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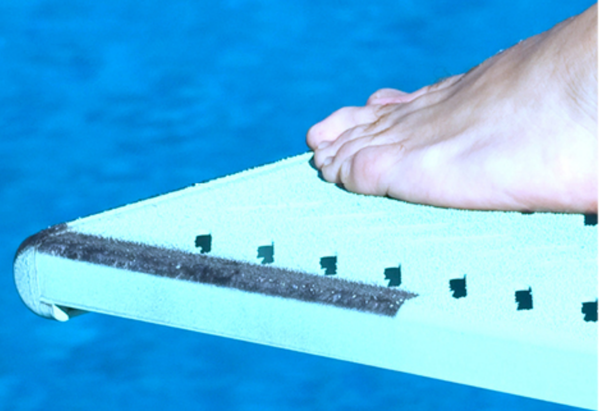

# 2019: STANDING ON THE EDGE – EUROPEAN FINANCIAL REGULATORY DEVELOPMENTS INTO 2019 AND BEYOND

MARCH 2019

# Foreword

This publication, the fifth edition in our series of annual EU financial regulatory updates, may well be the last that we write with the UK still being a member of the EU. As we approach the date set for Brexit, political chaos reigns in the UK, and there are still multiple possible outcomes of the political discussions, only a little more than two weeks before the earliest date on which Brexit could occur. Those possible outcomes include a Brexit with a fully-negotiated and ratified withdrawal agreement, a no-deal Brexit, an additional (longer) extension to Brexit day, a new cross-party approach to negotiating a withdrawal agreement, an early general election, a unilateral revocation of Brexit by the UK and another Brexit referendum.

The UK Treasury and regulators, such as the FCA, are doing what they can to prepare for Brexit (even if not all European authorities are), in order to minimize, as far as possible, the disruption of a potential no-deal Brexit and to position the UK regulatory framework so that, after Brexit, it can be objectively considered equivalent to the EU's framework by the European Commission. This would enable as close a relationship as possible with the EU in a no-deal Brexit scenario, given the constraint that the UK will (at least at the time of writing) be leaving the EU's Single Market.

We make no apology for focusing heavily on Brexit in this year's edition and how Brexit will affect specific areas of financial regulation. However, among other topics, we highlight developments in derivatives markets and topics such as the upcoming initial margin "Big Bang", proposed changes to the EMIR Regulation in respect of clearing, reporting and risk-mitigation and the proposed new regime for the supervision, and possible relocation to the EU, of non-EU (including the UK and the US) clearing houses. We also focus on upcoming developments that alternative investment fund managers and investment firms need to be aware of, the New Prospectus Regulation and upcoming changes to the PRIIPs Regulation, as well as the regulation of financial benchmarks and the transition away from IBORs, changes to the bank stability and resolution regime, the regulation of crypto-assets and green and social bonds.

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# 1. BREXIT

Following the results of the 2016 UK referendum, which voted narrowly in favour of the UK leaving the European Union ("**Brexit**"), and having served a notice under Article 50 of the Treaty on the European Union on 29 March 2017, the UK was due to leave the EU at 11:00 p.m. London time on 29 March 2019. However, on 21 March 2019, following a request from the UK government, the other EU member states (the "**EU27**") agreed to an extension of the date on which the UK will cease to be a member of the European Union ("**Brexit day**"), which extension we discuss below.

On 25 November 2018, the UK government reached agreement with the EU27 on a binding withdrawal treaty (the "**Withdrawal Treaty**") and a non-binding political declaration setting out the framework for the future relationship between the UK and EU27. Although the Withdrawal Treaty is intended to have a binding effect, it will not take effect until it is ratified by both the UK Parliament and the European Parliament.

If the Withdrawal Treaty is ratified by both the UK Parliament and the European Parliament, it will provide for a transition period starting on the day after Brexit day and lasting until 31 December 2020. That period could be extended beyond31 December 2020 for up to one or two additional years but only extended once and only if the UK and the EU27 agree to such an extension by 1 July 2020. During the transition period, the UK would continue to be subject to all existing and new EU regulations but would have no say in their creation. The transition period is expected to be used by the UK and the EU27 to finalise the terms of their future relationship, following the transition period, based on the non-binding political declaration.

On 15 January 2019, the UK government put forward a motion to Parliament to approve the Withdrawal Treaty, but the House of Commons rejected the Brexit deal negotiated by the UK government by a record 230 votes. On 12 March 2019, the House of Commons again considered a slightly revised form of the Withdrawal Treaty and again rejected it, this time by nearly 150 votes. On 13 March 2019, the House of Commons voted that the UK should not leave the EU without signing a withdrawal agreement. However, such a vote is advisory only and not binding on the UK government.

The House of Commons, on 14 March 2019, voted overwhelmingly to request an extension of the date of Brexit day. On 20 March 2019, the UK government formally requested an extension of the date of Brexit day until 30 June 2019. However, the consent of all the EU27 was required to agree such an extension. The response of the EU27 was that they would agree to an extension of the date of Brexit day to 22 May 2019 (the day before the start of elections to the European Parliament), in the event that the House of Commons approves the Withdrawal Treaty by no later than the end of 29 March 2019, or to 12 April 2019 (the date by which the UK would need to give notice of the poll, in order to hold elections to the European Parliament), in the event that the House of Commons fails to approve the Withdrawal Treaty by 29 March 2019. It is now expected that the UK government will hold an additional (third) vote in the House of Commons on the Withdrawal Treaty negotiated with the EU27, on 26 or 27 March 2019. Many issues surrounding Brexit remain unclear at the time of publication, including:

- what policy the UK government will pursue in attempting to achieve a withdrawal agreement before Brexit day, including whether the UK government will attempt for the fourth time (if the third vote is unsuccessful) to obtain the approval of the House of Commons of the existing proposed Withdrawal Treaty;
- if the Withdrawal Treaty cannot obtain the approval of the UK Parliament by 29 March 2019, whether or not the UK government (or the House of Commons) will have the ability or inclination to prevent the UK leaving the EU on 12 April 2019 without a comprehensive withdrawal agreement (a "**no-deal Brexit**"). To achieve this would probably involve the UK government making a further request for a much longer

extension of the date for Brexit day. The consent of each EU27 member state to such an extension would again be required, and in order to obtain such consent, it is likely that the UK government would need to explain its plans for a completely different approach to reaching a ratified withdrawal agreement. The UK would also be compelled to give notice of the poll for elections to the European Parliament by 12 April 2019, and to hold such elections between 23-26 May 2019;

- if a no-deal Brexit is avoided, whether the UK government will adopt a cross-party political approach to developing a withdrawal agreement to which both the UK Parliament and the EU Parliament can agree; and
- whether a new UK general election may be triggered, for instance if the current UK government collapses, and, if so, whether any resulting UK government would propose a materially different approach to reaching a withdrawal agreement, including, but not limited to, a new national referendum on Brexit to seek direction from the electorate.

Alternatively, the UK has the power, acting unilaterally, to revoke the Article 50 notice altogether by 12 April 2019. However, it is doubtful that the UK Parliament would give approval to such a measure without holding a second national referendum on Brexit. Currently, there appears to be insufficient support in the UK Parliament for a second referendum and it is not clear, in any case, what the terms of such a referendum, would be.

## Changes to UK Legislation

In preparation for Brexit, the European Union (Withdrawal) Act 2018 ("**Withdrawal Act**") adopts direct EU legislation, such as EU regulations, into domestic UK law, beginning on Brexit day, and it also empowers the UK government to make secondary legislation to amend pre-Brexit UK legislation and newly-domesticated EU legislation, to ensure that it operates properly post-Brexit.

The Withdrawal Act has the effect of creating a new body of domestic law ("**Retained EU Law**"), which includes:

- retained direct EU law;
- EU-derived domestic law; and
- directly effective laws derived from the EU treaties that confer rights directly on individuals and that can be enforced without the need for national implementing measures.

"Retained direct EU law" is directly applicable EU law, as at Brexit day, which is converted by the Withdrawal Act into UK law on Brexit day. This "on-shoring" of EU legislation includes Level 1 legislation, such as EU regulations, but also secondary legislation, such as EU implementing and delegated acts and regulatory technical standards. Such retained direct EU law will be unaffected by any changes to EU laws made by the EU27 after Brexit day. This category of Retained EU Law includes direct EU legislation that is fully operative before Brexit day but does not include legislation that is (i) in force before Brexit day but (ii) not then applicable ("**in-flight legislation**").

"EU-derived domestic law" consists of pre-Brexit UK legislation, which implements the UK's EU obligations. This is preserved in UK law by the Withdrawal Act on Brexit day. This category of Retained EU Law generally implements EU directives and comprises primary legislation, such as acts, and secondary legislation, such as rules, regulations and orders. It includes UK legislation that is derived from EU law and that has been made, but is not yet enforced, as of Brexit day.

The Withdrawal Act also allows for Retained EU Law to be amended to make sure that it operates properly as of Brexit day. It includes the power to make correcting amendments to Retained EU Law pursuant to Brexit statutory instruments.

Pursuant to one of those Brexit statutory instruments, the Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018, the UK Treasury has delegated certain powers to the UK's Financial Conduct Authority ("**FCA**") and other financial services regulators. In this regard, the FCA is responsible for amending and maintaining on-shored EU binding technical standards and also amending the FCA Handbook to ensure that it remains fit for its purpose as of Brexit day.

As mentioned above, the Withdrawal Act does not encompass EU legislation that has either:

- been adopted by the EU but will not be implemented by Brexit day; or
- is currently under negotiation and may be adopted shortly after Brexit day.

## Financial Services (Implementation of Legislation) Bill

In order to allow for the above categories of EU laws to be effectively domesticated into UK law at a later date, the UK government has proposed the Financial Services (Implementation of Legislation) Bill, which contains powers that enable the UK Treasury to enact legislation that corresponds to, or is similar to, specified provisions of EU financial services legislation in the event of a no-deal Brexit.

Among other pieces of legislation, this bill (which is still progressing through the UK Parliament) encompasses the following pieces of, or provisions of, EU legislation:

- the provisions of the Markets in Financial Instruments Regulation (Regulation No. 600/2014) that deal with non-discriminatory access to financial benchmarks and access for foreign central clearing counterparties ("**CCPs**") to domestic trading venues and for foreign trading venues to domestic CCPs;
- the provisions of Regulation (EU) 2017/1129 (the "**New Prospectus Regulation**") that apply from 21 July 2019, together with any delegated acts under the New Prospectus Regulation, other than technical standards, that are adopted by the European Commission before 21 July 2019;
- the reporting obligations under the Securities Financing Transactions Regulation (Regulation (EU) 2015/2365); and
- any EU directive or regulation adopted before, on or after Brexit day as a result of any of the following proposals:
    - the proposed amendments to the CRD4 Directive (Directive 2013/36/EU), the Capital Requirements Regulation (Regulation (EU) No. 575/2013) and the Bank Recovery and Resolution Directive (Directive 2014/59/EU)[1];
    - the proposed legislation on the recovery and resolution of CCPs;
    - the proposed EMIR II (or EMIR Refit) Regulation and the proposed regulation on the enhanced supervision of non-EU CCPs (for further details on these topics, please see the section on EMIR in this publication);
    - the proposed legislation on a new prudential framework for investment firms (for further details, please see the section of this publication on this topic);

[1] For certain details of these proposed amendments, please see our client alert: "Shaping MREL for European (and non-European) Banks", available at https://media2.mofo.com/documents/161209-shaping-mrel-for-european-banks.pdf.

- the proposed new legislation in relation to the cross-border distribution of collective investment funds (for further details on this topic, please see the section on AIFMD in this publication);
- the proposed new legislation in relation to the issuance and public supervision of covered bonds and their associated capital requirements;
- the proposals in relation to amending the Benchmarks Regulation (Regulation (EU) 2016/1011) in relation to low carbon benchmarks and positive carbon impact benchmarks;
- the proposals in relation to promoting the use of SME growth markets; and
- the so-called omnibus legislation in relation to the powers of the three European Supervisory Authorities (being the European Insurance and Occupational Pensions Authority ("**EIOPA**"), European Banking Authority ("**EBA**") and the European Securities and Marketing Authority ("**ESMA**").

Later in this publication, we highlight some of the specific effects that the UK government's no-deal Brexit legislation may have in relation to certain specific financial sectors and financial legislation.

## Preparations for a No-Deal Brexit

Given the continuing possibility that the UK could leave the EU without a withdrawal agreement, the UK Treasury has been busy making legislative preparations, inter alia, to ensure that the UK's financial laws and regulations will operate properly following a no-deal Brexit.

Such new legislation will need to be in place, in any case, at the point when the UK ceases to be subject to EU rules and regulations. This is because, at such point, the UK and the EU27 will cease to have mutual "passporting" rights. This point of time will occur on 29 March 2019 (or any later date to which the UK's exit is postponed with the agreement of the EU27) if no withdrawal agreement has been ratified by the UK and EU Parliaments by such date or following the end of the implementation period in 2020 (or any later date to which that implementation period is extended) that would result from both sides ratifying a withdrawal agreement.

However, at the current time, the legislation enacted by the UK Treasury has the feel of emergency legislation because it simply purports to domesticate all existing EU financial regulations into UK law following a no-deal Brexit. In contrast, the expectation is that, if the transition period becomes operational following the ratification of a withdrawal agreement, then the UK and the EU27 will manage to negotiate a more nuanced and cooperative future framework in relation to financial services and that the UK Treasury will reflect this agreement by enacting a completely new set of legislation.

In terms of financial services, the UK government originally proposed to the EU27 that there should be mutual access to each other's financial markets when the existing EU passporting rights cease. However, the EU27 did not agree to this approach.

In order for firms in the UK to continue to be able to access EU markets, there currently are a couple of possibilities. Firstly, UK firms could seek to make use of the various EU provisions for regulatory equivalence for non-EU countries. This is not a comprehensive network, and equivalence works differently for different pieces of legislation. It requires a legislation-by-legislation decision by the European Commission as to the equivalence of the relevant UK regime and, once given, a decision of equivalence can be revoked by the European Commission if it considers that the UK's laws have diverged too far from the EU's laws. In order to allow as much scope as possible for the European Commission to make equivalence decisions in respect of the UK, post-Brexit, the approach of the UK Treasury has been to change only what needs to change in EU legislation to achieve a domesticated UK set of legislation that is as equivalent as possible to EU law. However, the granting of equivalence by the European Commission to non-EU countries has proven to be an extremely

political process, and such determinations of equivalence cannot be taken for granted, even if UK law is objectively equivalent.

In addition to possible reliance on regulatory equivalence, UK firms could make a decision to obtain authorisation in both the UK and the EU27, although this would generally require the establishment of branches or subsidiaries in the EU27.

A no-deal Brexit should not generally affect the validity of pre-Brexit private contractual obligations; although, as we highlight in relation to EMIR later in this publication, some EU-focused activities that are needed to support certain contractual obligations post-Brexit, such as derivatives, may cease to be permitted without new EU authorisation.

As we also highlight later in this publication, the UK has introduced a temporary permissions regime for a maximum period of three years (extendable by an additional one year) to allow EU firms to continue operating in the UK as they have been pre-Brexit, while they apply for full UK authorisation. A similar regime will also allow EU funds marketing in the UK under a passport to continue that marketing for the same temporary period.

The EU has, so far, not yet agreed to implement any EU legislation equivalent to the UK's temporary permissions regime.

Later in this publication, we highlight some of the specific effects that the UK government's no-deal Brexit legislation will have in relation to certain specific financial sectors and financial legislation.

# 2. EMIR

## Initial Margin

On 1 September 2018, phase three of the implementation of the initial margin rules for non-centrally cleared derivatives ("**NCDs**") under the European Market Infrastructure Regulation ("**EMIR**")[2] came into effect. This phase obliges counterparties to NCDs to exchange initial margin ("**IM**") (subject to any available exemptions) where both counterparties belong to groups that have an aggregate average notional amount ("**AANA**") of NCDs above EUR1,250 billion but not exceeding EUR2,250 billion.

On 1 September 2019, phase four will come into effect and will include, in the scope of the IM obligations, NCDs between counterparties where both of their groups have an AANA of NCDs above EUR750 billion but not exceeding EUR1,500 billion.

The AANA for each counterparty is to be determined by (i) taking the average of the total gross notional amounts recorded on the last business day of each of the March, April and May immediately preceding the date on which the relevant phase takes effect; as well as (ii) taking into account the NCDs of all entities within the relevant counterparty's group; and (iii) including all intragroup NCDs (counted only once).

