TRAVERS SMITH

Wednesday, 10 January 2018

Financial services regulation 2018: New Year briefing

"Reports that say that something hasn't happened are always interesting to me, because as we know, there are "known knowns"; these are things we know that we know. We also know there are known unknowns; that is to say, there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know."

Donald Rumsfeld
Former US Secretary of Defense

Although the subject of much derision at the time (and indeed since), Donald Rumsfeld's baffling words have assumed a degree of resonance in these uncertain times. For firms, 2018 will bring plenty of known knowns: for instance, the PRIIPs Regulation, the Benchmarks Regulation and MiFID II all came into force while New Year hangovers were still being nursed – the headache will linger for some considerable time. For some institutions, they will be closely followed by PSD 2. Although many of these measures are subject to a good number of what Donald Rumsfeld might have referred to as "certain uncertainties", we do know to a very large extent *what* they involve for affected firms. Implementation issues will continue well into the New Year.

CONTENTS

1. Brexit – p.2

EU LEGISLATION IN FORCE WITHIN THE NEXT YEAR

2. MiFID II – p.3
3. PRIIPs Regulation – p.8
4. Benchmarks Regulation – p.9
5. PSD 2 – p.14
6. Insurance Distribution Directive – p.17
7. Money Market Funds Regulation – p.23
8. Securitisation Regulation – p.27

UK DEVELOPMENTS

9. Changes to regulatory perimeter for investment advice – p.36
10. Extension of SMCR – p.38
11. Costs disclosures to institutional investors – p.47

EU DEVELOPMENTS IN THE PIPELINE

12. AIFMD 2 and Omnibus Regulation – p.48
13. Proposed new EU prudential regime for MiFID firms – p.49
14. CRD V and CRR II – p.49
15. EBA RTS on triggers for prudential consolidation – p.50
16. MLD 5 – p.56

EU LEGISLATION ROUND-UP

17. EMIR – p.62
18. CSDR – p.68
19. SFTR – p.72

GLOSSARY – p.74

Aside from *financial services* regulation, but regulation nonetheless, there is an additional implementation headache for firms in preparing and being ready for the application of the EU General Data Protection Regulation (not covered in this briefing). This comes into force on 25 May 2018.

The extension of the SMCR regime to all financial services firms could be described as a known unknown, insofar as the FCA's proposals are now broadly clear, but the timing of implementation remains uncertain (although the FCA has proceeded on an assumption that the regime will not be extended to FCA solo-regulated firms until the middle of 2019 at the earliest).

However, can there be any known unknown bigger than Brexit? At the time of writing we know that Phase 1 negotiations have been finalised with an all-important agreement in principle and that the UK is seeking a transitional period from March 2019, during which, if agreed, it will largely be "business as usual" for UK firms despite being outside the EU – how long such a period will be is a matter for negotiation. With March 2019 only fifteen months away, it is still unclear as to what "end state" model the UK will be seeking for its future trading relationships. Even when that does become clear (or clearer) there is no certainty that the EU will agree to what the UK seeks. Financial service providers which currently rely on single market access will need to step up their Brexit contingency planning.

In this briefing we summarise some of those key known knowns and known unknowns which should be the focus of attention for firms in the coming year and beyond. As for the unknown unknowns, who knows? And there is always next year's New Year briefing ...

1. BREXIT: A HARD ROAD AHEAD TO SOFT EXIT?

On 8 December 2017, the European Commission announced that, in its view, "sufficient progress" had been made to allow the Brexit talks to advance to the next stage, including the UK's future relationship with the EU. This was ratified by the European Council at its summit meeting on 15 December 2017. This means that there has been agreement in principle on the three issues which the EU said had to be agreed before talks could proceed to future trading relations: the protection of the rights of EU citizens in the UK (and UK citizens in the EU), the financial settlement that the UK will pay and the avoidance of a "hard border" between Northern Ireland and the Republic of Ireland.

For the "Phase 2" talks, the UK has asked that, to avoid a "hard Brexit" in March 2019, there should be a transition period of about two years following the withdrawal date during which the UK will remain part of the Single Market and the Customs Union. The negotiating guidelines issued by the Council of the EU indicate that the granting of such a transitional period will be conditional on the UK respecting: the whole of EU law, including new law that emerges during the transition period, budgetary commitments, judicial oversight and other related obligations. In short, the UK will remain subject to EU law and will pay for the privilege of Single Market and Customs Union access, whilst no longer having any say in the formulation of new legislation or membership of the European Parliament.

As regards what future relationship with the EU the UK is seeking, there is still a great deal of uncertainty. The Council of the EU has said that it needs more clarity as to how the UK sees the future relations: this, it is to be hoped, will become clearer over the coming weeks and months. The cabinet is due to discuss the "end state" the UK will be seeking. Will it be "Canada-style", "Canada-plus" or "Canada plus plus plus"? Since the trade deal with Canada (CETA) does not cover services the "pluses" must refer, at least, to financial services.

Whatever the model, Michel Barnier, the EU chief negotiator, has made it clear that UK firms will lose passporting rights for financial services after Brexit and there will be no access to the single market except in those areas where the legislation includes an equivalence regime and such equivalence has been determined. There will not, he says, be any bespoke trade deal for financial services.

And as regards equivalence, on 20 December 2017, the European Commission published its proposal for a regulation on the prudential requirements of investment firms. Amongst the proposed changes to the EU prudential rules, and taking the lead from the Commission's February 2017 document on equivalence, the proposed regulation included some specific provisions on equivalence assessment. The Commission stated that any equivalence assessment "will have to be very detailed and granular" and will have to assess "supervisory convergence with the EU".

So, while the successful conclusion of the Phase 1 negotiations might have meant that the risk of a "hard, no deal Brexit" had receded somewhat, subsequent events have indicated that the Phase 2 negotiations will be far from easy and, as mentioned above, the likelihood of a special deal for financial services may not be as achievable as the UK might have hoped, if at all. In addition, and in any event, the timetable for reaching agreement will be extremely challenging, even assuming the deadline is extended because of an agreed transitional arrangement beyond the March 2019 exit day. On 20 December 2017, Michel Barnier said that any post-Brexit transition period would run logically to 31 December 2020, being the duration of the EU's current multi-annual financial framework.

There is clearly a great deal of hard talking still to do.

While so much remains up in the air, for financial services firms, amidst their Brexit-planning, some things are reasonably certain at least for the immediate future: they are likely to remain subject, one way or the other, to all of the upcoming EU legislation referred to in this briefing which is relevant to their business. The European Union (Withdrawal) Bill 2017-19 continues to progress through Parliament. The effect will broadly be to rewrite EU law (including those provisions which are currently directly-applicable) into UK law as from exit day, although how those provisions which are dependent on EU institutions will be carried forward in practice remains to be seen. As mentioned above, if a transitional period is agreed, the likelihood is that EU legislation coming into force between exit day and the end of that transitional period will also apply to UK firms.

While the position remains fluid, our view remains that firms should be working to comply with all relevant EU legislation as and when it enters into force, while in parallel making serious advancements to their Brexit plans, continuing to hope for the best, but planning for the worst. For those financial firms which are heavily dependent on single market access, many have focused on expanding their existing EU presence in the interests of preserving rights of passport (or corresponding EU rights).

Our website has a specific section dedicated to Brexit developments which is regularly updated. We will publish separate briefings on Brexit-related issues specific to financial services firms and markets, as and when appropriate.

If you would like specific guidance on Brexit-planning issues please contact us.

2. MIFID II: BIG BANG – THEORY NOW TO EVOLVE INTO PRACTICE

It is unlikely that anyone missed the fact that the MiFID II legislative package (or the vast majority of it, at least) entered into force on 3 January 2018, following years of negotiation and implementation delays. Although this represented the "big bang" date for the application of the new regime, some of which is by way of directly-applicable EU regulations, fewer than half of the 28 EU Member States have so far transposed the directive provisions into their national law. Perhaps not a whimper, but possibly not the New Year firework that had been expected by many.

The UK is one of the Member States that has transposed the MiFID II rules into laws and regulations. Even then, there is a sense of pragmatic transition to the full requirements of the new regime rather than it starting with a big bang. The FCA has acknowledged that, in terms of practical implementation "on the ground", many

firms will not have been able to transition fully to the new regime by day one. It has communicated a cautious degree of regulatory forbearance: provided firms can evidence the fact that they have taken "sufficient steps" in making a genuine attempt to be ready, the regulator will not be taking a strict liability enforcement approach from the outset. From the perspective of trading venues, *on 3 January 2018 itself*, the FCA announced that ICE Futures Europe and the London Metal Exchange had been granted a transitional arrangement under which they will not be required to consider open access requests under Articles 35 or 36 of MiFIR until 3 July 2020.

Finally, and leading right up to 3 January 2018, there have been numerous late clarifications on the scope and application of MiFID II rules, some last-minute concessions and the finalisation of some key delegated acts.

So, it is likely that, for many, the first few months of 2018 will continue to be dominated by MiFID II as affected firms carry on with their implementation and finalisation of MiFID-related changes and adjust to the new requirements. At the same time, such firms should continue to monitor developing market practice and any further announcements and guidance from the regulators and supervisors, which may help clarify how certain potentially unclear provisions in the legislation should be applied in practice.

MiFID II and MiFIR and the associated delegated legislation and guidance underpinning them contain a huge number of provisions: somewhere between 1.4 million and 1.7 million paragraphs of rules, depending on which estimate you read. Below, in rather fewer paragraphs, we summarise a few of the late developments that emerged shortly before the new regime went live.

LEGAL ENTITY IDENTIFIERS

The transaction reporting rules in MiFIR and its associated regulatory technical standards (**RTS**) provide that from 3 January 2018, a MiFID firm which is proposing to provide a service that would result in an obligation to submit a transaction report must refuse to do if the relevant client is a person who is eligible to receive a legal entity identifier (**LEI**), but has not provided an LEI to the MiFID firm. At the time that these rules were first proposed, a number of market participants expressed concern that many entities may not obtain LEIs in time and that this could cause significant disruption in the financial markets as a result.

On 20 December 2017, the European Securities and Markets Authority (**ESMA**) published an announcement on its website, accompanied by a formal statement, which indicated a slight relaxation of this requirement for a period of 6 months from 3 January 2018 (i.e. until **3 July 2018**).

ESMA stated that during that six-month grace period, MiFID firms may provide services for clients who have not yet obtained LEIs, but only if the MiFID firm obtains all necessary information from the client to apply for an LEI on that client's behalf. This information must be obtained before the firm provides the service and the firm must then immediately submit an application to obtain a LEI on the client's behalf. The firm should not submit the transaction report until the LEI has been obtained. In practice, this means that the relevant transaction report may have to be submitted after the normal T+1 reporting deadline.

In order to facilitate this, ESMA will disable one of the validation rules in its transaction reporting rule set which requires the issuance date of an LEI to be before the execution date of the reported transaction. The FCA issued its own announcement on 20 December 2017, noting the publication of ESMA's statement, but informing firms that it would be unable to change its own validation rules from 3 January 2018. The FCA advised that firms whose reports would fail validation as a result (i.e. because the client does not have the necessary LEI and the firm is therefore obtaining one of its behalf) should not submit their reports until the FCA has confirmed that it has implemented the rule change. The FCA also emphasised that firms are still expected to make every effort to secure a client's LEI before trading on its behalf.

While this may provide welcome relief to firms who were concerned about having to cease undertaking transactions for clients without LEIs, firms should note that they are still required to obtain the relevant information to permit them to submit an LEI application on such a client's behalf. They will also need to ensure that they have the client's consent to apply for an LEI and that another firm is not simultaneously applying for an LEI for the same client (as the same entity cannot have more than one LEI).

EU trading venues have a separate obligation to supply financial instrument reference data to regulators on behalf of issuers whose instruments are traded through their systems. ESMA has stated that where a non-EU issuer does not have an LEI code, the trading venue may, again for 6 months from 3 January 2018 (i.e. until 3 July 2018) use its own LEI code rather than the code of the non-EU issuer while that issuer obtains the relevant code. The trading venue is still expected to continue to populate missing LEI data for issuers in due course.

LATEST ESMA Q&A DOCUMENTS

ESMA continues to issue updated Q&A on the various aspects of MiFID II, with the last updated sets being published in December 2017, covering data reporting (ESMA70-1861941480-56), investor protection (ESMA-35-43-349), transparency (ESMA70-872942901-35) and market structures (ESMA70-872942901-38). To the extent that these topic areas are relevant to firms' operations, they should review the new Q&As in detail as part of their continuing implementation efforts. By way of summary, the key additions are as follows:

- **Transaction reporting – financial instruments with more than one level of underlying:** ESMA has confirmed that for transaction reporting, where a financial instrument has more than one level of underlying instrument, the firm need only consider the *immediate* underlying and not the ultimate underlying in order to determine if the instrument is within scope. Therefore, for example, if a firm is undertaking a transaction in relation to an over-the-counter (**OTC**) contract for difference (**CFD**) over a option on a share where the option is not traded on a trading venue, the transaction will not be reportable. This is because neither the CFD nor the immediate underlying (i.e. the option) is traded on a trading venue – the fact that the ultimate underlying share *is* traded on a trading venue is irrelevant. If the option *were* traded on a trading venue, however, the transaction would be reportable. ESMA has also confirmed that transactions in depositary receipts are reportable where the underlying instrument is traded on a trading venue, as are transactions in convertible bonds where the instrument into which the bond may be converted is traded on a trading venue. Transactions in warrants are also reportable where the instrument on which the warrant is based is traded on a trading venue.

- **Inducements:** ESMA's new Q&As address the position of the application of the inducements rules where a MiFID firm receives payment for performing the function of delegated investment management or portfolio management on behalf of a UCITS management company or an AIFM, but also provides services to other clients relating to those same investment funds. This could be the case, for example, where the MiFID delegated manager also acts as a segregated portfolio manager for a third party client and in that context, decides to invest in the relevant AIF or UCITS on that client's behalf. ESMA's view is that it is necessary to determine whether payments received by the MiFID firm for performing the delegated management function can be said to be paid *in relation to, or in connection with*, the MiFID services provided to the firm's other clients. Generally speaking, ESMA considers that this will not be the case (and therefore the payment from the AIFM or UCITS manager will not need to comply with the MiFID inducements rules), provided that the payment is received for the provision of a genuine service and not as a means of circumventing the MiFID II requirements. However, even where the MiFID II inducements requirements do not apply, the MiFID firm must still consider any other applicable MiFID requirements, such as the conflicts of interest and best execution requirements. Note that ESMA considers that where the MiFID firm is receiving payment from the AIFM or UCITS manager in relation to marketing the relevant AIF or UCITS and performs an investment service for a third party client in relation to the relevant fund, the payment will however be subject to the MiFID II inducements rules, as ESMA views the function of

marketing as being closely related to the provision of resulting services to the MiFID firm's own external clients.

- **Equity and non-equity transparency:** ESMA has provided guidance on what firms should use for the purposes of the transparency rules when the necessary transparency parameters or liquidity assessments are not available from ESMA (or the relevant non-delegating national competent authority). These "temporary" parameters vary according to the specific type of instrument and therefore firms should check the applicable guidance carefully. ESMA has also confirmed how the nominal value of debt instruments should be calculated for the purposes of the non-equity transparency rules and that subscription rights (including allotment rights and purchase rights) should be treated as an extension of the "shares" category and therefore as equity, rather than non-equity instruments.

- **Late transposition issues:** ESMA has provided guidance on how Member States should approach issues of late transposition of the MiFID II requirements. Broadly speaking, entities that have existing authorisations under MiFID I may continue to provide existing services on a passported basis into other Member States, irrespective of whether the home and/or host Member States have transposed the MiFID II rules, provided that the firms comply in practice with the new requirements. However, regulators in host Member States are not obliged to accept new passport notifications (or extensions of existing passport notifications) relating to firms authorised in Member States that have not transposed MiFID II after 3 January 2018. Conversely, regulators in Member States that have not transposed MiFID II by the deadline may not refuse new passporting notifications from firms based in those jurisdictions which have successfully transposed the legislation by that date.

- **Reverse solicitation of third country firms:** MiFID II provides that where a retail client or elective professional client established in the EU initiates at "its own exclusive initiative" the provision of an investment service by a third country firm, the third country firm is not subject to the rules which could otherwise require it to provide services through an EU branch (if the Member State has opted in to the branch regime). However, where the third country firm is deemed to have solicited EU clients or potential clients, the client is not deemed to be acting via its own exclusive initiative. ESMA has stated that in its view, any potential solicitation, promotion or advertising which would preclude valid reverse solicitation by the client should be considered regardless of the person through whom it is issued – i.e. whether it comes from the third country firm itself or another entity acting on its behalf or otherwise having close links with it. In ESMA's view, any type of communication may amount to a solicitation for these purposes, including press releases, internet advertising, brochures, phone calls or face-to-face meetings, if they have the effect of promoting or advertising the firm's potential services in the EU. The situation must be assessed on a case-by-case basis by reference to the relevant facts, irrespective of any contractual clause or disclaimer which might otherwise seek to state that the client is deemed to be acting on its own exclusive initiative.

INDUCEMENTS AND RESEARCH: RESEARCH FROM THIRD COUNTRY FIRMS

From 3 January 2018, EU portfolio managers are no longer able to purchase "bundled" execution/research services (in the UK this also extends to collective portfolio managers, other than private equity firms, when executing orders or placing them for execution). Instead, they are required to have arrangements ensuring that there are separate and identifiable payments for execution and research, either paid for by themselves from their own resources or by their clients through research payment accounts in accordance with the detailed MiFID II rules. In preparation for their compliance with the new regime, EU portfolio managers had been contacting their US and other non-EU brokers seeking separate pricing for execution and research (and also setting up compliant arrangements with their non-EU delegates).

For US brokers the request for separate pricing had become a significant concern because, in broad outline, receipt of distinct and identifiable research payments would have meant that they would either have to become

registered as investment advisers under the US Investment Advisers Act 1940 (with all that would have meant in terms of additional regulatory burdens and fiduciary duties) or, more likely, stop the provision of research to the EU portfolio managers. Through the Securities Industry and Financial Markets Association (SIFMA), the broker-dealers made representations to the SEC arguing that they would be significantly disadvantaged given the global nature of the US capital markets and the reliance placed by EU and other non-US portfolio managers on the research provided by the broker-dealers.

On 26 October 2017, the US Securities and Exchange Commission, the European Commission and the UK Financial Conduct Authority provided a degree of certainty – in the medium-term at least - as to how EU portfolio managers may continue to obtain research from their US affiliates and broker-dealers after 3 January 2018 in a way that does not breach regulation on either side of the Atlantic.

The SEC issued three "no action" letters in respect of US broker-dealers, money managers and investment advisers who continue to provide services to EU portfolio managers under MiFID II. The SEC has said that it will not take enforcement action against any of the following:

- a US broker-dealer where it provides research services that constitute registrable investment advice under the Investment Advisers Act of 1940, where such services are provided to a portfolio manager that is required to pay for the research services separately under an RPA and/or from its own resources (https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm);
- a US money manager (e.g. a sub-adviser to an EU portfolio manager) where it makes separate payments to a broker-dealer through an RPA arrangement provided the broker-dealer is mandated through contract to pay for research through the use of an RPA (http://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf); and
- a US investment adviser which aggregates orders for the sale or purchase of securities on behalf of its clients, provided that such advisers adopt certain policies and procedures including those which are reasonably designed to ensure that each client in an aggregated order pays the average price for the security and the same cost of execution and the payment for research in connection with the aggregated order is consistent with the regulatory requirements of each relevant jurisdiction (e.g. the US and the EU) (https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm).

The critical relief provided to broker-dealers is temporary: it will expire 30 months from 3 January 2018 – i.e. **3 June 2020**. The SEC says that it will see how the MiFID II research regime beds down over the next 2 ½ years in order to determine what future action to take. It has not discounted the possibility of making new rules. The SEC's press release is here.

On the same day, to coincide with the SEC's announcements, the European Commission published two FAQs (https://ec.europa.eu/info/system/files/non-eu-brokers-dealers.pdf) which reinforce what is expected of EU portfolio managers and clarifies how they may comply with MiFID II when paying third country broker-dealers for research (the FAQs do not expressly refer to US sub-advisers and broker-dealers or the SEC's no-action letters). The Q&As confirm that a portfolio manager will be able to pay a single commission to broker-dealers, provided the amount attributable to the research component can be identified. They also emphasise that the portfolio manager (through, if relevant, its third-country sub-adviser) is required to identify a separate charge for any research supplied by third-country broker dealers. Where (as will be the case as regards a US broker-dealer at least) there is no separate research invoice, the guidance provides that the portfolio manager or its sub-adviser may, among other things, consult with third parties, including the broker dealer, with a view to determining the charge attributable to the research element.

In a statement, also issued on 26 October 2017, Andrew Bailey, Chief Executive of the FCA welcomed the co-ordinated clarifications from the SEC and European Commission. Indeed, he went further in suggesting that, in the FCA's view, there are other ways of that such compliant arrangements might be achieved, such as arrangements in which a UK portfolio manager pays the EU entity of a non-EU broker for global research and research is circulated within a buy-side group, provided such arrangements do not influence a firm's order routing decisions, execution costs or its ability to act in its clients' best interests. The FCA went on to explain to participants of its MiFID II implementation: Trade Association Roundtable that these further suggestions were intended to confirm how the regulator thinks the rules work when research is shared within an asset management group. Broadly, it sees the following scenarios as permissible:

- where the UK asset manager has paid for research from a research payment account, it may share that research with other group affiliates, provided that is manages any resulting conflicts of interest and acts in its clients' best interests;

- where the UK asset manager purchases research from its own resources (i.e. from P&L), or produces the research itself in-house, it can circulate such material or offer access to other group entities "as it sees fit"; and

- the UK asset manager may receive third party research which has been procured by a group-affiliated manager in a third country, provided that this does not influence its order-routing decisions or costs of execution and it manages any resulting conflicts of interest.

There could be a number of ways of interpreting certain aspects of the FCA's thinking as stated above: it does not cover all scenarios under which research may be circulated within a group and should be approached with a certain degree of caution. However, at face value the regulator's comments are helpful.

3. PRIIPS REGULATION: THE NEW KID ON THE BLOCK

After a postponement of a year, the PRIIPs Regulation (Regulation (EU) No 1286/2014) finally came into force on **1 January 2018**. As from that date, it requires that retail investors are provided with a standardised, short disclosure document containing key information about the product (the "Key Information Document" or "**KID**") where it is made available to them in the EU. There is a transitional period for UCITS until 31 December 2019.

As we have previously reported, a PRIIP is a packaged retail investment or insurance-based product and is widely defined. It includes instruments issued by special purpose vehicles, securitisation special purpose vehicles, derivatives, structured products, structured deposits and some debt securities. Units in a wide range of investment funds are also caught, including NURSs, QISs, investment companies, investment trusts, venture capital funds, EuSEFs and EuVECAs.

