



## Regulatory Reform in Europe: What to expect in 2014

European financial regulatory reform has moved no more quickly than in the U.S. in 2013, and with the need to reach consensus between 28 member states, with often very different interests, there is little chance that the pace will pick up much in 2014, especially with European Parliament elections due for May. The following will give a taste of what to expect in 2014 in the banking, securities, derivatives and structured products sectors.

### **EU Bank Structural Reform Proposals**

In January 2012, the European Commission announced its intention to establish a high-level expert group to consider reform to the structural aspects of the European banking sector. The core recommendation of the resulting Liikanen report, published in October 2012, was the structural separation of the “socially useful” activities of a bank, such as deposit-taking, household lending and lending to small and medium-sized enterprises, from its “riskier” proprietary trading activities. The proposed reforms are intended to reduce the probability and impact of banks’ failure and to ensure, in the event of such failure, the continuation of economically essential services and the protection of retail consumers.

2013 saw the Commission publish a consultation paper in May and the European Parliament adopt a resolution in July, setting out core principles for structural reform. The consultation paper focused on the policy options for structural separation, with a separate annex setting out the Commission’s work on determining the thresholds of trading activity to trigger the separation requirement. The definition of “trading activity” is key in determining the separation trigger, and in the consultation paper the Commission sought views on exactly what activities should constitute “separable activities”. There is intended to be a *de minimis* exemption to be introduced for banks whose trading activities are not systemically important enough for them to be subject to the separation requirement and possible discretionary powers for national regulators to decide whether the separation requirement should apply to banks which have crossed the relevant separation thresholds. The Commission also sought views on the desired strength of the separation between the trading entity and the deposit bank, such as whether the functional separation (covering economic, governance and operational matters) of such entities would be sufficient, allowing such entities to be part of the same group if they are legally separate, or whether it was necessary to go further and impose ownership separation, where the entities would have to have different owners with no affiliations – in effect preventing banking groups from engaging in both categories of activities.

The Commission’s legislative proposal may be published in early 2014, although with the European Parliament elections in May and the change of the Commission towards the end of 2014 it is possible that it may not be published until late in 2014 or even 2015. The UK, in particular, will need to consider the interaction of such proposals with those enacted nationally, such as the Financial Services (“Banking Reform”) Act 2013.

## UK Financial Services (Banking Reform) Act 2013 (the “Banking Reform Act”)

The Banking Reform Act was enacted on 18 December 2013. It gives HM Treasury and the Prudential Regulation Authority powers to implement the principal recommendations made by the Independent Commission on Banking (“ICB”), or Vickers Commission, most notably those relating to ring-fencing retail banking services and holding additional primary loss-absorbing capacity (“PLAC”). Other notable reforms introduced via the Act include (i) raising the priority of deposits insured by the Financial Services Compensation Scheme above other unsecured creditors and floating charge holders; (ii) a bail-in stabilisation tool for the Bank of England as part of its resolution powers; (iii) the introduction of a senior persons regime, a licensing regime for staff whose behaviour could seriously harm the bank and new banking standards rules and (iv) a new criminal offence of reckless misconduct in the management of a bank.

The ring-fencing provisions regime will oblige UK banks to structurally separate, or ring-fence, their retail and SME deposit-taking businesses from their other “excluded” activities such as proprietary trading. Ring-fenced banks will also be prohibited from certain activities, such as having exposures to certain financial institutions. A firm will be classified as a ring-fenced bank if it carries on the “core” activity of accepting deposits, subject to exemptions such as the *de minimis* exemption for small banks, the exemptions for building societies and credit unions or where it does not accept “core deposits”, which include retail deposits, but expressly exclude deposits from high net worth individuals and large companies. In order to facilitate the observance of the ring-fence, there will be provisions allowing a bank to transfer all or part of its business to another body without needing to obtain the consent of all affected parties and also powers given to the PRA to “electrify” the ring-fence by requiring banking groups to restructure their operations if it considers that their implementation of the ring-fence has been ineffective.

The minimum PLAC requirements will apply to systemically important UK banks and building societies (including UK-headquartered global systemically important banks) to provide a loss buffer in times of financial stress, reducing the likelihood of failure and ensuring that in the event of failure, losses are borne by shareholders and unsecured creditors rather than the taxpayer. PLAC should consist of the best quality loss-absorbing capital, such as regulatory capital or eligible debt instruments. The government intends to impose a minimum PLAC requirement of 17% of risk-weighted assets for the largest banks and building societies. These PLAC requirements are intended to satisfy the requirement under the proposed BRRD (see below) for banks to maintain a minimum amount of “eligible liabilities” that may be bailed-in, in times of financial stress.

The government aims to implement all secondary legislation under the Act by 2015, and compliance with the ring-fencing requirements will be expected by 2019 at the latest.

### European Implementation of Basel III

In the European Union (the “EU”), the Basel III reforms will be implemented through the CRD IV package of reforms from 1 January 2014. CRD IV is the name given collectively to the Capital Requirements Regulation or “CRR” and Directive 2013/36/EU (known as the “CRD IV Directive”). The CRD IV package will replace the current Capital Requirements Directives (2006/48/EC and 2006/49/EC).

CRD IV will apply directly to EU banks and to investment firms that fall within the scope of the Markets in Financial Instruments Directive.

The main contents of CRD IV relating to Basel III can be summarised as follows:

- **Quality of capital.** CRD IV will tighten the criteria for components to be recognised as regulatory capital, and in particular will strengthen the definition of common equity (which will be the main component of their Tier 1 capital). Tier 3 capital will be abolished.

