REGULATORY DEVELOPMENTS IN EMEA

Volume 2, 2021
This newsletter outlines Northern Trust’s thoughts about recent regulatory changes, and how they might affect your programmes. It summarises recent developments impacting the financial industry and how Northern Trust will support clients through this period. For more information, contact your Northern Trust representative or visit northerntrust.com.
REGULATORY OUTLOOK

When one reviews the speeches that regulators are making and the consultations that are being launched both on a European Union (EU) and on a national competent authority level, the themes are increasingly consistent.

Whilst culture and accountability remain hot topics, other common themes include focus on costs and charges, liquidity, operational resiliency and, of course, Environmental, Social and Governance (ESG) investment factors.

Brexit-wise, the technical negotiations on the Memorandum of Understanding (MoU) successfully concluded on 28 March, 2021, and the European Commission is now working on formal mechanisms to involve the European Council and European Parliament in the future Joint UK-EU Regulatory Cooperation Forum.

The new Joint Regulatory Cooperation Forum will provide a valuable space for EU and United Kingdom (UK) representatives to discuss potential legislative or regulatory changes. While the Commission still maintains its tough stance concerning the future of equivalence for the UK in the short-term, the fact that both sides will soon have a formal mechanism to raise and discuss their differing regulatory approach is a welcome step.

However, given the MoU is not legally binding, whether the Forum will trigger ‘enhanced cooperation and coordination’ will largely depend on the political will from both sides.

In addition, there are increasing signs that the UK is not waiting for ‘equivalence’ and will take the opportunity to diverge wherever it sees fit. A recent example would be the extension of the Undertakings for the Collective Investment in Transferable Securities (UCITS) funds Packaged Retail and Insurance-based Investment Products (PRIIPs) Key Information Document (KID) exemption for a further five years. Although the core objectives are likely to remain similar between UK & EU regulation, we expect to see further divergence in the coming months.

The UK government’s response to the recently closed consultation on the future of the UK funds industry and how other jurisdictions, particularly Ireland and Luxembourg, respond is also worth staying close to.

As can be seen by the plethora of reviews highlighted in our ‘Watching Brief’, there are several reviews of key European regulation that are due to conclude in the coming months. The outcome of all of these is likely both to require change and give a clear indication of the regulators’ current thinking and priorities.

In this Newsletter

We discuss the latest relating to CSDR settlement discipline, the transition away from LIBOR, updates on uncleared margin, along with various fund and ESG-related regulations.
UPCOMING REGULATORY CHANGES

Although there has been a slight slowdown in new regulation coming into force in recent months, there are a number of impactful regulations being implemented before the next version of this newsletter will be published in early 2022 as well as some reviews of key EU regulations that will also conclude over the same period.

We continue to track regulatory developments, with key items in the pipeline across the region highlighted below:

- The Alternative Investment Fund Managers Directive (AIFMD) review and its potential to impact on delegation
- The operational resiliency consultation response and potential regulation in various jurisdictions
- The development of the UK Long-Term Asset Fund (LTAF) in comparison to the European Long-Term Investment Fund (ELTIF)
- The PRIIPs Regulatory Technical Standard (RTS), which will soon be before the European Parliament
- The EU’s Markets in Financial Instruments Directive (MiFID) review, which is taking place in the second half of 2021
- The Central Securities Depositories Regulation (CSDR) consultation response
- The Money Market Fund Regulation (MMFR) review
- The PRIIPs review
- Regulation on Markets in Crypto Assets (MICA)
- The Digital Operational Resiliency Act (DORA)
- Regulatory clarity relating to
  - Sustainable Finance Disclosure Regulation (SFDR)
  - The EU taxonomy and the UK’s Task Force on Climate-Related Financial Disclosures (TCFD)
  - The next phase of European Market Infrastructure Regulation (EMIR) Uncleared Margin

Whether change is initiated locally, regionally or globally, the continuing evolution of regulation requires constant monitoring.

Northern Trust dedicates significant time to tracking and analysing the implication of regulatory change. Should you wish to find out further details, please contact your Northern Trust representative.
TRANSITION AWAY FROM LONDON INTERBANK OFFERED RATE (LIBOR)

REMINDER OF KEY DATES

The UK’s Financial Conduct Authority (FCA) announced in March that from 31 December, 2021, most of the 35 LIBOR settings would cease to exist or no longer be representative. The exceptions are five USD LIBOR settings that will cease immediately following the LIBOR publication on 30 June, 2023. This later date for certain USD LIBOR settings is intended to allow more legacy USD LIBOR-linked contracts to mature on their existing terms. Note that the euro overnight index average (EONIA) will also be discontinued on 3 January, 2022 and replaced by the euro short-term rate (€STR).

The market has been working to transition away from LIBOR since 2017, with national working groups for the relevant currencies putting forward alternative Risk-Free Rates (RFRs) that seek to address the challenges inherent in LIBOR definition, namely:

- The lack of underlying transactions on which to base the rate;
- The use of expert judgement to supplement the rates; and,
- The impact of the underlying liquidity dynamics of the markets being referenced.

With the deadline nearing, the focus on executing the transition is becoming more acute. Speaking before the US House of Representatives, Federal Reserve Vice Chair for Supervision, Randal K. Quarles, said completing the LIBOR transition was one of the regulator’s two highest priorities for 2021 and ‘the time for comment, speculation, and delay has long since passed.’ He added that banks’ practices would be examined in accordance with the fact that using LIBOR in new contracts post 31 December, 2021 would create safety and soundness risks.

REGULATORS GLOBALLY PUSHING FOR ACTION

The evolution away from use of LIBOR is a global regulatory theme. On 2 June, 2021, the Financial Stability Board (FSB) announced that all new use of LIBOR benchmarks should cease as soon as practicable and no later than the timelines set out by home authorities and/or national working groups in the relevant currencies.

In particular, even though some USD LIBORs will continue until mid-2023, the US Banking Supervisors have stated that firms should cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable, and in any event by no later than 31 December, 2021.
In a supervision newsletter published in May, the European Central Bank (ECB) re-enforced the message that ‘it is crucial that banks actively manage these transitions by reducing their legacy contracts and, where necessary, amending the wording of other affected contracts to provide clarity on these changes.’

