WHITE & CASE

Financial Regulatory Observer

The Financial Regulatory Observer regularly sets spotlights on selected topics driving the regulatory and technological changes in the financial industry.

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Brexit preparedness for financial services: The German response

It is yet unclear if and when the House of Commons will again decide about the Withdrawal Agreement and whether the date for the UK leaving the EU will be changed. Under the current circumstances, a hard Brexit on 29 March 2019 still remains an option. To prepare for this possibility, the UK, EU Commission and EU27 have taken measures to minimize disruption in various areas. Partners **Henning Berger** and **Charles Balmain** of global law firm White & Case discuss how the German Government is planning to uphold certain aspects of the current passporting regime for UK financial service providers after Brexit.

The current draft of the Withdrawal Agreement (WA) sets out arrangements for the UK's departure from the EU and Euratom. While it contains numerous provisions on a wide range of issues, financial services are not specifically addressed. Still, Part IV of the WA is of great importance for this sector. Firstly, it provides that there will be a transition period running from Brexit day until December 31, 2020 (Article 126 WA). Secondly, during this period EU law and its acquis will continue to apply to the UK as if it were a Member State (Article 127(1) WA). Lastly, the Joint Committee may extend the transition period by adopting a single decision (Article 132(1) WA). So, the WA would secure the continuation of the status quo in relation to financial services during the transition period, including the EU passporting regime.

The end of the transition period from the the start of Brexit

From passporting to partial equivalence after the transition period

The EU passporting regime grants Member State financial service providers unrestricted rights to offer financial services throughout the EU under the license granted by their home country and under the supervision of their home country supervisory authority. Due to the EU law principle of mutual recognition and harmonized market access, there is no need to open a local subsidiary and have it licensed in order to provide services in another Member State.

Once the transition period has ended, the UK would become a third country. UK financial institutions would lose their automatic passporting rights, and hence their market access to the EU and vice versa. To prepare for this change, the EU and the UK have opted for the regime of equivalence in the draft political declaration on the framework for the future relationship (Point 38 of the Future Framework). This would enable the EU Commission to recognize the UK regulatory and supervisory rules as equivalent to the corresponding

> **"The current draft of the Withdrawal Agreement sets out arrangements on a wide range of issues for the UK's departure from the EU, but financial services are not specifically addressed**

EU rules. The EU Commission would have to verify that the UK has legally binding requirements, ensures effective supervision and achieves the same results as required by EU rules. The equivalence assessment would start following Brexit day and be concluded by June 2020.

The benefits reaped from the equivalence regime will probably be far less attractive than those under the automatic passporting regime. Equivalence decisions can only be taken in the areas where it is explicitly provided for under EU legislation. For example, equivalence is not provided for under CRD IV, which means that UK banks can only offer services in Member States in which they are licensed. Other legislative acts include a third-country equivalence regime limited to specific areas, such as MiFID II/MiFiR in relation to investment services. Furthermore, equivalence may only be granted partially, for a limited period, or only to a limited number of a non-UK country's supervisory authorities. Hence, UK financial service providers would potentially gain only restricted market access in limited areas, which could be revoked at a moment's notice. This is why the UK's Chequers plan (a UK Government white paper on Brexit published in July 2018) proposed to introduce a regime of "enhanced" equivalence. However, the Future Framework agreed upon so far falls far short of this.

Similar to the UK's notion of "enhanced" equivalence, the Association of German Banks (Bundesverband der deutschen Banken e. V.) has issued a proposal to revise the equivalence regime so that decisions would be made on the basis of reciprocity and to extend its scope inter alia to CRD IV services. This is, however, still to be debated at the EU level.

No deal scenario

In the event of a hard Brexit, the UK's passporting rights will immediately cease at 11:00 p.m. GMT on March 29, 2019. UK entities' market access to the EU will most likely depend on country-specific rules in force on that date. To avoid major market disruption and instability, the EU has published notices and called upon its Member States to prepare for the eventuality.

EU Brexit preparedness

The series of Brexit preparedness notices published by the EU Commission reminds stakeholders that, in the event of a hard Brexit,UK entities would no longer hold an EU passport. This would result in the cessation of the application of CRD IV, CRR and PSD II to UK providers of banking and financial services, of MiFID II and MiFIR to UK investment service providers and of Solvency II to UK insurance/reinsurance providers (extending to online sales).

In order to provide cross-border services into the EU, UK entities would have to apply for authorization in each Member State in which they want to operate. Each entity would be assessed on its own merits by the relevant authority. EU subsidiaries of UK entities would need to be licensed. The notices state that in order to continue using their subsidiaries to provide services, UK entities would need to adhere to the rules of the respective Member State. Moreover, UK subsidiaries of EU-licensed entities would still be required to abide by EU law when conducting their business in the UK.

The EU Commission urges UK entities to assess contracts relating to the provision of financial services on an individual basis, as they might be unable to fulfill all of their contractual obligations without their EU passport.

Grandfathering provisions of EU Member States: The German example

On January 4, 2019, the German Government initiated a legislative process regarding a draft act supplementing the act on tax-related provisions concerning the withdrawal of the UK from the Union (Draft German Brexit Act, Brexit-Steuerbegleitgesetz), which would be directly applicable in Germany in the event of a hard Brexit. The draft act has two aspects. On the one hand, it entails Brexit-related amendments to German tax law. On the other hand, it contains amendments to several financial services acts, introducing a possible transition period during which UK financial service providers could continue to provide services (banking and financial) and wind up existing contracts in Germany until the end of the transition period (insurance). The amendments regarding financial services are subsidiary to a potential harmonized response on the EU level.

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June 2020

EC equivalence assessment period, during which the EC will need to verify that the UK regulatory and supervisory rules are equivalent to the corresponding EU rules

As to the tax-related amendments, the draft aims to insure that current fiscal privileges relying on the UK's EU and EEA membership will, post-Brexit, continue to apply to those fiscally relevant actions that were executed pre-Brexit. This entails amendments to the Income Tax Act (Einkommensteuergesetz), the Corporation Tax Act (Körperschaftsteuergesetz), the Transformation Tax Act (Umwandlungssteuergesetz) and the Foreign Tax Act (Außensteuergesetz).

