in goods and services between the UK and EU
  - the UK will seek a mutually beneficial new customs agreement with the EU
  - financial services is of particular importance to the UK and the UK will be aiming for the freest possible trade in financial services between the UK and the EU
  - it is in no-one's interests for there to be a "cliff-edge" to business or a threat to stability as the UK leaves the EU – it indicates there will be a phased process of implementation and interim measures will be a matter for negotiation

Brexit – Article 50 Notice, cont'd.

EU Negotiating Position

- Following service of the Article 50 notice, the EU Council of Ministers, the President of the EU Council and the President of the EU Commission published draft guidelines for the negotiation of the UK's withdrawal from the EU which are expected to be approved at an extraordinary summit of the EU Council on 29 April 2017. These include:
  - the UK should not enjoy similar benefits to those enjoyed by remaining member states
  - negotiation by the UK of trade agreements with non-EU countries before Brexit would be contrary to EU law and result in the expulsion of the UK from EU trade negotiation procedures
  - transitional arrangements may be acceptable but should be limited to three years
  - the withdrawal agreement should designate the European Court of Justice as the competent authority for the interpretation and enforcement of the withdrawal agreement
  - the first phase of negotiations must settle the disentanglement of the UK from the EU, including settlement of the UK's financial obligations to the EU
  - The EU is ready to engage in discussions as to the future relationship between the UK and the EU once sufficient progress is made in phase one – this may include a "balanced, ambitious and wide-ranging" free trade agreement following Brexit

Brexit – Great Repeal Act

- Great Repeal Bill (GRB) will repeal one law, the European Communities Act 1972 (ECA), and enshrine thousands more automatically in UK law
- ECA currently gives direct effect and primacy to EU law
- The UK government will be able to amend or scrap any ex-EU law following Brexit but all ex-EU laws will be preserved and transposed into UK law on Brexit Day
- Following service of Article 50 notice the UK government published a White Paper on the GRB:
  - WP acknowledges the volume and complexity of EU law
  - a significant proportion of EU derived law will no longer work or make sense when the UK leaves the EU or will not achieve its purpose – secondary legislation will therefore be required to allow amendment of prior primary legislation
  - The WP states this power should not be used to make a policy change which is not designed to deal with deficiencies in preserved EU-derived law arising out of Brexit

Passporting

- Refers to the process whereby a firm authorised in one member state can provide authorised activities or services in other EU member states without the need for separate authorisation in such other states
- Passporting can also apply to products that need to be authorised (e.g. securities prospectuses)
- Passporting must be considered on a case by case basis
- BBA "Quick Brief" identified nine different passports that banks and other financial services firms rely on in connection with provision of activities and services to businesses and customers across the EU
- Passports are based on the single EU rulebook for financial services:
  - not available for banks and firms based in jurisdictions outside the EU/EEA
  - UK will become a "third country" upon leaving the EU and EEA

- Impact of loss of passporting rights is potentially severe for UK-based banks/financial institutions (including UK authorised branches and subsidiaries of non-EU institutions):
  - banks could lose ability to sell products and services directly to customers in EU member states
  - relying on domestic licensing regimes in EEA member states (which are not uniform) will be complex and costly
  - existing branches of UK banks would become 'foreign' bank branches for EU purposes which may limit their permitted activities
  - branches of EEA banks in the UK would not have the benefit of the EU passport in the UK – will be up to UK as to how it will treat such branches following Brexit
- One of the key discussion areas in relation to Brexit and financial services is therefore the extent to which (if at all) UK banks and other UK financial institutions will be able to continue to rely on the EU passport for financial services

Passporting, cont'd.

Alternatives to Passporting

- Even if the various EU passports highlighted above will not be available to UK authorized firms following Brexit, it may still be possible for firms to access the single market through other means:
  - specific arrangements negotiated between the UK and the EU, including pursuant to the Brexit negotiations
  - reliance on 'equivalence' provisions in certain EU legislation
  - firms establishing branches or subsidiaries in EU jurisdictions
- It is likely that firms will rely upon a mix of all of the above following Brexit

Equivalence

- Certain EU legislation relating to banks and financial services enables firms located outside the EU to obtain the benefit of all or part of the relevant legislation if the law/regulation in the non-EU jurisdiction is regarded as "equivalent" to the relevant EU legislation:
  - equivalence is dealt with on a case by case basis in respect of each piece of relevant EU legislation
  - the EU Commission is required to determine the legislation/regulation of the non-EU jurisdiction to be equivalent to relevant EU legislation
  - the EU and the non-EU jurisdiction will also generally be required to have cooperation arrangements in place, e.g. in relation to information sharing
  - will usually require reciprocity from non-EU jurisdiction
  - equivalence is granted in respect of a jurisdiction, not to individual firms or entities
  - equivalence is of limited scope in some cases and may not give the same level of access to relevant markets as passporting

- Equivalence determinations are discretionary and generally take considerable time:
  - equivalence is not automatic – it is discretionary and must be requested
- UK will, however, be in a unique position as of "Brexit Day". All existing EU laws will form part of EU law under the GRB
- EU may be concerned about future amendments to UK law – however this is also an issue for any non-EU jurisdiction which is the subject of an equivalence determination:
  - equivalence determinations can always be withdrawn at EU's discretion
- Equivalence in relation to relevant legislation may form part of the Brexit negotiations
- Concern has already been raised in some EU jurisdictions about the possible general reliance of the UK on equivalence determinations

Equivalence, cont'd.

Prospectus Directive (PD)

- Current regime:
  - consists primarily of Prospectus Directive (2003/71/EC, as amended) and Prospectus Regulation ((EC) No. 809/2004, as amended)
  - PD imposes form and content requirements for prospectuses in respect of:
    - offers of transferable securities to public in EU
    - issuances listed on an EU-regulated exchange
  - exemptions in certain cases where securities are not listed on regulated exchange in the EU, such as offers:
    - of securities with a denomination of €100,000 or more; or
    - to qualified investors (primarily institutional and professional investors); or
    - made to fewer than 150 persons, other than qualified investors, per EU member state

- Current regime (cont.):
  - PD-compliant prospectus must be approved by competent authority in issuer's "home member state" and published
  - approval (once notified by home member state competent authority to competent authorities in other member states where offerings are proposed) allows issuer to benefit from "prospectus passporting" and offer securities across multiple EU member states without requiring further authorisations
  - there are current proposals to implement a new EU prospectus regime (new Prospectus Regulation) as part of the EU Commission's Capital Markets Union initiative (CMU)

Prospectus Directive (PD), cont'd.

Effect of Brexit on Prospectus Directive

- Following Brexit and the UK leaving the EU and EEA then:
  - subject to Brexit terms, the PD regime will cease to apply in respect of securities offered or listed in the UK
  - the GRB will enshrine the PD regime into UK law so UK entities will need to comply with the prospectus regime in place immediately prior to Brexit
  - however, the UK will cease to be a member of the EU and so the Prospectus Directive/Regulation will no longer apply to the UK
  - firms will not therefore be able to rely on the EU passporting regime where prospectuses are approved by the UKLA
  - it is not clear whether the effect of the GRB will be that the UK will recognise prospectuses approved by an EU competent authority following Brexit – may be an issue to be agreed in Brexit negotiations
  - subject to any special agreement between the UK and the EU, the Financial Conduct Authority as the UK Listing Authority (UKLA) will cease to be a relevant competent authority for purpose of approving prospectuses under the PD

- issuers of securities to be offered in the EU would therefore not be able to utilise the UK as "home member state"
- "home member state" can be selected for issuances of non-equity securities with a denomination of at least EUR1,000, from among:
  - jurisdiction in which it has its registered office, if in the EU; or
  - EU member state where securities were/are to be admitted to trading; or
  - EU member state where securities are offered to the public
- For other securities, "home member state" will be either:
  - jurisdiction of issuer's registered office, if established in EU; or
  - the EU member state where securities are intended to be offered to the public for the first time or where the first application for admission to trading on an EU-regulated market is made
- Therefore, a non-EU issuer of equity securities, or low-denomination debt, with UK as home member state in respect of existing securities pre-Brexit, would (post-Brexit) need to select a new home member state for securities issued post-Brexit

Effect of Brexit on Prospectus Directive, cont'd.

- For such an issuer, the situation as to the home member state for equity/low-denomination debt securities outstanding as at time of Brexit is currently unclear
- For issuers accustomed to producing prospectuses in English, the language requirements for the prospectus are unlikely to change, on the basis that English is "a language customary in the sphere of international finance"
- Absent special agreements, issuers offering securities in the UK and EU member states post Brexit may have to obtain approval from UKLA and a competent authority within the EU
- Article 20 of the PD provides the power (though not the obligation) for the home member state competent authority to approve a prospectus drawn up in accordance with the legislation of a third country, provided that:
  - it has been drawn up in accordance with international standards, such as the IOSCO disclosure standards; and
  - the third country's information requirements are equivalent to those under the PD

Effect of Brexit on Prospectus Directive, cont'd.

- To date, prospectuses drawn up under third country laws have always required a “wrapper” to be produced, in order to bridge the gap between information requirements of the third country and those under the PD. They have also required financial statements to be drawn up according to IFRS, unless the third country accounting standards are declared by the European Commission to be equivalent, such as U.S. and Japanese GAAP
- From a legal point of view, this ought not to be required for UK issuers, if the UK replicates the PD, post-Brexit
- Post-Brexit, the Main Market of the London Stock Exchange would cease to be an EU-regulated market for purposes of PD:
  - securities listed on Main Market would not automatically require PD-compliant prospectus to be approved by an EU competent authority even if offered in EU. However, the effect of GRB is likely to be to replicate EU requirements
  - prospectuses listed on the Main Market would therefore be likely to need the approval of UKLA
  - absent special agreement with the EU, such a prospectus would not be able to be “passported” into the EU

Effect of Brexit on Prospectus Directive, cont’d.

Transparency Directive

- Harmonises transparency requirements for issuers of securities admitted to trading on a regulated market
- Requires disclosure of minimum level of information to public
- Requires:
  - companies to publish an annual and half yearly financial report
  - major shareholders and financial instrument holders to disclose holdings exceeding certain levels (and companies to disclose these)
  - companies to provide prescribed information to European investors (certain rules also apply to storage of this information)
- Exemptions for issuers exclusively of debt securities with a denomination of at least EUR100,000
- Home member state issues will apply to the Transparency Directive similarly to the PD

New Prospectus Regulation

- Part of the CMU initiative to overhaul EU capital markets regime
- Draft Prospectus Regulation published by EU Commission in November 2015 and is currently going through EU legislative process
- Prior to UK Referendum, the new Regulation was anticipated to come into force by end of 2016 or early 2017, and current draft provides that it would be effective one year after coming into force (this is likely to be extended to two years)
- Result of a review of existing prospectus regime and public consultation on possible reform
- New Prospectus Regulation aims to:
  - provide all types of issuers with disclosure rules that are tailored to their specific needs
  - make the prospectus a more relevant tool of informing potential investors

- Significant changes were proposed by European Commission in its November 2015 legislative proposal:
  - abolition of "wholesale" exemption for debt securities with denomination of €100,000 or more (other exemptions to be left largely unchanged)
  - overhaul of requirements in relation to prospectus summaries
  - requirement for prospectus summaries for all prospectuses (they are not currently required for securities with a denomination of at least €100,000)
  - introduction of "Universal Registration Document", intended to be a shelf regulation mechanism similar to that used in the U.S. which will apply to frequent issuers admitted to trading on a regulated market or MTF in the EU
  - a new minimum disclosure regime for SMEs and other companies with a market capitalisation not exceeding €200 million
  - non-EU issuers seeking approval of a prospectus would be required to appoint a representative established in the issuer's home member state who will, together with the non-EU issuer, be responsible for compliance with the Prospectus Regulation – this would likely include UK, post-Brexit
  - other changes relating to content, including detailed rules on risk factors

New Prospectus Regulation, cont'd.

New Prospectus Regulation – Current Status

- In September 2016, the EU Parliament adopted an amended version of the EU Commission's proposals
- Following further 'trialogue' discussions between the EU Parliament, EU Commission and EU Council of Ministers, the EU Commission announced in December 2016 that informal agreement had been reached on the proposals
- On 5 April 2017, the EU Parliament resolved to adopt the draft Prospectus Regulation in the form agreed following the trialogue discussions
- It is expected that the EU Council will formally adopt the Prospectus Regulation on 16 May 2017 and will come into force in June or July 2017
- The position set out below reflects the final version of the Prospectus Regulation based on the trialogue agreement and the form adopted by the EU Parliament in April 2017

New Prospectus Regulation – Expected Final Position

- Exemptions:
  - the threshold for the total consideration of an offer of securities below which the Prospectus Regulation will not apply is increased from €500,000 to €1 million (this is envisaged to be helpful for "crowdfunding" issuances)
  - although the EU Parliament had sought to increase the number of investors per member state to whom offers could be addressed without requiring the publication of a prospectus to 350, the exemption remains unchanged with the relevant threshold set at 150 natural or legal persons (not being qualified investors) per member state
  - the "wholesale" exemption for offers of securities whose denomination per unit is at least EUR 100,000 has been reinstated
  - the obligation to publish a prospectus will not apply to the admission to trading on a regulated market of securities fungible with securities already admitted to trading provided that, over a 12 month period, they represent less than 20% (increased from the current 10%)of the securities already admitted to trading (subject to certain exclusions including where shares qualify as Common Equity Tier 1 or eligible own funds for regulatory capital purposes)

- Prospectus summary:
  - the proposals to overhaul the rules relating to summaries have been largely retained
  - a summary will continue to be not required for non-equity securities with a denomination per unit of at least €100,000 or whose securities are to be traded only on a regulated market, or specific segment thereof, to which only qualified investors can have access for the purpose of trading in such securities
  - the summary must be no more than seven A4 pages in length (increased from 6 in the original proposal) but the EU Parliament amendment to allow flexibility to increase this to 10 pages in some cases has not been included
  - the issuer will be required to give an indication of the most material conflicts of interests and to state whether the offer is underwritten on a firm commitment basis (and the proportion of the offer not covered by such commitment)
  - the total number of risk factors in the summary may not exceed 15

New Prospectus Regulation – Expected Final Position, cont'd.

- Prospectus summary (cont'd):
  - the summary will be required to include certain specified warnings
  - the summary will also be required to state the relative seniority of the securities in the issuer's capital structure in the event of insolvency, including the potential impact of the investment under the Bank Recovery and Resolution Directive (BRRD) (e.g. the potential for bail-in)
  - if the securities constitute a PRIIP, the issuer may substitute the requirement for information about the securities set out in the Prospectus Regulation with the information required in the KID under the PRIIPs Regulation. In this case, the length limit of the summary is extended by three pages

- Universal Registration Document:
  - original proposal included the concept of a "Universal Registration Document" (URD) intended to be a shelf registration mechanism similar to that used in the US
  - URD would be available to frequent issuers admitted to trading on a regulated market or MTF
  - after an issuer has had a URD approved by the relevant competent authority every financial year for two consecutive years, subsequent URDs may be filed with the competent authority or amended without prior approval (but still remains subject to review by such competent authority)

- Simplified disclosure regime:
  - certain issuers may draw up a simplified prospectus under a simplified disclosure regime for secondary issuances including issuers whose securities have been admitted to trading on a regulated market or SME growth market for 18 continuous months issuing securities fungible with existing securities and, in relation to an issuance of equity securities, issuers whose equity securities have been admitted to trading on a regulated market or SME growth market for 18 continuous months
  - for primary issuances, SMES (or certain other issuers including issuers issuing securities to be admitted to trading on an SME growth market where the issuer has had an average market capitalisation of less than £500 million for the previous three years) may issue an "EU growth prospectus" which is intended to be a simplified, standardised document with proportionate disclosures
- Retail cascades:
  - financial intermediaries will be able to rely on the prospectus published by the issuer once approved for the resale of securities as long as a valid prospectus remains in place and the issuer or the person responsible for drawing it up, consents in writing

New Prospectus Regulation – Expected Final Position, cont'd.

- The EU Commission is required to adopt delegated acts to set out detailed content requirements for prospectuses
- A specific (presumably shorter) set of requirements shall apply to prospectuses relating to the admission to trading on a regulated market of non-equity securities that have a denomination per unit of at least €100,000 or are to be traded only on a regulated market, or specific segment thereof, to which only qualified investors can have access for the purposes of trading in such securities

New Prospectus Regulation – Expected Final Position, cont'd.

- Risk factors:
  - issuer is required to assess the materiality of each risk factor based on the probability of occurrence and the expected magnitude of its negative impact
  - risk factors shall be presented in a limited number of categories depending on their nature – in each category the risk factors shall be ranked by the issuer on the basis set out above
  - ESMA is to develop guidelines in relation to the new rules on risk factors
- Third party representative:
  - the proposal in the original draft regulation that non-EU issuers seeking approval of a prospectus must appoint a representative in its home member state appears to have been dropped
- Timing:
  - most provisions of the Regulation are now stated to apply two years from the date of its entry into force (the initial draft provided for one year):
    - therefore likely to apply from around mid-2019

New Prospectus Regulation – Expected Final Position, cont'd.

New Prospectus Regulation – Market Reaction

- Many market participants are relieved that some of the issues giving them greatest concern in the initial draft of the proposals have been dropped or significantly amended:
  - reinstatement of €100,000 "wholesale" denominations exemption
  - lighter disclosure regime will also still be available for wholesale issuances
  - deletion of requirement for non-EU issuers to appoint a representative
- Some concerns do however remain for some issuers:
  - limitation to fifteen risk factors in summary and requirement to categorise risk factors will give use to liability concerns and the risk of judgment in hindsight
  - limitation of summary to 7 pages could be challenging in some cases
- It currently seems likely that the Prospectus Regulation will come into force after Brexit – UK will need to decide whether to replicate its terms (as it is arguable as to whether it will come within the scope of the GRB)

New Prospectus Regulation – Other Workstreams

- In January 2017, the EU Commission sent a mandate to ESMA in relation to technical advice for delegated acts contemplated under the Prospectus Regulation
- The EU Commission has also commenced work on "level 2" implementing measures to be adopted by the Commission in the form of delegated acts no later than 18 months after the entry into force of the Regulation
- On 3 March 2017, the UK FCA published a Consultation Paper in relation to amendments under the Prospectus Regulation that are expected to apply from the date the Regulation comes into force (relating to certain of the exemptions from the requirement to publish a prospectus)

MAR - Scope

- The EU Regulation on Market Abuse (MAR) came into effect on 3 July 2016, replacing the previously existing Market Abuse Directive (MAD)
- MAR extends the application of the EU's market abuse regime and now applies to financial instruments:
  - admitted to trading, or for which a request for such admission has been made, on a regulated market in an EU Member State;
  - traded, admitted to trading, or for which a request for such admission has been made, on a multilateral trading facility (MTF);
  - traded on an organised traded facility (OTF); or
  - the price or value of which depends on or has an effect on the price or value of a financial instrument referred to above, including derivative instruments
- MAR also applies to behaviour or transactions relating to emissions allowances, as well as to market manipulation related to spot commodity contracts, commodity derivatives and benchmarks

- MAR applies to actions and omissions in the EU and in a third country, so an issuer of securities that meet any of the definitions above will be within the scope of MAR whether it is an EU issuer or a non-EU issuer
- Where a non-EU issuer's financial instruments are admitted to trading in the EU only on an MTF or an OTF and the issuer has not approved or consented to such admission to trading, the issuer obligations in MAR (i.e. disclosure of inside information, control of inside information and insider lists and dealings by PDMRs) will not apply
- However, the insider dealing, unlawful disclosure and market manipulation offences will still apply in relation to those instruments

MAR – Scope, cont'd.

MAR – Offences

MAR prohibits:

- insider dealing (Article 14(1)(a));
- attempted insider dealing (Article 14(1)(b));
- recommending or inducing another to engage in insider dealing (Article 14(b));
- unlawful disclosure of inside information (Article 14(c));
- market manipulation (Article 15);
- attempted market manipulation (Article 15); and
- dealing by a person discharging managerial responsibilities during a closed period (Article 19(ii))

MAR – Insider Dealing Offences

- Under Article 14 MAR, the following are offences:
  - engaging or attempting to engage in insider dealing;
  - recommending or inducing another to engage in insider dealing; or
  - unlawfully disclosing inside information
- Insider dealing is where a person possesses inside information and uses that information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates
- The definition also applies to the use of inside information by cancelling or amending an order concerning a financial instrument to which the information relates, where the order was placed before the person concerned possessed the inside information

Inside Information definition

Inside information means information:

- **of a precise nature**;
- which has not been made public;
- relating, directly or indirectly, to one or more issuers or to one or more financial instruments; and
- which, if it were made public, would be **likely to have a significant effect** on the prices of any of those financial instruments or on the price of related derivative financial instruments

- Although this definition seems to have expanded compared to MAD, the FCA in the UK has indicated that there will not be a significant change in the way it interprets inside information
- In contrast to the US, there is no requirement that there be a fiduciary or fiduciary-like relationship or a duty of trust or confidence between the source of inside information and the recipient. It is possible that activity that is permissible under US laws relating to insider trading will be prohibited under MAR

Insider Dealing – Legitimate Behaviour

- Article 9 of MAR provides various examples of behaviour that is considered legitimate behaviour in the context of the insider dealing offences, as well as the market manipulation offences. These include situations where:
  - the legal person in possession of inside information has taken steps to ensure that the natural person who made the acquisition or disposal is not in possession of the inside information, and has not influenced that natural person;
  - the person in possession of inside information is a market maker acting legitimately in the normal course of the exercise of such function;
  - the person in possession of inside information is authorised to execute orders on behalf of third parties and acts legitimately in the normal course of the exercise of that person's employment, profession or duties; and
  - the person in possession of inside information acquires or disposes of financial instruments in discharge of a pre-existing obligation that has become due in good faith

Unlawful Disclosure and Market Soundings

Unlawful Disclosure Offence

- MAR prohibits a person from unlawfully disclosing inside information relating to securities within the scope of the legislation (Article 14(c))
- An unlawful disclosure is made when a person possesses inside information and discloses it to any other person, except in the normal exercise of their employment, profession or duties

Market Soundings Safe Harbour

- A disclosure of inside information made in the course of a market sounding is deemed to be made in the normal exercise of a person's employment, profession or duties where the disclosing market participant (**DMP**) complies with certain specified conditions

Market Soundings: Compliance Requirements

- A market sounding is the communication of information, usually by a dealer or manager on behalf of an issuer, about a potential new issuance, in order to gauge the interest of potential investors in a potential transaction and related conditions
- DMPs and market sounding recipients (MSRs) must comply with a number of conditions whenever conducting a market sounding, whether or not the market sounding involves the disclosure of inside information
- Prior to conducting a market sounding, a DMP must specifically assess whether the market sounding will involve the disclosure of inside information and make a written record of its conclusion and the reasons therefor. This obligation applies to each separate disclosure of information during a market sounding
- Where information that has been disclosed in the course of a market sounding ceases to be inside information according to the assessment of the DMP, the DMP shall inform the MSR accordingly, as soon as possible
- All records must be made available to the competent authority on request

- If the DMP concludes that the market sounding involves inside information, the communication from the DMP to the MSR must:
  - include a statement that the communication is for the purposes of a market sounding;
  - if the conversation is being recorded, include a statement to that effect and a statement obtaining consent to record the conversation;
  - include confirmation from the MSR individual that they are the person entrusted by the recipient institution to receive the sounding;
  - clarify that if the person agrees to receive the sounding (i) that inside information will be disclosed and (ii) the recipient is obliged to separately consider for itself whether it is inside information;
  - if possible, include an estimation of when the information will cease to be inside information, the factors that might affect that estimation and how the recipient will be informed of any change;
  - inform the recipient of their obligation to keep the information confidential and not to trade (or amend a pre-existing instruction to trade) on the basis of it;
  - obtain the recipient's consent to receiving inside information; and
  - if the MSR consents, identify the information that is inside information

Market Soundings: Compliance Requirements, cont'd.

- If the DMP concludes the market sounding does not involve inside information, its communication to the MSR must include:
  - a statement that the communication is for the purposes of a market sounding;
  - if the conversation is to be recorded, a statement to that effect and obtaining consent to recording the conversation;
  - confirmation that the individual is the person entrusted by the recipient institution to receive the sounding;
  - a statement that (i) the recipient will receive information which the discloser considers not to be inside information and (ii) the recipient should separately consider this question; and
  - the recipient's consent to receive the market sounding
- The same level of information must be communicated to each recipient of each market sounding
- The DMP must also comply with certain record-keeping requirements, including that records be kept for 5 years, even where it is decided that the market sounding does not contain inside information
- ESMA has published guidelines for the recipients of market soundings

Market Soundings: Compliance Requirements, cont'd.