The PRIIPs requirement to produce a KID only applies where a PRIIP is "made available" to retail investors. Consequently, many manufacturers of the types of funds and other PRIIPs which have routinely been targeted at the professional market in the past are likely to have tightened up on measures designed to ensure that distribution does not reach any retail investors. However, while the PRIIPs Regulation may not be relevant, any distribution of such a product by a MiFID firm to EU investors will require client disclosures under MiFID II and ESMA has given guidance to the effect that firms should use the PRIIPs methodology (as set out in the PRIIPs RTS (see below)) to calculate the costs and charges associated with the product – i.e. even if the investor is a professional client.

The detailed methodology for producing the KID is set out in the PRIIPs RTS (Commission Delegated Regulation (EU) 2017/653 on the presentation, content, review and revision of key information documents and

the conditions for fulfilling the requirement to provide such documents). While the end product – the KID – is in standardised format and is designed to be simple and user-friendly (with a risk indicator, performance scenarios and costs information) the detailed methodologies underlying each of the calculations require a significant amount of data capture and manipulation on the part of the firm and are often highly complex.

The Joint European Supervisory Authorities have published some Questions and answers (Q&A) on the PRIIPs KID, which are updated from time to time (last updated on 20 November 2017). They have also published a flow diagram for the risk and reward calculations in the PRIIPs KID (last updated on 16 August 2017).

There was helpful clarification in the most recent Q&A that a KID is not required for a product listed on a regulated market when it is clear that the product is meant only for non-retail investors – see our briefing of 28 November 2017 in which we summarised the clarification.

In July 2017, the European Commission published a communication containing Guidelines on the application of the PRIIPs Regulation. Amongst other things, these contained a useful confirmation on the territorial application of the PRIIPs Regulation which had been assumed to be the case, but which was not manifest on the face of the legislation itself – i.e. that where a PRIIP is only made available to investors outside the EU, a KID is not required. They also clarified that, because the PRIIPs Regulation does not contain any transitional provisions, any PRIIP made available to investors before 1 January 2018 that continues to be made available to retail investors after that date will be subject to the requirements. However, where a PRIIP is no longer made available to retail investors as of 1 January 2018 and changes to the existing commitments are only subject to the contractual term and conditions which were agreed before that date, a KID is not required. Further, where those contractual terms and conditions allow exiting from the PRIIP, but that PRIIP is no longer made available to other retail investors after 1 January 2018, a KID is not required.

4. EU BENCHMARKS REGULATION

The majority of the provisions in the EU Benchmarks Regulation (Regulation (EU) 2016/1011) took effect across the EU on **1 January 2018**. The Benchmarks Regulation is designed to introduce a new framework for the regulation of benchmarks across the EU in order to ensure that they are accurate and robust and that the processes used to determine them are carried out with integrity. The legislation is partly a response to the well-documented past instances of attempted manipulation of key benchmarks such as LIBOR and EURIBOR.

WHAT IS A BENCHMARK?

For the purposes of the new regime, a "**benchmark**" is defined as any index:

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

An "**index**" is defined as any figure that:

- is published or made available to the public; and

- that is regularly determined:
  - entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and
  - on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys.

The obligations under the Benchmarks Regulation vary depending upon the connection of the relevant firm to a particular benchmark and the relative importance of that benchmark.

TYPES OF BENCHMARKS

The Benchmarks Regulation divides benchmarks into the following types:

- **Critical benchmarks:** As the name implies, these are benchmarks that are fundamental to the operation of the financial markets. The European Commission is required to compile a list of all such benchmarks that are provided by administrators located within the EU. In order to be classified as a critical benchmark, the relevant benchmark must not be a regulated data benchmark (see below), and must meet one of the following criteria:
  - it is used as a reference for financial instruments, financial contracts or for measuring the performance of investment funds which have a total value of at least EUR 500 billion, based on the full range of maturities or tenors of the benchmark;
  - it is based on submissions by contributors the majority of whom are located in one EU Member State and it has been recognised as being critical in that Member State on the basis of a procedure specified in the Benchmarks Regulation; or
  - it is used as a reference for financial instruments, financial contracts or for measuring the performance of investment funds which have a total value of at least EUR 400 billion (but not reaching EUR 500 billion), it has no (or very few) appropriate market-led substitutes and, in the event that it were to cease being provided or became unreliable, there would be significant adverse impacts on market integrity. The Benchmarks Regulation also contains a procedure for recognising a benchmark as critical where it has a reference value below EUR 400 billion, but meets the other criteria set out in this bullet point.

  To date, the Commission has recognised LIBOR, EURIBOR and EONIA as critical benchmarks for these purposes in Commission Implementing Regulation (EU) 2017/2466.

- **Regulated data benchmark:** These are benchmarks that are determined by sole reference to information that is deemed to be more reliable because it is provided by a regulated entity by reference to transaction data. As the definition of a "critical benchmark" above makes clear, these can never be classified as critical benchmarks. The Benchmarks Regulation states that regulated data benchmarks are those determined by the application of a formula from:
  - input data contributed entirely and directly from:
    - an EU trading venue or a third country trading venue that has been recognised as equivalent, in relation to transaction data involving financial instruments traded on those venues;

    - an approved publication arrangement or a consolidated tape provider (as each is defined under MiFID II), in relation to mandatory post-trade transparency data concerning financial instruments traded on a trading venue;
    - an approved reporting mechanism (as defined under MiFID II), but only in relation to transaction data concerning financial instruments traded on a trading venue that must be disclosed in accordance with mandatory post-trade data transparency requirements;
    - an electricity exchange as defined under the Electricity Directive;
    - a natural gas exchange as defined under the Gas Directive;
    - an auction platform as defined under the Emissions Trading Scheme Auctioning Regulation; or
    - a service provider to which the benchmark administrator has outsourced data collection in accordance with the outsourcing rules in the Benchmarks Regulation, provided that the service provider receives the data entirely and directly from any of the above sources; or
  - net asset values of investment funds.
- **Significant benchmark:** These are benchmarks which are not critical benchmarks (see above), but meet one of the following conditions:
  - it is used, directly or indirectly, within a combination of benchmarks, as a reference for financial instruments or financial contracts, or for measuring the performance of investment funds, having a total average value of at least EUR 50 billion (on the basis of all the range of maturities and tenors) over a period of six months; or
  - it has no, or very few, appropriate market-led substitutes and, if it were to cease to be provided or became unreliable, there would be a significant and adverse impact on market integrity, financial stability, consumers, the real economy or the financing of households or businesses in one or more EU Member States.
- **Non-significant benchmark:** This is any benchmark that is not a critical benchmark or a significant benchmark. These are subject to fewer mandatory requirements under the Benchmarks Regulation.
- **Commodity benchmark:** This is any benchmark that is regularly determined on the basis of the value of a commodity (excluding emissions allowances).
- **Interest rate benchmark:** This is any benchmark that is regularly determined on the basis of the rate at which banks may lend to, or borrow from, other banks or agents other than banks in the money market.

Commodity and interest rate benchmarks are generally subject to a separate regime under the Benchmarks Regulation and are not subject to the general requirements relating to significant and non-significant benchmarks.

STATUS OF ENTITIES INTERACTING WITH BENCHMARKS

The Benchmarks Regulation broadly provides for, and imposes obligations on, three different types of entities in relation to benchmarks:

- **Benchmark administrator:** This is any natural or legal person that has control over the provision of a benchmark. Broadly speaking, administrators are generally required to:
  - use a robust and reliable methodology for determining a benchmark that has clear rules identifying how and when discretion may be exercised;
  - have in place robust governance arrangements with well-defined, transparent and consistent roles and responsibilities for all persons involved in the provision of a benchmark;
  - take adequate steps to identify and to prevent or manage any conflicts of interest that may arise in connection with their role as administrator of a benchmark, including by ensuring that any other part of their business that may create an actual or potential conflict of interest is operationally segregated from the performance of their benchmark administration function;
  - ensure that their employees and other natural persons under their control whose services are directly involved in the provision of a benchmark have the necessary knowledge, skills and experience to perform their duties and are not compensated or evaluated in ways that result in conflicts of interest in relation to the determination of the benchmark;
  - maintain a permanent and effective oversight function to ensure oversight of all aspects of the provision of benchmarks, either through a separate committee or by "another appropriate governance arrangement";
  - operate an effective and proportionate control framework, including by conducting reviews on at least an annual basis of the benchmark's definition and methodology;
  - have in place an effective accountability framework, covering record-keeping, auditing and review, and a complaints process;
  - avoid outsourcing functions involved in the provision of a benchmark in such a way as to cause a material impairment to the administrator's control over the provision of the benchmark or the ability of the relevant national regulator to supervise it, and ensure that any outsourcing arrangements comply with certain mandatory requirements;
  - publish a benchmark statement for each benchmark (or family of benchmarks) that may be used in the EU, which clearly and unambiguously defines the market or economic reality measured by the benchmark and the circumstances in which that measurement may become unreliable and lays down technical specifications identifying the elements of the calculation of the benchmark in relation to which discretion may be exercised and the criteria for the use of such discretion; and
  - if the relevant benchmark is based on input data from contributors, develop a code of conduct for the benchmark (or where applicable, family of benchmarks) clearly specifying the contributors' responsibilities, including any systems and controls that contributors are required to establish.

  Modified requirements apply depending on the precise status of the benchmark. For example, certain requirements that would apply to critical benchmarks are disapplied for significant benchmarks, while a greater number of requirements are disapplied for non-significant benchmarks. Specific requirements apply to interest rate or commodity benchmarks.

- **Supervised contributor:** These are supervised entities that contribute input data to a benchmark administrator located in the EU. Input data is any data which relates to the value of one of more underlying

assets or prices that are used by a benchmark administrator to determine a benchmark. A "**supervised entity**" is any of the following entities:

- a credit institution or a MiFID investment firm;
- an insurance undertaking or reinsurance undertaking as defined under the Solvency II Directive;
- a UCITS fund or UCITS management company;
- an AIFM;
- an institution for occupational retirement provision (**IORP**) as defined under the IORP Directive;
- a creditor as defined under the Consumer Credit Directive;
- a non-credit institution as defined under the Mortgage Credit Directive for the purposes of credit agreements as defined under that Directive;
- a market operator as defined under MiFID II;
- a central counterparty as defined under EMIR;
- a trade repository as defined under EMIR; or
- a benchmark administrator (when contributing input data to another benchmark administrator).

Supervised contributors are required to ensure that their provision of input data to a benchmark is not affected by any actual or potential conflict of interest and that if they are required to exercise discretion, they do so independently and honestly in accordance with the contributor's code of conduct published by the relevant benchmark administrator. They must also have in a place a control framework to ensure the accuracy, integrity and reliability of any input data.

- **Benchmark users:** Supervised entities (as defined above) may only use benchmarks in the EU if the benchmark is provided by a benchmark administrator located in the EU which is included on a public register of administrators and benchmarks maintained by ESMA, or is a third country (i.e. non-EU) benchmark that has been included on that register. A third country benchmark can only be included on the register where all of the following conditions are satisfied:

  - the Commission has adopted an equivalence decision in relation to the relevant third country for the purposes of the Benchmarks Regulation;
  - the administrator of the relevant third country benchmark is authorised or registered, and is subject to supervision, in the third country in question;
  - the administrator has notified ESMA that it consents to its benchmarks being used by supervised entities in the EU; and
  - ESMA has established cooperation arrangements with the relevant regulator(s) in the third country.

  Until an equivalence assessment has been carried out in relation to the third country, EU supervised entities may use a benchmark provided by an administrator located in that country if the administrator has obtained prior recognition from an EU national regulator in its Member State of reference. The

Benchmarks Regulation sets out a series of complex rules for determining the Member State of reference in any given case. Alternatively, an authorised or registered EU benchmark administrator (see below) may apply to its national regulator to endorse a benchmark (or family of benchmarks) provided in a third country, provided that certain conditions are met (including that there is an objective reason for providing the benchmark in a third country and for that benchmark to be endorsed for use in the EU).

AUTHORISATION AND REGISTRATION OF EU BENCHMARK ADMINISTRATORS

Any natural or legal person located in the EU that intends to act as a benchmark administrator must apply to its national regulator for either authorisation as an administrator, or registration, in accordance with the following rules:

- if the person is providing indices which are used or are intended to be used as critical benchmarks, it must apply for authorisation as a benchmark administrator;
- if the person is a supervised entity (see above) otherwise than by virtue of being a benchmark administrator, it need only apply for registration, provided that the provision of a benchmark is not prevented by the sectoral rules applying to that entity and is not a critical benchmark;
- if the person is not a supervised entity, then it must apply for authorisation as a benchmark administrator, unless it is providing only indices which would qualify as non-significant benchmarks, in which case it may apply for registration instead. Note that commodity benchmarks and interest rate benchmarks cannot be classified as non-significant benchmarks.

5. PSD 2: IMMINENT

INTRODUCTION

The UK has implemented Directive (EU) 2015/2366 on payment services in the internal market (**PSD 2**) by way of the Payment Services Regulations 2017 (SI 2017/752) (**PSRs 2017**). These Regulations will, as required by PSD 2, come into force on **13 January 2018** and will revoke the Payment Services Regulations 2009 (although they carry forward a good deal of the same material). However, new security provisions under PSD 2 on strong customer authentication and common and secure open standards of communication will not come into force until 18 months after relevant regulatory technical standards enter into force, which is due to happen shortly (see below).

For a large number of payment service institutions that are already authorised or registered there will be transitional relief effectively allowing them to apply for re-authorisation or re-registration later in the year with the provision of the additional information required by PSD 2. Other firms wishing to provide payment services will need to be authorised or registered under the PSRs 2017.

The FCA has amended its rules and guidance to reflect the changes introduced by the PSRs 2017. It has also issued a revised and updated approach document, which now consolidates in one document its approach to both payment services and e-money: "Payment Services and Electronic Money – Our Approach (The FCA's role under the Payment Services Regulations 2017 and the Electronic Money Regulations 2011)".

REMINDER OF THE KEY CHANGES

PSD2, as transposed by the PSRs 2017, will enhance the existing electronic payment services framework in the UK. Changes coming in on 13 January 2018 will include the following:

- *Scope*: certain provisions dealing with transparency of terms and conditions, customer information and other conduct of business requirements will apply to payment transactions *in all currencies*, including *where only one* of the payment service providers is located in the EU (a so-called one-leg transaction) in respect of those parts of the payment transaction carried out in the EU.

- *New regulated payment services*: the new regime encompasses two new types of payment services:

    - *Payment Initiation Services*: this e-commerce service is defined as a "service to initiate a payment order at the request of the payment service user with respect to a payment account held at another payment service provider". Payment initiation services providers "typically help consumers to make online credit transfers and inform the merchant immediately of the payment initiation, allowing for the immediate dispatch of goods or immediate access to services purchased online" (*European Commission - Payment Services Directive: frequently asked questions*). They establish a "software bridge" between the merchant's website and the online payment platform of the payer's account servicing payment service provider in order to initiate payments on the basis of a credit transfer, allowing the customer to pay without the use of a credit or debit card.

    - *Account Information Services*: this is defined as "an online service to provide consolidated information on one or more payment accounts held by the payment service user with either another payment service provider or with more than one payment service provider". In other words, the user is given a consolidated view or dashboard of his or her bank and/or other payment accounts held with various payment service providers.

- *Narrowing of exclusions*: the PSD 2 regime will retain many of the exclusions that currently apply. However, in certain cases there has been a narrowing of individual exclusions meaning that a number of firms which did not require authorisation under the PSD 1 regime may need to seek authorisation or registration under the PSD 2 regime.

    - For instance, the *commercial agents' exclusion* will make it clear that it is only available to an agent that is authorised *via an agreement* to negotiate or conclude the sale or purchase of goods or services on behalf of *only* the payer or *only* the payee (some platforms have previously relied on the exclusions where they are acting for both parties).

    - The *limited network exclusion* (relating to services based on specific payment instruments used to acquire goods or services within a limited network of service providers or to acquire a very limited range of goods or services) will also be tightened up to avoid it being used by large networks with high payment volumes or wide ranges of products or services. The PSRs 2017 provide that when the total value of payment transactions executed over the preceding 12 months through a network relying on the exclusion exceeds a certain value (EUR 1,000,000) the payment service provider must notify its relevant competent authority (which will then determine whether the activity does or does not qualify under the exclusion). UK firms will be required to make their annual notifications to the FCA as from 13 January 2019.

- *Security of payments*: a number of provisions relating to operational and security risks and authentication will change. These provisions include:

    - *Incident reporting*: requirements to report any major operational or security incident to the competent authority (and to also notify payment service users if their financial interests are or may be impacted by such incident). The EBA was mandated to develop guidelines on major incident reporting under PSD 2, and published its final report on 27 July 2017 – these include guidance on the classification of major incidents (including standard notification templates and the procedures for notifying such incidents)

and on the criteria competent authorities should take into account in assessing the relevant of a reported incident. The guidelines come into force, alongside the rest of PSD 2, **on 13 January 2018**.

- *Strong customer authentication*: payment service providers will be required to apply "strong customer authentication" when a payer initiates an electronic payment transaction. Strong customer authentication means "an authentication based on the use of two or more elements categorised as knowledge (something only the user knows)" (e.g. a password or PIN), "possession (something only the user possesses) (e.g. the card or an authentication code generating device)" and "inherence (something the user is)" (e.g. the use of a fingerprint or voice recognition) that are "independent, in that the breach of one does not compromise the reliability of the others, and is designed in such a way as to protect the confidentiality of the authentication data". For electronic remote payment transactions (such as online payments) the payment service provider must apply strong customer authentication that includes elements which "dynamically link" the transaction to a specific amount and specific payee. On 27 November 2017, the Commission adopted a Delegated Regulation with regard to regulatory technical standards for strong customer authentication and common and secure open standards of communication (C(2017) 7782 final)(the "**Customer Authentication RTS**") based on a draft that the EBA had developed. This includes, among other things, the requirements with which security measures must apply in order to protect the confidentiality and integrity of the payment service user's personalised security credentials. The Delegated Regulation has been submitted to the Council and the European Parliament, and provided that neither of them objects, it will proceed to publication in the Official Journal and enter into force 20 days after that publication. The RTS as a whole will then apply **18 months after that publication** (now expected to be in Q3 2019): a couple of provisions (applying to account servicing payment service providers and relating to access interfaces and the provision of a testing facility) will apply earlier - 12 months after publication (likely to be Q1 2019).

- *Passporting:* a more detailed passporting procedure is being introduced, designed to reinforce the investigative and supervisory powers of the host state and ensure better cooperation and information exchange between competent authorities. Host Member States can ask for payment institutions operating with agents and branches to provide regular reports on activities and the payment institution can be asked to set up a central contact point in the host territory. Commission Delegated Regulation (EU) 2017/2055 of 23 June 2017 was published in the Official Journal on 11 November 2017 and entered into force on 1 December 2017. It specifies the details of the information to be transmitted in the case of a branch, agent or services passport application and includes the notification templates for the exchange of information between Member State competent authorities.

NEW APPLICATIONS FOR AUTHORISATION OR REGISTRATION

Since 13 October 2017, it has been possible for firms to apply for authorisation or registration under the PSRs 2017 (or, if applicable, the Electronic Money Regulations as amended by the PSRs 2017) on a new suite of application forms and the FCA has been encouraging new applicants to follow this route (rather than seeking authorisation or registration under the PSRs 2009). The new regime broadly requires the provision of more detailed information than previously and, as outlined above, imposes new security requirements (although the specific requirements regarding customer authentication will not be in force for some time).

Where a firm's average monthly turnover in payment transactions will be less than €3 million it will (as before) be eligible to apply to register as a small payment institution (although, as such, it will not be authorised to provide the newly-regulated payment initiation services or account information services).

TRANSITIONAL PROVISIONS FOR PRE-EXISTING PAYMENT INSTITUTIONS

There will be no grandfathering of those payment institutions that are already authorised or registered under PSD as at 13 January 2018; however, there *will* be transitional relief, suspending the date on which they effectively need to seek re-authorisation or re-registration. This means that they will be allowed to continue to provide their services beyond 13 January 2018, as long as they have submitted the additional information required by the PSRs 2017 by a specified deadline, as follows:

Payment services institution type	Unless an application for authorisation or registration is refused or authorisation or registration is otherwise discontinued, can continue to provide services on or after:	*Provided* PSRs 2017 information or, as the case may be, EMRs 2011 information, has been submitted by the following deadline:
Authorised payment institutions **Authorised e-money institutions** **Small e-money institutions**	**13 July 2018**	**13 April 2018**
Small payment institutions	**13 January 2019**	**13 October 2018**

Existing APIs, authorised EMIs and small EMIs therefore have three months in which to submit the required PSD 2 information. Note that there are separate transitional arrangements in respect of account information service providers and payment initiation service providers who were operating as such ***before 12 January 2016*** – they are able to continue to provide their services without registration or authorisation under the PSRs 2017 but only until 18 months after the Customer Authentication RTS enters into force and without the benefit of the rights of access which PSD 2 gives. Notwithstanding this transitional relief, the Treasury and the FCA have strongly encouraged (and they expect) such firms to apply for authorisation or registration as soon as possible.

6. INSURANCE DISTRIBUTION DIRECTIVE

The Insurance Distribution Directive (Directive (EU) 2016/97) (**IDD**) is currently scheduled to apply from **23 February 2018**. However, on 21 December 2017, the European Commission published a legislative proposal to push back the application date of the IDD by seven months until **1 October 2018** to give firms more time to prepare for the new requirements, although EU Member States will still be required to transpose the IDD into their national laws by 23 February 2018. The proposal will still need to be agreed by the European Parliament and the Council before it becomes effective, but it is likely that the legislative process will be accelerated for these purposes.

The IDD has often been termed "MiFID II for insurance intermediaries" and in certain respects, it is designed to ensure greater alignment between the conduct of business requirements applicable to MiFID firms and those applicable to firms distributing insurance products. However, in practice, the changes introduced by the IDD

are less extensive and wide-ranging than those under the MiFID II legislative package. This is particularly the case in the UK, where the FCA's gold-plating of the implementation of the previous Insurance Mediation Directive has meant that the implementation of some IDD standards will be less challenging in practice.

To date, the FCA has published two policy statements on the implementation of IDD in the UK: PS 17/21 published in September 2017 and PS 17/27 published in December 2017. The FCA has also consulted in a third consultation paper (CP 17/33), the policy statement for which is expected to be published in January 2018. We provide a non-exhaustive summary below of some of the key aspects of the FCA's implementation of the IDD requirements. (Note that in some cases, modified rules apply in relation to life insurance, insurance-based investment products, contracts of large risk and/or reinsurance activities. We do not address these distinctions in detail in this briefing.)

STAFF KNOWLEDGE AND COMPETENCE AND GOOD REPUTE REQUIREMENTS

New minimum knowledge and competence requirements will apply to the staff of any firm which has permission to carry on any of the following activities in relation to contracts of insurance or interests in a life policy (**insurance distribution activities**):

- dealing as agent;
- arranging (bringing about) or making arrangements with a view to contracts of insurance;
- assisting in the administration and performance of a contract of insurance;
- advising on contracts of insurance; or
- agreeing to carry on any of the above activities.