As to financial services, the draft act would amend the German Banking Act (Kreditwesengesetz, KWG) and the Insurance Supervision Act (Versicherungsaufsichtsgesetz), empowering the Federal Financial Supervisory Authority (Bundesanstalt für Finanzaufsicht, BaFin) to grant companies domiciled in the UK, which have until now operated cross-border in Germany or have a German subsidiary, to continue their existing business. According to the draft act, it is at the discretion of BaFin to order the application of the EU passport regime in whole or in part to UK-licensed entities for a transitional period not exceeding 21 months starting on Brexit day. BaFin can do so, for example, by means of a general decree which will effect all UK entities concerned.

The application of the EU passport regime to banking transactions or financial services can only be considered insofar as the activity is closely related to pre-Brexit contracts. The explanations annexed to the

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The Draft German Brexit Act upholds parts of the existing passporting regime for the benefit of UK financial service providers operating in Germany for a transitional period of up to 21 months post-Brexit

act make it clear that such a close connection is to be presumed if the activity is legally or economically linked to existing contracts. The draft would thus give affected UK-based companies the opportunity to continue their business in Germany pursuant to section 32(1) KWG within the transitional period. For insurance services, the draft is narrower and only permits those insurance contracts that were agreed upon pre-Brexit to be continued and wound up during the transition period. According to the explanations, this means that UK insurers have to terminate existing contracts with German counterparts and wind them up or to establish a subsidiary in Germany and have it licensed within the transition period.

With regard to the German Covered Bond Act (Pfandbriefgesetz), the draft act proposes protection for British assets covered pre-Brexit. These may continue to be used as coverage until their maturity. In the Building Societies Act (Gesetz über Bausparkassen), the additions grant protection for existing investments in the UK and for the security of claims under real estate liens. The amendments made to the Investment Ordinance (Anlageverordnung) and the Pension Fund Supervisory Mandate (ch 30, Pensionsfonds-Aufsichtsverordnung) mean that German insurance companies and pension funds may keep assets located in the UK as part of their security assets to fulfill their obligations towards the insured pensioners, in so far as these assets have been acquired prior to March 30, 2019.

In summary, the Draft German Brexit Act would directly address the consequences of a hard Brexit for financial services by upholding parts of the existing passporting regime for the benefit of UK financial service providers operating in Germany for a transitional period of up to 21 months post-Brexit. During this period, certain aspects of market access might remain as if UK financial service providers were still holding an EU passport. This, however, would be limited to services agreed upon before Brexit and areas contained in the draft. The time allotted would give UK entities the opportunity to adhere to the German requirements applicable to third-country entities. Consequently, the Draft German Brexit Act facilitates grandfathering but offers less market access than the pre-Brexit EU passporting regime.

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EU Regulatory Capital Wall Chart

Essential features of bank capital regulation across Europe in one handy wall chart.

Regulatory capital requirements for prudentially supervised financial services companies across Europe are complex and changing rapidly. To keep track of the regulatory framework in the region, we have brought together the essential features of bank regulation in our EU Regulatory Capital Wall Chart.

The Wall Chart provides a list of regulatory capital acronyms, the most important definitions and key ratios of the current regulatory framework, as well as an overview of the loss absorption waterfall deriving from rules on the hierarchies of creditors' entitlements in bank insolvency and resolution scenarios.

The Wall Chart also highlights the interplay between regulations on total loss-absorbing capacity (TLAC) and the Minimum Requirement for own funds and Eligible Liabilities (MREL), which is a requirement under the EU Bank Recovery and Resolution Directive.

On the Wall Chart there are columns setting out the basics of Bank Regulatory Capital in the European Economic Area (EEA). The key features are:

- The "Paradigm Business Model" contains the European Banking Authority (EBA)'s standardized description of bank business models, showing where exposures and liabilities can arise
- The "Asset Stack," which refers to the basic capital requirements of the Capital Requirements Regulation (CRR) which defines, within the framework created by the Capital Requirements Directive (CRD IV), the requirements imposed on banks and certain investment firms to hold specific levels of regulatory capital, dependent on the institutions' specific exposures and liabilities. The CRR requires regulated institutions to issue identified categories of equity and debt instruments to build a regulatory capital base (referred to as "Own Funds") to a prescribed amount, such that when a bank looks at the ratio of its exposures to its liabilities, (with assets being determined on a risk-weighted basis), the ratio will not fall below certain specified percentages for the different categories of regulatory capital being issued. Broadly speaking, the risk-weighted asset total is calculated by adding together all of the institution's assets and some off-balance sheet items. Both assets and off-balance sheet items are determined in accordance with the specific valuation and risk-weighting multipliers set out in CRR
- The "Creditor Hierarchies," which indicate the current creditor hierarchies at the EU level and UK level. As the national insolvency regimes are not fully harmonized, creditor hierarchies differ from country to country, although, the recently implemented Directive 2017/2399 on the ranking of unsecured debt instruments in insolvency hierarchy aims to achieve a consistent approach across the EU, thereby leveling the playing field

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Banks face steep climb in MREL issuance

The upcoming enforcement of the MREL requirement will require European banks to issue a significant amount of subordinated and senior notes. But political instability and differing levels of investor demand could push up pricing and stifle access in some European markets, write **Stuart Willey, Paul Alexander** and **Angelo Messore** of global law firm White & Case.

The Minimum Requirement for Own Funds and Eligible Liabilities (MREL) was introduced in 2016 as part of the bank recovery and resolution directive (BRRD). In the event of a bank failure, the MREL acts as a "buffer" that resolution authorities can use when applying the bail-in tool to absorb losses and provide new regulatory capital to the failing institution.

Although MREL has largely remained a silent issue since then due to the prudent approach followed by regulators in its implementation, the time is now coming for European banks to meet binding MREL targets.

The road to MREL

Resolution authorities have so far adopted a prudent stance in applying the new requirements, which have been phased in gradually. This caution was also due to the timing and complexities surrounding the startup of the Single Resolution Board (SRB) and Single Resolution Mechanism (SRM), the ongoing discussions at the EU level regarding the review of the EU's regulatory framework on prudential requirements and bank resolution (the Banking Reform Package), and around the significant impact that MREL targets will have on the capital structure of EU banks.

