Regulatory brief

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EU regulatory outlook

With European elections on the horizon, political pressure has heightened over the past few months to finalize major financial regulatory initiatives. This legislative momentum is shaping the EU regulatory outlook for the rest of the year.

In particular, agreements were recently reached on two pillars of the Eurozone banking union, the single supervisory mechanism ("SSM") and the single resolution mechanism ("SRM"). These were finalized in October and December 2013 respectively, setting up several key events in 2014 (including a new supervisory regime by the European Central Bank).

In addition, political agreement was finally reached this month on revising the wide-reaching Markets in Financial Instruments Directive ("MiFID") with an effective date likely for this year. And with a final draft regulation of the EU banker bonus cap expansion (beyond senior managers) issued in December, expect the expanded cap to also take effect in 2014.

Finally, we expect some long-awaited major legislative initiatives to make significant progress in the coming days and months. The legislative proposal on bank structure and proprietary trading is likely to be released by the European Commission ("Commission")[1] this week, while it seems reasonable to expect a new version of the financial transaction tax later this year.

This **Financial Services Regulatory Brief** provides our view of these and other upcoming EU regulatory developments, and delineates upcoming key dates in the **Appendix**.

Eurozone Banking Union

On October 15, 2013, the Council of the European Union ("Council")[2] reached an agreement on the SSM, the first of the three pillars of Eurozone's banking union. Under this agreement, the European Central Bank ("ECB") is charged with Eurozone-wide supervisory authority, and will directly supervise approximately 130 financial institutions in 18 countries,[3] covering 85% of total banking assets in the Eurozone.[4]

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[1] In the EU legislative process, the Commission proposes legislation that, once finalized, is submitted to the EU's bicameral legislature for approval.

[2] The Council (composed of EU member state ministers) is distinct from the European Council (composed of EU heads of states). While the former is part of the EU's bicameral legislature (comprising the Council and the European Parliament), the latter has no formal legislative powers.

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In order to address potential weaknesses in the EU banking sector before assuming supervisory responsibilities in November 2014, the ECB is conducting a comprehensive assessment of these 130 banks. This assessment includes an asset quality review and stress testing, and is expected to apply stricter standards than prior examinations. The assessment process began in November 2013 and is expected to be completed within 12 months. It could result in a number of banks being required to raise significant capital or to otherwise de-leverage.

The second pillar of banking union, the SRM, has been more controversial than the SSM, due largely to widespread opposition to any proposal that calls for the ECB control of the banking resolution mechanism. Germany also opposes the concept of an EU-wide resolution fund.

After months of negotiation, Council ministers reached an agreement on an SRM blueprint in December 2013 which addresses both concerns. First, instead of concentrating resolution decision-making powers in the ECB, the blueprint puts a pan-European resolution board in charge. Second, the blueprint for the Eurozone resolution fund suggests that it would form slowly over a 10 year period, and does not yet prescribe how the fund would be deployed. The blueprint allows the current SRM proposal to move forward in the legislative process separate from the resolution fund. A final agreement on the fund by the Council is expected during the first half of 2014.

The SRM is expected to be the focus of final negotiations to become law during the current session of the European Parliament ("EP"). If passed by the EP, it will become effective on January 1, 2015, with bail-in and resolution functions applicable beginning on January 1, 2016. However, SRM compliance will not be required until the single resolution fund also enters into force.

Meanwhile, the Banking Recovery and Resolution Directive[5] ("BRRD"), which provides the underlying framework for bank resolutions (applicable to all 28 EU nations) is expected to clear the legislative process in time for an expected compliance date of January 1, 2015.[6] The BRRD mandates that banks bail-in up to 8% of their total assets before other resolution measures or public funds can be applied.

Finally, the third pillar of the banking union, a deposit guarantee scheme ("DGS"), is no longer a short-term priority. The Commission issued its DSG proposal in 2010, and the Council reached a political agreement on the proposal in December 2013. However the political agreement falls short of creating a Euro-wide DGS, opting instead to improve the existing national deposit guarantee programs. We expect that short-term efforts will focus on harmonizing the current patchwork of national deposit guarantee programs.