**STATE OF READINESS**

There has been significant progress in the transition away from LIBOR, driven by a series of industry milestones set by national works and the work of market participants. As of August 2021, more than 14,000 parties had adhered to the International Swaps and Derivatives Association (ISDA) 2020 IBOR Fallbacks Protocol (according to a list published online by ISDA), with the Bank of England’s (BOE) Governor Andrew Bailey estimating that over 97% of sterling interest rate derivatives now have a robust safety net in place.

In line with the UK Sterling Risk-Free Reference Rates (RFR) Working Group milestones, from the end of March this year, the majority of new GBP LIBOR business should have ceased, further shifting demand to RFR markets. New sterling floating rate note issuance has almost exclusively referenced Sterling Over Night Indexed Average (SONIA) for some time. In the Sterling swap market, the share of SONIA-referencing swaps regularly exceeds the LIBOR equivalent, with continued progress since the ‘SONIA-first’ interdealer quoting convention switch last year.

As of May 2021, over 50 GBP bonds have actively transitioned from LIBOR to SONIA ahead of cessation and while this can be considered as leading transition away from LIBOR in comparison to other markets, a significant body of work nonetheless remains to deal with existing legacy contracts.

Lending has proved more challenging; here, market conventions and relevant infrastructure to support the use of overnight rates have been slower to settle and implement. In a March 2021 letter from UK supervisory authorities to UK banks, the pace of transition in syndicated lending business was highlighted as lagging other segments of the market.

**KEY MILESTONES FOR H2 2021**

While much good progress has been made, there are still significant milestones through Q3 and Q4 of this year. In the US, the Commodity Futures Trading Commission (CFTC) recommended, as a market best practice, that interdealer brokers change USD linear swap trading conventions from USD LIBOR to the Secured Overnight Financing Rate (SOFR) on 26 July, 2021. The initiative (referred to as ‘SOFR-First’ in a nod to the UK’s earlier ‘SONIA-First’ switch) is a key enabler of a SOFR term rate. Following the successful completion of that change, the Alternative Reference Rates Committee (ARRC) formally recommended CME Group’s forward-looking SOFR term rate, and put forward use cases for how best to employ the SOFR Term Rates to successfully transition away from USD LIBOR.
Derivative central counterparties (CCPs) have been considering some of the challenges posed by relying on ISDA Fallbacks for cleared swaps. Consultations with the industry have been progressing, and proposals are being developed to execute pre-emptive conversions of legacy LIBOR contracts to market standard Overnight Index Swap trades shortly before LIBOR cessation.

In Singapore, the process to transition from the SGD Swap Offer Rate (SOR) to the Singapore Overnight Rate Average (SORA) has also progressed. Financial institutions will have to cease issuing SIBOR-linked financial products and SOR derivatives by the end of September this year. The extension of USD LIBOR discontinuation means that SOR will end when USD LIBOR ceases in mid-2023, however as with the US, the priority is to ‘stop adding legacy SOR exposure as soon as practicable.’

The UK RFR Working Group’s roadmap for 2021 includes an end-Q3 target to ‘complete active conversion of all legacy GBP LIBOR contracts expiring after end-2021 where viable and, if not viable, ensure robust fallbacks are adopted where possible.’

“TOUGH LEGACY”

‘Where possible’ is an important caveat, and several initiatives to address the tough legacy challenge are in flight and gaining increasing attention from supervisors. In the same Congressional hearing referenced earlier, Federal Reserve Vice Chair Quarles, when asked about the issue of tough legacy LIBOR exposures, reiterated that ‘there's really no way to address that other than legislation.’

Legislation has been passed in the EU and in New York, allowing for a fallback rate to be mandated where existing contractual clauses have no or ‘no-suitable’ fallback provision. Federal legislation is being drafted in the US. The FCA in the UK is taking a different approach, gaining new powers to change the underlying methodology of LIBOR and to continue publishing a ‘synthetic LIBOR’ for certain LIBOR settings once the rate loses representatives. Consultations are continuing with a final policy not expected until Q4, leaving some uncertainty as to the scope of the provisions. The FCA has continually reminded market participants ‘that any permitted use of synthetic LIBOR would not be a permanent solution, so parties will need to continue their efforts to amend their contracts.’ This sentiment can be applied more broadly with a consensus view across supervisors that fallbacks are not an alternative to pre-emptive actions.
CREDIT SENSITIVE RATES

There has been some coverage in the market on credit sensitive benchmarks, such as AMERIBOR and Bloomberg’s BSBY rate. These rates behave similarly to LIBOR; they could therefore be easier to implement operationally than daily RFRs, which lack a credit sensitive element, do not in some cases have term rates available and need to be compounded or averaged over a period. While some see arguments in favour of the challenger rates, supervisors have been expressing caution and reinforcing recommendations of a switch to robust, alternative RFRs.

Speaking on this topic at ARRC’s SOFR symposium in May, Governor Andrew Bailey (BOE) reiterated the need for financial firms and borrowers to choose the most robust alternative reference rates, noting concerns in his speech that ‘substituting LIBOR for credit sensitive rates that do not address all of its [LIBOR’s] fundamental weaknesses, …risks much of the good progress that has been made.’

Remarks by Secretary of the Treasury Janet L. Yellen echoed this view; ‘The decisions made now around the selection of alternative rates will determine whether some of LIBOR’s shortcomings may be replicated through the use of alternative rates that lack sufficient underlying transaction volumes. I am concerned about recent use, and potential future growth in use, of these rates in derivatives. The most critical step in the transition is the move toward truly robust alternative rates, like SOFR, which can mitigate the need for future transitions.’

July’s confirmation by the ARRC that it ‘supports the use of SOFR Term Rate in addition to other forms of SOFR for business loan activity’, and that it recognises that the SOFR Term Rate may be appropriate for end-user facing derivatives that hedge cash instruments linked to the Term Rates, may help in this regard, however the ARRC was clear it ‘does not support the use of the SOFR Term Rate for the vast majority of the derivatives markets.’