In 2016, the SRB started developing its MREL policy together with national resolution authorities in the Banking Union and communicated non-binding MREL targets to banking groups under its remit. The purpose was to enable banks to prepare for future binding MREL requirements and at the same time to refine the SRB methodology for MREL calibration.

> **"Credit institutions are required to hold a sufficient amount of MREL at all times, consisting of "own funds" instruments and eligible liabilities**

In 2017, the SRB adopted its first binding decisions on MREL requirements for major banking groups, while the 2018 resolution planning cycle was split in two waves of resolution plans—the second one being based on the updated MREL policy it published on January 16, 2019. In this updated policy, the SRB announced its intention to "raise the bar" on MREL targets to better prepare for the upcoming changes to the regulatory framework deriving from the approval of the Banking Reform Package, on which the European Parliament and the Council reached a political agreement on February 15, 2019.

Updated MREL policy published

Bank-specific MREL targets are accordingly in the process of being set by resolution authorities in light of the new rules regarding bank capital that will soon be enacted at the EU level. To ensure a smooth transition to full MREL implementation, the SRB has decided to set individual transition periods of up to four years, taking into account bank and market-specific characteristics. But the SRB will also set non-binding interim targets, and banks will be required to submit an implementation and monitoring plan and provide enhanced disclosure on their liability data.

MREL, capital structures and funding strategies

Credit institutions are required to hold a sufficient amount of MREL at all times, consisting of "own funds" instruments and eligible liabilities that can be used by resolution authorities to absorb losses and recapitalize institutions that are failing or likely to fail. The rationale underpinning the MREL requirement is reflected in the default formula for MREL calibration, which is based on two components:

- The loss absorbency amount (LAA), which is the amount of MREL capital that should ensure the full absorption of losses incurred by the bank in case of resolution. The default LAA is equal to the sum of the bank's Pillar 1 and Pillar 2 capital requirements and its fully loaded combined buffer requirement
- The recapitalization amount (RCA), corresponding to the amount of MREL capital that would be used by the resolution authority to restore

the capital position of the credit institution following resolution. The default RCA is equal to the sum of the Pillar 1 and Pillar 2 capital which the bank would need to maintain to hold a banking license, plus an additional buffer to ensure sufficient market confidence after resolution (which according to the SRB methodology is equal to the combined buffer requirement minus 125 basis points).

It is important to note that the RCA does not apply to those credit institutions where the preferred strategy of the resolution authority is the liquidation of the credit institution or banking group. Hence, the quantitative impact of the MREL requirement will be less significant for smaller credit institutions or groups, whose failure should not pose systemic risks.

Resolution authorities may set and adjust the LAA and RCA on a case-by-case basis, considering also the possibility of adopting resolution tools other than the bail-in (i.e., sale of business, establishment of a bridge institution or a "bad bank"/ asset separation vehicle) in case of a resolution. Notwithstanding this bank-specific approach, the SRB confirmed that the benchmark level of MREL should be at least equal to 8 percent of total balance sheet liabilities and own funds. This benchmark level should ensure that in case of a resolution, the bank can access financing arrangements such as the Single Resolution Fund in accordance with BRRD rules.

Credit institutions must use qualifying bail-inable instruments meeting the MREL eligibility criteria set forth in the applicable regulations, which will become more stringent after the enactment of the Banking Reform Package. The question for European banks is accordingly whether they hold a sufficient amount of MREL-eligible instruments to meet their MREL targets, as determined by competent resolution authorities.

This could be a challenge for several banks, in particular because many traditional funding instruments, such as sight deposits, short-term deposits with a maturity of less than one year, and covered bonds do not qualify under the MREL eligibility rules. As a result, any shortfall would need to be filled through the issuance of MREL-eligible instruments, mostly in the form of senior or subordinated notes.

Will supply outstrip demand?

In its 2017 Quantitative Update of the MREL Report, the European Banking Authority stated that the estimated funding needs of European banks range between €206.8 billion and €284.6 billion. Meanwhile, the SRB said that, based on a sample of 100 banks representing approximately 95 percent of the total assets of SRB banks, the MREL shortfall deriving from the application of its 2018 MREL policy amounted to €171 billion, of which €67 billion would need to be met through subordinated instruments. Some research reports have put the figure as high as €526 billion because they assume that resolution authorities will require MREL targets to be met largely with subordinated issuances.

Although the outcomes of these analyses differ—not least as a consequence of the multiple samples and variables used—the figures give pause for thought. The geographical breakdown of the shortfall across EU Member States may be even more significant. Commentators have expressed concerns that, despite MREL being applied at the EU level, the depth of demand for issuers across the EU may vary significantly, especially between northern and southern Member States of the European Union, which could result in an overall fragmentation of the market for MREL and, for smaller issuers in Southern Europe, a potential barrier in terms of issuance costs.

> **"Meeting MREL targets could be a challenge for several banks, because many traditional funding instruments do not qualify under the MREL eligibility rules**

€171bn

The total MREL shortfall deriving from the application of 2018 MREL policy

In a study published in December 2017, the European Central Bank noted that the debt markets of Southern Euro-area countries (i.e., Greece, Spain, Italy and Portugal) are characterized by home bias, with a large portion of bank debt being issued domestically. The market capacity to absorb the issuance required to cover the MREL is accordingly country-specific and depends on the ability and appetite of local investors. This home bias could further hinder the capacity of markets to absorb MREL-eligible securities issued by banks established in Southern Euro-area countries.

Political fears

The investment environment may prove to be challenging in 2019, as a consequence of slower economic growth, tighter monetary policy, weaker earnings and higher volatility. Political instability—with the growth of populist parties, the imminent European elections in May and the approach of Brexit—is also contributing to an unfavorable backdrop for the issuance of new debt instruments, especially in Southern Euro-area countries.

Credit institutions already face higher premiums in issuing new debt compared to previous years, so a further rise in the cost of financing could hit profitability.

Italy has been caught in the cross-hairs of political instability. As the government disputed its deficit plans with the European Commission, yields on Italian sovereign bonds rose, causing Italian banks, which hold a significant portion of the outstanding domestic government debt, to struggle to gain access to bond markets.