- **Quantity of capital.** The minimum ratios for common equity and Tier 1 capital will increase to 4.5% and 6% respectively, although the minimum capital ratio will remain at 8%. These will be phased in to be fully effective as of 1 January 2015.
- **Capital buffers.** CRD IV introduces two capital buffers, which will apply in addition to the increased common equity and Tier 1 capital ratios:
  - Capital conservation buffer. This buffer, which comprises 2.5% of risk-weighted assets (RWAs) and should consist of common equity, will limit the ability of a firm to make distributions if its capital ratios fall within the buffer levels. This will be phased in between 1 January 2016 and 1 January 2019.
  - Countercyclical capital buffer. This buffer, also consisting of common equity, will increase the capital conservation buffer at the discretion of individual national authorities. Its aim is to require firms to build up a buffer of capital during periods of excessive credit growth.
- **Counterparty credit risk.** CRD IV strengthens the capital requirements for counterparty credit risk exposures arising from banks' derivatives, repo and security finance activities. It also aims to encourage increased use of central counterparties for clearing over-the-counter derivatives trades.
- **Credit valuation adjustment risk.** CRD IV contains measures intended to address exposures to CVA risk (that is, the risk of deterioration in the creditworthiness of a counterparty).
- **Leverage ratio.** The CRD IV package introduces a leverage ratio. The leverage ratio is defined as Tier 1 capital divided by a measure of non-risk weighted assets. As the leverage ratio is a new regulatory tool the European Commission will be gathering more information before making it a binding requirement. The European Commission expects to report on the leverage ratio by the end of 2016, producing, where necessary, a legislative **proposal to make it a binding measure as of 2018.**
- **Liquidity requirements.** CRD IV introduces:
  - the Liquidity Coverage Ratio (LCR) which is intended to improve short term resilience of the liquidity risk profile of institutions, and which is intended to become effective as from 1 January 2015; and
  - the concept outlined in Basel III of a Net Stable Funding Ratio (NSFR) which is intended to ensure that an institution has an acceptable amount of stable funding to support its assets and activities over the medium term. However, these proposals are at an early stage and need to be developed, with the aim of the NSFR applying from 1 January 2018.

In addition to the Basel III provisions, the CRD IV package contains provisions attempting to address a perceived over-reliance on external credit ratings by banks when determining the risk weights of their exposures. These provisions include the requirement for a bank to form its own internal credit opinion on exposures, and not rely “solely and mechanistically” on external ratings.

CRD IV, as a whole, will come into effect on 1 January 2014, although certain of its provisions will take effect at a later date or will be phased in only over a period of time. CRD IV contains specific mandates for the European Banking Authority (“EBA”) to develop binding technical standards, guidelines and recommendations (well over 100 of them) which will form part of the single European rulebook established by the CRD IV package. The EBA has already drafted a number of these technical standards and will continue to do so during the course of 2014. Market participants can also expect to see many more EBA consultation papers published in the next few months,

and should be prepared to respond to these within a limited timeframe. More information on the progress with this work and consultations on the draft standards are available from the EBA. The EBA has also launched a Q&A tool to facilitate common understanding of provisions related to CRD IV.

### Remuneration for Financial Institutions

Quite separately from its Basel III related provisions, CRD IV controversially introduces substantive restrictions on the executive compensation arrangements of banks and investment firms subject to CRD IV. Broadly, CRD IV now requires the following:

- CRD IV requires firms to ensure that their remuneration policy makes a clear distinction between criteria for setting basic fixed remuneration and variable remuneration. Variable remuneration should reflect a “sustainable and risk-adjusted performance as well as performance in excess of that required to fulfil the employee’s job description as part of the terms of employment”. In addition, a new bonus cap will apply to remuneration awarded for services provided or performance from 1 January 2014 onwards, whether due on the basis of contracts concluded before or after 31 December 2013.
- This cap is in addition to the remuneration restriction and principles in force since the so-called CRD III amendments, and the composite effect of the CRD III amendments and the new CRD IV amendments is as follows:
  - there should be a basic ratio of variable to fixed remuneration set at a maximum of 1:1, which can only increase to 2:1 with shareholder approval (with a quorum of 50% of shareholders, 66% of votes in favour would be required, and, if that quorum is not reached, 75% of votes in favour).
  - there is now a specific requirement that up to 100% of total variable remuneration must be subject to malus or clawback arrangements, which shall cover situations where the staff member participated in or was responsible for conduct which resulted in significant losses to the institution, or failed to meet appropriate standards.
  - 25% of total variable remuneration can consist of long-term financial instruments, discounted with reference to factors reflecting risk inherent in the instruments.
  - guaranteed bonuses should not form part of prospective remuneration plans. These should be the exception and only occur where the firm has a sound and strong capital base and (as at present) it should be limited to the first year of employment.
- **Golden hellos:** Remuneration packages relating to compensation or buyouts from contracts in previous employment must align with the firm’s long-term interests, including as to retention, deferral, performance and clawback arrangements.
- **Website on remuneration:** Firms and institutions that maintain a website must provide an explanation on it of how they comply with their CRD IV remuneration requirements.
- **Disclosure:** The information to be disclosed in relation to remuneration will increase, in particular requiring disclosure of the ratios between fixed and variable remuneration, the number of individuals being remunerated EUR1 million or more per financial year and the total remuneration of each member of its management body or senior management.

The CRD IV rules on remuneration will apply to all credit institutions and investment firms (within the meaning of MiFID). Firms are required to apply the new rules at the group, parent company and subsidiary levels including staff of EU-based firms working outside the EU.