NORTHERN TRUST ACTIONS

Northern Trust’s LIBOR Transition Program remains on track. Relationship Managers and Client Service Teams are reaching out to clients to identify specific actions to be undertaken to execute on the transition. Please contact your Relationship Manager if you have questions or for further information.
OPERATIONAL RESILIENCE

INTRODUCTION

In March 2021 the Basel Committee on Banking Supervision (BCBS) published its ‘Principles for Operational Resilience’, emphasising the need for further work ‘to strengthen banks’ ability to absorb operational risk-related events, such as pandemics, cyber incidents, technology failures and natural disasters, which could cause significant operational failures or wide-scale disruptions in financial markets.’

Operational resilience is an evolution beyond business continuity. The BCBS recognises that a range of potential hazards cannot be prevented, but ‘that a pragmatic, flexible approach to operational resilience can enhance the ability of banks to withstand, adapt to and recover from potential hazards and thereby mitigate potentially severe adverse impacts.’

COMMON PRINCIPLES

The principles put forward by the BCBS share core themes with recent policy statements from the UK Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA), as well as a consultation from the Central Bank of Ireland (CBI). Principles include having governance and accountability at the appropriate levels, third-party dependency management, incident management and learning from responses to events with the aim of continually enhancing the operational resilience of a firm.

Concepts common across the work of the Irish and UK supervisory authorities include the identification of ‘Important Business Services’ provided to clients, and the definition of ‘Impact Tolerances’ that quantify the maximum acceptable level of disruption to those services. Firms are expected to understand and map out how Important Business Services are delivered and test their ability to remain within their Impact Tolerances using scenarios that are ‘severe but plausible.’ Where third-party providers are employed in the provision of Important Business Services then these components must be understood, and firms should work with providers to set and remain within Impact Tolerances. Ultimately, the requirements to set and remain within tolerances are the responsibility of the firm, regardless of whether it uses external parties for the provision of Important Business Services.

Internal and external communication plans are key components of an overarching operational resilience framework, enabling firms to respond quickly and effectively to reduce the harm caused by operational disruptions. Post-incident ‘lesson learned’ exercises and ongoing self-assessment can support a culture of learning and continuous improvement as operational resilience evolves.

Important Business Services

Defined by the FCA* and the PRA** as a service provided by a firm, or by another person on behalf of the firm, to one or more clients of the firm which, if disrupted, could:

1. Cause intolerable levels of harm to one or more of the firm’s clients;
2. Pose a risk to the soundness, stability or resilience of the UK financial system or the orderly operation of financial markets; or;
3. The firm’s safety and soundness (applicable to dual regulated firms)
KEY DATES IN IRELAND AND THE UK

Firms in scope for the FCA and PRA policies are now in an implementation period before the rules take effect on 31 March, 2022. In the time remaining, in-scope firms should identify their Important Business Services and define the associated Impact Tolerances, while completing mapping and scenario testing to a level of sophistication necessary to:

- Identify important business services;
- Set impact tolerances; and
- Identify any vulnerabilities in operational resilience

Following the 31 March, 2022 date, firms must be able to remain within their Impact Tolerances as soon as reasonably practicable, but no later than 31 March, 2025.

The CBI consultation on published guidance closed in early July 2021 with output still pending at time of publication, however the CBI "expects firms to be actively and promptly addressing operational resilience vulnerabilities and be in a position to evidence actions/plans to apply the guidance at the latest within two years of its being issued".

GLOBAL ACTIVITY

As noted by the CBI, 'operational resilience for the financial services sector does not, at present, benefit from one clear, detailed international standard', but regulators are aligned on the fundamentals. Globally, we have seen an increased focus in the development of principles, guidelines, consultations and statements on the topic of ensuring operational resilience for firms.

Examples include:

- The European Central Bank statement from December 2020 emphasising its commitment 'to working closely with the Federal Reserve and the UK Prudential Regulatory Authority to ensure that supervisory approaches on operational resilience are well coordinated.' This followed earlier publication of the EU Digital Operational Resilience Act (DORA).
- In the US, the Federal Reserve published "Sound Practices to Strengthen Operational Resilience", outlining practices to increase operational resilience that are drawn from existing regulations, guidance, statements, and industry standards. More recent was the July 2021 request for comment on proposed risk management guidance for third-party relationships; this is inter-agency guidance that "seeks to promote consistency in its third-party risk management guidance and to clearly articulate risk-based principles on third-party risk management."
- The Australian Prudential Regulation Authority (APRA) reported that Australia's financial entities were "weathering the pandemic well so far", but signposted its intention to apply lessons learned in relation to operational resilience and improve its supervision practices.

Applicability

The FCA* policy applies to banks, building societies, designated investment firms, insurers, Recognised Investment Exchanges (RIEs), enhanced scope Senior Managers’ and Certification Regime (SM&CR) firms and entities authorised or registered under the Payment Services Regulations 2017 (PSRs 2017) or the Electronic Money Regulations 2011 (EMRs 2011).

The PRA** supervisory statement is relevant to all UK banks, building societies, and PRA-designated investment firms; and UK Solvency II firms, the Society of Lloyd's, and its managing agents.

The CBI guidance applies to all regulated financial service providers.
• The Hong Kong Monetary Authority announced plans to revise operational risk principles in light of the work of the BCBS, with a consultation to follow “in due course”.
• The Monetary Authority of Singapore and the Association of Banks in Singapore issued a joint paper, “Risk Management and Operational Resilience in a Remote Working Environment” in March 2021 to raise awareness of remote working risks in the financial sector.

At Northern Trust we continue to monitor developments globally.

NORTHERN TRUST ACTIONS

Northern Trust has a program in place focussed on meeting the requirements set by the UK supervisory authorities. This program comprises subject matter experts from across the organization who are developing and implementing a plan that aligns with the requirements of our UK regulators.
CENTRAL SECURITIES DEPOSITORIES REGULATION (CSDR)

INDUSTRY AND REGULATORY DEVELOPMENTS

The Central Securities Depositories Regulation (CSDR) aims to increase safety and improve settlement efficiency, as well as provide a set of common requirements to ensure the safety of EU Central Securities Depositories (CSDs).

To support this, CSDR has been harmonising the authorisation and supervision of CSDs within the EU since 2014. Since 2014, there has been a phased introduction of the requirements, including:

- T+2 settlement cycle;
- Authorisation, including strict prudential and conduct rules for CSDs;
- Internalised settlement reporting; and
- Omnibus and segregated accounts, including risk and cost disclosures

The next phase of CSDR focuses on the Settlement Discipline Regime, and is currently scheduled to be implemented by the various impacted market participants by 1 February 2021.