For these purposes, the relevant in-scope staff are any employees or other persons who are:

- directly involved in carrying on any insurance distribution activities;
- responsible for supervising an employee who is directly involved in carrying on any insurance distribution activities; or
- responsible within the management structure for the firm's insurance distribution activities.

Firms should note that the concept of an "employee" in this context is not restricted to a person under a normal contract of employment, but also includes any legal or natural person whose services are placed at the disposal of the firm and includes appointed representatives and their employees. This means that the new knowledge and competence requirements will also apply to, for example, consultants or secondees who are involved in providing any of the above services.

The basic knowledge and competence requirements as are follows:

- the firm must ensure that relevant staff possess the appropriate knowledge and ability to complete their tasks and perform their duties;
- each relevant staff member must comply with continuing professional training and development (**CPD**) requirements in order to ensure that they maintain an adequate level of performance, which must include at least 15 hours of CPD in each 12-month period (but can include various training and development opportunities, including courses, e-learning and mentoring);

- each relevant staff member must be able to demonstrate certain minimum knowledge and competence requirements which vary depending upon the type of insurance contracts in relation to which the person performs insurance distribution activities; and

- the firm will need to comply with new record keeping requirements, including maintaining CPD records for each relevant employee within the scope of the CPD requirements.

The existing FCA rules in the Training and Competence (**TC**) sourcebook (which are separate from the CPD and knowledge requirements above) are also being modified to clarify their interaction with the IDD CPD requirements, but the overall scope of TC is not being amended. This means that the modified TC rules will only apply where the relevant firm is already subject to TC (for example, because it provides advice on non-investment insurance contracts to consumers).

Firms must also ensure that in-scope staff are of good repute and must, at a minimum, ensure that the relevant person:

- has a clean criminal record in relation to serious criminal offences linked to crimes against property or other crimes related to financial services; and

- has not previously been declared bankrupt,

unless "rehabilitated in accordance with national law". In the UK, the FCA states that a person will have been rehabilitated if the offence is considered "spent" under the Rehabilitation of Offenders Act 1974 or the bankruptcy has been discharged.

The FCA has not defined the concept of a "serious criminal offence" as referred to above, but has noted that this is not restricted to offences committed in the UK and that firms should pay particular attention to any offence involving dishonesty, fraud, financial crime or a breach of banking, financial services, company, insurance or consumer protection laws

INSURANCE PRODUCT INFORMATION DOCUMENTS

There is an overarching general requirement under the IDD for firms to provide a customer with appropriate information about an insurance policy in good time (i.e. prior to the conclusion of the contract) and in a comprehensible form so that the customer can make an informed decision about whether to enter into the relevant contract. The type and extent of information that the firm provides should take into account the complexity of the policy and the type of customer.

The IDD introduces the concept of an insurance product information document (**IPID**), which is essentially the insurance equivalent of a PRIIPs KID. Where the firm deals with a consumer (i.e. a natural person acting for purposes outside of his/her trade, business or profession), it must provide that person with an IPID for each policy (except for pure protection contracts – i.e., essentially life insurance products). Firms dealing with commercial customers may provide the customer with an IPID if they wish, but are not required to do so. However, they must ensure that they still provide appropriate information to the commercial customer, even if they elect not to provide an IPID.

The IPID must be drawn up by the manufacturer of the relevant insurance policy. The term "manufacturer" is not defined in the IDD itself, but the FCA has stated that firms should take into account the general meaning of the term "manufacturer" in the FCA's rules and the definition of a manufacturer in the proposed IDD delegated regulation on product oversight and governance arrangements (**POG Regulation**) (Delegated Regulation (EU) 2017/2358). In practice, therefore, it appears that the manufacturer is the entity (or entities) responsible

for determining the essential features and main elements of the insurance product, such as the coverage, costs, risks and/or target market. If there are multiple manufacturers, the FCA has stated that they should agree amongst themselves who will be the lead manufacturer named on the IPID. In many cases, it is likely that the insurer will be the manufacturer, as the POG Regulation indicates that where an insurance intermediary merely adapts existing insurance products (e.g. by choosing between different variations of clauses or products offered by the insurer), it is not acting as a manufacturer.

The mandatory content of the IPID is specified by the IPID Regulation (Commission Implementing Regulation (EU) 2017/1469). This includes information relating to:

- the type of insurance being provided;
- the cover offered by the insurance, including the main risks insured, the insured sum, the geographical scope and any excluded risks;
- the means of paying the premium and the duration of any payments;
- the main exclusions when claims cannot be made;
- any obligations at the start of the contract and during the term of the contract;
- any obligations if a claim is made under the contract;
- the term of the insurance contract, including the start and end dates; and
- the means of terminating the contract.

These information requirements mean that the IPID must be personalised, as it must reflect, for example, the start and end dates and the premium applicable to the particular customer. The FCA has stated that in its view, it is permissible to cross-refer to certain other documents in order to personalise the IPID – e.g. it could state that the dates for the policy cover are "as specified in the policy schedule".

The IPID Regulation also contains a template settling out the required format of the IPID and specifies that it must generally be no longer than two sides of A4 paper; exceptionally it may extend to a maximum of three sides of A4 paper, provided that the firm can demonstrate to its regulator, if requested, why the extra length was necessary. This is likely to raise similar issues to the PRIIPs KID in relation to the challenges of condensing the often extensive terms of insurance policies into plain language that fits the required format and length.

OTHER CONDUCT OF BUSINESS REQUIREMENTS

The IDD introduces a number of other conduct of business obligations, including those relating to client information disclosures, financial promotions and extension of the "clear, fair and not misleading" general requirement.

There are specific new disclosure requirements in relation to life policies which relate to the status of the firm itself, whether it is providing a personal recommendation about the insurance products offered and whether it is connected to an insurer. When offering non-insurance ancillary products as part of a package with a life policy, the firm is required to inform the client whether it is possible to buy the different components separately and must provide an adequate description of each separate component and its cost. When offering a

life policy as an ancillary part of a non-insurance product of service, the firm must provide the client with the option of buying the non-insurance goods or services separately (except in certain specified cases).

Additional disclosure requirements also apply in relation to insurance distribution activities carried on for retail clients, including information about the firm itself and about costs and charges.

The requirement for firms to ensure that a communication or financial promotion is fair, clear and not misleading is being extended to include communications with eligible counterparties in the context of insurance distribution. The requirement for financial promotions to be identifiable as such is also being applied to all financial promotions in relation to insurance distribution, including non-retail communications and excluded communications.

Modified MiFID-style suitability and appropriateness requirements are also being applied to firms which provide investment advice or portfolio management activities in relation to "insurance based investment products" (**IBIPs**) – i.e. essentially, non-life insurance, non-occupational pension products which offer a maturity or surrender value which is partially or wholly exposed to market fluctuations. When providing those services in relation to IBIPs, firms will need to obtain the necessary information from the client to carry out a suitability assessment and will need to ensure that any proposed IBIP is consistent with the client's insurance demands and needs. Where the firm carries on insurance distribution in connection within an IBIP (other than providing investment advice or portfolio management), the firm will generally need to carry out an appropriateness assessment and a demands and needs analysis, although the appropriateness assessment will not be required if the IBIP only provides an investment exposure to other non-complex financial instruments or can otherwise be considered non-complex itself. Additional rules setting out the criteria for assessing whether an IBIP is non-complex are contained in the delegated regulation on conduct of business rules applicable to the distribution of IBIPs (**IBIP Regulation**) (Delegated Regulation (EU) 2017/2359).

INDUCEMENTS

In CP 17/33, the FCA has proposed applying inducements rules in relation to the distribution of IBIPs that are broadly consistent with the MiFID inducement rules. These proposals are based in part on the content of the IBIP Regulation. This means that firms will not be permitted to:

- pay to or accept from any party (other than the client) any fee or commission; or
- provide to or receive from any party (other than the client) any non-monetary benefit;

in connection with the distribution of an IBIP or an ancillary service to such distribution unless:

- the fee, commission or non-monetary benefit is designed to enhance the quality of the relevant service to the client and does not have a detrimental impact on the quality of the relevant service to the client and does not impair the firm's compliance with its duty to act honestly, fairly and professionally in the best interests of the client; or
- the payment or benefit enables or is necessary for the provision of the service by the firm.

The IBIP Regulation sets out when an inducement will be considered to have a "detrimental impact" on the quality of the relevant service to a customer. Broadly, this is where the scale or nature of the inducement provides an incentive to carry out insurance distribution activities in a way that is not in compliance with the obligation to act honestly, fairly and professional in accordance with the customer's best interests. When assessing whether this is the case, firms should take into account all relevant factors which may increase or

decrease the risk of a detrimental impact and reach an overall conclusion. The IBIP Regulation includes further detail on the individual factors that firms should consider in this context.

REMUNERATION REQUIREMENTS

The IDD introduces certain remuneration requirements in connection with insurance distribution activities. Under the FCA's rules, these will only apply in relation to such activities where they are carried on by an insurance distributor from an establishment maintained by it, or by its appointed representative, in the UK.

Insurance distributors must ensure that are not remunerated, and that they do not remunerate or assess the performance of their employees, in a way which conflicts with their duty to act in the customer's best interests. In particular, they must not use any arrangements (e.g. sales targets) that could provide an incentive to the firm or to its employees to recommend a particular contract of insurance to a customer when the firm could offer a different contract which would better meet the customer's needs.

Although the specific rules themselves are new, in many cases firms would already need to have considered these issues in order to ensure that they do not breach the general FCA principles requiring them to act in the best interests of customers and to manage conflicts of interest fairly.

The IDD also introduces new requirements to disclose to customers certain information about how the firm and its staff are remunerated. In good time before a contract of insurance is concluded, amended or renewed, insurance intermediaries must provide the customer with the following remuneration information:

- information about the remuneration received by the firm in relation to the insurance contract;
- details about whether a fee is paid directly by the customer or whether a commission is payable to the firm and is included in the premium;
- details about any other kind of remuneration received by the firm, including any economic benefit of any kind offered or given in connection with the contract; and
- information about the nature of the remuneration received by the firm's employees in connection with the insurance contract.

This includes information about any remuneration paid by an insurer or another firm in the distribution chain, as well as any remuneration which is contingent on meeting certain targets.

COMPLAINTS HANDLING REQUIREMENTS

Where a firm or its appointed representative carries on insurance distribution activities from a UK establishment, it must have in place appropriate and effective procedures for registering and responding to complaints from a person who is not an eligible complainant for the purposes of the UK Financial Ombudsman Service rules. This may require some insurance intermediaries to introduce new policies for this purpose.

PROFESSIONAL INDEMNITY INSURANCE REQUIREMENTS

The existing annual minimum limits for professional indemnity insurance (**PII**) for non-exempt CAD insurance intermediaries in MIPRU 3 are being revised so that when the IDD takes effect, they will be as follows:

- for a single claim, EUR 1,250,000 (up from the current level of EUR 1,120,200); and

- in aggregate, the higher of: EUR 1,850,000 (up from the current level of EUR 1,680,300) and an amount equivalent to 10% of annual income (subject to a cap of EUR 30,000,000).

These PII indemnity limits will be subject to review by the European Insurance and Occupational Pensions Authority every five years and therefore are expected to be subject to future adjustments.

The revised PII levels of EUR 1,250,000 for a single claim and EUR 1,850,000 in aggregate are also being applied to exempt-CAD insurance intermediaries that are subject to IPRU(INV) 9 and to personal investment firms that are subject to IPRU(INV) 13.

PRODUCT GOVERNANCE REQUIREMENTS

The POG Regulation sets out a number of additional requirements in relation to product governance which are applicable to all insurance products, including contracts of general insurance, IBIPs and insurance-based pension products. These are similar to the MiFID product governance requirements and will require manufacturers of insurance products to:

- establish and maintain a product approval process for new insurance products;
- ensure that the staff involved in designing insurance products have the necessary skills, knowledge and expertise;
- identify a target market for each insurance product (including, where relevant, a "negative target market" of groups for whom the product is not suitable);
- test the product before it is made available to the market;
- use distribution channels that are consistent with the identified target market and take reasonable steps to ensure that any distribution is to that target market;
- provide appropriate information on the relevant insurance product to distributors; and
- carry out regular reviews of products to ensure that the product remains consistent with the needs of the target market and that the distribution strategy remains appropriate.

Distributors of insurance products will need to put in place adequate arrangements to ensure that they obtain sufficient information about the product to understand the target market. Where a distributor is also a co-manufacturer of an insurance product because it has a decision-making role in designing the product, it will need to put in place an agreement with the main insurance manufacturer which outlines the respective responsibilities of both parties in connection with the manufacture of the product.

As under MiFID II, the IDD product governance regime is clear that the requirements apply proportionately, according to the complexity of the insurance contract, the degree of potential consumer risk that is represents, the characteristics of the target market and the scale and complexity of the relevant business of the manufacturer and/or distributor.

7. MONEY MARKET FUNDS REGULATION

Following years of protracted negotiations between the EU Parliament and the Council, the final text of the EU Money Market Funds Regulation (Regulation (EU) 2017/1131) (**MMF Regulation**) was published in the EU's Official Journal in June 2017 and will apply from **21 July 2018**.

The MMF Regulation is designed to encourage greater stability in the structure of money market funds (**MMFs**) and in particular aims to ensure that MMFs have sufficient liquidity in times of market stress to meet redemption requirements and do not pose broader systemic risk to the financial system as a whole.

WHAT IS AN MMF?

For the purposes of the MMF Regulation, an MMF is any collective investment undertaking (i.e. essentially, any investment fund) which:

- must be authorised as a UCITS fund or an AIF;
- invests in short term assets (being financial assets with a residual maturity not exceeding 2 years); and
- has as a distinct or cumulative objective, offering returns in line with money market rates or preserving the value of the investment.

Under the MMF Regulation, MMFs must be structured as one of three different types:

- **variable net asset value MMF (VNAV MMF):** these are MMFs with varying net asset values so that the units or shares of the MMF are issued or redeemed at a price which is equal to the NAV per unit or share, with the MMF's assets being valued on a daily basis. These are generally considered to present the lowest risk of the three types and therefore benefit from more flexible rules relating to the composition of their investment portfolios;
- **public debt constant net asset value MMF (public debt CNAV MMF):** these are MMFs which seek to maintain an unchanging NAV per unit or share (the "constant NAV") and will issue and redeem units or shares in the MMF at that price. Income on the MMF's investments accrues daily and may either be paid out to investors as a dividend or used to purchase more units or shares in the MMF. The NAV of the MMF will be rounded to the nearest percentage point (or equivalent in currency terms) and the MMF must invest at least 99.5% of its assets in permitted public debt instruments or cash; or
- **low volatility net asset value MMF (LVNAV MMF):** these are MMFs which, like public debt CNAV MMFs, seek to issue or redeem their units or shares at a price that is equal to a constant NAV per unit or share. However, they are only permitted to do so where that constant NAV per unit or share does not deviate from the true NAV per unit or share (calculated in accordance with rules specified in the MMF Regulation) by more than 20 basis points. Once the relevant deviation exceeds the 20 basis point limit, the LVNAV MMF must redeem its units or shares at the true, variable NAV per unit or share instead.

MMFs are also divided into two different types: short-term MMFs and standard MMFs. Public debt CNAV MMFs and LVNAV MMFs cannot be standard MMFs (i.e. they will always be short-term MMFs). VNAV MMFs may be either short-term or standard MMFs. Different rules apply to the composition of the MMF's investment portfolio depending upon whether it is a short-term or a standard MMF. For example, the weighted average maturity (**WAM**) of the portfolio of a short-term MMF must not exceed 60 days, whereas the WAM of a standard MMF must not exceed 6 months.

No fund can be established, marketed or managed in the EU as an MMF unless it has been authorised as an MMF in accordance with the MMF Regulation. The authorisation must explicitly state the relevant classification of the MMF (i.e. VNAV, public debt CNAV or LVNAV) and is valid across all EU Member States. Where the MMF is a UCITS MMF, the MMF Regulation modifies the authorisation procedure under the UCITS Directive for these purposes. Since AIFs are not themselves subject to authorisation requirements under AIFMD, the MMF Regulation introduces a specific authorisation mechanism for AIF MMFs, which

supplements the AIFMD rules. Where the MMF comprises more than one investment compartment, each compartment is to be treated as a separate MMF for the purposes of the rules governing the investment and operational requirements under the MMF Regulation.

Funds that have not been authorised as MMFs in accordance with the MMF Regulation must not use the designation "MMF", "money market fund" or any other designation that suggests that the fund is an MMF in any external documents (including prospectuses, reports, statements, advertisements, etc.) or in any other written, oral or electronic communications.

WHAT REQUIREMENTS APPLY TO AN MMF UNDER THE MMF REGULATION?

Very broadly, the MMF Regulation imposes the following requirements on MMFs:

- **Eligible asset requirements:** MMFs may only invest in certain specified categories of eligible assets. These include, for example, money market instruments issued by EU public bodies or certain international organisations, deposits with credit institutions, eligible securitisations and asset-backed commercial paper, permitted financial derivatives, eligible repo and reverse-repo agreements and units or shares of other MMFs. The MMF Regulation sets out the detailed eligibility requirements for each type of investment by reference to criteria such as the legal maturity of the relevant investment.

- **Prohibitions on certain investment activities:** MMFs are prohibited from engaging in short selling of money market instruments, interests in securitisations, asset-backed commercial paper or units or shares in other MMFs. They are also prohibited from taking direct or indirect exposures to equities or commodities, including via certificates, derivatives or indices based on those instruments. They must also not enter into securities lending or borrowing agreements, other agreements which would encumber the assets of the MMF or any arrangements for the borrowing or lending of cash.

- **Diversification and concentration requirements:** MMFs must not invest more than 5% of their assets in money market instruments, securitisation interests or asset-based commercial paper issued by the same body (although this rule is modified for VNAV MMFs, who may invest up to 10% of their assets in such instruments, provided that the total value of all instruments for all issuers in which they have invested more than 5% of their assets does not exceed 40% of the total assets of the MMF). MMFs are also prohibited from investing more than 10% of their assets in deposits with the same credit institution, subject to a very limited exception in relation to Member States which have a very limited number of credit institutions. In addition to these investment limits, MMFs must not hold more than 10% of the money market instruments, securitisation interests or asset-backed commercial paper issued by a single body (except in relation to instruments issued or guaranteed by EU public bodies or certain international organisations).

- **Internal credit quality assessments:** MMF managers must establish and implement prudent internal credit quality assessment procedures for determining the credit quality of any money market instruments, securitisations and asset-backed commercial paper in which the MMF invests. These must use information that is of sufficient quality, up-to-date and from reliable sources. The manager may have regard to credit ratings issued by credit rating agencies that are registered and certified in accordance with the Credit Rating Agencies Regulation, but must not solely or mechanistically rely on such ratings.

- **General portfolio requirements:** As mentioned above, there are specific portfolio rules that apply depending upon whether the MMF is a short-term or standard MMF. These rules generally relate to the maturity of the underlying assets in order to ensure that there are sufficient daily and weekly maturing assets to provide liquidity.

- **Know-your-customer policy:** Without prejudice to the anti-money laundering requirements under MLD 4, MMF managers must establish and implement procedures that attempt to anticipate the effect of concurrent redemptions by several investors by taking into account information about the investor such as the investor type, the number of units or shares held in the MMF and the evolution of inflows and outflows over time. The manager must ensure that the value of units or shares held by a single investor does not materially impact the liquidity profile of the MMF where this accounts for a substantial part of the total overall NAV of the MMF.

- **Stress testing requirements:** Each MMF must have sound stress testing procedures to identify possible events or future changes in economic conditions which would have an unfavourable impact on the MMF. The stress tests must be based on objective criteria and must consider the effects of plausible but severe scenarios. These must include certain parameters such as changes in the liquidity levels of assets held in the portfolio, changes in credit risks associated with such assets, movements in interest rates and exchange rates, varying levels of redemption, widening or narrowing of spreads among indices or interest rates to which the securities in the portfolio are tied, and macro-systemic shocks affecting the economy as a whole. For public debt CNAV and LVNAF MMFs, these stress tests must also model the difference between the constant NAV per unit or share and the true NAV per unit or share in each case.

- **Valuation rules:** The MMF Regulation sets out detailed valuation rules, which vary depending on the type of MMF. Generally, the assets of the MMF must be valued on at least a daily basis using prudent mark-to-market valuation wherever possible. If mark-to-market valuation is not possible, the assets may be valued using a conservative mark-to-model approach. There are some exceptions for public debt CNAV and LVNAV MMFs, where the amortised cost method may be used.

- **Additional requirements for public debt CNAV and LVNAV MMFs:** Managers of public debt CNAV MMFs and LVNAV MMFs are required to establish and implement prudent and rigorous liquidity management procedures in order to comply with weekly liquidity thresholds. The MMF Regulation contains detailed provisions relating to the nature of these procedures, which must include the potential introduction of liquidity fees on investor redemptions, temporary redemption gates and temporary suspensions of redemptions. Where a public debt CNAV MMF or an LVNAV MMF has suspended investor redemptions for more than 15 days in any 90 day period, it automatically ceases to be such an MMF.

- **Prohibition on external support:** All MMFs are prohibited from receiving any external support – i.e. direct or indirect support offered to an MMF by any third party (including a sponsor) that is intended to or would in effect result in guaranteeing the liquidity of the MMF or stabilising the NAV per unit or share. This includes, but is not limited to, cash injections, purchasing of the MMF's assets at an inflated price, purchasing units or shares in the MMF in order to provide liquidity, or issuing any implicit or explicit guarantee. This is intended to limit contagion within the financial system if one or more MMFs fail.

- **Transparency and reporting:** MMFs must clearly indicate which type of MMF they are, and whether they are short-term or standard MMFs, in any external document, report, statement, advertisement, letter or other written document issued by the MMF or its manager which is intended for distribution to prospective or actual investors. On at least a weekly basis, the MMF manager must make available all of the following information to the MMF's investors:

  - the maturity breakdown of the MMF's portfolio;
  - the credit profile of the MMF;
  - the WAM and the weighted average life (**WAL**) of the MMF;

- details of the 10 largest holdings of the MMF, including the name, country, maturity and asset type, and the counterparty in the case of permitted repos and reverse-repos;
- the total value of the MMF's assets; and
- the net yield of the MMF.

MMF managers must also report to the relevant national regulator of the MMF on at least a quarterly basis, unless the assets under management in relation to the MMF do not exceed EUR 100 million, in which case reporting may be on an annual basis. The information that must be reported includes:

- the type and characteristics of the MMF;
- details of the portfolio, including total value of assets, NAV, WAL, WAM, maturity breakdown, liquidity and yield;
- the results of stress testing and, where applicable, any resulting action plan;
- additional information on the granular assets held by the MMF;
- information on the liabilities of the MMF, including details about where investors are established, the type of investors and their subscription and redemption activity;
- any other information solicited by national regulators if necessary and duly justified; and
- in the case of LVNAV MMFs, certain additional information relating to the deviation of the constant NAV per unit or share from the true NAV per unit or share and about the impact of the application of the amortised cost method of valuation.