Public Disclosure of Inside Information

- MAR requires an issuer to inform the public as soon as possible of inside information which directly concerns the issuer (Article 17(1))
- The disclosure needs to be made in a manner which enables "fast access and complete, correct and timely assessment of the information by the public" and on the European Electronic Access Point, when this is established by ESMA
- The issuer cannot combine the disclosure with the marketing of its activities. All inside information must be posted and maintained on the issuer's website for at least 5 years
- An issuer may generally only delay disclosure if, and for so long as:
  - the issuer's legitimate interests are likely to be prejudiced by immediate disclosure; and
  - the delay of disclosure is not likely to mislead the public; and
  - the issuer is able to ensure the confidentiality of that information

Creation and Maintenance of Insider Lists

- MAR requires that issuers or persons acting on their behalf shall maintain a list of all persons who have access to inside information and who are working for or under them, or otherwise have access to inside information
- This list must be kept updated and made available to the competent authority on request and should be retained for at least 5 years
- These lists must adhere to the prescribed format (see Commission Implementing Regulation (EU) 2016/347)
- Issuers, or any person acting on their behalf or on their account, shall take all reasonable steps to ensure that any person on the insider list:
  - acknowledges in writing the legal and regulatory duties entailed; and
  - is aware of the sanctions applicable to insider dealing and unlawful disclosure of inside information

Investment Recommendations

- MAR requires persons who produce or disseminate investment recommendations or other information recommending or suggesting an investment strategy to take reasonable care to:
  - ensure that such information is objectively presented; and
  - to disclose their interests or indicate conflicts of interest concerning the financial instruments to which that information relates
- An “investment recommendation” means information:
  - recommending or suggesting an investment strategy;
  - explicitly or implicitly concerning one or several financial instruments or the issuers;
  - including any opinion as to the present or future value or price of such instruments;
  - intended for **distribution channels** or **for the public**

- In the ESMA Final Report of September 2015, ESMA took the view that:
  - "an investment recommendation is intended for distribution channels or for the public … when it is intended or expected to be distributed to clients or to a specific segment of clients, whatever their number, as a non-personal recommendation… ESMA considers that a too narrow definition of 'investment recommendation intended for distribution channels or for the public' would entail the risk of leaving some investment recommendations provided to investors unregulated, without investors being in a position to know that the recommendation received is not regulated"
- ICMA has interpreted the ESMA report in their Q&A in March 2016 as meaning "…that investment recommendations are in scope of MAR where they are disseminated to more than one client"
- However, this issue is still being raised with the FCA in the UK who are reviewing it

Investment Recommendations, cont'd.

MAR and Brexit

- MAR will cease to form part of UK law following Brexit
- However, the effect of the GRB will be to replicate the provisions of MAR in the UK
- It seems unlikely that the UK will seek to make any immediate change to the MAR provisions following Brexit
- In any event, MAR would still apply to UK Issuers with financial instruments traded (or which have applied to trade) on a regulated market, MTF, or OTF in the EU, or the price or value of which depends on or has an effect on the price of such a financial instrument
- In order for UK-based financial institutions to be able to have access to the single market, it is likely the EU will require the UK to maintain a market abuse regime which is compatible with the requirements of MAR

Benchmark Regulation - Overview

- Use of benchmarks in financial transactions has been the subject of focus from international regulations in recent years:
  - LIBOR setting
  - Wheatley Review
  - UK Banking Reform Act 2013
  - FCA has added further benchmarks to its regulatory oversight
- July 2013 – IOSCO General Principles for Financial Benchmarks
  - endorsed by FSB and G20
- EU Commission published draft Regulation in September 2013 in relation to indices used as benchmarks in financial instruments and contracts
  - Regulation came into force on 30 June 2016
  - most provisions become effective from January 2018 with certain specified provisions already in effect

Benchmark Regulation - Scope

- Regulation applies to “benchmarks” which include:
  - in relation to financial instruments or financial contracts, any index by reference to which the amount payable under such instrument or contract is determined or by which the value of a financial instrument is determined
  - in relation to investment funds, any index that is used to measure the performance of any such fund with the purpose of tracking the return of such index or of defining the asset allocation of a relevant portfolio or in computing performance fees
- “Index” is defined as any figure that is:
  - published or made available to the public; and
  - regularly determined entirely or partially by the application of a formula or any other method of calculation, or by an assessment and on the basis of the value of one or more underlying assets or prices, actual or estimated interest rates, quotes and committed quotes or other values or surveys

- A “financial instrument” is any instrument listed in Annex I(C) to MiFID II that is either:
  - traded on a trading venue as defined in MiFID II; or
  - is the subject of a request made for admission to trading on a trading venue; or
  - traded via a systematic internaliser under MiFID II
- A “financial contract” is any credit agreement within the ambit of the Consumer Credit Directive or the Mortgage Credit Directive (EU consumer credit agreements and residential mortgages)
- An “investment fund” is:
  - an AIF as defined in the AIFMD; and
  - a UCITS funds as defined in the UCITS IV Directive
- Some limited exemptions provide that the Regulation will not apply to certain entities including central banks and CCPs (in their capacity of providing reference or settlement prices)

Benchmark Regulation – Scope, cont’d.

Benchmark Regulation - Administrators

- An administrator is any natural or legal person that has control over the provision of a benchmark:
  - no specific guidance as to meaning of "control"
- Any benchmark administrator located in the EU must apply to its relevant competent authority for authorisation if it provides or intends to provide indices for use as benchmarks under the Regulation
- Benchmark administrators supervised under other relevant EU financial regulation only need to be registered with the relevant competent authority
- Transitional provisions apply to entities already providing benchmarks on the date the Benchmark Regulation comes into force:
  - such entities have 42 months to apply for authorisation or registration
  - transitional rules only apply in relation to indices being provided at the time the Regulation comes into force

- Benchmark administrators are subject to a number of requirements aimed at maintaining the integrity and reliability of relevant benchmarks including:
  - robust governance requirements including in relation to identification and prevention or management of conflicts of interest
  - oversight function requirements
  - control framework requirements
  - accountability framework requirements
  - recording keeping requirements
  - controls over outsourcing of functions
  - requirements in relation to input data
  - requirements relating to benchmark methodology
  - reporting of infringements
  - code of conduct to be developed for each contributor to a benchmark

Benchmark Regulation – Administrators, cont'd.

Benchmark Regulation – Type Specific Provisions

- Administrators of different types of benchmarks are subject to additional or fewer requirements depending on the category of benchmark
- Commodity benchmarks are subject to additional requirements:
  - administrator must formalise, document and make public the calculation methodology
  - cannot benefit from lighter regime applicable to significant or non-significant benchmarks
- Interest rate benchmarks:
  - specific priority of use of input data – priority to be given to a contributor's transactions in the markets that the benchmark is intended to measure
  - need for oversight committee
  - additional record keeping requirements
- Regulated data benchmarks (determined by input data from regulated venues) are exempt from certain of the governance and control requirements that would otherwise apply

Benchmark Regulation - Critical Benchmarks

- EU Commission must adopt implementing legislation to establish and review (at least every two years) a list of critical benchmarks in the EU
- A benchmark is a critical benchmark if one of the following applies:
  - it is used directly or indirectly within a combination of benchmarks as a reference for financial instruments or contracts having a total value of at least €500 billion; or
  - it is based on submissions by contributors, the majority of which are located in one member state, and is recognised as being critical by the relevant competent authority; or
  - it meets the criteria specified in relation to the first bullet point above but with a total value of at least €400 billion and has no, or very few, market-led substitutes and if the benchmark ceased to be provided, there would be a significant and adverse impact on market integrity, financial stability, consumers or the real economy in at least one member state
- Critical benchmarks are subject to additional requirements including a requirement for the administrator to ensure the licenses related to the benchmark are provided to all users on a fair, reasonable, transparent and non-discriminating basis
- Special rules apply where the administrator of a critical benchmark intends to cease to provide such benchmark (these rules are already in effect)

Significant and Non-significant Benchmarks

- A benchmark that is not a critical benchmark will be regarded as a significant benchmark if:
  - it is used directly or indirectly within a combination of benchmarks as a reference for financial instruments or financial contracts having a total average value of at least €50billion; or
  - it has no or very few appropriate market-led substitutes and, if it were to be no longer provided, there would be a significant and adverse impact on market integrity, financial stability, consumers or the real economy in member state(s)
- Any benchmark that is not a critical or significant benchmark is a "non-significant" benchmark
- Administrators of a significant benchmark may, on a "comply or explain" basis, seek not to apply certain provisions of the Benchmark Regulation subject to competent authority approval
- Administrators of non-significant benchmarks can seek to disapply on a "comply or explain" basis a wider list of provisions

Restrictions on "Use" of Benchmarks in the EU

- A supervised entity will only be permitted to "use" a benchmark in the EU if it is provided by an administrator authorised or registered under the Benchmark Regulation
- "Use of a benchmark" means:
  - issuance of a financial instrument which references an index or combination of indices
  - determination of the amount payable under a financial instrument or a financial contract by referencing an index or combination of indices
  - being a party to a financial contract which references an index or a combination of indices
  - providing a borrowing rate calculated as a spread or mark-up over an index or combination of indices, solely used as a reference in financial contract(s)
  - measuring the performance of an investment fund through an index or combination of indices for the purpose of tracking the return thereof or defining the asset allocation of a portfolio or computing performance fees

Non-EU Benchmarks

- Where a non-EU administered benchmark is already used in the EU on the date the Benchmark Regulation comes into force, the Benchmark Regulation "grandfathers" the use of the benchmark for existing financial instruments, financial contracts or investment funds for 42 months
- Where grandfathering is not available, there are three alternative routes through which a benchmark administrator located outside the EU can facilitate the use of their benchmarks in the EU:
  - equivalence
  - recognition
  - endorsement

Non-EU Benchmarks – Equivalence

- ESMA may register a non- EU benchmark administrator and the benchmark if:
  - an equivalence decision is adopted by the EU Commission for the jurisdiction where the administrator is located specifying that the administrator is subject to requirements equivalence to the Benchmark Regulation;
  - the administrator is authorised or registered and subject to supervision in such jurisdiction;
  - the administrator notifies ESMA of its consent to the benchmark(s) being used by supervised entities in the EU; and
  - co-operation arrangements are in place between ESMA and the relevant authority in the administrator's jurisdiction (must cover at least the mechanism for exchange of information between ESMA and competent authority in the non-EU jurisdiction and procedures concerning the coordination of supervisory activities)

Non-EU Benchmarks – Recognition

- Until an equivalence determination is made in relation to a non-EU jurisdiction, benchmarks administered in such jurisdiction may be used by supervised entities in the EU if the administrator obtains prior recognition by its EU "member of state of reference"
- "Member state of reference" is determined by various criteria including:
  - location of affiliated supervised entities
  - location of relevant trading venues for financial instruments referencing relevant benchmarks
  - location of supervised entities using the benchmarks
- Relevant non-EU administrators will need to comply with the vast majority of the obligations that apply to EU administrators under the Benchmark Regulation
- The non-EU administrator must have a legal representative (accountable to the competent authority in its member state of reference) to perform an oversight function in respect of such benchmarks

Non-EU Benchmarks – Endorsement

- A non-EU administrator can register benchmarks for use in the EU if there is an application to the relevant competent authority to endorse the use of the relevant benchmark in the EU by:
  - a benchmark administrator supervised in the EU; or
  - another supervised entity located in the EU with a clear and well-defined role within the control or accountability framework of the non-EU administrator; and
  - which, in each case, is able to monitor effectively the provision of the relevant benchmark
- The relevant competent authority must be satisfied as to the satisfaction of certain conditions before it can make such an endorsement

Benchmark Regulation and Brexit

- Benchmark Regulation likely to become effective before UK leaves the EU
- Once UK leaves the EU, the Benchmark Regulation will cease to form part of UK law
- The terms of the Benchmark Regulation will, however be replicated into UK law under the GRB
- However, UK based benchmark administrators will not be located in the EU and will not therefore be capable of being authorised or registered with an EU competent authority
- Any benchmark administrator located in the UK is therefore likely to need to rely on either equivalence, recognition or endorsement to ensure the relevant benchmark can continue to be used in the EU
- Brexit agreement may provide an interim/transitional arrangement for UK benchmark administrators authorised or registered at the time of Brexit

PRIIPs - Overview

- Regulation on Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs Regulation) came into force on 29 December 2014:
  - after a delay in the original implementation date, the Regulation will now become effective on 1 January 2018
- Aim is to obtain greater consistency and more level playing field in pre-contract disclosure across different retail investment products in the EU
- Significant technical detail is contained in Regulatory Technical Standards (RTS):
  - final draft RTS were first adopted by EU Commission on 30 June 2016 after consultation process
  - following concerns by market participants over certain aspects of the RTS, the EU Parliament rejected the draft RTS (which led to the delay in PRIIPs implementation)
  - revised RTS were published by the EU Commission on 8 March 2017
  - RTS will enter into force 20 days after publication in EU Official Journal and will apply from 1 January 2018
  - "Level 3" Guidance in form of Q&As expected to be published shortly

PRIIPs - Scope

- Regulation applies to packaged retail and insurance-based investment products or PRIIPs, being either of:
  - packaged retail investment products (PRIPs), being "an investment … where, regardless of the legal form of the investment, the amount repayable to the investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor"
  - insurance-based investment products, defined as "an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations"
- Certain categories of product are expressly excluded:
  - deposits other than structured deposits (as defined in the MiFID II Directive)
  - certain "vanilla" securities that are exempted from the scope of the Prospectus Directive
  - life insurance contracts where the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or infirmity
  - non-life insurance products listed in Annex I to the Solvency II Directive
  - many occupational pension schemes and pension products which, under national law, have the primary purpose of providing the investor with an income in retirement

- EU Commission and ESAs have confirmed they will not publish a list of products that are in or out of scope but in correspondence / discussions with industry around the RTS have given guidance in some areas:
  - all derivatives are potentially in scope
  - some uncertainty around fx forwards in deliverable currencies
  - further guidance expected in Q&As
- Territorial scope of PRIIPs Regulation is also not clear on its face:
  - EU Commission has confirmed that the requirement to produce a KID for an in-scope product applies where it is sold by any entity (whether or not EU resident) to an EU retail investor
  - EU Commission has also confirmed that a KID is not required for sales of PRIIPs to retail investors situated outside the EU
  - not yet clear if/when PRIIPs Regulation will be adopted by the EEA

PRIIPs – Scope, cont'd.

PRIIPs – KID

- Regulation applies to manufacturers of, and persons advising on or selling, PRIIPs and provides that where a PRIIP is to be made available to retail investors a Key Information Document (KID) must be prepared:
  - retail investor comprises retail clients under MiFID II
- Generally, a person advising on or selling a PRIIP to retail investors must provide a KID in good time (free of charge) before he is bound by any contract or offer relating to the PRIIP
- Must be provided to the retail investor or a person with written authority to make relevant investment decisions on behalf of the investor
- Primary responsibility to draw up KID is on the PRIIP manufacturer
  - definition includes any entity that manufactures PRIIPs or that makes changes to an existing PRIIP including altering its risk and reward profile or the costs associated with an investment in a PRIIP

- KID requirements as to form and content are detailed:
  - intended to create standardised format of KID to aid comparability of pre-contractual information across different types of product
  - stand-alone document separate from any marketing materials
  - must provide key information and be consistent with the contractual documents, relevant parts of the offer documents and the terms and conditions of the PRIIP
  - to be clearly titled "Key Information Document" at the top of the first page
  - drawn-up in (or translated into) one of the official languages of the member state where the product is being sold
  - KID should be written in a concise manner, promoting comparability and be a maximum of 3 sides of A4 paper
  - can be provided on website of manufacturer with paper copy to be produced if requested
  - where applicable, must contain a "comprehension alert" that the investor is about to purchase a product that is not simple and may be difficult to understand – latest draft of RTS indicates this should be required for any "complex" product under MiFID II

PRIIPs – KID, cont'd.

- Required sections of KID include:
  - “What is this product?”
  - “What are the risks and what could I get in return?”
  - “What happens if [the PRIIP manufacturer] is unable to pay out?”
  - “What are the costs?”
  - “How long should I hold it and can I take my money out early?”
  - “How can I complain?”
- RTS contain further detail on the content requirements and provide a draft template for the KID
- Annexes to the RTS contain detailed methodology related to:
  - determination of the market risk measure (MRM) and the credit risk measure (CRM) each forming part of the “What are the risks….” section
  - the presentation of the “summary risk indicator” (SRI)
  - the presentation of performance scenarios
  - calculation and presentation of costs

PRIIPs – KID, cont’d.

- Composition of costs section:
  - must comprise both direct and indirect costs and one-off and recurring costs
  - costs should be presented using two tables:
    - costs over time (using a reduction in yield (RIY) indicator)
    - composition of costs
  - costs must be indicated in monetary and percentage terms
  - costs over time table should indicate potential exit periods for different holding periods, including the recommended holding period
- Summary risk indicator (SRI):
  - indicator uses a scale of 1 (least risky) to 7 (most risky)
  - SRI should be assigned using MRM and CRM
  - MRM measure varies by reference to 4 specified categories
  - CRM is based on credit assessment of relevant obligor by external credit assessment institutions
  - additional narrative for PRIIPs with particular liquidity or currency risks

PRIIPs – KID, cont'd.

- Performance scenarios are subject to requirements on calculations and presentation corresponding to favourable, moderate and unfavourable outcomes at recommended holding and intermediate periods:
  - the revised RTS has introduced an additional “stress” performance scenario
- RTS provide special treatment for exchange-traded derivatives given their fast-changing nature, to avoid frequent updates:
  - performance scenarios at recommended holding periods can be shown as pay-off structure graphs
- RTS provide that for PRIIPs with multiple options, one of two approaches may be selected by the manufacturer:
  - a separate KID for each option with generic information about the KID and specific information about the option
  - a single generic KID on the PRIIP and specific information on the options provided in a supplemental document which meets the KID requirements
  - if a multi option product has a UCITS fund as an underlying investment option, the manufacturer may continue to publish a KIID under the UCITS IV rules until 31 December 2019

PRIIPs – KID, cont’d.

PRIIPs – KID, cont'd.

- PRIIPs Regulation does not contain "grandfathering" provisions:
  - EU Commission has confirmed that any existing products that continue to be offered to retail investors will require a KID
- Secondary market trading:
  - any PRIIPs offered to retail investors in the secondary market will require a KID
  - uncertainty as to when PRIIPs traded in the secondary market will be regarded as available to retail investors
- UK FCA published on 18 July 2016, a consultation paper on amendments to the FCA handbook to reflect the PRIIPs Regulation:
  - FCA consultation closed on 16 September 2016

PRIIPs – Liability

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

PRIIPs and Brexit

- The PRIIPs Regulation will cease to form part of UK law following Brexit
- The GRB will reinstate provisions equivalent to the PRIIPs Regulation immediately following Brexit
- It currently seems unlikely that UK government will seek to amend the PRIIPs rules as they apply to the UK following Brexit (at least in the short term)
- PRIIPs Regulation would still apply to UK manufacturers/ distributors selling products to retail investors in the EU

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PRIIPS Update: EU Commission Adopts Revised RTS

On March 8, 2017, the European Commission adopted and published a revised Delegated Regulation relating to the Regulation on Key Information Documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs).

Background

The EU Commission had adopted the previous version of the Delegated Regulation in June 2016. The Delegated Regulation sets out detailed Regulatory Technical Standards (RTS) in relation to the content of the KID that manufacturers of PRIIPs are required to prepare under the PRIIPs Regulation and provide to retail investors, prior to any sale of a PRIIP, to those investors. Market participants and trade associations raised concerns about various aspects of the initial Delegated Regulation, and it was rejected by the European Parliament in September 2016. The EU Commission subsequently agreed to delay the implementation date of the PRIIPs Regulation by one year, to January 2018, so that the RTS could be finalized prior to the implementation date. We discuss below the principal changes made by the revised Delegated Regulation.

Comprehension Alert

Products that are "complex" products within the meaning of the MIFID II Directive (or which, in the case of insurance-based products, provide exposure to complex products) must contain in the "General Information" section of the KID, a comprehension alert in accordance with the PRIIPs Regulation. This, therefore, provides specificity as to when a comprehension alert is required. The PRIIPs regulation is silent on this point other than stating that such an alert must be provided "when applicable."

However, this approach is likely to mean that many PRIIPs will require a comprehension alert. All derivatives or products embedding a derivative are regarded as complex under MiFID II. Any product that incorporates a structure that makes it difficult for investors to understand the associated risks, or which contains any clause, condition, or trigger that fundamentally alters the nature or risk of an investment or its payment profile, will also require a comprehension alert.

Insurance-based Products

For insurance-based products, the "What is the product" section will be required to set out a summary of either the impact of the biometric risk premium on the investment return at the end of the recommended holding period of the product or the impact of the cost element of the biometric risk premium taken into account in the recurring cost element of the "Costs over time" table required to be included in the KID. For such products, this section should also include an explanation of the impact of the insurance premium payments, equivalent to the estimated value of insurance benefits, on the returns of the investment for the retail investor.

These changes therefore seem to address one of the concerns raised by the insurance industry that the aggregation of the biometric risk premium and investment costs was misleading in the context of insurance-based products and gave a misleading impression when compared with other products.

New Performance Scenario

In the "What are the risks and what could I get in return section" of the KID, an additional performance scenario is now required. In addition to the previous favorable, moderate, and unfavorable scenarios, a "stress scenario" is also required to be included in accordance with methodology set out in Annex IV to the Delegated Regulation. For the calculation of expected values for intermediate holding periods, as was previously the case, the unfavorable, moderate, and favorable scenarios shall be the estimate of the value of the PRIIP at the start of such intermediate periods consistent with the 10th, 50th, and 90th percentiles respectively. For the stress scenario, the value is to be taken at the intermediate period consistent with the percentile level that corresponds to 1% for one year and 5% for the other holding periods of the simulated distributions in accordance with the other provisions of the RTS.

Multi-Option Products and UCITS Funds

For multi-option products, where UCITS funds (or non-UCITS funds subject to an obligation to publish a Key Investor Information Document (KIID) on the same basis as UCITS funds) are an underlying investment option, the manufacturer

may, instead of complying with the requirements under the PRIIPs RTS, continue to publish a KIID meeting the requirements set out in the UCITS IV Directive until December 31, 2019.

Next Steps

The European Council of Ministers and the European Parliament must now consider the revised Delegated Regulation. The current expectation is that both these institutions will approve it well within the three-month scrutiny provided for. Once the Delegated Regulation has been adopted by the relevant institutions, it will come into force 20 days after its publication in the Official Journal of the EU. However, it will not become effective until January 1, 2018, the same date from which the PRIIPs Regulation will apply.

Observations

The amendments to the Delegated Regulation are relatively narrow. However, they do address the major concerns raised by the EU Parliament in 2016. Whether the revised version addresses all concerns raised by market participants, particularly in the insurance industry, seems more questionable. Although the EU Commission has added a stress scenario to the performance scenarios, there have been no changes to the underlying methodology used to calculate future projections and no inclusion of past performance data, which many in the insurance industry had advocated.

However, initial feedback from some members of the EU Parliament that voted against the original Delegated Regulation seems to suggest that the amendments made by the Commission, particularly the inclusion of the stress scenario, have gone a long way toward addressing their concerns. At present, it therefore seems reasonably likely that the RTS will be adopted in the form set out in the revised Delegated Regulation.

It should also be noted that European Supervisory Authorities (ESAs) are working on developing “level 3” materials, principally in the form of a Q&A, relating to technical methodologies on risk, reward, and cost disclosure requirements, calculation of costs, and the calculation of market and credit risk measures, among other issues. Although these level 3 materials were originally due to be published in mid-2016, they have been subject to significant delay. The timing is still uncertain, although market participants will hope that these are published by the end of Q2 2017 in order to give sufficient time for consideration in advance of the PRIIPs Regulation becoming effective.

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UNCERTAIN SEAS:

EUROPEAN FINANCIAL & REGULATORY DEVELOPMENTS INTO 2017

JANUARY 2017

“There are greater storms in politics than you will ever find at sea. Piracy, broadsides, blood on the decks. You will find them all in politics.”

