WELCOME TO CAPCO'S

REGULATORY MONITORING NEWSLETTER

2018 3RD ISSUE

CAPCO

THE FUTURE. NOW.

SECTION 1: INTRODUCTORY NOTE

Capco continuously monitors the scope of regulations, prepares newsletters on major regulatory developments in the financial industry and develops technical notes on specific rules. Implementation of complex changes over extended timescales is forcing businesses to change the way they operate while pressure from the market and the competition is already driving change. The Capco Regulatory Monitoring Newsletter compiles regulatory developments and anticipates major changes in regulations while providing insights of new rules put forward by global, regional and national policy setting bodies. Capco established the Regulatory Monitoring Newsletter to translate policy, legislative and regulatory developments into actionable intelligence. This helps our clients to manage strategy, business models and operating procedures – while at the same time addressing fundamental issues around profitability and future plans.

This Newsletter contains references to the most important regulatory changes and forthcoming publications. For regulations that have the biggest impact, we issue technical notes that seek to synthesize these regulations, put them into context and explain some of their potential impacts.

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EMIR: Lessons learned – early adoption of the amending regulation

ANNOUNCEMENT IN SHORT/ INTRODUCTION

Following the EU Parliament's vote for its committee´s version of the EMIR amending regulation, negotiations with the European Commission and Council will begin in July. Though the regulation is still at a draft stage for some important amendments, there is no transition period planned regarding, for example, the reporting of over-the-counter (OTC) derivative transactions to the trade repository (TR). As previous experience shows, it is never too early for market participants to begin implementing preparatory measures, even while the regulation still gains shape.

EMIR REGULATORY ROADMAP

EMIR is a regulatory response to problems with uncontrolled OTC derivatives trading; that of which intensified during the financial crises of 2008. The regulation was introduced in 2012 and was implemented in 2014. The focus lies on the introduction of a clearing obligation (CO) for standardized OTC derivatives, risk mitigation for non-cleared OTC derivatives, reporting of derivatives trades (ETD and OTC) to a trade repository (TR), and requirements for central counterparties (CCPs) and central securities depositories (CSDs).

In 2015, under the Regulatory Fitness and Performance (REFIT) programme, the EU Commission[1] started an evaluation of lessons learned, followed by a proposal for EMIR amendments in 2017. Since the goal of REFIT is a reduction of the disproportionate regulatory burden for small and medium enterprises (SMEs), and to increase transparency, amongst other things, changes to the regulation have been planned. Currently, the trialogue process is under way. Presuming an early agreement, the final text will be available on September of 2018, and becomes effective at the end of the 2018.

The regulatory roadmap reveals overlap between EMIR 1.0 and EMIR 2.0, making industry side preparation quite challenging:

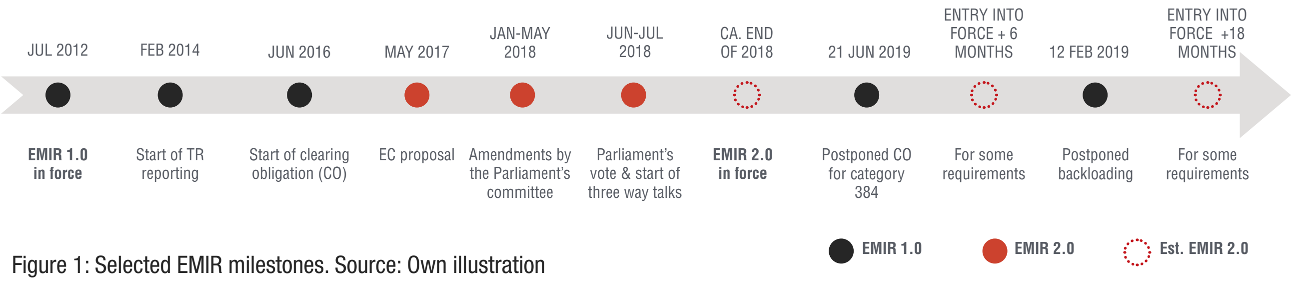

Figure 1: Selected EMIR milestones. Source: Own illustration

MOST IMPORTANT CHANGES AND IMPACT ON THE EUROPEAN BANKS[2]

At first, the amendments aim at a more **differentiated approach**, both to business nature, and to trade volume of market participants. To relieve the burden of regulatory compliance costs for small FIs, EMIR 2.0 introduces a new type of financial counterparties (FC), namely "FC-". Also, additional types of FCs appear: alternative investment fonds (AIFs) and central securities depositories (CSDs) will be considered FCs, with all resulting implications, such as clearing obligation.