TRANSITIONAL ARRANGEMENTS

Existing UCITS or AIFs that operate as MMFs (i.e. invest in short-term assets and have as distinct or cumulative objectives, offering returns in line with money market rates or preserving the value of the investment) benefit from limited transitional relief.

By **21 January 2019**, such funds must have submitted an application to the relevant national regulator, together with all necessary supporting documentation, which evidences that the fund complies with all of the requirements of the MMF Regulation. The national regulator than has two months to assess the application and to determine whether the UCITS or AIF is in compliance with the relevant rules. Although the MMF Regulation is not explicit about the consequences if the UCITS or AIF is deemed not to have met the relevant requirements, it appears that the fund would be in breach of the relevant rules if it were continue to operate on that basis following the regulator's determination that it was not compliant or the relevant deadline having elapsed without an application being made.

8. SECURITISATION REGULATION AND CORRESPONDING CRR AMENDMENTS

On 28 December 2017, the Securitisation Regulation (Regulation (EU) 2017/2402) and the regulation amending the regulatory capital rules relating to securitisations in the Capital Requirements Regulation (**CRR**) (Regulation (EU) 2017/2401) (the **CRR Amending Regulation**) were published in the EU Official Journal.

The Securitisation Regulation is designed to consolidate the existing patchwork of EU rules relating to securitisations contained in other EU legislation (e.g. the CRR, the Solvency II Directive, AIFMD, etc.) in one

harmonised regime that will apply directly across the EU. It will apply from **1 January 2019** to securitisations which issue securities on or after that date. Existing securitisations that do not issue further securities after the Securitisation Regulation enters into force will generally benefit from grandfathering arrangements. The CRR Amending Regulation will repeal and replace the entire regime for exposures to securitisations in the existing CRR and replace this with a more risk-sensitive set of requirements. These will also apply from **1 January 2019**, subject to transitional arrangements for exposures to existing securitisations.

We discuss the key elements of the Securitisation Regulation and CRR Amending Regulation below.

RISK RETENTION REQUIREMENT ("SKIN-IN-THE-GAME")

The "skin-in-the-game" risk retention requirement will remain as a 5% material net economic interest in the securitisation (measured at origination), which is likely to come as a welcome relief to market participants, given some of the original proposals from the European Parliament during the legislative process to increase this substantially. However, the text also requires the European Systemic Risk Board (**ESRB**), in conjunction with the European Banking Authority (**EBA**), to publish a report at least every 3 years (or whenever else it considers it necessary) on stability risks in the securitisation market, which may include recommendations for modifying the risk retention requirement. This means that the required retention level could be revisited again in the future if the ESRB identifies any particular financial stability concerns.

Under the Securitisation Regulation, the retention requirement will operate as a direct obligation on the originator, sponsor or original lender and therefore failure to ensure that this requirement is satisfied for an in-scope securitisation may expose any regulated original lender, originator or sponsor to the risk of regulatory sanctions. Currently, this is an indirect obligation which operates by increasing the level of regulatory capital that regulated investors are required to hold in connection with an exposure to a non-compliant securitisation.

On 15 December 2017, the EBA published a consultation paper (EBA/CP/2017/22) containing draft RTS specifying elements of the risk retention requirement in greater detail, including:

- the different methods of risk retention (essentially mirroring the current methods, such as a "vertical slice" of 5% of each tranche, or holding the entire risk retention in the first-loss "equity" tranche or retaining randomly selected exposures amounting to 5% of the nominal value of the securitised exposures);
- the measurement of the level of the retention (e.g. clarifying that nominal values should be used and that the acquisition price of assets or excess spread should not be taken into account when measuring the level of net economic interest that has been retained) ;
- the prohibition on hedging or selling the retained interest; and
- retention on a consolidated basis (i.e. essentially clarifying that where a parent company satisfies the retention requirement on the basis of its consolidated group, if a subsidiary included within the scope of consolidation ceases to be consolidated, one of the remaining consolidated entities must assume an exposure to the securitisation in order to satisfy the risk retention requirement).

These RTS will, when they enter into force, repeal the existing delegated regulation which sets out the retention requirements for the current securitisation regime. The consultation closes on **15 March 2018**.

WHO CAN QUALIFY AS AN "ORIGINATOR"?

The definition of an "originator" for the purposes of the Securitisation Regulation has been narrowed in scope, by adding a requirement that an entity cannot qualify as an originator if its sole purpose is to securitise

exposures. This suggests that where firms wish to rely on an originator to hold the required risk retention, they will need to ensure that the relevant entity undertakes some other type of substantive business and has not been established solely to facilitate the securitisation.

WHO CAN QUALIFY AS A "SPONSOR"?

The definition of a "sponsor" is also being revised under the Securitisation Regulation. The current rules refer to a sponsor being an "institution" which, as defined, covers only credit institutions (i.e. essentially, deposit-taking banks) and MiFID investment firms that are subject to the CRR (i.e. in the UK, IFPRU investment firms). Under the new rules, the definition of a sponsor will be expanded to include any MiFID investment firm that establishes and manages a securitisation that purchases exposures from third party entities. This will mean that firms that are currently classified as BIPRU firms will also be able to act as a sponsor for these purposes (although firms that are exempt-CAD firms will not, as while they are MiFID firms, the regulatory restrictions on the scope of their activities mean that they will generally be unable to carry out activities which would be considered "managing" the securitisation).

While BIPRU firms will be able to act as sponsors going forward, firms that operate existing securitisations should be careful about the operation of transitional provisions under the Securitisation Regulation and the CRR Amending Regulation if they are seeking to substitute a current IFPRU sponsor with a BIPRU one. Although there is currently some uncertainty about how these transitional rules should operate in practice, it is possible that they may require IFPRU investment firms to continue to act as the sponsor in relation to existing securitisations. Firms may also need to consider the representations in investor documentation relating to existing securitisations in this regard.

DUE DILIGENCE REQUIREMENTS

The Securitisation Regulation will impose new mandatory due diligence requirements on EU "institutional investors", which will require them to:

- verify that the securitisation complies with the relevant risk retention requirements;
- verify that, if the originator or original lender is not an EU credit institution or an EU investment firm subject to the CRR, it grants all credits giving rise to the exposures underlying the securitisation on the basis of "sound and well-defined criteria" and has clearly established processes for such purposes;
- carry out a due diligence assessment which permits them to understand:
  - the risks involved in the position(s) that they are taking in the securitisation and the relevant exposures underlying them;
  - the structural features of the securitisation that could materially impact the performance of the position(s) held, including payment priorities, credit and liquidity enhancements, market value triggers and transaction-specific definitions of default; and
  - if the securitisation is a "simple, transparent and standardised" (**STS**) securitisation (see below), how the securitisation complies with the requirements in order to be classified as such (although they may rely on an STS notification and on information provided by the originator, sponsor or securitisation vehicle to "the extent appropriate"); and
- establish appropriate and proportionate written procedures to ensure compliance with the above requirements, including requirements for regular stress testing and appropriate internal reporting.

For these purposes, "institutional investors" are defined as:

- AIFMs that manage and/or market AIFs in the EU;
- UCITS management companies and internally managed UCITS funds;
- insurance and reinsurance undertakings under the Solvency II Directive;
- IORPs – i.e. essentially, most EU occupational pension schemes – and managers or other authorised entities appointed by them under the IORP II Directive; and
- credit institutions and MiFID investment firms subject to the CRR.

The new due diligence requirements are likely to require these institutional investors to update their internal policies and procedures in order to ensure that they carry out the necessary verifications.

RESTRICTION ON SALE OF INTERESTS IN SECURITISATIONS TO RETAIL CLIENTS

The Securitisation Regulation states that positions in securitisations must not be sold to retail clients (as defined under MiFID II) unless:

- the seller has performed a suitability test in relation to that investment and the relevant client in accordance with the requirements in MiFID II, has concluded that the investment is suitable and has provided a suitability report to the relevant client; and
- if the retail client's financial instrument portfolio does not exceed EUR 500,000, the seller ensures that the client does not invest, in aggregate, more than 10% of the financial instrument portfolio in securitisation positions and that the minimum investment in or more positions is EUR 10,000. For these purposes, the financial instrument portfolio includes both cash deposits and financial instruments, but excludes any instruments that have been given as collateral.

Therefore, to the extent that firms sell securitisation interests to MiFID retail clients, they are likely to need to revise their procedures to incorporate the required suitability and financial instrument portfolio checks.

BAN ON RE-SECURITISATIONS

The Securitisation Regulation prohibits any of the underlying exposures used in a securitisation from including securitisation positions – i.e. this acts as a ban on re-securitisations.

However, this ban does not apply where:

- the securities of the securitisation were issued before the Regulation entered into force; or
- the re-securitisation is used for a "legitimate purpose". The concept of a legitimate purpose is defined in the Securitisation Regulation as any of the following;
  - facilitating the winding-up of a credit institution, investment firm or financial institution;
  - ensuring the viability of any of the above institutions in order to avoid their winding-up; or
  - preserving the interests of investors where the underlying exposures are non-performing.

National regulators may grant permission to firms that they supervise to establish re-securitisations where they consider that one of the above legitimate purposes is satisfied.

RESTRICTION ON LOCATION OF SECURITISATION SPECIAL PURPOSE ENTITIES

The Securitisation Regulation prohibits securitisation special purpose entities (**SSPEs**) from being established in any jurisdiction which:

- is listed as a high-risk and non-cooperative jurisdiction by the Financial Action Task Force on Money Laundering (FATF); or
- which has not signed an agreement with an EU Member State committing it to comply with the OECD Model Tax Convention on Income and Capital or the OECD Model Agreement on the Exchange of Information on Tax Matters.

For these purposes, an SSPE is defined as a corporation, trust or other entity (other than an originator or sponsor) which has been established for the purpose of carrying out a securitisation, with a structure that is designed to isolate the SSPE's obligations from those of the originator.

TRANSPARENCY AND REPORTING REQUIREMENTS

Originators, sponsors and SSPEs will become subject to new transparency rules which will require them to make certain information available to holders of positions in their securitisations, to national regulators and to potential investors upon request.

Some of this information must be provided before pricing of the securitisation occurs, including:

- all underlying documentation that is essential to understand the transaction (including, to the extent applicable, documents such as the final offering document; the asset sale or transfer agreement; any relevant derivatives and guarantee agreements; the servicing, administration and cash management agreements; the trust deed and security deed; and any relevant inter-creditor agreements, subordinated loan agreements and liquidity facility agreements);
- if a Prospectus Directive-compliant prospectus has not been drawn up for the transaction, a transaction summary or overview of the main features of the securitisation; and
- if the securitisation is an STS securitisation, the relevant STS notification (see below).

Other information will need to be provided on an ongoing basis, including:

- information on the underlying exposures on a quarterly basis (except in the case of asset-backed commercial paper (**ABCP**) securitisations, where they must provide information on the underlying receivables or credit claims on a monthly basis);
- quarterly investor reports (except in the case of ABCP securitisations, where the reports must be on a monthly basis), which cover the following issues:
    - all materially relevant data on the credit quality and performance of underlying exposures;
    - information on events which trigger changes in the priority of payments to investors or the replacement of any counterparty;

  - for a non-ABCP securitisation, data on the cash flows generated by the underlying exposures and by the liabilities of the securitisation; and
  - information about the risk retention element of the securitisation and how the parties responsible for establishing it have complied with the relevant risk retention rules in the Securitisation Regulation;
- any inside information relating to the securitisation that the originator, sponsor or SSPE is required to publish under the EU Market Abuse Regulation; or
- to the extent that it is not inside information required to be disclosed under the above bullet point, information about any other significant event, such as a material breach of obligations under the securitisation documentation, a change in the risk characteristics of the securitisation or its underlying exposures that could materially affect its performance, or any material amendment to the transaction documentation.

For securitisations in relation to which a prospectus that is compliant with the Prospectus Directive (or from 21 July 2019, the Prospectus Regulation) has been prepared (which ESMA terms "**public securitisations**"), this information must be made available by means of a securitisation repository which has been registered in accordance with the Securitisation Regulation. If no securitisation repository has yet been registered, the information must instead be made available through a website that meets certain qualifying conditions. While non-public securitisations (which ESMA terms "**private securitisations**") are not required to submit information to a securitisation repository, they are nonetheless still subject to the general requirement to ensure that the information discussed above is provided to investors.

On 19 December 2017, ESMA published a consultation paper (ESMA33-128-107) containing, amongst other items, its proposed draft technical standards on the content and format of reporting on the underlying exposures in a securitisation. This was accompanied by a series of standard templates published on ESMA's website which vary according to the nature of the assets underlying the securitisation. The consultation closes on **19 March 2018**.

SIMPLE, TRANSPARENT AND STANDARDISED (STS) SECURITISATIONS

The Securitisation Regulation introduces a new concept of an STS securitisation. This is a new designation that can only be used if the securitisation meets certain requirements, which vary depending upon whether the securitisation is an ABCP securitisation or not. For a non-ABCP securitisation, the criteria for being designated as an STS securitisation include, amongst others, the following:

- the originator, sponsor and SSPE must all be established in the EU;
- the title to the underlying assets must be transferred to the SSPE by means of a true sale or an assignment or transfer having an equivalent effect, and must not be subject to certain claw-back provisions which could otherwise affect the validity of the transfer;
- the seller of the underlying exposures must include representations and warranties in relation to the sale that, to the best of its knowledge, the underlying exposures are not encumbered;
- the underlying exposures must be transferred from the seller to the SSPE in accordance with "predetermined, clear and documented" eligibility criteria which do not allow for active management of the exposures on a discretionary basis;

- the underlying assets must be part of a single homogeneous asset type and may not include transferable securities (as defined under MiFID II), other than corporate bonds that are not traded on a trading venue. The term "trading venue" is not defined in the Securitisation Regulation, but presumably this should be interpreted by reference to the MiFID II definition – i.e. a regulated market, MTF or OTF. On 15 December 2017, the EBA published a consultation paper (EBA/CP/2017/21) setting out draft RTS which define in further detail when assets will be considered to be homogenous for these purposes. The consultation closes on **15 March 2018**;

- the underlying assets must not be interests in securitisations – i.e. an STS securitisation cannot be a re-securitisation;

- the underlying assets must have been originated in the ordinary course of the originator or original lender's business pursuant to standards that are no less stringent than those that the originator or original lender applied at the time of origination to similar exposures that were not securitised; and

- the underlying assets transferred to the SSPE must not include, at the time that they are selected for transfer, any exposures in default.

The originator and sponsor of an eligible securitisation are required to make a joint notification to ESMA using a standard template, which must explain how each of the relevant criteria are satisfied. National regulators may authorise third parties to assess the compliance of securitisations with the relevant STS criteria. ESMA will maintain an official list on its website of all securitisations in respect of which it has received a notification that the relevant criteria are met.

In addition to acting as an identifiable brand of less complex securitisations, STS securitisations also benefit from reduced risk weightings under the revised regulatory capital rules applicable to securitisations.

AMENDMENT TO THE CRR SECURITISATION REGULATORY CAPITAL RULES

The current CRR sets out the regulatory capital requirements applicable to exposures to securitisations held by firms subject to the CRR (i.e. banks and IFPRU investment firms) in Chapter 5 of Title II of Part Three. From **1 January 2019**, that entire chapter will be repealed in its entirety and replaced by the new provisions contained in the CRR Amending Regulation, which are primarily designed to achieve two overarching objectives:

- to introduce a new, more risk-sensitive regime for assessing the credit risk associated with securitisation positions, in line with revised international standards published by the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions; and

- to facilitate a more favourable regulatory capital regime for exposures to STS securitisations, as part of the introduction of the STS securitisation regime.

Hierarchy of rating methods

The new rules are complex and are too lengthy to summarise in any great level of detail in this briefing. Broadly, they introduce a new mandatory hierarchy of methods for calculating the risk weightings applicable to securitisation exposures, which must be applied in the following order:

- first, if a firm meets the relevant criteria, it must apply the **Securitisation Internal Ratings Based Approach** (**SEC-IRBA**). This is likely to be the most efficient method from a regulatory capital perspective, given that it relies on internal models adopted by the firm itself. However, a key condition for

applying SEC-IRBA is that the exposures underlying the securitisation must be of a type for which the firm has permission to apply the general (i.e. non-securitisation) Internal Ratings Based Approach under the CRR. In practice, this means that many non-bank firms will be unable to apply SEC-IRBA as they will not have the resources or the required regulatory permission to operate such models. National regulators may also prohibit the use of SEC-IRBA in relation to securitisations which have highly complex or risky features;

- if a firm is unable to apply SEC-IRBA, it must apply the **Securitisation Standardised Approach** (**SEC-SA**), provided that:
  - it meets the general criteria for applying SEC-SA;
  - if the relevant position is an exposure to an STS securitisation, the application of SEC-SA would not result in a risk weighting higher than 25%. (If the resulting risk weighting would be higher than 25%, SEC-ERBA must be used instead – see below);
  - if the relevant position is an exposure to a non-STS securitisation, the application of SEC-SA would not result in a risk weighting higher than 25% and the application of SEC-ERBA would not result in a risk weighting higher than 75%. (If either of these thresholds are exceeded, SEC-ERBA must be used instead);
  - the securitisation is not backed by pools of auto loans, auto leases or equipment leases (otherwise it must apply SEC-ERBA); and
  - it has not otherwise made a valid election to apply SEC-ERBA instead of SEC-SA to all of its positions in securitisations which are either rated or in respect of which a rating may be inferred;
- where the firm cannot apply either SEC-IRBA or SEC-SA, or has otherwise made a valid election not to apply SEC-SA, it must apply the **Securitisation External Ratings Based Approach** (**SEC-ERBA**); and
- where none of SEC-IRBA, SEC-SA or SEC-ERBA can be applied, **a fall-back 1,250% risk weighting** must be applied instead.

SEC-SA calculation methodology

The new SEC-SA is considerably more complex than the existing standardised approach for securitisation exposures in the CRR. This is because it will require firms to understand:

- the composition of the asset pool underlying the securitisation so that they can calculate the overall risk-weighted exposure amount applicable to those underlying assets;
- the point at which losses sustained in relation to the underlying assets will begin to be allocated to the relevant securitisation position that they hold and the point at which such losses would result in a complete loss of principal in relation to the tranche containing the relevant securitisation position. The firm must then perform a calculation using those two points to determine the "tranche thickness" of the position; and
- the level of the underlying exposures in default (defined as 90 days or more past due, or being subject to bankruptcy or insolvency proceedings, or being in default in accordance with the securitisation documentation) at the point at which the regulatory capital calculation is being performed. If the firm does not have information about the delinquency status of over 5% of the underlying assets, the default 1,250% risk weighting must be applied instead. (Where it is missing information for certain exposures that in total

amount to 5% or less of the underlying assets, there is a calculation which effectively permits the firm to extrapolate from the existing data.)

SEC-SA then uses standard formulae which take these factors relating to the riskiness of the underlying pool and the relative position of the securitisation position held by the firm and converts them into an appropriate risk weighting. There are modified rules for re-securitisation positions and STS securitisation positions.

SEC-ERBA calculation methodology

SEC-ERBA is comparatively simpler and, as the name implies, relies in part upon external ratings for the relevant securitisation position issued by credit rating agencies (or potentially, inferred ratings where the position itself is unrated, but is effectively analogous to a position that has been rated). Part of regulators' logic for preferring SEC-SA rather than SEC-ERBA is to attempt to move away from perceived over-reliance upon external ratings issued by credit rating agencies wherever possible. The applicable risk weightings for SEC-ERBA are shown in standardised tables set out in the CRR Amending Regulation, with the final risk weight being adjusted in accordance with:

- "tranche maturity" (i.e. effectively a calculation which adjusts the standard maturity applicable to the position in accordance with the size and timing of expected contractual payments); and
- for securitisation positions in tranches other than the most senior tranche, "tranche thickness", as described under SEC-SA above.

The result of the SEC-ERBA methodology is that it will no longer be possible solely to rely on an external credit rating which is then converted into a credit quality step and mapped to a final risk weighting (as under the current securitisation standardised approach in the CRR). Instead, the firm will still need to perform certain calculations to apply adjustments to the standardised risk mapping in order to determine the final applicable risk weighting.

Given that SEC-ERBA uses a simpler methodology for determining securitisation regulatory capital requirements, some firms may prefer to apply it over SEC-SA (although in many cases, it is potentially less efficient). The CRR Amending Regulation specifies that firms may elect to apply SEC-ERBA to all of their positions in securitisations which are rated or in respect of which a rating may be inferred if they inform their relevant regulator **no later than 45 days before 1 January 2019** (i.e. by **17 November 2018**). If they do not make the relevant election by that date, but wish to do so at a later time, they must inform their regulator by 15 November in any subsequent year, with the election taking effect from the following 1 January, provided that the national regulator does not otherwise object.

Information requirements

It is clear that applying any of SEC-IRBA, SEC-SA or SEC-ERBA will require a firm to have access to detailed information about the relevant securitisation in order to facilitate, amongst other requirements, the calculations relating to the risk weighting of the underlying assets and the relative levels of default of those assets, the tranche maturity and the tranche thickness. The new investor transparency and reporting requirements may go some way towards meeting these information requirements, but originators and sponsors should be aware that they may need to provide additional information to ensure that institutional investors are able to comply with the new regulatory capital rules in the most efficient manner possible.

Transitional arrangements

The CRR Amending Regulation requires firms to continue to apply the existing (i.e. pre-amendment) CRR provisions on securitisations, in the form applicable on 31 December 2018, until 31 December 2019 to any exposures to securitisations which have issued securities before the CRR Amending Regulation enters into force (i.e. 1 January 2019). Two important consequences flow from this:

- firms that invest in securitisation positions which were issued before 1 January 2019 and invest in new securitisations after 1 January 2019 will need to operate two sets of rules in parallel in order to determine the applicable regulatory capital requirements throughout 2019; and

- depending on the precise interpretation of the transitional rules by regulators, the requirement for firms to comply with the existing CRR rules for positions in pre-existing securitisations may preclude IFPRU sponsors of such securitisations from converting to BIPRU firms before 31 December 2019. Although a BIPRU firm will be eligible to be classified as a "sponsor" under the revised definition from 1 January 2019, under the current rules, a BIPRU firm cannot be a sponsor because it is not an "institution" as defined under the CRR. If institutional investors must comply with the existing rules for one year in connection with existing securitisations, this may mean that they would suffer punitive regulatory capital treatment if the sponsor were to convert from IFPRU to BIPRU status during that time because the securitisation would then be non-compliant with the current CRR criteria. This point may be clarified by regulators in due course.

