SECURITIES SERVICES – REGULATORY ECOSYSTEM

~ Mind Map ~

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Key Regulatory Reforms for Intermediaries

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FATCA

US Foreign Account Tax Compliance Act

Timeline

- **Signed into law** in March 2010; from **Aug 2013** IRS online registration available
- **From July 2014** withholding and FATCA compliant procedures must be in place

Key Themes

- **Rationale:** prevent tax evasion by US investors through non-US accounts; **FDIP income** is fixed, determinable, annual or periodical income sourced in US
- **Foreign Financial Institutions FFI** defined as holding financial assets for the accounts of others; can enter into an agreement with US authority IRS to be identified as participating **PFFI**; entails duty to report to US authorities any accounts held by US investors; local reporting possible where countries have signed Intergovernmental Agreement (IGA) with the US IRS
- Non-participating **N-PFFIs** will be subject to **30 % tax withholding** of all US-sourced payments such as dividends/interests paid by US corporates
- **Operational challenges:** to identify end-investor, to verify as US citizen through chain of intermediaries; new documentation and investor disclosure requirement towards US authorities; change of IT systems
- Applies also to **"pass-through payments"** including those "attributable to" withholdable payments/US sourced income resulting in a wide scope

DODD-FRANK-ACT / VOLCKER / CFTC

US comprehensive rules reforming financial services

Timeline

- **Signed into law** in July 2010; phased implementation
- **Dodd-Frank effective from July 2011; Volcker Rule phased from July 2012**

Key Themes

- **US/non-US investment advisors** need to register with the US SEC if AUM greater than USD $100/25 million respectively attributable to US investors
- **Consequence are stricter record keeping, reporting requirements, oversight and inspection** on eg AUM, capital leverage ratios, counter-party credit risk exposure, trading and investment positions, valuation policies, liquidity and short selling provisions, books and records retention: **Form PF for HFs**
- **US CFTC** regulates swaps; has identified 38 areas divided into 8 sections: swap dealers, clearing, trading, data, products, enforcement, position limits, other
- **Volcker Rule** mandates the segregation of banking and proprietary trading and from sponsoring or investing in AI management functions; leading to spin-offs of proprietary trading desks, HF/PE arms by banks (UK equivalent "Vickers report")
- **Central clearing of OTC derivatives** same concept as European EMIR rules agreed by the G20 in 2009

Impact Themes

- **EVOLVING MARKET INFRASTRUCTURES**
  - Pan-European Integration & Harmonisation
  - Vertical & Horizontal Structures
  - Competition & Consolidation Dynamics
- **COSTS**
  - Cost of Capital & Collateral
  - Price Transparency & Efficiency
  - Technology investment spend
  - Accounting Separation & Service Unbundling
- **RISKS**
  - Credit & liquidity
  - Counterparty exposure
  - Cross-asset class comingling & segregation
  - Cross-border legal & operations
  - Concentration/diversification of service providers
- **OPERATIONS & TECHNOLOGY**
  - Access & Interoperability
  - Speed, Reliability
  - Algo/High Frequency/Robotic/Automated Trading
  - Innovation, Migration, Legacy Systems

Securities Market Infrastructures

TRADING

Stock Exchanges
MTFs , OTFs , ATFs (Trading Facilities)

CLEARING

Central Counterparties (CCPs)

SETTLEMENT

Central Securities Depositaries (CSDs)
Trade Repositories (TRs: derivatives)

Financial Intermediaries

BANKING / SERVICES

Investment Banks
Brokers / Dealers
Asset Managers

Intermediary Banks
Clearing Members (ICM/GCM)
Collateral Management

Depositary Banks
Settlement Agents
Registrars
I/CSDs

focus on safety & soundness

EXPOSURE TO COUNTERPARTIES ← **RISK DYNAMICS** → **MARKET OPERATIONS**

Capital
Clearing
Collateral

Systems
Settlement
Service Providers

AIFMD / UCITS V

EU Alternative Investment Fund Managers Directive / EU Mutual Funds Law

Timeline AIFMD

- **Level 1** Directive in force since July 2011; effective for industry from July 2013
- **Level 2** final delegated regulation adopted in Dec 2012, in force from July 2013

Timeline UCITS

- **UCITS IV** in force and mostly implemented by EU 28 member states
- **UCITS V** proposal published in July 2012; target industry effective date end 2014

Key Themes – service providers – regulatory convergence

- **AIFMD applicable:** to **non-UCITS funds**, including hedge funds, private equity
- **Depositary: new liability rules as in AIFMD** expected spill over into **UCITS V** whereby depositaries are
  - liable for the loss of financial instruments held in custody
  - have the obligation to return corresponding amount without undue delay
  - only following the return may prove – cumulatively – that the loss is a result of 1) an external event, 2) beyond its reasonable control, 3) the consequence was unavoidable, 4) despite efforts to the contrary
- **Delegation:** similar to UCITS/MiFID, but aims to prevent any potential approach by service providers of "outsourcing of risk or liabilities"