Last November, UniCredit, Italy's largest lender, issued €3 billion in senior non-preferred notes, in what has been described as a "one and done" strategy to fulfill their total loss absorbing capacity (TLAC) requirements for 2019. The issue was priced at a 7.83% coupon, 420 basis points over the Euro mid-swap rate, which would imply almost unaffordable pricing for other Italian banks—although recent debt issuances made by Italian banks seem to show a more favorable trend.

The bind of Brexit

Banks established in some EU Member States (including Italy and other Southern European countries) have traditionally turned to English law to issue bonds on the international capital markets due to decades of market practice and the confidence investors have in the English legal system. However, in the event of a no-deal "hard" Brexit, or at the end of any transition period agreed between the UK and the EU, bonds governed by English law would thereafter be considered liabilities subject to the laws of a third country for the purposes of the BRRD rules, which may prevent EU banks from counting such instruments towards their MREL capital.

The fact that the draft Withdrawal Agreement negotiated between the UK and the European Union has failed to gain approval from the UK Parliament means the outcome of negotiations remains uncertain. If the Withdrawal Agreement is not signed and no extension is agreed upon by March 29, 2019, the risk of MREL disqualification will become relevant on such date. Conversely, if the Withdrawal Agreement is signed, EU credit institutions will theoretically have an additional period of almost two years to properly adjust their indebtedness, considering the transition period (lasting until December 31, 2020) provided under Article 126 of the Withdrawal Agreement.

EU authorities have already urged EU banks to include clauses on "contractual recognition of bail-in" in their MREL-eligible instruments subject to English law, and to be prepared to demonstrate that any decision of an EU resolution authority would be effective in the UK. However, a large amount of liabilities subject to English law do not contain any such clause (e.g., because they were issued before the Brexit referendum) and could accordingly be subject to disqualification for the purposes of the MREL requirements. To avoid this outcome, EU credit institutions might either amend the terms of existing English law bonds or refinance them via new debt issuances. The costs would, however, be relevant in both cases, and there is no assurance (again) that the market will be willing to refinance the existing stock of English law debt.

The SRB has left open the possibility to provide for an extension of transitional periods for banks that have MREL shortfalls as a consequence of ineligibility of issuances governed by English law. Furthermore, EU banks have been invited to start issuing bonds under the laws of EU Member States rather than English law to avoid MREL eligibility issues. The most recent trend is currently showing top-tier Spanish and Italian banks issuing (or considering the issuance of) MREL-eligible instruments under their own national law—in line with the practice traditionally followed by French and German banks. It remains to be seen whether the same path will be followed by lower-tier banks and the market in general as they navigate political instability amid the new MREL regime.

> "If the Withdrawal Agreement is not signed and no extension is agreed by March 29, 2019, the risk of MREL disqualification will become relevant on that date

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FRO in-depth: The future of cryptoassets regulation

Partners **Julia Smithers Excell** and **Stuart Willey**, and associate **Laura Kitchen** of global law firm White & Case take a deep dive on the latest publications from EU and UK regulators aimed at providing supervisory clarity on the nascent cryptoasset market.

Recent publications by EU and UK regulators bring much-needed clarity to the nascent cryptoasset market. Regulators recognise increased speed and a reduction in cost of cross-border money remittance as benefits of cryptoassets; however, they remain concerned by consumer protection and market integrity issues, particularly in relation to market abuse and money laundering.

At the EU level, the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) have considered how the cryptoasset market operates across Member States and have assessed whether the existing regulatory framework is fit for purpose. It is for EU policymakers to determine what action is required to address the shortcomings identified in the reports.

Meanwhile, the UK Financial Conduct Authority (FCA) issued consultation paper CP19/3, which sets out a taxonomy of cryptoassets and provides guidance on which types of cryptoassets fall within the regulatory perimeter. The ensuing dialogue will give market participants the opportunity to shape regulatory policy in this area.

Cryptoassets regulation in the EU

On January 9, 2019, the EBA and ESMA published reports containing their advice on cryptoassets. These reports form a response to the request by the European Commission in its 2018 fintech action plan for European Supervisory Authorities (ESAs) to assess the suitability of the current EU regulatory framework.

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EBA and ESMA published advice on cryptoassets

At the same time, ESMA published the outcome of its 2018 survey of EEA Member States' transposition of the Markets in Financial Instruments Directive II (MiFID II) and their application of its "financial instruments" definition to a sample set of six cryptoassets under their particular national regulatory regimes. This covered a range of characteristics, including investment, utility and hybrids of both (including payment hybrids). Pure payment-type cryptoassets such as Bitcoin were excluded. The survey results fed into ESMA's advice.

Pending any regulatory reform, these publications provide some clues about how regulators in Europe may view the provision of cryptoasset services in their territories in the future against the existing regulatory framework. The publications should be reviewed by any participant intending to develop a new cryptoasset service.

A question of interpretation

The results of the ESMA survey show that different Member State regulators have different interpretative approaches to some aspects of the definitions of MiFID II "financial instrument", creating difficulties for the regulation and supervision of cryptoassets.

Those qualifying as "transferable securities", or other types of MiFID II "financial instruments", would render their issuer and related service providers potentially subject to the full set of EU financial rules, including the

> **"ESMA's survey shows that Member States have different interpretative approaches to some aspects of the definitions of MiFID II "financial instrument", creating difficulties for the regulation and supervision of cryptoassets**

Prospectus Directive, the Transparency Directive, MiFID II, the Market Abuse Directive, the Short Selling Regulation, the Central Securities Depositories Regulation (CSDR) and the Settlement Finality Directive (SFD).

ESMA's advice takes each of these rules in turn and shows how they might apply to cryptoassets, highlighting areas requiring additional review, amendment, interpretation or reconsideration.

Most Member State regulators that responded to ESMA's survey viewed ancillary rights to profit alone (and not alongside ownership or governance rights) as sufficient for a cryptoasset to qualify as a "security", and hence, as a "transferable security" (in addition to the required MiFID II criteria). None viewed a pure utility token as a "transferable security" or a "financial instrument", leading ESMA to conclude that utility tokens fall outside the regulatory perimeter.

