

A blue-toned background image featuring a financial line chart with multiple data series and a grid. The chart shows various trends, including a sharp decline followed by a recovery and another decline.

LATHAM & WATKINS<sup>LLP</sup>

7 February 2018

# Financial Regulation Monthly Breakfast Seminar

# Overview



The background of the slide is a blue-tinted financial line chart. It features a grid of dashed lines and a thick, jagged blue line representing data points over time. The chart is partially obscured by a dark horizontal bar at the bottom.

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PRIIPs  
Nicola Higgs

# PRIIPs – Scope

<b>Definition of PRIIP</b>	<p>An Investment where, regardless of its legal form, the amount repayable to the retail investor is subject to fluctuations <b>because of</b> exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investor</p> <p><b>PRIIP = repayment amount subject to fluctuations + exposure to a reference value / assets) (not directly held by the investor)</b></p> <p><b>Note:</b> ‘packaged’ element is absent in bonds issued by non-financial corporates</p>	
<b>Out of Scope</b>	<p><i>Regulatory guidance:</i></p> <ul style="list-style-type: none"> <li>• Corporate shares (Recital 7 PRIIPs KID Regulation)</li> <li>• Sovereign bonds (Recital 7 PRIIPs KID Regulation)</li> <li>• Government bonds (/local authority bonds) (article 2(2)(d) PRIIPs KID Regulation; Article 1(2)(b) Prospectus Directive)</li> <li>• Fixed rate notes (FCA Policy Statement, Annex 2, point 6)</li> <li>• Floating rate notes linked to EURIBOR / LIBOR or another interest rate index (unless non-linear linking to underlying interest rates exist) (Statements from the European Commission and ESAs at a workshop in July 2016)</li> </ul>	<p><i>Examples:</i> Zero coupon bonds; Fixed rate bonds with call rights at a fixed amount</p>
<b>In Scope</b>	<p><i>Regulatory guidance:</i></p> <ul style="list-style-type: none"> <li>• Floating rate note linked to an underlying reference value / asset</li> <li>• Convertible bonds that embed a derivative (Joint Committee of the ESAs Discussion Paper 17 November 2014, paragraph 1.6.2)</li> </ul>	<p><i>Examples:</i> ABS; convertibles; sukuk; cocos; CLOs</p>

# PRIIPs – Impact on retail bonds

- Issuances post 1 Jan 2018
  - Majority are limited to professionals
  - Exclude private banks from the book unless purchased on behalf of discretionary managed clients only
  - Some have removed makewhole provisions to ensure the bond is not considered a PRIIP
- Exclusion from exchange offers
  - In voluntary exchange offers the new bonds usually have more attractive features than the old ones
  - Investors are excluded and therefore left holding a stub bond with minimal liquidity

# PRIIPs – Grey areas

- Issuer calls (make-whole)
  - Right allowing issuer to pay off a bond early without the consent of the bond holders
  - Calculated by reference to a Treasury underlyer
- Caps and floors
  - Maximum / minimum reference interest rate where the bond stops tracking the reference interest rate
- Change of control put
  - Put the bonds back to the issuer upon a change of control (as defined in the given indenture)
- Inflation-linked bonds
  - Regulation does not specifically cover consideration of inflation-linked bonds
  - Floating rate of return calculated in a linear fashion by reference to an inflation index

# PRIIPs – Who is the manufacturer?

- Who is the manufacturer?
  - Recital 12 defines PRIIP manufacturers: “such as fund managers, insurance undertakings, credit institutions or investment firms”
  - Are non-financial corporate issuers in scope of the ‘manufacturer’ definition?
- How will rules be enforced against corporate issuers?
- Delegation of KID preparation?
  - To EEA regulated institutions
  - To another unregulated third party

# KIDs for bonds

Section	Challenge
Manufacturer	<ul style="list-style-type: none"><li>• Obligation to list NCA</li></ul>
Risks & return	<ul style="list-style-type: none"><li>• <i>SRI</i> – score is calculated on the basis of an assessment of market risk and credit risk and must be kept up to date in light of the manufacturer’s review obligations</li><li>• <i>Performance scenario</i> – modelled in the context of the relevant financial instrument and kept up to date</li></ul>
Costs	<ul style="list-style-type: none"><li>• Specify the total aggregated cost of the instrument as a single number in monetary and percentage terms</li><li>• Includes any one off costs, such as dealing commissions charged by the broker</li></ul>
Complaints	<ul style="list-style-type: none"><li>• Process for complaints to the manufacturer</li></ul>
Other relevant information	<ul style="list-style-type: none"><li>• Not possible to limit EEA legal liability by cross-referring to more fulsome offering documents or by incorporating those offering documents by reference</li><li>• Links to the relevant documentation should be kept up to date</li></ul>

# A global perspective

- 10b-5 rep and negative assurance coverage on KID
  - Material omission
  - Consequences of updating
- Can a KID be comforted or expertized?
- Selective provision of KID if non-EEA retail investors do not receive KID

# ICMA legends

Long-form – For prospectuses and other documents<sup>27</sup>

Do not include the MiFID II product governance language UNLESS there is an EEA investment firm (including a non-EEA branch of an EEA firm) performing a manufacturing role.