The scope of EMIR's margin rules encompasses (i) EU financial counterparties ("**FCs**") and EU "above-threshold" non-financial counterparties ("**NFC+s**") as well as (ii) non-EU entities trading NCDs with other non-EU entities, where (a) both counterparties would be FCs or NFC+s if they were EU entities and (b) the transaction would be deemed to have a "direct, substantial and foreseeable effect" in the EU, according to EMIR's criteria in this regard. Various exemptions from IM may be applicable for such entities, including the following:

- no IM is required to be collected in respect of physically-settled foreign exchange swaps or forwards, or in respect of the exchange of principal within a currency swap;
- no margin is required to be collected where the amount that would otherwise be required is equal to or less than an agreed minimum transfer amount (which may not exceed EUR500,000);
- the counterparties may agree that any IM that would otherwise be required to be collected is reduced by EUR50 million (where the counterparties do not belong to a group or belong to different groups) or by EUR10 million (where the counterparties belong to the same group);
- IM is not required for NCDs concluded in connection with hedging certain covered bonds;
- IM need not be posted for NCDs with counterparties in non-EU jurisdictions where there is uncertainty as to the enforceability of the parties' netting arrangements and collateral exchange arrangements or where the collateral segregation requirements of EMIR (including certainty of protection of collateral rights in an insolvency of a collecting counterparty) cannot be met; and
- certain intra-group NCDs may be exempted from the EMIR margin requirements.

The amount of IM to be collected and delivered between non-exempt, in-scope entities is to be determined at least once every 10 business days and also, inter alia, upon the event of (i) a new NCD being exercised or added to the netting set, (ii) the expiry on removal from the netting set of an NCD and (iii) a payment or delivery under an NCD (other than the posting or collection of margin).

[2] Regulation No. 648/2012.

The amount of IM to be exchanged between non-exempt, in-scope entities is to be determined using either or both of an IM model that complies with Section 4 of the EMIR Margin Regulatory Technical Standards[3] ("**Margin RTS**") (such as the Standard Initial Margin Model developed by the International Swaps and Derivatives Association ("**ISDA**")) and the initial margin provisions contained in Annex IV to the Margin RTS.

When collecting and delivering IM, no offsetting of IM amounts may be performed between the two counterparties. The IM, once collected, must be segregated in accordance with the provisions of the Margin RTS.

Looking further into the future, phase five (the final phase) of the EMIR's IM rules implementation is due to take effect on 1 September 2020. This will capture NCDs between counterparties whose respective group AANAs are both in excess of EUR8 billion but do not exceed EUR750 billion. This phase is sometimes referred to as the IM "Big Bang" due to the number of counterparties that will be brought within the IM regime for NCDs for the first time (1100 entities by ISDA's estimates).

ISDA estimates that this will equal to roughly 19,000 IM custody accounts. However, it also estimates that a large number of these 1100 entities will, in fact, not be required to exchange IM because their counterparty exposures will fall below the EUR50 million posting threshold mentioned above. Despite the significant upheaval that will be involved in the documentation and operation preparations for phase five, therefore, the amount of additional IM "captured" is not expected to achieve much in the way of reducing systemic risks (the main objective of the Margin RTS).

Various industry associations, including ISDA, sent a joint letter to the Basel Committee and the International Organisation of Securities Commissions ("**IOSCO**") in September 2018, recommending that the lower threshold of EUR8 billion for phase five should be raised to EUR100 billion and stating that such an increase would not result in a large reduction in the amounts of IM actually posted. It is not yet clear what the regulators' response will be.

## EMIR II

EMIR II (or the "**EMIR Refit**") is the name given to the proposals to amend, by EU regulation, many provisions of EMIR, in order to streamline or reduce the burden of EMIR on derivatives counterparties. For further detail on these proposals, please see our client alert: "Proposed EMIR II – Key Points for Derivatives Markets Participants".[4]

On 5 February 2019, the Council of the EU and the European Parliament announced that they had reached political agreement on EMIR II. Although the detailed drafting of the political agreement is not yet publicly available, it is expected to include the following:

- an extension of the definition of "financial counterparty" to bring more entities within the scope of EMIR's central clearing provisions and risk mitigation provisions for NCDs. However, although the extended definition is expected to include central securities depositories and certain alternative investment funds ("**AIFs**"), a large number of AIFs that would have been included in the European Commission's original proposals are now expected to be excluded from the definition, along with securitisation special purpose entities;

- streamlined reporting requirements, including (i) the FC being solely responsible for reporting on behalf of both counterparties where it is facing an entity that is an NFC but not an NFC+ (an "**NFC–**" entity), (ii) removing the obligation to report transactions entered into before 12 February 2014 ("**back-loaded**

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[3] Commission Delegated Regulation (EU) 2016/2251 – https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN.
[4] https://media2.mofo.com/documents/170518-proposed-emir-ii-derivatives-markets.pdf.

**transactions**") and (iii) removing the reporting requirement, in certain circumstances, for intra-group transactions where at least one party is an NFC;

- provisions that only FCs that exceed the clearing thresholds set under Commission Delegated Regulation (EU) No. 149/2013[5] will be obliged to clear their over-the-counter ("**OTC**") derivatives trades (instead of the current position under EMIR, where all FCs must clear their OTC trades that are subject to the clearing obligation);
- provisions that NFCs that exceed the clearing threshold will be obliged to clear only their OTC derivatives trades within the asset class for which they have exceeded the threshold (or, put another way, they will be NFC+ entities for that asset class, but not for any asset class for which they have not exceeded the relevant clearing threshold). For any asset classes for which they have not exceeded the clearing threshold, they will not be subject to EMIR's margin rules either;
- provisions allowing for the access of non-EU regulators to EU trade repositories ("**TRs**") data, where mutual access arrangements exist for EU regulators in the relevant non-EU jurisdiction;
- the ability for ESMA to suspend the clearing obligation for up to one month (renewable up to a total of 12 months), in respect of specific asset classes or counterparties, where necessary due to significant changes in market conditions or to maintain financial stability;
- removal of the requirement for variation margin on physically-settled foreign exchange forwards and swaps, except for credit institutions and investment firms; and
- extending the clearing exemption currently enjoyed by pension schemes.

On 31 January 2019, ESMA published a statement addressing certain implementation issues with the proposed EMIR II. At present, the deadline for an FC falling in category 3 of the delegated regulations on clearing (i.e., FCs with outstanding gross notional amounts of NCDs of EUR8 billion or lower) to clear its OTC derivative contracts is 21 June 2019. Since EMIR II (which will exempt certain of those category 3 FCs from clearing their contracts) may not be in effect by that time, ESMA has stated its expectation that national competent authorities will "de-prioritise" their enforcement actions in relation to FCs that are not expected to exceed the clearing thresholds when EMIR II comes into effect. ESMA expects national competent authorities to take a similar approach in respect of the reporting of back-loaded transactions, which will not be required when EMIR II becomes applicable (see above).

## Derivatives Regulation Post-Brexit

## UK Preparations

The UK Treasury, as part of its preparations for a no-deal Brexit, has published the Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment etc., and Transitional Provision) (EU Exit) Regulations 2019[6], the Central Counterparties (Amendments etc., and Transitional Provision) (EU Exit) Regulations 2018[7] and the Trade Repositories (Amendment and Transitional Provision) (EU Exit) Regulations 2018[8]. These regulations will create, for the UK, a domesticated form of EMIR following a no-deal Brexit, except that the UK version of EMIR will have the following differences:

- the roles of the European Commission and ESMA under EMIR will be replaced by the UK Treasury and the FCA/Bank of England, respectively;

[5] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0149&from=EN.
[6] http://www.legislation.gov.uk/uksi/2019/335/made.
[7] http://www.legislation.gov.uk/ukdsi/2018/9780111171882/pdfs/ukdsi_9780111171882_en.pdf.
[8] http://www.legislation.gov.uk/ukdsi/2018/9780111174289/pdfs/ukdsi_9780111174289_en.pdf.

- the power to make decisions as to equivalence in respect of TRs is transferred to the UK Treasury. Currently, since no equivalence decisions have been made by the UK Treasury in relation to EU TRs, nor by the European Commission in relation to UK TRs, following a no-deal Brexit, UK parties would have to report their derivatives trades to a UK TR, and EU parties would have to report to an EU TR;
- UK TRs may submit advance applications to the FCA for registration as TRs before Brexit day. UK TRs that have been registered under EMIR, prior to Brexit day shall automatically be regarded as being registered in the UK after Brexit day, so long as they have notified the FCA of their request to be registered under the post-Brexit UK regime. In addition, a UK entity that is part of a group containing a TR registered under EMIR will be treated as if it were a TR for a temporary period (not exceeding three years from Brexit day), so long as it has submitted an advance application to the FCA. EU authorities will cease to have access to data reported to UK TRs;
- a non-UK CCP may apply to be recognised by the Bank of England where it intends to operate as a central counterparty in the UK on and after Brexit day, subject to the UK Treasury having determined the equivalence of the regime in the relevant non-UK country and there being in place co-operation arrangements with the relevant non-UK supervisor of the CCP. The regulations also introduce a system of deemed recognition of non-UK CCPs that were authorised or recognised under EMIR immediately before Brexit day and have notified the Bank of England that they intend to provide clearing services in the UK on and after Brexit day. This deemed recognition system is intended to be in effect for a temporary period (not exceeding three years);
- in the event of a no-deal Brexit, UK counterparties currently subject to the EMIR clearing obligation will continue to be obliged to clear derivatives trades declared to be subject to the clearing obligation but with CCPs authorised or recognised by the Bank of England. The Bank of England will also have the power to set the clearing obligations for different asset classes. Existing intragroup exemptions from clearing will continue to be available to UK firms via a temporary three year intragroup exemption regime; and
- the UK statutory instruments currently make no mention of applying the EMIR clearing exemption for pension schemes. Although the previous pension scheme exemption under EMIR expired in August 2018, ESMA issued guidance for national competent authorities to de-prioritise enforcement of clearing obligations for pension schemes until EMIR II has been agreed. The approach of the UK Treasury, in drafting the statutory instrument, has been to wait and see whether EMIR II is finalised before Brexit day and react accordingly. However, if a no-deal Brexit occurs before EMIR II is finalised then, pursuant to guidance issued by the UK Treasury on 21 February 2019, the UK Treasury has indicated that it intends that the temporary clearing exemption under the UK's post-Brexit legislation will apply to both UK and EEA pension schemes. It is intended that the UK Treasury will be given power under the Financial Services (Implementation of Legislation) Bill[9] introduced by the UK Treasury on 22 November 2018, to domesticate any changes made to certain EU laws during a two-year period after a no-deal Brexit. The bill applies to EMIR II and also to many other pieces of in-flight EU legislation listed on the schedule to the bill that have been proposed by the European Commission but that are not yet in force.

## EU27 Preparations

In terms of the EU's preparations for the post-Brexit EMIR regime, ESMA released a statement on 18 February 2019 that it would recognise LCH, ICE Clear Europe and LME Clear as central clearing counterparties under EMIR in the event of a no-deal Brexit. This follows the December 2018 decision by the European Commission to temporarily recognise the UK as equivalent in respect of the regulation of CCPs (until 30 March 2020) and central securities depositories (until 30 March 2021). It also follows the 4 February 2019 announcement by ESMA that it has agreed a memorandum of understanding with the Bank of England,

[9] https://services.parliament.uk/bills/2017-19/financialservicesimplementationoflegislation.html.

in relation to the co-operation and information exchange provisions that are necessary for UK CCPs to operate under EMIR's recognition provisions.

On 14 March 2019, the Commission Delegated Regulations (EU) 2019/396 and (EU) 2019/397 entered into force. Such Commission Delegated Regulations have the effect of grandfathering, for 12 months after Brexit day, the status of NCDs that are novated in that 12 month period, solely in order to replace a UK counterparty with an EU27 counterparty. This will ensure that where NCDs are novated due to a UK counterparty's inability to perform certain services in the EU, post-Brexit, these NCDs will not lose any exemption from the EMIR clearing obligation and/or from applying the EMIR margin provisions that they previously enjoyed.

The European Commission has not yet made a decision as to the equivalence of UK regulated markets for the purpose of determining whether a derivative is an OTC derivative for the purpose of Article 2a of EMIR. Therefore, at present, derivatives traded on a UK regulated exchange following a no-deal Brexit would be treated as OTC derivatives for the purposes of EMIR. The effect of this is that the amount of OTC derivatives traded by an entity would be artificially inflated by the amount of derivatives traded by them on a UK regulated exchange and, where the entity is an EU NFC or a non-EU NFC (whether UK or not), this may cause the entity to exceed the EMIR clearing threshold. Under EMIR II, when it takes effect, the same issue could cause an FC to artificially exceed one or more clearing thresholds.

In addition to the problems caused in relation to EMIR clearing thresholds, the lack of a European Commission equivalence decision for UK regulated markets, multilateral trading facilities ("**MTFs**") and organised trading facilities ("**OTFs**") under the Markets in Financial Instruments Regulation ("**MiFIR**") means that EU FCs and NFC+s would currently be unable to execute derivatives trades on such UK markets after a no-deal Brexit, where such derivatives were subject to the MiFIR trading obligation.

ESMA published a statement on 1 February 2019, summarising its position in relation to reporting of derivatives trades under EMIR following a no-deal Brexit. In summary:

- UK counterparties will cease to be required to report to EU authorised or recognised TRs following Brexit day. This applies to trades entered into, or amended, on or after Brexit day. Therefore, there will be a de-coupling between the data reported by an EU counterparty and a UK counterparty in respect of the same transaction;
- EU TRs will terminate the reports provided by UK counterparties;
- there will be no reconciliation of trades between different TRs where at least one of the parties is a UK counterparty; and
- a UK TR will only have access to data in EU TRs where the UK TR is recognised under EMIR, in the absence of an equivalence decision by the European Commission. EU TRs with affiliate UK-based TRs are expected to ensure continuous direct and immediate access to EMIR data.

## U.S. and UK Relations Post-Brexit

Although the post-Brexit relationship between the UK and the EU has attracted the most attention since the Brexit vote, in relation to derivatives markets, the relationship between the UK and the U.S. is at least as important, since the UK and the US together host the vast majority of the world's derivatives activity.

On 25 February 2019, the U.S. Commodity Futures Trading Commission ("**CFTC**"), the Bank of England, including the UK's Prudential Regulation Authority ("**PRA**"), and the FCA issued a Joint Statement[10] on the continuity of derivatives trading and clearing, post-Brexit. The statement provides that the UK and U.S. authorities are taking measures to ensure that Brexit, in whatever form it takes, will not create regulatory

[10] https://www.cftc.gov/PressRoom/PressReleases/7876-19?utm_source=govdelivery.

uncertainty regarding derivatives market activity between the UK and the U.S. The UK and U.S. authorities have agreed to co-ordinate on the following specific measures by the end of March 2019:

- the Bank of England and CFTC are in the process of updating the 2009 memorandum of understanding between them in relation to clearing activity;
- the FCA and CFTC are updating their existing 2013 and 2016 memoranda of understanding, covering certain derivatives firms and alternative investment funds;
- the CFTC intends that existing regulatory relief granted by it to EU firms will continue to benefit UK firms post-Brexit. Specifically, the CFTC:
  - will issue new "no action" letters to UK market participants, which will permit the UK participants to rely on CFTC staff relief in relation to several issues, such as broker registration, swap data reporting and the trading and clearing of inter-affiliate swaps;
  - will grant new substituted compliance and exemption orders to confirm that UK firms may satisfy certain entity-level and transaction-level requirements of the CFTC, by complying with relevant UK laws, and may satisfy CFTC trade execution requirements by using eligible UK trading venues. Where necessary, CFTC staff will issue temporary no-action relief to cover any period until the CFTC orders can be finalised; and
  - confirms that UK CCPs currently registered with the CFTC will be able to continue providing services in the US as they do now; and
- UK authorities have confirmed that U.S. trading venues, firms and CCPs will be able to continue providing services in the UK, by the following measures:
  - the UK Treasury confirmed that existing European Commission equivalence decisions in relation to the CFTC's regulatory framework relating to margin and other risk mitigation requirements and to trading venues will continue to apply in UK law post-Brexit. This will allow UK firms to apply CFTC margin rules for contracts with U.S. parties regulated by the CFTC and to access CFTC-regulated trading venues to satisfy their derivatives trading obligations;
  - the UK Treasury expects to announce imminently that the CFTC clearing regime, already determined by the European Commission to be equivalent to the EU regime, will be determined to be equivalent to the UK regime; and
  - in the event of a no-deal Brexit, the Bank of England has confirmed that U.S. CCPs may utilise the UK's new three-year temporary recognition regime, in order to continue providing services in the UK on the same basis as they do now.