David Lloyd George, British Prime Minister, 1916-1922

“The greater the difficulty the more glory in surmounting it. Skillful pilots gain their reputation from storms and tempests”

Epictetus

Charting New and Dangerous Waters

Lloyd George and Epictetus may be long gone but their words have much resonance with the events of 2016. The political fallout from the UK's vote to leave the European Union ("**EU**") was immediate and brutal and Lloyd George's words above could have been written for the events in the UK in the aftermath of the vote. Prime Minister David Cameron resigned immediately. Theresa May became the new UK Prime Minister after a short and dramatic Conservative Party leadership election contest, following which she swiftly sacked Chancellor of the Exchequer George Osborne and appointed Boris Johnson, not known for his diplomatic turn of phrase, as UK foreign secretary (days after he had withdrawn from the leadership race after a spectacular falling out with his fellow Brexit supporter Michael Gove). In the subsequent months, the new UK government has had to plot a course for the UK to negotiate its exit from the EU, regarded by many commentators as likely to be one of the most complex political and trade negotiations ever attempted. And this in a continuing febrile political environment with many Brexit supporters suspicious that the UK government will strike a deal with the EU that will neuter the effect of Brexit, many businesses and financial institutions concerned that a "hard" Brexit could result in a swift loss of access to the EU single market and many EU politicians keen that a hard line should be taken against the UK in negotiations to deter other member states from leaving. Financial markets, initially stunned by the result, reacted with the pound losing 15% of its value against the dollar (falling to a 30-year low), but they have subsequently stabilised although the potential for future volatility remains acute.

As if that wasn't enough, the election in November of Donald Trump to the Presidency of the United States shocked not only the political establishment in the US but almost the entire world. Again, despite some initial jitters, financial markets have remained relatively stable in the aftermath of his election but considerable uncertainty surrounds the direction of the new administration with President-elect Trump having made inconsistent statements on the stump, at times espousing protectionist views on trade whilst calling for less financial regulation and greater fiscal stimulus. We should have more clarity on some of these issues in the coming months.

Despite the uncertainty caused by the events of 2016, we can surely add the ongoing development of global financial regulation to Benjamin Franklin's two certainties of death and taxes. However, the direction of travel is perhaps now more uncertain than it has been for a while. We highlight below some of the uncertainties within the EU caused by the Brexit vote in the UK. Whilst the impact of the forthcoming Trump presidency in the US on the Dodd-Frank Act and other relevant financial regulation in the US is outside the scope of this memorandum, European regulators and legislators will keep a very close eye on the new administration's approach on financial regulation as the position becomes clearer. As we set out in more detail below, the EU has also undertaken a review on the impact of new regulation since the onset of the financial crisis and this may result in some changes to certain aspects of EU regulation. Also, looking at the political landscape, there are major presidential and governmental elections in a number of important jurisdictions in 2017 including France, Germany and the Netherlands. With populist parties growing in importance in all these elections, the outcomes will be keenly awaited.

That said, few in the EU are expecting a dramatic change in the global approach to financial regulation in the foreseeable future, and it would be a major surprise if there were a significant deviation from the coordinated approach of recent years, spearheaded primarily by the G20 group of nations ("**G20**"), the Basel Committee for Banking Supervision ("**BCBS**") and the Financial Stability Board ("**FSB**"). Therefore, for the most part, our expected developments for 2017 as set out below are a continuation of the development of rules and regulations that have already been many years in the making. However, if there has been one lesson of the last 12 months, it is that nothing is certain and the potential for further surprises remains.

In this guide we set out our summary of the principal areas of financial regulation and other important events impacting on financial regulation that have impacted markets over the recent past, as well as how we see these areas developing in 2017 and beyond.

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1. Brexit

On 23 June 2016, the UK voted in referendum to leave the EU. This outcome was generally a surprise to the financial markets and gave rise to immediate market volatility, particularly in relation to the pound, which fell heavily in value against the euro and dollar. The vote, however, has no immediate effect. The UK currently remains a member of the EU, and existing EU-derived laws and regulations continue to apply to the UK. To commence its exit from the EU, the UK government has to serve notice of its intention to leave under Article 50 of the EU Treaty. The UK then has two years to negotiate the terms of its exit with the EU. If no agreement is reached, then at the end of this period (assuming no extension is agreed), the UK will automatically leave the UK and its trading relationship with the EU will default to World Trade Organisation ("**WTO**") rules. The UK Prime Minister, Theresa May, has indicated her intention that the Article 50 notice be served by the end of March 2017. The UK Supreme Court is currently considering whether such notice can be served by the UK government under its Royal Prerogative or whether the approval of the UK Parliament is necessary. The Supreme Court's decision is expected in early 2017 but, whatever the outcome, it is not expected to have a major impact on the timing of service of the Article 50 notice.

There is considerable uncertainty as to the nature of the UK's relationship with the EU following its exit. In particular, it is currently unclear the extent to which the UK will seek, and the terms on which it will be able to agree, access to the EU single market for goods and services once it leaves the EU. Having regard to the importance of the financial services industry to the UK and the importance of London as an international financial centre, banks and other financial institutions are already considering carefully the potential implications of Brexit and, in many cases, seeking to consult with the UK government on the impact of the various options for the UK to leave the EU.

We will not consider in detail here the potential options for the future relationship between the UK and the EU. However, it currently seems unlikely that the UK will seek to remain in the European Economic Area ("**EEA**") (made up of the current 28 EU members plus Norway, Liechtenstein and Iceland). Although this option would enable the UK to retain access to the EU single market, it would continue to be bound by much existing EU law (including being bound to the free movement of people across the EEA) and continue to contribute to the EU budget, both of which were major issues for Brexit supporters. Although Theresa May has, as yet, given very little in the way of detail as to what the UK will seek from the Brexit negotiations, she has indicated the UK is likely to seek a bespoke arrangement, different from any current arrangement between the EU and any non-member state.

One of the key areas for banks and financial services firms currently located in the UK is the extent to which, following Brexit, the UK will be able to continue to benefit from the "single passport" for financial services that operates within EU member states, whereby a firm that obtains authorisation to carry out a particular financial activity or service in one EU member state can carry out that activity or service in other member states without further authorisation. In reality, there is no single EU passport for financial services, but the matter is dealt with separately in relation to each piece of relevant legislation.

Assuming the UK will not remain in the EEA, it seems unlikely that it will be able to maintain its current position in relation to passporting. There are, however, other options that could be sought in the Brexit negotiations. Many pieces of relevant EU financial services legislation enable firms located in non-EU jurisdictions to perform relevant services and activities, often on a pan-European basis, where the EU Commission has determined regulation in the entity's home jurisdiction to be equivalent to relevant rules in the EU. Although such determinations have so far taken considerable time, the UK is in a unique position since, as at the immediate point of exit, EU law will form part of UK law and therefore be, as a matter of fact, equivalent. It should not be controversial for the UK to maintain the bulk of EU financial regulation then in force as much of it derives from international accords and G20 agreements, and the UK has had an important role in the development of much existing EU law in this regard. However, not every piece of EU financial regulation includes

equivalence arrangements, including legislation relating to the provision of financial services to retail investors and new proposed rules relating to securitisation.

Having regard to their importance to the UK economy, the regulation of financial services is expected to form a central element of the negotiations with the EU. Other free trade agreements entered into by the EU, including with Canada and South Korea, took many years to negotiate and did not cover financial services in any detail, so it seems unlikely that a comprehensive arrangement can be reached between the EU and the UK in two years. An interim arrangement where the EU Commission provides an immediate equivalence determination where it can, and transitional arrangements are agreed in other fundamental areas, is more realistic. Many banks and financial institutions have already sought to persuade the UK government of the benefit of interim arrangements of this nature and in December 2016, the Chancellor of the Exchequer, Phillip Hammond, indicated that such an arrangement made sense. The issue is, however, politically sensitive, and many Brexit supporters are pushing for a "clean break" from the EU at an early stage.

It remains unclear how much transparency the UK government will be prepared to give in advance of serving the Article 50 notice as to what relationship it will seek with the EU after Brexit. It is equally unclear to what extent and on what terms the rest of EU will be prepared to negotiate continued access for the UK to the EU single market. The position is not helped by the fact that the French presidential election and German parliamentary election (amongst other elections in EU member states) will take place during 2017 and the outcome of these elections will undoubtedly have an impact on the dynamics of the Brexit negotiations.

2. EMIR Implementation

The European Market Infrastructure Regulation ("**EMIR**")[1] regulating derivatives transactions in the EU entered into force on 16 August 2012. However, much of the relevant rule-making under EMIR needs to be introduced by technical standards through delegated legislation. Although this process is well under way, some aspects of EMIR are still in the process of being introduced and this will continue into 2017 and beyond. Two areas in particular that are still not or are only just in the process of being implemented are the provisions for mandatory clearing of derivatives and the margining requirements for OTC derivative transactions that are not subject to central clearing.

Clearing

One of the central limbs of EMIR is the requirement for mandatory central clearing for derivatives entered into by financial counterparties and certain significant non-financial counterparties ("**NFCs+**"), subject to the European Securities and Markets Authority ("**ESMA**") mandating that a particular class of derivative should be subject to such requirement. The first regulatory technical standards ("**RTS**") on clearing interest rate swaps[2] provide for mandatory clearing of the following:

- fixed-to-floating (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.

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN
[2] Commission Delegated Regulation (EU) 2015/2205, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32015R2205.

The RTS divide market participants into categories in order to ensure the most active market participants are required to clear first, and Category 1 and 2 counterparties became subject to the obligation during 2016. 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.

Pursuant to further RTS[3] relating to the clearing of interest rate swaps, mandatory clearing will apply from 9 February 2017 for Category 1 counterparties in respect of fixed-to-floating rate interest rate swaps and forward rate agreements denominated in Norwegian krone, Swedish krona and Polish zloty. Category 2 counterparties will be subject to mandatory clearing in respect of such transactions from 9 August 2017, category 3 counterparties from 9 February 2018 and category 4 counterparties from 9 August 2019.

Mandatory clearing of certain credit default swap ("**CDS**") transactions will also commence in 2017, pursuant to further RTS[4]. The obligation will apply to untranched index CDS referencing the iTraxx Main and ITraxx Crossover indices with a tenor of five years from 9 February 2017 in respect of Category 1 counterparties. Category 2 counterparties will be subject to mandatory clearing in respect of such transactions from 9 August 2017, category 3 counterparties from 9 February 2018 and category 4 counterparties from 9 August 2019.

An ESMA Consultation Paper[5] published in July 2016 considers whether the implementation date for the clearing obligation in respect of financial counterparties in category 3 should be delayed by up to two years for all classes of derivatives above in view of difficulties such counterparties are having in establishing the necessary clearing arrangements. ESMA is likely to revert on this issue during 2017. ESMA confirmed back in 2015 that, for the time being, the clearing obligation will not apply to foreign exchange derivatives. There are also no current proposals to extend the obligation to any classes of equity or commodity derivatives. It is however possible that these areas will be reviewed further in the future.

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[6] and their second Consultation Paper on draft RTS[7] was published in June 2015, which, among

[3] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1178&from=EN
[4] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0592&from=EN
[5] https://www.esma.europa.eu/sites/default/files/library/2016-1125_cp_on_clearing_obligation_for_financial_counterparties.pdf
[6] http://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf
[7] http://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf

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.

Following a somewhat protracted process, the EU Commission adopted a final draft text of relevant RTS[8] (the "**Risk Mitigation RTS**") on 4 October 2016. The Risk Mitigation RTS only directly affect financial counterparties and NFCs+ that are established in the EU. However, non-EU entities that trade with EU entities that are subject to the margin requirements are likely to be obliged to put collateralisation procedures in place in order to allow their EU-established counterparties to comply with EMIR. The Risk Mitigation RTS require the posting of Initial Margin ("**IM**") and Variation Margin ("**VM**"). They also set out the eligibility criteria for assets that may be used as collateral, designed to ensure that the collateral is sufficiently liquid, not exposed to excessive credit, market or FX risk, and it holds its value during times of financial stress.

Collateral collected as IM must be segregated from the other assets of the third party or custodian that is holding it. Counterparties that collect IM are forbidden from re-hypothecating, re-pledging or otherwise re-using the collateral. There are some exemptions from the collateral requirements for transactions below certain financial thresholds and intragroup transactions complying with specified criteria. The Risk Mitigation RTS came into force on 4 January 2017. However, only the largest market participants (those trading non-centrally cleared derivatives in excess of €3trn in aggregate notional amount) will initially be subject to the rules. By September 2020, all in-scope entities trading such derivatives in excess of €8bn will be subject to the requirements.

Other aspects of EMIR and the EC Commission Report

Other provisions of EMIR that had been largely implemented prior to 2016 included trade reporting requirements for all counterparties (including non-financial counterparties ("**NFCs**") to derivative transactions and risk mitigation measures (other than margining) in respect of uncleared derivatives. On 23 November 2016, the EU Commission published a Report[9] to the European Parliament and the EU Council of Ministers that recommended a number of changes in relation to EMIR.

In particular, the Report notes that NFCs are, due to limited resources and experience, facing significant challenges in complying with relevant provisions of EMIR, and it is considered that it may be appropriate to remove such entities from the scope of the operational risk mitigation requirements and to simplify their transaction reporting obligations. The Report also recommends that consideration be given as to whether the clearing and margining requirements should apply to any NFCs based on the volume and type of their activity in derivatives markets. The EU Commission also recognises that small financial counterparties are facing significant challenges in establishing access to clearing facilitates in meeting their obligations to clear relevant derivatives. As mentioned above, ESMA has already proposed postponing the date on which the clearing obligation applies to such entities. ESMA also notes in the Report that certain pension funds currently benefit from an exemption from the EMIR clearing requirements – the EU Commission has indicated that it is likely to extend this exemption until August 2018 due to the difficulty such funds would have in meeting variation margin requirements. ESMA suggests further extending this exemption or making it permanent. Following on from this Report, the EU Commission will undertake a legislative review of EMIR in 2017 that will consider the issues raised in more depth and possibly propose relevant amendments to EMIR.

[8] https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-6329-EN-F1-1.PDF
[9] http://ec.europa.eu/finance/financial-markets/docs/derivatives/161123-report_en.pdf

3. 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**")[10] and recast Directive[11] (together with MiFIR referred to as "**MiFID II**"). MiFID II was published in the Official Journal (the "**OJ**") of the EU on 12 July 2014 and entered into force 20 days after that date.

MiFID II was originally due to become effective on 1 January 2017. However, due principally to delays in drafting and finalising a number of the many RTS required to be prepared under MiFID II, legislation was adopted in July 2016,[12] delaying the implementation date of MiFID II for a year until 3 January 2018. The deadline for member states to transpose the MIFID II Directive into national legislation was extended to 3 July 2017.

MiFID II will make some fundamental changes to MiFID, including significantly widening the regulatory capture for both financial products and entities within the EU. Structured deposits are now subject to a number of the provisions of MiFID II, and MiFID II extends the scope of many existing provisions to "organised trading facilities" or "**OTFs**" that will cover many forms of organised trading venues (not being regulated markets or multilateral trading facilities ("**MTFs**")) on which bonds, structured finance products and derivatives are traded. All derivatives that are subject to the clearing obligation under EMIR, and that ESMA determines to be sufficiently liquid, will be required to be traded on a regulated market, MTF or OTF, and MiFID II extends 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.

In addition, new product governance rules will require manufacturers of financial instruments to undertake a product approval process for each financial product and ensure that each product is designed to meet the needs of an identified target market. Distributors must have arrangements in place to obtain relevant information for products they have not manufactured and to understand the characteristics and identified target market of products they distribute. New rules in relation to inducements will severely limit the circumstances in which firms can pay or be paid fees or commissions by any party other than their client.

Many of the relevant technical standards under MiFID II have now been finalised and adopted. The Commission has published (and maintains) a table[13] providing an overview of the RTS and Implementing Technical Standards ("**ITS**") required under MiFID II and their current status. This includes, where relevant, the date the relevant technical standards were adopted by the EU Commission and the date they were published in the OJ.

Much of the focus during 2017 will be on competent authorities in member states ensuring that they are in a position to ensure compliance with MiFID II from 2018. In the UK, the Financial Conduct Authority ("**FCA**") is currently consulting on the UK implementation of MiFID II, with a deadline for comments of 4 January 2017. The FCA is expected to publish policy statements on all aspects of MiFID II implementation in the first half of 2017. Member states are required to have transposed MiFID II into national laws by 3 July 2017.

In the UK, the FCA published has published four Consultation Papers in relation to MiFID II implementation. The first published in December 2015[14] focused on secondary trading of financial

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[10] Regulation (EU) No 600/2014, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN
[11] Directive 2014/65/EU, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN
[12] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L1034&from=EN and http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1033&from=EN
[13] http://ec.europa.eu/finance/securities/docs/isd/mifid/its-rts-overview-table_en.pdf
[14] https://www.fca.org.uk/publications/consultation-papers/cp15-43-markets-financial-instruments-directive-ii-implementation

instruments including the rules relating to pre- and post-trade transparency. A further paper in July 2016[15] covered a number of issues, including commodity derivatives, supervision, senior management arrangements, remuneration and the impact of MiFID II on the Client Assets Sourcebook ("**CASS**"). In September 2016, the FCA published a third Consultation Paper[16] that principally covered conduct of business issues. These Consultation Papers propose changes to the UK Financial Services and Markets Act 2000 (the "**FSMA**")(and relevant secondary legislation) and the FCA Handbook. In relation to amendments to the FSMA, HM Treasury has also consulted on draft statutory instruments to give effect to the necessary amendments and draft statutory instruments have been published in this regard.

In its third Consultation Paper, the FCA deals with requirements in relation to MiFID II "Article 3" firms. Article 3 of MiFID II permits member states to disapply the MiFID II Directive to firms that do not have permission to hold client assets and whose activities are limited to investment advice and reception and transmission of orders (and many UK firms currently benefit from the equivalent opt out under MiFID). MiFID II requires member state rules relating to such entities to be at least analogous to the MiFID II rules relating to authorisation, conduct of business and organisational requirements. In its consultation, the FCA states that it intends to apply certain MiFID II rules directly on such firms to comply with the "at least analogous" requirement. This includes rules relating to best execution and inducements. In relation to inducements, the FCA indicates that it will apply the required restriction on inducements to both restricted and independent advice (only the latter is required to be covered under MiFID II) and will ban the rebating of inducements to retail clients. The FCA also proposes specific rules to deal with the MiFID II exemption from the restriction on inducements relating to research payments that are paid out of an investment firm's own resources or from a separate research payment account complying with certain requirements. The third Consultation Paper sets out some guidance from the FCA as how the research payments exemption should work in practice. In relation to MiFID II's rules relating to product governance, many of these are already similar to FCA guidance. The FCA proposes to replace its existing guidance with binding rules on product governance in a new sourcebook to the FCA Handbook, PROD.

The FCA published its final Consultation Paper in relation to MiFID II governance on 16 December 2016[17]. This relates to provisions in respect of tied agents, market data, SME growth markets and fees. The deadline for responses to the consultation is 17 February 2017 (16 January in respect of the provisions relating to fees). The FCA has indicated that it will publish two Policy Statements in the first half of 2017 (one in March and the second in June) dealing with the matters covered in all four Consultation Papers.

In addition to the FCA consultations, the UK Prudential Regulation Authority ("**PRA**") has also published two Consultation Papers on MIFID II implementation. The first Consultation Paper[18] published in March 2016 focused on passporting and algorithmic trading. It followed this with a Policy Statement[19] published in October 2016. The second Consultation Paper[20] published in November 2016 considers how the PRA will amend its governance requirements and how it will apply MIFID II rules on management and organisational requirements (including in relation to Article 3 firms). This second consultation is open until 27 February 2017.

[15] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp4316.pdf
[16] https://www.fca.org.uk/sites/default/files/cp16-29.pdf
[17] https://www.fca.org.uk/publication/consultation/cp16-43.pdf
[18] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp916.pdf
[19] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2016/ps2916.pdf
[20] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp4316.pdf

4. PRIIPS Implementation

The Regulation on key information documents ("**KIDs**") for packaged retail and insurance-based investment products ("**PRIIPs**")[21] ("the **PRIIPs Regulation**") was due to become effective on 29 December 2016, having come into force in December 2014. This 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. However, due to a delay in finalising the RTS setting out the detailed requirements for preparation of the KID, the implementation date has now been delayed until 1 January 2018.

Under the PRIIPs Regulation, when a person is advising on or selling a PRIIP to retail investors, a pre-contract KID must be provided to the investor prior to any contract being concluded, 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 and must be a maximum of three sides of A4. The Regulation contains detailed requirements as to the form and content of the KID, 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.

The draft RTS were first published by the ESAs in November 2015. They focused, in particular, on the presentation and content of the KID (including methodologies for calculating and presenting risks, rewards and costs), the review, revision and republication of KIDs, and the conditions for fulfilling the requirement to provide the KID in good time. The draft RTS also require each KID to contain a risk indicator scale from 1 to 7 on which PRIIPs must be ranked. The draft RTS also provide that the KID be reviewed by the PRIIP manufacturer at least every 12 months to ensure that 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. Following the consultation process, revised draft RTS[22] were published by the ESAs on 31 March 2016. The EU Commission adopted the RTS in June 2016 and proposed a draft delegated regulation to give effect to them. A workshop was also held for market participants in July 2016. However, echoing the concerns raised by a number of market participants and trade associations, the EU Parliament subsequently raised a number of issues on the draft RTS including the methodology for the calculation of future performance scenarios and the lack of detailed guidance on how the required "comprehension alert" should be structured. It formally rejected the proposed delegated regulation in September 2016, and the EU Commission subsequently agreed to the delay in the implementation date.

In its revised timetable, the EU Commission has indicated that the ESAs should submit revised RTS to it by the end of 2016, with a view to them being finalised within the first half of 2017. The EU Commission is also expected to issue further guidance on aspects of the PRIIPs Regulation and the RTS during the first half of 2017 in the form of Q&A. Although many market participants were well advanced in preparing their KID templates, the delay is generally welcome in the market. In particular, manufacturers of complex products were concerned with the prospect of the PRIIPs Regulation becoming effective without detailed guidance as to contents of the KID. The delay will give product manufacturers more time to consider fully whether and how the requirements in respect of the KID can be applied in respect of certain products.

[21] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R1286&from=EN
[22] https://www.esma.europa.eu/sites/default/files/library/jc_2016_21_final_draft_rts_priips_kid_report.pdf

5. EU Benchmark Regulation

The use of benchmarks in financial transactions has been in focus in recent years, following alleged misconduct in relation to the setting of LIBOR and other financial indebtedness. In July 2013, the International Organisation of Securities Commissions ("**IOSCO**") published a Final Report[23] on principles for financial benchmarks, and later that year the European Commission published a draft regulation in relation to indices used as benchmarks in financial contracts with the aim of reducing the risk of manipulation by ensuring that benchmark providers in the EU have prior authorisation and are subject to supervision. The subsequent legislative process was lengthy and involved significant amendments to the initial draft. The final regulation (the "**Benchmark Regulation**")[24] came into force on 30 June 2016, although most of its provisions do not become effective until January 2018.

The Benchmark Regulation takes a different approach from existing benchmark regulation in a number of jurisdictions (including the UK) that have focused principally on widely-used benchmarks. Instead, the Benchmark Regulation will apply to a very wide range of indices, including proprietary indices, which are used as benchmarks in a wider range of financial instruments or investment funds. The Regulation requires administrators of benchmarks that are located in the EU to be authorised or registered by their relevant competent authority. Such benchmark administrators are subject to a number of obligations, including governance requirements, oversight function obligations and record-keeping. Additional requirements apply to administrators of commodity and interest rate benchmarks. Benchmarks that are regarded as "critical" (determined by specified criteria, including that the benchmark is used as a reference for financial instruments having a total value of at least €500 billion) are subject to additional requirements, particularly where the administrator of such benchmark intends to cease to provide such benchmark.

The Benchmark Regulation is particularly significant for financial securities sold in the EU, as a supervised entity will only be permitted to "use" a benchmark in the EU (which includes the issuance of a financial instrument referencing a benchmark or determining the amount payable under a financial instrument or contract by reference to a benchmark) if it is provided by an administrator authorised or registered under the Benchmark Regulation. For administrators located outside the EU, the Regulation provides various routes under which they can come within the scope of the Regulation. This will generally require the administrator to be authorised in a jurisdiction with equivalent regulation or to comply with the vast majority of the provisions of the Benchmark Regulation.