**MIFID II product governance / Professional investors and ECPs only target market** – Solely for the purposes of [the/each] manufacturer's product approval process, the target market assessment in respect of the [Notes] has led to the conclusion that: (i) the target market for the [Notes] is eligible counterparties and professional clients only, each as defined in [Directive 2014/65/EU (as amended, "MiFID II")][MiFID II]; and (ii) all channels for distribution of the [Notes] to eligible counterparties and professional clients are appropriate. Any person subsequently offering, selling or recommending the [Notes] (a "distributor") should take into consideration the manufacturer['s/s'] target market assessment; however, a distributor subject to MiFID II is responsible for undertaking its own target market assessment in respect of the [Notes] (by either adopting or refining the manufacturer['s/s'] target market assessment) and determining appropriate distribution channels.

Banks prefer **not** to reference 'or otherwise made available' due to concerns about not being able to control secondary markets.

This language is being included in all (global) debt and equity linked (convertible / exchangeable) (MLPs / REITs) issuances without formal confirmation that an instrument constitutes a PRIIP. Some banks are concerned having reference to the key information document embeds an assumption that the product is a PRIIP and are making the minor amendments highlighted to show this.

**[PRIIPs Regulation / Prospectus Directive]<sup>28</sup> / Prohibition of sales to EEA retail investors** – The [Notes] are not intended to be offered, sold ~~or otherwise made available~~ to and should not be offered, sold ~~or otherwise made available~~ to any retail investor in the European Economic Area ("EEA"). For these purposes, a retail investor means a person who is one (or more) of: (i) a retail client as defined in point (11) of Article 4(1) of Directive 2014/65/EU (as amended, "MiFID II"); or (ii) a customer within the meaning of Directive 2002/92/EC (as amended, the "Insurance Mediation Directive"), where that customer would not qualify as a professional client as defined in point (10) of Article 4(1) of MiFID II; or (iii) not a qualified investor as defined in Directive 2003/71/EC (as amended, the "Prospectus Directive")<sup>29</sup>. ~~[Consequently]~~ No key information document required by Regulation (EU) No 1286/2014 (as amended, the "PRIIPs Regulation") for offering or selling the [Notes] or otherwise making them available to retail investors in the EEA has been prepared. ~~[and therefore]~~ Offering or selling the [Notes] or otherwise making them available to any retail investor in the EEA may be unlawful under the PRIIPs Regulation.<sup>30</sup>

NOTE – The ICMA position is that the above PRIIPs KID legend can replace the Prospectus Directive legend.

For US SEC registered prospectuses or 144A/Reg S OMs [ & APAC ] add the following language:

'This [Prospectus] [Offering Memorandum] has been prepared on the basis that any offer of the [Notes] in any Member State of the EEA will be made pursuant to an exemption under the Prospectus Directive from a requirement to publish a prospectus for offers of [Notes]. This [Prospectus] [Offering Memorandum] is not a prospectus for the purpose of the Prospectus Directive.'

<sup>27</sup> This drafting relates to 'standalone' bond issuance. Consideration will need to be given to adapting this language for a debt issuance programme and related drawdowns.

<sup>28</sup> Because a PD selling restriction is not required for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more, this reference to the Prospectus Directive does not need to be included for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more.

<sup>29</sup> Because a PD selling restriction is not required for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more, the third limb of the definition of retail investor (which relates to the PD public offer regime) does not need to be included for issues of bonds with a denomination of EUR 100,000 (or equivalent) or more.

<sup>30</sup> Do not include this legend if the prospectus/offering circular relates to an issue of bonds that clearly falls outside the scope of the PRIIPs Regulation.

A blue-toned background image featuring a financial line chart with multiple data series and a grid. The chart shows various peaks and troughs, typical of market data. The overall aesthetic is professional and data-oriented.

