

Financial Services Regulation And Legislation To Watch In 2017

By **Melissa Lipman**

Law360, New York (January 2, 2017, 1:03 PM EST) -- The pace of new financial services rules making their way through the legislative process in Europe has slowed from its post-crisis peak, but a number of new reforms will be forging ahead in 2017 as banks try to grapple with the changing U.K. legal landscape in the wake of Brexit.

In the European Union, the changes include new proposals on bank capital requirements as the European Commission continues to eye ways to streamline the wide-ranging reforms the bloc hurried into place after 2008. Moreover, how regulators implement new rules on over-the-counter derivatives and other financial investments could end up having outside implications for the U.K. as it prepares to begin negotiations next year on its future relationship with the EU.

At the same time, those talks and the future of the EU's financial services rules could also face additional pressure if President-elect Donald Trump manages to undo some of the key reforms the U.S. implemented through the Dodd-Frank Act.

"The global political outlook for 2017 is uncertain," said Linklaters LLP's Edward Chan. "If he's successful ... this could pave the way to the most favorable environment for financial institutions since the financial crisis. But it will raise even more questions for the regime in Europe and future negotiations on Britain's departure from the EU."

Meanwhile, other efforts in the U.K. like new legislation that could make it easier for banks to face criminal charges for failing to prevent tax evasion are forging full steam ahead. And major cybersecurity breaches like the recent Tesco Bank hacking make more prescriptive rules in Europe likely as well.

Here are a few reforms worth watching in 2017.

MiFID II and Brexit

The implications of the U.K.'s decision to leave the EU will reverberate across the full range of European financial services rules that have made their way into U.K. law. But certain reforms that are still being put into place may take on outside importance in the wake of the vote because of their implications for how financial services firms from outside the EU will be treated.

For example, the 2014 Markets in Financial Instruments Directive II lays out a broad and complex framework covering everything from bonds, derivatives and structured finance trading to extracting research costs from trade commission charges.

The rules were delayed a year until 2018, but the directive will have to be transposed into national law during the summer and the European Securities and Markets Authority will be putting out Q&As and other guidance about how it plans to interpret the new rules throughout the year.

In general, the latest version of the directive expands the reach of the current regulations to cover exchanges for a host of different financial products, such as certain types of derivatives contracts, and firms doing high-frequency and algorithmic trading.

The measure and accompanying regulation also provide a path for investment firms hailing from outside the EU to receive permission to do business within the bloc starting at the beginning of 2018 if they are regulated by “equivalent” regimes. How those provisions get interpreted could end up proving crucial to U.K. financial services firms as Britain could ultimately end up being treated as a “third country” under the rules depending on its ultimate Brexit agreement with the EU.

“The assessment of a third country’s equivalence is made with reference to various criteria including that country’s authorization, supervisory and enforcement arrangements, its capital requirements and its conduct of business requirements,” said Norton Rose Fulbright LLP’s Peter Snowden. “Although the assessment process is essentially a legal test, there are concerns that the ultimate decision is political in nature.”

Likewise, the European Market Infrastructure Regulation which governs derivatives trading will continue to go into effect in stages, with margining requirements for non-centrally cleared trades kicking in over the next few years.

Indeed, the issue of clearing regulation itself will likely play a prominent role in Brexit negotiations. A large volume of euro clearing takes place in London, but the British government had to go to court to win a ruling that euro clearing could take place outside the eurozone. And the EU court indicated at the time that it was not clear the result would have been the same if the U.K. were outside of the bloc itself.

“There’s a host of operational reasons why you’d say you don’t want to fragment the clearing market,” said Covington & Burling LLP’s Carlo Kostka. “But the flip side ... is this is going to be a horse-trading negotiation [and] this is going to be one of the chips on the table.”

Capital Requirements and Bail-In Rules

The European Commission released its much-anticipated final amendments to the bloc’s capital requirements rules, which force banks to maintain sufficient capital buffers to withstand market shocks, in November. At the same time, it also put out tweaks to bank resolution rules often referred to as bail-in requirements, which are designed to make sure that shareholders, rather than taxpayers, bear the brunt of rescuing failing banks.

The new legislation will impose limits on bank debt levels and force institutions deemed too-big-to-fail to maintain minimum buffers to absorb losses for the first time.

The proposed changes stem from a global agreement known as Basel III. But they also come amid tension over how to continue to shore up European banks, which have remained generally weaker than their U.S. counterparts, and boost lending into the economy, which has also not rebounded to the same extent in Europe.