In May 2016 (following on from an earlier Discussion Paper), ESMA published a Consultation Paper[25] on draft technical advice on the Benchmark Regulation that covered various aspects of the Regulation, including the circumstances in which an index will be regarded as having been made available to the public, measurements for the use of critical and significant benchmarks, and the criteria for the identification of critical benchmarks. ESMA published copies of the responses received to the Consultation Paper in July 2016. It was due to have published its final technical advice to the Commission in relation to the areas covered by the consultation in October 2016. This has not yet been published and is therefore likely to come out some time in early 2017.

ESMA published a further Consultation Paper[26] in September 2016 setting out draft RTS in relation to certain aspects of the Benchmark Regulation for which technical standards are required.
These include:

- procedures, characteristics and positioning of the oversight function;
- appropriateness and verifiability of input data;

[23] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf
[24] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1011&from=EN
[25] https://www.esma.europa.eu/sites/default/files/library/2016-723_cp_benchmarks_regulation.pdf
[26] https://www.esma.europa.eu/sites/default/files/library/2016-1406.pdf

- the code of conduct for benchmark contributors;

- information to be provided in applications for authorisation and registration as benchmark administrator; and

- procedures for the application for recognition by non-EU administrators.

Responses were due by 2 December 2016. It is expected that ESMA will submit final draft RTS to the EU Commission by April 2017, with a view to these being finalised well in advance of the 1 January 2018 implementation date.

On 11 August 2016, the EU Commission adopted an implementing Regulation that specified EURIBOR as a critical benchmark for the purpose of the Benchmark Regulation.

6. Capital Markets Union

In September 2015, the EU Commission launched its Capital Markets Union ("**CMU**") Action Plan[27], intended to cover the 28 EU member states. The CMU initiative was first suggested in response to concerns that, compared with the United States 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 United States, European small and medium-sized enterprises ("**SMEs**") receive five times less funding from capital markets.

Based on consultations that 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 that stand between investors' money and investment opportunities. The EU Commission has stated that this is a long term plan, but that it intends to have a fully functioning CMU by 2019.

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.

In April 2016, the EU Commission published a Staff Working Document[28] giving its first status report on CMU. It notes that work undertaken since the adoption of the Action Plan includes:

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

- to seek to reduce the costs for companies accessing capital markets it has sought to overhaul the legislation relating to prospectuses for offerings of securities (see further below);

- it has already sought to boost infrastructure investments by reducing the calibration of capital charges under the Solvency II Regulation for insurance sector exposures to infrastructure projects

[27] http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf
[28] http://ec.europa.eu/finance/capital-markets-union/docs/cmu-first-status-report_en.pdf

and European long-term investment funds. These changes entered into force under a delegated regulation in April 2016;[29]

- the Commission published a Green Paper[30] on retail financial services in December 2015, with a view to overcoming barriers to the creation of a deeper single market for financial services;

- it launched a consultation on business, restructuring and insolvency in the EU[31] (and subsequently, in November 2016, published a Proposal[32] for a Directive on preventative restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures);

- it has sought to strengthen supervisory convergence including through the establishment of an ESMA standing committee on supervisory convergence; and

- it has consulted in relation to the cumulative impact of financial reform in the EU (see further below).

The Working Document also set out further planned initiatives including work in relation to crowdfunding (and it subsequently published a Report[33] on this issue in May 2016), work to strengthen venture capital markets and support for small high-growth firms. Longer term projects include supporting market-led initiatives on the development of private placements of corporate debt, possible changes to the Solvency II Regulation, a further review of the covered bonds markets in the EU (see further below) and work on encouraging finance for sustainable and green investments.

The EU Commission subsequently published a Consultation Document[34] in relation to "CMU Action on Cross-border Distribution of Funds (UCITS, SIF, ELTIF, EUVECA and EUSEF) across the EU". This set out a number of questions to seek further evidence from fund managers, investors and customer representatives to assess where and how the cross-border distribution of funds could be improved.

In September 2016, the EU Commission published a further Communication[35] in respect of the CMU headed "Accelerating Reform". This stated the view that in the current political and economic context, developing stronger capital markets in the EU is even more important, it is essential to step up implementation of the CMU and to accelerate reform. It indicated a mid-term review of the CMU would be carried out by the EU Commission in 2017.

7. 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[36] 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 Commission's Consultation Document[37] published in February 2015, the EU Commission concludes that the barriers to accessing capital in the EU need lowering and that the mandatory disclosure requirements under the Prospectus Directive are particularly burdensome. Therefore, the

[29] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0467&from=en
[30] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0630&from=EN
[31] http://ec.europa.eu/newsroom/just/item-detail.cfm?item_id=30544
[32] http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf
[33] http://ec.europa.eu/finance/general-policy/docs/crowdfunding/160428-crowdfunding-study_en.pdf
[34] http://ec.europa.eu/finance/consultations/2016/cross-borders-investment-funds/docs/consultation-document_en.pdf
[35] http://ec.europa.eu/finance/capital-markets-union/docs/20160913-cmu-accelerating-reform_en.pdf
[36] http://eur-lex.europa.eu/resource.html?uri=cellar:036c16c7-9763-11e5-983e-01aa75ed71a1.0006.02/DOC_1&format=PDF
[37] http://ec.europa.eu/finance/consultations/2015/prospectus-directive/docs/consultation-document_en.pdf

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:

- 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);

- the doubling of 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;

- a shorter, clearer prospectus summary emphasising only material risk factors;

- a fast-track approvals process for frequent issuers via a 'Universal Registration Document' (the "**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.

In September 2016, the EU Parliament adopted PD III with some amendments, including:

- a proposed amendment to the current exemption where offers are to fewer than 150 persons per member state so that the exemption will apply where an offer is to less than 350 persons per member state and no more than 4,000 persons in the EU in aggregate;

- an exemption where the offer raises less than €1 million over a 12-month period. Member states will also be able to exempt offers where the total consideration of the offer in the EU does not exceed €5 million over a 12-month period;

- in exceptional circumstances, a competent authority may permit summaries of up to 10 pages (rather than 6) where the complexity of the issuer's activities so requires.

It is understood that the EU Parliament, EU Council of Ministers and the EU Commission have now reached political agreement as to the terms of the Regulation. The final version should therefore be published sometime early in 2017, and it is expected that the Regulation will come into force sometime during 2017. It is believed that agreed amendments to the previous draft include:

- the wholesale disclosure regime, including exemption from the summary requirement, will be available for prospectuses relating to the admission to trading of securities on a regulated market that can only be traded on a regulated market or that have a minimum denomination of €100,000;

- some amendments to the provisions on risk factors. Risk factors will still be required to be presented in a limited number of categories with the most material risk factors being listed first in each category; and

- removal of the EU Commission's requirement for a representative to be appointed by non-EU issuers.

The draft Regulation provides that it will come into effect 12 months after it is published in the OJ. It is, however, believed that this period may be extended to two years in the final version of the Regulation. In this case, the provisions would not become effective until sometime in 2019 at the earliest.

8. EU Securitisation Regulation

Securitisation has 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.

In connection with the CMU, on 30 September 2015, the EU Commission published a legislative proposal for a "Securitisation Regulation"[38] 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 UCITS label. According to the EU Commission, the development of an 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 principal 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 in relation to securitisation 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.

To achieve the second goal, the Securitisation Regulation seeks to create a framework for STS securitisations and aims to provide clear criteria for transactions to qualify as STS securitisations. These include residential mortgage-backed securities ("**RMBS**"), auto loans/leases and credit card transactions, whereas actively managed portfolios (for example, CLOs), resecuritisations (for example, CDOs and SIVs) and structures, which include derivatives as investments, have been specifically prohibited. 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.

The proposed Securitisation Regulation has made slow progress during 2016, and the timing of the Regulation being adopted and finalised is not yet clear. Although the ECB and the EBA support the Securitisation Regulation, some members of the European Parliament have expressed concern at efforts to reinvigorate the securitisation markets. The European Parliament's Committee on Economic

[38] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015PC0472&from=EN

and Monetary Affairs ("**ECON**") has prepared reports seeking various amendments to the proposals. In particular, Paul Tang, the EU parliament's rapporteur in relation to the draft Regulation has sought to make amendments to the "risk retention" requirements currently set at 5% in CRD IV (as defined below). He has proposed increasing the requirement to 20%. Many in the securitisation industry believe this would have a detrimental effect on securitisations and run counter to the stated aims of the CMU in this regard. Other proposed amendments include requirements for further disclosures by originators, sponsors and original lenders of loan-level data through the European Securitisation Data Repository and a requirement for a third-party certification of a transaction's compliance with the STS requirements. Some MEPs are also seeking to change the minimum capital requirements for STS securitisations in the CRR from the 10% proposed in the draft Regulation to 13%.

It is expected that the European Parliament will vote on the proposed Securitisation Regulation and amendments in plenary session early in 2017. It is not yet clear when it will be possible to have political agreement between the EU Parliament, the EU Commission and the EU Council of Ministers. However, the Securitisation Regulation remains an important element of the CMU initiative, and the EU Commission is likely to seek to get the legislation finalised during 2017 if possible.

9. BRRD Implementation

Having come into force in July 2014, the Bank Recovery and Resolution Directive[39] ("**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. The bail-in tool is most likely to be used to resolve banks that are systemically important – whether on a global basis or a domestic basis.

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 total loss-absorbing capacity ("**TLAC**") rules referred to below (in that they provide for each EU national resolution authority to prescribe, for each bank under its jurisdiction, a minimum level of loss-absorbing capital and liabilities to be held by the bank, that can credibly be bailed-in in a bank resolution situation). These MREL provisions will apply to EU banks on top of the minimum regulatory capital requirements and capital buffer requirements that have been prescribed by the CRR.

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

This Article also became effective from 1 January 2016, and it has given rise to a flurry of activity for EU banks in explaining this obligation to their non-EU counterparties and obtaining their agreement

[39] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN

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 2017, until counterparties become familiar with the requirement and its implications.

On 23 November 2016, the European Commission released a package of proposed legislative reforms to the BRRD, primarily focused on the setting of MREL for global systemically important institutions ("**GSIIs**") and for non-GSIIs, but also proposing changes to Article 55 of BRRD and a new pre-resolution power of suspension. These proposals consist of a draft Regulation[40] to amend the CRR, a draft directive amending the BRRD in relation to MREL[41], a draft second directive amending BRRD in respect of the insolvency ranking of certain liabilities[42]and a draft regulation[43] amending the SRM Regulation (see below).

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

In addition to Article 55 and the MREL provisions discussed below, the European Commission also proposed an additional power for resolution authorities to intervene early in a bank's decline, in the form of the ability to suspend any payment or delivery obligation of a bank for up to five working days. However, excluded from this power are obligations owed to central clearing counterparties, payment and securities settlement systems and deposits covered by a deposit guarantee scheme, as well as eligible claims under investment compensation schemes.

The European Commission's proposals will now be considered by the European Parliament and the EU Council during 2017.

10. TLAC/MREL

On 9 November 2015, the FSB published its final principles on the amount of loss absorption capacity to be held by global systemically important banks ("**GSIBs**")[44]. 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.[45] 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 continue to be so designated thereafter, 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

[40] http://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF
[41] http://ec.europa.eu/finance/bank/docs/crisis-management/161123-proposal-directive-recapitalisation-capacity_en.pdf
[42] http://ec.europa.eu/finance/bank/docs/crisis-management/161123-proposal-directive-unsecured-debt-instruments_en.pdf
[43] http://ec.europa.eu/finance/general-policy/docs/banking-union/single-resolution-mechanism/161123-proposal-regulation_en.pdf
[44] http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf
[45] http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf

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 capital, other than Common Equity Tier 1 capital, or Tier 2 capital held towards a GSIB's minimum capital requirements also can 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 that cannot be bailed-in without risk of a successful legal challenge or compensation claim from the relevant creditor.

2016 has seen the beginning of efforts to implement the TLAC principles into national legislation. In Europe, the Bank of England issued its Statement of Policy[46] on setting MREL for UK banks on 8 November 2016. In addition, the European Commission set out its legislative proposals (as mentioned in "BRRD Implementation" above) for the setting of MREL on 23 November 2016, by way of proposed amendments to BRRD and to the Capital Requirements Regulation. 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. Currently, they are 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, the European Commission now proposes that MREL should be set as a ratio both of risk-weighted assets and of the bank's leverage ratio denominator. For GSIBs, the minimum MREL will mirror the FSB's minimum TLAC requirements mentioned above, although there is to be no minimum level of MREL established for non-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 final form of the BRRD when this is amended

[46] http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelpolicy2016.pdf

pursuant to the above legislative proposals, as supplemented by the final RTS on setting MREL, as adopted by the European Commission and published in the OJ on 3 September 2016[47]. 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 UK, the Bank of England has stated in its Statement of Policy that it intends to use its MREL-setting powers to reflect the FSB's TLAC principles in relation to UK-based GSIBs.

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. The Bank of England also proposes that MREL liabilities for UK GSIBs should be subordinated to senior operating liabilities of the relevant bank. This is not required by the current form of BRRD, but it will be required for GSIBs if the European Commission's new legislative proposals are implemented as drafted. For non-GSIBs, the legislative proposals intend that NRAs will have the final decision on whether subordination of MREL-eligible liabilities should be required.

The issue of subordination of certain liabilities, in the context of MREL and TLAC, is and will remain throughout 2017, a controversial subject. Under the FSB principles, TLAC-eligible liabilities are required to be subordinated to other unsecured liabilities that cannot be bailed-in or are unlikely to be bailed-in during 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, deposits in particular, 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 a level of subordination for MREL-eligible liabilities. For instance, the UK envisages that structural subordination will be employed. This entails MREL liabilities being issued from a holding company that has no MREL-excluded liabilities that rank junior or *pari passu* to its MREL liabilities. In contrast, Germany is in the process of enacting legislation which will provide that certain existing and future bank bonds are automatically subordinated to depositors and other unsubordinated liabilities. In turn, France is in the process of enacting a law that provides for a new class of "non-preferred senior debt," which would rank junior to other senior debt, but senior to regulatory capital.

The European Commission has proposed that all member states should provide for a new class of non-preferred senior debt, along the lines being enacted in France. However, these European Commission proposals represent only one of the possible methods of achieving subordination, and 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. We expect further developments in this regard during 2017.

Intermediate Holding Companies

One of the most controversial proposals in the draft November 2016 legislative proposals of the European Commission was to amend the CRD IV Directive, by way of a draft directive,[48] to require the establishment of EU intermediate holding companies ("**IHCs**"). An IHC would be required where a non-EU banking group has at least two subsidiaries in the EU that are banks or investment firms, in circumstances where the total value of all EU assets of the non-EU banking group (including for this

[47] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1450&from=EN
[48] http://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-854-F1-EN-MAIN.PDF

purpose assets of all EU branches and subsidiaries) is at least EUR30 billion, or where the non-EU banking group is a GSIB.

It seems that such IHC would need to comply with the capital, liquidity and other CRR requirements, as well as the eventual MREL requirements, on a consolidated basis.

This proposal has been explained by the Commission as a natural continuation of bank resolution plans, though some commentators have explained this proposal in different terms – a "tit-for-tat" measure aimed at creating in Europe a similar regime for foreign banks as exists in the United States or, alternatively, a measure designed to make life difficult, post-Brexit, for UK banks with substantial EU business.

11. 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[49]) 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. As mentioned in "BRRD Implementation" above, the European Commission, in November 2016, proposed various changes to the BRRD, and, at the same time, it also proposed various changes to the SRM Regulation, which were designed to keep its provisions consistent with the BRRD.

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.

[49] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0806&from=EN

The EU Council of Ministers confirmed that they had no objections, and assuming the European Parliament raises no objections, it will enter into force 20 days after its publication in the OJ of the EU.

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.

12. CRD IV/Basel III

The Basel III reforms, in the form of the Capital Requirements Regulation ("**CRR**")[50] and the CRD IV Directive[51] (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 net 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[52] in relation to the LCR mandated by the Basel III framework, containing detailed provisions for the ratio that 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, following the EBA Report[53] in relation to the introduction of the NSFR in the EU, the European Commission's November 2016 legislative proposals to amend CRR (see "BRRD Implementation" above) now include a proposal for a binding NSFR. These proposals closely match the Basel III NSFR provisions, but they differ in some

[50] Regulation (EU) No. 575/2013, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN.
[51] Directive 2013/26/EU, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN.
[52] http://ec.europa.eu/finance/bank/docs/regcapital/acts/delegated/141010_delegated-act-liquidity-coverage_en.pdf.
[53] https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-22+NSFR+Report.pdf

respects, such as the RSF factors assigned to certain assets. These differences will be reviewed by the Commission within the first three years of operation of the NSFR.

The above legislative proposals will be considered by the European Parliament and the EU Council during the first half of 2017 and, if approved, are currently intended to become applicable two years after the entry into force of the legislative changes.

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 the draft legislation published by the EU Commission tentatively envisages the NSFR requirement becoming applicable two years after the amends to the CRR enter into force.

Leverage Ratio

The leverage 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 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.

Following on from the Report[54] of the EBA on the impact and effectiveness of the leverage ratio, the European Commission's November 2016 legislative proposals to amend CRR (see "BRRD Implementation" above) now include a proposal for a binding leverage ratio. These proposals closely match the Basel III leverage ratio provision, including the minimum 3% calibration.

The above legislative proposals will be considered by the European Parliament and the EU Council during the first half of 2017 and, if approved, are currently intended to become applicable two years after the entry into force of the legislative changes.

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 consist of (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 may 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 the buffer requirements will be fully implemented by 1 January 2019. In December 2015, the EBA published an Opinion[55] 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. Under the European Commission's proposed changes to CRDIV, a differentiation is made between Pillar 2 requirements on own funds and Pillar 2 guidance on own funds. It is proposed that a failure to comply with the latter will not reduce the maximum distributable amount.

Under CRD IV, national competent authorities must assess GSIIs and other systemically important institutions ("**OSIIs**"). Each GSII will be placed into one of five sub-categories. CRD IV imposes an additional buffer for each GSII of between 1% and 3.5% of RWAs. Competent authorities will also

[54] http://www.eba.europa.eu/documents/10180/1360107/EBA-Op-2016-13+%28Leverage+ratio+report%29.pdf
[55] https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-24+Opinion+on+MDA.pdf

have the discretion to impose a buffer on OSIIs of up to 2% 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 GSII buffer and the OSII buffer. Only the highest will apply to a firm.

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. 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[56] 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 must 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 must be applied to all institutions.

In December 2015, the EBA published an Opinion[57] on the application of the proportionality principle. It also published a Final Report on its Guidelines in relation to the CRD IV remuneration requirements.[58] The revised Guidelines will come into force on 1 January 2017 and will apply on a "comply or explain" basis, i.e. national competent authorities will have to state whether they intend to comply with the Guidelines and, if not, the reason for not doing so. However, in February 2016, the UK's PRA and FCA issued a joint statement that they had notified the EBA that they would not automatically impose the bonus cap on all UK firms and that they consider the imposition of a bonus cap is subject to the proportionality principle.

In the Opinion, the EBA repeated its view in relation to the proportionality principle stated above. It also proposed amendments to CRD IV that would permit smaller and less complex firms to disapply the requirements in relation to deferral and payment in instruments, as well as for these requirements

[56] http://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-10+Opinion+on+remuneration+and+allowances.pdf
[57] https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-25+Opinion+on+the+Application+of+Proportionality.pdf
[58] https://www.eba.europa.eu/documents/10180/1314839/EBA-GL-2015-22+Guidelines+on+Sound+Remuneration+Policies.pdf/1b0f3f99-f913-461a-b3e9-fa0064b1946b

to be waived for staff who receive low levels of variable remuneration. These proposals have been adopted by the European Commission in its November 2016 legislative proposals to amend the CRD IV Directive (see "BRRD Implementation" above).

However, neither the Opinion nor the European Commission's legislative proposals have suggested 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). However, no change has been made by the FCA or the PRA to their position on the bonus cap since February 2016, and in September 2016, the FCA consulted on proposals to amend the FCA Handbook to be consistent (in most cases) with the Guidelines, and this consultation closed in November 2016. The FCA consultation restated the position that smaller UK firms would have discretion to disapply the bonus cap, where relevant.

13. UK Ring-fencing

The UK's Financial Services (Banking Reform) Act 2013 requires retail banking services to be ring-fenced from other bank activities. The base legislation has now been in force for some time in the UK, but the precise details of exactly what will be required to comply with the new ring-fencing regime, by its proposed implementation date of 1 January 2019, are to be provided by secondary legislation to be passed by the UK Treasury. Over the course of 2016, there have been various developments in such secondary legislation, some of which are intended to assist UK banks in making more definitive plans as to how to reorganise their businesses. Furthermore, the PRA and Bank of England were particularly active in 2016 in publishing consultation papers and statements relating to ring-fencing.

What is known is that the ring-fenced retail entity can remain as part of the broader banking group, so long as it is functionally and legally separated. The legislation will catch firms that, on a three-year average period, hold more than £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 ("**RFBs**," each an "**RFB**") will be subject to stand-alone prudential rules, including minimum capital requirements, leverage ratios, liquidity ratios and risk buffers.

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

The Financial Services and Markets Act 2000 (Ring-fenced Bodies, Core Activities, Excluded Activities and Prohibitions) (Amendment) Order 2016 (SI 2016/1032)[59] ("**Amendment Order**") came into force on 1 December 2016. The Amendment Order made various technical amendments to the Financial Services and Markets Act (Ring-fenced Bodies and Core Activities) Order 2014 (the "**Core Activities Order**") and the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (the "**Excluded Activities Order**"). According to an undated memorandum by the UK Treasury, published in October 2016,[60] among other considerations, the purpose of these legislative developments is to ensure legislative consistency, provide greater clarification, mitigate unintended consequences, remove unnecessary and administrative logistical burdens and strengthen the "resolution toolkit."

The Amendment Order, inter alia, allows an RFB to hedge the risks of another entity in its ring-fenced sub-group, amends the definition of liquidity risk in the Excluded Activities Order to allow an RFB to hedge the liquidity risks of its subsidiaries or financing vehicles and removes the

[59] http://www.legislation.gov.uk/uksi/2016/1032/pdfs/uksi_20161032_en.pdf
[60] https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/Amendments-Explanation.pdf

requirement for larger corporate depositors to complete a "qualifying declaration" (before a bank can move their account to a non-ring fenced bank ("**NRFB**")) and instead requires banks to reach a determination as to whether a customer is eligible to be moved to the NRFB.

In March 2016, the PRA published a policy statement on ring-fencing transfer schemes[61] ("**RFTSs**") and a final statement of policy in respect of its approach to RFTSs.[62] In the same month, the FCA also published its final guidance on how it will approach RFTSs.[63] Without requiring affected parties' consents, an RFTS allows a bank to transfer all or part of its business to another body, in order to comply with the ring-fencing regime. It is the PRA's responsibility, after consultation with the FCA, to (i) approve the skilled person who is appointed to make a related scheme report, and (ii) approve the scheme report itself.

In July 2016, the PRA published a policy statement relating to prudential requirements, intra-group arrangements and the use of financial market infrastructures.[64] Furthermore, the PRA published a new webpage relating to ring-fencing, providing information on applications that firms should submit to the PRA (including on applications for the approval of a skilled person relating to preparing a scheme report for a ring-fencing transfer scheme[65] and applications for permission to indirectly participate in inter-bank payment systems).[66]

At the end of January 2016, the Financial Policy Committee of the Bank of England (the "**FPC**") published a Consultation Paper (the "**FPC Consultation Paper**")[67] 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 ("**SRiB**") is intended to apply, inter alia, to RFBs and is part of the UK's framework for identifying and setting higher capital requirements for domestic systemically important banks.

The FPC Consultation Paper sets out the FPC's proposals that each RFB 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. After the FPC's consultation (in respect of the FPC Consultation Paper) closed in April 2016, the FPC then published its framework for the systemic risk buffer in May 2016[68] ("**FPC Framework**"), with broadly the same proposals that were set out in its FPC Consultation Paper. The amount of required additional Tier 1 capital will range from a SRiB rate of 1% for banks with total assets of £175 billion or greater to a SRiB rate of 3% for banks with total assets of £755 billion or greater (although the FPC expects that the largest ring-fenced banks will have an initial SRiB rate of 2.5%). A 3% minimum leverage ratio requirement and an additional leverage ratio buffer of 35% of the relevant SRiB rate ("**ALRB**") will be applicable to firms subject to the SRiB. According to the FPC, the SRiB (including through its impact on the ALRB) is expected to add around 0.5% of RWAs to equity requirements of UK systemic banks overall.