## EU Supervision of CCPs

As reported in more detail in our previous publication "2018: Business As (Un)usual"[11], the European Commission in 2017 made proposals for an overhaul of the supervisory system for EU and non-EU CCPs involving:

- enhanced powers for ESMA and the European Central Bank; and
- enhanced supervision for certain non-EU CCPs.

This involved the categorisation of all non-EU CCPs into one of two categories, depending on ESMA's determination of the level of the relevant CCP's systemic importance to the EU. The less systemic category

[11] https://media2.mofo.com/documents/180200-european-financial-regulatory-2018.pdf.

would continue to operate under the existing EMIR regime and the more systemic category would become subject to the stricter supervision requirements. Within that latter category, some non-EU CCPs may be determined to be so systemically important that they will be allowed to operate in the EU only if they operate through an entity established in the EU. Such a requirement, if it prevails in the final version of the legislation, could cause major changes to the business model of non-EU CCPs, particularly those currently established in the UK and the U.S. The European Commission, having reached mutual agreement with the CFTC as to the ability of EU and U.S. CCPs to operate in each other's jurisdiction, has been regarded by the CFTC and by the UK as "moving the goal posts" with regard to these proposals, and they remain highly controversial outside the EU.

## Current Status

The next step was for the Council of the EU and the European Parliament to complete their ongoing trialogue negotiations on the draft legislation. On 13 March 2019, the European Commission announced that the European Parliament and the Council of the EU have reached political agreement. The final text (not yet publicly available) will now need to be formally adopted, which adoption is expected during April 2019.

# 3. THE NEW PROSPECTUS REGULATION

The New Prospectus Regulation[12] will apply in full from 21 July 2019, whereupon it will replace the current Prospectus Directive and its related secondary legislation[13]. The focus in 2018 and so far in 2019 has been on developing the necessary Level 2 and Level 3 legislation to give full effect to the New Prospectus Regulation.

On 28 November 2018, the European Commission published a draft delegated regulation relating to the format, content, scrutiny and approval of prospectuses and the annexes containing the detailed minimum disclosure requirements for different securities. It requested feedback on the draft regulation by 26 December 2018. Under the New Prospectus Regulation, the European Commission is required to have adopted delegated acts on the above topics by 21 January 2019. This date passed without the European Commission adopting them, but it is expected that these acts will be adopted no later than April 2019. Thereafter, the delegated regulation will be submitted to the European Parliament and Council of the EU for scrutiny. They will have a three-month non-objection period, which can be extended for a further three months. However, the European Parliamentary recess period will begin on 19 April 2019, and it is not yet certain whether the delegated regulation will be published in the Official Journal of the EU prior to the full application of the New Prospectus Regulation on 21 July 2019.

In July 2018, ESMA published its final report on draft regulatory technical standards ("**RTS**") under the New Prospectus Regulation. The RTS address the topics of key financial information for the prospectus summary, data and machine readability of prospectuses, advertisements, prospectus supplements and prospectus publication. The RTS have not yet been endorsed by the European Commission, and it is expected that the timing of endorsement and publication in the Official Journal will mirror that of the proposed delegated regulation above.

In terms of Level 3 regulation, ESMA published a consultation paper on Guidelines on Risk Factors in July 2018, which consultation was open to comments until 5 October 2018. It is currently expected that those guidelines will be published before the end of March 2019.

In addition, ESMA's questions and answers document on prospectuses, which was last updated in January 2019 in relation to the current Prospectus Directive regime, will be updated to reflect the provisions of the New Prospectus Regulation. However, there is not yet any indication of when this will take place.

## The Effect of Brexit

In the event of the UK leaving the EU on a no-deal Brexit basis by the end of March 2019, the majority of the provisions of the New Prospectus Regulation will not have come into force. It is proposed in the Financial Services (Implementation of Legislation) Bill that the UK government will have the power to implement the provisions of the New Prospectus Regulation that are to apply from 21 July 2019, together with any delegated acts under the Prospectus Regulation, other than technical standards, that are adopted by the European Commission before 21 July 2019.

In relation to those provisions of the New Prospectus Regulation that have already entered into force, the UK Treasury, on 12 December 2018, published the Official Listing of Securities, Prospectus and Transparency (Amendment etc.) (EU Exit) Regulations 2019. This statutory instrument will delete certain aspects of the New Prospectus Regulation where the domesticated equivalent will be included in the Financial Services and Markets Act 2000 or the FCA's Prospectus Rules.

[12] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R1129&from=EN.
[13] For the key details of the New Prospectus Regulation, please see our client alert: "Evolution Not Revolution: The New EU Prospectus Regulation", available at https://media2.mofo.com/documents/170706-evolution-not-revolution.pdf.

In relation to passported prospectuses, the instrument provides that a prospectus approved by the competent authority of an EEA member state, other than the UK, and passported into the UK before Brexit day, can be used in the UK until its validity expires. It will be treated, as of Brexit day, as if it had been approved by the FCA at the time when it was actually approved by the EEA home state authority. Issuers will be able to supplement these prospectuses, with the FCA's approval, as necessary during the period of their validity. A prospectus that is valid in the UK before Brexit day, whether approved in the UK or in another EU member state, will be valid for 12 months from the date of its approval, even where Brexit day occurs part way through that 12-month period.

In relation to the EU, ESMA has stated, in the latest version of its Questions and Answers on Prospectuses, that prospectuses approved by the FCA before Brexit day cannot be passported to EU or EEA Member States after a no-deal Brexit. In addition, prospectuses approved in the UK and passported into the EU or EEA before Brexit day can no longer be supplemented after Brexit day.

As a result, such a passported prospectus cannot be used to offer securities to the public or admit securities to trading on a regulated market within the EU or EEA after Brexit day, because if a significant new factor, material mistake or inaccuracy arose, then the issuer would be unable to inform investors about the publication of the supplemental prospectus, and this would deny investors their right of withdrawal.

Lastly, the statutory instrument transfers responsibility to the UK Treasury for various functions currently carried out by the European Commission under the Prospectus Directive. It also permits the FCA to make technical standards for various purposes.

The FCA, on 28 February 2019, also published a near-final version of the Exiting the European Union: Listing, Prospectus and Disclosure Source Books (Amendments) Instrument 2019, which sets out the changes that will be made to the UK's Prospectus Rules in the event of a no-deal Brexit.

# 4. BENCHMARKS

## EU Financial Benchmarks Regulation

Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "**Benchmarks Regulation**" or "**BMR**")[14] came into force on 30 June 2016, and the vast majority of its provisions came into effect on 1 January 2018[15].

The BMR is a new regime for the authorisation and supervision of administrators of financial benchmarks that are used in the EU. Transitional provisions under the BMR state that any benchmark provided by a non-EU administrator can still be used in the EU after 1 January 2018 if such benchmark is already used in the EU as a reference for financial instruments. Under the Q&A document dated 8 November 2017, ESMA states that, for the purpose of the transitional provisions relating to non-EEA benchmarks, the term "already used" should be interpreted as meaning where the benchmark is already used in the EU on or before 1 January 2020. This means any non-EU administrators are able to continue to administer both existing and new benchmarks in the EU up until 1 January 2020.

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

On 28 February 2019, the Council of the EU and the European Parliament announced that the transition period for administrators of so-called "critical" benchmarks and non-EU benchmarks would be extended for an additional two years until 31 December 2021.

## Transitioning Away From the IBORs

There is considerable pressure from regulators around the globe for markets to move away from inter-bank offered rates ("**IBORs**") to risk free rates, and industry associations, such as the Loan Market Association ("**LMA**") and ISDA, have been considering the ramifications of these future changes for their members' operations and legal documentation. In the case of the LMA, this has resulted in the updating of the "replacement of screen rate" clause in October 2018.

In March 2018, the FCA published a Policy Statement on its powers to require banks to contribute to the London Interbank Offered Rate ("**LIBOR**")[16], following an earlier consultation paper on the FCA's proposed approach to its compulsion powers in June 2017. In it, the FCA:

- provided feedback on the responses received to the consultation;
- reported on the data it collected from banks alongside the consultation; and
- set out its conclusions on the methodology it would expect to use if it had to compel one or more banks to contribute data to LIBOR, using the powers in the BMR.

The FCA had previously confirmed in a statement that all 20 current LIBOR panel banks have agreed to continue to submit to LIBOR until the end of 2021. The FCA indicated that it hoped to no longer need to compel contributions as the transition to alternative benchmarks progressed. However, in the event it did

[14] https://goo.gl/mRJxyb.
[15] For further details, see our earlier publication: "Setting the New Benchmark: EU Regulation on Financial Benchmarks", available at https://media2.mofo.com/documents/160613eufinancialbenchmarks.pdf.
[16] PS18/5, available at https://www.fca.org.uk/publication/policy/ps18-05.pdf.

need to use these powers, the policy statement set out the approach, criteria and methodology that the FCA proposed to apply in the event it did need to use these powers.

On 19 September 2018, ISDA published the ISDA Benchmarks Supplement, which was developed in response to BMR and gives firms the ability to improve the contractual robustness of derivatives that reference interest rate, FX, equity and commodities benchmarks. The aim of market participants incorporating the ISDA Benchmarks Supplement into the terms of their interest rate, FX, equity and commodity derivatives is to ensure these events are taken into account in their contracts and to specify the fallback arrangements that would apply.

On 20 December 2018, ISDA published a report summarising the final results of a consultation on technical issues related to new benchmark fallbacks for derivatives contracts that reference certain IBORs. Stemming from these results, ISDA is proceeding in 2019 with developing fallbacks for inclusion in its standard definitions based on the compounded setting in arrears rate and the historical mean/median approach to the spread adjustment for all of the benchmarks covered by the consultation.

## UK Benchmarks Regulation Post-Brexit

The Benchmarks (Amendment and Transitional Provision) (EU Exit) Regulations 2019 will implement in the UK a domesticated UK-only version of the BMR, in the event of a no-deal Brexit.

The BMR functions of ESMA will transfer to the FCA in respect of the UK regime, and the functions of the European Commission will transfer to the UK Treasury.

On Brexit day, benchmark administrators who have already been authorised or registered in the UK will be automatically migrated to a new UK register, maintained by the FCA. The same will be true for non-UK benchmarks and/or administrators (whether in the EU27 or elsewhere) who, as at Brexit day, have already been recognised by the FCA or endorsed by UK administrators/supervised entities and such endorsement approved by the FCA.

Non-UK benchmarks and administrators (whether from the EU27 or elsewhere) who are not entitled to automatic migration to the UK register will need to become approved by one of the routes of equivalence, recognition or endorsement in the UK, before they can be added to the UK register.

Having said that, the statutory instrument provides for a two-year grandfathering period in which any non-UK benchmark or administrator that was entered on the ESMA register as of Brexit day will be temporarily entered in the UK register for a maximum period of two years.

At the end of such two-year period, they will be removed from the UK register unless they have obtained UK approval. They will also be removed from the UK register as from any earlier date on which (i) an application for approval in the UK is refused or (ii) they are removed from the ESMA register (assuming no UK approval has been granted at such time).

# 5. AIFMD

## European Commission Report

On 10 January 2019, the European Commission published a report, dated 10 December 2018, prepared by KPMG, in relation to the operation of the Alternative Investment Fund Managers Directive (2011/61/EU) ("**AIFMD**").

The report was commissioned by the European Commission pursuant to its obligations under Article 69 of AIFMD, to start a review on the application and scope of AIFMD, including analysing its impact on investors, AIFs and AIFMs (defined below), within the EU and outside the EU, and the degree to which the objectives of AIFMD have been achieved. Following its mandate, KPMG conducted a general survey, addressed to AIFMD stakeholders, such as AIFMs, investors, distributors, depositories, asset managers, regulators and investment advisers, as well as industry representative bodies. KPMG received 478 "useable" responses, the majority of which were given on behalf of institutions. KPMG made the following findings, pursuant to the survey and various interviews with market participants.

## Overall

AIFMD has played a major role in helping to create an internal market for alternative investment funds ("**AIFs**") and a harmonised regulatory and supervisory framework for managers of AIFs ("**AIFMs**"). However, some of AIFMD's provisions (or alternatively the detail or application of certain revisions) have not contributed to the achievement of these aims and may even, in some cases, be contrary to those aims.

A high percentage of survey respondents considered that AIFMD is not applied consistently between member states, although most of these consider that only a small number of areas needed further harmonisation in order to prevent arbitrage between different countries' roles and to ensure a common level playing field.

## Sub-Threshold AIFMs

A number of member states apply additional provisions to the authorisation of sub-threshold AIFMs[17], which can include requiring full authorisation, in the case of some member states. This differentiation is expressly permitted by AIFMD.

## AIFMD Reporting

Respondents and interviewees noted that not all the data required by AIFMD's reporting requirements to be reported to national competent authorities ("**NCA**") may be essential. In other cases it can be insufficient and there are also duplicative provisions. In addition, some of the reporting obligations overlap with other EU legislative reporting requirements. Although the details of the regulatory reporting requirements are contained in AIFMD's delegated regulation (which is directly applicable in all EU member states and therefore provides no national discretion), the AIFM's home member state NCA can stipulate the method of data delivery and can also require additional information from time to time. As a result, respondents considered that differences in national interpretation and filing procedures increased their costs.

Having said that, many respondents and interviewees emphasised the need for the Commission, before making amendments to the reporting requirements, to recognise the significant irrecoverable costs already

[17] An AIFM is "sub-threshold" if it directly, or indirectly through a company with which it is linked by common management or control or by substantive direct or indirect holding, manages portfolios of AIFs with an aggregate volume of assets under management that either does not exceed EUR100 million, including any assets acquired through the use of leverage, or does not exceed EUR500 million in circumstances where the portfolio of AIFs consists of AIFs that are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each AIF.

incurred by AIFMs, NCAs and ESMA in implementing reporting systems and urged that the issue of reporting should be looked at, at the same time, for both asset and fund managers.

## Leverage

Respondents and interviewees requested the harmonisation of calculation methodologies for leverage, as between AIFMD, the Undertakings for Collective Investments in Transferable Securities ("**UCITS**") directive and other relevant legislation. However, given the ongoing work by the IOSCO on common leverage measures, it will be most efficient for the industry for changes to the EU requirements to be proposed only after completion of IOSCO's work and to be introduced simultaneously for UCITs funds and AIFs.

## Valuation

One issue that is considered by respondents to have hampered the effectiveness of AIFMD for some asset classes relates to the choice in AIFMD's valuation rules between internal valuation or external valuation and the different national interpretations of the extent of the liability of external valuers.

## Remuneration

The remuneration requirements of AIFMD were some of the most hotly-negotiated provisions during the legislative phase, due to the fact that many major non-EU jurisdictions do not impose similar restrictions on AIFMs and, therefore, this potentially leads to competitive disadvantages for EU firms. Respondents also felt that the rules on remuneration favour less complex business models and create a disadvantage for more complex participants. It was also noted that investors in many respects do not receive transparent and consistent information, which can vary according to the domicile of the reporting entities within the EU. For instance, each AIF may disclose the total amount of remuneration paid by the AIFM to its staff (compared to on an AIF-by-AIF basis), which provides very little transparency for investors where the AIFM manages many AIFs.

In addition, carried interest and partner remuneration are often only partially incorporated in the remuneration figures and are therefore disclosed by AIFMs on an inconsistent basis. This lack of a level playing field can expose market participants in those jurisdictions with a stringent AIFMD implementation policy to unfair competition.

## Variations in Regulatory Fees

Approximately half of the respondents expressed concerns about the variations in fees paid to NCAs as part of the marketing passport notification process or under the national private placement regimes ("**NPPRs**"). Some interviewees believe that this factor, together with the divergence of marketing requirements between different EU member states, results in foreign-domiciled AIFs being at a competitive disadvantage to domestic funds.

In relation to such variations, the proposal by the European Commission on cross-border distributions of funds[18] was generally considered a positive development since it aims to increase transparency about regulatory fees by providing ESMA with greater supervisory powers and setting out some high-level common principles on how regulatory fees should be determined.