Markets in Financial Instruments Directive and Regulation ("MiFID II")

On January 14, 2014, after over two years of negotiations, the Commission, the Council, and the EP reached a political agreement on revisions to MiFID and the new accompanying Regulation ("MiFIR"), collectively known as MiFID II. This agreement is intended to enhance existing rules on competition, transparency, and consumer protection, and to complete fulfilment of the EU's G20 commitments on derivative market reform. MiFID II is expected to become effective in 2014, with a two-year transition period to allow EU member states to implement the directive into their national laws.

The agreement introduces a market infrastructure framework that will push over-the-counter ("OTC") derivatives trading onto regulated platforms similar to swap execution facilities in the US.[7] MiFID II also seeks to promote market competition by providing non-discriminatory access to trading venues, benchmarks, and central counterparties.

Beyond derivative market reform, MiFID II expands the existing MiFID rules on the governance and operation of investment firms, extends pre- and post-trade transparency to a wider range of financial instruments, and introduces new consumer protection rules. The

[3] While the SSM is automatically applicable to the 18 Eurozone nations, participation by the 10 EU member states that are not members of the Eurozone (e.g., the UK) is optional.

[4] All other credit institutions (6000+ in the Eurozone) will remain supervised by their national authorities, although the ECB may elect to exercise direct supervision on these institutions in the future.

[5] In the EU legislative process, issues covering highly prescriptive provisions (e.g., capital, liquidity and leverage ratios, as well as counterparty exposure and disclosure requirements) are proposed as *regulations*, while issues covering areas of national interest (e.g., authorization, supervision, sanctioning, and governance of financial institutions) are proposed as *directives*. While regulations are applicable directly to covered institutions upon passing into law, directives must first be implemented into national laws by each EU member state.

[6] Normally member states are provided with a two-year timeframe to implement directives nationally, but given the banking union's political urgency, implementation timeframe is being shortened.

[7] For information about US swap execution facilities, see PwC's *Financial Services Regulatory Brief, Derivatives: SEFs – Opening bell sounds* (June 2013).

agreement also imposes specific new controls on algorithmic and high frequency trading, and introduces position limits for commodity derivative market participants.

Finally, MiFID II changes the terms under which branches of non-EU firms can access European clients. Branches whose home state regulations are deemed equivalent to MiFID II will benefit from the same pan-European passporting rights (i.e., the ability to conduct business freely across the EU) as EU firms when dealing with professional counterparties.

Capital Requirement Directive ("CRD IV") and Bonus Cap

CRD IV's phase-in began on January 1, 2014, with a full implementation date of January 1, 2019. To fulfil its legislative mandate, the European Banking Authority ("EBA")[8] is set to draft over 100 CRD IV regulations by the end of 2014.

The CRD IV package comprises the Capital Requirements Directive ("CRD"), and the Capital Requirements Regulation ("CRR"). Compliance with both CRD and CRR is phased-in beginning on January 1, 2014. However CRR is applicable directly to all institutions across the EU, while CRD must be implemented on a national level and its application will depend on national legal systems. Therefore, as stated in our prior brief,[9] we expect uneven timing for implementation of CRD.

Of particular importance is CRD's cap on bankers' bonuses, generally limiting bonuses to a maximum of 200% of base salaries.[10] The bonus cap is effective as of January 1, 2014, impacting senior management employed by EU-based banks, and their affiliates and subsidiaries in the US and elsewhere. A draft regulation to expand the cap to certain "material risk takers" was proposed by the EBA in December 2013 and is expected to take effect around mid-2014.[11] As proposed, the regulation will expand the number of bankers subject to the bonus cap, although not by as much as a previous draft of the regulation (released in September) had contemplated.

European Market Infrastructure Regulation ("EMIR")

The first EMIR reporting requirements become effective in February 2014. Regulators aim to finalize outstanding requirements for central clearing, non-centrally cleared margins, and cross-border transactions by the end of the year.

Transaction reporting: With the first group of trade repositories authorized by the European Securities and Markets Authority ("ESMA") on November 7, 2013, EMIR's derivative transaction reporting is set to begin on February 12, 2014 for both OTC and exchange-traded derivatives ("ETD").[12] Market participants are struggling to reconcile EMIR reporting standards to other existing reporting standards, and certain EMIR data protocols that must be endorsed by EU legislators are yet to be finalized.