Secondly, the amendments implement some specific changes in the focus areas of EMIR 1.0, as summed-up on the next page.

[1] With support of the European Securities and Markets Authority (ESMA), the European Systemic Risk Board (ESRB), and the European Central Bank (ECB)

[2] Non-exhaustive

EMIR: Lessons learned – early adoption of the amending regulation continued

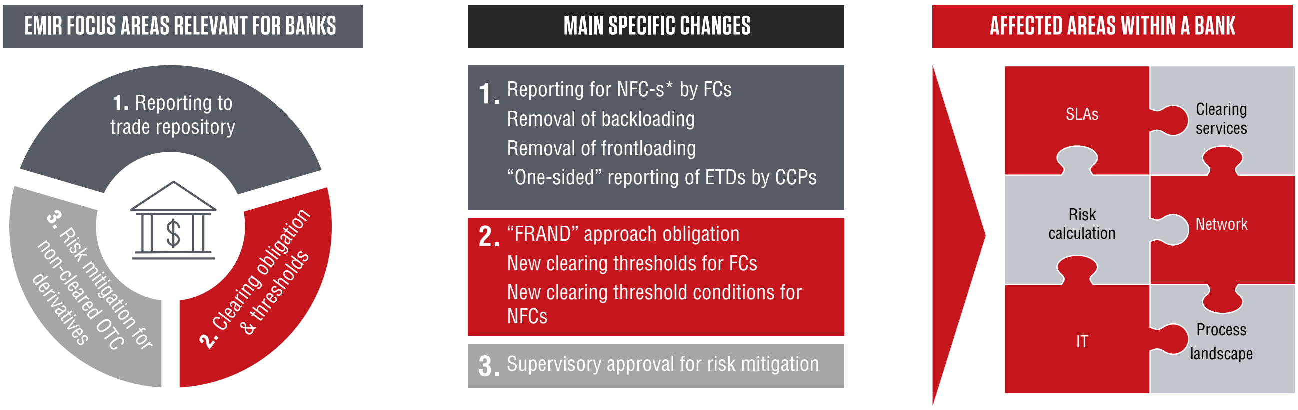

Figure 2: EMIR impact analysis with focus on banks. Source: Own illustration

*NFC- "refers to non-financial counterparties with average notional of outstanding OTC derivatives under clearing threshold.

Particularly, **changing reporting and clearing requirements** will be of importance for European banks:

I. Reporting (selected issues)

For transactions between an FC and NFC- (NFC not subject to clearing obligation), the FC will be responsible for the TR reporting. Although quite a few FCs are already doing so on behalf of NFCs as a service, in the future, FCs will be responsible for the reporting of data quality as well.

The good news is that there will no longer be the issue of backloading obligations (uploading of historical transaction data[3] for derivatives subject to CO), which has been currently postponed (see the regulatory roadmap above).

An additional relief will be the omission of frontloading (a quasi-test reporting phase prior to the start of a CO). This will stay true for asset classes currently not subject to CO, which can be added to the list by ESMA in future.

Also relieving for the European banks will be an introduction of the so-called "one-sided" TR reporting for ETDs, which will be provided by clearinghouses alone. It is important to note; this proposed amendment is still under discussion and could be removed from the final text.

II. Clearing (selected issues)

The exact meaning of the obligation to provide access to clearing services on fair, reasonable and non-discriminatory (FRAND) terms including indirect clearing[4] is still to be defined by ESMA in a related RTS. Irrespective of the exact definition, additional costs for clearing service adjustments can be assumed.

For FCs with derivatives trading volume under the clearing threshold[5] (FC-) in all asset classes subject to the CO, the CO will be removed. For threshold test purposes, FCs will have to calculate annually their group´s month-end average position for March, April, and May.

Besides the Commission´s proposal, and the Parliament´s amended version, a detailed list of changes under EMIR 2.0 can also be found in publications by industry observers.

Since most of the amendments above will become effective 20 calendar days after publication in the Official Journal, a **timely impact analysis** is required.

One preparatory step that must be taken is an identification of counterparties, for which an FC will take over the TR reporting obligation. Afterwards, all affected agreements with those counterparties are to be identified, including any need for adaptation. Also, timely communication with a TR to facilitate coordinated test planning is another critical factor for a successful implementation.

