

Structured products: key regulatory developments in the UK and EU

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Bank Recovery and Resolution and Bail-in

The deadline for member states to adopt and publish implementing legislation and regulations relating to the Bank Recovery and Resolution Directive (BRRD) was 31 December 2014.

Member states are required to apply their implementing legislation and regulations from 1 January 2015. As an exception to this, the BRRD permits member states to apply the provisions on the bail-in tool from 1 January 2016 at the latest (Article 130(1), BRRD).

In July 2014, HM Treasury stated that the UK would apply all the provisions in the BRRD from 1 January 2015, including the bail-in requirements, with the exception of the provisions relating to the Minimum Requirement for Eligible Liabilities and the requirement in Article 55 of the BRRD to include a contractual term in liabilities governed by third-country law stating that the liability may be subject to bail-in and write-down.

PRIIPS KID

1) Text of PRIIPS KID Regulation published in Official Journal of EU

The regulation on key information documents (KID) for packaged retail and insurance-based investment products (PRIIPs) (PRIIPS KID Regulation) was published in the Official Journal of the EU on 9 December 2014. The PRIIPS KID Regulation applies from 31 December 2016 and will introduce a new pan-European pre-contractual product disclosure document for PRIIPs.

In Spring 2015, there will be consultation papers on the proposed regulatory technical standards (RTS) on review, revision and republication of the KID and on the RTS on timing of delivery of the KID. In Autumn 2015, there will be a consultation paper on the RTS on

the content, presentation and calculation of information in the KID. These RTS will then apply from the same date as the Regulation itself. These follow the joint ESAs discussion paper released in 2014 and discussed below.

2) Joint ESAs discussion paper on format and content of KID

On 17 November 2014, the three European Supervisory Authorities released a discussion paper on the detailed format and content requirements of the PRIIPS KID. Responses are due by 17 February 2015.

See Ashurst briefing "[PRIIPS KID Discussion Paper Released](#)".

3) EIOPA consultation on product intervention powers under PRIIPS KID Regulation

EIOPA has published a consultation paper (dated 27 November 2014) on product intervention powers under the PRIIPs KID Regulation.

The consultation puts forward a proposal relating to technical advice EIOPA is to provide to the European Commission on the criteria and factors to be taken into account in determining when there is a:

- significant investor protection concern; and
- threat to the orderly functioning and integrity of financial markets, or to the stability of the whole or part of the financial system of the EU, or to the stability of the financial system within at least one member state.

Prospectus Directive

In September 2014, ESMA published a consultation paper on draft RTS in respect of certain aspects of the prospectus regime. The draft RTS propose important changes in the following four areas: (i) procedures for the approval of prospectuses; (ii) the incorporation by reference of information in prospectuses; (iii) the publication of prospectuses and final terms; and (iv) the dissemination of advertisements relating to public offers and admissions to trading.

Each of the Joint Associations Committee (JAC) and the International Capital Market Association (ICMA) has submitted a response to the consultation paper to ESMA within the deadline (19 December 2014). Copies of both responses are available on the ICMA website. Ashurst prepared the response on behalf of the JAC.

The final RTS are due to be published by 1 July 2015 and implemented by member states by 1 January 2016.

See Ashurst briefing "[ESMA consults on certain aspects of the Prospectus Directive and Prospectus Regulation](#)".

Fines

On 12 November 2014, five banks were found to have breached FCA Principle 3 – failing to take reasonable care to organise and control their affairs properly and effectively – in relation to their G10 FX spot trading businesses. There was a global response to the banks' behaviour; between the five banks they paid the FCA £1.1bn in fines and overseas regulators (the CFTC, OCC and Finma) also imposed financial penalties amounting to over US\$2bn.

The FX market is one of the largest and most liquid markets in the world. The most significant currencies traded are the G10 currencies. Benchmarks are set in relation to the Spot FX market, especially in relation to G10 currency pairs:

- the 4.00pm WM Reuters Fix – based upon Spot FX trading activity in 30 seconds before and after 4.00pm UK time – often used for valuation purposes; and
- a 1.15pm ECB Fix – takes place at 1.15pm UK time and is colloquially known as a "flash" fix.