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# EU Benchmarks Regulation – new ESMA Q&A Nicola Higgs

# ESMA EU Benchmarks Regulation Q&A

- For the purpose of “tracking the return of [an] index”? Includes:
  - Investment funds the strategy of which is to replicate or track the performances of an index or indices e.g. through synthetic or physical replication
  - Structured investment funds that provide investors with algorithm-based payoffs that are linked to the performance of indices, or to the realisation of their price changes or other conditions
- Using an index for the purpose of “defining the asset allocation of a portfolio”?
  - Documentation (e.g. investment policy or strategy) define constraints on the asset allocation in relation to an index, e.g. by requiring the fund to invest some or all of the portfolio in securities that are constituents of an index
- Using a benchmark as a comparison?
  - Does not fall within the scope of “using a benchmark to measure the performance of a fund” – provided this is the only ‘use’

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# Brexit

## Axel Schiemann and Rob Moulton

# Update of ECB's Brexit FAQs

- Initial FAQs released in April 2017
- Primarily addressed at UK financial institutions considering relocating against the background of Brexit (but may also affect other institutions)
- FAQs cover six topics:
  - Competencies for banking supervision in the euro area
  - Authorisations and licenses to carry out banking activities in the euro area
  - Internal Governance and risk management
  - Recovery planning
  - Internal Models
  - Issues related to ongoing supervision

# Update of ECB's Brexit FAQs

- Key additions in 2018 relate to discussion on required substance of EU27 institutions:
  - “Can I continue to provide services to customers in the EU from a branch in London post Brexit?”
  - “Will the use of a back-to-back booking model be accepted? What arrangements do you expect to be in place when it comes to booking models generally?”
  - “How will booking models be assessed? What are the supervisory expectations vis-à-vis back-to-back booking?”

# Update of ECB's Brexit FAQs

- To be read in connection with opinions released by ESAs
  - ESMA
    - Crosssectoral: General principles to support supervisory convergence in the context of the United Kingdom withdrawing from the European Union (31 May 2017) (ESMA42-110-433)
    - Investment firms: Opinion to support supervisory convergence in the area of investment firms in the context of the United Kingdom withdrawing from the European Union (13 July 2017) (ESMA35- 43-762)
    - Trading venues: Opinion to support supervisory convergence in the area of secondary markets in the context of the United Kingdom withdrawing from the European Union (13 July 2017) (ESMA70- 154-270)
    - UCITS & AIFM: Opinion to support supervisory convergence in the area of investment management in the context of the United Kingdom withdrawing from the European Union (13 July 2017) (ESMA34-45- 344)

# Update of ECB's Brexit FAQs

- To be read in connection with opinions released by ESAs
  - EBA
    - Opinion on issues related to the departure of the United Kingdom from the European Union (12 October 2017) (EBA/Op/2017/12)
  - EIOPA
    - Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union (11 July 2017) (EIOPA-BoS-17/141)

# Key observations re. substance of EU27 institutions

- “Dual hatting”
  - If banks plan on giving more than one role to staff on a temporary or permanent basis, i.e. with staff working for several group entities (“dual hatting”), the ECB and national authorities will carry out a thorough assessment to ensure that sufficient time is spent carrying out the relevant functions in the supervised banks
- Outsourcing
  - Outsourcing may not be used with the intention of stripping the institution’s corporate substance and of setting up a legal vehicle with the sole purpose of benefiting from an EU passport (no “empty shells”)
  - Outsourced activities must be sufficiently monitored and managed by the EU27 institution

# Key observations re. substance of EU27 institutions

- “Back-to-back” transactions
  - Back-to-back transactions must not threaten the continuity of the EU27 entity in the event of the failure of the institution to which the risks have been transferred
  - The EU27 entity must have enough capital in excess of the pillar 1 minimum requirement as well as in-house risk management and operational capabilities to be able to cover any material risks stemming from the unhedged portfolio, manage it actively and wind down the positions (pillar 2 SREP requirement)
  - Back-to-back transactions must be appropriately reflected in the market and credit risk strategies as well as the management of large exposures of the EU27 institution

# Key observations re. substance of EU27 institutions

- Third country branches
  - ECB and national supervisors do not expect that branches in third countries perform critical functions for the credit institution itself or provide services to customers based in the EU27
  - Banks will be asked to clarify the role of branches in third countries and the UK in their Brexit plans (i.e. they will be required to submit detailed information on the branch's activities, organisational structure and geographical distribution of customers, as well as on the persons responsible for managing the branch and any proposed arrangements for dual hatting involving other group entities)

# Other Brexit hot topics

- Continued debate over transitionals
  - December 2020 or March 2021?
  - Whole single market or sectoral?
  - Jurisdiction of ECJ?
  - Rule taking
- Preparation for debate over trade deal
  - Relevance of UK statements on “the”, “an”, “a” single market

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# MiFID II Product Governance

## Rob Moulton

# Product intervention in the UK

- Initial discussion launched on product intervention powers in January 2011
- FCA product intervention powers introduced by the Financial Services Act 2012 and set out in Part 9A of FSMA
- Current policy on use of temporary product intervention rules set out in March 2013 Statement of Policy
- Use of intervention to date:
  - October 2014 - restriction on distributing CoCos to retail investors; later replaced with permanent rules affecting CoCos and mutual society shares