Considering a rather modest clearing profit margin, for clearing service providers other than clearinghouses, a future service portfolio of a bank is to be strategically re-assessed.

In connection with new calculation methods for clearing thresholds, an adjustment demand for risk calculation (models and processes) is to be evaluated. Further, any impact on regulatory capital requirements is to be identified.

These are just some of the measures anticipated from the entrance of EMIR 2.0 into force. European FIs would do well in distributing the workload over time, starting no later than Q4 2018.

[3] Transactions terminated before the reporting date, 12 February 2014

[4] Clearing services for a client of a client of a clearing member

[5] Clearing threshold now used for NFCs

BaFin: revised guidelines on Internal Capital Adequacy Assessment Process – ICAAP

On May 24th, 2018, the German Federal Supervisory Authority (BaFin) published its revised guidelines on Internal Capital Adequacy Assessment Process (ICAAP). This is the final step of the discussions between BaFin and the industry to revise the guidelines introduced in 2011.

The guideline on ICAAP (German: "RTF-Leitfaden") constitutes as guidance for supervisor's assessments on the ICAAP of supervised banks. As the Single Supervisory Mechanism (SSM) BaFin's role is to be the supervisory authority for non-systematically important German institutes, this guidance only applies to them. But as major contents of the guidelines aim for consistency to European Banking Authority (EBA)'s draft guidelines on ICAAP, which will be a document in parallel applying to entities supervised by EBA, equal steps from other regulatory bodies of the SSM are expectable.

REVISION

Doing parallel steps to EBA's guideline, BaFin introduces the dual view of the normative perspective and the economic perspective for ICAAP in Germany. For this reason, the whole document was restructured reflecting the new dualistic approach.

The normative perspective aims for the regulatory measures outlined by the Capital Requirements Regulation (CRR) and the risk capital, based on those accounting-based measures given in the CRR. The economic perspective aims for long-term preservation of the institute's substance in combination with creditor protection based on internal and economic measures.

While the new views on risk capital are typically new to German institutes - which are having a going-concern approach demanded in the old ICAAP guide, BaFin explicitly allows banks to still use their old approaches which are still outlined in an appendix to the guide.

In addition to the new approaches, a deeper integration of the ICAAP into the management culture, including strategic processes, is demanded.

IMPACT

As the new guideline has no implementation date for institutes, and old going concern approaches will still be accepted, one can expect that the impact on the affected institutes will be on a medium level in comparison to other new regulations. However, the interplay of both approaches, and the implementation and links within capital allocation, must be assessed.

In the long term, institutes are directly advised by BaFin to evaluate the transformation of their current ICAAP processes which rely on 'going concern' methods into the new dualistic framework.

Hence the guide on ICAAP by BaFin is a piece of mosaic, forming a convergent ICAAP supervision within EU's SSM area.

MiFID II: ESMA issues latest double volume cap data

On May 8th, 2018, the European Securities and Markets Authority (ESMA) updated its public register with the latest set of double volume cap (DVC) data under the Markets in Financial Instruments Directive (MiFID II).

The updates included DVC data and calculations for the period of April 1st, 2017 to March 31st, 2018 (commonly referred as the **April 2018 publication**), as well as updates to previously published DVC periods.

BACKGROUND

MiFID II introduced the DVC mechanism to limit the amount of "dark trading" in equities under the reference price waiver and the negotiated transaction waiver. The DVCs refer to the total volume of financial instruments with an International Securities Identification Number (ISIN) traded across all EU venues.

The basis for the calculation to establish such limits or caps for any ISIN is twofold:

- For any ISIN, the average trading on a single venue is capped at 4% of the total trading volume over the previous 12-month period.
- For any ISIN, the average trading on all EU venues is capped at 8% of the total trading volume over the previous 12-month period.

Based on this, a financial instrument in a specific venue may breach the cap of 4%, but still can be traded on other venues across the EU until the market reaches 8%.

UPDATE ON CAP BREACHES

According to April 2018 publication, the net amount of new breaches occurred as following:

- The 8% cap exceeded 58 new equities (Mar 2018: 47) applicable to all trading venues across EU
- The 4% cap exceeded 10 new equities (Mar 2018: 8) applicable to individual trading venues

Actions to be taken by ESMA and NCAs

To maintain the soundness of the financial system, ESMA and National Competent Authorities (NCAs) implement measures in relation to the concerned instruments.