As part of the investigation, examples were identified of banks attempting to manipulate the fix alone or in collusion with other firms. Traders disclosed to and received confidential information from traders at other firms regarding the size/direction of the firms' net orders at the forthcoming fix. Those traders used the information to determine their trading strategies and, depending on circumstances, attempted to manipulate the fix in the desired direction.

The spot FX market is not a regulated market and spot FX trading is not regulated activity. Nevertheless, the FCA said that it "*expects firms to identify, assess and manage appropriately the risks that their business poses to the markets in which they operate and to preserve market integrity, irrespective of whether or not those markets are regulated*". The FCA also acknowledged "*[t]here are no detailed requirements for systems and controls concerning spot FX trading in the Authority's Handbook*".

Interestingly, in relation to fix orders, the FCA noted that such behaviour could be used legitimately. The FCA indicated it "*does not consider the netting off of orders ahead of fixes as inappropriate in all*

circumstances", but firms must have appropriate systems and controls to manage risks (such as conflicts of interest and incentives to manipulate the fix).

These are the largest-ever fines imposed by the FCA and also represent an example of significant cross-jurisdictional co-ordination of the regulators. The FCA identifies the spot FX market as a systemically important financial market. In addition to the substantial fines levied, the FCA has also launched an industry-wide remediation programme to ensure firms address the root causes of these failings and drive up standards.

Benchmarks

1) *ECON draft report published*

On 11 December 2014, the European Parliament's Committee on Economic and Monetary Affairs (ECON) published its draft report on the European Commission's proposed Regulation on indices used as benchmarks in financial instruments and financial contracts (the Benchmark Regulation).

The draft report contains a legislative resolution on the proposed Benchmark Regulation, the text of which sets out suggested amendments to the European Commission's original proposal, which was published on 18 September 2013 (see Ashurst briefing "[European Commission releases proposed regulation on benchmarks](#)").

The draft report highlights a number of what ECON sees as key issues. These include:

- *scope* – should be broad in principle but some indices should not be considered as benchmarks;
- *determining criticality* – a two-tiered approach is needed to determine criticality: (i) benchmarks with very large reference values (in excess of €500bn) should be deemed critical; and (ii) discretion for competent authorities to include other benchmarks in critical category on basis of systemic importance;
- *proportionality* – for critical benchmarks appropriate to impose binding governance requirements. For non-critical benchmarks, increased transparency through publication by benchmark administrators of a benchmark statement and of a compliance statement; and
- *third countries* – given current lack of comprehensive legislative frameworks in jurisdictions outside the EU, additional tools are needed to ensure EU users can maintain access to third-country benchmarks. Therefore partial

equivalence decisions and recognition of individual third-country administrators should be permitted.

2) *FCA to regulate seven additional financial benchmarks*

On 22 December 2014, the UK Government confirmed that it will be extending the legislation originally put in place to cover LIBOR to cover seven additional major UK-based financial benchmarks in the fixed income, commodity and currency markets.

The relevant benchmarks are:

- SONIA (Sterling Overnight Index Average) and RONIA (Repurchase Overnight Index Average), which both serve as reference rates for overnight index swaps;
- WM/Reuters London 4.00pm Closing Spot Rate, which is the dominant global foreign exchange benchmark;
- ISDAFIX, which is the principal global benchmark for swap rates and spreads for interest rate swap transactions;
- London Gold Fixing and the LMBA Silver Price, which determine the price of gold and silver in the London market; and
- ICE Brent Index, traded on the ICE Futures Europe (IFEU) exchange, which acts as the crude oil futures market's principal financial benchmark.

This announcement is further to a recommendation of the Fair and Effective Markets Review (FEMR) made on 25 September 2014 that these FICC benchmarks be bought within the current UK regulatory regime. FEMR consists of representatives from the Treasury, Bank of England and Financial Conduct Authority, who were established and tasked in June 2014 to review the way wholesale markets operate.

Ahead of the legislation coming into force, the FCA is consulting on their draft rules, and will then publish final rules. The Government intends for the legislation to commence on 1 April 2015.