The measures to apply to CSDs, trading venues and investment firms and, in particular, include:

i. the mandatory buy-in regime;
ii. the requirement for CSDs to implement penalty mechanisms; and
iii. the cash compensation mechanism for failed buy-ins.

As with other EU regulations, Article 75 of CSDR requires the European Commission (EC) to prepare a report on its implementation and submit it to the European Parliament and Council, including any proposed legislative changes if necessary.

As we mentioned in our last newsletter, the EC issued a targeted consultation for stakeholders, which closed in April. There was a strong response from the industry, and in conversations with the industry associations, the consensus of feedback from the consultation was that a majority of respondents agreed that there was a need to revise the Settlement Discipline Regime, in particular advocating that buy-ins should be made voluntary and that the rules on buy-in agents should be amended. The European Commission’s report in response to the consultation was released on 1 July, 2021. The report highlights that the Settlement Discipline Regime, in particular the mandatory buy-in rules, were a key focus area in the responses of many stakeholders.

The European Central Securities Depositories Regulation (CSDR) is one of the key regulations adopted in the aftermath of the 2008 financial crisis.
Almost all stakeholders have noted that there is a significant lack of clarity as to the scope of application of the mandatory buy-in rules. In addition, the vast majority of respondents to the consultation indicated that buy-in rules should be reviewed, with a large majority in favour of voluntary rather than mandatory buy-ins. A clear and consistent argument was that mandatory buy-ins will reduce liquidity in the market, increase costs for investors and place EU CSDs at a competitive disadvantage when competing with third-country CSDs that do not have to comply with similar rules. Most respondents to the targeted consultation also noted that settlement discipline, in particular mandatory buy-ins, would have had a significant negative impact on the market during the turmoil provoked by COVID-19 as it would have:

- Increased liquidity pressure;
- Increased the cost of securities at risk of being bought-in; and
- Hampered the ability to hedge.

In conclusion, the European Commission report noted that, “In light of stakeholders’ feedback, it is appropriate for the Commission to consider proposing certain amendments, subject to an impact assessment, to the settlement discipline framework, in particular the mandatory buy-in rules, to make it more proportionate and avoid potential undesired consequences.” The report also illustrated that clarity on the scope of the rules on cash penalties may also be required.

Following the publication of the report, it is generally viewed that cash penalties will be implemented without further material revisions but that there may well be changes to the buy-ins regime. However, importantly the European Commission has provided no indication in its report of what the possible changes might be or when they will be formally announced.

As a consequence, the industry associations have sent a joint letter to the European Commission in which, “the Joint Associations therefore urge ESMA and the Commission to ensure that the current mandatory buy-in rules are not subject to application on 1 February, 2022, when the relevant RTS is currently set to enter into force, and to provide clarity to market participants on the matter at the earliest opportunity. The implementation of the current rules, which in our view are deeply flawed, would be a considerable endeavour requiring major technology and operational changes, as well as a global contractual repapering exercise.”

In addition, a consolidated letter from 16 industry associations was sent to the European Commission stating; ‘We therefore believe that the implementation of the mandatory buy-in rules should be urgently disapplied through an appropriate regulatory mechanism that provides legal certainty to market participants. As yet, there has been no further response from the European Commission.

The hope is that the European Commission will provide further clarity in Q3 2021, before the CSDR legislation is finalised at the end of the year which would include confirming its views on de-coupling mandatory buy-ins or a possible postponement of CSDR beyond February 2022.
We continue to watch developments with interest but the general consensus is increasingly that time has now run out and the industry cannot wait any longer for the open questions to be answered. As such, on the whole, the industry continues to work off the existing timetable of CSDR settlement discipline coming into force in February 2022, as it is currently written.

NORTHERN TRUST ACTIONS

Northern Trust has a formal execution programme in place to ensure we meet our obligations under the settlement discipline regime, in addition to supporting our clients. Our CSDR implementation programme is committed to effectively managing this change and providing timely information to enable clients to assess impacts to their business.

Our core impacted products and services have identified service offering changes for cash penalties to support readiness activities. We on-boarded an external third-party system for the management of messaging and cash penalties, as well as daily and monthly reporting.

We have recently re-started our buy-in project with the intention to be ready on time. However, due to the high level of uncertainty and likelihood of further delay and/or change, our plans are to implement manual solutions where practicable.

Our client engagement has increased with both client communications, industry updates and a client toolkit released to clients.

Northern Trust representatives are actively engaged in the Association for Financial Markets in Europe (AFME), Association of Global Custodians (AGC) and the Investment Association (IA) to ensure we continue to monitor regulatory developments and support ongoing industry lobbying and development of market practice guides where open questions remain. We continue to monitor any developments resulting from the EC survey and will provide any updates to you on these as they arise.
SUSTAINABLE FINANCE

INTRODUCTION

In our more recent newsletters, we have highlighted the increased attention on sustainable finance within the financial services sector across Europe, and the increase in regulatory developments since the European Commission’s (EC) Action Plan on Sustainable Finance was released in March 2018. These updates have focused on the introduction of the EU regulation on sustainability-related disclosures in the financial services sector, the Sustainable Finance Disclosure Regulation (SFDR).

As a reminder, this regulation requires financial market participants to disclose how they have integrated an assessment of sustainability risk into policies, processes and due diligence, with Level 1 measures commencing on March 10, 2021, and Level 2 measures due by January 1, 2022. However, in July 2021 the European Commission announced delays to the implementation of the Level 2 technical standards to June 2022, with further revised regulatory technical standards (RTS) due to be published in H2 2021, consolidating prior published RTS documents.

For UK firms, the SFDR legislation was not on-shored as part of the Brexit withdrawal agreement legislation process, therefore management level disclosures do not apply. However, there could be circumstances where product level rules apply, e.g. for a fund marketing into an EU country under the National Private Placement Regime of the Alternative Investment Fund Managers Directive (AIFMD); in this instance, fund level disclosures would continue to apply. Firms should prioritise identifying funds falling within the scope of the legislation to ensure any extra territorial obligations are met.