The FPC Framework recommended that the PRA should ensure that, where systemic buffers apply at different levels of consolidation, there is sufficient capital within the consolidated group, and distributed appropriately across it, in order to address both global systemic risks and domestic systemic risks. The PRA published a consultation paper in July 2016 ("**PRA CP25/16**,")[69] stating its intention to comply with such recommendations and that it would increase the PRA buffer at the group consolidated level where the applicable SRiB rate at the RPB sub-group level exceeds the GSIB buffer rate applied at the group consolidated level.

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[61] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2016/ps1016.pdf
[62] http://www.bankofengland.co.uk/pra/Documents/publications/sop/2016/rftssop.pdf
[63] https://www.fca.org.uk/publication/finalised-guidance/fg16-1.pdf
[64] http://www.bankofengland.co.uk/pra/Documents/publications/ps/2016/ps2016.pdf
[65] http://www.bankofengland.co.uk/pra/Pages/authorisations/rfts/default.aspx
[66] http://www.bankofengland.co.uk/pra/Pages/authorisations/structuralreform/indirect.aspx
[67] http://www.bankofengland.co.uk/financialstability/Documents/fpc/srbf_cp.pdf
[68] http://www.bankofengland.co.uk/financialstability/Documents/fpc/srbf_cp260516.pdf
[69] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp2516.pdf

In PRA CP25/16, the PRA also set out reporting requirements applicable to RFBs. Proposals included: (i) extension of non-CRR reporting requirements to an RFB sub-group (as these currently only apply on a consolidated basis to banking groups affected by ring-fencing); (ii) a RFB sub-group must report transactions with group entities outside of its RFB sub-group; and (iii) reporting requirements to monitor an RFB's use of exceptions to excluded and prohibited activities under the Excluded Activities Order and extent of adherence to certain PRA supervisory statements. PRA CP25/16 also recommends making amendments to ring-fencing notifications, which would require RFBs to provide specification notifications in respect of the core deposit level condition.

The PRA published a statement of policy ("**SoP**") on 5 December 2016[70] based on an earlier draft as published in July 2016. The SoP sets out how the PRA will approach the implementation of the SRiB and the FPC Framework. The SRiB rates to be set by the PRA are expected to be announced in early 2019 and the PRA will apply these rates three months following the announcement. Once these initial SRiB rates are applied, the PRA will then apply the FPC Framework on an annual basis. The PRA also affirms that SRiB institutions cannot use capital maintained to meet the SRiB to meet any other capital requirements or buffers. The PRA plans to review the SoP in 2018 (after the review of the FPC Framework). It is expected that the PRA will publish another policy statement in the first half of 2017 relating to ring-fencing rules that it consulted on in the PRA CP25/16.

The SRiB is proposed to apply in tandem with the implementation date for the ring-fencing regime.

In its Occasional Consultation Paper as published in October 2016 ("**OCP**")[71], the PRA also set out proposed changes to certain parts of the PRA Rulebook. In relation to the chapter on Ring-fenced Bodies and Notifications Parts, and the Rulebook Glossary, the consultation closed on 12 December 2016. The OCP sets out proposals for consequential amendments to the ring-fencing rules and amendments to the reporting templates and instructions for monitoring the use of exceptions in the Excluded Activities Order.

Following the publication of its July 2015 consultation paper on disclosures that non-RFBs should make to customers that are individuals, the FCA published near-final rules in a policy statement in March 2016 and then published its final rules in November 2016. These came into force on 1 December 2016.[72]

14. Possible EU Banking Reform

As we noted in our client alert "From EMIR To Eternity?" that was published in 2015[73], the draft Regulation[74] 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 2017 and will attempt to reach political agreement with the Council in the latter part of 2017. 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.

[70] http://www.bankofengland.co.uk/pra/Documents/publications/sop/2016/srbapproach.pdf
[71] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp3616.pdf
[72] https://www.fca.org.uk/publication/handbook/handbook-notice-38.pdf
[73] http://www.mofo.com/~/media/Files/ClientAlert/2015/01/150105FromEMIRtoEternity.pdf
[74] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0043&from=EN.

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 certainly need to change.

15. AIFMD

The Alternative Investment Fund Managers Directive[75] (the "**AIFMD**") and its supplementary Regulation came into effect in the EU in July 2013 and introduced a centralised rulebook for the management and marketing of alternative investment funds ("**AIFs**") within the EU by alternative investment fund managers ("**AIFMs**").

The concept of an AIF is fairly broad and is defined as a collective investment undertaking (including investment compartments thereof) that 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 that 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 AIF 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 apply only 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 marketing EU AIFs. It was hoped that the passporting regime for non-EU AIFMs would come into play as early as 2015, but even now this has not yet happened. The extension of the AIFMD passport depends on the recommendations of ESMA, and ESMA has provided its advice and opinion to the European Commission in this regard on a country-by-country basis, even though it is unclear whether (under the AIFMD itself) it is possible to extend the passport on a country-by-country basis.

Despite a positive recommendation from ESMA in July 2016 (which was updated in September 2016) for the extension of the passport to Canada, Guernsey, Japan, Jersey and Switzerland ("**ESMA 2016**

[75] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF

Advice,")[76] the EU Commission has not yet adopted the delegated act specifying when the passporting regime will become effective for these, or any, jurisdictions.

Although ESMA concluded in the ESMA 2016 Advice that there are no significant obstacles to extending the passport regime to Hong Kong and Singapore, ESMA did express concerns about limited access of UCITS to retail investors in these jurisdictions. Furthermore, ESMA concluded that there are no significant obstacles relating to market disruption and obstacles to competition if the passport were to be extended to Australia, provided that the Australian Securities and Investment Committee extends to all EU member states the "class order relief" from some requirements of the Australian regulatory framework.

In terms of investor protection and monitoring systemic risk, ESMA found no significant obstacles in extending the passport to the United States of America, and ESMA noted that it did not find any significant obstacles for funds marketed by managers to professional investors so long as they do not involve any public offering. However, to the extent that funds are marketed by managers to professional investors, which do involve a public offering, it concluded that there is a risk of an "un-level playing field" between EU and non-EU AIFMs if the passport were to be extended to the United States of America.

In the ESMA 2016 Advice, ESMA was unable to provide any advice relating to Bermuda or the Cayman Islands. This is because both jurisdictions are currently in the process of adopting new regimes. Additionally, ESMA found it difficult to assess investor protection in the Isle of Man (as there is an absence of any AIFMD-like regime).

In preparing the ESMA 2016 Advice, ESMA also gathered intelligence on Malaysia, Egypt, Chile, Peru, India, China and Taiwan in relation to investor protection, competition, potential market disruption and monitoring of systemic risk. ESMA set out its intention to agree a memorandum of understanding with the authorities of these jurisdictions in future. At the time of delivering the ESMA 2016 Advice, ESMA found that the current level of activity by entities from these countries within the EU did not justify a detailed assessment. Nonetheless, ESMA intends to both monitor the evolution of the level of activity between these jurisdictions and consider whether a particular jurisdiction should be assessed in detail.

On 11 October 2016, ESMA's Chair, Steven Maijoor made an opening statement to the Economic and Monetary Affairs Committee ("**SM Statement**,")[77] which detailed ESMA's next steps. Firstly, ESMA aims to continue its assessment of Bermuda and Cayman Islands in order to determine whether there is scope to extend the passport to those countries. Secondly, ESMA plans to assess another group of non-EU countries after receiving further clarity from the co-legislators as regards next steps. Thirdly, ESMA is looking to focus on setting up the framework foreseen by co-legislators should the passport be extended to one or more non-EU countries (and ESMA would therefore be required to prepare itself for the role as an overseer of such system).

As set out in our client alert "Extension of the AIFMD Passport to Non-EU Managers",[78] the intention of the AIFMD is that a non-EU AIFM in a jurisdiction to which the passport is extended will, for a period of three years, have the option of either becoming authorised in its EU member state of reference and using the passport to market or manage funds throughout the rest of the EU or, alternatively, continuing to use the individual national private placement regimes ("**NPPRs**") of those EU member states in which it wishes to market its AIFs. However, after that three-year period, the expectation is that, at least for AIFMs in those non-EU jurisdictions that have the benefit of the passport, NPPR regimes shall cease to be available. It is also possible that certain individual member states will

[76] https://www.esma.europa.eu/press-news/esma-news/esma-advises-extension-funds-passport-12-non-eu-countries
[77] https://www.esma.europa.eu/sites/default/files/library/2016-1459_econ_hearing_aifmd_passport_steven_maijoor_opening_statement.docx
[78] https://media2.mofo.com/documents/160728extensionoftheaifmd.pdf

withdraw their NPPR, and Germany, for instance, has already indicated that it will do so once the passport has been extended.

Furthermore, the consequences of the United Kingdom's Brexit vote on 23 June 2016 could potentially require (depending on the United Kingdom's future post-Brexit relationship with the EU) United Kingdom-based AIFMs to be treated as those of a non-EU country. Therefore, UK AIFMs may, post-Brexit, be required to (a) use individual NPPRs of EU member states (if NPPRs for such member state(s) is/are still available by then); (b) become authorised in a (non-UK) member state of reference to be eligible for the passport, if the passport is extended to the UK as a third country; or (c) if the passport is not extended to the UK as a third country, have a registered office in a (non-UK) member state to be authorised as an EU AIFM. Given the level of implementation of EU law throughout the United Kingdom as part of its EU membership (both historic and current), it would be unsurprising if UK AIFMs were to become eligible for the passport.

In March 2016, ESMA published its final report on guidelines on sound remuneration policies under the UCITS Directive and the AIFMD.[79] The amended AIFMD guidelines came into force on 1 January 2017, and the amendments relate to the application of remuneration rules in a group context (and are intended to acknowledge the potential outreach of CRD IV rules in a banking group).

ESMA published a call for evidence on asset segregation and custody services under the AIFMD and UCITS V in July 2016[80] and the responses to the call for evidence in October 2016.[81] ESMA will consider such feedback with a view to finalising its work on asset segregation and had intended to finalise such work by the end of 2016. However, this has not yet happened.

ESMA has also made various amendments to its Q&A on the application of the AIFMD[82] (of which the latest draft was published on 16 December 2016). These updates relate to, inter alia, notification requirements relating to AIFs; reporting to national competent authorities under Articles 3, 24 and 42 delegation; and the impact of EMIR on 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.

The United Kingdom's FCA also published some final guidance for depositaries of AIFs,[83] which they consulted on in their March 2015 quarterly consultation paper CP15/8.[84]

16. 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.[85] 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.

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[79] https://www.esma.europa.eu/sites/default/files/library/2016-411_final_report_on_guidelines_on_sound_remuneration_policies_under_the_ucits_directive_and_aifmd.pdf
[80] https://www.esma.europa.eu/sites/default/files/library/2016-1137_call_for_evidence_asset_segregation.pdf
[81] https://www.esma.europa.eu/press-news/consultations/call-evidence-asset-segregation
[82] https://www.esma.europa.eu/sites/default/files/library/2016-1669_qa_on_aifmd.pdf
[83] https://www.fca.org.uk/publication/policy/ps16-02.pdf
[84] https://www.fca.org.uk/publication/consultation/cp15-08.pdf
[85] See "Shadow Banking: Scoping the Issues", http://www.financialstabilityboard.org/wp-content/uploads/r_110412a.pdf.

In November 2016 the FSB published its workplan for 2017.[86] This stated that the FSB has agreed that it will undertake by July 2017 an assessment of progress in transforming shadow banking into resilient market-based finance. This will include an assessment of the evolution of shadow banking activities since the global financial crisis and related financial stability risks and whether the policies and monitoring put in place by FSB members since then are adequate to address these risks.

The EU Commission has also identified resolving the issues surrounding shadow banking as a priority and published its "Communication"[87] 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 shadow banking areas, in respect of which there has been considerable work in the EU legislative context during the last two years or so, have been securities financing transactions and money market funds. The current status of each is as follows:

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[88] 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 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 (the "**SFT Regulation**"),[89] and the SFT Regulation came into force on 12 January 2016. 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 reporting obligations will be phased in, the timing dependent upon the nature of the relevant counterparty. Investment firms and credit institutions will be subject to the obligation 12 months after the relevant RTS enter into force. The obligation comes into force 15 months after such date for Central Securities Depositaries and CCPs, 18 months after such date for all other financial counterparties and 21 months after such date for all other counterparties. On 30 September 2016, ESMA published a Consultation Paper[90] in relation to draft RTS and ITS under the SFT Regulation.

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[86] http://www.fsb.org/wp-content/uploads/Financial-Stability-Board-agrees-2017-workplan.pdf
[87] http://ec.europa.eu/internal_market/finances/docs/shadow-banking/130904_communication_en.pdf.
[88] http://www.fsb.org/wp-content/uploads/SFT_haircuts_framework.pdf
[89] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R2365&from=EN
[90] https://www.esma.europa.eu/sites/default/files/library/2016-1409_sftr_consultation_paper_-_draft_rts_and_its_under_sftr_and_amendments_to_related_emir_rts.pdf

ESMA indicates that following the completion of the consultation by the end of 2016, it will submit final draft RTS to the EU Commission during the first half of 2017. It therefore seems unlikely that the RTS will come into force until towards the end of 2017 at the earliest, and, in that case, the reporting obligations would not come into force until late 2018.

On 4 October 2016 ESMA published a Report[91] on securities financing transactions and leverage in the EU. The Report makes a number of recommendations including that:

- the FSB qualitative standards[92] on the methodology used to calculate haircuts in non-centrally cleared SFTs should be introduced to improve the transparency and stability of haircuts and the resilience of financial institutions;

- the procyclicality of collateral haircuts used by CCPs should be addressed in the context of the upcoming EMIR review;

- the numerical haircut floors for non-centrally cleared transactions should only be introduced and calibrated following a thorough analysis and careful assessment of the scope, considering in particular the size and relevance of EU government bond markets;

- other macroprudential instruments, including counter-cyclical ones, should be agreed at international level first, and they should only be introduced after a careful assessment that existing measures do not limit the leverage in the system.

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[93] and October[94] 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 US Securities and Exchange Commission ("**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[95] ("**MMF Regulation**") which will introduce a framework of requirements to enhance the liquidity and stability of MMF funds. Progress on the draft Regulation has been slow with concerns raised about fundamental aspects of the draft including the proposed imposition of a capital buffer of 3% for constant NAV funds. Many in the industry believed this would make such funds uneconomic.

On 7 December 2016, the EU Council of Ministers announced that it reached an agreement with the EU Parliament on the terms of a revised MMF Regulation and published the agreed compromise text.[96] Key elements in the MMF Regulation as amended in principle following such negotiations are:

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[91] https://www.esma.europa.eu/sites/default/files/library/2016-1415_-_report_on_sfts_procyclicality_and_leverage.pdf
[92] http://www.fsb.org/wp-content/uploads/SFT_haircuts_framework.pdf
[93] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf
[94] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD392.pdf?v=1
[95] http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmfs-regulation_en.pdf.
[96] http://data.consilium.europa.eu/doc/document/ST-14939-2016-INIT/en/pdf

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

- LVNAV is a new category of fund introduced following the EU negotiations;

- CNAVs will be required to seek to maintain an unchanging NAV per unit or share and must invest at least 99.5% of its assets in specified assets and cash;

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

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

- MMFs will be subject to diversification requirements including a 17.5% limit on investments in other MMFs and a 15% limit on reverse repos; and

- the proposed constant NAV fund buffer has been deleted.

The agreed draft must be approved by the European Parliament. This is expected to happen early in 2017. It will then be submitted to the EU Council for adoption and is likely to come into force sometime within the first half of 2017. Existing MMFs will have 18 months to comply with the MMF Regulation after it comes into force.

17. MAR/MAD II Implementation

On 3 July 2016, the Market Abuse Regulation (Regulation 596/2014) ("**MAR**")[97] came into effect and repealed and replaced the Market Abuse Directive (2003/6/EC) ("**MAD**") and its implementing legislation. MAR forms 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 the new legislation is to strengthen the market abuse regulatory framework and bring the instruments and markets within its scope into line with the MiFID II regime.

MAR greatly expands the scope of the market abuse regime in the EU. In addition to applying to financial instruments admitted for trading (or subject to a request for admission to trading) on an EU regulated market or traded or admitted for trading (or subject to a request for admission to trading) on an MTF, it will also apply to instruments traded on an OTF (within the meaning of MiFID II). The definition of "financial instruments" has also been widened and includes 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

[97] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0596&from=EN

participants subject to MAR will need to adjust their internal compliance procedures to ensure that they comply with the new requirements on insider lists, notification obligations and directors' dealings, amongst other changes. The bulk of MAR provisions became effective on 3 July 2016, but certain provisions relating to OTFs, SME growth markets, emission allowances and related auctioned products will not apply until January 2018 when MiFID II becomes applicable.

MAR makes significant changes to the "market soundings" regime which applies to the communication of information, usually by a dealer or manager on behalf of an issuer, about a potential new issuance, in order to gauge the likely interest of potential investors. New and more detailed requirements now have to be satisfied by the disclosing party. These include a statement that the communication is for the purposes of a market sounding, confirmation from the receiving individual that they are the person entrusted by the recipient institution to receive the sounding and, if possible, an estimation of when the information will cease to be inside information. ESMA has published Guidelines[98] on the market soundings rules. These will apply from 1 January 2017. MAR also introduces new requirements in relation to persons discharging managerial responsibilities ("**PDMRs**") and requires PDMRs and persons closely associated with them to notify the issuer and the relevant competent authority of certain transactions relating to the shares or debt instrument of that issuer or to derivatives or other financial instruments linked to them.

ESMA was required to prepare various draft RTS and ITS on MAR, which it published in a final Report[99] in September 2015. The EU Commission subsequently adopted a Delegated Regulation[100] giving effect to such RTS and an Implementing Regulation[101] giving effect to such ITS which became effective at the same time as MAR. The 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, notification of 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. ESMA has also issued Guidelines[102] on the circumstances in which it may be acceptable for firms to delay the public dissemination of inside information.

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) were required to 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.

18. Possible New Covered Bond Framework

Further to the EU Commission's CMU initiative referred to above, in September 2015, the EU Commission published a Consultation Document[103] launched a consultation to assess the assessing the merits of a potential harmonised EU covered bond framework. The Consultation Document considers that such framework could either be achieved through the voluntary convergence of covered bond legislation through non-legislative co-ordination measures or, alternatively, EU legislation providing a regulatory framework in respect of covered bonds including harmonisation as to issuance structures, licensing, segregation of assets in the cover pool, eligibility requirements for cover pool assets, hedging and other risk mitigation requirements and coverage requirements and administration and supervision of the cover pool following segregation of the cover pool assets.

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[98] https://www.esma.europa.eu/sites/default/files/library/2016-1477_mar_guidelines_-_market_soundings.pdf
[99] https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1455_-_final_report_mar_ts.pdf
[100] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1052&from=EN
[101] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1055&from=EN
[102] https://www.esma.europa.eu/sites/default/files/library/2016-1478_mar_guidelines_-_legitimate_interests.pdf
[103] http://ec.europa.eu/finance/consultations/2015/covered-bonds/docs/consultation-document_en.pdf

Subsequently on 20 December 2016, the EBA published a Report[104] in relation to harmonising covered bond frameworks in the EU. The EBA proposes that, for this purpose and to continue to obtain favourable capital treatment under CRDIV, covered bonds should be required to meet harmonised structural, credit risk and prudential standards. The EBA recommends that this framework should be established by a new EU Directive and that necessary amendments are made to the CRR provisions relating to risk weighting of covered bonds.

It remains to be seen whether, and how quickly, the EU Commission decides to move forward with a harmonised framework and whether it seeks to do so through a legislative framework under an EU Directive. This route is likely to take some time and it is questionable whether the EU Commission would be able to publish draft legislation during 2017.

19. UCITS

UCITS funds in the EU are currently regulated pursuant to the existing UCITS Directive ("**UCITS IV**")[105] as amended by an amending Directive ("**UCITS V**"),[106] which was published in the OJ on 28 August 2014. EU member states had until 18 March 2016 to transpose UCITS V 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, including changes to the provisions relating to the appointment of a depositary in respect of a UCITS fund, rules setting out the terms on which the depositaries' safekeeping duties can be delegated and a revision of the eligibility criteria for depositaries.

The EU Commission is required to publish and implement various delegated acts and technical standards and guidance under UCITS V, particularly in relation to depositories. In April 2016, a Delegated Regulation[107] came into force (and applied with effect from October 2016) that provided, among other things:

- minimum requirements to be included in the contract between the depositary and the management / investment company;
- certain duties and obligations on the depositary including safe-keeping, custody and ownership verification, oversight and record-keeping;
- 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
- liability of the depositary in circumstances where custody assets are lost by the depositary or a third party.

In addition, on 31 March 2016, ESMA published its final Report[108] setting out Guidelines 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. The final Guidelines are largely consistent with the AIFMD Remuneration Guidelines with certain amendments on the grounds of proportionality. The Guidelines apply with effect from 1 January 2017. However,

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[104] http://www.eba.europa.eu/documents/10180/1699643/EBA+Report+on+Covered+Bonds+%28EBA-Op-2016-23%29.pdf
[105] Directive 2009/65/EC, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF.
[106] Directive 2014/91/EC, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0091&from=EN.
[107] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0438&from=EN
[108] https://www.esma.europa.eu/sites/default/files/library/2016-411_final_report_on_guidelines_on_sound_remuneration_policies_under_the_ucits_directive_and_aifmd.pdf

the relevant AIFMD Guidelines have not yet been amended to reflect the UCITS Guidelines pending clarification of the principles of proportionality. In particular, in a letter to the EU Commission in March 2016,[109] ESMA set out its view that the proportionality principles could result in the remuneration payout requirements not being applied in certain circumstances. It also suggested that certain funds (below a certain value or with limited activities) should be excluded from having to apply requirements in relation to the pay-out process. The Commission has yet to respond to these proposals.

In June 2016, ESMA published a Call for Evidence[110] in relation to asset segregation and custodial services under UCITS V and AIFMD following on from a previous consultation. It is expected to clarify its proposed next steps during the early part of 2017.

More generally, in relation to UCITS, in April 2016 ESMA published a Discussion Paper[111] in relation to UCITS share classes. This followed-up on a previous Discussion Paper published in December 2014. In its latest paper, ESMA suggests a principles-based framework in respect of share classes. It invited responses on its proposed principles by June 2016. ESMA is expected to publish its revised framework sometime in 2017.

20. EU Deposit Insurance Regulation

The recast Deposit Guarantee Schemes Directive[112] 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 President Jean-Claude Junker 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.[113] 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.

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[109] https://www.esma.europa.eu/sites/default/files/library/2016-412_letter_to_european_commission_european_council_and_european_parliament_on_the_proportionality_principle_and_remuneration_rules_in_the_financial_sector.pdf
[110] https://www.esma.europa.eu/sites/default/files/library/2016-1137_call_for_evidence_asset_segregation.pdf
[111] https://www.esma.europa.eu/sites/default/files/library/2016-570_discussion_paper_on_ucits_share_classes_2016_0.pdf
[112] http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0049&from=EN
[113] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015PC0586&from=EN

In April 2016, the ECB published an Opinion[114] in relation to the Proposed EDIS Regulation. It was generally supportive of the proposals but was concerned that requirements to have risk mitigation measures fully in place before progressing EDIS could lead to delays. Its view is that progress on these measures should be made in parallel with establishing the EDIS. Also in April 2016, the European Forum of Deposit Insurers raised a number of concerns on the proposals, including whether individual depositors would have the same level of confidence in a central authority as in a local scheme and the need for further measures to address potential conflicts of interest.

In June 2016, the EU Parliament published a working document on the EDIS Regulation which generally supported the proposal but highlighted concerns in relation to work on risk reduction and the calculation of risk based contributions (currently proposed by the EU Commission to be dealt with in technical standards). In November 2016, ECON published its draft report[115] on the Regulation and suggested amendments, including deferring the initial reinsurance phase to 2019 and extending that period to five years. This phase would provide up to 100% of liquidity shortfall to participating DGSs.