MiFID II

ESMA publishes technical advice and launches consultation on implementation of MiFID II

On 19 December 2014, ESMA published its final technical advice (TA) and launched a consultation paper (the Consultation Paper) on its draft regulatory technical and implementing standards (RTS/ITS) regarding the implementation of the Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR). These papers follow ESMA's

consultation paper and discussion paper on the same topics published in May 2014.

Both ESMA's TA and draft RTS translate the MiFID II/MiFIR requirements into practically applicable rules for market participants and national supervisors. The new regulatory framework aims at ensuring that secondary markets are fair, transparent and safe, and that investors' interests are safeguarded when being sold investment products.

The key proposals in ESMA's TA/draft RTS cover the main issues raised in the May 2014 papers including summaries of responses received by ESMA. Ashurst looked at these issues in its MiFID II series of briefings found [here](#), [here](#) and [here](#). ESMA has confirmed its earlier proposals in this area. The definition of a manufacturer is deliberately broad – simply being the issuer of a product will do. This will mean the end of the light-touch pure manufacturer definition in the UK. All manufacturers will be required to have a distribution agreement, even with a non-EU distributor. Further guidance is given on transparency of charges.

ESMA's TA is final and is not subject to further public consultation. The TA will be sent by ESMA to the European Commission which will then decide whether to adopt it (in full or in part) and to draft the delegated act based on it.

The Consultation Paper closes on 2 March 2015. ESMA will use the input received from the consultation to finalise its draft RTS, which will be sent to the Commission for endorsement by mid-2015. It will send its draft ITS to the Commission by January 2016. MiFID II and its implementing measures will be applicable from 3 January 2017.

Retail Distribution Review

Post-implementation review of the Retail Distribution Review – Phase 1

On 16 December 2014, the FCA published a post-implementation review of the Retail Distribution Review (RDR) which came into force at the end of 2012. While the conclusions are not definitive (the FCA says it is too early for that), the preliminary findings are positive. The FCA has found that there has been:

- a reduction in product bias, with a decline in the sales of products that pre-RDR came with higher commission and an increase in the sale of products that paid lower or no commission pre-RDR. The FCA suggests that this shows that commission is no longer a driving factor in advisers' recommendations;

- a fall in product prices by at least the amounts paid in commission pre-RDR and in some instances even further than that. While product and platform costs have broadly fallen, there has, however, been no fall in adviser charges;
- an increase in the number of financial advisers gaining further qualifications, which the FCA believes demonstrates growing professionalism in the sector; and
- firms better placed to deliver on their long-term commitments, with average revenues and profitability of advisory firms increasing.

The FCA believes that some areas still need time for the full effect of RDR to transpire, in particular:

- there is little evidence that the availability of advice has reduced as a result of RDR, however the evidence revealing the true cost of advice has led consumers to consider the extent to which the advice they receive represents value for money; and
- there are opportunities for innovation in the market, particularly for simplified or automated advice (the FCA is trying to combat this general failing through its Project Innovate and the publication of finalised guidance on sales involving personnel recommendations in 2015).

Finally, the FCA comments on the need for further improvement in relation to disclosure of the cost of ongoing services, as the complexity of charging structures and the way in which this is communicated may lead to an increase in consumer search costs and limit how consumers can drive effective price competition between advisers.

The FCA also says that it will publish a discussion paper in March 2015 on how it will implement the investor protection aspects of MiFID II. The FCA notes that in some areas MiFID II, requirements are similar to those introduced by RDR (e.g. requirement to classify advice as independent or not), however in other areas the requirements go further (e.g. the ban on portfolio managers retaining commission from third parties). Generally, however, the next phase of the RDR review to show the medium-term impacts of the RDR will be published in 2017.

Product governance

EBA consultation paper on product oversight and governance arrangements for retail banking products

On 10 November 2014, the EBA published guidelines for manufacturers and distributors of retail banking

products as part of its work programme to address some of the underlying drivers of conduct failure.