Most felt that those qualifying as "financial instruments" should be regulated as such, with necessary changes to accommodate issues such as the risk of forking (i.e. changing the underlying software to create two versions) and the custody of private keys and a potential review of current rules on clearing, settlement, safekeeping and record of title. The vast majority of respondents viewed any move to classify all cryptoassets as "financial instruments" as unwelcome, since it would legitimize them and have unwanted collateral effects.

Respondents' views on the creation of a bespoke new regime outside MiFID II were mixed. However, of the eight Member State regulators that viewed the mooted creation of a new C12 category of "financial instrument" in MiFID II as beneficial for legal certainty and EU harmonization reasons, six believed the full set of EU financial rules should apply.

ESMA provides an overview of how the MiFID II rules are likely to apply to platforms trading cryptoassets qualifying as "financial instruments" and their operators and investment firms, covering minimum capital, organizational, governance and investor protection rules, open access, pre- and post-trade transparency, transaction reporting and record-keeping.

It is not clear to ESMA how to apply MiFID II rules to decentralized trading platforms that use smart contracts to match orders with no identifiable platform operator, without a significant review and amendment of current rules.

Applying transparency requirements to platforms trading cryptoassets would also present a significant challenge. Data reporting and record-keeping rules would need amendment to apply to the specificities of cryptoassets, but would not be workable until common identifiers and classifications (CFI codes, ISINs) are developed for cryptoassets.

ESMA also notes that the Market Abuse Regulation may not capture inside information held by miners and wallet providers, and that it is not clear how miners would be treated under the CSDR in terms of governance and technical requirements due to their novel and essential role in the settlement process.

It is similarly unclear how settlement finality would be achieved from an operational and legal perspective under the SFD in a distributed ledger technology (DLT) environment in light of consensus validation, the risk of forks and governance issues with permissionless DLTs, or how national law variables regarding the legal effect of book entries would interface with the CSDR requirement to represent securities in book entry form when applied to cryptoassets.

The application of EU rules on safekeeping and segregation under the CSDR and the Financial Collateral Directive raises the question of whether, in the cryptoasset world, the provision of safekeeping services equates to having control of private keys on clients' behalf and how this applies in different contexts, e.g., multi-signature wallets with several private keys.

Other identified gaps in applying existing legislation to cryptoassets as MiFID II financial instruments include rules to ensure that the protocol and smart contracts underpinning cryptoasset activities meet minimum reliability and safety requirements, and rules addressing the novel cyber-security risks of DLT.

Falling between the gaps

ESMA believes that consumers are exposed to substantial risks where cryptoassets neither qualify as MiFID II financial instruments nor fall within the scope of other EU rules, such as the second Electronic Money Directive (EMD2) or the second Payment Services Directive (PSD2).

Some EU Member States have, or are considering, specific rules to address these, but in light of the cross-border nature of cryptoasset activities, ESMA believes an EU-wide approach will provide a more level playing field. ESMA believes that EU policymakers should consider how to address these risks with a bespoke approach, with risk disclosure rules and warnings as a priority.

Five Member State regulators have reported to the EBA cryptoassets qualifying in their view as e-money within the scope of EMD2. Should a firm carry out a payment service with such assets, its activity would fall within the scope of PSD2. However, the EBA remains concerned about those forms of cryptoassets and related activities potentially falling outside the current regulatory perimeter, including the activities of cryptoasset custodian wallet provision services and cryptoasset trading platforms.

ESMA's report sets out risks for regulators to consider when dealing with cryptoassets. While both ESAs regard cryptoasset activity in the EU as relatively limited, with little current risk to financial stability, they remain concerned about consumer protection, shallow liquidity, operational resilience and market integrity issues where cryptoassets fall outside the regulatory perimeter. ESMA identifies the most significant risks as fraud, cyberattacks, money laundering and market manipulation, with investor protection undermined where cryptoassets fall outside the current regulatory perimeter, and thus do not benefit from regulatory safeguards.

ESMA questions whether custodial wallet providers are safeguarding and segregating cryptoassets properly for their clients, noting that many also act as cryptoasset trading platforms. It highlights issues associated with DLT including governance, privacy and territoriality.

ESMA and most of its survey respondents also believe that cryptoassets and related activities should be subject to anti-money laundering (AML) rules as a priority. The EBA asks the EC to consider the latest AML guidance by the Financial Action Task Force (FATF) in relation to cryptoassets and the need for a further review of EU AML legislation in relation to providers of crypto-to-crypto exchange services and financial services for Initial Coin Offerings (ICOs). The EBA also notes that the ESAs will be producing a joint opinion in 2019 on the AML and terrorist financing risks associated with virtual currencies.

The EBA advises the EC to carry out a cost/benefit analysis to assess the feasibility of EU-level action to address these issues, as well as the environmental impact of cryptoasset activity, adopting a technology-neutral and future-proof approach.

The EC is due to commission a study on the legal, governance and interoperability aspects of blockchain technology. As the market develops, ESMA highlights the need for further work on the application of the existing regulatory framework to in-scope cryptoassets, and on the scoping of new rules for those which fall outside. The EBA will also continue to monitor where cryptoassets stand in relation to the regulatory perimeter.

Once the Basel Committee on Banking Supervision (BCBS) has concluded its work on the prudential treatment of banks' holdings of, and exposures to, cryptoassets, the EBA will report to the EC on whether the Capital Requirements Directive or the Capital Requirements Regulation will need amendment or clarification.

Comments are due on the FCA guidance for market participants

The EBA will also monitor the need for any guidance to support the common application of current regulatory capital rules to banks' exposures to and holdings of cryptoassets. Pending further regulatory developments, including the outcome of the BCBS work, the EBA notes that regulators and banks should adopt a conservative prudential approach to the treatment of exposures to cryptoassets in Pillar 1, supplemented by Pillar 2 requirements if necessary.

The EBA also calls on the EC to promote consistency in the accounting treatment of cryptoassets, in light of the current absence of clarity about whether, for example, a holding of a cryptoasset should be treated as an intangible asset, potentially leading to questions around the resulting prudential treatment and with divergent approaches undermining the EU level playing field.