9. AMENDMENT TO THE UK REGULATORY PERIMETER IN RELATION TO INVESTMENT ADVICE

On 3 January 2018, certain amendments to the UK Regulated Activities Order (**RAO**) took effect which have changed the regulatory perimeter in relation to the activity of advising on investments. These changes were introduced as a result of the Financial Advice Market Review (**FAMR**), the results of which were published in March 2016.

FAMR identified that some firms were reluctant to provide information to consumers on investments because there was a lack of certainty over when they would be deemed to be providing regulated investment advice (for which they either might not be authorised, or which would otherwise require them to comply with additional regulatory requirements). As a result, FAMR recommended amending the UK definition of regulated investment advice to align with the definition in MiFID, so that providing investment advice would only be regulated if the advice constituted a personal recommendation (as defined under MiFID) made to an investor or potential investor, or the agent of such a person.

HM Treasury consulted on this basis in September 2016, but when it published its final proposals in February 2017, it adopted a more complicated approach than FAMR originally envisaged. This resulted from concerns expressed during the consultation that cutting back the regulatory perimeter in relation to investment advice so that it only captures firms giving personal recommendations would risk allowing potential fraudsters or other unscrupulous operators to provide more general advice to consumers to invest in high risk and/or unsuitable products, without providing any regulatory recourse against such persons.

As a result, the final rules are more complex and apply as follows:

- if a firm has been authorised by the FCA to carry on any regulated activities under the RAO other than advising on investments (Article 53 RAO) and agreeing to advise on investments (Article 64 RAO), it will only be considered to be advising on investments if it making a personal recommendation (see below). If the firm does not in fact make personal recommendations, it will no longer need the Article 53 RAO advising on investments permission at all (if it had it to begin with), even though it may be providing more

general (i.e. non-personal recommendation) investment advice. However, such firms should still consider whether there is a risk that their activities may, from time to time, stray into making personal recommendations, such that they would still require the relevant Article 53 RAO permission;

- if a firm has only been authorised by the FCA to carry on the regulated activities of advising on investments and agreeing to advise on investments (but no other activities under the RAO), then it will be deemed to be advising on investments on the same basis as immediately before 3 January 2018. This means that such a firm will be subject to all of the FCA rules applicable to advising on investments, and will need to retain the Article 53 RAO permission, irrespective of whether the advice constitutes a personal recommendation or more general non-personal recommendation regulated investment advice; and

- if a firm has not been authorised by the FCA, the rules apply on the same basis as immediately before 3 January 2018. This means that such firms are unable to provide any form of regulated investment advice, irrespective of whether the advice is general in nature or whether it constitutes a more personal recommendation, and in the absence of any other available exemption, are likely to commit a criminal offence if they do so.

In December 2017, the FCA published a policy statement (PS 17/25) on the implementation of FAMR, which contained, amongst other elements, changes to the FCA rules resulting from the RAO amendments to the activity of advising on investments. This included, amongst others, the following changes that took effect on 3 January 2018:

- generally, the FCA's approach is that where a firm provides non-personal recommendation advice, it should be subject to the same obligations as regulated firms when they carry on other unregulated activities (e.g. when providing factual information to customers). However, in certain cases, the FCA has modified how the rules apply in the context of non-personal recommendation advice;

- the FCA has amended the DISP rules to specify that a customer will have a right to complain to the Financial Ombudsman Service (**FOS**) in relation to the provision of non-personal recommendation investment advice. The FCA has clarified that it expects that the FOS will, as part of its obligations to take into account all relevant facts when deciding what is fair and reasonable, pay due regard to the fact that such advice is not subject to the same regulatory standards as a personal recommendation;

- the provisions relating to the Financial Services Compensation Scheme (**FSCS**) in the FCA's COMP rules have been amended so that non-personal recommendation investment advice will be deemed to have been given in connection with protected business provided that the firm had, or would have required, regulatory permission to carry on an activity that amounted to regulated investment business or non-investment insurance business (depending on whether the advice relates to investments or non-investment insurance) at the time that the act or omission giving rise to the relevant claim occurred. This means that recipients of non-personal recommendation investment advice will be eligible for FSCS protection if they meet the other necessary requirements (such as falling within the definition of an eligible claimant);

- the FCA has amended the scope of its Training and Competence (**TC**) rules, which previously applied to, amongst other individuals, any staff within a firm who provided investment advice on retail investments. The revised rules state that staff who only provide non-personal recommendation investment advice on retail investments will not be subject to TC – i.e. it only applies to staff providing personal recommendations on such investments. This change applies to all FCA authorised firms (i.e. including those firms which are only authorised to provide investment advice and therefore cannot benefit from the changes to the RAO, as discussed above). The FCA has emphasised, however, that the general "competent employee" rule continues to apply in all cases, even where TC does not apply, and therefore firms will still

need to ensure that relevant individuals have the necessary knowledge and skills to provide non-personal recommendation investment advice; and

- the FCA has added additional guidance to its Supervision Manual (**SUP**) which clarifies how the revised rules work in the context of appointed representatives (**ARs**). Where a firm is able to take advantage of the RAO amendment because it has permission to carry on regulated activities other than advising on investments (and therefore does not need permission to provide non-personal recommendation investment advice), it still needs to ensure that the terms of the AR's appointment cover any non-personal recommendation investment advice that may be given by the AR and that the principal firm accepts responsibility for the AR carrying on such business.

10. SENIOR MANAGERS AND CERTIFICATION REGIME: EXTENSION TO ALL FCA FIRMS

The Senior Managers and Certification Regime (**SMCR**) has applied to the banking sector since 7 March 2016. Parliament made further changes to the underlying legislation in May 2016 which broadly require the FCA to extend the SMCR regime to all firms authorised under the Financial Services and Markets Act 2000 – i.e. so that it covers insurers and FCA solo-regulated firms.

The precise date(s) on which the SMCR regime will be extended to FCA solo-regulated firms (and to insurers) will depend on the stipulation of a commencement date(s) in legislation, which is a matter for HM Treasury. However, for the purposes of the consultations, the FCA has assumed that the extension of the SMCR to insurers will commence in late 2018, followed by **commencement of the regime for FCA solo-regulated firms in mid to late 2019**.

THE TECHNICAL CONSULTATIONS ON TRANSITION AND THE DUTY OF RESPONSIBILITY: GENERAL

On 26 July 2017, the FCA marked the start of its formal proposals by publishing two consultation papers. These addressed the FCA's detailed policy proposals for replacing the existing Approved Persons Regime (**APR**) – see our July 2017 briefing. At the time, the FCA said that it would consult again on the technical details as to how to implement the regime in terms of transitioning and the requisite forms for new applicants.

On 13 December 2017, the FCA published three consultation papers on the technical details:

- CP17/40: Individual accountability: Transitioning FCA firms and individuals to the Senior Managers & Certification Regime
- CP17/41: Individual accountability: Transitioning insurers and individuals to the Senior Managers & Certification Regime
- CP17/42: The Duty of Responsibility for insurers and FCA solo-regulated firms

Consultation for all three of these papers closes on **21 February 2018**. We cover CP17/40 and CP17/42 below.

On 3 November 2017, the FCA published CP17/37: Consultation Paper on Industry Codes of Conduct and Discussion Paper on FCA Principle 5. As noted below, this has relevance to the SMCR. Consultation for this paper closes on **5 February 2018**.

CP 17/40: TRANSITIONING FROM THE APPROVED PERSONS REGIME TO THE SMCR

CP17/40 focuses on the FCA's technical proposals for transitioning from the APR into the SMCR regime. Broadly, the FCA proposes that most of the approved persons at Core and Limited Scope firms (see our

previous briefing and the reminder below for the proposed classification system) will convert automatically into the corresponding new Senior Management Functions. Enhanced Firms (broadly, the biggest firms) will need to submit a conversion notification form, with accompanying documents. The consultation paper also sets out several other consequential amendments as well as the new and amended forms.

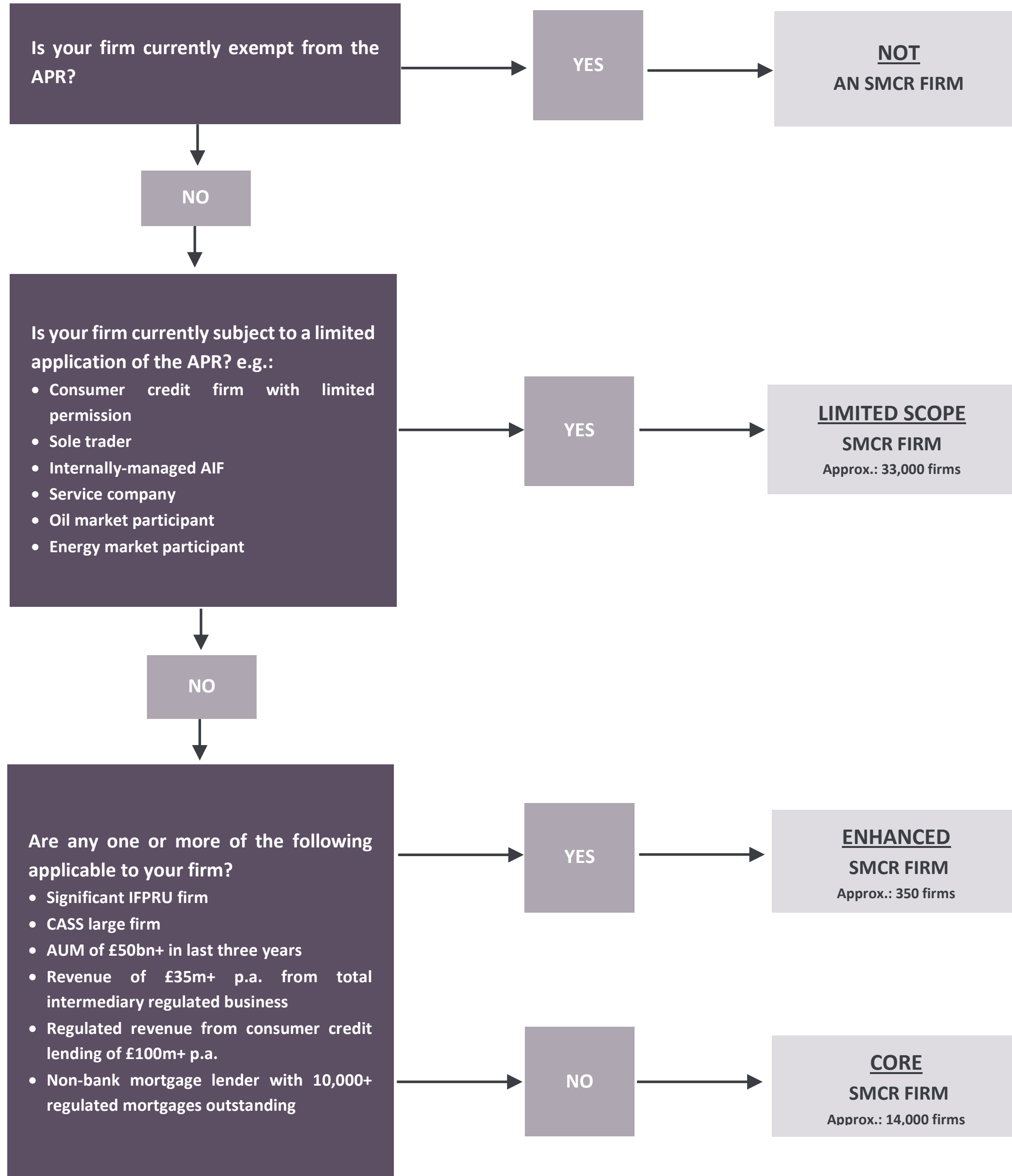
PROPOSED CLASSIFICATION OF FIRMS: A REMINDER

The extension of the SMCR to almost all FCA-regulated firms poses a challenge due to the wide variation in terms of the size, structure and business activities of individual entities. In order to reflect this, and to apply the rules on a calibrated basis, the FCA is proposing to classify firms according to three types: Limited Scope firms, Core firms and Enhanced firms. The effect of the classification criteria is that the majority of firms will be **Limited Scope** or **Core** SMCR firms. In addition to delineating the application of the rules, a firm's classification will determine whether it will be subject to the transitional conversion mapping of functions from the APR to corresponding SMF functions under the SMCR: this will be available to Core and Limited Scope firms, but not to Enhanced firms (which will have to submit applications for SMR status, together with supporting documents). As with our July 2017 briefing, this section of our briefing focuses on the impact of the proposals on Core SMCR firms.

The basic criteria used to classify firms as Limited Scope, Core or Enhanced are shown in the diagram on the next page.

SMCR: FCA SOLO-REGULATED FIRMS

FIRM CLASSIFICATION



TRANSITIONAL ARRANGEMENTS

Transitional arrangements: conversion of controlled functions from APR to SMCR – the basic position

In CP17/40 the FCA proposes the following:

- *Limited Scope and Core firms*: with one exception, individuals at these firms (see above) who are currently approved persons will *automatically* convert "wherever possible" into the corresponding senior management function (assuming they continue to carry on the relevant function)

- *Enhanced firms*: these firms will need to submit a conversion notification (Form K), together with a Statement of Responsibilities and a Responsibilities Map – the deadline for submission will be one week before the start of the SMCR regime.

Transitional arrangements: conversion for Core and Limited Scope firms

With one exception (mapping individuals to perform the SMF9 chair role), conversion from the APR to the SMCR regime will be automatic and firms will not need to do anything. However, a number of controlled functions under the APR will not map across to an SMF function when the SMCR regime comes into force. They will therefore fall away, without any requirement to submit a Form C (cancellation of an approved function); that said, it should be noted that the firm may nonetheless need to self-certify a number of these under the Certification regime instead (subject to the transitional arrangements outlined below).

The table on the following page sets out the proposed automatic conversion of current APR controlled functions to corresponding SMFs for Core and Limited Scope firms.

APR: current controlled function	Automatic conversion to corresponding SMF
CF1 – Director	**SMF3 – Executive Director** Note: if the director is also an Executive Chair, it will be necessary to submit a Form A for that person to hold the SMF9 – Chair function
CF2 – Non-executive director (chair only)	**SMF9 – Chair** Note: the conversion is not automatic. If the director is a Non-Executive Chair, it will be necessary to submit a Form K for that person to hold the SMF9 – Chair function (otherwise approval will lapse)
CF2 – Non-executive director (non-chair NEDs)	No – NED function lapses – no corresponding SMF
CF3 – Chief Executive	**SMF1 – Chief Executive**
CF3 – Chief Executive (third country firms with UK branch)	**SMF19 – Head of Third Country Branch**
CF4 – Partner (EEA and non-EEA branches only)	**SMF3 – Executive Director** Only relevant for EEA and non-EEA branches
CF4 – Partner (other firms)	**SM27 - Partner**
CF8 – Apportionment and Oversight Function	**SMF29 – Limited Scope** Only relevant for Limited Scope firms
CF10 – Compliance Oversight	**SMF16 – Compliance Oversight**
CF10a – CASS Oversight Function	No – CASS oversight function lapses – no corresponding SMF
CF11 – Money Laundering Reporting Officer (MLRO)	**SMF17 – Money Laundering Reporting Officer (MLRO)**
CF28 – Systems & Controls Function	No – Systems & Controls function lapses – no corresponding SMF
CF29 – Significant Management Function (EEA branches only)	**SMF21 – EEA Branch Senior Management Function** Only relevant to EEA branches.
CF29 – Significant Management Function (all other firms)	No – Significant Management Function lapses – no corresponding SMF CF29s at Core firms that are not EEA branches will not be automatically converted to an SMF function unless approved for a mapped controlled function before Commencement.
CF30 – Customer Function	No – Customer Function lapses – no corresponding SMF

As indicated above, the conversion will not be automatic in the case of individuals who will perform the SMF9 – Chair role. In the case of an Executive Chair, while the CF1 – Director function under APR will convert automatically to the SMF3 – Executive Director SMF, it will be necessary to submit a new SMCR Form A for that person to hold the SMF9 – Chair function. In the case of a Non-Executive Chair, the NED function lapses under SMCR and it will be necessary to submit a Form K conversion notice seeking approval. Core firms will not however be required to submit a Statement of Responsibilities to support the Form K application.

Core and Limited Scope firms: applications for approval up until SMCR commencement date

The APR will remain in place up until the SMCR regime comes into effect and so the FCA will continue to accept applications on the existing forms right up to that date. This will be relevant for those firms taking on new staff who will be performing controlled functions, or moving existing staff from and into controlled functions, between now and then.

Any persons newly approved to perform a controlled function under the APR regime between now and the SMCR commencement date will be transitioned automatically to the mapped SMCR function (assuming there is one) – see above.

If it is the firm's intention that an approved person will cease performing a mapped function as at the SMCR application date (for instance, because they will enter an application to perform a new SMF) it will be necessary to submit a Form C (otherwise the function will automatically transition across to the corresponding SMF function).

Since the FCA will be accepting Form A applications under the APR right up to the SMCR application date, there will inevitably be a number of applications which the FCA will not have determined by that date; the FCA describes these as "in flight" applications. Where this applies, the application will be converted automatically into an application for the relevant SMF without the firm needing to do more (assuming that the function maps across as above).

It will be possible to make an application to perform a new SMF function in advance of the SMCR commencement date on one of the new forms when they become available (drafts are attached to the consultation paper), but the approval will not take effect until that date.

Transitional arrangements: certified staff

See our Part D of our July briefing for a list of the FCA's specified "certification functions".

The Conduct Rules in COCON will apply to all identified staff performing certification functions as from the commencement of the new SMCR regime, meaning that firms will need to have identified them in advance of that date. However, firms will not be required to formally certify such staff until **12 months after the date on which the SMCR regime comes into force**, so firms will have that transitional period in which to complete their fitness and propriety assessments of relevant staff and prepare for the issue of the certificate.

Firms that are issuing a certificate (including on a renewal) are ordinarily required to obtain regulatory references in relation to the person's current employment and employment for the previous six years. However, the transitional requirements will provide that, as regards the first certification, references will not be required in relation to existing members of staff who will be performing the same role after the start of the SMCR regime.

Transitional arrangements: other conduct rules staff

As regards those employees who do not hold a senior management function or a certification function but who are nonetheless within the scope of COCON, **firms will have up to 12 months from the commencement of the SMCR regime before applying the conduct rules to them**. This will apply regardless of how the firm is classified.

Transitional arrangements: conversion for Enhanced firms

While there will be mapping of functions, there will be no automatic conversion for Enhanced firms. Instead, they will be required to submit:

- a Form K conversion notification, setting out details of all the approved persons that will need to be converted to SMFs as at the SMCR commencement date;
- Statements of Responsibilities for all of the approved persons listed in the Form K notification;
- a Responsibilities Map;
- Forms A for new individuals and Forms E for transferred individuals.

NEW SMCR FORMS

CP17/40 sets out the FCA's proposed new forms for the extended SMCR regime. Many of these will be familiar in that they are heavily based on those currently used under the APR, although they have been subject to simplification and consolidation. So, for instance, there will still be two versions of the Form A application – long form and short form, a Form D which deals with changes to personal information/ application details and Form E for internal transfer of a person. REP008 (Notification of Conduct Rule Breaches and Disciplinary Action) and the Statement of Responsibilities for solo-regulated SMCR firms are extensions of SMCR rules currently used in the banking regime.

MINOR CONSEQUENTIAL CHANGES

CP17/40 also includes a number of minor, consequential changes to various parts of the Handbook in the light of the extension of the SMCR. These include:

- *Appointed representatives* - it is important to remember that the extension of the SMCR regime to all FCA solo-regulated firms does not cover appointed representatives. The FCA currently does not have the power to do this. Consequently, it is necessary to retain a pared down version of SUP10A (FCA approved persons) and certain elements of APER (Code of Practice for Approved Persons), in each case for appointed representatives only. While appointed representatives will remain subject to the existing APR, the current appointed representative application forms will be replaced, on the SMCR commencement date, by the new SMCR forms into which the appointed representative provisions will be combined.
- *Introduction of gender-neutral titles* – all those roles which, under the existing Banking SMCR regime include the word "Chairman" will be amended to read "Chair" (e.g. Chair of the Governing Body, Chair of the Remuneration Committee etc).
- *Additional guidance on SMF24 – Chief Operations functions* – the consultation includes additional FCA guidance on what areas of responsibility fall within the new function (including business continuity,

cybersecurity, IT and outsourcing, procurement and vendor management). The SMF24 function will only apply to Enhanced firms.

WHEN WILL THE SMCR BE EXTENDED TO FCA SOLO-REGULATED FIRMS?

As stated above, the precise date(s) on which the SMCR regime will be extended to FCA solo-regulated firms (and to insurers) will depend on what HM Treasury stipulates as the commencement date(s) in legislation. However, for the purposes of the consultation, the FCA has assumed that the extension of the SMCR to insurers will commence in late 2018, followed by **commencement of the regime for FCA solo-regulated firms in mid to late 2019**.

The consultation period for CP17/40 closes on **21 February 2018**. Firms should feed any comments and responses they have to their relevant trade associations.

They should also continue to watch developments closely, keeping a particular eye out for the legislation which will confirm the date on which the regime will apply. While this date has not yet been set, the FCA's working assumption of a commencement in mid to late 2019 (see above) and its proposals for automatic conversion of certain APR functions and for transitional relief in relation to the introduction of the certification regime and the application of COCON to those employees who do not hold a senior management function or a certification function are all helpful. In light of the consultation and an indicative timeline leading to the commencement and transition, SMCR implementation planning should be a high priority for 2018.

CP 17/41: THE DUTY OF RESPONSIBILITY UNDER SMCR FOR FCA SOLO-REGULATED FIRMS

The Duty of Responsibility came into force on 10 May 2016 and currently applies to senior managers under the banking SMCR regime. It will be extended to senior managers of FCA solo-regulated firms as and when the SMCR regime is extended to them.

The Duty of Responsibility (as set out in section 66A and section 66B, FSMA) provides that the FCA/PRA may take action against a senior manager where:

- There has been (or has continued to be) a contravention of a relevant requirement by the authorised firm;
- The senior manager was at the relevant time responsible for the management of any of the firm's activities in relation to which the contravention occurred; and
- The senior manager did not take such steps as a person in their position could reasonably be expected to take to avoid the contravention occurring (or continuing).

The burden of proof is on the regulator to show that the senior manager did not take the steps a person in their position could reasonably have been expected to take to avoid the breach occurring or continuing.

For the purposes of the SMCR banking regime, guidance provisions have been included with the Decision Procedure and Penalties Manual (**DEPP**) setting out the circumstances in which the FCA will apply the duty, together with the considerations that may be relevant in determining whether a senior manager was responsible for the management of the activities in relation to which the breach occurred and in determining whether the senior manager took the steps that could reasonably expected of someone in his position.

The FCA has decided that it does not need to amend its existing DEPP guidance and so, with appropriate definitional changes, it will apply, as already drafted, to senior managers in FCA solo-regulated firms (and insurers) as and when the SMCR regime is extended to such firms.