In December 2016, the EU Council of Ministers published a progress report[116] on its work in relation to the Regulation noting that some member states still have objections to the proposal and the proposed timetable. It therefore seems unlikely that progress will be rapid during 2017, and the EU Parliament and EU Council will continue their work in seeking to reach political agreement on the proposals. The EU Commission's current proposed timetable of having the EDIS established by July 2017 therefore seems unlikely and the ECON's proposed 2019 commencement seems more realistic.

21. 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 "**PSD II**")[117] was published in the OJ on 23 December 2015 and entered into force on 12 January 2016. EU member states are required to transpose PSD II into national laws by 13 January 2018.

PSD II 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 PSD II, 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. PSD II 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

[114] http://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_26_f_sign.pdf
[115] http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-592.334&format=PDF&language=EN&secondRef=03
[116] http://data.consilium.europa.eu/doc/document/ST-14841-2016-INIT/en/pdf
[117] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015L2366&from=EN

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:

- 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 PSD II, 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 PSD II, 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 PSD II 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, that provide account servicing cannot discriminate against TPPs.

The PSD II requires the EBA to develop RTS and/or guidelines in relation to certain aspects of PSD II. The EBA has published consultation papers in relation to various matters, including draft Guidelines on major incidents reporting,[118] the authorisation of payment institutions[119], criteria on the minimum monetary amount of professional indemnity insurance[120] and passporting notifications.[121]

In the UK, in February 2016, the FCA published a Call for Input[122] on its approach to PSD and its transposition into UK law by January 2018. It subsequently published a Feedback Statement in November 2016, indicating that respondents were broadly happy with its existing guidance in relation to the PSD but thought an update was needed to reflect recent developments. The FCA is expected to publish a consultation paper in 2017 to set out its specific proposals.

[118] https://www.eba.europa.eu/documents/10180/1688810/Consultation+Paper+on+the+Guidelines+on+Major+Incidents+Reporting+under+PSD2+%28EBA-CP-2016-23%29.pdf/1db1cbdc-648c-434f-b31c-1d37d402802d
[119] https://www.eba.europa.eu/documents/10180/1646245/Consultation+Paper+on+draft+Guidelines+on+authorisation+and+registration+under+PSD2+%28EBA-CP-2016-18%29.pdf/b8d49c1c-be4f-4b36-a5ce-e6710e00383c
[120] https://www.eba.europa.eu/documents/10180/1586019/EBA-CP-2016-12+%28Consultation+Paper+on+draft+Guidelines+on+PII+under+PSD2%29.pdf/f573498f-7e2c-4351-8cb3-a92bd58fc2ee
[121] https://www.eba.europa.eu/documents/10180/1694291/Final+draft+RTS+on+passporting+%28EBA-RTS-2016-08%29.pdf/7a77aa22-dcc8-44a7-89ec-5779eb1c4bbc
[122] https://www.fca.org.uk/publication/call-for-input/call-for-input-payment-services-regime.pdf

22. EU Consultation in Relation to Combined Impact of Financial Regulation

In September 2015, the EU Commission launched a public consultation in the form of a Call for Evidence[123] relating to the EU regulatory framework for financial services. It stated that in view of the huge amount of financial legislation put in place since the crisis, it sees merit in understanding the combined impact of such legislation and identifying any unintended consequences. In particular, the EU Commission sought views on areas of regulation that firms regard as imposing excessive burdens, costs or complexity out of proportion with the intended policy objectives. Specific questions included:

- whether any legislation produced undue obstacles to the ability of the wider financial sector to finance the economy, in particular in relation to SME financing, long-term innovation and infrastructure projects and climate finance;

- whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity and on investor and consumer protection and confidence; and

- whether the new rules been appropriately adapted to the diversity of financial institutions in the EU.

There were almost 300 responses to the Call for Evidence, including from many regulators, governments and central banks. In a Summary of Contributions to the Call for Evidence,[124] the EU Commission highlighted a number of themes that had come out of the responses including:

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

- the need for improvements in financing conditions for SMEs. Many respondents suggested extending capital relief for banks' investments in bonds and equities issued by SMEs;

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

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

- disclosure rules are seen as inconsistent across different pieces of relevant legislation.

Subsequently, in November 2016 the EU Commission published a further Call for Evidence[125] in relation to the EU regulatory framework for financial services. The EU Commission states in the Call for Evidence that it is a key contribution to its "Better Regulation" agenda and the Regulatory Fitness and Performance programme ("**REFIT**") aimed at ensuring EU legislation "delivers results for citizens and businesses effectively, efficiently and at minimum cost". In relation to its earlier consultation, the EU Commission stated that, having regard to the responses received, its view was that overall the financial services framework is working well. It states that the feedback from the previous consultation has already been integrated into existing reviews and legislative initiatives including the

[123] http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/consultation-document_en.pdf
[124] http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/summary-of-responses_en.pdf
[125] http://ec.europa.eu/finance/general-policy/docs/general/161123-communication_en.pdf

recent proposals to amend the CRR and CRD IV summarised above and will be important in the development of the CMU. In terms of follow-up action, the Commission states that this will include:

- reducing unnecessary regulatory constraints on financing the economy – in this regard it notes the importance of retaining banks' ability to finance the wider economy and to ensure SME financing;
- enhancing the proportionality of rules without compromising prudential objectives;
- reducing undue regulatory burdens (it indicates the EMIR review will focus on reducing reporting burdens for non-financial counterparties); and
- making the regulatory framework more consistent and forward-looking.

In terms of the next steps, the EU Commission states that certain adjustments to the financial regulatory framework will be taken forward through:

- fitness checks and legislative reviews as part of REFIT, including reporting requirements;
- calibration measures at both the legislative and implementation levels;
- ongoing policy work, including refining and accelerating measures under the CMU; and
- input from the EU Commission on work on global initiatives to measure and evaluate the combined effect of reforms.

In addition to the above work, in August 2016, the EU Commission published a Consultation Document[126] entitled "Review of the EU Macro-Prudential Policy Framework." It notes in the paper that the macro-prudential framework has evolved through a piecemeal approach of many years that has resulted in an overlapping toolset of macro-prudential instruments available in the EU with inconsistencies in the way such instruments are activated and on overly complex process for coordinating relevant measures. It also notes that the role of the European Systemic Risk Board ("**ESRB**") has evolved into a co-ordination and analytical hub for macro-prudential policy which is a much broader role than initially envisaged.

On 21 December 2016, the EU Commission published a Feedback Statement[127] and Executive Summary[128] in relation to this consultation, giving a summary of responses received. The Commission states that there was broad support amongst stakeholders for some revisions to the macro prudential toolset, and stakeholders also supported simplifying the use of certain macro prudential instruments, either by amending the pecking order of use or amending the activation mechanisms associated with certain instruments. Stakeholders expressed some support for an expansion of the macro prudential toolset beyond the banking sector. The Commission states that the Feedback Statement is a summary of the responses it received to the consultation and should not be seen as reflecting its position. It, however, seems likely that the Commission will publish proposals to deal with some of the issues raised during 2017.

[126] http://ec.europa.eu/finance/consultations/2016/macroprudential-framework/docs/consultation-document_en.pdf
[127] http://ec.europa.eu/finance/consultations/2016/macroprudential-framework/docs/summary-of-responses_en.pdf
[128] http://ec.europa.eu/finance/consultations/2016/macroprudential-framework/docs/executive-summary_en.pdf

23. Final Thoughts

As can be seen from the above summaries, the European regulatory agenda remains packed even though we are now many years on from the onset of the financial crisis. Whilst most of the ongoing work relates to implementation of regulation that has been many years in the making, new developments continue. In particular, the Capital Markets Union project of the EU Commission is still in its relatively early days. Despite some initial doubts as to whether this project would survive the Brexit vote, the EU Commission has reavowed its commitment to CMU and further developments are likely in the coming years although some elements of the project may take on a different complexion without the influence of the UK. Brexit itself will add complexity to the EU regulatory landscape and has the potential to slow down the regulatory agenda to some extent as resources are focused on the negotiations with the UK once it serves the Article 50 Notice. We would, however, expect that one year from now as we sit down to compile the outlook for 2018 there will still be plenty of activity for us to reflect on and much to ponder for the coming years ahead.

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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.

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BREXIT: SOME INITIAL THOUGHTS ON PROSPECTUS REQUIREMENTS FOR ISSUERS OFFERING FINANCIAL SECURITIES IN THE UK/EU

In this article based on a client briefing, Peter Green (Partner) and Jeremy Jennings-Mares (Partner) at Morrison & Foerster LLP provide some initial thoughts on the potential impact of Brexit on issuers and distributors of securities in the context of prospectus requirements applying to offers of financial securities in the UK and the rest of the EU.

Peter Green and Jeremy Jennings-Mares, Morrison & Foerster LLP

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The United Kingdom has voted in a referendum by a narrow majority to leave the European Union (Brexit).

The outcome of the referendum will have far-reaching consequences on financial markets and international capital raising. This article sets out some initial thoughts on the potential impact of Brexit on issuers and distributors of financial securities in the context of the prospectus requirements applying to offers of financial securities in the UK and rest of the EU.

EFFECT OF BREXIT VOTE

The referendum result is advisory only and therefore has no automatic effect under UK or EU laws. For the time being, the UK remains a member of the EU and subject to the EU treaties. All existing EU-derived laws and regulation continue to apply in the UK. However, the UK government has stated that it intends to give effect to the result of the referendum.

The UK will need to commence the process of its exit from the EU by serving a notice of its intention to leave the EU under Article 50 of the Lisbon Treaty (Article 50 Notice). Once the Article 50 Notice is served, the UK will have two years to negotiate and agree the terms of its exit. The terms would need to be approved by a qualified majority of the European Council (excluding the UK), and the consent of the European Parliament. If no agreement is reached within such two-year period, or any extended period agreed by all member states, the UK would automatically cease to be a member of the EU.

There is no prescribed timescale for the UK to submit its Article 50 Notice and it is not currently expected to be presented to the EU Council of Ministers until sometime after David Cameron's successor as Prime Minister has been appointed.

A key issue in determining the effect of Brexit on the issuance and distribution of financial securities is the legal and trading relationship put in place between the UK and the EU following Brexit and, in particular, if and the extent to which the UK will continue to have access to the EU single market after leaving the EU.

This article does not consider in detail the various options that the UK may seek to pursue in this regard. It is, however, worth noting that the option that would cause the least disruption in the context of financial regulation is what has been termed the "Norwegian model". Under this model, the UK would leave the EU but remain a member of the European Economic Area (EEA) and the European Free Trade Area (EFTA). This would continue to give the UK access to the EU single market, but it would also require the UK to make financial contributions towards the EU without having any right to participate in EU rule-making and would require the UK to be bound by many of the rules of the EU which have been unpopular with Brexit supporters, including the free movement of people. The general view of market and political commentators at the moment is therefore that this route is unlikely to be the favoured route of the UK government in Brexit negotiations. Such option would, however, have a relatively small impact on EU financial regulation, as the vast majority of such regulation applies to EEA members.

It is currently regarded as more likely that the UK will seek to pursue a free trade agreement model with the EU along the lines of the free trade agreements between the EU and South Korea, and the EU and Canada, which would preserve some access to the EU single market. However, these agreements took many years to agree and it would seem ambitious to expect arrangements between the UK and the EU to be agreed within a two-year period. These agreements also do not provide access to the EU single market for financial services in any material way. Having regard to the scale and importance of the financial services market to the UK, preserving the UK's access to such market is likely to be an important objective in its negotiations with the EU. The extent to which this can be achieved is, however, very uncertain at present.

THE EXISTING PROSPECTUS DIRECTIVE

The Prospectus Directive (PD) imposes form and content requirements for prospectuses in respect of offers of financial securities to the public in the EU or where the issuance is listed on an EU-regulated exchange. Where the securities are not listed on a regulated exchange in the EU, there is an exemption from the need to prepare a PD-compliant prospectus in certain cases. The most commonly used exemption at present is for securities with a denomination of at least EUR100,000. Other exemptions include offers to qualified investors (primarily institutional and professional investors) and offers made to fewer than 150 persons, other than qualified investors, per member state.

Before securities within the scope of the PD can be offered to the public in the EU, a PD-compliant prospectus must be approved by the competent authority in the issuer's "home member state". Following such approval, the issuer can take advantage of "passporting" provisions and offer the securities across all EU member states without the requirement for any further authorisations.

Assuming that the UK does not remain a member of the EEA following Brexit, subject to the Brexit terms agreed between the UK and the EU, the PD will cease to apply to the UK (and the rest of this article assumes this to be the outcome following Brexit).

The UK will therefore need to decide whether to replicate the PD (or if it has then come into force the new Prospectus Regulation referred to below) into UK law. UK law currently implements the existing provisions of the PD, so this should not be a major exercise. In view of the amount of other issues the UK will need to deal with in relation to Brexit, it would seem unlikely that making changes to the current approach to prospectus regulation will be high on its list of priorities. In addition, many issuers of financial securities seek to distribute them to investors in both the UK and the rest of the EU. It would be highly undesirable for such issuers to have to comply with two different sets of prospectus requirements. It therefore seems likely that immediately after Brexit, the UK rules in relation to prospectuses for offers of financial securities will be consistent with those then applying in the EU.

However, even if the UK does replicate the PD following Brexit, the UK Financial Conduct Authority as the UK Listing Authority (the UKLA) will cease to be a relevant competent authority for the purpose of the PD. Issuers of securities into the EU would therefore not be able to utilise the UK as their home member state and would have to seek approval of the prospectus of its "home member state" within the EU.

For issuers of non-equity securities with a denomination of at least EUR1,000, the issuer has a choice of its home member state. The home member state can be either the jurisdiction in which it has its registered office (if in the EU) or a member state where the securities are admitted to trading or offered to the public. Therefore, absent any special agreement between the UK and the EU following Brexit, it is likely that the issuers of securities offering those securities in the UK and elsewhere in the EU would be faced with obtaining approval by both the UKLA and a competent authority within the EU. Where the UK is the home member state in respect of securities to be issued under a base prospectus approved before Brexit, it is not yet clear whether a further approval from another EU competent authority appointed as the new home member state would be required before any further post-Brexit issuances could be made off the base prospectus. Provided that the UK continues to have in place regulation identical or very similar to the PD, then under the PD, other EU competent authorities will have the power (but not the obligation) to approve a prospectus drawn up by a UK issuer on the basis that it has been drawn up in accordance with international standards equivalent to the PD.

Because the Main Market of the London Stock Exchange would cease to be an EU-regulated market for the purposes of the PD following Brexit, any securities listed on that market would not automatically require a PD-compliant prospectus to be approved by an EU competent authority even if offered in the EU. Therefore, if in these circumstances an appropriate exemption to the PD applies, it would be possible for the issuer to avoid the need for approval of the prospectus by an EU competent authority (although it may still need to be approved by the UKLA if the UK replicates the PD into UK law).

THE NEW PROSPECTUS REGULATION

The issues relating to prospectus approval in the aftermath of Brexit are somewhat complicated by the potential implementation of the draft Prospectus Regulation prior to Brexit. The draft Regulation forms part of the EU's Capital Markets Union (CMU) Action Plan aimed at encouraging further access to the EU capital markets. The proposed Prospectus Regulation will significantly overhaul the PD. The more significant changes include:

- The current "wholesale" exemption for debt securities with a denomination of at least EUR100,000 referred to above will be abolished. However, the other exemptions will be largely unchanged including the current exemption related to offers of securities addressed to investors who acquire securities for a total consideration of at least EUR100,000 per investor for each separate offer.

- The requirements in relation to prospectus summaries are significantly overhauled and will be required for all prospectuses (they are not currently required for securities with a denomination of at least EUR100,000).

- The introduction of a "Universal Registration Document" intended to be a shelf regulation mechanism similar to that used in the US which will apply to frequent issuers admitted to trading on a regulated market or MTF in the EU.

- A new minimum disclosure regime for SMEs and other companies with a market capitalisation not exceeding EUR200 million.

- Non-EU issuers seeking approval of a prospectus under the new Regulation (which will include the UK after Brexit) must appoint a representative established in the issuer's home member state which will, together with the non-EU issuer, be responsible for compliance with the Prospectus Regulation.

- Various changes related to content, including detailed rules relating to risk factors.

The draft Regulation was published by the EU Commission back in November 2015 and is currently going through the EU legislative process. Prior to the Brexit referendum, it appeared that the EU Commission hoped that the Regulation could be adopted by the relevant EU institutions and come into force by the end of 2016 or early 2017. The current draft of the Regulation provides that its provisions will become effective one year after the Regulation comes into force. On this basis, the new Prospectus Regulation may well be in force prior to the finalisation of the Brexit arrangements.

In this regard it should be noted that in the aftermath of the Brexit vote, some doubt has been cast on the future of the CMU, including the new Prospectus Regulation, particularly as this was an initiative led by Lord Hill as EU Commissioner for Financial Stability, Financial Services and Capital Markets Union, who immediately tendered his resignation following the referendum result. However, although the CMU had strong support from the UK, it is an initiative supported by many other EU member states. It is therefore far from certain that there will be any significant delay in the various elements comprising the CMU. In particular, the new Prospectus Regulation was not regarded as one of the more controversial elements of the CMU with many jurisdictions advocating an overhaul of the PD.

Assuming that the Prospectus Regulation does come into effect before Brexit, this would simplify the UK's approach, assuming it decides to seek to replicate the EU's rules in relation to prospectus regulation. Otherwise it would potentially be in the position of taking necessary steps to ensure that provisions equivalent to the PD continue to apply under UK law, and then having to amend the legislation to reflect the provisions of the Prospectus Regulation once it comes into force.

CONCLUDING REMARKS

The whole issue of prospectus regulation is therefore subject to a number of uncertainties in the context of Brexit. It will not be possible for those involved in securities issuances to undertake any detailed planning until there is much greater clarity as to the basis on which the UK will leave the EU and its future relationship with the EU, particularly in relation to financial services. Firms should, however, at some time over the next few weeks and months start to give some thought as to how their future debt securities issuances will be managed in the UK and the EU following Brexit.

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Practice Pointers on: EU Market Abuse Regulation: Requirements for U.S. Issuers

Background

The EU Regulation on Market Abuse ("**MAR**") came into effect on 3 July 2016, replacing the previously existing Market Abuse Directive and expanding the application of the EU's market abuse regime. In addition to detailing various offences, MAR imposes a number of requirements for information disclosure, insider lists and dealings by senior managers of issuers. For U.S. and other non-EU issuers of securities, MAR brings about a key change by expanding the scope of the market abuse regime to apply to securities listed on multilateral trading facilities and other trading venues in the EU (e.g., Luxembourg's Euro MTF and Ireland's Global Exchange Market).

This guidance note summarises some key requirements that U.S. and other non-EU securities issuers should be aware of, but it is intended only as a high-level overview of the MAR regime and we recommend that you consult suitably qualified legal counsel where you consider that MAR may be relevant to your situation.

Scope of MAR

MAR applies to financial instruments:[1]

(a) admitted to trading or for which a request for such admission has been made, on a regulated market in an EU Member State;
(b) traded, admitted to trading or for which a request for such admission has been made, on a multilateral trading facility ("**MTF**");
(c) traded on an organised traded facility ("**OTF**");[2] or
(d) the price or value of which depends on or has an effect on the price of a financial instrument referred to in (a), (b) or (c), including derivative instruments.

MAR also applies to behaviour or transactions relating to emissions allowances, as well as to market manipulation related to spot commodity contracts, commodity derivatives and benchmarks. However, these topics are outside the scope of this guidance note.

MAR applies to actions and omissions in the EU and in a third country, so an issuer of securities that meet any of the definitions above, whether an EU issuer or a non-EU issuer (an "**Issuer**"), will be within the scope of MAR. Note that MAR applies to any transaction, order or behaviour referred to in the following section, whether or not such transaction, order or behaviour takes place on a trading venue.

Where a non-EU Issuer's financial instruments are admitted to trading in the EU only on an MTF or an OTF and the Issuer has not approved or consented to such admission to trading, the Issuer obligations in MAR (i.e. disclosure of inside information, control of inside information and insider lists and dealings by PDMRs) will not apply. However, the insider dealing, unlawful disclosure and market manipulation offences will still apply in relation to those instruments.

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[1] For the purposes of MAR, the definition of "financial instruments" is found in Section C, Annex I to Directive 2014/65/EU ("**MiFID II**"). This is wide enough to cover most securities.

[2] Note that such instruments will only be captured by MAR from the date on which the MiFID II legislative package takes effect, currently scheduled to be 3 January 2018.

The MAR Offences and Accepted Market Practices

MAR prohibits:

(a) insider dealing (Article 14(1)(a));
(b) attempted insider dealing (Article 14(1)(b));
(c) recommending or inducing another to engage in insider dealing (Article 14(b));
(d) unlawful disclosure of inside information (Article 14(c));
(e) market manipulation (Article 15);
(f) attempted market manipulation (Article 15); and
(g) dealing by a person discharging managerial responsibilities during a closed period (Article 19(ii)).

1. **Insider dealing offences**

Engaging in insider dealing, attempting insider dealing or recommending or inducing another to engage in insider dealing are offences under Article 14 MAR.

Insider dealing is where a person possesses inside information and uses that information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates.

The definition also applies to the use of inside information by cancelling or amending an order concerning a financial instrument to which the information relates, where the order was placed before the person concerned possessed the inside information.

Inside Information

Inside information means information:

- of a precise nature;
- which has not been made public;
- relating, directly or indirectly, to one or more Issuers or to one or more financial instruments; and
- which, if it were made public, would be likely to have a significant effect on the prices of any of those financial instruments or on the price of related derivative financial instruments.

Although this definition seems to have expanded compared to MAD, the FCA in the UK has indicated that there will not be a significant change in the way it interprets the definition of inside information.

In contrast to the US, there is no requirement that there be a fiduciary or fiduciary-like relationship or a duty of trust or confidence between the source of inside information and the recipient. It is therefore possible that activity that is permissible under US laws relating to insider trading will be prohibited under MAR.

Information shall be deemed to be "**of a precise nature**" if it indicates:

- a set of circumstances which exists or which may reasonably be expected to come into existence, or
- an event which has occurred or which may reasonably be expected to occur,

in each case where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instrument or the related derivative financial instrument.

Information "**likely to have a significant effect**" if it were made public means information a reasonable investor would be likely to use as part of the basis of his or her investment decisions.

Article 9 of MAR provides for various examples of behaviour that is considered legitimate behaviour in the context of the insider dealing offences, as well as the market manipulation offences. These include situations where:

- the legal person in possession of inside information has taken steps to ensure that the natural person who made the decision to acquire or dispose of the relevant financial instrument is not in possession of the inside information, and has not influenced that natural person;
- the person in possession of inside information is a market maker acting legitimately in the normal course of the exercise of such function;
- the person in possession of inside information is authorised to execute orders on behalf of third parties and acts legitimately in the normal course of the exercise of that person's employment, profession or duties;
- the person in possession of inside information acquires or disposes of financial instruments in discharge of a pre-existing obligation that has become due, in good faith; and
- the person in possession of inside information obtained such information in the course of conducting a public takeover or merger with a company and uses the information solely for proceeding with that merger or public takeover (and not for stake-building), so long as that information has ceased to be inside information at the time of approval of the merger or acceptance of the offer by the shareholders of that company.

2. Unlawful disclosure of inside information

Under Article 10 MAR, unlawful disclosure of inside information arises where a person possesses inside information and discloses that information to any other person, except where the disclosure is made in the normal exercise of an employment, a profession or duties.

Market soundings

A disclosure of inside information made in the course of a market sounding is deemed to be made in the normal exercise of a person's employment, profession or duties where the disclosing market participant complies with certain specified conditions. A market sounding is the communication of information, usually by a dealer or manager on behalf of an Issuer, about a potential new issuance, in order to gauge the interest of potential investors of a potential transaction and related conditions. Certain detailed requirements have to be satisfied by the disclosing party, which are discussed in further detail in the guidance note "Market Soundings Safe Harbour: Compliance and Record Requirements."

3. Required disclosure of inside information

MAR requires an Issuer to inform the public as soon as possible of inside information which directly concerns the Issuer. The disclosure needs to be made in a manner which enables "fast access and complete, correct and timely assessment of the information by the public" and on the European Electronic Access Point, when this is established by the European Securities and Markets Authority. The Issuer cannot combine the disclosure with the marketing of its activities. All inside information must be posted and maintained on the Issuer's website for at least five years.