In November 2013, the three ESAs published a joint position paper on manufacturers' product oversight and governance processes which formed phase 1 of this work stream, which included eight high-level principles to form the basis of more detailed work to be produced by each independent authority.

The EBA's detailed guidelines form phase 2 of this work stream by the EBA. The guidelines apply to manufacturers (i.e. credit institution, creditor, payment institution or electronic money institution) or distributors (meaning a person who offers or sells the product to consumers). Products are widely defined as mortgages, deposits, payment accounts, payment services, other means of payment, e-money, and other forms of credit. The guidelines are broken down into the following themes and split between guidelines for manufacturers and guidelines for distributors.

Guidelines for manufacturers include the following themes:

- establishment, proportionality, review and documentation – such as a requirement to establish, implement and review effective product oversight and governance arrangements and documentation requirements of all actions;
- manufacturers' internal control functions – for example, senior management responsibility for internal compliance with product oversight and governance arrangements;
- target market – for example, product oversight and governance arrangements should identify the target market of a product and take steps to deem that the product is appropriate for the interests of the target market;
- product testing – this includes requirements to test products before it is brought to market or when an existing product is sold to new target markets;
- product monitoring – the manufacturer should be ultimately responsible for product monitoring according to the guidelines;
- remedial action – any problems identified by the manufacturer should be followed by necessary remedial action under the guidelines;
- selection of distribution channels – for example, the manufacturer should ensure that the distribution channels are appropriate for the target market and only sold outside that target market in exceptional circumstances; and
- information for distributors – such as a requirement under the guidelines to include a description of the main characteristics of the product to the distributor.

Guidelines for distributors are shorter and include:

- establishment, proportionality, review and documentation – such as a suggestion under the guidelines to establish, implement and review product oversight and governance arrangements which are specific to the role of the distributor in bringing the product to market;
- distributors' internal control functions – this requires a distributor to integrate its product oversight and governance arrangements within their general systems and controls;
- knowledge of the target market – i.e. using the information provided by the manufacturer to determine whether a consumer belongs to the target market; and
- information – this is the main focus of the guidelines for distributors and requires distributors to disclose to the target market the main characteristics of the product and provide information to the manufacturer on why they offered a product to a consumer who doesn't belong to the target market.

The EBA goes further and has also published "good practice examples" to accompany the guidelines.

Regulatory capital

FCA consultation paper on retail distribution of regulatory capital instruments

The FCA's consultation paper (CP14/23) of 29 October 2014 follows on from the FCA's introduction in August 2013 of temporary product intervention rules restricting the retail distribution of contingent convertible securities (CoCos).

The proposals in CP14/23 relate to permanent rules to replace the temporary rules when they expire on 1 October 2015. In CP14/23, the FCA sets out proposals for rules:

- restricting the distribution of CoCos in the retail market without first checking that prospective clients meet certain criteria. This means in practice that firms should not distribute these instruments to ordinary retail investors;
- restricting the retail distribution of certain pooled investments that invest wholly or predominantly in CoCos; and
- setting out requirements on the distribution of mutual society shares to ordinary retail investors (that is, core capital instruments issued by mutual societies, including core capital deferred shares).

These rules take the form of amendments to COBS, with revisions to COBS 9.3 (Guidance on assessing suitability) and a new section, COBS 22.2 (Restrictions on the retail distribution of contingent convertible instruments and CoCo funds).

The FCA intends to review these rules and those that apply distribution restrictions to other products (such as non-mainstream pooled investments) to assess any scope for simplification and to ensure rules imposing restriction on distribution are aligned with each other.

The deadline for responses is 27 January 2015. The FCA intends to publish the rules in a policy statement in summer 2015 with a view to permanent rules being in place by 1 October 2015.

Securities financing transactions

Securities financing transactions: EU Council agrees transparency rules

The EU Council has published a press release confirming that the EU Council's Permanent Representatives Committee has agreed a general approach on the proposed Regulation on securities financing transactions (the SFT Regulation). The Council emphasised that, on 20 November 2014, the SFT Regulation was being introduced to counter the risk of banking activities moving into the realm of shadow banking. The next steps are for negotiations to take place when a team from the European Parliament is given a mandate.

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