The consultation paper summarises the responses which the FCA gave when settling the existing guidance on the Duty of Responsibility as it applies to banking firms.

Consultation closes **on 21 February 2018**. The FCA's expectation is that the extension of the Duty of Responsibility (which will need to be done by way of a statutory amendment) will coincide with the extension of the SMCR regime more generally – as stated above, this is a matter for HM Treasury, but the FCA has assumed that the extension of the SMCR regime to FCA solo-regulated firms will be in **mid to late 2019**.

CP 17/37: CONSULTATION ON INDUSTRY CODES OF CONDUCT – UNREGULATED ACTIVITIES

On 3 November 2017, the FCA published [CP17/37: Consultation Paper on Industry Codes of Conduct and Discussion Paper on FCA Principle 5].

There are broadly three limbs to the proposals in the consultation:

- a general approach to the way that the FCA supervises and enforces the SMCR rules as they apply to a firm's *unregulated* activities, including those covered by industry codes of conduct.
- the basis on which the FCA will recognise certain industry codes of conduct which set out proper standards of conduct for *unregulated* markets and activities.
- a discussion on extending the current scope of FCA Principle 5 (market conduct) so that it covers unregulated activities.

The consultation, particularly as regards the first two points, is broadly relevant to FCA solo-regulated firms because of the future extension of the SMCR regime to them (see above).

Under SMCR the majority of individuals within a firm are subject to the Code of Conduct for Staff sourcebook (**COCON**). One of the rules requires them to observe "proper standards of market conduct" (COCON 2.1.5). This applies regardless of whether they are carrying out regulated or unregulated activities. As regards regulated activities, the FCA Handbook rules (and other provisions) will apply – e.g. the Code of Market Conduct (MAR1). As regards *unregulated* activities, guidance (COCON 4.1.15G) indicates that a general consideration about whether or not a person's conduct complies with the relevant requirements and standards of the market includes whether they or the firm, complies *relevant market codes*.

In this regard, the FCA outlines its new policy approach to recognising market codes of conduct covering unregulated markets; it outlines a recognition process, the criteria for recognition and the time limit for recognition (three years). A recognised code would be listed on the FCA website. In terms of its approach to discipline and enforcement, behaviour in line with an FCA-recognised code would tend to indicate compliance in relation to the carrying out of unregulated activities with applicable FCA rules that reference "proper standards of market conduct". The FCA would usually not take action against a person for behaviour in relation to unregulated activities that it considers to be in line with a relevant FCA-recognised industry code.

Separate from its SMCR-driven proposals on industry codes of conduct, but on the same theme of market conduct in unregulated markets, the FCA also initiates a discussion on whether it should extend Principle 5 of the FCA Principles for Businesses. Currently, Principle 5 (a firm must observe proper standards of market conduct) only applies to regulated activities and ancillary unregulated activities. The proposal is that Principle 5 should be extended to cover a firm's unregulated activities generally (not just those unregulated activities which are carried on in connection with, or held out as being for the purposes of, a regulated activity). Consistent with the approach outlined above, the FCA would not prescribe what a proper standard of conduct

is, but would rely on firms to consider this, including as may be written into industry codes of conduct (including those recognised by the FCA).

The consultation closes on **5 February 2018**.

11. FCA ASSET MANAGEMENT STUDY – COSTS DISCLOSURES FOR INSTITUTIONAL INVESTORS

In June 2017, the FCA published the final report (MS 15/2.3) setting out its findings from the Asset Management Market Study, which was launched in November 2015. As we explained in our client briefing at the time, the majority of the specific proposals which emerged from the review were directed at asset managers dealing with retail investors and/or retail funds. However, one key proposal relating to the development of a standardised template for costs and charges disclosures to institutional investors was not limited to the retail context.

In September 2017, the FCA announced that it had established an institutional disclosure working group (**IDWG**) chaired by Dr Chris Sier, Professor of Practice at Newcastle University Business School with expertise in pension scheme costs and charges disclosures. A full list of members and observers participating in the IDWG is available on the FCA's website, as are summaries of discussions at its meetings.

The IDWG's terms of reference were also published in September 2017 and further supplemented in November 2017. In summary, these provide that:

- the IDWG will aim to reach agreement on costs and fees disclosure templates (or data standards) for disclosure to professional investors – i.e. the ultimate product is not designed to provide data to retail investors;
- as part of that overall objective, the IDWG will consider how the data needs of different types of institutional investors can be met;
- the resulting templates should be accessible, easy to understand and comprehensive in terms of the total costs covered;
- the template should minimise the ability of users to record significant costs in the "other" categories;
- the underlying data in the templates should be prepared to consistent standards to facilitate easy comparison;
- comparisons should also be undertaken with templates that are already being used or are currently being developed, so that the IDWG will use both a "bottom up" and "top down" methodology;
- the IDWG will consider whether templates need to be segmented into more granular asset types or whether particular asset classes or fund types need separate data collection templates;
- the IDWG will assess whether compliance-testing mechanisms are required; and
- the IDWG will consider what can be done to encourage adoption of the template.

The terms of reference also set out an indicative timetable, which indicated that the IDWG would report to the FCA on the overall disclosure framework and associated template(s) by 24 December 2017. The IDWG is due to report on the remaining disclosure templates, including any relevant alternative asset classes, by 31 July 2018.

In December 2017, the IDWG published a report of its progress against its terms of reference. This indicated that the framework for data collection and aggregation would be split into two levels, consisting of:

- asset level costs calculated using asset level data which would be supplied by asset managers with input from ancillary service providers. This would be designed for use by, for example, pension scheme trustees who needed granular costs and charges information and other advisers; and
- a user summary, based on summary data which is calculated by aggregating the granular asset-level costs. This would be designed for use, for example, by pension scheme trustees who want a high level summary of applicable costs and charges.

In the December 2017 progress report, the IDWG indicated that to date, it has considered defined benefit pension costs disclosures as a test case for whether the underlying detail on costs and charges in the template is sufficiently robust. The report also states that the IDWG has not yet reached a final decision on whether there should be one combined and simple template, or whether multiple disclosure templates will ultimately be required (whether to take into account specific asset classes or to accommodate the needs of specific types of institutional investors, or both). It will revisit this issue in its future discussions and plans to road test its recommendations from January 2018 onwards. The IDWG's webpage on the FCA website states that if firms are interested in forming part of the testing group, they should contact the IDWG by email at institutionaldisclosuregroup@fca.org.uk.

12. AIFMD 2 AND OMNIBUS REGULATION

The EU Alternative Investment Fund Managers Directive (**AIFMD**) contains provisions requiring the European Commission to start a review of the application and scope of the AIFMD by 22 July 2017. The review must include a general survey of how all of the AIFMD rules function in practice, including:

- marketing by EU AIFMs of non-EU AIFs and by non-EU AIFMs of any AIFs in Member States under the national private placement regimes;
- the management and marketing of AIFs in the EU by authorised AIFMs under the AIFMD passporting provisions;
- the marketing of AIFs in the EU by entities other than AIFMs;
- investment in AIFs by or on behalf of European professional investors;
- the impact of the AIFMD depositary rules on the EU depositary market;
- the impact of the investor disclosure and reporting, regulatory reporting and portfolio company reporting rules on the assessment of systemic risk;
- the potential adverse impact to retail investors;
- the impact on the operation and viability of private equity and venture capital funds;
- the impact on investor access in the EU;
- the impact on investment in developing countries; and

- the impact of the rules on portfolio companies on the protection of non-listed companies or issuers and on the level playing field between AIFs and other investors following the acquisition of major holdings in, or control over, such companies.

Following its review, the Commission is permitted to propose appropriate legislative amendments to the AIFMD to address any identified issues.

Following the publication in early 2017 of an invitation to tender for firms to conduct the associated market study, we understand that the Commission has now appointed a firm to progress the study and that work is ongoing. It seems unlikely that any output from the review which may result in revisions to the AIFMD (commonly dubbed "AIFMD 2") will be published in the near future. Firms and industry associations should, however, continue to monitor for further developments in this area, particularly if there may be opportunities to feed comments or data into the Commission's analysis.

Separately, the Commission has been working on a new proposed Omnibus Regulation as part of its wider Capital Markets Union project. This is designed to address specific identified deficiencies in AIFMD and the UCITS Directive relating to marketing and passporting issues in order to reduce barriers to the distribution of funds within the EU. It may also clarify issues relating to reverse solicitation. It is anticipated that the Commission will publish the relevant legislative proposal during Q1 2018.

13. EUROPEAN COMMISSION PROPOSALS FOR NEW PRUDENTIAL REGIME FOR MIFID FIRMS

On 20 December 2017, the European Commission published a legislative proposal containing a new Directive and new Regulation which would introduce a new prudential regime for MiFID investment firms. This builds on the earlier advice provided by the EBA in a final report published on 29 September 2017 and, subject to the outcome of negotiations with the European Parliament and the Council, is likely to introduce significant changes for all MiFID firms when it finally takes effect.

Although the current timetable for the adoption of the legislation is unclear, it is possible that it could enter into force at some point during 2020 if it is not subject to undue delays in the legislative process.

We published a client briefing in December 2017 which discussed the most significant aspects of the Commission's proposals, including the proposed criteria for classifying firms according to their perceived complexity and the Commission's approach to the application of remuneration requirements to the most significant category of firms. We also noted that the Commission's proposal will amend some of the third country equivalence provisions under MiFIR governing the provision of MiFID services by non-EU firms on a cross-border basis, which appears likely to be the result of Brexit-related considerations.

Firms should continue to monitor for further developments throughout the legislative process which may clarify the final proposed application date for the new regime and the scope of the final rules.

14. CRD V AND CRR II: AN UPDATE

In November 2016, the European Commission published two legislative proposals: one was a proposed directive amending the existing CRD IV Directive (**CRD V**) and the other was a proposed regulation amending the existing CRR (**CRR II**). The proposed rules in CRD V will be of particular interest to firms, given that they include, amongst other elements, provisions:

- amending the current CRD IV remuneration rules by altering the application of the proportionality test and setting specific quantitative thresholds for the disapplication of certain remuneration requirements (which

will not include the so-called "bonus cap" relating to a maximum ratio of 2:1 variable to fixed remuneration, so that this could not be disapplied on proportionality grounds); and

- requiring two or more EU institutions that form part of the same third country group to have a single intermediate parent undertaking established in the EU, which would need to be authorised by the appropriate national regulator. On the basis of the current proposals, however, this would only apply if the relevant group has balance sheet assets in the EU of EUR 30 billion or more which, provided that this proposed threshold is maintained, means that it is only likely to be relevant to firms within groups containing banks or investment banks which are either based in the EU or have significant branches in the EU.

CRR II contains a number of detailed amendments to the CRR in areas such as the standardised approach under the credit risk rules, market risk requirements, the leverage and net stable funding ratio requirements, total loss absorbing capacity (TLAC), large exposures and regulatory reporting.

To date, the legislative progress on these texts has been relatively slow. The Council of the European Union published its first two compromise proposals in November 2017, while the European Parliament's ECON Committee published draft reports on the texts in December 2017. As a result, the precise timetable for finalising the legislation and for the entry into force of the new rules is not yet clear, although it is possible that the final texts could be settled by mid- to late 2018.

15. EBA REGULATORY TECHNICAL STANDARDS ON TRIGGERS FOR PRUDENTIAL CONSOLIDATION UNDER THE CRR

On 9 November 2017, the EBA published a consultation paper (EBA/CP/2017/20) containing draft regulatory technical standards (**RTS**) on the methods of prudential consolidation under Article 18 CRR. The purpose of the EBA's proposed RTS is to provide further clarity on a number of aspects of the triggers for consolidation, given that a number of key terms are not defined in the CRR and there is a significant amount of discretion for regulators.

The consultation is open until **9 February 2018** and comments may be submitted through the EBA's website.

TRIGGERS IN THE CRR FOR PRUDENTIAL CONSOLIDATION

The CRR provides for a number of different triggers for, and methods of, consolidation, depending upon the nature of the relationship between a CRR firm and another entity:

1. full consolidation of subsidiaries that are institutions or financial institutions, or proportional consolidation based on the share of capital held in the subsidiary, if certain conditions are satisfied;

2. consolidation, according to a method determined by the national regulator, of undertakings which are managed on a unified basis pursuant to a contract or constitutional provisions, or have a majority of the same persons in office on their administrative, management or supervisory bodies;

3. proportional consolidation, according to the share of capital held, where an undertaking which is included within the scope of consolidation manages one or more other undertakings which are not included within the scope of consolidation (provided that the liability is limited to the share of capital held);

4. where there are participations or capital ties other than those referred to above, such consolidation (if any) as may be required by the national regulator;

5. in any other case where, in the opinion of the national regulator, the firm exercises a significant influence over one or more institutions or financial institutions, without holding a participation or capital ties in those institutions, such consolidation (if any) as may be required by the national regulator; and

6. in any other case where two or more institutions or financial institutions are placed under single management otherwise than pursuant to a contract or constitutional provisions, such consolidation (if any) as may be required by the national regulator.

In our summary of the proposed RTS below, we cross-refer to these various triggers by reference to their number in the above list.

KEY ELEMENTS OF THE PROPOSED EBA RTS

The EBA's proposed RTS set out a number of provisions which are designed to clarify key aspects of the triggers for prudential consolidation discussed above. We discuss certain of these in further detail below.

Definition of an "undertaking"

The CRR itself does not define the term "undertaking", but Triggers 2 and 3 in the above triggers for prudential consolidation rely on that concept. The EBA is proposing to define an undertaking as any of the following:

- a credit institution;
- a MiFID investment firm;
- a financial institution as defined in the CRR (but see below for the EBA's observations on the "financial institution" definition more generally);
- an ancillary services undertaking as defined in the CRR when consolidated supervision is required; and
- an undertaking in a non-EU country which, if it were established in the EU, would be classified as any of the above entities.

In practice, this may be helpful in clarifying that the consolidation rules referring to undertakings will therefore only include undertakings that are connected with the provision of financial services.

Definition of "capital ties"

The concept of "capital ties" is not defined in the CRR, but again is relevant to Triggers 4 and 5 for prudential consolidation. The EBA is proposing to introduce a definition of "capital ties" that refers to direct or indirect ownership of the capital instruments of an undertaking.

Proportional consolidation of subsidiaries

The RTS state that where a parent undertaking wishes to consolidate a subsidiary using proportional (rather than full) consolidation in accordance with Trigger 1, it must request permission from the relevant national regulator in written form and must provide supporting documentation. The national regulator has 3 months from the date of receipt of a complete final application and supporting documentation to consider whether to grant such permission. Permission may only be granted where the following conditions are met:

- there is a legally binding contract between the parent undertaking and other shareholders or members of the relevant subsidiary, which together must hold the entirety of the capital of the subsidiary, which limits the liability of the parties on the following basis:
    - the limitation of liability is clearly established in the contract and is defined as a percentage of the total shareholding;
    - the contract clearly states that any potential losses arising from the subsidiary will be borne by the shareholders or members proportionately to the share of capital held by each of them at such point in time;
    - the contract provides that any changes in the share of capital of the shareholders or members are subject to the explicit consent of all shareholders or members;
    - the contract provides that the if the subsidiary is recapitalised, each shareholder or member shall contribute to the recapitalisation in proportion to its current share of the capital of the subsidiary and that the national regulator shall be kept informed of the progress of the recapitalisation; and
    - there are no other agreements in the articles of association or separate memorandum between some or all of the shareholders or members themselves, or between some or all of the shareholders or members and any third party, that could override any of the above conditions;
- if there are any changes in the contract limiting the liability of the shareholders or members which would affect any of the above conditions, the parent undertaking must inform the national regulator at least three months in advance so that the national regulator may decide whether full consolidation may now be required;
- in its application for proportional consolidation, the parent undertaking demonstrates to the satisfaction of the national regulator that the other shareholders or members of the subsidiary have satisfactory solvency at individual and consolidated levels and can reasonably be expected to maintain that solvency; and
- the other shareholders or members are financial sector entities that are subject to prudential supervision and fulfil the financial soundness criteria under the CRD IV Directive on an ongoing basis.

The EBA notes that the application of proportional consolidation will result in prudential treatment that is different from the accounting treatment in relation to the subsidiary, as subsidiaries will be consolidated for accounting purposes. It also notes that the CRR II text, as proposed by the Commission, would delete the ability of national regulators to permit proportional consolidation of subsidiaries and that if that deletion is adopted, the content of the final RTS will also need to change to remove the corresponding provisions.

Undertakings that are managed on a unified basis or by the same persons

The RTS clarifies which entity should act as the consolidating entity in a situation where there is a group of undertakings that are managed on a unified basis in accordance with a contract or provisions in their constitutional documents, or are under single management otherwise than pursuant to a contract or provisions in their constitutional documents (Triggers 2 and 6 above). This is determined on the following basis:

- if there is only one authorised EU institution within the relevant group of undertakings, that institution will be the consolidating entity;
- if there are institutions established in one or more EU Member States within the relevant group, the consolidating entity is the institution which has the largest balance sheet total, based on the latest audited

consolidated financial statements or, if audited consolidated statements are not required, based on the latest audited individual financial statements; and

- national regulators may agree to waive the above balance sheet test if it is considered inappropriate and may designate another institution as consolidating entity, but prior to taking any such decision, must give the institution with the largest balance sheet total an opportunity to state its opinion on the decision.

The institution that is identified as the consolidating entity will need to comply with the consolidated financial and consolidated reporting requirements and will be considered to be the parent institution for the purposes of the CRR rules.

Method of prudential consolidation for undertakings managed on a unified basis or with the majority of the same persons in office during the financial year

Where undertakings are managed on a unified basis in accordance with a contract or provisions in their constitutional documents or are managed in major part by the same persons in office during the financial year (Trigger 2 above), the RTS clarifies that they must prepare consolidated financial statements in accordance with the aggregation method specified in the EU Accounting Directive. The EBA's consultation paper provides further details on how this aggregation method should apply in practice.

The EBA's narrative discussion to the RTS gives examples of when entities might be considered to be managed on a unified basis, which include where the undertakings:

- are managed as a single unit;
- share a single interest; or
- are fully owned, controlled and/or managed by the same natural person(s).

Entities could be managed in major part by the same persons in office during the financial year if, for example, the persons in office have executive functions which give them the ability to control and manage the affairs of those undertakings (e.g. by virtue of being directors or members of the Board).

Proportional consolidation of undertakings with limited liability

The RTS clarifies that proportional consolidation will be permitted under Trigger 3 above – i.e. where the firm holds a share of capital in another undertaking which is not consolidated and the firm's liability is limited to the share of capital held – if all of the following conditions are met:

- the voting rights and decision making process in the relevant undertaking (**X**) are based on a contractual arrangement with other undertakings that hold shares in A (**participating undertakings**);
- the firm manages X together with one or more of the participating undertakings sharing the control;
- decisions related to the relevant activities of X require the unanimous consent of the parties sharing control; and
- a legally enforceable contract establishes that the liability of the participating undertakings is limited to the share of the capital each party holds in the undertaking.

If these conditions are all satisfied, the firm must carry out a proportional consolidation of X in accordance with the rules for proportional consolidation contained in the EU Accounting Directive.

The EBA's narrative clarifies that the above conditions are based on the joint arrangements provisions in the IFRS 11 accounting standards, but that the resulting prudential treatment may diverge from the accounting treatment. This is because IFRS 11 requires the use of the equity method in certain situations, rather than the proportional consolidation envisaged by the CRR and the RTS.

Consolidation in the case of other participations or capital ties

For situations falling within Trigger 4 – i.e. where a firm holds participations or capital ties other than in subsidiaries or undertakings where its liability is limited to the share of capital held - the RTS confirm that it is for the national regulator to determine the consolidation method to be used on a case-by-case basis, but that it should take into account a number of different elements contained in the RTS.

The provisions setting out the relevant considerations are complex and we have not set these out in detail here. In short, the RTS provides that the equity method may generally be applied if the national regulator is satisfied that the relevant undertaking in which the firm holds the participation or capital ties does not need to be included in consolidated supervision. However, the regulator may require proportional consolidation in some situations (for example, where the undertaking is owned by several institutions that act jointly without unanimous consent as regards the management and operation of the undertaking, but with an agreement between shareholders to support it jointly, and there is strong evidence that the institutions will support the undertaking in proportion to their investments) or even full consolidation (for example, where the regulator considers that the firm is exposed in substance to the majority of the risks and/or benefits arising from the activities of the undertaking).

Consolidation where there is significant influence

For the purposes of Trigger 5 above – i.e. where the firm has significant influence over an institution or financial institution without having a participation or capital ties – the RTS state that significant influence may be demonstrated by (but is not limited to) direct or indirect evidence of one or more of the following:

- having a representative or being able to appoint a representative to the management or supervisory body of the undertaking;
- participation in policy-making processes, including participation in decisions about dividends and other distributions;
- the existence of material transactions with the undertaking;
- the interchange of managerial personnel;
- provision of essential technical information or critical services; and/or
- the enjoyment of additional rights in the undertaking, by virtue of a contract or of a provision contained in its constitutional documents, that could affect the management or decision making of the undertaking.

Therefore, in forming their opinion of whether significant influence exists, national regulators should take into account at least the above factors.

In addition, the RTS states that where the firm holds share warrants, share call options, debt instruments convertible into ordinary shares or similar instruments that are currently exercisable or convertible and which, if exercised or converted, could potentially give the firm voting power (or reduce another party's voting power) over the financial and operating policies of the undertaking, these should also be considered when assessing whether there is significant influence.

If significant influence is deemed to exist, the national regulator must assess any risks that the undertaking over which the influence is exerted may pose to the relevant firm and the potential impact on the solvency of the group, based on a range of factors set out in the RTS. If necessary, the regulator may require full consolidation of the undertaking where, as a consequence of the resulting organisational and financial relationship, the firm is exposed in substance to the majority of the risks and/or benefits arising from the undertaking's activities. Since there are no participations or capital ties in this situation, the EBA's narrative confirms that proportional consolidation is not available.

Consolidation where undertakings are placed under single management

For the purposes of Trigger 6 – i.e. where two or more institutions or financial institutions are placed under single management otherwise than pursuant to a contract or constitutional provisions – the RTS states that national regulators should take into account the following indicators:

- whether two or more institutions or financial institutions are controlled by the same natural person(s); or the same entity or group of entities not included within the scope of regulatory consolidation; or by the same entity or group of entities that are not established in an EU Member State; and
- where the majority of the management body of two or more institutions or financial institutions is composed of people appointed by the same entity or entities or the same natural person(s), even if the management bodies do not necessarily consist of the same people.

In all cases, the conclusion that two or more undertakings have been placed under single management must be based on a case-by-case assessment by the national regulator, which must consider whether, in practice, there is effective coordination of the financial and operating policies of those undertakings.

Where two or more institutions or financial institutions are placed under single management, the consolidating entity should be determined in accordance with the same rules for consolidation of undertakings managed on a unified basis (see above). Similarly, the applicable consolidation method should be the aggregation method as set out in the EU Accounting Directive.