Benefits of DLT and ICOs

On the upside, ESMA notes the potential benefits of DLT, referencing its 2017 report on this topic, and of tokenization in its enhancement of the liquidity of traditional assets represented on the blockchain. The speed and efficiency of funding from a diverse investor base via ICOs is also recognized as a benefit, provided appropriate safeguards are in place.

The UK perspective: FCA consults on crypto guidance

On January 23, 2019, the FCA launched its highly anticipated consultation (CP19/3) on guidance for market participants regarding where certain cryptoassets sit in relation to the regulatory perimeter- and whether relevant stakeholders need to be authorized by the FCA. Comments are due by April 5.

Last October, the Cryptoassets Taskforce, comprising the FCA, HM Treasury and the Bank of England, published a final report that trailed the aim of the FCA to clarify the regulation of security tokens for market participants, including ICO issuers and secondary market platforms, which may not realize that they fall within the current regulatory perimeter.

In parallel, the FCA has been monitoring for potential breaches by entities or individuals carrying out regulated activities without the appropriate authorization and will be increasing its anti-avoidance focus on ICO issuers who market securities as non-regulated utility tokens.

CP19/3 sets out the FCA's views on whether tokens are likely to be classed as "specified investments" under the Regulated Activities Order (RAO), "financial instruments," such as "transferable securities" under MiFID II, "e-money" under the E-Money Regulations (EMRs), or captured under the Payment Services Regulations (PSRs).

The FCA uses the term "security token" to denote tokens constituting "specified investments" under the RAO and notes that HM Treasury will be publishing a consultation on potentially broadening the FCA's regulatory remit to capture additional types of cryptoassets.

Security tokens: Inside the regulatory perimeter

The guidance is aimed at helping firms more easily determine whether certain cryptoassets fall within the perimeter by mapping them across to RAO and MiFID II instruments and investments, with case studies, an indicative list of market participants undertaking cryptoasset activities and the types of permissions they may need, and model Q&A.

Factors listed by the FCA as indicative of an RAO "specified investment" include any contractual entitlement to profit share, revenues, payments or other benefits, quasi-voting rights and tradability on cryptoasset exchanges.

The FCA believes the most relevant RAO "specified investments" are shares, debt instruments, warrants, certificates representing certain securities, units in collective investment schemes, and rights and interests in investments. The FCA's proposed guidance on mapping these across to tokens is summarized as follows:

(a) Shares

Tokens giving holders voting, dividend, capital distribution or similar rights to shares, or which represent ownership or control, are likely to be security tokens. But a token that provides the holder with the right to vote on future ICOs in which the firm will invest, and no other rights, would likely not be considered a share, since the voting rights give only direction and do not confer control-like decisions on the future of the firm.

For a token to be considered a MiFID II "transferable security", it must be capable of being traded on the capital markets, so tokens conferring ownership, control and similar rights that are so tradable are likely to be categorized as "transferable securities".

Even if a token that looks like a share is not a MiFID II "transferable security" e.g., due to restrictions on transferability, it may still be capable of being an RAO "specified investment".

(b) Debt instruments

A token creating or acknowledging indebtedness by representing money owed to the holder is a debenture and therefore constitutes a security token. If it is tradable on the capital markets, being transferable from one legal titleholder to another, it may be a MiFID II "transferable security" too.

(c) Warrants

Tokens giving holders the right to subscribe for different tokens in the future, where the latter are RAO "specified investments", will likely constitute warrants and thus securities.

(d) Certificates representing certain securities

Tokens akin to depository receipts would fall into the security token category if they confer rights on the holder in relation to tokenized shares or tokenized debentures.

(e) Units in collective investment schemes

A token acting as a vehicle through which profits or income are shared or pooled, or where the investment is managed as a whole by a market participant, is likely to be a collective investment scheme. References to pooled investments, pooled contributions or pooled profits in the ICO white paper could also render a token to be more like a security.

- **Rights and interests in investments**
  Tokens representing rights to or interests in certain investments, including those listed above, comprise RAO "specified investments". So a token representing a right in a share is a security token, even though the token itself does not have the characteristics of a share
- **Products referencing tokens**
  Products that reference tokens (e.g. derivatives) are very likely to fall within the regulatory perimeter as "specified investments" (either as options, futures or CFDs under the RAO) and may also be MiFID II "financial instruments"
- **Jurisdictional differences**
  The FCA notes that different countries may define a security differently, so the nature of the token must be assessed for every jurisdiction in which the token is sold or in which the firm operates, to determine whether it triggers the application of any securities regulation.

(f) Exchange tokens: Outside the regulatory perimeter

The FCA asks stakeholders if they agree with its conclusion that exchange tokens are not RAO "specified investments" and currently fall outside the regulatory perimeter. While they can be held for the purpose of speculation rather than exchange, the FCA views this as insufficient for exchange tokens to constitute "specified investments". So a cryptoasset exchange that only facilitates transfers of exchange tokens such as Bitcoin, Ether and Litecoin between participants is not carrying on a regulated activity.

The FCA gives a case study from its regulatory sandbox where exchange tokens are used to facilitate regulated payment services and the PSRs cover the fiat currency remittance at each end of the transfer, but not the use of cryptoassets in between which acts as the vehicle for fast remittance. It seeks feedback on whether further guidance on this use case could be beneficial.

(g) Utility tokens

While the FCA regards utility tokens as not constituting MiFID II "specified investments" (even if traded on the secondary market and used for speculative investment purposes), they could be e-money in certain circumstances, so related activities could fall inside the perimeter.

> "Exchange tokens (e.g. Bitcoin and Ether) are unlikely to represent e-money because they are not usually centrally issued upon the receipt of funds, nor do they represent a claim against an issuer

(h) Cryptoassets as e-money

Exchange tokens (e.g. Bitcoin and Ether) are unlikely to represent e-money because they are not usually centrally issued upon the receipt of funds, nor do they represent a claim against an issuer.