An Issuer may only delay disclosure if, and for so long as:

- the Issuer's legitimate interests are likely to be prejudiced by immediate disclosure;[3] and
- the delay of disclosure is not likely to mislead the public; and
- the Issuer is able to ensure the confidentiality of that information.

If such disclosure is delayed, the Issuer must notify the competent authority that disclosure of the information was delayed, immediately after the information is disclosed. Competent authorities may require a written explanation of how the conditions set out above were met to be given on request, or to be provided with the notification.

ESMA's Final Report on MAR (published 13 July 2016) has set out a non-exhaustive, indicative list of situations when it will be in an Issuer's legitimate interests to delay disclosure, including where:

- the Issuer is conducting negotiations, the outcome of which would likely be jeopardised by immediate public disclosure of that information;
- the financial viability of the Issuer is in grave and imminent danger, and immediate public disclosure of the inside information would seriously prejudice the interests of existing and potential shareholders, by jeopardising the conclusion of the negotiations aimed at ensuring the financial recovery of the Issuer;
- the inside information relates to decisions taken or contracts entered into by the management body of an Issuer which need the approval of another body of the Issuer (other than shareholders) in order to become effective and immediate disclosure would jeopardise the correct assessment of the information by the public, provided that the Issuer has arranged for the other body to take its decision as soon as possible;
- the Issuer has developed a product or an invention and the immediate public disclosure of that information is likely to jeopardise the intellectual property rights of the Issuer;
- the Issuer is planning to buy or sell a major holding in another entity and disclosure may jeopardise the deal;
- a UK deal or transaction that has been previously announced is subject to a public authority's approval and the approval is subject to conditions and disclosure of those conditions is likely to affect the Issuer's ability to meet the conditions.

ESMA's Final Report on MAR also sets out three (non-exhaustive) examples when the delay in the disclosure is likely to mislead the public and where immediate and appropriate disclosure is always necessary and mandatory:

- the inside information is materially different from a previous public announcement of the Issuer on the matter to which the inside information relates; or
- the inside information relates to the fact that the Issuer's financial objectives are not likely to be met, where such objectives were previously publicly announced; or
- the inside information contrasts with the market's expectations, where such expectations are based on signals that the Issuer has previously sent to the market, such as interviews, roadshows or any other type of communication organized by the Issuer or with its approval.

In assessing the market's expectations, the Issuer should take into account the market sentiment, for instance considering the consensus among financial analysts.

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[3] Guidance on when it will be in an Issuer's legitimate interests to delay disclosure is set out in the ESMA guidelines on MAR (https://www.esma.europa.eu/sites/default/files/library/2016-1130_final_report_on_mar_guidelines.pdf).

In order to preserve the stability of the financial system, an Issuer that is a credit or financial institution may delay the public disclosure of inside information (Article 17(5)). This includes information relating to a temporary liquidity problem and the need to receive temporary liquidity assistance from a central bank or lender of a last resort, if all of the below are satisfied:

- the disclosure of insider information entails a risk of undermining the financial stability of the Issuer and of the financial system;
- it is in the public interest to delay the disclosure;
- the confidentiality of that information can be ensured; and
- the relevant competent authority has consented to delay on the basis that the above conditions are met.

4. Creation and maintenance of insider lists

MAR requires that Issuers or persons acting on their behalf shall maintain a list of all persons who have access to inside information and who are working for or under them, or otherwise have access to inside information.

This list must be kept updated and made available to the competent authority on request.

These lists must adhere to the prescribed format.[4]

5. Dealings by PDMRs

Persons discharging managerial responsibilities ("**PDMRs**"), as well as persons closely associated with them, must notify the Issuer and the competent authority of certain transactions[5] relating to the shares or debt instruments of that Issuer or to derivatives or other financial instruments linked to them.

A person closely associated with a PDMR includes:

- a spouse, or a partner considered to be equivalent to a spouse in accordance with national law;
- a dependent child, in accordance with national law;
- a relative who has shared the same household for at least one year on the date of the transaction concerned; or
- a legal person, trust or partnership, the managerial responsibilities of which are discharged by a PDMR or a person referred to above, which is directly or indirectly controlled by a person, which is set up for the benefit of such a person, or the economic interests of which are substantially equivalent to those of such a person.

Such notification must contain certain information[6] and must be made to the competent authority within three working days of the transaction date.

The notification requirement is subject to a *de minimis* threshold of €5,000 (or a higher threshold, not exceeding €20,000, set by a Member State).

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[4] Detailed in Commission Implementing Regulation (EU) 2016/347.

[5] These are detailed in MAR Article 19(1) and (7) and include selling, purchasing, pledging, and lending and can also include some transactions undertaken on behalf of PDMRs, even where discretion is exercised.

[6] Listed in MAR Article 19(6).

PDMRs are also prohibited from trading any securities of the Issuer, or derivatives or other financial instruments linked to them, during a closed period of 30 calendar days before the announcement of an interim financial report or a year-end report which the Issuer is obliged to make public under either its national laws or the rules of the trading venue where the Issuer's shares are admitted to trading.

6. Investment Recommendations

MAR requires persons who produce or disseminate investment recommendations or other information recommending or suggesting an investment strategy to take reasonable care to:

- ensure that such information is objectively presented; and
- to disclose their interests or indicate conflicts of interest concerning the financial instruments to which that information relates.

An "investment recommendation" means information:

- recommending or suggesting an investment strategy;
- explicitly or implicitly concerning one or several financial instruments or the Issuers;
- including any opinion as to the present or future value or price of such instruments;
- intended for distribution channels or for the public.

In the ESMA Final Report of September 2015, ESMA took the view that:

> "an investment recommendation is intended for distribution channels or for the public … when it is intended or expected to be distributed to clients or to a specific segment of clients, whatever their number, as a non-personal recommendation... ESMA considers that a too narrow definition of 'investment recommendation intended for distribution channels or for the public' would entail the risk of leaving some investment recommendations provided to investors unregulated, without investors being in a position to know that the recommendation received is not regulated."

ICMA has interpreted the ESMA report in their Q&A in March 2016 as meaning "…that investment recommendations are in scope of MAR where they are disseminated to more than one client." This issue is currently under review in the UK by the FCA.

7. Market manipulation offences

The following is a list of activities which would fall within the market manipulation offence:

(a) entering into a transaction, placing an order to trade or any other behaviour which:

(i) gives, or is likely to give, false or misleading signals as to the supply of, demand for or price of a financial instrument; or

(ii) secures, or is likely to secure, the price of one or several financial instruments at an abnormal or artificial level,

unless the relevant person establishes that such transaction, order or behaviour has been carried out for legitimate reasons and conforms with an accepted market practice (see "Legitimate reasons and accepted market practice" below);

(b) entering into a transaction, placing an order to trade or any other activity or behaviour which affects or is likely to affect the price of one or several financial instruments which employs a fictitious device or any other form of deception or contrivance;

(c) disseminating information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to the supply of, demand for or price of a financial instrument or secures, or is likely to secure, the price of one or several financial instruments at an abnormal or artificial level, including the dissemination of rumours, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading; and

(d) transmitting false or misleading information or providing false or misleading inputs in relation to a benchmark where the person who made the transmission or provided the input knew or ought to have known that it was false or misleading, or any other behaviour which manipulates the calculation of a benchmark.

MAR provides (in Article 12(2) and Annex 1) a non-exhaustive list of conduct that will be considered as market manipulation and indicators of the employment of a fictitious device or deception, and indicators relating to false/misleading signals and to "price securing".

Legitimate reasons and accepted market practice

Under Article 13 MAR, the actions specified in paragraph (a) of the foregoing section will not constitute market manipulation (or attempted market manipulation) under Article 15 MAR where they conform with an "accepted market practice" and have been carried out for "legitimate reasons."[7]

Accepted market practice

A competent authority may establish an accepted market practice ("**AMP**," or in plural "**AMPs**"). They will need to take into account the following criteria in doing so, as set out in Article 13(2) of MAR:

(a) whether the market practice provides for a substantial level of transparency to the market;

(b) whether the market practice ensures a high degree of safeguards to the operation of market forces and the proper interplay of the forces of supply and demand;

(c) whether the market practice has a positive impact on market liquidity and efficiency;

(d) whether the market practice takes into account the trading mechanism of the relevant market and enables market participants to react properly and in a timely manner to the new market situation created by that practice;

(e) whether the market practice does not create risks for the integrity of, directly or indirectly, related markets, whether regulated or not, in the relevant financial instrument within the EU;

[7] Note that under MAR Recital 42, an infringement could still be deemed to have occurred if the relevant competent authority determines that there was an illegitimate reason behind the relevant action.

(f) the outcome of any investigation of the relevant market practice by any competent authority or by another authority; and

(g) the structural characteristics of the relevant market.

Note that a market practice that has been established by a competent authority as an AMP in a particular market shall not be considered to be applicable to other markets, unless the competent authorities of those other markets have accepted that practice under Article 13 MAR.

At the time of writing this guidance note, no AMPs had been established by any of the FCA in the UK, the CBI in Ireland or the CSSF in Luxembourg.

However, the European Commission has adopted some criteria (in Commission Delegated Regulation (EU) 2016/908) for individual competent authorities to establish AMPs. Please see the below extract from Article 3 for more information:

"1. In determining whether a market practice can be established as an AMP and whether it fulfils the criterion set out in point (a) of Article 13(2) of Regulation (EU) No 596/2014, competent authorities shall examine whether the market practice ensures that the following information will be disclosed to the public:

(a) Before a market practice is performed as an AMP:
  (i) the identities of the beneficiaries and the persons who will perform it and the one among them that is responsible for fulfilling the transparency requirements under points (b) and (c) of this paragraph;
  (ii) the identification of the financial instruments in relation to which the AMP will apply;
  (iii) the period during which the AMP will be performed and situations or conditions leading to the temporary interruption, suspension or termination of its performance;
  (iv) the identification of the trading venues on which the AMP will be carried out, and, where applicable, indication of the possibility to execute transactions outside a trading venue;
  (v) reference to the maximum amounts of cash and of the number of financial instruments allocated to the performance of the AMP, if applicable.

(b) Once the market practice is performed as an AMP:
  (i) on a periodic basis, details of the trading activity relating to the performance of the AMP such as the number of transactions executed, volume traded, average size of the transactions and average spreads quoted, prices of executed transactions;
  (ii) any changes to previously disclosed information on the AMP, including changes relating to available resources in terms of cash and financial instruments, changes to the identity of persons performing the AMP, and any change in the allocation of cash or financial instruments in the accounts of the beneficiary and the persons performing the AMP.

(c) When the market practice ceases to be performed as an AMP on the initiative of the person who has been performing it, of the beneficiary or of both:
  (i) the fact that the performance of the AMP has ceased;
  (ii) a description of how the AMP has been performed;
  (iii) the reasons or causes for ceasing the performance of the AMP.

For the purposes of point (b)(i), where multiple transactions in a single trading session are performed, daily aggregated figures may be acceptable in relation to the appropriate categories of information.

2. In determining whether a market practice can be established as an AMP and whether it fulfils the criterion set out in point (a) of Article 13(2) of Regulation (EU) No 596/2014, competent authorities shall examine whether the market practice ensures that the following information will be disclosed to them:

(a) Before a market practice is performed as an AMP, the arrangements or contracts between the identified beneficiaries and the persons who will perform the market practice once established as an AMP where such arrangements or contracts are needed for its performance;

(b) Once the market practice is performed as an AMP, periodic report to the competent authority providing details about the transactions executed and about the operations of any arrangement or contract between the beneficiary and the persons performing the AMP."

Overview of U.S. Issuer Actions

An Issuer with a class of debt securities which are subject to MAR should assess what actions need to be taken immediately to ensure that it is in compliance. These actions may include:

- training for key personnel on the regime and its implications;
- creating policies or procedures on the disclosure of inside information;
- instituting a log for inside information and for recording delayed disclosures (and the follow up notifications);
- creating and maintaining insider lists;
- preparing a list of PDMRs (later defined) and closely associated persons; and
- establishing policies for PDMRs providing notification to regulators.

Additionally, an Issuer will need to consider the effect of MAR if the Issuer intends to redeem a class of in-scope securities (or a portion of a class) or engage in a repurchase of some or all of its securities in open market transactions.

Buy-backs of Securities

An Issuer intending to conduct a buy-back of some or all of its in-scope securities needs to bear in mind that there may be a risk of the buy-back constituting insider dealing or market manipulation (as outlined above).

MAR provides an express exemption from those offences for any share buy-back program that meets the specific requirements set out in Article 5 of MAR. However, there is no express exemption provided for buy-backs of debt securities.

Therefore, whether the proposed buy-back of debt securities is intended to be conducted by way of open market transactions or by individual negotiations, and whether by way of a programme or an opportunistic transaction, the Issuer will need to consider the exemptions generally available from the insider dealing and market manipulation prohibitions.

In terms of insider dealing, there can be no insider dealing if there is no unpublished inside information. Therefore, the Issuer must consider whether it is in possession of inside information, as defined earlier. However, it is likely to be only in rare instances that information would constitute inside information in relation to debt securities, as compared to equity securities. However, if those rare circumstances exist, an Issuer should generally consider delaying any buy-back until after the inside information has been made public, or otherwise has ceased to be inside information.

In terms of possible market manipulation, the Issuer will need to be as certain as possible that the buy-back is carried out for legitimate reasons and in accordance with an accepted market practice, as outlined above. In the absence of an Accepted Market Practice established by the competent authority for the relevant jurisdiction of listing/trading, it would be prudent to follow as closely as possible the principles outlined above by the European Commission for the establishment of Accepted Market Practices by EU competent authorities.

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Practice Pointers on: EU Market Abuse Regulation Market Soundings Safe Harbour: Compliance and Record Requirements

Background: The Prohibition

The EU Regulation on Market Abuse ("**MAR**") prohibits a person from unlawfully disclosing inside information relating to securities within the scope of the legislation. An unlawful disclosure is made when a person possesses inside information and discloses it to any other person, except in the normal exercise of their employment, profession or duties.

MAR applies to financial instruments:[1]

(a) traded (or which have applied to trade) on a regulated market in an EU Member State;
(b) traded (or which have applied to trade) on a multilateral trading facility ("**MTF**");
(c) traded on an organised traded facility ("**OTF**"); or
(d) the price or value of which depends on or has an effect on the price of a financial instrument referred to in (a), (b) or (c), including derivative instruments.[2]

The legislation applies to actions and omissions in the EU and in a third country, so a U.S. bank performing market soundings on behalf of an issuer subject to MAR will need to comply and be aware of the requirements summarised in this note.

Inside Information

Inside information means information **of a precise nature,** which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments and which, if it were made public, would be **likely to have a significant effect** on the price of any of those financial instruments or on the price of related derivative financial instruments.

Information shall be deemed to be "of a precise nature" if it indicates:

- a set of circumstances which exists or which may reasonably be expected to come into existence, or
- an event which has occurred or which may reasonably be expected to occur,

where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instrument or the related derivative financial instrument.

Information "likely to have a significant effect" if it were made public means information a reasonable investor would be likely to use as part of the basis of his or her investment decisions.

Market Soundings Safe Harbour

A disclosure of inside information made in the course of a market sounding is deemed to be made in the normal exercise of a person's employment, profession or duties where the disclosing market participant ("**DMP**") complies with certain specified conditions. DMPs and market sounding recipients ("**MSRs**") must comply with certain conditions whenever conducting a market sounding, whether or not the market sounding involves the disclosure of inside information.

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[1] For the purposes of MAR, the definition of "financial instruments" is found in Section C, Annex I to Directive 2014/65/EU ("MiFID II"). This is wide enough to cover debt securities.
[2] MAR Article 2(1). Note that the action/behaviour itself does not have to occur on a trading venue (see Article 2(3) MAR).

Compliance

Prior to conducting a market sounding, a DMP must specifically assess whether the market sounding will involve the disclosure of inside information and make a written record of its conclusion and the reasons therefor. This obligation applies to each separate disclosure of information during a market sounding.

Where information that has been disclosed in the course of a market sounding ceases to be inside information according to the assessment of the DMP, the DMP shall inform the MSR accordingly, as soon as possible.

If the DMP concludes that the market sounding involves inside information, the communication from the DMP to the MSR must:

- include a statement that the communication is for the purposes of a market sounding;
- if the conversation is being recorded, include a statement to that effect and a statement obtaining consent to record the conversation;
- include confirmation from the MSR individual that they are the person entrusted by the recipient institution to receive the sounding;
- clarify that if the person agrees to receive the sounding (i) that inside information will be disclosed and (ii) the recipient is obliged to separately consider for itself whether it is inside information;
- if possible, include an estimation of when the information will cease to be inside information, the factors that might affect that estimation and how the recipient will be informed of any change;
- inform the recipient of their obligation to keep the information confidential and not to trade (or amend a pre-existing instruction to trade) on the basis of it;
- obtain the recipient's consent to receiving inside information; and
- if the MSR consents, identify the information that is inside information.

If the DMP concludes that the market sounding does not involve inside information, the communication from the DMP to the MSR must include:

- a statement that the communication is for the purposes of a market sounding;
- if on a recorded telephone line, a statement that the conversation is being recorded and obtaining consent to recording the conversation;
- confirmation that the individual is the person entrusted by the recipient institution to receive the sounding;
- a statement that (i) the recipient will receive information which the discloser considers not to be inside information and (ii) reminds the recipient that they are obliged to separately consider for themselves whether it is inside information; and
- the recipient’s consent to receive the market sounding.

The same level of information must be communicated to each recipient of each market sounding.

Recordkeeping Requirements

The DMP must also comply with certain recordkeeping requirements, even where it is decided that the market sounding does not contain inside information.

All records must be made available to the competent authority on request.

Records of the following must be kept for five years:

- the list of all persons receiving information (including contact details), date/time of sounding and any follow-up;
- the list of any potential investors refusing to receive any soundings;
- the obligation to refrain from sounding out these investors;
- the facts relevant to the assessment that any inside information has ceased to be such;
- the discloser's written procedures and standard set of information on market soundings;
- all communications with recipients of market soundings including documents provided to them (i.e., copies of written correspondence, audio/video recordings or minutes); and
- if conversations are not recorded, then minutes are required, drawn up by discloser in accordance with a European Securities and Markets Authority template and which include the date/time, identity of parties, information and materials disclosed, and the consents obtained. If minutes are not agreed within five business days after the sounding, then records of both the discloser's and recipient's versions of the minutes must be retained.

ESMA has published guidelines for the recipients of market soundings.

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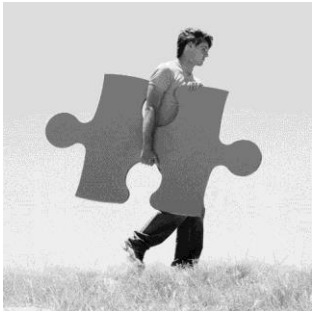
Client Alert

13 June 2016



Setting the New Benchmark: EU Regulation on Financial Benchmarks

Background

The integrity of benchmarks used in financial transactions has been the subject of increasing focus from regulators since the investigations into manipulation of the setting of LIBOR, EURIBOR and other benchmarks. Action was taken in the UK following the Wheatley Review of LIBOR[1] to reform the setting and usage of LIBOR, and the UK Financial Conduct Authority (FCA) has subsequently taken action to regulate additional specific financial benchmarks[2].

At an international level, in July 2013, the International Organisation of Securities Commissions (IOSCO) published its Final Report on Principles for Financial Benchmarks[3]. Shortly thereafter, the EU Commission published a draft regulation seeking to establish a pan-European approach to the regulation of benchmark administrators, contributors and users. The subsequent legislative process has been lengthy and has involved significant amendments to the initial draft. However, on 17 May 2016, the European Council of Ministers formally adopted the final version of the Regulation on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "Benchmark Regulation") which had previously been adopted by the EU Parliament. It published what is expected to be the final version of the Benchmark Regulation on 10 June 2016.[4] The Benchmark Regulation will come into force the day after it is published in the Official Journal of the EU. This is expected to happen in June or early July 2016. Most of its provisions will not, however, be implemented until 18 months after such date (so December 2017 or January 2018) with the exception of some provisions that will apply immediately upon it coming into force and provisions amending the Market Abuse Regulation[5] (which will apply from 3 July 2016 to dovetail with the Market Abuse Regulation becoming effective).

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf.
[2] SONIA (Sterling Overnight Index Average), RONIA (Repurchase Overnight Index Average), WM/Reuters London 4pm Closing Spot Rate, ISDAFIX, London Gold Fixing, the LMBA Silver Price and the ICE Brent Index.
[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf.
[4] http://data.consilium.europa.eu/doc/document/PE-72-2015-REV-1/en/pdf.
[5] Regulation 596/2014, 65 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0596&from=EN.

Scope of Regulation

The Benchmark Regulation will apply to a very wide range of indices, including proprietary indices, which are used as benchmarks in financial instruments. The key definitions in this context include the following:

Benchmark: There are two elements to this definition:

- in relation to financial instruments or financial contracts, any index by reference to which the amount payable under such instrument or contract is determined, or by which the value of a financial instrument is determined;
- in relation to investment funds, any index that is used to measure the performance of any such fund with the purpose of tracking the return of such index or of defining the asset allocation of a relevant portfolio or in computing performance fees.

Index: This is defined as any figure that is:

- published or made available to the public; and
- regularly determined (i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment, and (ii) on the basis of the value of one or more underlying assets or prices including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys.

In draft technical advice referred to further below, the European Securities and Markets Authority (ESMA) provides that an index should be deemed to be made available to the public if (i) it is accessible by a large or potentially indeterminate number of recipients, or (ii) it is provided or is accessible to one more supervised entities to allow use of the index in the EU.

Financial instrument: Any instrument listed in Annex I(C) to MiFID II[6] that is either traded on a trading venue (as defined in MiFID II) or is the subject of a request made for admission to trading on a trading venue or via a systematic internaliser[7]. The instruments listed in Annex I(C) of MiFID II are very wide and include transferable securities, money-market instruments, UCITS, a very wide range of derivative transactions and financial contracts for difference.

Financial contract: Any credit agreement within the ambit of the Consumer Credit Directive[8] or the Mortgage Credit Directive[9] (basically EU consumer credit agreements and residential mortgages).

Investment fund: An alternative investment fund (AIF) as defined in the Alternative Investment Fund Managers Directive (AIFMD)[10], or a UCITS fund as defined in the UCITS IV Directive[11].

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[6] The recast Markets in Financial Instruments Directive, Directive 2014/65/EU, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN.
[7] investment firms which, on an organised, frequent, systematic and substantial basis, deal on own account by executing client orders outside a regulated market, MTF or organised trading facility as defined in MiFID II.
[8] Directive 2008/48/EC, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:133:0066:0092:EN:PDF.
[9] Directive 2014/17/EC, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0017&from=EN.
[10] Directive 2011/61/EC, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF.
[11] Directive 2009/65/EC, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF.

The Benchmark Regulation therefore diverges from the existing approach to regulation of benchmarks by the FCA and other regulators which have to date focused on a small number of key benchmarks that are widely used in the financial markets and which are regarded as systemically important. In contrast, the Benchmark Regulation will, subject to limited exceptions, apply to all indices used in financial securities or derivatives traded on a regulated venue in the EU or traded outside such a venue, using an investment firm designated as a systematic internaliser under MiFID II. Although the definition of "index" limits the scope of the Benchmark Regulation to indices that are published or made available to the public, this is likely to be construed widely with the draft ESMA technical standards recommending that an index should be considered as being made available to the public even if only provided to supervised entities to allow use of the index in the EU.

To ameliorate the impact of the vastly increased number of benchmarks to become subject to regulation and supervision in the EU under the Benchmark Regulation, the Regulation distinguishes between "critical", "significant" and "non-significant" benchmarks as specified further below with differing standards of regulatory requirements applying to each category.

The Benchmark Regulation will not, however, apply to the following:

- central banks;
- public authorities, in respect of such an authority contributing data to or having control over the provision of benchmarks for public policy purposes (e.g., indices measuring employment, economic activity or inflation);
- central counterparties (CCPs) in their capacity of providing reference prices or settlement prices used for CCP risk-management purposes and settlement;
- the provision of a single reference price for any financial instrument;
- commodity benchmarks based on submissions from contributors, the majority of which are non-supervised entities, provided that the benchmark is referenced by financial instruments for which a request for admission to trading has been made on only one trading venue or which are traded on only one trading venue, and the total notional value of financial instruments referencing the benchmark does not exceed €100 million;
- an index provider, in respect of an index provided by it where such provider is unaware and could not reasonably have been aware that the index is used as benchmark within the scope of the Benchmark Regulation.

