Measures proposed by the European Commission´s Capital Markets Recovery Package due to the effects of the COVID-19 pandemic. International Bulletin, November 2020.

On 24 July 2020, the European Commission (EC) proposed a capital markets recovery package, as part of its general strategy for the recovery of the economy in the face of the pandemic caused by the coronavirus (COVID-19). The package proposes specific changes to capital markets rules to encourage investment in the economy, allow rapid recapitalisation of companies and increase the ability of banks to finance recovery. Specifically, the package contains specific adjustments to Directive 2014/65/EU on markets in financial instruments (MiFID II), Regulation 2017/1129 on prospectuses, Regulation 2017/2402 on securitisation and Regulation 575/2013 on capital requirements of credit institutions and investment firms. All the proposals are part of the advance towards the Capital Markets Union.

The final version of the legislative texts will be agreed by the European Parliament and the Council and, once they have entered into force, the Regulations will be directly applicable in the Member States, while the amendments to MiFID II will have to be transposed into national laws.

On 24 July the European Commission also published a consultation on the amendment of Commission Delegated Directive (EU) 2017/593 supplementing MiFID II in terms of the part related to the regime applicable to the provision of research services by third parties on small and mid-cap issuers and fixed income instruments.

1) *Amendments to MiFID II*

The amendments seek to facilitate investor access to financial instruments, freeing up financial intermediaries' resources currently used for regulatory compliance so that they can devote themselves to their core business and to allow the recapitalisation of companies. There is also a set of measures that affect commodity derivative markets, particularly energy. The changes can be grouped into the following sections:

1.1.) Reduction of reporting obligations to investors (and customers) and product governance standards

1.1.1.) Phasing out the default paper communication method

Investment firms (IFs) must provide all the information required to their clients or potential clients in electronic format, except in the case of retail clients who have asked to receive such information on paper, in which case the information will be provided in this format free of charge. IFs shall inform clients or potential retail clients that they have the option of receiving information on paper. In addition, they need to inform their current retail customers that they will receive the information in electronic format at least eight weeks before it is sent in that format and that they have the option of either continuing to receive the information on paper, or switching to electronic format (new Section 5a) of Article 24 of MiFID II).

1.1.2.) Exemption from the obligation to inform professional clients and eligible counterparties of costs and charges thereto

The EC suggests that the obligation to provide information on costs and charges should not apply in the case of services provided to professional clients except for investment advice and portfolio management (new Article 29a of MiFID II). In the case of eligible counterparties, IFs will not be obliged to comply with the information obligations of Articles 24 and 25, except for the new Section 5a of Article 24 on sending information in electronic format (amendment to Section 1 of Article 30 of MiFID II).

1.1.3.) Delayed transmission of cost information when using remote communication means

If the purchase and sale of financial instruments is carried out using remote means of communication, the IF can provide information on costs and charges in electronic format without undue delay after the completion of the transaction provided that (a) the IF has given the client the option to delay the conclusion of the transaction until receiving the information and (b) the client has agreed to receive the information just after the transaction has been made (new paragraph introduced in Article 24.4 of MiFID II).

1.1.4.) Easing of the obligation to provide reports on the services provided and a new obligation for professional investors and eligible counterparties
regarding the cost-benefit analysis in the framework of the suitability assessment for switching financial instruments

IFs will not be obliged to provide the following information to professional clients, unless they request it in writing (opt in) (a) adequate reports on the service provided (also loss reports) that include costs of the operations and services carried out on behalf of the client (new Article 29a.1 of MiFID II) and (b) cost-benefit analysis of a switch of financial instruments in the portfolio within the framework of the suitability assessment in case of provision of investment advisory services or portfolio management (new Article 29a.2 of MiFID II). The IF will keep a record of all written requests from professional clients to receive this information (new Article 29a.3 of MiFID II).

In the case of eligible counterparties, see point 1.1.2.