Eligible own funds attributable to persons other than the undertakings included in the scope of prudential consolidation

The RTS also sets out rules relating to the inclusion of own funds instruments issued by undertakings, and share premium accounts, retained earnings and other relevant reserves attributable to such undertakings, when:

- the aggregation method of consolidation in the EU Accounting Directive is applied;
- two or more institutions are placed under unified or single management; or
- proportional consolidation is applied.

The narrative explanation in the consultation paper sets out a number of examples with diagrams showing the extent to which the own funds of the various undertakings may be recognised for the purposes of the consolidation requirements in each case.

EBA OBSERVATIONS ON THE DEFINITION OF A "FINANCIAL INSTITUTION"

The EBA has also noted that it is not within its legislative mandate to provide further clarification on the definition of a "financial institution", which is key to determining which entities can be subject to certain forms of consolidation. It has suggested, however, that this issue may need to be explored in further detail in the future because consolidation requirements could be circumvented if certain entities are excluded from being financial institutions. The EBA gives as potential examples asset management companies created to manage repossessed real estate assets, or special purpose entities issuing capital or funding instruments to the market. It also notes that there is a variety of practices across EU Member States about whether securitisation special purpose entities should be treated as financial institutions or not and should be included within the scope of prudential consolidation. One of the questions in the consultation specifically asks whether such entities should be treated as financial institutions and whether firms currently consolidate these for prudential purposes.

Given that any introduction of rules that specifically address the consolidation treatment of securitisation vehicles has the potential to have a very significant impact on securitisation activities, firms may wish to respond to the consultation on this point and should monitor for any further developments in this area.

NEXT STEPS

After the EBA's consultation closes on **9 February 2018**, it will analyse the relevant feedback and produce final draft RTS which will be submitted to the European Commission for endorsement. Provided that the Commission endorses the resulting RTS, they will take effect 20 days after they are published in the EU Official Journal.

16. MLD 5: POLITICAL AGREEMENT

On 20 December 2017, the Council of the EU announced that its Permanent Representatives Committee (COREPER) has confirmed the political agreement it has reached with the European Parliament on the Directive that will amend the Fourth Money Laundering Directive (**MLD 4**), known as the Fifth Money Laundering Directive (**MLD 5**).

Once both the Council and the European Parliament have formally adopted MLD 5, it will enter into force 20 days after its publication in the Official Journal. Member States will have **18 months** from that date in which to transpose the majority of the Directive's provisions (a few provisions are expressed as having different transposition deadlines). Assuming, therefore, that the final text is published in the Official Journal during Q1 2018, this would mean that these provisions will apply **from early-to-mid Q3 2019**.

HEADLINES: THE CHANGES LIKELY TO BE OF MOST RELEVANT TO FIRMS

Although the details will be dependent on precisely how the UK chooses to implement MLD 5 (against the backdrop of Brexit), the Directive is likely to require firms to review and update their AML/CFT policies and procedures and particularly in the following ways:

- to include a longer list of mandatory EDD measures that the firm *must* carry out in relation to a business relationship or transaction involving high risk third countries – by the time that MLD 5 becomes effective, it is likely that the European Commission will have adopted a different methodology for listing third countries based more specifically on their financial importance to the EU and their exposure to the risks of money laundering and terrorist financing, with the possibility that the black list itself may be longer than it is now;

- to set out additional circumstances in which the firm must refresh CDD measures in relation to their existing customers to include where the firm has a *legal duty* to contact the customer for the purpose of reviewing relevant information relating to the customer's beneficial owner(s) under tax or other legislation;
- to take account of changes to the types of person who might constitute a PEP, based on a list of prominent public functions issued by the UK FCA and/or by the European Commission (as applicable);
- to include an internal and external procedure for making a report in the event that a discrepancy is found between the information on the central register and the information that is available to the firm in relation to beneficial ownership;
- to take account of changes requiring a wider range of trusts to be registered on the central register and the fact that obliged entities will be allowed access in order to carry out CDD.

These, and other changes, are discussed in further detail below.

SUMMARY DETAILS OF MLD 5 CHANGES

Changes that will be introduced by MLD 5 include the following:

- *Additional obliged entities*: the list of obliged entities will be extended to catch:
  - In addition to auditors, external accountants and tax advisors (who are already caught), any other person that undertakes to provide, directly or by means of other persons to which it is related, material aid, assistance or advice on tax matters as its principal business or professional activity;
  - Estate agents (who are already caught) including when they are acting as intermediaries in the letting of immovable property, but only in relation to transactions for which the monthly rent is equivalent to or exceeds €10,000;
  - Providers engaged in exchange services between virtual currencies and fiat currencies – a virtual currency is a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency, and does not possess a legal status of currency or money, but is accepted by natural or legal persons, as a means of exchange, and which can be transferred, stored and traded electronically;
  - Custodian wallet providers (i.e. entities that provide services to safeguard private cryptographic keys on behalf of their customers, to hold, store and transfer virtual currencies);
  - Persons trading or acting as intermediaries in the trade of works of art, including when this is carried out by art galleries and auction houses, where the value of the transaction or a series of linked transactions amounts to €10,000 or more;
  - Persons storing, trading or acting as intermediaries in the trade of works of art when this is carried out by freeports, where the value of the transaction or a series of linked transactions amounts *to* €10,000 or more;
- *Prohibition on anonymous safe deposit boxes*: Article 10, MLD 4 currently provides that Member States must prohibit credit institutions and financial institutions from keeping anonymous accounts or anonymous passbooks – MLD 5 extends this to cover anonymous *safe deposit* boxes;

- *Payment instrument derogation – limit reduced:* currently, obliged entities may disapply certain CDD measures with respect to a payment instrument if it is not reloadable, or has a maximum monthly payment transactions limit of €250 and where the maximum amount stored electronically does not exceed €250 – under MLD 5, in an attempt to make it harder to use payment instruments in the context of terrorism, those limits will be reduced to €150. In addition, Member States will no longer have the discretion to increase the maximum limit to €500 and must ensure that the derogation does not apply to any redemption in cash or cash withdrawal of the monetary value where the amount exceeds €50 or, in the case of remote payment transactions, the amount exceeds €50 per transaction;

- *Anonymous prepaid cards issued in third countries*: to complement the previous points, Member States will be required to ensure that credit institutions and financial institutions acting as acquirers only accept payments carried out with anonymous prepaid cards issued in third countries where such cards meet the derogation criteria set out in the previous point (this provision must be transposed within 6 months of the deadline for transposition of MLD 5 generally). Member States are given discretion to prohibit the acceptance *any* payments made by such anonymous cards.

- *Verification:* there will be clarification that verifying a customer's identity on the basis of documents, data or information obtained from a reliable and independent source, can include, where available, electronic identification means, relevant trust services (as defined in Regulation (EU) No 910/2014 on electronic identification and trust services for electronic transactions) or any other secure, remote or electronic identification process regulated, recognised, approved or accepted by the relevant national authorities. In addition, where an identified beneficial owner is a senior managing official, MLD 5 expressly provides that a firm must take the necessary reasonable measures to verify the identity of the natural person who holds that position and to keep records of the actions taken, and any difficulties encountered;

- *Beneficial owner of corporate entity:* MLD 4 provides that, provided there are no grounds for suspicion and where a firm has exhausted all possible means and has *not* identified a beneficial owner or where there is any doubt as to whether the person(s) that the firm *has* identified are in fact the beneficial owner(s), firms may instead treat the natural person(s) who hold the position of senior managing official(s) as the beneficial owner(s). While this may have been implicit, MLD 5 will add an express obligation requiring the firm to take the necessary reasonable measures to *verify the identity* of such a senior managing official.

- *Re-application of CDD measures*: in addition to the existing obligation to re-apply CDD measures to existing customers on a risk-sensitive basis or when the relevant circumstances of the customer change, firms will also have carry out their CDD again whenever they have a legal duty to contact the customer for the purpose of reviewing any relevant information relating to the beneficial owner(s) of the customer, or if they have had this duty under Directive 2011/16/EU (the Directive on administrative co-operation in field of taxation);

- *High-risk third countries – mandatory EDD:* MLD 5 specifies the enhanced due diligence measures which must be carried out in relation to business relationships or transactions involving high risk third countries:

  - obtaining additional information on the *customer* and on the *beneficial owner(s)*;

  - obtaining additional information on the *intended nature of the business relationship;*

  - obtaining information on the *source of funds* and *source of wealth* of the customer and of the beneficial owner(s);

  - obtaining information on the *reasons* for the intended or performed transactions;

- *obtaining the approval of senior management* for establishing or continuing the business relationship;
- conducting *enhanced monitoring* of the business relationship by increasing the number and timing of controls applied, and selecting patterns of transactions that need further examination;

- *High-risk third countries – additional EDD – Member State discretion*: Member States may require obliged entities to ensure that the first payment is carried out through an account in the customer's name with a credit institution subject to CDD standards that are "not less robust" than those laid out in MLD 5;
- *High*-risk *third countries – additional mitigating measures*: firms will be required to apply, where applicable, one or several additional mitigating measures to persons and legal entities from high risk third countries as follows:
  - applying additional elements of due diligence;
  - introducing enhanced relevant reporting mechanisms or systematic reporting of financial transactions;
  - limiting business relationships or financial transactions with natural persons or legal entities from the identified high risk third country
- *High-risk third countries – Member State prohibitions, refusals and requirements*: In addition to the above, Member States are required to apply, "where applicable" and "in compliance with international obligations of the Union" (and taking into account, as appropriate, relevant evaluations, assessments or reports drawn up by international organisations and standard setters with competence in the AML/CTF field), one or several of the following measures with regard to high risk third countries:
  - *refusing the establishment of subsidiaries* or *branches* or representative offices of financial institutions from the country concerned (or otherwise taking into account the fact that the relevant country is from a country that does not have adequate AML/CFT systems);
  - *prohibiting obliged entities* from establishing branches or representative offices in the blacklisted country (or otherwise taking account of the fact that the relevant branch or representative office would be in a country that does not have adequate AML/CFT systems);
  - requiring financial institutions to review and amend, or if necessary terminate, *correspondent relationships* with financial institutions in the country concerned;
  - requiring *increased supervising examination* or *external audit requirements* for branches or subsidiaries of financial institutions based in the high risk third country;
  - requiring increased *external audit requirements* for financial groups with respect to any of their branches and subsidiaries located in the high risk third country.

  Member States must notify the Commission before enacting or applying the measures outlined above.
- *Domestic and international PEPs:* each Member State will be required to issue and keep up to date its own list indicating the exact functions which, according to its national laws, regulations and administrative provisions, qualify as prominent public functions for the purposes of the definition of "politically exposed person". Similarly, a Member State will be required to request any international organisation accredited by that state to issue and keep up to date a list of prominent public functions at that organisation.

- *EU institution PEPs:* the European Commission will be required to compile and keep up to date its list of the exact functions which qualify as prominent public functions at the level of EU institutions and bodies (including any function which may be entrusted to representatives of third countries and international bodies accredited at EU level).

- *Beneficial ownership information:* article 30 of MLD 4 will be amended to provide that:

  - breaches of the requirement for corporate and other entities to obtain and hold adequate, accurate and current information on their beneficial ownership are subject to effective, proportionate and dissuasive measures or sanctions;

  - the beneficial owners themselves are subject to an obligation to provide the relevant corporate or other entity with all the information the latter needs to comply with its obligations;

  - Member States shall require that the information held in the central register of beneficial ownership is adequate, accurate and current and shall put in place mechanisms to achieve this including by imposing a positive reporting obligation on obliged entities and competent authorities to report any discrepancies they find between the information on the central register and the information that is available to them;

  - Member States must require the information held in the central trust register of beneficial ownership is adequate, accurate and current – obliged entities will be subject to a positive obligation to report any discrepancies they find between the information on the central register and the information that is available to them;

  - any member of the general public must be able to access to information on the central register relating at least to the name, the month and year of birth and the country of residence and nationality of the beneficial owner, and the nature and extent of the beneficial interest held (with the right of Member States to also provide for access to the *date* of birth or *contact details* in accordance with data protection rules);

  - Member States will have the option to make the information held in their national registers available on the condition of an online registration and the payment of an administrative fee;

  - Member States may provide for an exemption from any access sought by an obliged entity *or member of the general public* if such access would expose the beneficial owner to *disproportionate risk*, risk of fraud, kidnapping, blackmail, *extortion*, *harassment*, violence or intimidation, or where the beneficial owner is a minor or otherwise incapable (the references to disproportionate risk, extortion and harassment being new);

- *Trusts and beneficial ownership:*

  - MLD 4 currently requires the trustees of an *express* trust to obtain and hold adequate, up-to-date and accurate information on the beneficial ownership of the trust, which must be available to competent authorities and financial intelligence units and must be disclosed to obliged entities when the trustee forms a business relationship or carries out an "above threshold" occasional transaction;

  - MLD 5 widens this to apply to trusts and other types of legal arrangements such as *fiducie*, certain types of *Treuhand* or *fideicomiso* when having a structure or function similar to trusts;

- The information to be maintained by the trustee must include (as now) the identity of the settlor(s), the trustee(s), the protector(s)(if any), the beneficiaries or class of beneficiaries and any other natural person exercising ultimate control of the trust;

- MLD 4 currently provides that "where the trust generates tax consequences", beneficial ownership information in relation to the trust must also be held in the central register. MLD 5:

  - removes the reference to the generation of tax consequences;

  - requires that the beneficial ownership of any express trust and any other type of legal arrangement which has a structure or function similar to a trust must be held in a central beneficial ownership register set up by the Member State where the trustee of the trust or similar legal arrangement is established or resides or, where that establishment or residence is outside the EU, by the Member State where the trustee enters into a business relationship or acquires real estate in the name of the trust or similar legal arrangement;

- As now, information must be accessible to competent authorities (e.g. AML/CTF public authorities, tax authorities, investigators, supervisors of obliged entities, prosecuting authorities) and FIUs and to obliged entities in order to carry out CDD. Under MLD 5, information must also be available to any person or organisation that can demonstrate a *legitimate interest* or *any person* that files a written request in relation to a trust or similar legal arrangement where that trust/arrangement holds or owns a controlling interest in any corporate or other legal entity (other than one which is subject to the beneficial ownership provisions of article 30) – the information in this regard must relate at least to the name, the month and year of birth and the country of residence and nationality of the beneficial owner, and the nature and extent of the beneficial interest held (with the right of Member States to also provide for access to the *date* of birth or *contact details* in accordance with data protection rules – and even wider access, in accordance with their national law);

- Member States will have the option to make the information held in their national registers available on the condition of an online registration and the payment of an administrative fee;

- Member States may provide for an exemption from any access sought by an obliged entity, person or organisation demonstrating a legitimate interest or a person filing a written request in relation to a trust holding or owning a controlling interest in any corporate or legal entity if such access would expose the beneficial owner to disproportionate risk, risk of fraud, kidnapping, blackmail, extortion, harassment, violence or intimidation, or where the beneficial owner is a minor or otherwise incapable;

- Member States must require the information held in the central trust register of beneficial ownership is adequate, accurate and current – obliged entities will be subject to a positive obligation to report any discrepancies they find between the information on the central register and the information that is available to them.

As stated above Member States will have **18 months** from the publication of MLD 5 in the Official Journal in which to transpose the majority of the Directive's provisions (a few provisions are expressed as having different transposition deadlines). This would mean that these provisions are likely to apply **from early-to-mid Q3 2019** (i.e. very close to the Brexit date). It remains to be seen how, and to what extent, the UK will implement the requirements of MLD 5 into national law.

17. EMIR: A ROUND UP

EMIR: VARIATION MARGINING ON PHYSICALLY-SETTLED FX FORWARDS – COUNTERPARTIES OTHER THAN CREDIT INSTITUTIONS AND INVESTMENT FIRMS

Commission Delegated Regulation (EU) 2016/2251, the delegated act under the European Market Infrastructure Regulation (EMIR) setting out Regulatory Technical Standards relating to margining requirements for non-centrally cleared OTC derivatives (the **Margin RTS**), came into force on 4 January 2017.

In accordance with the Delegated Act, there is and has been phased implementation. The phased implementation of *initial* margin requirements was explained our briefing of November 2016.

Broadly, the *variation* margining requirements came into effect on the following dates:

- 4 February 2017: transactions where both counterparties have, or belong to groups each of which has, an outstanding average notional amount of non-centrally cleared derivatives above EUR 3 trillion;
- 1 March 2017: all other transactions entered into by in-scope counterparties, subject to the one deferral mentioned below.

The delegated act provided that, for physically settled FX forwards, the variation margin requirements were deferred. However, that deferral was only applicable until 3 January 2018 (which is when a common, EU-wide definition for physically-settled FX forwards was introduced under a delegated act under MiFID II). On the face of the in-force legislation, therefore, the requirement to exchange variation margin in relation to physically settled FX forwards applies to *all* in-scope counterparties and transactions.

Since the finalisation of the Margin RTS industry participants had been lobbying the EU regulators heavily, arguing that the EU approach was wider than in some other global jurisdictions (notably the US) and that some counterparties, particularly small ones, would have difficulty in exchanging variation margin for physically settled FX forwards.

On 15 November 2017, the Council of the European Union proposed by way of a Presidency compromise text an amendment to EMIR. While not primarily driven by the variation margin issue, it did include a short paragraph proposing an amendment to Article 11 EMIR. This provides that "physically settled foreign exchange forwards shall not be subject to initial margin exchanges and shall only be subject to exchange of variation margins for transactions concluded between credit institutions authorised in accordance with Directive 2006/48/EC". The reference to the Banking Consolidation Directive, which has now been replaced by CRD IV, is presumably a mistake. On the face of the proposed amendment, investment firms would not be subject to the requirement to exchange variation margin in respect of physically settled foreign exchange forwards.

Shortly after the appearance of the Council text, the European Supervisory Authorities issued a statement on 24 November 2017 in which they noted that:

- some counterparties (particularly certain end-users) faced challenges in exchanging variation margining for physically-settled FX forwards;
- the requirement to exchange variation margin for such products is part of a globally-agreed framework and that those international standards state, amongst other things, that the variation margining of physically-settled FX forwards is an established practice among *significant market participants;*

- the international standards have been implemented around the world through national regulation or supervisory guidance;
- in the context of EMIR, the standards were implemented by way of directly-applicable regulation applicable to *all* counterparties and transactions within the scope of EMIR;
- however, it had become apparent that other jurisdictions had implemented the international standards in a narrower way than was provided for in the RTS.

In the light of this, the ESAs confirmed that they were in the process of reviewing, and proposing amendments to, the RTS - the changes would look to align the treatment of physically settled FX forwards with the supervisory guidance applicable in other jurisdictions, broadly by not mandating the exchange of variation margin in relation to transactions where one of the counterparties is not an institution (i.e. is neither a credit institution *nor an investment firm*). The proposed amendments would have to be submitted to the European Commission within one month.

Pending finalisation of the amendments to the RTS, and "as regards difficulties that in particular end-users are facing", the ESAs stated that competent authorities should generally apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation in a proportionate manner.

In the light of the ESAs' statement, the FCA issued its own statement on 7 December 2017 in which it confirmed that it will take a proportionate approach to enforcing variation margin requirements on physically settled foreign exchange forwards when the new rules take effect on 3 January 2018. The FCA confirmed that it will not require firms whose physically settled FX forwards are likely to be outside the scope of the amended requirements to continue putting processes in place to exchange variation margin (subject to any further statements from the ESAs or the FCA).

On 18 December 2017, the ESAs published their final report on amending the RTS to give effect to the changes they proposed in relation to the scope of the variation margin requirements in the context of physically settled FX forwards. A draft delegated regulation was attached which includes a new provision the effect of which is to limit the mandatory requirement to collect variation margin physically settled FX forwards to only transactions concluded between "institutions" as defined in the CRR - i.e. credit institutions and investment firms or with an equivalent entity located in a third country that would meet the definition of "institution" if it were located in the EU.

This proposed amendment is now subject to the legislative process and will take effect shortly. It was never likely that the legislative process was going to be rushed through quickly enough to be in force on or before the lapsing of the deferral on 3 January 2018. However, in the light of the ESAs' statement on 24 November 2017, the FCA's statement on 7 December and the clear intent signalled in the draft amending RTS firms can be confident in disapplying the requirement to exchange variation margin where the counterparty is neither an EU credit institution or investment firm, nor a non-EU equivalent of such a firm. Obviously, the requirement to exchange variation margin as between institutions (credit institutions and investment firms) is now in force.

It remains to be seen whether the RTS amendment (once adopted by the Commission and published in the Official Journal) is intended to operate merely as an interim "quick fix" provision pending a more long-term amendment to EMIR itself (such as the one included in the Council's proposed compromise text). In any event, it is unlikely that the Council intended to relieve all investment firms from the requirement to exchange variation margin in respect of physically settled foreign exchange forwards (as the text published on 15 November 2017 appears to provide) or, if it did, whether such a proposal would be acceptable to the European Parliament.

EMIR: CLEARING OF OTC DERIVATIVES – A REMINDER

A number of classes of OTC derivatives have so far been declared subject to the EMIR clearing obligation, subject to phased introduction depending on counterparty categorisation.

Counterparty categorisation

By way of reminder, the counterparty categorisation for the purposes of the phased implementation of mandatory clearing is as follows:

Counterparty category	Entities covered by category
Category 1	Clearing members of any CCP authorised or recognised to clear the relevant classes of derivatives
Category 2	Counterparties not in Category 1 which are financial counterparties (which include AIFs managed by an authorised or registered AIFM) or AIFs that are NFC+s, in each case with an aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives for January, February and March 2016 of **above EUR 8 billion**
Category 3	Counterparties not in Category 1 or 2 which are financial counterparties (which include AIFs managed by an authorised or registered AIFM) or AIFs that are NFC+s, in each case with an aggregate month-end average of outstanding gross notional amount of non-centrally cleared derivatives for January, February and March 2016 of **EUR 8 billion or less**
Category 4	Any other counterparty classified as an NFC+ which is not in Categories 1 - 3 above

An NFC+ is a non-financial counterparty which is subject to the clearing obligation because its positions in OTC derivative contracts exceed prescribed clearing thresholds.

Note that the calculation of the aggregate month-end average of outstanding gross notional amount for the purposes of determining whether the EUR 8 billion threshold has been passed and therefore whether the firm is Category 2 or Category 3 must be done in relation to all non-centrally cleared derivatives, including foreign exchange forwards, swaps and currency swaps on *a group basis*. However, there is an exception for AIFs and UCITS: here the EUR 8 billion threshold applies *at the fund level*.

The phased-in clearing obligation

The categorisation of the counterparty is important in determining when the phased-in clearing obligation applies to it in respect of those OTC derivatives that have so far been declared subject that obligation. The table below summarises the current state of play – deadlines which are still yet to come in are emboldened.