The EBA has published a final draft technical standard on the criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile. Broadly, staff will be identified as having a material impact on the institution's risk profile if they meet one or more of the criteria set out in the final draft technical standard:

- qualitative criteria related to the role and decision-making power of staff members (such as if the individual is a member of a management body, is a senior manager or has the authority to commit significantly to credit risk exposures).
- quantitative criteria, related to the level of total gross remuneration in absolute or in relative terms. In this respect, staff should be identified if their total remuneration exceeds, in absolute terms, EUR 500,000 per year, or they are included in the 0.3% of staff with the highest remuneration in the institution, or their remuneration is equal or greater than the lowest total remuneration of any member of senior management and other risk takers. However, staff identified only according to quantitative criteria may be excluded from being identified as a material risk-taker in justified cases, under additional conditions and subject to supervisory review.

The EBA intends to finalise the remaining draft technical standards on remuneration at the beginning of 2014 and submit them to the European Commission by 31 March 2014.

### **UK Government Challenges Bonus Cap**

In September 2013, the UK government lodged a legal challenge to the bonus cap contained in CRD IV with the European Court of Justice. The UK government is challenging the bonus cap on a number of grounds including that the legislation is not fit for the purpose of improving stability across the banking system, as the proposals will lead to an increase in fixed salaries. The challenge also covers the compatibility of the bonus cap provisions with the EU Treaty and the powers delegated to the EBA which powers, the government believes, "go well beyond its remit of setting technical standards".

It is likely to take at least a year before the outcome of the UK government's challenge is known. Notwithstanding its legal challenge, the UK government has confirmed that it will still be implementing the remuneration provisions of CRD IV as from 1 January 2014.

### **EU Bank Recovery and Resolution Directive ("BRRD")**

The BRRD looks set to become law in the first half of 2014, with triologue agreement reached, and a full vote of the European Parliament currently scheduled for 24 to 27 February 2014.

The BRRD represents one strand of the EU's approach to dealing with the too-big-to-fail issue in respect of systemically important banks and financial institutions, and it introduces a range of new regulatory powers.

Firstly, it requires firms to submit to their relevant competent authorities recovery plans, which detail the arrangements the firm has in place to restore its viability in a time of severe financial stress. Despite the fact that BRRD has not yet been completely finalised, 39 EU banks are required by the European Banking Authority to have presented group recovery plans to their competent authorities by 31 December 2013. The EBA will submit to the European Commission final draft rules as to the required content of recovery plans, and as to the required criteria for assessment of plans by competent authorities, with 12 months of the BRRD coming into force.

Secondly, the BRRD provides various intervention powers to competent authorities to take action to address problems at an early stage, including requiring a firm to implement its recovery plan and prepare a debt restructuring plan with its creditors. If its financial position deteriorates dramatically and the other early intervention powers are insufficient to remedy the situation, the competent authority can appoint a special manager to replace the firm's management for up to one year.

Thirdly, where the recovery plan and early intervention measures are not able to prevent the failure of a firm, the BRRD gives various resolution powers to a resolution authority. These are exercisable only where the firm is failing or likely to fail, where there is no reasonable prospect that any action, other than a resolution action, would prevent the firm's failure within a reasonable timeframe and where a resolution action is necessary in the public interest.

The overall objectives of the resolution powers are to ensure the continuity of the critical functions of the firm, to avoid instability in the financial system, to protect taxpayers by minimizing any extraordinary public sector financial support, to protect deposits covered by a deposit guarantee scheme and to protect client funds and client assets.

Resolution authorities must also have prepared a resolution plan for the firm based upon information required to be provided by the firm, setting out in advance of any financial deterioration how the firm might be resolved in accordance with the above objectives.

The BRRD provides 4 resolution "tools" for resolution authorities – the sale of business tool, the bridge institution tool (allowing a resolution authority to transfer the good assets of the firm to a bridge institution which would then be sold), the asset separation tool (allowing the assets of a firm to be transferred into an asset management vehicle, to maximize their recovery value over time) and the bail-in tool.

The bail-in tool is the most controversial of all the tools at the disposal of the resolution authority and allows the write-down and/or conversion into equity instruments of certain of the firm's debt obligations. Its purpose is either to absorb losses and recapitalize a firm if it can continue as a going concern, or to wind down a firm in a liquidation scenario. It does this by ensuring that shareholders and certain unsecured creditors bear the first losses incurred by the firm. Secured liabilities of the firm are immune from bail-in, as are deposits covered by a guarantee scheme, liabilities for client money/assets and liabilities with an original duration of less than one month.

In order to ensure sufficient loss-absorbing capacity, the BRRD requires banks to maintain a minimum amount of liabilities eligible for bail-in. This amount should be proportionate for each type of firm, based on their risk or funding sources, but the European Commission originally indicated that a minimum amount equal to 10% of total liabilities might be appropriate.

Certain principles must be observed by resolution authorities in their use of the available tools. These are (i) that shareholders must bear the first loss, (ii) thereafter unsecured creditors bear losses in accordance with the order of priority of their claims pursuant to RRD, (iii) firm's senior management is replaced and can be required to bear losses according to their individual responsibility, (iv) creditors of the same class are treated in a pari passu manner except where otherwise provided and (v) no creditor shall be worse off than it would have been under normal insolvency proceedings.

The BRRD also provides for the establishment of national resolution funds, to which firms must make ex ante contributions in proportion to their liabilities. The European Commission envisages the minimum target fund level to be set at 1% of that country's covered deposits by 2025. To the extent this ex ante fund is not sufficient to cover losses and expenses, member states can levy ex post contributions from firms. The BRRD envisages that

national resolution funds may borrow from each other and that in cases of resolutions of cross border financial groups, the resolution funds of each relevant member state must contribute to the resolution.