TAXONOMY REGULATION

In tandem with the SFDR regulation was the development of a taxonomy for climate change and environmentally and socially sustainable activities. The Taxonomy Regulation was published in the Official Journal of the European Union in June 2020, establishing a system of indicators to classify and compare which economic activities and investments are deemed “environmentally sustainable”. These must contribute substantially to one or more of the following objectives, whilst not significantly harming any other objectives, or meet minimum social safeguards, and comply with the technical screening criteria:

- Climate change mitigation;
- Climate change adaptation;
- Sustainable use and protection of water and marine resources;
- Transition to a circular economy;
- Pollution prevention and control; and
- Protection and restoration of biodiversity and ecosystems
The EC published a consultation paper on the draft delegated act setting out technical screening criteria on climate change mitigation and adaptation. In March 2021, the European Supervisory Authorities (ESAs) published a further consultation paper on the draft RTS regarding the content and presentation of sustainability disclosures. This consultation amends the SFDR to develop further RTS on taxonomy related product disclosures.

The Taxonomy Regulation does not provide a comprehensive list of ‘green’ activities, much less a separation of ‘good’ and ‘bad’ economic activities and investments. Rather, it provides a common set of principles to be observed by investors, financial institutions, companies and issuers in line with their own ESG commitments and the mobilisation of capital toward more sustainable financing.

Taxonomy reporting is phased to commence from 1 January, 2022.

**UK DEVELOPMENTS**

The UK Government remains committed to the transition to a lower-carbon economy and to the delivery of sustainable development goals, demonstrating this with the creation of a Green Finance Strategy, which is a government-established taskforce chaired by HM Treasury.

The Green Finance Taskforce (GFT) has published a roadmap setting out an indicative path towards mandatory climate-related disclosures across the UK economy, which is aligned with the recommendations of the Taskforce on Climate-Related Financial Disclosures (TCFD). The GFT’s Green Finance Report suggests making clear the fiduciary duties of pensions schemes and company directors to protect long-term value; consideration of environmental risks should be disclosed in light of this. It suggested that all companies and investors should report on their TCFD alignment on a ‘comply or explain’ basis.

By March 2020, the FCA published a consultation paper introducing a new Listing Rule for companies with a UK premium listing, requiring them to state whether they comply with TCFD-aligned disclosures or to explain any non-compliance. In November 2020, the Chancellor pledged to go further than a ‘comply or explain’ obligation, making TCFD-aligned disclosures mandatory across the UK economy by 2025, with a significant portion of mandatory requirements in place by 2023. Also in November 2020, the joint government-regulator TCFD Taskforce published its interim report and a roadmap for implementing mandatory disclosures.

Further, the FCA and the PRA have established a Climate Financial Risk Forum aimed at improving data and further developing climate-related scenario planning. In November 2020, the Chancellor announced that the UK Government would issue its first Sovereign Green Bond in 2021, setting the groundwork for future issuances to meet demand. The bonds will be ring-fenced to tackling climate change, infrastructure investment, and creating green jobs.
To support the growth of the Green Bond market, the UK plans to introduce its own green taxonomy, which will utilise scientific metrics from the EU taxonomy and be reviewed by a UK Green Technical Advisory Group. The UK will also join the International Platform on Sustainable Finance. We anticipate the policy landscape to continue to change at pace in the run up to the UN Climate Change Conference of the Parties (COP) 26 in November 2021, which is hosted by the UK.

ROADMAP TOWARDS MANDATORY TCFD-ALIGNED DISCLOSURES

Timeline of planned or potential regulatory actions or legislative measures is available [here](#).

NORTHERN TRUST ACTIONS

At Northern Trust, we have established a working group to perform an analysis of the data elements of sustainable finance reporting. As before, should you wish to discuss this topic in further detail, please contact your Northern Trust representative.
MIFID REVIEWS AND QUICK FIX

MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE AND REGULATION (MIFID II / MIFIR)

INTRODUCTION

The second Markets in Financial Instruments Directive and Regulation (MiFID II / MiFIR) was implemented on 3 January, 2018, with requirements on market infrastructure, investor protection, transparency and reporting included in the legislation. By February 2020, the European Commission (EC) had launched a consultation survey, which kicked off its review of the regime. This survey took place in parallel with a volume of consultation papers issued by the European Securities and Markets Authority (ESMA) on topics including the review report on the transparency regime on equity and equity-like instruments, double volume cap mechanism and trading obligation for shares, MiFIR report on systematic internalisers and draft technical standards on the provision of investment services and activities in the EU by third-country firms under MiFID II and MiFIR.

On 26 February, 2021, the EC published in the Official Journal a 'quick fix' amendment to the legislation with a view to supporting economic recovery post COVID-19. EU member firms are required to transpose the legislative requirements into their national frameworks by 28 November, 2021 with implementation required by 28 February, 2022. Alongside this quick fix implementation, the MiFID II review continues, and announcements of further legislative proposals are expected from the EC before the end of 2021.

WHAT CHANGES ARE INCLUDED IN THE EU QUICK FIX?

The quick fix amendments aim to simplify some of the existing requirements and reduce the administrative burden for firms while continuing to safeguard investor protection requirements. Changes are being introduced across information and reporting requirements, product governance, research requirements and commodity derivatives regime as follows:

- Information and reporting requirements
  - A new exemption from ex-ante cost and charges disclosures provided clients have consented to receiving the information after conclusion of the transaction;
  - A switch in the default method of client communication from paper-based to electronic. Retail clients can continue to elect to receive paper communications;
A temporary suspension for Best Execution reporting required under RTS 27, which will apply for two years after the implementation date of the legislation, i.e. until 27 February, 2023. Further clarification of this requirement has been issued by ESMA to National Competent Authorities due to the delayed implementation of the legislation at a national level.

A cost benefit analysis requirement for product switching, applicable to those providing investment advice or portfolio management. Evidencing that the benefits of switching outweighs the costs will no longer be applicable to professional clients unless they opt in.

- **Product governance**
  - An exemption from the product governance requirements for bonds that have no other embedded derivative other than a make-whole clause.

- **Research requirements**
  - Amendments to the research unbundling requirements, allowing firms to bundle costs for research and execution with respect to small and mid-cap issuers whose market capitalisation does not exceed EUR 1 billion.