OTC Derivative	Category 1	Category 2	Category 3	Category 4
Interest rate derivatives – G4 currencies (EUR, GBP, USD & JPY) – 4 basis swaps classes, 4 fixed-to-float interest rate swaps classes, 3 forward rate agreement classes, overnight index swaps classes - see Commission Delegated Regulation (EU) 2015/2205	21 June 2016	21 Dec 2016	**21 June 2019***	**21 Dec 2018**
Interest rate derivatives – non-G4 currencies (SEK, PLN and NOK) – fixed-to-float interest rates swaps and forward rate agreements – see Commission Delegated Regulation (EU) 2016/1178	9 Feb 2017	9 July 2017	**21 June 2019***	**9 July 2019**
Credit default derivative contracts – untranched iTraxx Index credit default swaps (Europe Main, 5-year tenor, series 17 onwards), with EUR as the settlement currency) and untranched iTraxx credit default swaps (Europe crossover, 5-year tenor, series 17 onwards, with EUR as the settlement currency)	9 Feb 2017	9 August 2017	**21 June 2019***	**9 May 2019**

The above table (i) does not indicate the specific parameters of each of the classes and (ii) does not include the frontloading obligation date that applies to Category 1 and Category 2 counterparties (FCs)

In the above table, the asterisked date specified for the start of the clearing obligation for Category 3 counterparties reflects a deferral in the original deadline in each case: this was effected by Delegated Regulation (EU) 2017/751. The relevant start date for UCITS and their management companies and for AIFs will therefore depend on the level of non-centrally cleared OTC derivatives trading undertaken, averaged over three month ends (January, February and March 2016) and therefore whether they are Category 2 or Category 3 counterparties. Only those UCITS/AIFs whose aggregated month-end average gross notional amount of all non-centrally cleared derivatives transactions is EUR 8 billion or below (calculated at the level of the fund) will have been able to benefit from the deferral of the phase-in date.

Interrelationship with the MiFID derivatives trading obligation

Article 28 of the Markets in Financial Instruments Directive (MiFIR) requires that financial counterparties and NFC+s (as determined in accordance with Article 10 of EMIR and relevant RTS) must, in relation to OTC transactions in derivatives that have been declared subject to the trading obligation by ESMA, conclude them on a regulated market, MTF or OTF (or on a third country trading venue that has been declared equivalent by the Commission). Only classes (or sub-classes) of a derivative that have previously been declared subject to the clearing obligation under EMIR are eligible for being declared subject to the trading obligation under MiFIR.

On 28 September 2017, ESMA published a final version of the regulatory technical standards defining the initial scope of the derivatives trading obligation under MiFIR and sent the draft to the European Commission

for its endorsement – the declared classes were specified types of fixed-to-float interest rate swaps (denominated in EUR, USD and GBP) and index CDS. The Commission subsequently endorsed those RTS and published a final version on 16 November 2017 (C(2017) 7684 final and annex) with the European Parliament issuing a notice of early non-objection on 12 December 2017. Assuming that no objection is received from the Council, the binding RTS should be published in the near future.

Under the RTS, the trading obligation, in respect of those declared classes, will take effect from **the later of** the following dates:

- 3 January 2018 (being the date on which MiFIR comes into force); and
- the relevant date that the firm becomes subject to the EMIR clearing obligation for **those derivatives** (which, as seen above, will depend on the EMIR counterparty category that applies to that firm).

The dates for the introduction of the MiFIR trading obligation in relation to the declared classes of derivative are summarised in the following table:

OTC Derivative	Category 1	Category 2	Category 3	Category 4
Fixed-to-float single currency interest rate swaps – EUR EURIBOR 3 and 6M	3 Jan 2018	3 Jan 2018	**21 June 2019**	**21 Dec 2018**
Fixed-to-float single currency interest rate swaps – USD LIBOR 3M	3 Jan 2018	3 Jan 2018	**21 June 2019**	**21 Dec 2018**
Fixed-to-float single currency interest rate swaps – USD LIBOR 6M	3 Jan 2018	3 Jan 2018	**21 June 2019**	**21 Dec 2018**
Fixed-to-float single currency interest rate swaps – GPB LIBOR 3 and 6M	3 Jan 2018	3 Jan 2018	**21 June 2019**	**21 Dec 2018**
Untranched index CDS – iTraxx Europe Main – EUR 5Y tenor	3 Jan 2018	3 Jan 2018	**21 June 2019**	**9 May 2019**
Untranched index CDS – iTraxx Europe Crossover – EUR 5Y tenor	3 Jan 2018	3 Jan 2018	**21 June 2019**	**9 May 2019**

As with the clearing obligation, the relevant trading obligation start date for UCITS and their management companies and for AIFs will depend on the level of non-centrally cleared OTC derivatives trading undertaken, averaged over three month ends (January, February and March 2016) and therefore whether they are Category 2 or Category 3 counterparties. Only those UCITS/AIFs whose aggregated month-end average gross notional amount of all non-centrally cleared derivatives transactions is EUR 8 billion or below (calculated at the level of the fund) will be able to benefit from the delayed phase-in date of 21 June 2019 in respect of the declared classes. All other UCITS and AIFs will already be subject to the trading obligation in respect of the declared classes.

EMIR: AMENDMENTS PROPOSED BY THE EUROPEAN COMMISSION

On 4 May 2017, the European Commission published a proposal for a regulation to amend EMIR. We published a briefing at the time which looked at the above proposals in some detail. However, in brief, the proposal (which is now subject to ongoing negotiations with the Council and the European Parliament) included the following key elements:

- an amendment to the definition of a "financial counterparty" so that the category will include:
  - any AIF as defined in AIFMD (i.e. not just AIFs managed by authorised or registered AIFMs)
  - a central depository as defined in the Central Securities Depositaries Regulation (**CSDR**)
  - a securitisation special purpose entity as defined under the CRR;
- a change to the scope of the clearing obligation as it applies to financial counterparties that will subdivide the category of financial counterparties into two separate categories, comprising:
  - financial counterparties whose annual aggregate month-end average positions (including intra-group OTC derivative contracts) for the months of March, April and May exceed the specified clearing thresholds (which will be subject to the clearing obligation as regards all specified classes of OTC derivatives);
  - financial counterparties in relation to which those month-end average positions (including intra-group OTC derivative contracts) do not exceed the relevant clearing threshold (small financial counterparties) (which will not be subject to the clearing obligation);
- a revised scope of the clearing obligation for non-financial counterparties so that:
  - NFCs would also need to calculate their annual aggregate month-end average position for the months of March, April and May (excluding OTC derivative contracts entered into by it or other NFC group entities which are objectively measureable as reducing risks directly relating to the commercial activity or treasury financing activity of the NFC or its group);
  - If these positions exceed one of more of the relevant clearing thresholds the firm will be classified as an NFC+ and will be subject to the clearing obligation in respect of the relevant class of OTC derivative contract;
- an extension of the clearing derogation for pension scheme arrangements for a further 3 years following the entry into force of the amending legislation (together with a provision enabling the Commission to extend the exemption by another two years beyond that);
- the removal of the frontloading obligation;
- the imposition of a requirement on clearing members and any of their clients who provide indirect clearing services to ensure that such services are provided under fair, reasonable and non-discriminatory terms, together with the power on the part of the Commission to draft RTS specifying in further detail what "fair, reasonable and non-discriminatory commercial terms" means in this context;
- amendments to the reporting obligation provisions so that:

- CCPs will be required to report on behalf of both counterparties to any *exchange-traded* derivative contract;
- FCs will be required to report on behalf of both counterparties where the counterparty to an *OTC* derivative contract is an NFC-;
- UCITS management companies will be responsible for reporting the details of all OTC derivative contracts to which the UCITS is a counterparty;
- the manager of an AIF will be responsible for reporting the details of all OTC derivative contracts to which that AIF is a counterparty;
- any intra-group derivative contract in respect of which one of the counterparties is an NFC will be exempt from the reporting requirements

The proposal is currently proceeding through the EU legislative process and so there will be changes before the amendments are finally agreed. On 28 September 2017, the Council of the EU issued its first Presidency compromise text proposal on the Commission proposal. A second compromise proposal was issued on 15 November 2017. Final agreement may not be reached until later in 2018 and the changes may not come into effect until late this year, or early 2019.

18. EU CENTRAL SECURITIES DEPOSITORIES REGULATION

INTRODUCTION

As we have previously reported, the Regulation on improving securities settlement in the European Union and on central depositories (Regulation 909/2014), (the EU Central Securities Depositories Regulation (**CSDR**)), came into force on 17 September 2014, and has been subject to a lengthy (and still ongoing) process of phased, piecemeal implementation over a number of years.

The CSDR is directly-applicable in EU member states, and is subject to a number of Level 2 implementing measures by way of regulatory and technical implementing standards and delegated acts. A number of provisions within national legislation require amending in order to ensure consistency.

The CSDR broadly divides into two parts:

- The first part addresses the process of securities settlement and applies broadly to market operators and so-called "settlement internalisers" (as defined in Article 2(11) CSDR) – the overriding policy aim is to improve settlement efficiency and safety.
- The second part focuses on the regulation of the central securities depositories themselves, imposing among other things specific conduct of business and prudential requirements.

CSDR SECURITIES SETTLEMENT - IMPLEMENTATION STATUS

A brief overview of the implementation status of the securities settlement requirements in CSDR is as follows:

Requirement	In force yet?
Transactions in transferable securities on a trading venue must be recorded in electronic book-entry form in a CSD on or before the intended settlement date, unless they have already been so recorded (Article 3(2))	**YES** – 17 September 2014
Transactions in transferable securities which are executed on trading venues must be subject to a T+2 intended settlement date (subject to certain exceptions) (Article 5(1))	**YES** – 1 January 2015 (although this had been effective in the UK since 6 October 2014)
Settlement discipline: • measures on CSDs to *prevent* settlement fails through the monitoring and facilitation of transactions (Article 6, CSDR); and • measures on CSDs and market participants to *address* settlement fails (Article 7, CSDR)	**NO** – [10 March 2019?*] RTS currently under review by EC *When submitting its final report in February 2016, ESMA had proposed a 2-year phase in after publication in Official Journal – but likely to coincide with the application date of the RTS on cash penalties for settlement fails (see below)?
Issuers established in the EU must immobilise or dematerialise transferable securities admitted to trading or traded on a trading venue (Article 3(1))	**NO** - 1 January 2023 (for new issues issued after that date) **NO** - 1 January 2025 (for all other issues)* *In its Consultation Paper on 8 December 2015 and its Responses Paper of 11 September 2017, HM Treasury suggested that there may be a case for bringing compulsory dematerialisation forward. The options for implementing compulsory dematerialisation are expected to be set out in an awaited Consultation Paper from BEIS.

SETTLEMENT DISCIPLINE MEASURES – ADOPTION OF FINAL RTS STILL AWAITED

As we reported in last year's New Year briefing, the settlement discipline provisions will impact not only on CSDs, but also on trading venues and investment firms.

The requirements under CSDR for trading venues, investment firms and CSDs to establish procedures to *prevent* (Article 6, CSDR), and on CSDs to *address* (Article 7, CSDR) settlement fails (collectively referred to as settlement discipline measures) will come into force in accordance with Level 2 delegated legislation adopted by the Commission.

On 1 February 2016, ESMA published its final report (including draft RTS) setting out its advice on the relevant technical standards in this regard, and proposed that the application date of the RTS should be delayed until **two years after publication of the RTS in the Official Journal**. ESMA's rationale for this two-year

phase-in was because CSDs, CCPs, trading venues and participants of trading venues would all require significant IT system builds in order to accommodate the new settlement discipline requirements. According to ESMA, these draft RTS remain with the European Commission for review. See below as regards the Delegated Regulation on the calculation of cash penalties for settlement fails.

DELEGATED AND IMPLEMENTING ACTS – CSDs AND SETTLEMENT INTERNALISERS

Other than in relation to the technical standards on settlement discipline (see above), all Level 2 implementing measures under CSDR have now been finalised, and they were all published in the Official Journal on 10 March 2017. The application date of the measures differs depending on the precise terms of the legislation (see below). Broadly speaking, these measures are relevant to CSDs and settlement internalisers:

Level 2 Measure	Application date
Commission Delegated Regulation (EU) 2017/389 as regards the parameters for the calculation of cash penalties for settlement fails and the operations of CSDs in host Member States	**10 March 2019** with the following exceptions: • Art 2 (calculation of cash penalties) and Art 3 (reference price of the transaction) – date of entry into force of the settlement discipline RTS • Art 7 (determination of market values) – **3 January 2018** (i.e. to coincide with MiFIR) • Art 8 (transitional provisions) – **30 March 2017**
Commission Delegated Regulation (EU) 2017/390 with regard to regulatory technical standards on certain prudential requirements for central securities depositories and designated credit institutions offering banking-type ancillary services	**30 March 2017** (subject to certain transitional provisions set out in Art 41)
Commission Delegated Regulation (EU) 2017/391 with regard to regulatory technical standards further specifying the content of the reporting on internalised settlements	**30 March 2017**
Commission Delegated Regulation (EU) 2017/392 with regard to regulatory technical standards on authorisation, supervisory and operational requirements for central securities depositories	**30 March 2017** (with the exception of Art. 54 (transaction/settlement instruction (flow) records) which shall apply from the date of entry into force of the settlement discipline RTS and subject to certain transitional provisions set out in Art 95)
Commission Implementing Regulation (EU) 2017/393 laying down implementing technical standards with regard to the	**10 March 2019**

Level 2 Measure	Application date
templates and procedures for the reporting and transmission of information on internalised settlements	
Commission Implementing Regulation (EU) 2017/394 laying down implementing technical standards with regard to standard forms, templates and procedures for authorisation, review and evaluation of central securities depositories, for the cooperation between authorities of the home Member State and host Member State, for the consultation of authorities involved in the authorisation to provide banking-type ancillary services, for access involving central securities depositories, and with regard to the format of the records to be maintained by central securities depositories	**30 March 2017** (with the exception of Art. 11(1) (format of records) which shall apply from the date of entry into force of the settlement discipline RTS)

UK CENTRAL SECURITIES DEPOSITORIES REGULATIONS

In order to implement those provisions of the CSDR which came into immediate effect in 2014 and which required an element of national implementation, the UK introduced the Central Securities Depositories Regulations 2014 (S.I. 2014/2879). As an initial measure, these Regulations designated the competent authorities relevant for those provisions of the CSDR active at that time - i.e., broadly, the FCA as the competent authority for the supervision of trading venues, the PRA as the competent authority for the authorisation and supervision of CSDs that are credit institutions and the Bank of England as the competent authority for the authorisation and supervision of other types of CSD and the oversight of securities settlement systems. The relevant bodies were given the requisite powers for the enforcement of CSDR and for the imposition of sanctions.

On 8 December 2015, H.M. Treasury published its consultation on proposed further changes to domestic legislation arising from CSDR. The consultation closed on 4 February 2016. The Treasury has decided to issue its response in two stages. In September 2017, in the first stage, H.M. Treasury published its response to the consultation on The Central Securities Depositories Regulations 2017. The document sets out a summary of the Treasury's responses and the government's decisions in relation to the Central Securities Depositories Regulations 2017 which were subsequently laid before Parliament on 7 November 2017 and came into force on 28 November 2017.

The second stage of H.M. Treasury's response, focusing on the Uncertificated Securities (Amendment) Regulations 2017, will be published "in 2018". These amendment Regulations will ensure that the USRs (the statutory framework underpinning "relevant systems" – i.e. systems that enable title to units of a security to be evidenced and transferred without a written instrument and which facilitate supplementary and incidental matters) remain compatible with the CSDR.

The Treasury consultation did not directly address the requirement in Article 3(1) of CSDR for issuers of transferable securities admitted to trading or traded on trading venues to arrange for those securities to be "represented in book-entry form as immobilisation or subsequent to a direct issuance in dematerialised form". A separate consultation from the Department for Business, Energy and Industrial Strategy (**BEIS**) will address this requirement. However, the Treasury had said, in passing, that "there may be a case for bringing

dematerialisation forward". Subject to the comments of BEIS and the uncertainties of Brexit, the dates set out in CSDR stand: 1 January 2023 (for new issues issued after that date) and 1 January 2025 (for all other issues).

EU Q&A ON CSDR IMPLEMENTATION

The European Commission has published a set of frequently asked questions on the CSDR, covering issues such as timing and scope.

ESMA from time to time publishes updates to its Q&A on CSDR implementation – these were most recently updated on 14 December 2017.

ESMA has also published certain guidelines – for example, guidelines on CSD participant default rules and procedures (ESMA70-151-294) in June 2017.

19. EU SECURITIES FINANCING TRANSACTIONS REGULATION

The EU Securities Financing Transactions Regulation (**SFTR**) has applied from 12 January 2016, although certain requirements under the SFTR have been entering into force in stages.

By way of recap:

- the pre-investment disclosure requirements in relation to the use of securities financing transactions (**SFTs**) by AIFs or UCITS have applied since 12 January 2016, except for any funds constituted prior to that date, in which case the requirements took effect on 13 July 2017;
- the requirements relating to reuse of financial instruments under a collateral arrangement have applied since 13 July 2016; and
- the requirements relating to the reporting of the use of SFTs by AIFs or UCITS in their annual (and for a UCITS, half yearly) reports have applied since 13 January 2017.

The final substantive obligations under the SFTR, which relate to the requirement for counterparties to SFTs to report details of those SFTs to a trade repository, have still not entered into force and are dependent upon the European Commission adopting delegated legislation which provides further detail on the required format and content of reporting.

ESMA provided draft RTS to the Commission setting out the proposed reporting requirements on 30 March 2017 and the Commission technically had until 30 June 2017 to either adopt the draft or reject it. However, to date the Commission does not appear (at least publicly) to have responded to ESMA's proposals and therefore there is no further public indication on when the SFTR reporting regime will enter into effect.

This cannot now occur until 2019 at the earliest, as the SFTR provides that the first set of counterparties to be subjected to the reporting obligation are EU credit institutions and MiFID investment firms (and their third country equivalents) and that this will take effect 12 months after the entry into force of the Commission delegated act containing the reporting RTS.

Firms should continue to monitor for further announcements during 2018 in relation to this issue which may clarify the potential timeline for future reporting.

FOR FURTHER INFORMATION, PLEASE CONTACT

10 Snow Hill
London EC1A 2AL
T: +44 (0)20 7295 3000
F: +44 (0)20 7295 3500
www.traverssmith.com

Tim Lewis
Partner

E: tim.lewis@traverssmith.com
T: +44 (0)20 7295 3321

Jane Tuckley
Partner

E: jane.tuckley@traverssmith.com
T: +44 (0)20 7295 3238

Mark Evans
Partner

E: mark.evans@traverssmith.com
T: +44 (0)20 7295 3351

Phil Bartram
Partner

E: phil.bartram@traverssmith.com
T: +44 (0)20 7295 3437

Stephanie Biggs
Partner

E: stephanie.biggs@traverssmith.com
T: +44 (0)20 7295 3433

The information in this document is intended to be of a general nature and is not a substitute for detailed legal advice. Travers Smith LLP is a limited liability partnership registered in England and Wales under number OC 336962 and is authorised and regulated by the Solicitors Regulation Authority. The word "partner" is used to refer to a member of Travers Smith LLP. A list of the members of Travers Smith LLP is open to inspection at our registered office and principal place of business: 10 Snow Hill London EC1A 2AL. Travers Smith LLP also operates a branch in Paris.

GLOSSARY OF ABBREVIATIONS

ABCP	Asset-backed commercial paper
AIF	Alternative investment fund
AIFM	Alternative investment fund manager
AIFMD	Alternative Investment Fund Managers Directive
APER	FCA Statements of Principle and Code of Practice for Approved Persons
AR	Appointed representative
BEIS	Department for Business, Energy and Industrial Strategy
BIPRU	FCA Prudential Sourcebook for Banks, Building Societies and Investment Firms
CASS	FCA Client Assets sourcebook
CCP	Central counterparty
CF	Controlled function
CFD	Contract for difference
CNAV MMF	Constant net asset value money market fund
COCON	FCA Code of Conduct for Staff sourcebook
CP	Consultation paper
CPD	Continuing professional development
CRD IV	EU Fourth Capital Requirements Directive
CRD V	Proposed EU Directive amending CRD IV
CRR	EU Capital Requirements Regulation
CRR Amending Regulation	Regulation amending the provisions relating to securitisation exposures in the CRR
CRR II	Proposed EU Regulation amending the CRR
CSD	Central securities depository
CSDR	Central Securities Depositories Regulation
Customer Authentication RTS	Proposed Delegated Regulation with regard to regulatory technical standards for strong customer authentication and common and secure open standards of communication
DEPP	FCA Decision Procedure and Penalties Manual

EBA	European Banking Authority
EC	European Commission
EEA	European Economic Area
EMIR	European Market Infrastructure Regulation
EONIA	Euro OverNight Index Average
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EURIBOR	Euro Inter-Bank Offered Rate
FAMR	Financial Advice Market Review
FC	Financial counterparty
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Service
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
FX	Foreign exchange
IBIP	Insurance-based investment product
IDD	Insurance Distribution Directive
IDWG	Institutional Disclosure Working Group
IFRS	International Financial Reporting Standard
IFPRU	FCA Prudential Sourcebook for Investment Firms
IORP	Institution for occupational retirement provision
IPID	Insurance Product Information Document
IPRU(INV)	FCA Interim Prudential Sourcebook for Investment Businesses
KID	Key information document
LEI	Legal entity identifier
LIBOR	London Inter-Bank Offered Rate

LVNAV MMF	Low volatility net asset value money market fund
MiFID II	Recast Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MLD 4	Fourth Money Laundering Directive
MLD 5	Proposed EU directive amending MLD 4
MMF	Money market fund
NAV	Net asset value
NFC	Non-financial counterparty
NFC+	A non-financial counterparty which is subject to the clearing obligation because its positions in OTC derivative contracts exceed prescribed clearing thresholds
NFC-	A non-financial counterparty which is not an NFC+
OTC	Over-the-counter
PII	Professional indemnity insurance
POG Regulation	IDD delegated regulation on product oversight and governance arrangements
PRIIP	Packaged retail investment or insurance-based product
PS	Policy statement
PSD 2	Second Payment Services Directive
PSRs	Payment Services Regulations
RAO	FSMA (Regulated Activities) Order 2001
RTS	Regulatory technical standards
SEC-ERBA	Securitisation External Ratings Based Approach
SEC-IRBA	Securitisation Internal Ratings Based Approach
SEC-SA	Securitisation Standardised Approach
SFT	Securities financing transaction
SFTR	Securities Financing Transactions Regulation
SMCR	Senior Managers and Certification Regime
SMF	Senior management function
SSPE	Securitisation special purpose entity

STS	Simple, transparent and standardised
SUP	FCA Supervision Manual
TC	FCA Training and Competence sourcebook
UCITS	Undertaking for collective investment in transferable securities
USRs	Uncertificated Securities Regulations 2001
VNAV MMF	Variable net asset value money market fund
WAL	Weighted average life
WAM	Weighted average maturity