## Investor Disclosures

A large percentage of respondents expressed concerns about AIFMD's investor disclosure requirement, and, in particular, the inconsistent application of the requirements between different jurisdictions, including the additional disclosure requirements imposed by some member states that can hamper investors who are

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[18] *See* "The Cross-Border Distribution of Investment Funds" section of this publication.

selecting the most relevant information for their own monitoring purposes, which undermines the investor protection goals of AIFMD.

## Other Issues in the Report

Further clarity was requested by many respondents on the interaction between AIFMD and the legislative package consisting of Directive 2014/65/EU and MiFIR ("**MiFID II**"), particularly in the case where the AIFM also provides MiFID services. In addition, there is confusion as to the interplay between AIFMD and NPPRs, which may have slightly different definitions (depending upon the EU jurisdiction) of what constitutes a professional or semi-professional investor or client, consequently giving rise to differing marketing requirements.

Many respondents noted the difficulties caused by so-called "gold-plating" of the AIFMD requirements by different member states, leading to a lack of harmonisation. In particular, differing custody standards and interpretations were targeted, such as in relation to the segregation of assets, use of custody records and liability of the central securities depositary in a custody chain. These differing standards prevent depositary groups from operating a common model throughout the EU.

In addition, respondents pointed out the lack of harmonised rules hindering the marketing of AIFs across borders because of issues such as the difference in definition of an AIF between different member states and differences in interpretation of "marketing" and the passporting requirements. As an example, there are significant differences in the extent to which (permissible) "pre-marketing" can take place in different member states before full "marketing" is deemed to be taking place.

At the moment, the AIFMD marketing passport is not available to non-EU AIFMs. AIFMD envisages that, if it becomes available to non-EU AIFMs, the current system of non-EU AIFMs using each member state's NPPR will eventually be abolished. The European Commission expressed the view in the report that, from an investor's point of view, it is clearly of EU added value that NPPRs should be permitted to continue to operate in order to maximise investor choice. Many respondents to the survey also indicated that NPPRs should not be abolished, even once the marketing passport has been extended to non-EU AIFMs, and should co-exist with the marketing passport. This last fact comes as no surprise, given that many non-EU AIFMs, who currently use the NPPRs, will find it impractical to use the marketing passport in its current form, due to the small scale and geographical scope of their EU marketing efforts and, in some cases, domestic structural hurdles to their compliance with the requirements necessary for authorisation in the EU.

## Next Steps

The European Commission may now propose amending legislation that it considers necessary in respect of AIFMD. The Commission's review is required to take due account of developments at the international level and of discussions held with non-EU countries and international organisations. After finalising its review, the European Commission is obliged to submit a report to the European Parliament and the Council of the EU without undue delay (the European Commission has indicated that it will report to the European Parliament and the Council in 2020).

One would hope that, within the same timeframe, the European Commission will be able to make a decision as to whether to extend the benefit of the EU marketing passport to non-EU AIFMs from all, or certain, non-EU countries, since several years have now passed since ESMA produced its advice on several non-EU countries in this regard. If it does finally decide to extend the passport, it will also need to decide, in due course, whether to retain or abolish the NPPRs, which will continue to be important to many non-EU AIFMs after the extension of the passport.

## AIFMD and Brexit

As part of its preparations for a possible no-deal Brexit, the UK Treasury, on 21 February 2019, published the Alternative Investment Fund Managers (Amendment etc.) (EU Exit) Regulations 2019[19], which will amend the UK's Alternative Investment Fund Managers Regulations 2013 in such circumstances.

The aim of these regulations is to ensure that the UK's AIFMD-related legislation functions properly in the event of a no-deal Brexit. These regulations amend references to the EEA passporting system (which will cease to be applicable to UK AIFMs in such a scenario) and they replace references to the European Union with references to the UK and replace references to the European Commission and ESMA with references to the UK Treasury and the FCA, respectively. They also remove any obligation for the UK authorities to share information and co-operate with EU authorities without a guarantee of reciprocity.

In terms of specific changes:

- "AIF" will include any investment fund that is not a UK UCITS fund;
- the information and reporting requirements of AIFMD will be disapplied for funds that are recognised under Section 272 of the Financial Services and Markets Act 2000 for marketing to retail investors;
- the UK Treasury is introducing a temporary permissions regime for EEA AIFs and UK AIFs that were marketed by EEA AIFMs in the UK, via the marketing passport, before Brexit day. The relevant AIFM will need to notify the FCA before Brexit day that it requests temporary permission to market the relevant AIF in the UK. The FCA expects the regime to be in place for a maximum of three years. AIFMs that wish to use the regime must notify the FCA through its "Connect" system before the end of 28 March 2019. Having made such a notification, an AIFM will be able to market its AIFs in the UK on the same terms and conditions as it currently does;
- both UK and EEA AIFMs marketing AIFs in the UK for the first time after Brexit day will need to use the UK's NPPR; and
- UK AIFMs will continue to report information to the FCA on both their UK and EU AIFs.

## The Cross-Border Distribution of Investment Funds

As part of its Capital Markets Union ("**CMU**") initiative, the European Commission made proposals in March 2018 for a new directive[20] and regulation[21] in relation to the cross-border distribution of collective investment funds. The legislative proposals will amend both AIFMD and the UCITS Directive. The key proposals that will affect AIFs and AIFMs are discussed below.

## Pre-Marketing

AIFMD contains the following definition of "marketing" in the context of shares or units of an AIF: "a direct or indirect offering or placement, at the initiative of the AIFM or on behalf of the AIFM, of units or shares of an AIF it manages to or with investors domiciled, or with a registered office, in the Union".

An AIFM engaging in marketing under the definition above is required to have at least pre-notified the relevant competent authority in the member state of the marketing or, in some cases, to be authorised in that member state. Promotional activities that fall short of the above definition of marketing, or that can be regarded as merely a precursor to marketing, are not prohibited by AIFMD, and different member states have different approaches to these "pre-marketing" activities.

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[19] S.I. 2019/328, available at http://www.legislation.gov.uk/uksi/2019/328/pdfs/uksi_20190328_en.pdf.
[20] http://ec.europa.eu/transparency/regdoc/rep/1/2018/EN/COM-2018-92-F1-EN-MAIN-PART-1.PDF.
[21] http://ec.europa.eu/transparency/regdoc/rep/1/2018/EN/COM-2018-110-F1-EN-MAIN-PART-1.PDF.

In the UK, the FCA has issued helpful guidance as to the dividing line between AIFMD marketing and pre-marketing, but most other EU regulators have not issued such guidance and it has become apparent that many EU regulators take a very different stance to the FCA on the question of where the dividing line should be drawn. The inconsistent approach by different EU regulators makes it very difficult in practice for an AIFM to simultaneously gauge levels of investor interest in a potential fund across multiple EU jurisdictions.

As a result, the European Commission has proposed in its draft directive a new definition of "pre-marketing" for the AIFMD. Pre-marketing is proposed to be defined as:

> a direct or indirect provision of information on investment strategies or investment ideas by an AIFM or on its behalf to professional investors domiciled or registered in the [EU] in order to test their interest in an AIF which is not yet established.

The European Commission's proposed concept of pre-marketing is that each EEA member state should permit an authorised EU AIFM (N.B. not a non-EU AIFM) to engage in pre-marketing activities, without any prior notification to competent authorities, so long as the pre-marketing relates to an investment idea or strategy at a time when no actual AIF has already been established for such idea or strategy. In addition, investors should be unable to subscribe to the units of the AIF during the course of pre-marketing because the fund does not exist at that point, and no offering documents, whether draft or final, should be distributed to potential investors during the pre-marketing.

If, following the pre-marketing activities, the AIFM intends to offer for subscription units of an AIF that has features similar to the idea or strategy that has been pre-marketed, then the appropriate marketing notification procedures for a full AIFMD "marketing" should be observed, and the AIFM would not be able to classify such offer and subscription as "reverse solicitation" (to which AIFMD would not apply).

In addition to the proposed principles of pre-marketing, the proposed directive also sets out some negative conditions for pre-marketing.

The European Commission's proposed new Article 30a of AIFMD states that EU member states must ensure that an authorised EU AIFM may engage in pre-marketing in the EU, except where the information presented to potential professional investors:

- relates to an established AIF;
- contains reference to an established AIF;
- enables investors to commit to acquiring units or shares of a particular AIF; or
- amounts to a prospectus, constitutional documents of a not-yet-established AIF, offering documents, subscription forms or similar documents, whether in draft or final form, allowing investors to make an investment decision.

This "pre-marketing" proposal has attracted a great deal of criticism. Many commentators have interpreted this new concept as an exhaustive definition of pre-marketing (though it remains to be seen whether all individual member states adopt this interpretation when implementing the directive into their national laws). They have interpreted the proposals as meaning that any promotional activities by an EU AIFM that do not meet the above conditions should be regarded as "marketing" and therefore must be subject to the required marketing notification. Such a narrow definition would effectively restrict the ability of EU AIFMs to gauge the level of investor interest in a potential fund or a new fund by bringing forward the time at which "full" marketing is deemed to occur and notification is required. Compare this to the current FCA-stated position that it will not regard the use of draft AIF documentation as "marketing" (so long as such documents cannot be used by a potential investor to invest in the AIF) because the AIFM cannot apply for permission to market

an AIF under Article 31 of AIFMD until the documents required to be submitted with each application are in final form.

The pre-marketing definition proposed by the European Commission is much narrower than the FCA's policy position and is too narrow to be of much practical help to AIFMs trying to gauge investor interest. This therefore actually runs counter to the stated aim of the draft directive of eliminating regulatory barriers to the cross-border distribution of funds.

In addition, given that this definition applies only to EU AIFMs, then if it is interpreted by member states as an exclusive definition of permissible pre-marketing, it could allow non-EU AIFMs to conduct certain pre-marketing without the notification requirement that would apply to EU AIFMs in respect of the same pre-marketing activity. This is inconsistent with the CMU's aim of deepening and broadening EU capital markets.

Help seems to be at hand in the form of the legislative amendments proposed by the Council of the EU and the European Parliament. They propose that the pre-marketing definition can apply to an AIF that has already been established and that draft offering documents and constitutional documents may be used, so long as the promotion does not amount to an offer or placement of AIF shares/units, and no subscription documents (whether draft or final) are presented to potential investors.

In addition, the procedure file of the European Parliament, to be considered at its plenary session of 15 April 2019 to 18 April 2019, provides that the harmonised pre-marketing rules should not disadvantage an EU AIFM, compared to a non-EU AIFM.

## Discontinuation of Marketing of AIFs

The draft directive also introduces proposed uniform conditions under which an authorised EU AIFM, having notified the competent authority of its home member state that it intends to market an EU AIF in another member state, may formally discontinue such marketing in such other member state ("**host member state**"). The conditions to be met for such discontinuance are that:

- either (i) no investor domiciled or registered in the host member state holds any units of that AIF; or (ii) no more than 10 investors domiciled or registered in the host member state hold any units in that AIF, and the total units held by such investors represent less than 1% of the assets under management of that AIF;
- the AIFM has made public, for at least 30 business days, an offer to repurchase all of the AIF units held by such investors; and
- the AIFM has made public its intention to discontinue marketing in that member state by a publicly available medium that is customary and suitable for the marketing of AIFs to typical AIF investors.

As soon as the competent authority of the home member state has notified the AIFM that the above information has been transmitted to the competent authority in the host member state, the AIFM must immediately cease all marketing activities in that member state. However, it remains obliged to observe the annual report and investor disclosure obligations in Articles 22 and 23 of AIFMD in respect of all investors who remain invested in the AIF.

## Facilities for Retail Investors

The draft directive also provides that an AIFM must establish, in each EEA member state where it intends to market an AIF to retail investors, facilities to perform certain tasks, such as processing subscriptions, payments and redemption orders from investors, providing certain information to investors and making available to investors information such as the fund rules on instruments of incorporation and the AIF's latest

annual report. The directive is intended to be applied by each EEA member state no later than two years after its entry into force.

## Requirements for Marketing Communications

The draft regulation provides that marketing communications to potential AIF investors must be identifiable as such, that AIFMs must present the risks and rewards of such an investment in an equally prominent manner and that they must ensure that all information contained in marketing communications is fair, clear and not misleading. They must also ensure that no information in any marketing communication contradicts the information required to be disclosed to investors under Article 23 of AIFMD, or (if applicable) contained in a prospectus pursuant to the New Prospectus Regulation, or diminishes its significance. The marketing communication must also indicate how and where investors can obtain a copy of the New Prospectus Regulation prospectus (if applicable).

## Publication of National Marketing Requirements

The national competent authority of each member state will be obliged to publish a central database containing all applicable national laws and regulations governing the marketing of AIFs and summaries thereof in a language that is "customary in the sphere of international finance". Notification of these laws and regulations would also have to be sent to ESMA, in order for ESMA to maintain its own central database containing these details for each member state.

## Verification of Marketing Communications

The draft regulation provides that, where a member state permits the marketing of AIFs to its retail investors, its national competent authority may require systematic notification of the marketing communications intended to be sent to the retail investors in order to verify compliance with the provisions of the draft regulation. However, such systematic notification would not be a prior condition to the marketing of the AIF.

If the competent authority requests any amendments to a marketing notification, that request must be sent to the AIFM within 10 business days after the business day following its receipt of the systematic notification.

## Fees and Charges

The draft regulation provides that fees or charges levied by competent authorities must be proportionate to the expenditure incurred in the authorisation/registration process and the performance of their supervisory and investigatory powers under AIFM.

The competent authorities must publish their fees and charges, or the methodology therefor, on a central database in a language that is "customary in the sphere of international finance". They must also send such details to ESMA, who would publish such details on its own interactive database on its website. ESMA is also required to make available on its website an interactive tool that allows users to perform online calculations.

## ESMA Central Database of AIFMs and AIFs

ESMA would also be required to maintain on its website a central database of all AIFMs, and all AIFs marketed by each AIFM, as well as the member states in which those funds are marketed. It is proposed that the provisions relating to the requirements for marketing communications and the publication of national marketing requirements would apply starting on the date falling two years after the regulation enters into force; whereas the provisions regarding the verification of marketing communications would apply starting on the date on which the regulation entered into force.

## Date of Application and Current Status

Certain parts of the regulation are expected to be applicable immediately upon its entry into force; whereas other parts of the regulation should enter into force two years after that date, and the directive will have to be transposed into the national laws of each EU member state by the same date.

On 5 February 2019, the Council of the EU and the European Parliament announced that they had reached preliminary agreement on the draft legislation, and the European Parliament is due to consider it in its April 2019 plenary session.

# 6. REVISED PRUDENTIAL FRAMEWORK FOR INVESTMENT FIRMS

In December 2017, the European Commission laid down legislative proposals for a new regulation[22] ("**IFR**") and directive[23] ("**IFD**") that will amend the prudential requirements and supervision regime for investment firms. The existing prudential requirements for investment firms are contained in the Capital Requirements Regulation ("**CRR**") and the CRD4 Directive ("**CRD4**"), and this proposed new framework will, for most investment firms, replace the existing prudential regime.

## Classification

Investment firms will be divided into three categories.

Class 1 firms are "bank-like" firms that will be reclassified as "credit institutions". They will remain subject to the prudential requirements set out in the CRR and CRD4, and they will cease to be classified as investment firms. Class 1 firms are firms that satisfy all of the following conditions:

- they have total assets exceeding EUR30 billion;
- they carry out the MiFID activities of "dealing on own account" or "underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis (or both)"; and
- they are not a commodity and emission allowance dealer, a collective investment undertaking or an insurance undertaking.

Class 2 firms are investment firms that are not Class 1 firms, as defined above, and not Class 3 firms, as defined below.

Class 3 firms are small firms with non-interconnected services that meet all of the requirements set out in Article 12 of IFR, including that:

- its assets under management are less than EUR1 billion;
- the daily value of client orders handled is less than EUR100 million for cash products or EUR1 billion for derivatives; and
- it does not hold client money or safeguard client assets.

## K-Factors

The IFR provides for a set of quantitative indicators (referred to by the European Commission as "**K-Factors**") that represent the risks that an investment firm can pose (i) to customers ("**risk-to-customer K-Factors**"); (ii) to market access or liquidity, i.e. the potential impact that an investment firm may have on the market in which it operates if the firm fails or otherwise needs to exit that market ("**risk-to-market K-factors**"); and (iii) to the firm itself ("**risk-to-firm K-Factors**").