At the time of writing, the final form of the BRRD is not available, though a 12 December press release from the European Parliament indicates that the BRRD will come into force on 1 January 2015 (except for the bail-in provisions, which will come into force on 1 January 2016). Of the liabilities subject to bail-in, shareholders and bondholders will be first in line to take losses and deposits not covered by a guarantee scheme would take losses last, after resolution funds and deposit guarantee funds had been applied.

The bail-in tools can be used until shares and liabilities in aggregate equal to 8% of the firm's total assets have been wiped out. Thereafter resolution funds can be applied up to an amount equal to a further 5% of the firm's total assets.

Public funds may only be used to bail-out a firm in exceptional circumstances, and only after 8% of the firm's assets have been bailed-in.

### **European Single Resolution Mechanism ("SRM")**

Closely coupled with the BRRD is the European SRM. For those banks that are participating in the Single Supervisory Mechanism (i.e. all banks in the Eurozone and in certain other participating member states – around 6,000 of them) whereby the European Central Bank is the single bank supervisory authority, the SRM further develops the "single rulebook" concept. It does this by adopting recovery and resolution mechanisms that essentially mirror those in the BRRD, and establishing a Single Resolution Board as the main resolution authority for all banks subject to the SSM.

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

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

In terms of the interaction between the BRRD and the SRM, where a resolution procedure would affect only banks governed by the SSM, then the SRM would apply. Where a resolution procedure would affect only banks outside the scope of the SSM, then the BRRD would apply.

Where a resolution procedure would affect both banks within and outside the scope of the SSM, then the BRRD will apply, with the SRB representing the national resolution authorities of the SSM-participating member states.

A plenary vote of the European Parliament is currently planned for 10 to 13 March 2014 and following approval and publication in the Official Journal, the SRM is planned to come into force on 1 January 2015 (with the bail-in provisions coming into force on 1 January 2016), simultaneously with the BRRD.

### **MiFID II**

MiFID II refers to the European Commission's review of the effectiveness of the Markets in Financial Instruments Directive in order to significantly expand its scope, taking into account technological developments in securities and derivatives trading since MiFID came into force, as well as to counter certain supervisory deficiencies that

were exposed by the financial crisis, and will facilitate a more interventionist approach on the part of national regulators and the European Securities and Markets Authority (“ESMA”).

The draft legislative proposals published by the Commission on 20 October 2011 consist of two separate documents. Provisions dealing with pre- and post-trade transparency (including the extension to instruments similar to equity and debt), exchange trading of derivatives, product intervention by national authorities and provision of certain services without a branch by non-EU firms are contained in a regulation (“MiFIR”) that will have direct effect in and be consistently applied across member states without the ability for such states to put their own interpretation on the provisions in implementing legislation. The remaining provisions dealing with matters such as authorisation and operating conditions for investment firms, regulation of new types of trading venues (known as organised trading facilities (“OTFs”)), passporting of activities across the EU, regulation of high frequency and algorithmic trading, more extensive regulation of commodity markets, conduct of business rules and powers of national authorities and ESMA are contained in a directive (“MiFID II”) that will need to be implemented by member states through national legislation.

On June 18, 2013, the Council of EU Ministers agreed the final drafts of the proposals and they will now be considered and finalised by the trialogue of the Council, European Commission and European Parliament. The aim is to agree the texts by early 2014 at the latest, to avoid the European Parliamentary elections.

### **EU Market Abuse Regime**

On 20 October 2011, the European Commission published proposals for a new Market Abuse Regulation (“MAR”) and a directive (“CSMAD”) on Criminal Sanctions for Market Abuse, with the proposals commonly referred together as “MAD II”) to replace the existing Market Abuse Directive. Currently the UK government has decided not to opt into CSMAD, although this may change at a later date.

Consistent with MiFID II, the proposals expand the scope of the market abuse framework beyond the current scope of financial instruments traded on an EU regulated market (or those whose value depends upon such instruments) to those traded on multilateral trading facilities, organised trading facilities and over-the-counter, which encompasses most derivatives as well as securities and other instruments. MAD II also expands the definition of inside information for the purpose of insider dealing, in that the information no longer needs to be “precise” and also includes information that, if available to a reasonable investor who regularly deals on the market and in the financial instrument concerned, would be regarded as relevant when deciding the terms of transactions in such financial instrument.

Further, MAD II introduces a new offence of attempted market manipulation and gives a new power to competent authorities to permit the delay of the public disclosure of inside information if it is of systemic importance, it is in the public interest to delay such publication and the confidentiality of the information can be ensured. The MAD II proposals also introduce an aggregate minimum of €20,000 per calendar year, below which transactions involving persons discharging managerial responsibilities will not need to be disclosed. Other provisions in MAD II include minimum rules for administrative measures and sanctions and a requirement for the criminalisation of intentional insider dealing and market manipulation, as well as inciting, aiding and abetting such offences.

The proposals were amended by the Commission in July 2012 to criminalise the manipulation of financial benchmarks. In December 2012, such proposals were agreed to by the Council and on 5 July 2013 the Council published the version of the text of MAR that it has agreed with the European Parliament, allowing the Parliament and the Council to agree the text of CSMAD in line with MAR. Once MAD II is adopted, it is proposed that MAR will apply in all member states from 24 months after its entry into force and that member states will have the same time to implement CSMAD into national law. It is intended that the provisions will enter into force at the same times as the instruments implementing MiFID II, and ESMA is expected to play a key role in 2014 in preparing the regulatory technical standards that will set out the detail of how MAD II will be implemented in practice.