- **Commodity derivative requirements**
  - The scope of commodity derivative position limits regime is amended such that it will only apply to critical or significant derivatives.
  - There are new exemptions from the position limits regime for securitised derivatives and for positions resulting from transactions undertaken to fulfil obligations to provide liquidity.
  - In the application of the ancillary activities exemption from the requirement to obtain authorisation as an investment firm for persons trading in commodity derivatives or emissions allowances, the EC should provide guidance on the circumstances under which national competent authorities (NCAs) can apply an approach combining quantitative and qualitative threshold criteria, as well as to develop a delegated act on the criteria. The ancillary activity exemption should not be available for persons who apply high-frequency algorithmic trading technique or are part of a group the main business of which is the provision of investment services or banking activities, or acting as a market-maker in relation to commodity derivatives.

Article 5 of the quick fix legislation also requires the EC to report on its review of aspects of the MiFID regime by 31 July, 2021 including:

- The operation and structure of the securities markets reflecting the new economic reality after 2020, data and data quality issues related to market structure, and the transparency rules and issues related to third countries;
- Rules on research;
- Rules on all forms of payments to advisers and their level of professional qualification;
- Product governance;
- Loss reporting; and
- Client categorisation;
The MiFID II amendments do not stop there, as indicated by EC Commissioner McGuinness in February 2021 in a keynote speech at the European Parliamentary Financial Services Forum Winter Conference: 'This year, we will also look at the review of the Markets in Financial Instruments Directive framework, as the Parliament called for in its resolution on Capital Markets Union. Our objective is to put forward a legislative proposal at the end this year.'

These legislative proposals could also revisit some of the items identified as part of the quick fix legislative amendments as areas under review, including market infrastructure, trading data and its quality, and conditions to create a consolidated tape, as well as continued focus on retail investment and investor protection more broadly aligned to an upcoming Retail Investment Strategy.

ARE SIMILAR DEVELOPMENTS IN PLACE FOR UK FIRMS?

In short yes, as part of the Brexit implementation the UK HM Treasury undertook an onshoring of some of the key European financial services regulations, one of which was the MiFID II regulation. In response to the EU MiFID quick fix, the FCA consulted on certain changes to the UK rules, including on inducements relating to research unbundling and on best execution reporting. The UK Quick Fix Statutory Instrument was laid before Parliament on 30 June, 2021. Key changes were implemented by 26 July, 2021.

Changes introduced across costs and charges, and; communications and reporting requirements are:

- Cost and charges disclosures
  - Detailed costs and charges disclosures to professional clients are removed, except for portfolio management or investment advice.
  - The obligation to provide cost and charges information before concluding a transaction is modified for distance communications if the clients consents to delay receipt.

- Communications
  - All information must be provided in a 'durable medium' for professional clients; existing requirements for retail clients remain. It is specified that the retail clients who have requested paper statements must receive these free of charge.
  - Only retail clients will be required to consent to receipt of information by website.
  - The requirement to provide detailed trade confirms is restricted to retail clients only.

- Reporting obligations
  - The portfolio manager 10% loss reporting obligation is removed for professional clients but remains for retail clients.
  - Portfolio managers will no longer be obliged to conduct an analysis of the cost and benefits of switching investments for professional clients.
• Best Execution reporting
  o Amendments have been made to remove RTS 27 and RTS 28 reporting obligations for certain trading venues, meaning firms will no longer be required to provide RTS 28 reporting in relation to services of reception and transmission of orders or portfolio management.
  o Firms providing services to retail clients will no longer be required to provide links to RTS 27 reports published by the execution venues.

While these changes are being introduced, further consultation is underway by way of the HM Treasury’s consultation on the UK Wholesale Capital Markets review, which was published on 1 July, 2021 and closes in September 2021.

NORTHERN TRUST ACTIONS
At Northern Trust, we continue to monitor regulatory developments to ensure that we remain compliant with existing MiFID II/MiFIR regulatory requirements while ensuring future obligations are understood and implemented as required. As before, should you wish to discuss this topic in further detail, please contact your Northern Trust representative.

DERIVATIVES UPDATE

PREPARING FOR THE UNCLEARED MARGIN RULES (UMR) FOR DERIVATIVES

WHAT IS CHANGING?
In response to the global financial crisis of 2008, regulators in the United States, the European Union and other jurisdictions around the world agreed to strengthen the safety and transparency of the uncleared, or ‘OTC’, derivatives market. One particular set of rules, called the Uncleared Margin Rules (UMR) requires that certain firms both pledge and collect initial margin for their uncleared derivatives.

WHEN WILL THE NEED TO POST INITIAL MARGIN BECOME APPLICABLE?
To determine if/when firms need to comply with this regulation, they would need to measure their derivatives notional vs a regulatory threshold. Many derivatives dealers and active derivatives trading organisations were already swept into this regulation in the first five phases of the initiative. There remains one final phase (with a deadline of September 2022) for firms with greater than USD$/EUR€ 8 billion of notional exposure, which will include a much larger number of organisations compared to the first five phases.
The notional exposure threshold is measured using Aggregate Average Notional Amount (AANA) of uncleared derivatives. Both counterparties must be above the relevant threshold for the initial margin (IM) requirements to apply.

The International Swaps and Derivatives Association’s (ISDA) ‘AANA Calculation Periods and Compliance Dates for Non-Cleared Margin Requirements’ document contains relevant details and may be viewed [here](#). An abbreviated chart is below.

<table>
<thead>
<tr>
<th>PHASE</th>
<th>DATE</th>
<th>THRESHOLD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phase I</td>
<td>4 Feb 2017</td>
<td>AANA threshold of EUR/USD* 3 trillion</td>
</tr>
<tr>
<td>Phase II</td>
<td>1 Sept 2017</td>
<td>AANA threshold of EUR/USD 2.25 trillion</td>
</tr>
<tr>
<td>Phase III</td>
<td>1 Sept 2018</td>
<td>AANA threshold of EUR/USD 1.5 trillion</td>
</tr>
<tr>
<td>Phase IV</td>
<td>1 Sept 2019</td>
<td>AANA threshold of EUR/USD 750 billion</td>
</tr>
<tr>
<td>Phase V</td>
<td>1 Sept 2021</td>
<td>AANA threshold of EUR/USD 50 billion</td>
</tr>
<tr>
<td>Phase VI</td>
<td>1 Sept 2022</td>
<td>AANA threshold of EUR/USD 8 billion</td>
</tr>
</tbody>
</table>

*local currency equivalent in other jurisdictions

**HOW ARE AGGREGATE AVERAGE NOTIONAL AMOUNTS (AANA) CALCULATED?**

Northern Trust has created a report that can assist clients in determining their AANA. In order to better leverage the data within the report, we encourage clients to understand the basic regulatory requirements, such as the observation period for their specific regulatory jurisdictions, uncleared derivatives in scope, accounts and legal entities to include, and the definition of ‘notional amount’.