All investment firms (i.e. excluding Class 1 firms, who will be reclassified as credit institutions) will be required to calculate their capital requirements with reference to the various K-Factors, and it is also these K-Factors that will determine whether an investment firm should be classed as a Class 3 firm.

## Application Level

All investment firms must comply with the IFR on an individual basis, although derogation is provided for Class 3 firms in banking groups that are subject to consolidated supervision under the CRR. Competent

[22] http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-790-F1-EN-MAIN-PART-1.PDF.
[23] http://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-791-F1-EN-MAIN-PART-1.PDF.

authorities may require the parent company of a group consisting only of investment firms to comply with the requirements on a consolidated basis where either:

- there are significant material risks to customers or to the market that are not fully captured by the individual capital requirements applicable to the investment firm within the group; or
- in the case of investment firm groups that have a high degree of inter-connectedness in their risk management, applying individual capital requirements to the investment firm may lead to a duplication of requirements for those firms.

## Own Funds

Investment firms will be required to hold "own funds" (the aggregate of their Tier 1 and Tier 2 capital) with the following characteristics:

- at least 56% of own funds must consist of Common Equity Tier 1 ("**CET1**") capital;
- up to 44% of own funds may consist of Additional Tier 1 ("**AT1**") capital; and
- up to 25% of own funds may consist of Tier 2 capital.

## Initial Capital Requirement

The initial capital requirement for an investment firm will differ depending upon the services that they provide. Firms that are authorised to provide any of the following services and activities must hold initial capital of EUR750,000:

- dealing on their own account;
- underwriting of financial instruments or placing a financial instrument on a firm commitment basis (or both);
- operating a multilateral trading facility; and
- operating an organised trading facility.

Firms that are not permitted to hold client money or securities, and are authorised to rely on one or more of the following services and activities, must hold initial capital of at least EUR75,000:

- receiving and transmitting orders;
- executing orders on behalf of clients;
- managing portfolios;
- providing investment advice; and
- placing of financial instruments without a firm commitment.

The initial capital for all other investment firms will be EUR150,000.

An investment firm's initial capital is required to consist of one or more of CET1 capital, AT1 capital and Tier 2 capital. For the purposes of the initial capital requirement and also the own funds requirements, the definitions of these different types of regulatory capital are identical to those existing classes of capital, as defined in the CRR.

## General Capital Requirements

Class 2 firms must at all times have capital that amounts to the highest of the following:

- their initial capital requirement;
- their fixed overheads requirement ("**FOR**"); and
- their K-Factor requirement.

Class 3 firms are required to have capital that amounts to the highest of their initial capital requirement and their FOR.

The FOR should be set to at least 25% of the fixed overheads of the previous year.

The K-Factor capital requirement will be set according to the detailed provisions set out in the IFR and will be equal to the aggregate of the risk-to-customer K-Factors, the risk-to-market K-factors, and the risk-to-firm K-Factors.

## Concentration Risk and Liquidity

Investment firms must identify, manage and monitor any concentration risk, and Class 2 firms must report their concentration risks to competent authorities. Both Class 2 and Class 3 investment firms are also required to have internal procedures to monitor and manage their liquidity needs and are required to hold a minimum of one-third of their FOR in liquid assets.

## Disclosure

Investment firms are required to disclose their levels of capital, capital requirements, remuneration policies and governance arrangements, although Class 3 firms will only be required to make such disclosures when they issue AT1 instruments.

## Reporting

All investment firms will be required to submit an annual report to the relevant competent authority, dealing with the level and composition of their own funds, their capital requirements (and calculations thereof) and the levels of their activities that are relevant for determining whether they are a Class 2 or Class 3 firm.

## Remuneration and Governance

The draft IFD contains provisions on governance and remuneration (based very broadly on existing provisions in CRD4), which provisions will apply to Class 2 firms but not to Class 3 firms.

The notable differences between these provisions and the provisions of CRD4, to which investment firms are currently subject (apart from the exemption from the governance and remuneration requirements for small and non-interconnected firms), are:

- although firms are still obliged to set appropriate ratios between variable and fixed remuneration, the IFD does not provide for a specific limit, but leaves it to individual member states to set an appropriate limit; and
- for small firms and staff with low levels of variable remuneration, these firms will be exempt from the requirements as to deferral of a certain percentage of variable remuneration, and from the requirement for a certain percentage of variable remuneration to be paid in financial instruments, rather than cash.

## Transitional Provisions

The IFR provides for a transitional period of five years, during which any increase in investment firms' capital requirements, due to the IFR, will be capped at certain levels.

## Class 1 Firms

For those firms that are sufficiently systemically important to meet the criteria for Class 1 firms, and consequently for re-designation as credit institutions, the IFR and IFD will make amendments to the CRR and CRD4. Among other things, Class 1 firms will have initial capital requirements of EUR5 million, as opposed to the current requirement of EUR730,000, and the liquidity coverage ratio requirements will apply to such firms.

In addition, since Class 1 firms are to be re-categorised as credit institutions, this will mean that Class 1 firms based in member states that are participating in the single supervisory mechanism ("**SSM**") will come within the scope of the SSM for the first time and, therefore, under the prudential supervision of the European Central Bank.

## Third Countries and Equivalence

The European Commission has also used the draft IFR and IFD to update the requirements relating to equivalence decisions for non-EU countries and the supervision of EU investment firms that are part of non-EU groups.

Firstly, the European Commission proposes to amend Article 47 of MiFIR in relation to equivalence decisions. If the European Commission determines that the services provided in the EU are likely to be of systemic importance to the EU, the European Commission must undertake a "detailed and granular" assessment of the relevant non-EU country's prudential and business conduct requirements.

In addition, where an investment firm has a non-EU parent, EU member states are required to assess whether the non-EU supervision of the parent is equivalent to the IFR and IFD. Where this is not the case, the relevant EU competent authority may require the establishment of an intermediate investment holding company or mixed financial holding company in the EU, which entity will then become subject to the own funds requirements in Article 7 of the IFR.

## Date of Application and Current Status of IFR and IFD

The IFR is expected to apply with effect from the date falling 18 months after it enters into force, and the IFD is expected to be transposed into the national laws of each EU member state by the same date.

On 26 February 2019, the Council of the EU and the European Parliament announced that they have reached political agreement on the IFR and IFD. The next step is for the informally agreed text of the IFR and IFD to be confirmed by a plenary vote before the end of the current legislature (expected to take place in April 2019).

# 7. CRYPTO-ASSETS AND BLOCKCHAIN

Innovations in technology have developed new types of financial instruments and fundraising methods. Crypto-assets (such as virtual currencies and tokens), along with the distributed ledger technology ("**DLT**") that underpins them, could greatly impact capital markets and payment services.

The advent of new sources of technological capital presents a number of risks, such as the volatility of crypto-currencies, misleading disclosures to investors in initial coin offerings ("**ICOs**") and the ability for crypto-assets to be used for money laundering or terrorist financing purposes. However, the important question is how legislators and regulators can address these risks without halting the innovations. So far, the response of EU regulators and supervisory authorities to the rise of crypto-assets has been limited to the non-interventional approach of issuing warnings to consumers, investors and EU firms and other market participants in relation to virtual currencies and ICOs. These warnings are focused on communicating risks to potential investors and consumers and reminding market participants involved in ICOs of relevant existing regulatory requirements. The European Commission notes in its March 2018 FinTech Communication[24], for example, that whilst it does not want to stifle innovation with over-zealous regulation, it recognises that a laissez-faire attitude could disadvantage EU financial services providers whilst also failing to adequately protect consumers. As a result, the Commission has announced initiatives in its FinTech Action Plan that are aimed at "enabling, accommodating and, where possible, encouraging innovation in the financial sector, while ensuring at all times the preservation of financial stability and high levels of investor and consumer protection".

## Blockchain Regulation

Blockchain is a form of DLT. The key characteristics of the data that is stored on a blockchain are that it is shared, verifiable and accessible. The potential benefits and risks of blockchain are a key focus of regulators and legislators and, in February 2018, the European Commission published a fact sheet on the current uses of blockchain in financial services.[25] These include automatic execution of insurance contracts, money transfers, peer-to-peer lending and transfers of securities.

In April 2018, 26 EU member states and Norway signed a declaration creating the European Blockchain Partnership ("**EBP**"), which aims to develop an EU-wide blockchain infrastructure that can "enhance value-based, trusted, user-centre digital services" across Europe.[26]

The UK's FCA has also taken a progressive approach to regulating firms that use DLT. The FCA's "regulatory sandbox", for example, allows firms to test innovative products and services in a live environment. In the fourth cohort that was announced in July 2018, over 40% of the companies that were accepted are using DLT.[27]

In relation to virtual currencies, although EU regulators have acknowledged the benefits of such a crypto-asset, they have also highlighted the potential issues surrounding this area. These include defrauding consumers and investors, money laundering, terrorism financing, tax evasion and circumventing capital controls and international sanctions. A joint report published in February 2018 by the EBA, ESMA and EIOPA (together, the "**ESAs**") warned of the risks of buying or holding virtual currencies, stating that extreme price volatility, a lack of regulation, a lack of transparency on pricing and incomplete and misleading disclosures present risks to consumers.[28] These warnings state that an investment in crypto-assets is high risk, and

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[24] http://ec.europa.eu/transparency/regdoc/rep/1/2018/EN/COM-2018-109-F1-EN-MAIN-PART-1.PDF.
[25] https://ec.europa.eu/digital-single-market/en/news/how-can-europe-benefit-blockchain-technologies.
[26] http://ec.europa.eu/newsroom/dae/document.cfm?doc_id=50954.
[27] https://www.fca.org.uk/firms/regulatory-sandbox/regulatory-sandbox-cohort-4-businesses.
[28] https://eba.europa.eu/documents/10180/2139750/Joint+ESAs+Warning+on+Virtual+Currencies.pdf.

investors could face substantial losses due to volatility, a lack of market transparency and operational weaknesses, along with vulnerabilities in crypto-asset services and exchanges.

These warnings mirror the concerns of the UK's House of Commons Treasury Committee[29], which considers that, due to factors such as the security risks, the unsuitability of crypto-assets as investments for retail investors and the lack of investor compensation schemes, it will press the UK government to urgently regulate crypto-assets and related transactions, such as ICOs and crypto-asset exchange services.[30]

Although crypto-assets are not regulated as a sector at EU level, certain crypto-asset services and products will come within the scope of EU regulations. These may include services associated with crypto-assets, such as custodial wallet providers and crypto-asset exchanges. The former is a third-party service that allows an individual to make electronic transactions, such as purchasing items online, whilst giving the third party control over an individual's crypto-assets. This differs from a non-custodial wallet that gives the owner complete control. Crypto-asset exchanges allow for the trading of crypto-assets for other assets like fiat money or other digital currencies.

One of the key concerns with crypto-assets such as virtual currencies is that the pseudonymity (or, in some cases, anonymity) that it enables in financial transactions can be exploited by criminals and terrorists to transfer proceeds of crime and terrorist funding without regulatory oversight. The recent amendment to the Anti-Money Laundering Directive ("**5AMLD**")[31] that entered into force on 9 July 2018 is a direct response to this concern. 5AMLD has a number of impacts on crypto-assets and crypto-asset exchanges, as it widens the regulatory perimeter for anti-money laundering ("**AML**") and countering the financing of terrorism ("**CFT**"). Crypto-asset exchanges and custodian wallet providers are now defined as "obliged entities" and thus brought under the ambit of the 5AMLD. 5AMLD states that providers of these two services must also be registered within their member state. 5AMLD is required to be transposed into member state laws by January 2020.

## The UK Approach to Crypto-Assets Regulation

The UK is planning to take a more robust approach, broadening the ambit of the 5AMLD requirements and aiming to further curtail the risks arising from the inherent anonymity of crypto-assets. A report from the UK Crypto assets Taskforce, comprised of representations from the FCA, Bank of England and HM Treasury, states that the UK government is set to consult on including the following within the UK's AML and CFT measures: exchange services between different crypto-assets, to prevent anonymous layering of funds to mask their origins; platforms that aid peer-to-peer exchanges of crypto-assets; crypto-asset ATMs; and non-custodian wallet providers that have functions similar to custodian wallet providers.[32]

Recently, the FCA has attempted to clarify its current regulatory perimeter in the Consultation Paper, "Guidance on Crypto assets", published in January 2019.[33] Specifically, the paper focuses on whether and when crypto-assets could be considered "Specified Investments" under the Regulated Activities Order (the "**RAO**"), "Financial Instruments" under MiFID II, or if they come under the Payment Services Regulations (the "**PSRs**") or the E-Money Regulations (the "**EMRs**"). The paper broadly classifies crypto-assets into three categories: exchange tokens, security tokens and utility tokens.

[29] House of Commons Treasury Committee – Cryptoassets – Twenty-Second Report of Session 2017-19, available at https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/910/910.pdf.

[30] For further details, please see our client alert "The Advent of Crypto-Asset Regulation in the UK?", available at https://www.mofo.com/resources/publications/181001-crypto-asset-uk.html.

[31] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32018L0843&from=EN.

[32] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf.

[33] https://www.fca.org.uk/publication/consultation/cp19-03.pdf.

## Regulatory Classification of Tokens

Exchange token is the term used by the FCA to describe what is sometimes termed as a "crypto-coin", "payment token" or "crypto-currency". It is not issued or backed by any central authority and is intended and designed to be used as a means of exchange. Examples of this include exchanges or organisations that facilitate transactions of Bitcoin, Ether or other exchange tokens between participants. Exchange tokens usually fall outside the FCA's regulatory perimeter.

Security tokens are tokens with characteristics that bring them under the definition of a "Specified Investment" under the RAO and thus within the FCA's regulatory perimeter. Broadly, if an instrument indicates an ownership position in an entity, a creditor relationship with an entity, or other rights to ownership or profit, they will be classed as a security token.

Lastly, utility tokens give holders access to a product or service, but the holder does not have the same rights as a holder of a security token and would normally fall outside the regulatory perimeter of the FCA. The FCA does not view pure exchange and utility tokens as securities, even if they are acquired and held for speculative gain. The FCA views this as akin to holding a fiat currency or commodity for investment purposes – both of which remain unregulated by the FCA.

The paper also suggests how tokens could be affected by the EMRs and PSRs. In regard to the EMRs, the guidance notes that whilst most exchange tokens are not likely to fall under the definition of "e-money" under the EMRs, tokens that are pegged to a fiat currency (such as a "stable coin") and used for the payment of goods and services could meet this definition. In regard to the PSRs, the FCA states that crypto-assets are not covered within the scope of the PSRs because the PSRs apply only to banknotes and coins, scriptural money and electronic money.

The FCA's Consultation Paper also notes the future direction of regulation in 2019. In addition to transposing and expanding the ambit of 5AMLD, the UK Treasury will be consulting on possibly expanding the regulatory perimeter to other crypto-assets. The FCA will also consult on the potential prohibition on the sale to retail customers of derivatives and transferable securities that reference crypto-assets. The FCA has invited stakeholders to give feedback on questions posed in the Consultation Paper by 5 April 2019 and aims to publish final guidance on the existing regulatory perimeter in relation to crypto-assets no later than summer 2019.

Given the complexity of many crypto-asset tokens, the FCA acknowledged that concluding whether a token is within the FCA perimeter can be difficult and recommended that persons or entities should consult professional advisers if they still remain in doubt, having reviewed the FCA guidance.

## The EU Approach to Crypto-Assets

In January 2019, ESMA published a report on crypto-assets and their suitability within the EU regulatory framework. The report concluded that with regard to crypto-assets that qualify as transferable securities and MiFID financial instruments, the EU rules, such as the Prospectus Directive, MiFID II, Market Abuse Directive and the Transparency Directive, would apply. However, ESMA acknowledged that there are "gaps and issues" within the framework that "leave certain risks unaddressed or that may not be adapted" to crypto-assets or DLT.[34]

Overall, ESMA proposes that a limited bespoke regime should be implemented at EU level to account for specific types and risk profiles of different crypto-assets. With regard to crypto-assets that do not qualify as transferable securities and MiFID financial instruments, ESMA believes that extending existing regulation could risk "legitimising crypto-assets and encouraging wider adoption" and advised that EU law-makers

[34] https://www.esma.europa.eu/press-news/esma-news/cryptoassets-need-common-eu-wide-approach-ensure-investor-protection.

should instead focus on issuing warnings, so as not to bring unregulated crypto-assets “into a similar regulatory remit as the one for crypto-assets that are financial instruments”. The idea of a limited bespoke approach at EU level is not universally accepted, however. The UK Treasury Committee argues that amending existing legislation, like the RAO, to include the issuance of ICOs and the provision of crypto-asset exchange services, is the best way to regulate crypto-assets and associated activities.