## European Market Infrastructure Regulation

In relation to the EU's G20 commitment to centrally clear all standardised derivatives contracts through central clearing counterparties ("CCPs"), the European Market Infrastructure Regulation ("EMIR") came into force on August 16, 2012 and by the end of 2013, a number of significant compliance deadlines had passed, including:

- **15 March 2013:** (1) EU non-financial counterparties were required to inform their competent authorities if their volume of traded derivatives exceeds or falls below the clearing threshold; and (2) all counterparties were required to ensure the timely confirmation of trades, where available, by electronic means; and
- **15 September 2013:** all counterparties were required to put formalised processes in place to reconcile derivative portfolios, manage associated risk and identify disputes.

The market appears to have adapted well to the regulatory changes; making use of the International Swaps and Derivatives Association ("ISDA") protocols and standardised bilateral amendment agreements in order to streamline and simplify the compliance process. However, in a number of respects, compliance has not been entirely straight forward and the European Securities and Markets Authority ("ESMA") has been called upon to respond to individual enquiries and provide market-wide guidance in the form of its Frequently Asked Questions.

2014 will see the advent of EMIR's reporting and clearing obligations. On the reporting side, we now understand that February 12, 2014 (the "Reporting Start Date") is scheduled to be the date that the reporting of derivatives trades (under Article 9 of EMIR) becomes mandatory for all counterparties (this obligation does not apply to third-country entities). In this respect, any derivatives that were entered into prior to August 16, 2012 and which remain outstanding after that date, shall have to be reported to a trade repository which has been authorised for that purpose. Similarly, any derivatives trades entered into after August 16, 2012 shall also have to be reported. For this purpose, on November 7, 2013, a number of trade repositories were finally approved by ESMA after a lengthy approval process.

There are, however, a few special cases. Any derivatives which: (1) were entered into prior to August 16, 2012 and which remain outstanding after that date; or (2) were entered into on or after August 16, 2012, which, in either case, are not outstanding on or after the Reporting Start Date, must be reported to a trade repository within 3 years of the Reporting Start Date. Any derivatives which were entered into prior to August 16, 2012 and which are still outstanding on the Reporting Start Date should be reported to a trade repository within 90 days of the Reporting Start Date. The start date for the reporting of data relating to exposures (i.e., the posting of collateral) has also been extended by 180 days from the Reporting Start Date for the relevant class.

In terms of the clearing obligation, a number of developments are predicted for the year ahead. Firstly, it is anticipated that the first CCPs will be authorised to clear particular classes of over the counter ("OTC") derivatives by March 2014. Following such authorisation, ESMA will publish one or more consultation papers in order to present the classes of OTC derivatives which might be subject to the clearing obligation. During the consultation period (which may take up to six months) ESMA shall take into account each such class of derivative's degree of standardisation (as regards its contractual terms and operational processes), volume, liquidity, and the availability of fair, reliable and generally accepted pricing information. It must then prepare Regulatory Technical Standards and submit them to the European Commission, who will have up to three months to conclude whether or not to endorse ESMA's recommendations. Thereafter, the European Parliament and the Council of the European Union will have an opportunity to make any changes to the final rules. Once the final rules are published in the Official Journal, they will not come into force for a further 20 days thereafter.

Given the above, it seems very unlikely that we shall see a clearing obligation come into force until the latter stages of 2014 at the earliest. Such obligations are also likely to be subject to at least some degree of phase-in.

Regardless, however, derivative counterparties will still need to allow for the possibility of clearing (in the future) any relevant OTC derivatives traded after the date on which a CCP is first authorised to clear that particular class of OTC derivatives (the “Frontloading Date”). This is on the basis that any trades entered into from the Frontloading Date may eventually have to be centrally cleared, provided that they have a remaining maturity (measured from the date that the clearing obligation actually comes into force) over a certain threshold to be determined by the Commission.

Commentators have noted that EMIR’s approach to frontloading is fraught with difficulty, primarily as a result of the number of unknowns. For one thing, it is difficult to say with any certainty that a particular class of derivative which is authorised for clearing will actually become subject to a clearing obligation. In addition, nobody knows what the precise length of the time-lag will be between the Frontloading Date and the date of the eventual clearing obligation. As a consequence, a number of pricing assumptions will need to be made when trading OTC derivatives, as parties struggle to determine whether they are entering into cleared or uncleared trades. It therefore remains to be seen how much disruption this will cause and the impact on the market as a whole.

### **Recovery and Resolution Plans for Non-Banks**

2014 is expected to herald the publication of a European Commission legislative proposal for the recovery and resolution of financial institutions other than banks. Originally consulted upon by the Commission back in October 2012, the proposals are expected to address the potential risks to the economic system arising from the failure of one or more systemically important non-bank financial institutions.

Systemically important non-bank financial institutions include financial market infrastructures (meaning CCPs and central securities depositories (CSDs)), insurance and reinsurance firms and other non-bank institutions such as payment systems. However, given the rapid evolution of EMIR and the forthcoming implementation of the clearing obligation, the resolution of CCPs has now become a concern of paramount importance. As such, in October 2013, the European Parliament, called “*upon the Commission to prioritise the recovery and resolution of CCPs*” and to put “*in place comprehensive recovery arrangements which provide protection over and above the funds and resources required by EMIR*”.