“What has been going on since the financial crisis ... has been a steady drumbeat of driving the capital requirements of banks upwards,” Kostka said. “A second push which has now been heard says basically, give

everybody breathing space because the banking system needs to generate its own capital and reinvest it in their business ... and the machine won't work to provide credit to the real economy because banks are so busy obtaining their own capital."

At the same time, even though the bail-in rules have been in place since the beginning of 2016, it remains unclear how that will work in practice.

But instability in Italy and continued weakness at Monte dei Paschi di Siena will likely provide the first test case for the new regime.

"The banking regulators will have to figure out how to mediate between rehabilitating the banks and not violating the various provisions that have been enacted in terms of bail-in," Kostka said. "That was all sort of drafted quite theoretically, if you will, and now it's going to be put to the test. Will people follow the rules as they're laid out, or will ways be found to bend the rules to find a more politically palatable solution?"

With populist movements succeeding at the ballot box in the U.S., U.K. and Italy in recent months, looming elections in France, Germany and the Netherlands ensure that any bank crises that arise will be in an "unbelievably politicized" environment, according to Kostka.

"Nothing can be done really at a technical level where it doesn't immediately have a political tail to it," Kostka said.

Criminal Finance Bill

In the U.K., meanwhile, the government introduced landmark proposals to allow authorities to pursue criminal charges against banks involved in tax evasion.

The measures, which are being fast-tracked through Parliament, would introduce a new "failure to prevent" standard to prosecute banks over corporate tax evasion, similar to the current test under U.K. law for foreign bribery charges.

The proposal will also give the police, the National Crime Agency and the Serious Fraud Office greater powers to freeze and seize assets and force those holding criminal property to forfeit it.

Lawyers have said the new laws will mean rising compliance bills and in some cases a culture change at the largest and more complex financial firms from the boardroom down.

"For financial institutions, the reverse burden of proof incorporated into this wide and extra-territorially effective failure to prevent tax evasion offense means 'prove your innocence,'" said Cooley LLP's Louise Delahunty. "International institutions will be urgently upgrading financial crime compliance systems and training in order to deal with this tough new standard."

Essentially, firms will have to hope that if they face an investigation they can say, "We did our best," and use the only defense the law allows for institutions that have "reasonable prevention procedures" in place, according to Delahunty.

The proposed changes also come as tamping down on tax evasion and money laundering have become a higher priority in the wake of the Panama Papers disclosures. At the same time, the fourth iteration of the EU's money laundering rules are set to take effect in 2017, increasing the burden on banks to find out more details about

their clients and where deposited funds come from.

Cybersecurity and Data Protection

Data protection and cybersecurity concerns cut through a broad swath of industries, but the banking industry may be particularly affected by efforts to ramp up protections given its reliance on financial details and personal information.

In addition to a wave of data hacks and credit card information theft at retailers in recent years, Tesco Bank, the banking arm of the U.K.'s largest supermarket chain, suffered what one regulator termed an "unprecedented" attack that led it to suspend all online transactions from checking accounts in November.

"Data is everything for the financial community, and what's been going on I think is going to get people more and more upset because there's no sign that it's getting better," Kostka said. "If anything, there are signs it's getting worse."

Thieves stole money from 20,000 accounts during the Tesco hack, leading lawmakers and enforcers in the U.K. to warn of the need to shore up wider weaknesses in banks' IT systems. Indeed Andrew Tyrie, an influential British lawmaker, called in December for the creation of a single regulator for cybersecurity in financial services.

Some U.S. enforcers have already taken a tough approach, like the New York Department of Financial Services, whose detailed regulations about how firms handle data breaches and manage third-party cybersecurity efforts kick in early in 2017. And a similar approach could be making its way to Europe.

"We haven't seen ... in Europe that level of prescriptive rule-making, but at some point that's I think really going to start happening," Kostka said.

At the same time, the EU's new data protection requirements will have full force in May 2018 and make wide-ranging changes to privacy and data management rules.

One of the biggest issues for banks is that the new rules require companies that hold personal data to house the data either in the same jurisdiction the individual is based in or in another EU country, which can make data storage more difficult for U.S. companies or multinationals that have data on EU customers or employees. And those changes could also have particularly significant effects on U.K. banks once the nation leaves the EU because of those limits on transferring data into and out of the bloc.

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