The EBA has also reported on crypto-assets in its January 2019 report.[35] The EBA identified a number of actions that it hopes to take in 2019, such as (i) the development of a common crypto-asset monitoring template to be issued to financial institutions, payment institutions and electronic money institutions; (ii) an assessment of business practices regarding crypto-asset advertising and disclosure of risks of crypto-assets and safeguards available to consumers; and (iii) the prudential treatment of banks’ exposures to crypto-assets.

The direction of EU regulation in respect of crypto-assets and ICOs is currently unclear. Authorities like the EBA and ESMA advocate limited action (such as monitoring and investor warnings) to be taken to address concerns surrounding crypto-assets that are not covered by existing regulation. However, it remains to be seen how the European Commission will react to these reports. Its statement in November 2018 indicates that the Commission may have a different view, implying that warnings may not be enough on their own to adequately protect consumers and investors. The European Commission stated that “rules of the road are necessary, not only to protect investors and increase market integrity, but also to provide legal clarity and certainty for a legitimate crypto-asset eco-system”.[36] It will be interesting to see how the upcoming UK proposals for crypto-asset regulation will compare to whatever is proposed by the European Commission.

[35] https://eba.europa.eu/documents/10180/2545547/EBA+Report+on+crypto+assets.pdf.
[36] https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/european-parliament-plenary-debate-vp-dombrovskis-statement-regulating-virtual-currencies-and-icos_en.

# 8. MIFID II

In last year's edition of this publication (for a link to last year's edition, please see footnote 11 above), we reported that MiFID II finally became effective on 3 January 2018, and discussed the many struggles that market participants were facing while attempting full compliance with the large volume of new requirements imposed by the MiFID II package. It is also worth noting that several EU member states failed to implement MiFID II into their respective national laws in time for the 3 January 2018 deadline. The issues that arose as a result were then clarified in the ESMA MiFID II Q&A[37].

## Investor Protection

The implementation of MiFID II inducement rules relating to the "unbundling" of research remained one of the key areas of concern for the market participants in 2018. At its Asset Management Conference in June 2018, the FCA announced the commencement of a thematic review of investment research and corporate access, focusing on asset managers and their approach to pricing models in light of the new inducement rules introduced by the MiFID II package[38]. The FCA also mentioned that the review would include the topic of conflicts. Going forward, market participants can therefore expect increased regulatory scrutiny around costs and charges disclosures and conflicts management.

## Market Structure and Transparency

As reported in last year's edition of this publication, the implementation of the new systematic internaliser ("**SI**") regime under the MiFID II framework was delayed until 1 September 2018 for equities and equity-like instruments and bonds, and into 2019 or 2020 for other instruments within the MiFID II framework. A number of firms, however, still opted into the regime before the mandatory implementation date. Looking ahead, an important milestone in the MiFID II framework implementation includes the implementation of the mandatory SI regime for derivatives, securitised derivatives, exchange-traded certificates and notes, structured finance products and emission allowances, which has been delayed and will not be operational "until at least 2020" according to ESMA's questions and answers on transparency.

In January 2018, ESMA decided to delay the publication of the data on the double volume cap ("**DVC**") mechanism for January 2018, indicating that while ESMA was aware of the legal obligation to apply the DVC from January 2018, it felt that the publication of the calculations triggered other legal obligations in terms of suspensions of transparency waivers related to dark trading and that initiating the new regime based on the insufficient data that ESMA had received was not appropriate at that stage[39]. ESMA's liquidity assessment for bonds subject to the pre- and post-trade transparency requirements of MiFID II was first published in May 2018[40].

As reported in last year's edition of this publication, ESMA allowed for a six-month transition period, following the 3 January 2018 MiFID II implementation date during which investment firms could continue to provide services to clients without legal entity identifiers ("**LEIs**"), so long as the firm had obtained all necessary documentation from the client to apply for a LEI on the client's behalf and the firm applies for the LEI immediately. The requirement to have a LEI became obligatory following the lapse of this six-month transition period.

Furthermore, as part of the implementation of Article 32(3) of the Commission Delegated Regulation (EU) 2017/565 ("**MiFID Org Regulation**"), dealing with a scenario where an investment firm outsources functions related to the investment service of portfolio management provided to clients by a service provider

[37] https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf.
[38] https://www.ft.com/content/8d912582-6fda-11e8-852d-d8b934ff5ffa.
[39] https://www.esma.europa.eu/press-news/esma-news/esma-delays-publication-double-volume-cap-data.
[40] https://www.esma.europa.eu/press-news/esma-news/esma-launches-bond-liquidity-system-under-mifid-ii.

located in a third country, the FCA published a list of the supervisory authorities in third countries with which they have cooperation agreements that meet the requirements set out in Article 32(2) of the MiFID Org Regulation[41].

On 20 December 2018, Commission Implementing Decision (EU) 2018/2047 on the equivalence of Swiss law as regards the requirements of MiFID II framework for stock exchanges was published in the Official Journal of the EU. The decision entered into force on 1 January 2019 and will expire on 30 June 2019[42].

We also expect that the FCA will continue communicating with firms that are within the scope of the MiFID II framework to supervise any shortcomings and potentially also investigate any breaches.

## Preparing for a "No-Deal" Brexit - The United Kingdom

The FCA and the PRA have devoted significant time and attention to the preparations for a "no-deal" Brexit where the UK leaves the EU without an implementation period in place. In a "no-deal" Brexit scenario, regulators and market participants will need to focus on ensuring that their MiFID II systems would work appropriately under the new tweaked MiFID II regime, as implemented into UK law.

In its CP18/28[43], the FCA and the PRA set out the proposed changes to their respective handbooks that would make the MiFID II package and the supporting EU technical and implementing standards into UK national law. Further changes were set out in CP18/36[44] where the FCA proposed to amend the FCA Handbook and the EU-derived binding technical standards, including its proposed approach to non-handbook guidance and to forms that appear in the FCA Handbook. In its 28 February 2019 Policy Statement, PS19/5[45], the FCA sets out a policy statement, a Brexit Policy Statement and Transitional Directions and its responses to feedback received on CP18/28 and CP18/36.

To prepare for a possible no-deal Brexit, a statutory instrument has been drafted by the UK Treasury to ensure that the MiFID II framework can operate effectively in the UK in a post-no-deal Brexit landscape. The Markets in Financial Instruments (Amendment) (EU Exit) Regulations 2018 (SI 2018/1403) were made on 19 December 2018[46]. The principal aim of the Regulations is to address deficiencies in retained EU law in relation to markets in financial instruments arising from the withdrawal of the UK from the EU. The Regulations amend key pieces of UK domestic law and EU tertiary legislation (as defined in the European Union (Withdrawal) Act 2018) to ensure that the legislation continues to operate effectively at the point when the UK leaves the EU. The changes made in this statutory instrument will not take effect on 29 March 2019 if the UK enters an implementation period pursuant to a ratified Withdrawal Treaty.

This statutory instrument does not intend to make policy changes, other than to reflect the UK's new position outside the EU, and to smooth this transition. Consistent with the government's policy of providing continuity to businesses and consumers when the UK leaves the EU, the policy approach set out in MiFID II legislation will not change after the UK has left the EU. The Regulations ensure that UK financial markets will continue to operate in a fair, stable and transparent manner post-Brexit and ensure that investors will be afforded the same protections that they currently enjoy.

[41] https://www.fca.org.uk/publication/corporate/outsourcing-portfolio-management-list-cooperation-agreements-2018.pdf.
[42] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2018:327:FULL&from=EN.
[43] https://www.fca.org.uk/publications/consultation-papers/cp18-28-brexit-proposed-changes-handbook-bts-first-consultation.
[44] https://www.fca.org.uk/publications/consultation-papers/cp18-36-brexit-proposed-changes-handbook-and-binding-technical-standards-second-consultation.
[45] https://www.fca.org.uk/publication/policy/ps19-05.pdf; https://www.fca.org.uk/publication/policy/ps19-05-appendix-1.pdf; https://www.fca.org.uk/publication/policy/ps19-05-appendix-2.pdf.
[46] http://www.legislation.gov.uk/uksi/2018/1403/pdfs/uksi_20181403_en.pdf.

## The EU27

In terms of the EU's preparations for the post-Brexit MiFID II regime, ESMA has also stated its concerns as to the effect of Brexit on the behaviour of MiFID firms. In particular, it has emphasised its concerns about the need for national EU regulators to monitor situations where EU investment firms can effectively be rendered mere "letter-box entities". This can happen either because of excessive delegation of functions by the EU firm to non-EU delegates or because the EU firms use non-EU branches to perform certain functions for EU clients. It has therefore instructed EU competent authorities that, where an EU firm intends to establish and maintain a non-EU branch, they should be satisfied that the use of the non-EU branch is based on objective reasons linked to the services provided in the non-EU jurisdiction and does not result in a situation where the non-EU branch performs material functions or provides services back into the EU. To this end, ESMA published a MiFID II Supervisory Briefing for EU competent authorities on 6 February 2019.

## Temporary Permissions Regime and Transitional Powers

Although it is not expected that Brexit will cause any issues of enforceability of contracts entered into before Brexit day, in the context of derivatives transactions, ISDA and other industry bodies have raised concerns that certain "lifecycle" events related to existing derivatives contracts may prove problematic. For instance, the performance of certain common lifecycle events may constitute regulated activities, such as the novation, material amendment or extension of maturity of a trade, as well as some types of portfolio compression. Therefore, with the loss of MiFID passporting rights following Brexit, firms need to be able to rely on an equivalence decision or an exemption to perform these events, or else obtain a licence from each relevant jurisdiction. Alternatively, the firm may seek to transfer the relevant contracts to an affiliate in the EU, but there can be many hurdles to successful transfer, including the consent of the other party (and any due diligence it requires to perform before giving such consent), the potential loss of "grandfathering" provisions, adverse tax consequences and structural restrictions.

In order to address these sorts of issues in the UK, the UK Treasury has implemented a temporary permissions regime, which will become applicable in the event of a no-deal Brexit and which will enable an EEA firm operating in the UK via the MiFID passport to continue its UK activities initially for up to three years after Brexit day, in order to provide sufficient time for the EEA firm to obtain authorisation in the UK or transfer business to a UK entity. It is hoped that the European Commission will enact an equivalent temporary permissions regime for UK firms, but so far no hint of such an EU regime has surfaced.

The UK Treasury has also empowered the FCA to delay or phase in changes to regulatory requirements made under the Withdrawal Act for a maximum period of two years after Brexit day. In the context of post-trade transparency obligations, the FCA has clarified, in a statement dated 13 March 2019, that it will use this temporary transitional power to delay reporting obligations of UK investment firms for transactions with EU27 investment firms. Where the relevant UK investment firm did not have a reporting obligation for a transaction with an EU27 investment firm before Brexit day, it will not be required to report such a transaction to a UK Approved Publication Arrangement, for a period of 15 months after Brexit day.

## Share Trading Obligations

Article 23 of MiFIR (the "**EU Share Trading Obligation**") requires EU investment firms to conclude transactions in shares that are admitted to trading on an EU regulated market or traded on an EU trading venue only on:

- EU regulated markets;
- EU multilateral trading facilities;
- EU systematic internalisers; or

- non-EU trading venues assessed as “equivalent” by the European Commission.

However, the Article 23 requirement does not apply to transactions in shares that are traded in the EU on a non-systemic, ad hoc, irregular and infrequent basis.

On 19 March 2019, ESMA published a statement on its expectations on the operation of the EU Share Trading Obligation in a no-deal Brexit scenario where the European Commission has made no equivalence decision in respect of the UK.

It states that EU27 and EEA shares (i.e. those with ISINs from an EU27 member state, Iceland, Liechtenstein or Norway) will be within the scope of the EU Share Trading Obligation. It also considers that UK shares (i.e. those with ISINs starting with a “GB” prefix) will be within the scope of the EU Share Trading Obligation if those shares qualify as “liquid”, based on their EU27 trading levels. ESMA has attached to its statement a list of all ISINs that would be subject to the EU Share Trading Obligation.

As the FCA has pointed out in a responding statement on 19 March 2019, the effect of this policy is that EU banks, funds and asset managers will not be able to trade these shares in the UK, even where the UK is the home listing venue of the relevant company.

Since the UK will be “onshoring” Article 23 of MiFIR by developing a domesticated share trading obligation (the “**UK Share Trading Obligation**”) in a no-deal Brexit scenario, the ESMA approach raises the possibility of conflicting obligations applying to the same shares and therefore firms being limited to trading certain shares only in either the UK or the EU27 and, in some cases, being caught by overlapping obligations.

The large degree of overlap between the EU Share Trading Obligation and the UK Share Trading Obligation could cause enormous disruption to market participants and share issuers in both the UK and the EU27 in terms of access to liquidity and would hamper the ability for firms to observe their duty of “best execution” to clients.

The FCA has urged ESMA to engage constructively with it on this issue to try and minimise such disruption.

# 9. PRIIPS REGULATION

The EU Packaged Retail Products and Insurance-based Investment Products Regulation (the "**PRIIPs Regulation**") became effective on 1 January 2018, impacting a wide range of products and the vast majority of structured products. The PRIIPs Regulation has been criticised by a number of market participants and trade associations.

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

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

## The PRIIPs KID

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

## FCA

In January 2018, the FCA published a statement on communications in relation to PRIIPs, reminding firms of the FCA rules requiring them to ensure that their communications with clients are fair, clear and not misleading[47]. Firms are also required to act honestly, fairly and professionally, in accordance with the best interests of their clients[48]. Where firms are concerned that the "performance scenario" information may appear too optimistic with the potential to mislead customers, the FCA stated that additional explanations could be included to put the calculation in context.

[47] Principle 7 of the FCA's Principles for Business.
[48] FCA Handbook - COBS 2.1.1R.

In July 2018, the FCA published a call for input on initial experiences with the new requirements under the PRIIPs Regulation and accompanying RTS. The call for input focused on soliciting feedback on both the scope of the PRIIPs Regulation and the practical challenges involved in calculating information to meet the content requirements of the KID. It is expected that the FCA will publish a feedback statement early in 2019, which will indicate the future steps that the FCA will take on the PRIIPs Regulation.

## ESAs

The Joint Committee of the ESAs wrote a letter to the European Commission[49] in October 2018 informing it that it believes that a targeted review of the PRIIPs Regulation is required so that the issues that have arisen from the implementation of detailed technical requirements could be addressed. Following on quickly in November 2018, the Joint Committee of the ESAs published a Joint Consultation Paper[50] containing draft amendments to the PRIIPs Delegated Regulation (Regulation (EU) 2017/653) and the amendments in the form of RTS have been submitted to the Commission for endorsement (with the amendments expected to apply from 1 January 2020).

Separately, in December 2018, the European Parliament's Economic and Monetary Affairs Committee ("**ECON**") adopted a report that amends the PRIIPs Regulation to (i) provide the European Commission with an extra year to review the PRIIPs regulations by delaying it to 31 December 2019; and (ii) prolong the exemption for UCITS funds by a further two years, to 31 December 2021.

## Brexit

The UK Treasury published the Packaged Retail and Insurance-based Investment Products (Amendment) (EU Exit) Regulations 2019 on 28 February 2019, addressing the way in which the PRIIPs Regulation would be amended in the UK, following a no-deal Brexit. The Regulations will transfer functions of the ESAs, in relation to the PRIIPs Regulation, to the UK authorities, as well as amend the territorial scope of the retained legislation so that it applies only to PRIIPs products sold to UK retail investors.

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[49] (JC 2018 55) https://esas-joint-committee.europa.eu/Publications/Letters/JC%202018%2055%20Joint%20letter%20to%20EC%20on%20PRIIPs.pdf.

[50] (JC 2018 60) https://eiopa.europa.eu/Publications/Consultations/Joint%20Consultation%20Paper%20on%20targeted%20amendments.pdf.

# 10. PAYMENT SERVICES DIRECTIVE II

In last year's edition of this publication (for a link to last year's edition, please footnote 11 above), we reported that the new Payment Services Directive (Directive (EU) 2015/2366)[51] ("**PSD II**") applied from 13 January 2018 (except for the security measures on Strong Customer Authentication and Secure Communication, which were required to be implemented into national laws by each EU member state by 14 March 2019).