CSD-R / SLL

EU CSD Regulation

Timeline CSD-R

- **CSD** Regulation proposal published in March 2012
- Target implementation timeline **before the T2S live date** targeted for mid 2015

Key Themes CSD-R

- **Part 1 – functional approach to focus on settlement activities**, including dematerialization of securities, harmonisation of settlement cycles, discipline
- **Part 2 – institutional approach to focus on CSD organizations**, including authorisation, supervision, segregation of assets, possible choice of issuer CSD

EU Securities Law Legislation

Timeline SLL

- **SLL** Legislation proposal expected to be published in 2014
- Removing the **Giovannini legal barriers** as identified in the 2001/2003 reports

Key Themes SLL

- Aim: increase European cross-border legal certainty of intermediated securities reflecting concepts also enshrined in **UNIDROIT** and **Hague/PRIMA Convention**
- Applicable to account holders and account operators across Europe

BASEL III

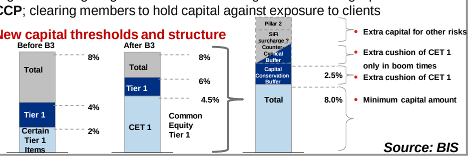
Global Capital Rules for Banks, Insurance & FMIs

Timeline

- **Banking: G20 by end 2012, EU CRD IV**; in US - Dodd Frank Act provisions
- **Similar aim as B3** for insurance sector is **EU Solvency II by 2015** and global Financial Market Infrastructures **FMIs the CPSS-IOSCO Principles April 2012**

Key Themes

- **De-risking/-leveraging:** new global standards designed to strengthen capital and liquidity; stress testing; creating a more robust and resilient banking sector
- **Systemically important financial institutions (SIFIs)**; "living-wills" recovery & resolution plans (**RRP**); measures to limit counterparty credit risk (CCP clearing)
- Higher risk weightings on **derivatives**: 2% against initial margin posted to the **CCP**; clearing members to hold capital against exposure to clients
- **New capital thresholds and structure**



Source: BIS

EMIR

European Market Infrastructure Regulation

Timeline

- **EMIR** entered into force Aug 2012; technical standards in force from March 2013
- **Industry implementation phased from Jan 2013 onwards** (G20 commitment)

Key Themes

- **Central clearing of OTC/ETD derivatives through a CCP** similar to US Dodd-Frank; otherwise capital charges apply; need to **review risk management**
- **Common governance standards for CCPs** and pan-EU requirements for CCP interoperability regarding equities; third country CCPs need to meet new EU standards if used by EU counterparties
- **Increased margin and collateral requirements:** portability and eligibility of collateral not yet finalised, eg required is "highly liquid collateral"
- **Operationally** need to review number and type of collateral relationships with clearing brokers factoring in all risk management aspects & optimisation
- **Mandatory daily independent valuation and collateralisation** of those trades that are not cleared through a CCP centrally
- **Trade repositories:** mandatory reporting of all derivative contracts

MiFID/R II

EU Markets in Financial Instruments Directive

Timeline

- **MiFID II** Regulation & Directive proposal published in Oct 2011
- **Industry implementation targeted from 2015 or after**

Key Themes

- **Wider scope in 3 aspects: 1)** new instruments, **2)** venues, **3)** activities to captured almost any type of derivatives; organised trading facilities (OTFs),
- **Derivatives on-exchange trading (ETD):** if sufficiently liquid (standardized) derivatives shall be traded on-exchange; then cleared centrally (EMIR)
- **OTFs:** scope will be widened to capture any organised trading facility, "dark pools", so called "(broker) crossing networks" etc which will be regulated under the same rules as incumbent stock exchanges
- **High Frequency Trading** and any other automated, algo or robotic trading will be captured to cover new strategies enabled through technology innovation
- **Depositary:** under the SLL will be classified as "investment advice" instead of just "ancillary service" and consequently under MiFID increasing compliance requirements and costs

ECB T2S

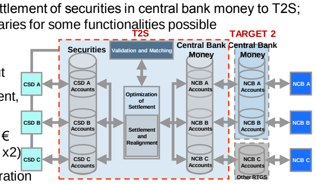
European Central Bank – Target-2 Securities

Timeline

- **Securities Settlement System** project first announced in July 2006
- **Go live date** for first migration wave planned for June 2015

Key Themes

- **Aim:** increase cross-border efficiency and safety of securities settled in central bank money (€ and some non-€ currencies); T2S is built on TARGET2 for cash
- CSDs to 'outsource' the settlement of securities in central bank money to T2S; direct access for intermediaries for some functionalities possible
- 18-€ NCBs participating
- UK & Switzerland opted out
- **Harmonisation** of settlement, asset servicing excluded
- T2S settlement **fee** of 0.15 € per transaction per side (ie x2)
- Prior testing & phased migration



Source: ECB T2S on Target2, November 2009