# Product intervention under MiFID II

- Article 42 MiFIR gives product intervention powers to all competent authorities
- Five grounds
  - Significant investor protection or financial stability concerns
  - Existing EU rules do not sufficiently address the risk
  - Action is proportionate
  - Consultation with other competent authorities
  - Non-discriminatory
- ESMA has issued guidance on assessing the above

# ESMA's product intervention powers

- Article 40 MiFIR contains ESMA's temporary intervention powers (three months unless extended)
- Five grounds
  - Significant investor protection or financial stability concerns
  - Existing EU rules do not sufficiently address the risk
  - Competent authorities have not taken (or not taken sufficient) steps to address the risk
  - Action is proportionate
  - No risk of regulatory arbitrage
- ESMA has issued guidance on assessing the above
- ESMA's actions "prevail" over any previous action taken by a national regulator

# ESMA's 18 January Call for Evidence on CFDs and binary options

- 15 December press release – “ESMA will conduct a brief public consultation in January 2018 on this matter”
- 18 January Call for Evidence
- CFDs
  - “significant risk of loss (both from trading and transaction fees) which is magnified by high leverage”
  - “complexity of these products and a lack of transparent information at point of sale which limits the ability of retail investors to understand the risks”
  - “use of aggressive marketing techniques [such as] incentives”
- Binary options – also mentions
  - “intrinsic negative expected returns, in the absence of compensating benefits”
  - “risk of addictive behaviour”

# ESMA's proposals

- Recognition of Article 40's limitations
  - “several NCAs have also taken action...ESMA remains concerned that the risks to investor protection are not sufficiently controlled or reduced by [their] actions”
- CFDs – retail proposals
  - Leverage limits (30:1 major currencies, 5:1 individual equities, 1:1 or a prohibition on cryptocurrencies)
  - Margin close-out rule (50% of margin, which halves the above limits)
  - Negative slippage protection
  - Restriction on financial and non-financial incentives
  - Standardised risk warning
- Binary options – retail proposals
  - Ban

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# Interactive Brokers fine Becky Critchley

# Interactive Brokers fine – background

- Interactive Brokers (UK) Limited (“IBUK”) is an online broker - arranges and executes transactions for UK clients and other entities in the Group
- IBUK fined £1,049,412 (no settlement discount)
- Breach of Principle 3 - *requires a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems*
- Breach of SUP 15.10.2R – reporting suspicious transactions
- Failings in post-trade systems and controls for identifying and reporting potential market abuse from February 2014 to February 2015
- IBUK delegated its post-trade monitoring to a team based at another company within the Group in the US

# Interactive Brokers fine – failings

- IBUK did not take reasonable care to ensure that the post-trade surveillance systems on which it relied were effective in identifying potentially suspicious transactions by its clients in that it failed to:
  - Have adequate policies and procedures in place during the Relevant Period
  - Provide adequate input into the design and calibration of those systems
  - Test the operation of those systems
  - Provide effective oversight of the review of the Post-Trade Surveillance Reports, which were generated by those systems
  - Provide adequate guidance or training to those carrying out that review

# Interactive Brokers fine – industry take-aways

- Market abuse
  - No suspicious transactions reported during the period February 2014 to February 2015
  - To conduct effective monitoring, firms need:
    - Appropriately designed trade monitoring systems
    - Staff with sufficient training and guidance to make appropriate judgments about the use of those systems
    - Robust oversight of the process
  - Consider whether reporting of suspicious trades to the FCA is appropriate

# Interactive Brokers fine – industry take-aways

- Systems and controls
  - Reliance on post-trade surveillance systems designed for the Group
  - Reports generated designed and calibrated by US – no testing by IBUK to ensure they were effective
  - No tailoring to market abuse specific risks of the UK business
  - IBUK market abuse policy:
    - Simply stated the law without any business specific market abuse risks
    - No IBUK specific guidance on how to apply the obligations
    - No guidance on when to escalate
    - No provision for IBUK checking the US reviews
    - No evidence of consideration or challenge by IBUK's Board or senior management as to the extent to which the Policy met UK legal and regulatory requirements

# Interactive Brokers fine – industry take-aways

- Outsourcing
  - Inadequate oversight of US team
  - Failure to monitor or check the reviews of transactions being conducted in the US
  - No procedures in place for quality assurance reviews or for data on performance to be provided to IBUK
  - Inadequate training of US team, e.g. no evidence the US team were aware of the IBUK market abuse policy and no training on UK requirements
  - Relied on US team being experts in the work they carried out
- Note that the Final Notice contains an annex with a summary of the key representations made by IBUK



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Questions?

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## HOT TOPICS

EU Benchmarks Regulation  
[more >](#)

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[more >](#)

Market Abuse Regulation  
[more >](#)

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[more >](#)

MIFID II Research  
[more >](#)

PRIIPs  
[more >](#)

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