## EBA Guidelines

On 18 July 2018, the EBA published its final Guidelines on fraud reporting under the PSD II. These Guidelines, which the EBA developed in cooperation with the European Central Bank ("**ECB**"), are aimed at contributing to the PSD II objective of enhancing the security of retail payments in the EU[52].

These Guidelines require payment services providers across the 28 EU member states to collect and report data on payment transactions and fraudulent payment transactions using a consistent methodology, definitions and data breakdowns. Following the consultation between the EBA and the ECB, the final Guidelines no longer require quarterly reporting of high-level data and a more detailed set of data on a yearly basis, but the reporting of a uniform set of data on a semi-annual basis instead.

The geographical scope of the data, too, has been reduced in size and complexity compared to the draft Guidelines, as the Guidelines no longer require country-by-country data breakdowns, and there is now a uniform geographical breakdown (instead of three different ones). In addition, fraudulent transactions where the payer is the fraudster are no longer within the scope of the Guidelines.

## FCA Approach Document

In July 2018, the FCA published version 2 of its Approach document on payment services and electronic money regulations[53], which is intended to serve as a navigation tool for the 2017 PSR and the 2011 EMR.

The FCA Approach document is intended to cover the operations of the following regulated firms:

- authorised payment institutions or small payment institutions;
- authorised e-money institutions or small e-money institutions;
- registered account information service providers; and
- credit institutions (which must comply with parts of the PSR and EMR when carrying out payment services and e-money business).

The previous September 2017 Approach Document has been amended to reflect changes brought about by PSD II; market changes which have since had an impact on previous guidance; and feedback from consultation papers. The new guidance covers "Reporting and notifications" and "Operational and security risks" in light of the PSR and EMR.

## NPSO

As part of the changes to the payment services architecture in the UK, during 2018, the New Payment System Operator ("NPSO") took over the operation of the three key interbank retail payment systems – Bacs, Faster

[51] https://goo.gl/zQKube.
[52] https://eba.europa.eu/-/eba-publishes-final-guidelines-on-fraud-reporting-under-psd2.
[53] https://www.fca.org.uk/publication/finalised-guidance/fca-approach-payment-services-electronic-money-july-2018-track-changes.pdf.

Payments, and the new Image Clearing System for cheques[54]. The NPSO is also responsible for designing and delivering several key strategic payments initiatives, which were developed by the Payments Strategy Forum and handed over to the NPSO in December 2017 for implementation.

## FCA Approach to Final RTS and EBA Guidelines Under PSD II

In December 2018, the FCA published its Approach to final RTS and EBA guidelines under PSD II[55], including the following:

- the RTS for strong customer authentication ("**SCA**") and common and secure open standards of communication ("**CSC**") ("**SCA-RTS**") and reflecting the EBA Opinion on the implementation of the RTS on SCA and CSC;
- new fraud reporting requirements in line with the EBA Guidelines on fraud reporting under PSD II; and
- in relation to SCA and CSC, an exemption process based on draft EBA Guidelines on the conditions to be met to benefit from an exemption from contingency measures under Article 33(6) of Regulation (EU) 2018/389.

This Approach sets out the FCA's expectations with respect to payment services providers' compliance with the relevant requirements and provides detailed guidance on the specific requirements.

## Impact of Brexit

The UK is due to leave the EU on 29 March 2019. To address deficiencies in retained EU law arising from the UK's withdrawal from the EU and ensure that the legislation continues to operate effectively in the UK after Brexit day (in the event of a no-deal Brexit), it is necessary for numerous statutory instruments to be created.

The Electronic Money, Payment Services and Payment Systems (Amendment and Transitional Provisions) (EU Exit) Regulations 2018 (2018/1201) (the "**Payment Services (EU Exit) Regulations**"), together with an explanatory memorandum, were published on 20 November 2018[56]. The Regulations' purpose is to make amendments to legislation including the PSRs, to ensure that the UK's payments regime continues to operate effectively in the UK once the UK has left the EU, following a no-deal Brexit.

Among other things, the Payment Services (EU Exit) Regulations:

- create a temporary permissions regime for payments and e-money institutions;
- amend the PSR so that payment institutions will be able to hold safeguarding accounts at an approved foreign credit institution anywhere in the world;
- ensure that Regulations 40, 63, and 85 of the PSRs continue to apply in full to Euro transactions made within the "qualifying area" (EEA, plus the UK) through the Single Euro Payments Area ("**SEPA**") payment scheme. This is to maximise the prospects of the UK remaining within the geographical scope of the SEPA payment schemes; and
- transfer the functions of the EBA relating to regulatory technical standards under PSD II to the FCA.

The Payment Services (EU Exit) Regulations came into force on 21 November 2018, except Regulations 2 and 3(i) and Schedules 1 (amendments to primary legislation) and 2 (amendments to subordinate legislation), which will come into force on Brexit day.

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[54] https://www.bacs.co.uk/NewsCentre/PressReleases/Pages/NewPaymentSystemOperatorForBacsFasterPaymentsSystems.aspx.
[55] https://www.fca.org.uk/publication/policy/ps18-24.pdf.
[56] https://www.legislation.gov.uk/ukdsi/2018/9780111173008/contents.

# 11. BANK RESOLUTION – BRRD/SRM REGULATION AND TLAC/MREL

The Bank Recovery and Resolution Directive[57] ("**BRRD**"), together with the Single Resolution Mechanism Regulation (Regulation 806/2014)[58] (the "**SRM Regulation**") in respect of Eurozone banks supervised under the Single Supervision Mechanism, since 1 January 2016 has created a resolution framework in which (in theory) a bank can be allowed to fail, with the minimum of public sector support and the minimum of disruption to the broader financial system. One of the most important "resolution tools" that BRRD and the SRM Regulation give to resolution authorities (especially in terms of resolving systemically important banks) is the "bail-in tool". This tool allows national resolution authorities or the Single Resolution Board ("**SRB**") 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.

## MREL/TLAC

Crucial to the successful employment of the bail-in tool is ensuring that the bank will have sufficient liabilities that can be bailed in if it enters resolution. BRRD and the SRM Regulation address this in the form of obligations to maintain Minimum Required Eligible Liabilities ("**MREL**"). MREL can be viewed as the European version of the Financial Stability Board's total loss absorbing capacity ("**TLAC**") rules referred to below (in that they provide for each EU national resolution authority/SRB 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.

## Contractual Recognition of Bail-In

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.

## BRRD2

More than two years after the European Commission introduced it, its package of proposed legislative reforms to the BRRD has still not been finally agreed upon by the various EU legislative bodies. The package of reforms focused primarily on the implementation of TLAC for EEA global systemically important institutions ("**GSIIs**") and for non GSIIs, as well as revisions to the existing MREL regime to align it with the TLAC principles, but also proposed changes to Article 55 of BRRD and introduced new pre resolution powers of suspension. These proposals consist of a draft Regulation[59] to amend the CRR ("**CRR2**"), a draft directive amending the BRRD in relation to MREL[60] ("**BRRD2**"), a second directive amending BRRD in respect of the insolvency ranking of certain liabilities[61] ("**Insolvency Hierarchy Directive**"), a draft regulation[62] amending the SRM Regulation ("**SRM2**") and a draft directive[63] amending CRD4 ("**CRD5**"). The Insolvency

[57] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN.
[58] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0806&from=EN.
[59] http://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF.
[60] http://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-852-F1-EN-MAIN-PART-1.PDF.
[61] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L2399&from=EN.
[62] http://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-851-F1-EN-MAIN-PART-1.PDF.
[63] http://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-854-F1-EN-MAIN.PDF.

Hierarchy Directive came into force in December 2017 and was to be implemented by EU member states into their national laws by 29 December 2018.

## Article 55

In relation to Article 55 of BRRD, 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 its national resolution authority (or the SRB as applicable) determines that (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.

## Resolution and Pre-Resolution Moratoria

In addition to Article 55 and the MREL provisions, the European Commission also proposed an additional "pre-resolution" 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 business days (which would also have the effect of extending the payment and delivery obligations of the bank's counterparties for the same period). This power could be exercised where the suspension is necessary either to assess whether the bank is likely to breach applicable EU legislation (for the purpose of Article 27(1) BRRD), such as required capital notices, or to assess whether the bank is "failing or likely to fail" (for the purpose of Article 32 BRRD). However, excluded from this power are obligations owed to central clearing counterparties and payment and securities settlement systems, as well as deposits covered by a deposit guarantee scheme, as well as eligible claims under investment compensation schemes.

The European Commission also proposed an additional "in-resolution" moratorium power, giving a resolution authority power to suspend payment or delivery obligations of the bank for up to five business days, if it determines, in consultation with the bank's regulator, that the exercise of such power is necessary for the effective application of one or more resolution tools or for the purposes of a resolution valuation (under Article 36 BRRD).

The European Commission's proposals in respect of the two additional moratoria powers have been heavily criticised, on the grounds that:

- the interaction between the existing "in-resolution" suspension power in Article 69 of BRRD and the proposed new moratoria powers is unclear, including whether the two "in-resolution" moratoria periods will run concurrently or consecutively; and
- the proposals run counter to internationally-agreed standards, such as the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions". The latter standards prescribe moratorium powers that last for no more than 48 hours and that should only be available within a resolution, not before a resolution.

## Moratoria Compromise

Subsequently, a compromise was proposed in summer 2018 for a new Article 33a of BRRD that, instead of the two new powers of moratoria, would introduce one new power of moratorium (in addition to the existing Article 69 BRRD), which could be exercised by a resolution authority where:

- the failing-or-likely-to-fail test has been met;
- no private sector solutions are immediately available; and

- exercise of the power is necessary to avoid further financial deterioration of the bank and necessary either (i) to determine that no alternative private sector measures or supervisory action would prevent the bank's failure; or (ii) to choose the appropriate resolution action.

This proposed power would not be able to be exercised for more than two business days, and excluded from its scope would be obligations owed to payment and settlement systems, to EU and recognised non-EU central clearing counterparties and to central banks.

The compromise proposal was that, where the above power is exercised, the Article 69 power should not be used until at least ten business days have elapsed following the end of the first suspension period.

## Current Status

The Council of the EU and the European Parliament are currently in trialogue negotiations on BRRD2 and SRM2. On 4 December 2018, the European Parliament published a press release, announcing that it and the Council of the EU had reached provisional political agreement on this legislation, as well as in relation to CRR2.

It is understood that the provisional agreement on BRRD2 contains a new moratorium power based on the proposed Article 33a, except that it will not be possible to use both the new Article 33a and the existing Article 69 powers sequentially. This will mean that the overall moratoria powers will not exceed a maximum of two business days.

The consolidated text of the political agreement will now need to be checked by lawyers, translated into the official languages of the EU and published in the Official Journal of the EU, and this is expected to happen in the first half of 2019. On the 20th day after publication, BRRD2 will enter into force, and EU member states (possibly including the UK) will have 12 months thereafter within which to implement BRRD2 into their national legislation, with such national legislation being applied no later than a further six months thereafter.

It is likely that CRR2 will follow the same timeline as BRRD2.

## Brexit

On 20 December 2018, the UK Treasury made the Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018 to make amendments to the domesticated UK form of the BRRD following a no-deal Brexit.

These Regulations will have the effect that an EEA-led resolution will be treated by the Bank of England in the same way as it treats non-EEA resolutions. This means that such EEA-led resolutions will be recognised in the UK, unless doing so would be contrary to one or more statutory safeguards.

The Regulations also transfer responsibility to make binding technical standards to the Bank of England, where the standards relate to the powers of the UK resolution authority, and to the PRA and the FCA in respect of other binding technical standards. In addition, powers that would be exercised by the European Commission are transferred to the UK Treasury.

# 12. CAPITAL MARKETS UNION

The EU continues to work towards its goal of achieving a comprehensive CMU. The CMU is envisaged to be a harmonised body of EU-wide rules and regulations that would allow the EU to compete directly with the United States in the breadth and depth of its capital markets. The CMU is also considered to have the ability to protect the EU from certain effects of any future financial crisis. Most European businesses depend on traditional bank finance, and they in turn are prone to be exposed to any major disruption in the bank sector. By easing market participants' entry into the capital markets, it is hoped that businesses will turn to the capital markets more often for their financing needs.

2018 saw further progress toward the goal of a CMU. A proposed Directive and Regulation on providing a unified framework for covered bonds – currently regulated at the national level across member states – was put forth by the European Commission on 12 March 2018[64] (based on EBA's recommendations and the European Parliament's July 2017 report). This proposal set out a common definition of covered bonds, uniform standards, and rules on the use of the European Covered Bonds label. ECON's and European Council's positions were adopted in November 2018, and tripartite talks between ECON, the European Council, and the European Commission are currently taking place. The Commission hopes that a vote on the legislation will take place ahead of May 2019's European Parliamentary elections so that the legislation can be finalised and adopted by then.

Despite this relative progress, there is still a lot of work to do, especially to meet the Commission's initial target date for a fully functioning CMU by late 2019. So far, of the thirteen proposals the Commission has put forward, only three have been adopted. These include the New Prospectus Regulation, regulations on European venture capital and social entrepreneurship funds and regulation on securitisation (the last of which is discussed in more detail in this publication's "Securitisation Regulation" section).

On 28 November 2018, the Commission released a communication[65] addressed to, among others, the European Parliament and the European Council. The communication, titled "Capital Markets Union: time for renewed efforts to deliver for investment, growth, and a stronger role of the euro" was an attempt by the Commission to re-emphasise the importance of achieving a comprehensive CMU. In fact, the European Commission wants the European Council and European Parliament to vote on the remaining proposals ahead of the European Parliament elections in May 2019. The timing seems quite ambitious given the speed of progress thus far. Other than those highlighted above, other key areas on which the Commission is keen to see significant progress include:

- finalisation of the proposed revisions to EMIR (covered in more detail in the "EMIR" section of this publication);
- finalisation of the CRR 2 Regulation and CRD 5 Directive;
- publication of a consultation on the EU's corporate bond market; and
- finalisation of the EU's legislative proposal on crowdfunding.

With the upcoming departure of United Kingdom – and thus, London, Europe's financial capital – from the EU, the entire purpose and scope of the CMU has been cast in doubt by some commentators, although the European Commission has stressed its continued focus on the project and stated that it regards it as even more imperative in the light of Brexit.

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[64] https://ec.europa.eu/info/publications/180312-proposal-covered-bonds_en.
[65] https://eur-lex.europa.eu/resource.html?uri=cellar:e9f083ee-f3d4-11e8-9982-01aa75ed71a1.0001.02/DOC_1&format=PDF.

# 13. SHADOW BANKING

The most recent global financial crisis exposed the risks inherent in some "shadow banking" activities. Since then, the Financial Stability Board (the "**FSB**") has led the global initiative to monitor, and in some cases regulate, certain shadow banking activities, or, as they can be termed, non-bank financial intermediation ("**NBFI**"). Shadow banking broadly refers to credit intermediation activities that are performed outside the regular banking system and, as such, are not subject to the same regulatory oversight.

The FSB has been developing policies in key areas, including: limiting banks' risks in interacting with entities performing NBFIs; limiting runs on money market funds ("**MMFs**"); increasing transparency and aligning incentives in securitisation; increasing transparency in relation to securities financing transactions; and mitigating financial stability risks that NBFI activities pose.[66]

## Securities Financing

In Europe, an important part of the regulation of shadow banking is the Securities Financing Transactions Regulation (the "**SFTR**")[67], which aims to increase transparency in relation to securities financing transactions ("**SFTs**"). SFTs are transactions where securities are used to support the borrowing of money or other securities, including securities, lending and repurchase agreements. The SFTR covers three main areas: transaction reporting, collateral reuse obligations, and disclosure obligations. Transaction reporting requires in-scope parties to SFTs to report the transaction to a registered EU TR. Separately, providers of financial collateral (whether under SFTs or not) are required to be informed of the risks involved in allowing their financial collateral to be reused by the recipient. In addition, the receiving party must receive explicit consent that the financial collateral provided to it can be used by it as part of another transaction with a third party, or agreement that legal title to the financial collateral is being transferred to the recipient. The SFTR also increases disclosure obligations for managers of UCITS funds and alternative investment funds, when reporting SFTs in their periodical reports.

Although the provisions as to collateral reuse and funds disclosure have been in force for some time, the transaction reporting obligations will only become operational on a phased basis, with the first phase taking place 12 months after the reporting technical standards enter into force. These standards were endorsed by the European Commission in December 2018 and will enter into force 20 days after their publication in the Official Journal of the EU. It is therefore expected that the first phase of SFTR reporting will go live early in 2020.