Regulation and Supervision of Benchmark Administrators

One of the key elements of the Benchmark Regulation is a new regulatory and supervisory regime that will apply to administrators of benchmarks that fall within the scope of the Benchmark Regulation. For these purposes, an administrator is any natural or legal person that has control over the provision of a benchmark. There is no guidance as to the meaning of "control" for this purpose, but the definition is likely to be construed fairly widely so any person or entity involved in producing a financial benchmark should consider whether it comes within the scope of the Benchmark Regulation as a benchmark administrator.

Title VI of the Benchmark Regulation requires any benchmark administrator that is located in the EU to apply to its relevant competent authority for authorisation to act in such capacity if it provides or intends to provide

indices for use as benchmarks within the scope of the Benchmark Regulation. There is a registration regime for entities supervised under other relevant EU regulation (including credit institutions, MiFID investment firms, insurance and reinsurance undertakings, UCITS funds and managers, AIFs regulated under the AIFMD and CCPs and trade repositories regulated under EMIR[12]). Benchmark administrators only need to be registered (rather than authorised) with their competent authority if they are only providing indices that are non-significant benchmarks (see further below).

There are also transitional provisions for benchmark administrators that are already providing benchmarks on the date the Benchmark Regulation comes into force. Such entities will have 42 months from such date to apply for authorisation or registration, as applicable. Until the end of that 42-month period (or, if earlier, until any application for authorisation or registration during that time is refused), such existing administrators may continue to provide such existing benchmark(s). If such administrator wants to provide a new benchmark after the Benchmark Regulation becomes effective, it will need to obtain appropriate authorisation or registration prior to doing so.

Benchmark administrators are subject to a number of requirements under the Benchmark Regulation aimed at maintaining the integrity and reliability of relevant benchmarks, including:

- ***Governance and conflicts of interest***: benchmark administrators are required to have in place robust governance arrangements including a clear organisational structure with well-defined transparent and consistent roles and responsibilities for all persons involved in the provision of a benchmark. Administrators will also be required to take adequate steps to identify and prevent or manage conflicts of interest and to ensure that where any judgment or discretion is required in the benchmark determination process, it is exercised independently and honestly. The provision of the benchmark must be operationally separated from any part of the administrator's business that may create an actual or potential conflict of interest.

- ***Oversight function requirements***: benchmark administrators will be required to establish and maintain a permanent and effective oversight function to ensure oversight of all aspects of the provision of their benchmarks. They will be required to develop and maintain robust procedures regarding their oversight function and make this available to the relevant competent authorities.

- ***Control framework requirements***: it will be necessary for benchmark administrators to have in place a control framework that ensures benchmarks are provided and published or made available in accordance with the Benchmark Regulation. The framework must be reviewed and updated as appropriate and made available to the relevant competent authority and, upon request, users of the benchmark.

- ***Accountability framework requirements***: benchmark administrators will be required to have in place an accountability framework covering record-keeping, auditing and review and a complaints process.

- ***Record-keeping***: record-keeping requirements provide that benchmark administrators must keep various records, including records of all data, the methodology used for the determination of a benchmark, exercises of judgment or discretion by the benchmark administrator and changes in or deviations from standard procedures and methodologies, including those made during periods of market stress or disruption. Records should be kept for a period of at least five years.

[12] European Market Infrastructure Regulation ("EMIR"), Regulation 648/2012, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN.

- ***Outsourcing***: benchmark administrators must not outsource functions in the provision of a benchmark in such a way as to impair materially the administrator's control over the provision of the benchmark or the ability of the relevant competent authority to supervise the benchmark. The administrator must comply with certain specified conditions when outsourcing any functions, including ensuring that the service provider has the ability, capacity and any applicable authorisations to perform the outsourced functions, services or activities reliably and professionally.

- ***Input Data***: various requirements apply to input data, including that it should be sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure. The input data must be transaction data if available and appropriate. If transaction data is not sufficient or is not appropriate to represent accurately and reliably the market or economic reality that the benchmark is intended to measure, input data which is not transaction data may be used, including estimated prices, quotes and committed quotes or other values. ESMA is required to develop draft regulatory technical standards to specify further how to ensure that input data is appropriate and verifiable.

- ***Methodology***: benchmark administrators are required to use a methodology for determining a benchmark that is robust and reliable, has clear rules identifying how and when discretion may be exercised in the determination of that benchmark and is rigorous, continuous and capable of validation including, where appropriate, back-testing against available transaction data. The methodology must also be resilient in a wide set of possible circumstances and be traceable and verifiable. The benchmark administrator must also develop, operate and administer the benchmark and methodology transparently.

- ***Reporting of infringements***: benchmark administrators will be required to report to the relevant competent authority any conduct that may involve manipulation or attempted manipulation of a benchmark under the Market Abuse Regulation and in this regard must monitor input data and contributors in order to be able to make any such notifications.

- ***Code of conduct for contributors***: where a benchmark is based on input data from contributors, the benchmark administrator must develop a code of conduct for each benchmark clearly specifying contributors' responsibilities with respect to the contribution of input data. This code of conduct shall contain the elements specified in the Benchmark Regulation. ESMA is required to develop draft regulatory technical standards to specify further the elements of the code of conduct.

Requirements for Specific Types of Benchmark

Commodity benchmarks: administrators of commodity benchmarks will be subject to additional requirements set out in Annex II of the Benchmark Regulation. These require the benchmark administrator to formalise, document and make public any methodology that the administrator uses for the benchmark calculation. It must also specify the criteria that define the physical commodity that is the subject of a particular methodology and give priority to concluded and reported transactions in respect of its input data. A commodity benchmark also cannot benefit from any of the exclusions relating to significant or non-significant benchmarks specified below. However, if a commodity benchmark which has gold, silver or platinum as the underlying asset is a critical benchmark, it will be able to comply with the rules generally relevant to financial benchmarks rather than the specific commodity rules.

Interest rate benchmarks: specific requirements set out in Annex I of the Benchmark Regulation will apply to interest rate benchmarks. These provide that the general priority of use of input data for such benchmarks will be:

- a contributor's transactions in the underlying market that the benchmark is intended to measure or, if not sufficient, in related markets;
- a contributor's observations of third-party transactions in such markets;
- committed quotes;
- indicative quotes or expert judgments.

The administrator of an interest rate benchmark must also have in place an independent oversight committee and ensure that a contributor's systems and controls include specific matters set out in Annex I. Additional record keeping requirements also apply, including in relation to input data and names and responsibilities of submitters (defined as a natural person employed by a contributor for the purpose of contributing input data).

Regulated data benchmarks: a regulated data benchmark is one that is determined by the application of a formula from input data contributed entirely and directly from certain regulated venues as specified in the Benchmark Regulation. Such benchmarks will be exempt from certain of the governance and control requirements that would otherwise apply under the Benchmark Regulation, including in relation to input data and the need to develop a code of conduct for contributors. Regulated data benchmarks may benefit from the provisions relating to significant and non-significant benchmarks if used as a reference for financial instruments or financial contracts or for measuring the performance of investment funds, having a total value of up to €500 billion on the basis of all the range of maturities or tenors of the benchmark, where applicable.

Critical Benchmarks

The EU Commission is required to adopt implementing legislation to establish and review, at least every two years, a list of critical benchmarks provided by benchmark administrators located in the EU. To be categorised as a critical benchmark, one of the following requirements must apply:

- the benchmark is used directly or indirectly within a combination of benchmarks as a reference for financial instruments or financial contracts or for measuring the performance of investment funds having a total value of at least €500 billion on the basis of all the range of maturities or tenors of the benchmark; or
- the benchmark is based on submissions by contributors, the majority of which are located in one member state and is recognised as being critical by the relevant competent authority in accordance with criteria specified in the Benchmark Regulation; or
- the benchmark fulfils all of the following: (i) it meets all the criteria specified in relation to the first bullet point above but with a total value of at least €400 billion, (ii) the benchmark has no, or very few, appropriate market-led substitutes and (iii) in the event that the benchmark ceases to be provided or is provided on the basis of input data no longer fully representative of the underlying market or economic reality or on the basis of unreliable input data, there would be a significant and adverse impact on market integrity, financial

stability, consumers, the real economy or the financing of households and businesses in one or more member states.

Critical benchmarks will be subject to additional requirements:

- the relevant competent authority shall establish a supervisory college in respect of each critical benchmark comprising the competent authority of the administrator, ESMA and the competent authorities of all supervised contributors to the benchmark;
- if the administrator of a critical benchmark intends to cease providing such benchmark, it must immediately notify its competent authority and within four weeks submit an assessment of how such benchmark is to be transitioned to a new administrator or is to cease to be provided. The administrator shall not cease to provide the benchmark during this four-week period. During this time the relevant competent authority shall liaise with the relevant supervisory college and make its own assessment of how the benchmark should be transferred to a new administrator or cease to be provided. At the end of this period, the competent authority has the power to compel the administrator to continue providing the benchmark until the benchmark has been transitioned to a new administrator or has ceased to be provided in an orderly manner or is no longer critical. The period in respect of which the competent authority may compel the administrator to continue to provide the benchmark cannot exceed 12 months (which period can be extended by a further 12 months);
- the administrator is required to take adequate steps to ensure that the licenses of, and information relating to, the benchmark are provided to all users on a fair, reasonable, transparent and non-discriminatory basis;
- administrators of a critical benchmark are required to submit to their competent authorities every two years an assessment of the capability of such benchmark to measure the underlying market or economic reality;
- if a supervised contributor to a critical benchmark intends to cease contributing input data in respect of the benchmark, it shall notify the administrator who shall also notify the relevant competent authority. The administrator must, within 14 days, submit to such competent authority an assessment of the implications of the benchmark to continue to measure the underlying market or economic reality. During this time, the competent authority has the power to require contributors to continue contributing input data (provided that this shall not impose an obligation on supervised entities to trade or commit to trade). The competent authority shall liaise with the relevant supervisory college and make its own assessment as to the capability of the benchmark to continue to measure the underlying market or economic reality. On the basis of such assessment, the authority can require supervised entities to continue to provide input data for a period not exceeding 12 months (which period can be extended by a further 12-month period).

The above rules in relation to mandatory administration and contribution to critical benchmarks will take effect on the date that the Benchmark Regulation comes into force.

Significant and non-significant benchmarks

A benchmark that is not a critical benchmark will be regarded as significant if either:

- it is used directly or indirectly within a combination of benchmarks as a reference for financial instruments or financial contracts or for measuring the performance of investment funds having a total average value of at

least €50billion on the basis of all of the range of maturities or tenors of the benchmark over a period of six months; or

- it has no or very few appropriate market-led substitutes and, in the event that the benchmark would cease to be provided or would be provided on the basis of input data no longer fully representative of the underlying market or economic reality or unreliable data, there would be a significant and adverse impact on market integrity, financial stability, consumers, the real economy or the financing of households or businesses in one or more member states.

Any benchmark that is not a critical or significant benchmark is regarded as a non-significant benchmark.

The administrator of a significant benchmark may choose not to apply certain provisions of the Benchmark Regulation that would otherwise apply, including the need to operationally separate the provision of a benchmark from parts of its business for conflict of interest reasons, certain of the provisions relating to diligence of employees and personnel and contributors on a "comply or explain" basis if it considers that complying with such provisions would be disproportionate, having regard to the nature or impact of the benchmark or the size of the administrator. The competent authority may, however, decide that one or more of such provisions should apply to the administrator on the basis of certain specified criteria set out in the Benchmark Regulation.

Administrators of non-significant benchmarks may choose not to apply a wider list of provisions from the Benchmark Regulation, including many of the specific requirements relating to the oversight function and control function. Again, this is on a "comply or explain" basis and requires the preparation of a compliance statement by the administrator explaining why it considers it appropriate not to comply with the relevant provisions. The relevant competent authority may request additional information and may require changes to the compliance statement to ensure compliance with the Benchmark Regulation.

Use of Benchmarks in the EU

Subject to the provisions relating to non-EU benchmarks below, a supervised entity will only be permitted to use a benchmark in the EU if the benchmark is provided by an administrator authorised or registered under the Benchmark Regulation.

The Benchmark Regulation provides that "use of a benchmark" means:

- issuance of a financial instrument which references an index or a combination of indices;
- determination of the amount payable under a financial instrument or a financial contract by referencing an index or a combination of indices;
- being a party to a financial contract which references an index or a combination of indices;
- providing a borrowing rate calculated as a spread or mark-up over an index or a combination of indices that is solely used as a reference in a financial contract to which the creditor is a party; or
- measuring the performance of an investment fund through an index or a combination of indices for the purpose of tracking the return of such index or combination of indices, or defining the asset allocation of a portfolio or of computing the performance fees.

The definition does not therefore prevent a supervised entity from acquiring, holding or trading a financial instrument that references an index within the ambit of the Benchmark Regulation. However, parties to an OTC derivative referencing a benchmark would appear to be regarded as issuing a financial instrument so where a supervised entity enters to such a derivative that is traded on a trading venue or where the counterparty is a systematic internaliser, entry into such derivative will be regarded as the use of a benchmark for the purpose of the Regulation.

Supervised entities that use a benchmark must produce robust written plans setting out the actions they would take if the benchmark should materially change or cease to be provided. Such plans must be provided to their relevant competent authority upon request.

Benchmark Contributors

The Benchmark Regulation defines a "contributor" as a natural or legal person contributing input data in respect of a benchmark. For this purpose, input data must be data not readily available to a benchmark administrator required in connection for the determination of the relevant benchmark. A "supervised contributor" is any supervised entity that contributes input data to a benchmark administrator located in the EU.

Article 15 of the Benchmark Regulation provides that where a benchmark is based on input data from contributors, the benchmark administrator is required to develop a code of conduct for each benchmark clearly specifying the contributors' responsibilities with respect to the contribution of input data and shall ensure that such code of conduct complies with the Benchmark Regulation. Administrators must be satisfied that contributors adhere to the code of conduct on a continuous basis.

The code of conduct is required to contain certain elements including:

- a clear description of the input data to be provided and the requirements necessary to ensure it is provided in accordance with the requirements of the Benchmark Regulation relating to input data;
- identification of the persons that may contribute input data to the administrator and procedures to verify the identity of a contributor;
- policies to ensure that a contributor provides all relevant input data; and
- the systems and controls that a contributor is required to provide.

Supervised contributors are also subject to certain requirements including:

- a requirement to ensure that the provision of input data is not affected by any existing or potential conflict of interest;
- the contributor has in place a control framework that ensures the integrity, accuracy and reliability of input data;
- it has in place effective systems and controls to ensure the integrity and reliability of all contributions of input data to the administrator including controls as to who may submit input data to an administrator, appropriate training for submitters, measures for the management of conflicts of interest and appropriate record keeping.

Non-EU Benchmarks

The ability for benchmarks administered outside the EU to continue to be used within the EU has been one of the most difficult and controversial issues during the drafting and negotiation of the Benchmark Regulation. As the EU is significantly ahead of other jurisdictions, including the US, in developing benchmark regulation, and having regard to the very wide scope of the Benchmark Regulation compared to the approach in other jurisdictions, there is a concern that any regime based on allowing non-EU benchmarks to be used in the EU only if subject to equivalent regulation in a non-EU jurisdiction would exclude a vast number of non-EU benchmarks from use in the EU.

To deal with some of these concerns, where a non-EU administered benchmark is already used in the EU on the date the Benchmark Regulation comes into force, the Benchmark Regulation provides for the "grandfathering" of existing financial instruments, financial contracts or investment funds referencing the benchmark for a period of 42 months after such date. In relation to new benchmarks, the Benchmark Regulation provides three alternative routes through which a benchmark administrator located outside the EU can seek to facilitate the use of their benchmarks in the EU as set out below:

- ***Equivalence***: ESMA may register a non-EU benchmark administrator and the benchmark if (a) an equivalence decision is adopted by the EU Commission in respect of the jurisdiction in which the administrator is located, (b) the administrator is authorised or registered and subject to supervision in such jurisdiction, (c) the administrator notifies ESMA of its consent that the benchmark(s) may be used by supervised entities in the EU and (d) cooperation arrangements between ESMA and the relevant authority in the administrator's jurisdiction are operational. Such cooperation agreements must cover at least the mechanism for exchange of information between ESMA and the competent authorities in the non-EU jurisdiction, mechanisms for notification to ESMA where the administrator is in breach of its conditions of authorisation in its home jurisdiction and the procedures concerning the coordination of supervisory activities.

The EU Commission may make an equivalence determination if either (i) administrators authorised or registered in the non-EU jurisdiction comply with binding requirements equivalent to the requirements under the Benchmark Regulation and such requirements are subject to effective supervision and enforcement on an ongoing basis in such jurisdiction or (ii) it is satisfied that binding requirements in the relevant jurisdiction with respect to specific administrators or specific benchmarks or families of benchmarks are equivalent to the requirements under the Benchmark Regulation (taking into account whether the legal framework and supervisory practice in such jurisdiction complies with the IOSCO principles) and such specific administrators or specific benchmarks or families of benchmarks are subject to effective supervision and enforcement on an ongoing basis.

At present, it is not clear that there will be any jurisdictions with equivalent provisions to the Benchmark Regulation at the time it becomes effective in respect of the same wide range of benchmarks within the scope of the Regulation. The ability for the EU Commission to determine equivalence where the relevant jurisdiction only regulates a limited category of administrators or benchmarks provides more scope for an equivalence determination. However, even with such increased flexibility, it seems likely that at the time when the Benchmark Regulation becomes effective, there will be relatively little scope for equivalence determinations to be made.

- ***Recognition***: Until such time as an equivalence determination is made in relation to any non-EU jurisdiction, a benchmark provided by an administrator located in such jurisdiction may be used by

supervised entities in the EU, provided that the non-EU administrator obtains prior recognition by the competent authority of its "member state of reference" in the EU. The member state of reference is to be determined by various criteria, including the location of affiliated supervised entities, the location of relevant trading venues for financial instruments referencing their benchmarks and the location of supervised entities using their benchmarks. For a non-EU administrator to obtain such recognition it will need to comply with the vast majority of the obligations that apply to EU administrators under the Benchmark Regulation. Such compliance may be fulfilled by compliance with the IOSCO Principles, provided that the relevant national competent authority determines that the application of such principles is equivalent to compliance with the requirements under the Benchmark Regulation (it may rely on an assessment by an independent external auditor or a certification by the competent authority in the relevant non-EU jurisdiction for such purpose). The non-EU administrator must also have a legal representative to perform an oversight function in relation to the provision of benchmarks by the administrator within the scope of the Benchmark Regulation which representative shall be accountable to the competent authority of the member state of reference.

Although the recognition process does provide greater scope for non-EU administrators to provide benchmarks for use in the EU, it is not a straightforward process. In particular, it may not be easy to identify the member state of reference and to obtain certification of compliance with the IOSCO principles. In addition, obtaining a legal representative to provide the functions required under the Benchmark Regulation may not be straightforward and is likely to involve considerable cost.

- ***Endorsemen***t: A non-EU administrator will be able to register benchmarks for use in the EU under the Benchmark Regulation if a benchmark administrator supervised in the EU or another supervised entity located in the EU with a clear and well-defined role within the control or accountability framework of the non-EU administrator and which is able to monitor effectively the provision of a benchmark, applies to its relevant competent authority to endorse a benchmark or a family of benchmarks provided in the relevant non-EU jurisdiction for use in the EU. Such application is dependent upon the satisfaction of specified conditions including:
    - the endorsing administrator or other supervised entity has verified and is able to demonstrate, on an on-going basis, to its competent authority that the provision of the benchmark or family of benchmarks to be endorsed fulfils (on a mandatory or voluntary basis) requirements at least as stringent as those under the Benchmark Regulation;
    - the endorsing administrator or other supervised entity has the necessary expertise to monitor the provision of the benchmark and to manage the associated risks; and
    - there is an objective reason to provide the benchmark or family of benchmarks in the non-EU jurisdiction and for them to be endorsed for use in the EU.

In determining whether the provision of the benchmark(s) fulfils requirements at least as stringent as under the Benchmark Regulation, the competent authority may take into account whether the provision of the benchmark(s) complies with the IOSCO principles.

The endorsement process was introduced as an alternative to the equivalence and recognition procedures above due to some of the challenges related to those regimes as outlined above. However, the endorsement route also presents challenges, not least the need to ensure that there is an appropriate supervised benchmark administrator or other supervised entity willing and able to perform the endorsing role. In particular, the requirement for such

entity to have a clear and well-defined role within the control or accountability framework of the non-EU administrator may give rise to practical challenges.

Supervision and Enforcement by Competent Authorities

National competent authorities will have wide-ranging powers to ensure compliance with the provisions of the Benchmark Regulation, including the ability to request relevant information, documents and data and to carry out onsite inspections and investigations. They will also have the ability to require corrective statements to be published about past contributions to a benchmark or the published level of a benchmark. Competent authorities will also have the ability to suspend trading of any financial instrument that references a regulated benchmark.

Competent authorities will also have the power to impose various sanctions upon entities or individuals breaching the Benchmark Regulation, including disgorgement of profits, imposition of fines or withdrawal or suspension of a regulated entity's authorisation.

Amendments to the Market Abuse Regulation and Other Legislation

The Benchmark Regulation makes amendments to the Market Abuse Regulation, including exempting persons discharging managerial responsibilities in relation to an issuer of securities from the requirement to disclose transactions in financial instruments linked to securities of the issuer where those securities provide an exposure not exceeding 20% of the issuer's shares or debt instruments. Amendments are also made to certain other financial services legislation, including amending the Mortgage Credit Directive to require that lenders making loans regulated under such Directive disclose to consumers the name of any benchmarks referenced in such loans, the name of the relevant benchmark administrator and the potential implications to the consumer from the use of the benchmark.

Next Steps and Impact of Benchmark Regulation

The Benchmark Regulation requires ESMA to produce drafts of a significant number of implementing and regulatory technical standards (some of which are highlighted above) – the EU Commission will then consider whether to adopt such technical standards. In addition, the EU Commission has requested that ESMA provide technical advice on certain aspects of the Benchmark Regulation.

Whilst the draft Benchmark Regulation was still going through the EU legislative process, ESMA published a Discussion Paper in February 2016[13]. Following responses in relation to the Discussion Paper, ESMA published a Consultation Paper on 27 May 2016[14] setting out its proposals in relation to the relevant technical advice (but not the draft technical standards). The technical advice covers the following issues:

- certain elements of the definitions, including when a benchmark is made available to the public and what constitutes the issuance of a financial instrument for the purpose of defining the "use" of a benchmark in the EU;
- the measurement of the reference value of a benchmark;
- the criteria for identification of critical benchmarks;

[13] https://www.esma.europa.eu/sites/default/files/library/2016-288_discussion_paper_benchmarks_regulation.pdf.
[14] https://www.esma.europa.eu/sites/default/files/library/2016-723_cp_benchmarks_regulation.pdf.

- framework for the endorsement of benchmarks provided by a non-EU benchmark administrator; and
- transitional provisions.

Responses to the Consultation Paper should be made by 30 June 2016. ESMA must provide its technical advice to the EU Commission within four months after the Benchmark Regulation comes into force. It is expected that ESMA will publish a further Consultation Paper in relation to its draft technical standards later in 2016.

Although the bulk of the provisions of the Benchmark Regulation will not come into effect until late 2017 or early 2018 (depending upon when it is published in the Official Journal), it will have a profound effect upon financial instruments and contracts referencing benchmarks in the EU. Firms administering, contributing to or using financial benchmarks should already be considering the effect of the Regulation on their businesses and, in the case of administrators, making preparations for obtaining authorisation or registration under the Benchmark Regulation.

Among the biggest concerns for market participants is the effect on benchmarks administered outside the EU. Although the final version of the Benchmark Regulation sought to address some of the concerns raised in this regard in previous drafts of the Regulation, there is a concern that many benchmarks administered outside the EU will cease to be used in the EU. The transitional provisions for benchmarks already in use when the Benchmark Regulation comes into force and the provisions for equivalence, recognition and endorsement of non-EU benchmarks outlined above are designed to facilitate the use of non-EU benchmarks within the EU. There are, however, challenges involved in all of these options, and it may be that certain non-EU administrators decide not to go down any of these routes.

As a result of these challenges, there is a likelihood that many benchmarks, both those administered in and outside of the EU, will be discontinued in due course and many non-EU benchmarks may cease to be available for use in the EU, reducing investor choice.

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