Additionally, ISDA has prepared an informational document that summarizes and explains the requirements for calculating AANA for phases five and six.

**WHAT GENERAL STEPS SHOULD BE TAKEN TO COMPLY WITH UMR?**

As an aid to the derivatives industry, the ISDA published the attached brief readiness document, which includes steps such as:

- Measuring AANA to determine if and when the requirements will apply – first considering what funds, affiliates, and accounts are to be included. Foreign exchange (FX) swaps, FX forwards, and non-deliverable forwards (NDFs) are in scope;
- Self-declaring based on notional threshold – informing appointed external asset managers and counterparties;
- Considering margin calculation requirements – deciding whether to adopt the Standard Initial Margin Model (SIMM) or notional grid approach;
- Determining where margin is to be segregated - the pledging party will likely decide where its margin will be held. A tri-party account or third-party collateral segregated account will be required. Documentation negotiations and on-boarding requirements will underpin both; and
- Contract negotiations with counterparties - the ISDA credit support annexes (CSAs) will need to be renegotiated in order to adopt IM.
HOW CAN NORTHERN TRUST ASSIST?

Northern Trust offers various services to assist clients in adhering to the Uncleared Margin rules. These capabilities extend across established service offerings.

SEGREGATED COLLATERAL ACCOUNTS

A third-party segregated collateral account allows clients to pledge securities as initial margin that are held away from their counterparty. Assets in a third-party segregated collateral account are restricted from rehypothecation and cannot be accessed by either party unless the parties agree to return the pledged assets, or a default event takes place.

These segregated collateral accounts are governed by a standard Account Control Agreement (ACA). This arrangement benefits the pledging party in that their assets can simply transfer from one Northern Trust account to another without the need to establish new custodian contracts.

COLLATERAL MANAGEMENT OUTSOURCING AND ASSET OPTIMISATION

Northern Trust has extended our existing Active Collateral Management services. These include:

- Calculation of Initial Margin requirements (in partnership with AcadiaSoft);
- Issuing and responding to margin calls with your counterparties;
- Asset optimisation capabilities to select the most efficient assets in your portfolio that meet the eligibility rules;
- Dispute resolution and reconciliations with your counterparties; and
- Expanded suite of client reporting

EUROCLEAR PLEDGEE REPRESENTATIVE SERVICE

We see a growing interest from sell side banks to select Euroclear as their triparty agent in which to pledge assets to their counterparties. Euroclear requires the pledgee to either become a member of Euroclear or to appoint an existing Euroclear member to act as its representative through a pledgee representative structure. As a result, Northern Trust is now offering a pledgee representative service that allows clients to access Northern Trust’s Euroclear account to accept IM pledged by its counterparties via Euroclear.

FOR MORE INFORMATION

If you have interest in leveraging our UMR services, please contact your Northern Trust client service representative.
FUND REGULATION

PACKAGED RETAIL AND INSURANCE-BASED INVESTMENT PRODUCTS (PRIIPs)

In our newsletter in H1 2021, we highlighted that the European Supervisory Authorities (ESAs) – the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pension Authority (EIOPA) – adopted revised PRIIPs regulatory technical standards (RTS) in February.

Among other things, the revised RTS, which was to come into force from 1 January, 2022, following its adoption by the European Parliament and Council, proposed significant changes to the PRIIPs Key Information Document (KID), including amendments to performance scenarios, the calculation of costs, and disclosures.

Simultaneously, the PRIIPs exemption currently in place for UCITS funds was due to expire on 31 December, 2021. UCITS have been exempt from producing a KID to date, and instead must produce a Key Investor Information Document (KIID); it is proposed that the KIID will no longer be a regulatory requirement once the KID becomes relevant to UCITS.

With asset managers struggling to meet the PRIIPs deadline of 31 December, and following industry pushback, in May, the European Commission (EC) postponed the deadline for the UCITS exemption and implementation of the new RTS requirements to 1 July, 2022.

In July of this year, the EC also issued a call for advice to the Joint Committee of the ESA regarding PRIIPs, effectively requesting a report by 30 April, 2022, that will examine several questions and provide other information in relation to the PRIIPs KID. This follows the EC’s announcement in September 2020, in the new Capital Markets Union Action Plan, to publish a strategy for retail investments in Europe in the first half of 2022.

The EC’s stated aim is to seek to ensure that retail investors can take full advantage of capital markets, and that rules are coherent across legal instruments, with individual retail investors benefiting from:

- Adequate protection
- Bias-free advice and fair treatment
- Open markets with a variety of competitive and cost-efficient financial services and products, and
- Transparent, comparable and understandable product information.

EU legislation should be forward-looking and should reflect ongoing developments in digitalisation and sustainability, as well as the increasing need for retirement savings.
In the UK, HM Treasury announced in June that the PRIIPs exemption for UCITS will be extended by five years to 31 December, 2026. A consultation paper was subsequently published by the FCA in July on proposed scope rules and amendments to the UK PRIIPs RTS. More specifically, the FCA proposed amendments to address the lack of clarity on the PRIIPs scope, misleading performance scenarios and summary risk indicators, and addressed concerns with elements of the transaction costs calculation methodology. The removal of performance scenarios in favour of a narrative description of a fund’s performance may be one of the more welcome suggestions in the industry, in an attempt to address the long-standing controversy over the relevance and comparability of future performance scenarios between different fund ranges.

The deadline for comments to the consultation paper is 30 September, and it is envisaged that the UK PRIIPs RTS will be amended, and associated guidance issued, in advance of a 1 January 2022 implementation.