To prepare for a possible no-deal Brexit, a statutory instrument has been drafted by the UK Treasury to ensure that the SFTR can operate effectively in the UK in a post-no-deal Brexit landscape. The Transparency of Securities Financing Transactions and of Reuse (Amendment) (EU Exit) Regulations 2019[68] were made by the UK Treasury on 12 March 2019 and amend the SFTR reporting requirements, bringing treatment of EEA branches in line with the current treatment of other third-country branches in the UK. After a no-deal Brexit, UK branches of EU firms and EU branches of UK firms will be required to report details of their securities financing transactions to both UK and EU TRs. UK regulators will no longer be obliged to share information or co-operate with EU authorities, and they will have the power to specify which third-country entities can access UK TR data directly. Functions in the SFTR carried out by the European Commission and the three ESAs will transfer to the UK Treasury and the FCA/PRA, respectively.

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[66] http://www.fsb.org/wp-content/uploads/P281118-1.pdf.
[67] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R2365&from=EN.
[68] http://www.legislation.gov.uk/ukdsi/2019/9780111179376/pdfs/ukdsi_9780111179376_en.pdf.

## Money Market Funds

The MMF Regulation (Regulation (EU) 2017/1131)[69], which applied from 21 July 2018 (the "**MMFR**"), is another key aspect of EU regulation on shadow banking. The MMFR aims to improve the liquidity and stability of MMFs, which entities experienced great losses during the financial crisis. The MMFR provides for a number of protections, including a minimum amount of liquid assets to be held, limits on the activities and investment policies of MMFs (such as diversification and concentration rules), risk-management requirements that impose stress testing, internal processes to determine credit quality for instruments, and Know Your Customer ("**KYC**") procedures. It also put new liquidity-management requirements in place and prohibited the use of external support to guarantee the MMF's liquidity or to stabilise the MMF's net asset value.

Since the passing of the MMFR, there have been a number of consultations that have sought to amend and supplement it. In September 2018, ESMA published a Consultation Paper on draft guidelines on stress test scenarios under the MMFR.[70] Under the MMFR, MMF managers must conduct regular stress tests. These stress-testing processes must include being able to identify stress events and changing macroeconomic conditions and assess how these may affect the MMF. The consultation paper builds on this by proposing parameters and scenarios of hypothetical risk factors, such as changes in the liquidity of assets held by the MMF, changes to credit risk, and changes to interest and exchange rates. The consultation closed to comments in December 2018, and ESMA intends to finalise these guidelines early in 2019.

The reporting of information to competent authorities is another area that has been discussed by ESMA. As set out in Article 37 of the MMFR, the manager of the MMF must report information to the relevant national competent authority on a quarterly basis. ESMA helped develop draft implementing technical standards ("**ITS**") to create a template that holds the required information for a report. In April 2018, the European Commission endorsed the ITS.[71] To supplement the ITS, in November 2018, ESMA published a consultation paper on draft reporting guidelines and the consultation was closed to comments on 14 February 2019.

At the international level, IOSCO, in February 2018, also published recommendations for liquidity risk management obligations for open-ended funds.[72] Those recommendations supplement the risk management framework contained in the IOSCO 2013 Liquidity Report.[73]

To prepare for a possible no-deal Brexit, a statutory instrument has been drafted by the UK Treasury to ensure that the MMFR can operate effectively in the UK in a post-no-deal Brexit landscape. The Money Market Funds (Amendment) (EU Exit) Regulations 2019 were made by the UK Treasury and published on 28 February 2019.[74] Notably, it amends the MMFR to apply only to MMFs established in the UK and requires that the manager of the MMF be established in the UK (with the temporary exception of EEA MMFs that are currently marketed in the UK via a marketing passport (under either the UK's UCITS regulations or AIFM regulations)). A transitional arrangement will allow all EEA MMFs with temporary marketing permission to continue marketing in the UK for three years after the date of Brexit. Functions currently exercised by the European Commission and ESMA will be transferred to the UK Treasury and the FCA, respectively.

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[69] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R1131&from=EN.
[70] https://www.esma.europa.eu/sites/default/files/library/esma-34-49-131_cp_on_mmf_stress_test.pdf.
[71] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R0708&from=EN.
[72] IOSCO, Recommendations for Liquidity Risk Management for Collective Investment Schemes: Final Report, February 2018, available at (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf).
[73] http://www.iosco.org/news/pdf/IOSCONEWS270.pdf.
[74] http://www.legislation.gov.uk/ukdsi/2019/9780111179178/pdfs/ukdsi_9780111179178_en.pdf.

# 14. SECURITISATION REGULATION

The European Commission's long-awaited Securitisation Regulation[75] (the "**Securitisation Regulation**"), one of many proposed pieces of legislation and regulation initially anticipated to come out of the Commission's effort to create a comprehensive CMU, came into effect on 1 January 2019. The Securitisation Regulation applies to securitisation transactions in respect of which securities are issued on or after 1 January 2019 and to any securitisation in which a new securitisation position is created after that date.

Prior to the Securitisation Regulation coming into effect, EU rules relevant to securitisations were set out in a number of different regulations and directives, and market participants, such as banks, fund managers and insurers, had to look to the CRR, the AIFMD and Solvency II (Directive 2009/138/EC), respectively, to glean the relevant rules.

The primary purpose of the Securitisation Regulation is to update and codify the existing EU rules relevant to securitisation transactions and to create a new EU framework for simple, transparent and standardised ("**STS**") securitisations. STS securitisations are securitisations that satisfy certain criteria and are able to benefit from the resulting STS label, including benefiting from a preferential regulatory capital regime. One of the key aims of the new STS regime is to make STS securitisations more attractive to investors with the intention of reinvigorating the EU securitisation market.

In addition to harmonising existing rules and introducing the STS regime, the Securitisation Regulation also introduces certain new, sometimes potentially onerous, requirements on market participants that are likely to have an impact on the EU securitisation market in a number of ways. Overall, the scope of securitisation transactions covered by the Securitisation Regulation is similar to the position under the previous EU rules. The definition of "securitisation" is largely unchanged from the definition set out in the CRR.

Among the changes introduced by the Securitisation Regulation, re-securitisations are now prohibited (subject to certain exemptions) as are residential mortgage-backed securitisations, backed by loans that have not been verified by the lender (also referred to as "self-certified loans"). It also makes changes to the risk retention obligations previously contained in the CRR. Although the existing 5% risk-retention requirement is retained, the obligation is now imposed directly on the originator, sponsor, original lender or issuer, even if the investors are all non-EU entities. Additional due diligence requirements are imposed on institutional investors that hold an exposure to a securitisation position, and new rules apply in respect of transparency and disclosure requirements.

The new disclosure requirements have presented particular challenges for originators, sponsors and issuers who are required to make certain information available to holders of a securitisation position and national competent authorities. ESMA had originally proposed different disclosure levels for public and private deals. However, guidance released on 22 August 2018[76] states that both public and private deals will need to follow the same disclosure rules. This represents a particular challenge to some participants as certain securitisation transactions, such as asset-backed commercial paper conduits, have not previously been subject to such extensive disclosure obligations.

The implementation of the new disclosure requirements has been complicated by delays in finalising the necessary technical standards. Upon implementation of the Securitisation Regulation on 1 January 2019, the final technical standards, guidelines and templates for disclosure – that would have provided much needed detail on how to proceed under the new Securitisation Regulation – had not been finalised by ESMA and the European Commission. Subsequently, the transitional provisions of the Securitisation Regulation took effect,

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[75] https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32017R2402.
[76] https://www.esma.europa.eu/press-news/esma-news/esma-defines-disclosure-standards-under-securitisation-regulation.

and reporting entities are now required to abide by the disclosure template requirements of Regulation 462/2013 until the new templates are in final form.

Anticipating that the final rules might not be in effect by 1 January 2019, and also appreciating the additional cost and effort of abiding by these new transitional rules, on 30 November 2018, the ESAs issued a joint statement[77] requesting that national regulators use their supervisory powers in a proportionate and risk-based manner when assessing whether disclosure rules were being followed. However, the ESAs do not have the power to suspend the Securitisation Regulation and the penalties for reporting entities being in violation of the Securitisation Regulation are quite punitive. Accordingly, there has been a significant amount of concern and confusion among market participants.

Market participants can look forward to greater clarity once the final disclosure standards and templates are in place later this year. On 31 January 2019, ESMA published an Opinion[78] containing a revised set of technical standards and updated reporting templates as well as a Q&A document[79] covering various aspects of the Securitisation Regulation. It is hoped that the standards will be finalised and endorsed as soon as possible during 2019.

In relation to Brexit and its impact on the Securitisation Regulation, one particular impact for UK securitisations is that they will be unable to qualify as an STS once the UK exits the EU, although it is hoped that it will be possible to negotiate, during the transitional period envisaged in any withdrawal agreement signed with the EU27, that UK securitisations will be able to obtain such status during the agreed upon transitional period. That is, however, far from certain at the time of publication.

In the UK, a draft of the Securitisation (Amendment) (EU Exit) Regulations 2019 was published on 23 January 2019[80]. These Regulations will enable securitisations recognised as STS securitisations in the EU before Brexit day to be recognised as STS in the UK for a period of two years and contain other provisions that seek to preserve the effect of the Securitisation Regulation in the UK during this time. They will also have the effect of transferring functions of the ESAs to the FCA or the PRA.

With regard to the possibility of the UK exiting the EU on a no-deal basis, the FCA has stated, in a statement published on 1 February 2019 that in these circumstances, it intends to use its powers broadly to ensure that firms and other regulated entities can generally continue to comply with their regulatory obligations as they did before Brexit day for a temporary period. However, the FCA further states that are some areas where it does not consider it would be consistent with its statutory objectives to grant transitional relief and where it expects firms to begin preparing to comply with changed obligations now. This includes UK originators, sponsors, or securitisation issuers that wish to be considered STS under the Securitisation Regulation. It states that UK originators or sponsors will need to direct notifications to the FCA starting on Brexit day for UK securitisations that they wish to benefit from STS status.

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[77] https://eba.europa.eu/documents/10180/2427712/JC_Statement_Securitisation_CRA3_templates_plus_CRR2_final.pdf.

[78] https://www.esma.europa.eu/sites/default/files/library/esma33-128-600_securitisation_disclosure_technical_standards-esma_opinion.pdf.

[79] https://www.esma.europa.eu/sites/default/files/library/esma33-128-563_questions_and_answers_on_securitisation.pdf.

[80] http://www.legislation.gov.uk/ukdsi/2019/9780111179024/pdfs/ukdsi_9780111179024_en.pdf.

# 15. GREEN AND SOCIAL BONDS

## Green Bonds

The term "green bond" broadly refers to any bond instrument where the proceeds are exclusively applied to fund 'green' projects, such as renewable energy, pollution prevention and sustainable agriculture, fishery, forestry and water management. There are three categories of green bonds: future use, immediate use and credit support. The main green-bond structure is future use, wherein the issuer states that it will use the proceeds from the issue to fund projects that meet the issuer's criteria.

Since 2007, issues of green bonds have grown rapidly. In 2018, global issuance was approximately USD167 billion, up 3% from 2017.[81] The market's growth has slowed compared to the 84% year-on-year increase in 2017.[82] This partly reflects a drop in U.S. municipal issuers, but also a rise in the issuance of social, sustainability and Sustainable Development Goals ("**SDG**") bonds, showing the increasing diversification of the market. Taking total issuance into account, the market has grown from USD199.3 billion to USD225.1 billion, an increase of around 13% in 2018.[83] There have also been 204 new issuers in 2018, bringing the total number of issuers up to 625 across 44 countries.[84]

Sustainable finance has been an important area of focus in Europe. In March 2018, the European Commission announced an action plan on financing sustainable growth.[85] Following the plan, the Commission introduced four legislative proposals – guidance to improve environmental, social and corporate governance ("**ESG**") disclosure to create benchmarks for low-carbon investment strategies to establish an EU green bond standard; and to create an EU classification system (taxonomy) for sustainable finance to determine whether an activity is environmentally stable.

Later in June 2018, a Technical Expert Group ("**TEG**") was established to discuss sustainable finance and the progress of the Action Plan. The TEG launched a consultation on the climate change-mitigation part of the taxonomy, which is open until 22 February 2019, and a consultation on the ESG disclosure is expected in the first quarter of 2019, with the climate change-adaptation and broader environmental activities to come in the second quarter of 2019. The report on the EU green bonds label is expected to be developed by the third quarter of 2019. Reports on the low carbon benchmark are expected in the second quarter of 2019.

There is currently no unified standard on the characteristics of a green project. Projects are instead usually ratified by a third-party agency. One of the key bodies that sets guidelines is the International Capital Market Association ("**ICMA**"), which, in June 2018, announced revised versions of the Green Bond Principles, Social Bond Principles and the Sustainability Bond Guidelines.[86] The updated version of the Green Bond Principles now includes five environmental objectives: climate change mitigation, climate change adaptation, natural resource conservation, biodiversity conservation and pollution prevention and control. The Principles also make a distinction between the environmental objectives and the projects designed to meet them. The next step will be to evaluate both the output of the projects and the development (e.g. renewable energy and carbon sequestering cement in construction). ICMA also confirmed that ESG or sustainability-themed bonds would not be fully aligned unless they are consistent with the four key components of the Principles (use of proceeds, process for project evaluation and selection, management of proceeds and reporting). The Principles also

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[81] https://www.climatebonds.net/resources/reports/2018-green-bond-market-highlights; https://www.climatebonds.net/resources/reports/bonds-and-climate-change-state-market-2018.
[82] Ibid.
[83] Ibid.
[84] Ibid.
[85] https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en.
[86] https://www.icmagroup.org/News/news-in-brief/green-bond-principles-and-social-bond-principles-2018-editions-now-released-along-with-best-practice-guidelines-for-external-reviewers-a-mapping-to-the-sustainable-development-goals-and-a-framework-for-social-bonds-impact-reporting/.

stress the importance of timely reporting on any material developments. Finally, the new Principles clarified definitions, such as the target populations that benefit from social projects within the Social Bond Principles.

Additional work is being done on these Principles to ensure that there is benchmarking to compare efficiencies and impacts with other projects and technology and to confirm the "net impact" of the project. For example, purchasers may want to confirm what will happen to the farmers displaced from farms repurposed for a solar development in Africa funded by green bonds. Such purchasers should also consider requiring a legal forum for persons impacted by projects developed by green bonds to voice concerns or file complaints.

In September 2017, the UK government launched a Green Finance Taskforce to aid the growth of green finance. In March 2018, the Taskforce published its first report, Accelerating green finance[87], which contained a number of recommendations, including the establishment of a new Green Finance Institute to assist and promote green finance and provide advice to sovereign and sub-sovereign issuers. The report also proposed to give incentives to sterling issuers of green securities by either removing tax barriers or giving grants to first-time issuers. Whilst current EU State Aid rules reduce the UK government's ability to provide such incentives, the report notes that the advent of Brexit could open up these opportunities to the UK government.

## Social Bonds

The labelled bond market has also developed beyond pure green bonds. Although sustainability and social bonds have existed for a number of years, in 2018, global issuance of these bonds increased greatly. 2018 sustainability bond issuance rose 114% from the previous year, totalling USD21 billion.[88] Although not as significant an increase, the global issuance of social bonds in 2018 rose 37% from the previous year.

In 2018, SDG frameworks started to make the distinction between green and social bond criteria, meaning that, depending on the use of proceeds, bonds can be classed as either "green", "social" or "sustainable". Social bonds generally refer to projects like affordable housing, vocational training and affordable social infrastructure, whereas sustainable bonds refer to a combination of environmental and social projects. These are separate and distinct from "social impact bonds," which are not actually bonds but pay-for-performance instruments issued typically by non-profit entities to purchasers who are repaid by third party guarantors (foundations/governments/corporations) if the non-profit issuers achieve certain designated impact goals. The guarantee payments are typically covered by cost savings experienced by the guarantors.

Although the market is still relatively small, it is predicted that around USD38—43 billion in social and sustainability bonds will be issued in 2019, making it an increasingly important component of global sustainable finance.[89]

[87] https://www.gov.uk/government/publications/accelerating-green-finance-green-finance-taskforce-report.
[88] https://www.climatebonds.net/resources/reports/2018-green-bond-market-highlights.
[89] https://www.climatebonds.net/resources/reports/bonds-and-climate-change-state-market-2018.

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