At the present time, it is difficult to say with any certainty, which policy options will be employed. However, rather than applying a broad framework approach to all non-bank institutions, the Commission’s roadmap, provided in May 2013, suggests that specific tools will be developed in relation to each diverse sector (insurance, securities etc.). This is reflective of the fact that different non-bank entities are exposed to different types of risk. For CCPs, a number of suggestions have been proposed, including resolution powers (comprehensive powers of intervention in the management of the institution), reorganisation tools (e.g., transfer of operations to a healthy market player) and loss allocation and refinancing tools (application of haircuts to margin, liquidity calls, ex-ante insurance policies etc.). Hopefully 2014 will provide some much needed colour in respect of the Commission’s intended approach.

### **European Financial Transactions Tax**

In September 2011, the European Commission proposed a Financial Transactions Tax (“FTT”), being a tax on all financial transactions (including derivatives but not including loans) in the EU. The FTT was initially expected to raise €35 billion a year from banks and be implemented by January 1, 2014.

The proposed FTT was expected to apply a minimum 0.1% tax rate for transactions in respect of all types of financial instruments except derivatives, which will attract a tax rate of 0.01% for options, futures, contracts for difference or interest rate swaps.

Only 11 member states were originally expected to sign up to the proposed FTT directive, which the Commission currently intends to implement through a procedure known as “enhanced cooperation”. These member states include Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovenia, Slovakia and Spain (the “FTT-11”). Germany and France are widely acknowledged to be the driving forces behind the FTT.

In April 2013, the UK mounted a legal challenge against the legality of the FTT, arguing that its impact would result in “inadmissible” effects on non-participating member states; namely that the rights and obligations of such non-participating states would not be respected and they might also be forced to incur certain costs. However, in a document prepared by advisers to the Commission, the view is taken that the FTT is in “*conformity both with customary international law and EU primary law*”, in a 20-page analysis document. This analysis, though, is contrary to an opinion issued by the European Council Legal Service in September, 2013, which seriously questions the legal validity of core elements of the proposed FTT directive.

As a consequence of the conflicting issues and opinions referred to above, the outlook for the FTT in 2014 remains extremely uncertain. Some commentators have suggested recently that the FTT could be implemented in 2014, provided the FTT-11 agrees the terms of the directive. In contrast, others, including a spokesperson for the EU tax commissioner, Algirdas Šemeta, believe that this is unlikely. As representatives from the FTT-11 were due to meet again in mid-December and the German coalition parties have pledged to swiftly implement a broad tax covering financial instruments, the market awaits further news as regards whether any significant progress will be made in 2014.

## PRIPS

The initiative relating to “packaged retail investment products” or “PRIPs” is a key element of the European Union’s regulatory agenda in relation to retail financial services and dates back to a Call for Evidence published by the EU Commission in October 2007 seeking a more consistent approach for the regulation of structured retail investment products, particularly in relation to pre-contractual disclosure and sales practices by product distributors. This arose out of a concern that similar products were regulated in different ways depending upon their legal nature and packaging. The initiative has focused in particular on structured securities, UCITs funds, structured deposits and certain life insurance policies.

Following various consultation papers, a draft Regulation was published by the EU Commission in July 2012. This proposed Regulation deals primarily with pre-contractual disclosure and introduces the concept of a “Key Information Document”, or KID to be provided to investors prior to their committing to the investment. Issues relating to sales practices are now primarily dealt with in the proposed overhaul of the Markets in Financial Instruments Directive (“MiFID II”) in relation to structured securities, UCITs funds and structured deposits and the proposed changes to the Insurance Mediation Directive (“IMD II”) in relation to insurance products.

Following the publication of the draft PRIPs Regulation by the EU Commission, the EU Council of Ministers has published compromise drafts setting out a number of proposed amendments. More recently in November 2013, the EU Parliament approved a draft Regulation which differs from the EU Commission and Council proposals in a number of important respects. These three bodies will now enter into “trialogue” discussions with a view to seeking to finalise the Directive in 2014 and are likely to seek to reach agreement prior to the EU Parliamentary elections.

The principal features of the proposed Directive and the issues likely to be of particular focus in the triologue discussions are set out below.

- **Scope.** The Commission and Council draft definitions of “investment product” move away from the requirement for there to be “packaging” of the product but still envisage indirect exposure to some type of underlying asset or index. The Commission provides that an investment product includes “an investment

where regardless of the legal form of the investment the amount repayable to the investor is exposed to fluctuations in the reference values or in the performance of one or more assets which are not directly purchased by the investor". It also proposes certain categories of product are expressly excluded including (i) deposits with a rate of return determined by reference to an interest rate, (ii) "vanilla" securities not embedding a derivative, (iii) insurance products where the surrender value is not exposed to fluctuation in underlying assets or reference values and (iv) occupational pension schemes covered by the Occupational Pensions Fund Directive or the Solvency II Directive. The EU Parliament proposes a much wider scope and envisages that investment products should generally come under the scope of the Regulation with an exemption for certain vanilla products.