For those instruments newly detected to be in breach of the DVC thresholds, NCAs must suspend the use of waivers within two working days. The suspension will last 6 months from May 14th,2018 until November 14th,2018. The instruments for which caps already existed in previous periods will continue to be suspended.

ESMA additionally highlighted that between reporting periods some trading venues have corrected their data. In other words, 12 instruments previously identified to breach the cap of 8% and 4% have been proved to be incorrect. This information affected past DVC publications. For these instruments, the suspensions of trading under the waivers will be lifted.

UPDATE ON ESMA DVCM FILES

As part of the April publication, ESMA published a slight amendment to the existing "DVC results files". The ESMA publication now encompasses a consolidated "Suspension File", which contains all financial instruments for which a suspension has already been issued with correspondent dates.

The Suspension File contains detailed information such as:

- All the ISINs that are subject to a suspension
- The new suspensions expected to be triggered
- The suspensions that must be revoked due to data corrections
- The history of suspensions for a given ISIN

ESMA will be providing the "Suspensions File" on a regular basis to enrich the interpretation of the monthly "DVC Results Files". The "DVC Result Files" contain the overall information on trade volume for those instruments which traded under waiver across EU or by individual Trading Venue (default in %).

MiFID II: ESMA issues latest double volume cap data continued

IMPACT

The publication of "Suspension File" is of great importance as it means that the consolidated information on the suspended ISIN will be made more accessible to NCAs and market participants. With this, market participants will be in the position to identify affected instruments without checking each individual DVC Results File. Furthermore, the overview on suspended will assist ESMA and NCAs to ensure the completeness of breached instruments.

This periodic report helps to maintain a healthy financial environment as the suspension of instruments reduces the risk of "dark trading" across EU venues.

Please find the full version of the regulation text regarding latest double volume cap data here.

MiFID II: ESMA publishes update to Q&As on investor protection and intermediaries topics

On May 25th, 2018, the European Securities and Markets Authority (ESMA) updated and added 9 new Questions and Answers (Q&A) in relation to investor protection topics, described in the Markets in Financial Instruments Directive (MiFID II). Some notable topics covered because of the updates include best execution, client categorization, provision of investment services, and activities by third country firms, amongst others.

BACKGROUND

Since January 3rd, 2018, MiFID II has strengthened protection of investors by regularly introducing new requirements, as well as by reinforcing existing ones. The purpose of this Q&A is to divulge common supervisory approaches, and the application of practices, while adhering to MiFID II investor protection rules.

UPDATE ON Q&AS

The overall MiFID II Q&A provide answers and clarifications to the following topics on the table overleaf.

SECTION 2: REGULATORY HIGHLIGHTS

MiFID II: ESMA publishes update to Q&As on investor protection and intermediaries topics continued

TOPIC	QUESTIONS POSED BY STAKEHOLDERS	ANSWERS FROM ESMA
BEST EXECUTION	What constitutes **'other liquidity provider'** under Recital 7 of regulatory technical standards (RTS) 27?	Firms willing to deal on own account and are committed to provide liquidity as part of their normal business activity on a continuous basis.
CLIENT CATEGORIZATION	When should an investment firm assess whether a **private individual investor may be treated as a professional client** under Section II of Annex II of MiFID II?	A private investor may be allowed to waive some of the protections by requesting to be treated as a professional client. This request must be initiated by the client in a written statement. It should be stated if client intends to be treated generally as a professional client either for all future services or in respect of a specific investment services.
	How should an **investment firm assess whether a private individual investor** may be treated, on request, as a professional client under Section II of Annex II of MiFID II?	Private individual investors may be treated as professional clients only if an adequate assessment of their expertise, experience and knowledge assure that the client is capable of undertaking investment decisions and understanding the risks involved.
	How should an **investment firm assess whether a private individual investor has carried out transactions of a "significant size"** in accordance with the first limb in the fifth paragraph of Section II.1 of Annex II of MiFID II?	When assessing whether a client transaction is of a significant size, the following should be considered: • the size of transactions on the relevant market • the scope of the analysis for the relevant threshold not be limited to (the size of) transactions previously carried out by the relevant client on the relevant market • whether the transactions were individually large enough to provide the client with meaningful exposure to the relevant market
	How should an investment firm assess whether a private individual client meets the conditions under the first limb in the fifth paragraph of Section II.1 of Annex II of MiFID II **where such investor has been trading on the relevant market for less than a year?**	Clients who have been trading on the relevant market for less than a year cannot fulfill the conditions imposed by the first limb in the fifth paragraph of Section II.1 of Annex II of MiFID II. To assess whether a client meets such conditions, investment firms shall review the client's trading history on the relevant market over the past four quarters.
	How should leveraged financial instruments be taken into account in order **to assess the size of a client's financial instrument portfolio** in accordance with the second limb of the fifth paragraph of Section II.1 of Annex II of MiFID II?	The threshold of client's financial instrument portfolio should exceed EUR 500,000. If an investment portfolio contains financial instruments for which a margin is deposited, the net equity of the specific positions (margin deposited plus any unrealized profits/losses) should be used to determine the size of the financial instrument portfolio. The notional value of the financial instruments should not be considered.