Central clearing: September 15, 2013 marked the deadline for central counterparties ("CCP") to apply for ESMA authorization. Authorization decisions are due from ESMA by March 15, 2014, and a proposed regulation on clearing requirements is due to be delivered to EU legislators by September 15, 2014, with an effective date yet to be determined. Given the length of the EU's regulatory approval process (two to six months), it is unlikely that EMIR clearing obligations will become effective in 2014.

Uncleared margin rules: We expect the European Supervisory Authorities[13] to publish their proposals for EMIR non-centrally cleared margin rules in early 2014. These proposals are being drafted in accordance with the requirements established in September 2013 by the Basel Committee and the International Organization of Securities Commissions ("IOSCO"). Final rules are expected to be effective beginning on December 1, 2015, as recommended by the Basel Committee and IOSCO.

Cross-border application: On November 15, 2013, ESMA delivered its final draft cross-border regulation to the Commission. The final draft regulation extends

[8] The EBA is one of the three European Supervisory Authorities ("ESAs"). The other two are the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority. In addition to supervising the EU's financial system, the ESAs are often called on by the Commission to provide draft financial regulations.

[9] See PwC's *Financial Services Regulatory Brief*, *European Regulatory Outlook* (June 2013).

[10] Bonuses that are higher than 100% of base salaries will be subject to shareholder approval. See PwC's *Financial Services Regulatory Brief*, *EU Bonus Cap: Fewer bankers likely impacted in 2014* (September 2013).

[11] See PwC's *Financial Services Regulatory Brief*, *EU bonus cap: Proposed expansion curtailed* (December 2013).

[12] In August 2013 ESMA requested a delay until January 1, 2015, for ETD reporting, in order to reconcile ETD reporting requirements under EMIR and other financial instruments regulations. After the Commission's rejection of that request in November 2013, ESMA filed a second request to delay reporting which remains under consideration by the Commission.

[13] See note 8.

certain EMIR obligations to OTC derivative transactions between third-country counterparties where (subject to certain conditions) either (a) at least one counterparty benefits from a guarantee by an EU counterparty, or (b) the counterparties are third-country financial counterparties that enter into transaction via their EU branches. The Commission is expected to issue an opinion by February 15, 2014. Third-country counterparties captured by the new rules will need to comply six months after the rules become effective.

Alternative Investment Fund Managers Directive ("AIFMD")

Following ESMA's revised final guidelines regarding AIFMD reporting obligations on November 15, 2013, the first round of asset manager annual reports from those managers who received AIFMD authorization in 2013 are due by January 31, 2014. While some non-EU managers marketing to EU member states since July 22, 2013 may be subject to this reporting deadline, EU managers have been granted a one-year transition period to fully comply with AIFMD's requirements by July 22, 2014.[14] The first annual reports for EU and non-EU managers who receive authorization in 2014 are not expected to be due until January 2015.

Bank structure and proprietary trading

A Commission proposal on bank structure is expected this week, based on the 2012 Liikanen Report, to prevent banks from engaging in risky trading and investment activities. The proposal could ban proprietary trading for the largest EU-based banking organizations, prohibiting them from owning, sponsoring, or having certain exposure to hedge funds. Other trading activities (e.g., market making) may be pushed out of the core retail banking unit (based on metrics to-be-determined for establishing the risk level of the activity). The Commission's proposal would likely pass into law by the end of 2015.

[14] See PwC's *Financial Services Regulatory Brief, EU's AIFMD: Impact on US asset managers – New regime starts July 22nd* (June 2013).

Financial transaction tax ("FTT")