But any cryptoasset could be e-money under the EMRs if it is electronically stored monetary value as represented by a claim on the electronic money issuer, which is issued upon the receipt of funds for the purpose of making payment transactions, accepted by a person other than the electronic money issuer and not excluded under the EMRs. "Electronic storage of monetary value" includes the possibility of using Distributed Ledger Technology (DLT) and cryptographically secured tokens to represent fiat funds, e.g. GBP or EUR.

(i) Stablecoins as e-money

Cryptoassets that establish a new sort of unit of account rather than representing fiat funds are unlikely to amount to e-money unless the value of the unit is pegged to a fiat currency, depending on the facts. The FCA considers that "stablecoins" that are "fiat-backed", "fiat-collateralized" or "deposit-backed" by being pegged to say, US dollars (usually with a 1:1 backing) and used to pay for goods or services on a network, could potentially meet the definition of e-money if they also meet the criteria in the paragraph above.

(j) Indicative list of market participants, potential activities and permissions

Table 1 in CP19/3 shows the main cryptoasset market participants likely to be carrying out regulated activities, some of the more common services they are likely to provide, and the permissions required to carry them out. Exchanges trading security tokens may be carrying out the RAO-regulated activities of arranging deals in investments and making arrangements with a view to investments. If the tokens are also MiFID II "financial instruments", the firm may also need permission to operate a multilateral trading facility (MTF) or an organized trading facility (OTF).
Firms providing custody services as wallet providers in relation to such securities may need to apply to the FCA for the relevant permission for conducting the RAO-regulated activity of safeguarding and administering investments. The FCA seeks input on whether any other key market participants are involved in the cryptoasset market value chain or whether any activities are performed in the cryptoasset market that do not map neatly across to traditional securities.

(k) Model Q&A

The Guidance Q&A includes model answers to the following questions:

- *If I accept only cryptoassets as a form of payment for my token, can it still be a security token?* The FCA model answer distinguishes e-money regulations where a token must be issued upon receipt of fiat funds vs security tokens, which disregard whether they are exchanged for fiat funds, exchange tokens or other forms of cryptoassets, or in some cases anything at all
- Utility tokens: *My network is/aims to be fully decentralized and I will not have any control over the network anymore. Does this have an impact on whether the tokens could be regulated or not?* The FCA model answer notes that the more decentralized the network, the less likely it is that the token will confer enforceable rights against any particular entity, so it may not confer similar rights to those of RAO "specified investments"
- *What other consumer protections may apply under UK law to utility tokens or cryptocurrencies that are not specified investments?* The FCA model answer lists Financial Promotion rules, Conduct of Business rules, Principles for Business rules, the Senior Managers and Certification Regime (SMCR) and the accountability regime, the Advertising Codes regulated by the Advertising Standards Authority, Trading Standards, general common law, criminal law and the General Data Protection Regulation

(l) Benefits of cryptoassets

The FCA views the only benefits of the current generation of cryptoassets as increased speed and a reduction in cost of cross-border money remittance when cryptoassets are used as a vehicle for exchange, but notes that this is a rapidly developing market. Firms providing innovative propositions with genuine consumer benefits are encouraged to contact the FCA's Innovate team if they are unsure about which regulated activities apply to their business models.

Consumer protection

The FCA has commissioned research on the use of cryptoassets by UK consumers and will be conducting a follow-up survey in 12 months' time to assess if the guidance has helped consumers to gain a greater understanding of the cryptoasset market. Confusion over consumers' lack of recourse to the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS) is compounded by firms offering both regulated and unregulated cryptoasset products in parallel.

CP19/3 cites examples of consumer harm caused by poor cybersecurity, fraud, market infrastructure failings, volatility, misleading advertising and limited transparency around price formation and prospectus-type disclosures in the white papers typically accompanying ICOs.

The FCA will consult during 2019 on a potential prohibition of the sale to retail consumers of derivatives referencing certain types of cryptoassets, e.g. exchange tokens, including contracts for difference (CFDs), options, futures and transferable securities.

The FCA is also considering whether the complex technological aspects of cryptoassets could potentially create

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equality and diversity considerations for certain consumers, and asks for input on this.

While CP19/3 does not cover the Market Abuse Regulation, the FCA notes that the novel nature of the cryptoasset market may create new abusive behaviors that are not captured by current regulation and market monitoring and surveillance arrangements.

Prospectus and transparency requirements

While issuers of tokens may themselves not need to be authorized, the FCA flags that prospectus and transparency requirements may apply.

If a token is a transferable security and will either be offered to the public in the UK or admitted to trading on a regulated market, the issuer will need to publish a prospectus unless an exemption applies (e.g., for offers made entirely in the UK for less than €8 million in any 12-month period). The FCA points out that for equity-type securities, historical financial information is required as well as a confirmation that the issuer has sufficient working capital and a capitalization and indebtedness statement. New listed issuers of tokens also need to complete an eligibility review with the FCA.

The FCA reminds firms to communicate financial promotions for cryptoasset products and services, regulated or unregulated, in a way that is clear, fair and not misleading, including setting out precisely which activities are regulated and those that are not, and ensuring that consumers can easily differentiate those activities that the firm is authorized by the FCA to conduct.

Money laundering

The FCA also reminds firms that MLD5 will be transposed into UK law by the end of 2019, extending AML and counter-terrorism financing regulation to entities carrying out the following activities, pending formal consultation by HM Treasury:

- Exchange between cryptoassets and fiat currencies
- Exchange between one or more forms of cryptoassets
- Transfer of cryptoassets
- Safekeeping or administration of cryptoassets or instruments enabling control over cryptoassets
- Participation in and provision of financial services related to an issuer's offer and/or sale of a cryptoasset

The development of the cryptoasset market requires clear, effective regulation, which fosters innovation while maintaining robust consumer safeguards. In light of the EU and FCA publications, the market should be primed for reform in the near future. To the extent possible, participants should engage with regulators to ensure that their perspective is represented in an evolving regulatory environment and seek legal advice if in doubt.

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Navigating uncertainty: Corporate governance for foreign banks in the US

With the regulatory agenda for the US operations of foreign banks in a state of flux, **Kevin Petrasic, Paul Saltzman, Glen Cuccinello, Will Giles** and **Alexander Abedine** of global law firm White & Case provide a map to help boards navigate an uncertain terrain.