MiFID II: ESMA publishes update to Q&As on investor protection and intermediaries topics continued

TOPIC	QUESTIONS POSED BY STAKEHOLDERS	ANSWERS FROM ESMA
PROVISION OF INVESTMENT SERVICES AND ACTIVITIES BY THIRD COUNTRY FIRMS	Article 42 of MiFID II regulates the provision of services by third country firms at the exclusive initiative of the client. How should **"initiates at its own exclusive initiative the provision of an investment service or activity by a third-country firm"** be understood in Article 42 of MiFID II?	A retail or professional client within the meaning of Section II of Annex II established or situated in the Union 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 requirements under Article 39.
	How should **«new categories of investment products or investment services»** within the meaning of Article 42 of MiFID II and Article 46 of MiFIR be understood?	A third-country firm provides a new investment service, product or activity as defined in Section A of Annex I of MiFID II where this service is added to the existing services, products or activities after 3 January 2018.
OTHER ISSUES	What are the **supervisory responsibilities of competent authorities in host Member States when a** Undertakings for Collective Investment in Transferable Securities **(UCITS) management company or an alternative investment fund manager (AIFM) provides investment services** through a branch established in the host Member State?	Under both the UCITS and the AIFM Directives, supervisory powers of competent authorities in relation to branches of UCITS management companies or AIFMs established in a Member State that is not the home Member State are shared. The competent authority of the Member State in which the branch is located (host Member State) is responsible for the supervision of the branch's compliance with conduct rules.

IMPACT

Although investor protection rules have been applied to the European financial sector as of January 3rd of this year, ESMA is still facing uncertainty and questions arising from banks related to the extent of their obligations. The answers provided by ESMA will assist financial institutions on which MIFID II regime applies to the investor protections, especially in assessing private individual investors and their services, transactions and products. This will ensure that financial institutions have more transparency over general investor protections rules and its realization.

Please find the update to MIFID II Q&AS on investor protection and intermediaries topics here.

CSDR: EU Commission adopts Delegated Regulation on settlement discipline

In May 2018, the European Commission has adopted a Delegated Regulation on settlement discipline. One major focus of this regulation is to improve and ensure safety and efficiency of securities settlement, especially for cross-border transactions. The main target is to allow buyers and sellers to receive their securities and money without delays and risks. By harmonizing the timing and framework for securities settlement in the European Union, failures in the settlement of securities transactions shall be reduced.

The Delegated Regulation harmonizes measures that must be taken by Central Security Depositories (CSDs), and Investment Firms, to prevent possible settlement fails. To achieve this, the Delegated Regulation requires clients to inform corresponding investment firms about cash and securities from specific transactions, and to confirm their acceptance of the terms of those transactions. At the same time, CSDs must proceed settlement instructions from their customers on an automated basis and provide a fully developed solution to support an automated, real time matching of cash and securities instructions. Moreover, CSDs are obliged to establish special mechanisms that enable their users to manage their settlement instructions in securities settlement systems, operated by the CSD. The Delegated Regulation also requires CSDs to develop systems that make it possible for them to monitor the number, length, and value of settlement fails which must be reported to corresponding supervisors on a monthly basis. This comes in addition to measures on how to improve settlement efficiency. The regulation also requires CSDs to charge cash penalties to users who cause settlement breaks, and in turn, compensate users that faced these breaks. Additionally, the Delegated Regulation specifies and describes penalty collection procedures, depending on CDSs specifications.