- **Purpose of the KID.** A key issue is whether the KID should be a standalone document which contains all the information an investor needs to understand the product and make an informed investment decision or whether it should aid in the investor's decision making process but be intended to be read in conjunction with other relevant documents, possibly a prospectus. The Commission draft takes the former approach whilst the Council supports the latter. The Parliament's proposal is less clear but does envisage the KID cross-referencing other documents. Having regard to the fact that the Council proposes a maximum length of the KID of three pages (and the Parliament draft reduces this to two), it does not seem realistic that the KID could replace the role of a prospectus or similar document and provide investors with the information necessary to make a fully formed investment decision.
- **Content.** The Commission and Council drafts provide that responsibility for drafting the KID is on the product manufacturer and any entity that significantly alters key features of the product. No standard form or precedent is provided although the drafts envisage a standardised look and feel to KIDs with high level content requirements and a requirement that each document have the same headings set out in the same order. It is envisaged that more detailed content requirements will be included in level 2 EU legislation. The Parliament draft sets out more detailed content requirements and also proposes inclusion of a "complexity label" and a link to an online fund calculator for investors to calculate the end value of their investment, after fees and costs. The Parliament also proposes an additional annex to the KID to provide information relating to product distributors. All the drafts envisage a risk reward indicator be included in the KID, despite industry concerns that investors are likely to place undue emphasis on such an indicator. The Commission does not propose a specific page limit to the KID although this may be included in level 2 legislation. The Council and Parliament propose a limit of three and two pages respectively.
- **Liability.** The Commission draft provides that where the product manufacturer produces a KID not in compliance with the Regulation and the retail investor has relied on this, the investor may claim damages from the product manufacturer for any loss caused by such reliance. The Commission also proposes that the normal burden of proof be reversed so if a retail investor can show loss as a result of relying on the KID, the burden of proof is on the product manufacturer to show the KID has been drawn up in accordance with the Regulation. The Parliament draft takes a similar approach. Concerns have been raised, particularly having regard to the subjective nature of some of the proposed content requirements, that it may be extremely difficult for the manufacturer to prove compliance, particularly for more complex documents and this may effectively give investors a "free put" where they have suffered loss. The Council draft does not include a standalone civil liability regime and, consistent with the approach taken in relation to summaries under the Prospectus Directive, provides that a product manufacturer should not incur civil liability solely on the basis of the KID unless it is inconsistent with other pre-contract or contract documents or is misleading or inaccurate.
- **Other product regulation proposals by the EU Parliament.** The EU Parliament draft also includes a number of other proposals including a product approval process to be adopted by the manufacturer, new product intervention powers for regulators (even though the MiFID II draft

contemplates equivalent powers), a risk management process to be adopted by the manufacturer to measure and monitor the product's risk profile at any time and restrictions on the structure and methodology of the product's payoff.

## Shadow Banking

Identifying and analysing the different parts of the "shadow banking" sector has become an increasingly large part of the regulatory response to the financial crisis. Following a mandate at the G20 summit at Seoul in 2010 the Financial Stability Board ("FSB") established a task force and has led international efforts to strengthen the oversight and regulation of shadow banking. It has published a number of papers (focusing on five workstreams set out below) and most recently, in advance of the St. Petersburg G20 meeting in November 2013, published an overview of policy recommendations and policy frameworks for securities lending and repos and strengthening oversight and regulation of shadow banking entities. It also published a "roadmap" setting out various milestones up to 2015.

The FSB has acknowledged the difficulty of establishing a clear definition of shadow banking, having regard to the wide range of activities it potentially covers. It has focused on "non-bank intermediation" which it regards as credit intermediation involving entities and activities fully or partially outside the regular banking system, accepting that any definition should be capable of adapting with changes and developments in the financial markets. Although acknowledging that such non-bank activities can provide a valuable alternative to bank funding in supporting the real economy, the FSB is concerned that they can create bank-like risks, particularly where they involve leverage or maturity transformation. The FSB has recommended that once potential risks to the financial system are identified, regulators should narrow the focus of regulation to activities that increase systemic risk.

In its March 2012 Green Paper on shadow banking, the EU Commission approved the FSB's general definition of shadow banking and sought to give a non-exhaustive indication of the types of entities and activities that fall within the scope of shadow banking. Activities comprise primarily securitisation and securities lending and repos. Entities include SPVs (such as ABCP conduits) performing liquidity and/or maturity transformation, money market funds, leveraged investment funds (including ETFs) and finance companies, insurance/reinsurance undertakings issuing or guaranteeing credit products. Both the FSB and the EU Commission highlight the need to put systems in place to monitor transactions and arrangements that can give rise to systemic risks outside the regular banking system. In the EU, the enhanced framework for transaction reporting under EMIR and MiFID II is expected to assist in this regard.

The EU Commission published a Communication on Shadow Banking in September 2014 setting out more detail on priority areas where it believes further work and legislation is needed. Below is a summary of the FSB workstreams and relevant action proposed by the EU Commission.

- **Interaction of the regular banking system with shadow banking.** This ties into the work of the BCBS in relation to Basel III, particularly increased capital requirements for banks. In December 2013, the BCBS published its final policy framework for capital requirements for banks' equity investments in investment funds. Other measures focused on shadow banking have included increased capital requirements for re-securitisation exposures and short term liquidity facilities provided to securitisation vehicles, increased capital requirements for exposures to unregulated institutions and enhanced disclosure requirements for securitisations. The EU Commission notes that CRD3 and CRD4 have already implemented many of these measures including the revised capital requirements for re-securitisations under CRD3 and additional capital requirements in relation to OTC derivative positions under CRD4. The Commission also states that it is considering extending the scope of prudential rules to some non-banking entities although no further detail has been provided. It notes that banks will have increased reporting requirements in relation to exposures to unregulated entities and that the EBA is due to report on guidelines to limit such exposures by the end of 2014.