Non-US banks operating in the US (Foreign Banking Organizations or FBOs) have unique corporate governance issues regarding the role of boards and branch leadership for their combined US operations (CUSO). US regulators expect the CUSO to be governed and resolved in the same general manner as comparable US institutions. However, the operating structure and management reporting framework of the CUSOs are different than those of US institutions due to differing home-country regulatory regimes and highly integrated operating models that rely on the global scale of parent operations. As a result, FBOs may find it difficult to readily adapt to a corporate governance model that is more segregated and legal entity-based or some other US-based approach.

The general policy of the Federal Reserve Board (FRB) regarding the treatment of US banks and FBOs is parity. That said, the operating structures, the competitive need for scale, and the active involvement of home office management greatly complicate matters for CUSOs and can often inhibit efficient and effective corporate governance. There is additional complexity for FBOs with large US operations given the requirement to form US Intermediate Holding Companies (IHCs) and the enhanced prudential standards prescribed by FRB Regulation YY.

Regulation YY requires not only that the IHC Board oversee the IHC, but that the US Risk Committee—which in most FBOs will be the same group of directors as the IHC Board Risk Committee—oversee the CUSO, even though branch operations may be outside of the legal entity for which the IHC board is responsible.

Furthermore, the presence of state or other federal regulators, such as the New York State Department of Financial Services or the Office of the Comptroller of the Currency, adds an additional layer of complexity for FBOs with US branches.

> **US regulators are committed to holding FBOs to prudential standards similar to those of their US peers and have not made significant adjustments to cater to these different operating models**

Signs of progress

Since US regulators are committed to holding FBOs to prudential standards similar to those of their US peers, they have not made significant adjustments to cater to these different operating models.

As a result, much more remains to be done to address these differences and variations in application across the spectrum of affected CUSOs. But industry efforts, combined with open-minded FRB leadership, have raised hopes that regulators will embrace a more tailored approach to FBO oversight.

The FRB recognizes the complexity of these corporate governance issues, and is in the process of revising expectations regarding the responsibilities of both bank boards and executive management. For example, the FRB has finalized a new

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The regulatory agenda for FBOs, which includes guidance regarding the proper oversight roles of board and branch managers, remains in flux

rating system for IHCs and other large financial institutions and is expected to propose tailoring the enhanced prudential requirements applicable to FBOs in the near future.

The FRB has also proposed supervisory guidance regarding board effectiveness, the supervisory expectations of boards and management, and the communication between boards and management. Thus, the regulatory agenda for FBOs, which includes guidance regarding the proper oversight roles of board and branch managers, remains in flux.

A path through uncertainty

Given the uncertainty of the existing regulatory framework, there are questions regarding what boards and branch chiefs should do when confronted with supervisory criticism. With this in mind, there are some basic guiding principles that FBO boards or branch executives should consider following regardless of—or despite—regulatory uncertainty.

- **Ensure a holistic approach to CUSO governance**. US regulators view the CUSO as a single, unified entity; thus, it is important to understand the relationship and dependencies among various operating entities in the US in order to ensure efficient and effective regulatory compliance. Equally important is the ability to explain and demonstrate to US regulators the holistic approach employed by the CUSO with a view toward underscoring the rationality of the CUSO governance structure.
- **Develop familiarity with the legal standard of care and accountable persons regime in the relevant jurisdictions**. In most cases, the boards of depository institutions confront heightened fiduciary expectations imposed by regulators to ensure board accountability and oversight of management and, perhaps more relevant, regulatory and supervisory responsiveness. It is therefore important for FBO boards and branch managers to understand all applicable US federal and, where applicable, state banking laws, regulations and agency guidance, including examination guidance, particularly in the context of subsidiary boards.
- **Double down on risk identification and internal controls**. Regulatory developments, such as the Dodd-Frank Act's mandatory supervisory stress testing and the Comprehensive Capital Analysis and Review (CCAR), underline the importance to policymakers, regulators and examiners of identifying, measuring and mitigating material risks. These developments also highlight that these practices are a founding principal of good governance for all financial institutions, whether or not subject to CCAR, and, thus, should be considered, incorporated and/or amplified where prudent to do so.
- **Insist on extensive, targeted training**. Management should maintain up-to-date proficiencies in identifying and managing emerging and other risks that are particularly acute for FBOs. These include, for example, cybersecurity, sanctions, anti-money laundering and Bank Secrecy Act issues, and cross-jurisdictional regulatory issues in areas such as intragroup funding, privacy, data governance, and the scope of permissible activities and in-country operations. Training should be idiosyncratic and tailored to the operating circumstances of an institution and not be on a one-size-fits-all basis.
- **Ensure planning of executive sessions and encourage a culture of candor and compliance**. As a general principle of good governance, management and the board should foster an environment of cooperation and transparency in order to maintain the highest levels of quality and integrity. Equally important, of course, is fostering and maintaining a culture of compliance that promotes strong regulatory and supervisory relations.
- **Audit data and Management Information System (MIS) integrity**. Effective board oversight and supervision requires boards to monitor the activities of management and the company as a whole based on granular and reliable data at the legal entity level (or other relevant category). Relatedly, boards should ensure that MIS monitors understand and adhere to applicable

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The challenges posed by FBO governance are due, in part, to unique and varied corporate structures and operating models that are distinct from those of their US counterparts

risk limits, and remain apprised of and alert to specific issues under current supervision.

- **Quarterly meetings with regulators and coordinated regulatory outreach**. Boards should cultivate positive working relationships with regulators and coordinate their message across multiple regulators. The ability to communicate regularly, effectively and with integrity with one voice to all regulators enhances firm-wide credibility and operational efficiency. It also establishes a culture of trust that not only may help during times of stress, it is a powerful and effective approach when regulatory support or sign-off is required to facilitate a transaction, operational changes or an application approval. The unique challenges posed by FBO governance are due, in part, to unique and varied corporate structures and operating models that are distinct from those of US counterparts. While the regulatory regime for FBOs with large US operations is evolving, FBO boards and branch managers should consider implementing the points referenced above into their US operations to help better integrate the FBO and its CUSO in the US regulatory framework.

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