The regulation introduces and provides detailed roles for new measures to reduce the amount of potential settlement fails: the mandatory buy-in. The mandatory buy-in is an obligatory execution of the initial trade within certain days after the trade date. The Delegated Regulation specifies cases when a buy-in is considered not possible or ineffective, and additionally introduces contractual agreements between parties in a settlement chain for the buy-in process.

The Delegated Regulation differentiates between three types of transactions:

- Cleared by a CCP,
- Cleared by CCP and executed on trading venue,
- Not cleared by a CCP and not executed on a trading venue

Depending on the type of transaction, the regulation defines different types of buy-in procedures. In the case when the buy-in process is not applicable or is considered inefficient, the regulation defines a procedure for notifying the settlement fail to the parties involved. It also requires the provision of a description of the procedure for payment of cash compensations to the party who is affected by settlement fail. In addition, the Delegated Regulation specifies the calculation and payment rules of the cash compensation for failed buy-ins. Generally, failing counterparties must pay the difference between the delivery price of the security and the price agreed at the time of the receiving counterparties. In the case when a CSD's user consistently causes settlement fails, CSDs have the right to discontinue its service with such clients.

IMPACT

The Delegated Regulation should enter into force 24 months after publication. That means that CSDs have approximately 2 years to adjust their contractual agreements with their clients, and implement required changes into their IT systems. The overall impact of this regulation seems to increase the efficiency of the settlement procedures and to reduce overall costs associated with settlement fails.

Please find the full version of the regulation text regarding settlement discipline here.

Wake-up call for digital token providers in Singapore

The Monetary Authority of Singapore (MAS) has warned a number of digital token exchanges in Singapore not to facilitate the trading of digital tokens; those of which are securities or futures contracts, without MAS' authorization. The regulator holds the view that the digital tokens traded on their platforms constitute securities or futures contracts, which fall under the Securities and Futures Act (SFA).

REMEDIAL ACTIONS REQUIRED

Additionally, MAS has directed a halt of action to the issuer of an Initial Coin Offering (ICO) of digital tokens to Singapore-based investors. It was assessed by the authority that the issuer had contravened the SFA because its tokens represented equity ownership in a company, and therefore would be considered as securities under the SFA. Furthermore, the offer was made without a MAS-registered prospectus - an SFA requirement.

As reported in the regulator's press release, the MAS intervention has resulted in the admonished issuer to cease the offer and take remedial actions to comply with MAS' regulations. This comes in addition to the issuer returning all funds received from Singapore-based investors.

CONSISTENT APPROACH

The warning follows MAS' guide for digital token offerings from November 2017. The detailed report noted, for example, that a currency exchange that swaps fiat currencies for virtual ones, and facilitates the trading of securities tokens, will have to be regulated under the SFA. The message can therefore be seen as a reminder of MAS' consistent stance, rather than a groundbreaking new announcement.

IMPACT

The warning came amid a time in Singapore when the number of digital token exchanges has been simultaneously increasing with the strengthening of its leading position in the Asian digital token market. Crypto companies that mean real business can, however, see a lot of opportunities in this hidden welcome message by the Singaporean regulator.

GREATER CLARITY FOR MARKET PARTICIPANTS AS A POSITIVE SIGNAL

Amid the MAS guidelines and rules, the government has been able to show that it is taking the crypto game seriously without tightening the regulation. More importantly, the increased scrutiny indicates that MAS believes the crypto economy will not disappear in the near future. The move can rather be seen as a step of MAS efforts to further clarify policies, while deciding on how to regulate the digital token market best.

SOURCES

MAS warns Digital Token Exchanges and ICO Issuer

http://www.mas.gov.sg/News-and-Publications/Media-Releases/2018/MAS-warns-Digital-Token-Exchanges-and-ICO-Issuer.aspx

Guide to digital token offerings

http://www.mas.gov.sg/~/media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Securities%20Futures%20and%20Fund%20Management/Regulations%20Guidance%20and%20Licensing/Guidelines/A%20Guide%20to%20Digital%20Token%20Offerings%20%2014%20Nov%202017.pdf

SECTION 3: CONTACT US

If you would like to find out more about Capco's Regulatory expertise around the subject areas discussed within these articles, or if you have any other questions related to our Regulatory Monitoring Newsletter, please contact the Regulatory Monitoring team: CE_CM_RegMonEditors@capco.com

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