- **Securitisation and excess leverage.** The FSB has stated that the resumption of an orderly securitisation market can aid the real economy and is a goal of the wider financial reform programme. It has, however, proposed reforms to address perceived issues, in particular the misalignment of incentives between originators and investors and the opaqueness and complexity of some securitisations. In this regard, IOSCO has, with the BCBS, published policy recommendations. These include monitoring the effectiveness of risk retention provisions (in particular the difference in approaches between the EU and the US), improved stress testing disclosure and greater standardization in global disclosure templates.
- **Regulation of securities lending and repos.** Although the securities lending and repo markets are vital in meeting many financial institutions' financing needs, supporting market liquidity and facilitating market-making, the FSB believes that many transactions entered into by non-banks give rise to maturity and liquidity transformation risks. Concerns raised by the FSB include the need for supervisory authorities to have sufficient tools to monitor the buildup of leverage and identify illiquidity, the extent of reinvestment of cash collateral, pro cyclicalities due to the relationship between funding levels and fluctuating asset values and volatility caused by valuation haircuts. It is also concerned that the risks relating to rehypothecation of collateral may not be fully understood. It has developed eleven policy recommendations including minimum regulatory standards for cash collateral reinvestment and new regulation of rehypothecation including sufficient disclosure to enable clients to understand their potential exposure in the event of a failure of the intermediary. The FSB also recommends minimum regulatory standards be adopted for collateral valuation and management and has published a consultation on minimum standards for methodologies in calculating haircuts and a draft minimum haircut framework it intends to finalise in the first half of 2014. The EU Commission has stated it is considering introducing draft legislation to address these issues although it is unlikely to publish this until well into 2014 at the earliest.
- **Money market funds.** The FSB acknowledges that MMFs are an important source of credit and short-term funding for the regular banking system and provide maturity transformation and leverage. However, some MMFs suffered large losses during the financial crisis, often due to ABS holdings, leading to significant redemptions, runs and subsequent bail-outs for some funds. IOSCO has driven much of the work on this workstream and published a final report in October 2012 setting out policy recommendations for a common approach in MMF regulation. Perceived vulnerabilities include the stable NAV feature built into many MMFs which IOSCO believes can mask credit, interest rate and liquidity risks that funds are subject to. It set out 15 policy recommendations that have been endorsed by the FSB including the need for fair value principles for portfolio valuations and requirements for MMFs to hold a minimum amount of liquid assets to meet redemptions. MMFs offering a stable NAV should be subject to measures designed to reduce specific risks related to this feature.

The EU Commission published a draft regulation relating to money market funds in September 2012. It recommends limiting investments by MMFs to certain low risk investments including money market instruments with high internal credit ratings and deposits with eligible credit institutions with a maximum maturity of 12 months. It also proposes stricter diversification and concentration limits. The draft regulation does not seek to abolish stable NAV MMFs but proposes they be subject to a capital buffer of at least 3% of total assets. Concerns have already been raised that this buffer may make such funds uneconomical. The regulation also proposes minimum average maturity and weighted average life requirements and a prohibition on external credit ratings. The draft regulation differs in a number of important respects from SEC proposals for regulation of MMFs in the US which include the possibility of prohibiting prime institutional MMFs from offering a stable NAV feature and imposing liquidity fees and redemption gates for non-government MMFs. Money market fund regulation, in particular any move to mandatory floating NAV funds, remains controversial with significant opposition to a number of proposed reforms.

- **Regulation of other shadow banking entities.** The FSB states that the focus should be to identify systemic risks that can arise from activities of non-bank entities, rather than looking solely at legal names or forms. It believes particular issues to address include entities with structures susceptible to investor runs including leveraged funds, long terms loans financed by short-term funding, credit intermediation relying on short-term funding, credit creation by non-banks (e.g. financial guarantee insurers) and securitisation. It has identified policy toolkits to assist regulators in addressing these risks - it believes it is vital for regulators to share information to maintain consistency in approach and intends to set out procedures for information sharing by March 2014. The EU Commission notes that the Alternative Investment Fund Managers Directive (“AIFMD”) now provides a coordinated pan European framework for the regulation of alternative investment funds. ESMA has also undertaken a consultation in relation to the regulation of ETFs.

Work on all of these workstreams will continue into 2014 and beyond. The FSB is likely to continue to raise concerns in relation to differences in approaches in regulation between the EU and US and elsewhere, particularly if it believes this may lead to regulatory arbitrage. Of interest in 2014 will be progress on the EU’s proposed regulation on money market funds and the possibility of EU legislation to deal with issues relating to repos and securities lending raised by the FSB, particularly in relation to investment of cash collateral and rehypothecation.

## UCITS V

The proposed “UCITS V” amendments to the existing UCITS directive (“UCITS IV”) continue to go through the EU legislative process and trialogue discussions between the EU Commission, Council and Parliament will seek to finalise these arrangements during 2014. The most significant outstanding issue is the extent of the proposed remuneration provisions, with the EU Parliament seeking to make these more consistent with the provisions in CRD IV and the AIFMD. The principal amendments to the UCITS regime proposed by the draft UCITS V directive which was first published by the EU Commission in July 2012 are:

- changes to the provisions relation to the appointment of a depositary in respect of a UCITS fund including new rules relating to duties of oversight, cash monitoring, custody duties and conflicts management;
- rules setting out the terms on which the depositary’s safekeeping duties can be delegated;
- revision of eligibility criteria for depositaries so that only credit institutions and investment firms will be able to act as depositaries;
- clarification of scope of a depositary’s liability in the event of losses relating to an asset held by the depositary;
- new remuneration policies; and
- minimum harmonisation rules to seek to provide more consistency in sanctions provisions in member states.

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## A Regulatory Reform Glossary

The new regulatory framework in the United States and Europe has introduced a series of new terms. This brief glossary is intended to serve as a helpful summary of frequently used terms. [Download a copy here.](#)

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