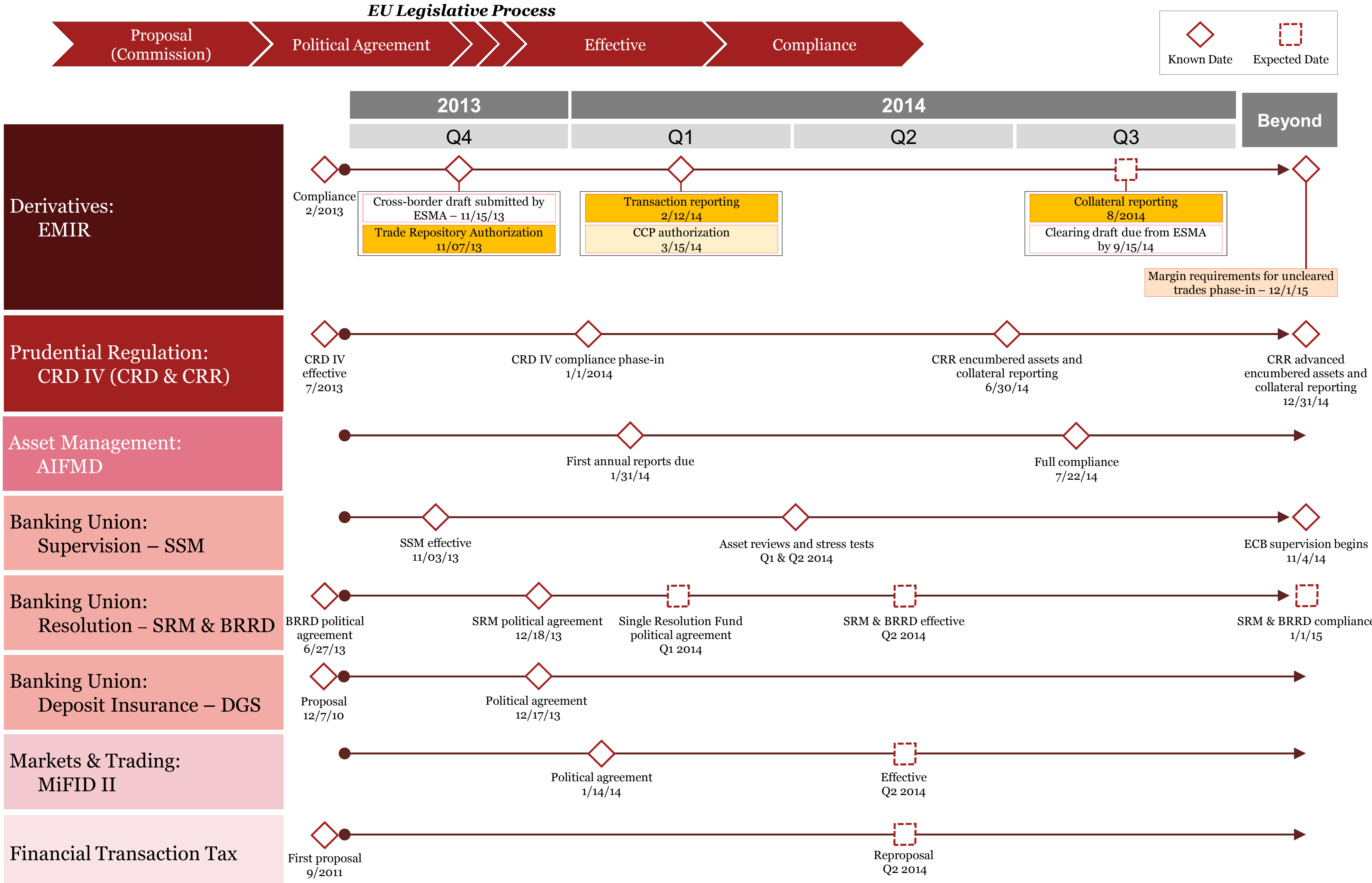
The EU financial transaction tax was first proposed by the Commission in September 2011 with an effective date of January 1, 2014. This initial proposal stalled in the legislative process due to opposition by a group of EU member states lead by the UK. As a result, in October 2012, 11 member states[15] moved forward with a proposal that would implement the FTT within those states.

With persisting disagreements among the 11 participating member states regarding FTT's scope, implementation, and collection provisions, it is now unlikely that the tax will become effective in 2014, as they initially hoped. Instead, a new proposal is likely in mid-2014.[16]

[15] These member states are: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia, and Spain. Under the "enhanced co-operation framework," a minimum of nine EU member states may pass laws within the EU legislative process without other member states. However, laws passed under the enhanced co-operation framework will be applicable only to those nations that participate in the effort.

[16] See PwC's *Financial Services Tax Newsflash, EU FTT: The long and winding road to…?* (December 2013).

Appendix: European regulatory agenda – Key dates



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