The divergence between EU and UK legislation on PRIIPs and UCITS may lead to additional requirements for cross-border asset managers, who may be required to generate more than one disclosure document for different UK and EU investors. We expect that requirements will crystallise following what may be a period of uncertainty in the coming months.

MONEY MARKET FUND REGULATION

In March, the European Securities and Markets Authority (ESMA) issued a consultation on the EU’s Money Market Fund Regulation (MMFR).

In accordance with the MMFR, the European Commission (EC), following consultation with ESMA, is mandated to review the regulation by July 2022. ESMA has also stated that the consultation and the potential reforms to the regulation that may follow should be considered in the context of difficulties faced by MMFs during the COVID-19 crisis in March 2020.

ESMA have set out four types of potential reforms for MMFs:

- Reforms targeting the liability side of MMFs – such as decoupling regulatory thresholds from suspensions / gates to limit liquidity stress, and to require MMF managers to use liquidity management tools such as swing pricing, or anti-dilution levies (ADL) / liquidity fees;
- Reforms targeting the asset side of MMFs – e.g. by reviewing requirements around liquidity buffers and their use;
- Reforms targeting both the liability and asset side of MMFs – by reviewing the status of certain types of MMFs, with the suggested potential elimination of stable net asset value (NAV) MMFs, conversion of public debt constant net asset value (CNAV) and LVNAV MMFs to Public Debt VNAVs and VNAV, or conversion of LVNAV MMFs only to VNAV; and
- Reforms that are external to MMFs themselves – by assessing whether the role of sponsor support should be modified.

Additional potential reforms are tied to areas including ratings, the frequency of reporting, and stress testing.
ESMA is considering feedback received up to 30 June, and expects to publish its opinion on the review of the MMF Regulation in the second half of 2021.

PAN-EUROPEAN PERSONAL PENSION PRODUCT

In our newsletter in H1 2021, we highlighted developments in the publication and enforcement of the regulation on the Pan-European Personal Pension Product (PEPP), the publication of draft regulatory and implementing technical standards by the European Insurance and Occupational Pensions Authority (EIOPA), and the adoption of the PEPP Key Information Document (PEPP KID) and the PEPP benefit statement.

In March, EIOPA issued a survey on the potential offering of PEPP, following the publication of the Delegated Regulation by the European Parliament and the Council on 22 March, supplementing the PEPP.

According to EIOPA, the aim of the survey is to understand the potential take-up by eligible PEPP providers, such as asset managers, insurance undertakings, banks and institutions for occupational retirement provision. The information gathered will provide insights to the European supervisory community and help to prepare for an effective implementation in 2022.

EUROPEAN MIFID TEMPLATE

In February, the FinDatEx (Financial Data Exchange Templates) Steering Group adopted the European MiFID Template (EMT) interim version 3.1.

The updates to the template meet the demand of product distributors and manufacturers to accommodate the basic implementation of MiFID II ESG SFDR principles, and in view of the misaligned application dates of SFDR Level 1, SFDR RTS and MiFID II delegated acts.

EMT version 3.1 will co-exist alongside version 3.0 until such time as a new version of the EMT is adopted in accordance with applicable updated legislation.

Northern Trust will continue to monitor developments to ensure our EMT product remains up to date.

SUPPLEMENTARY RULES ON MARKETING OF FUNDS ACROSS THE EU

In our newsletter in H2 2019, we highlighted the publication of a regulation and directive on the facilitation of cross-border distribution of collective investment funds, amending the existing EU rules governing Alternative Investment Funds (AIFs) and UCITS. Ultimately, the aim was to remove perceived distribution inefficiencies in order to reduce the cost, complexity and time taken to distribute on a cross-border basis.
In February, ESMA published a final report on implementing technical standards (ITS) under the regulation. The report outlines ESMA’s requirement to draft ITS in line with the regulation, specifying the information to be communicated, as well as the standard forms, templates and procedures for communication of the information by national competent authorities (NCAs) – which is necessary for the creation and maintenance of a central database on cross-border marketing of AIFs and UCITS – and the technical arrangements necessary for the functioning of the notification portal into which each NCA shall upload all documents.

The report also highlights the March 2020 ESMA Consultation Paper on the proposed draft ITS relating to the publications to be made by NCAs on their websites, which closed at the end of June, and goes on to summarise the feedback received and how it has been incorporated.

The EC has up to three or four months after the receipt of the draft ITS to adopt them.

**UK LONG-TERM ASSET FUND (LTAf)**

In May, the UK FCA launched a consultation on the long-term asset fund (LTAf), a new, open-ended fund type able to invest in long-term, illiquid assets.

According to the FCA, investment in such illiquid assets, including productive finance, has the potential to yield good long-term outcomes for appropriate investors who understand the risks involved, and there has been work conducted to date through the Productive Finance Working Group – comprising the FCA, the Bank of England, and HM Treasury – and the industry, seeking to ensure that the barriers to this type of investment can be sufficiently overcome. With potential to be of particular interest to defined contribution pension schemes, it is proposed that distribution of the LTAf be restricted initially to professional investors and sophisticated retail investors.

The consultation closed on 25 June, with conclusions expected to follow relatively quickly from the Productive Finance Working Group.

It is understood that the FCA is keen to avoid some of the problems encountered with the European Long-term Investment Fund (ELTIF), which we highlighted in our newsletter in H1 2021, and that it is trying to ensure that the LTAf is more successful, with more funds launched. European counterparts are monitoring progress with the LTAf and have indicated that if it is a success, they may make tweaks to the ELTIF to make it comparable.

**NORTHERN TRUST ACTIONS**

At Northern Trust, we continue to monitor regulatory developments to ensure our existing PRIIPs KID and Transaction Cost Calculations products remain compliant with regulatory requirements in the UK and the EU.

Should you wish to discuss this topic in further detail please contact your Northern Trust representative.
All source documents referenced within this newsletter can be directly accessed using the hyperlinks contained within the electronic edition of the newsletter. To access the electronic edition please go to:

www.northerntrust.com/insights-research/regulatory-developments

*Information contained herein is current as of the date appearing in this material only and is subject to change without notice.

CONTACT US

For more information, please contact your Northern Trust representative.