*1.1.5.) Exemption from the application of the rules on product governance to corporate bonds with make-whole cl*auses

The rules on product governance will not apply to corporate bonds with make-whole clauses as defined in the new Section 50a of Article 4.1 of MiFID II as bonds with a clause that obliges the issuer, in the event of early repayment, to return to the investor the principal plus the net present value of the coupons that the investor would have received if there were no early repayment (new paragraph in Article 24.2 of MiFID II).

This specific exemption will allow sophisticated retail investors to access a wider variety of issuers more easily and vice versa. It is considered an essential part of this package that retail investors be able to access the bond market since these instruments allow diversification and risk reduction.

1.1.6.) Suspension of the obligation to publish best execution reports

A paragraph is added to Article 27.3 of MiFID II suspending the requirement to publish these reports for trading venues and systematic internalisers in the case of financial instruments subject to the trading obligations of shares and derivatives as well as execution venues for other financial instruments for two years from the entry into force of this directive amending MiFID II. In the context of the full review of MiFID II in 2021, the Commission will assess whether this obligation should be permanently removed or reintroduced in an amended form.

1.2.) Measures affecting commodity derivative markets

The measures seek to reactivate the euro-denominated emerging commodity markets by doing away with the position limit regime except for derivatives on critical commodities and agricultural products. Applying the position limits regime to only the most developed commodity markets results in less need for hedging exemptions.

1.2.1.) Position limits in markets for critical or significant commodity derivatives and derivatives with agricultural products as their underlying

Position limits on the volume of a net position that a person may hold at any time will apply only to derivatives with agricultural products as underlying, critical or significant commodity derivatives traded on trading venues and economically equivalent OTC contracts. ESMA will develop regulatory technical standards to specify the characteristics of significant or critical commodity derivatives and agricultural derivatives subject to position limits, as well as the methodology for calculating the spot month position limits and other months' position limits for physically settled and cash settled commodity derivatives based on the characteristics of the derivative concerned. The criteria that ESMA will take into account to specify significant and critical derivatives are the following: the size of open interest of 300,000 lots on average over one year, the number of active market participants and the commodity underlying the derivative (amendments to Sections 1, 3 and 4 of Article 57 of MiFiD II).

1.2.2.) Extension of the hedging exemption

The hedging exemption is extended to (a) positions held by a financial entity that is part of a non-financial group and is acting on behalf thereof where such positions are reduce the risks directly related to the commercial activity of that non-financial entity in an objectively measurable way and (b) financial and non-financial counterparties for positions which are objectively measurable as resulting from transactions entered into in order to fulfil obligations to ensure a trading venue's liquidity. Position limits will also not apply to the securities referred to in Article 4.1.44.c) that have commodities or any of the financial instruments mentioned in Annex I.C.10 as their underlying (amendment to Article 57.1 of MiFID II).

2) *Amendments to the Prospectus Regulation*

The measures are intended to make it easier for issuers to raise capital in public markets so as to avoid excessive indebtedness and to facilitate fundraising by financial intermediaries, who play an essential role in financing the recovery of the real economy.

2.1.) EU Recovery Prospectus

The aim of this new type of prospectus is to make it easier for listed issuers to make new issues by simplifying the prospectus publication obligation to bring it more into line with their specific needs in a post-COVID-19 crisis environment. This short-form prospectus is intended to be easy for issuers to produce, easy for investors to understand, and easy for national competent authorities (NCAs) to approve.

This type of prospectus may be chosen for public offerings and admissions to trading according to the new Article 14a, paragraph 1 by (a) issuers that have had shares already admitted to trading on a regulated market continuously for at least the previous 18 months and that issue shares fungible with existing shares previously issued and (b) issuers that have shares already admitted to trading on an SME Growth market continuously for at least the previous 18 months, have published a prospectus for the offer of those shares and who issue shares fungible with existing shares previously issued.

The prospectus is to be written and presented in a concise, comprehensible form that is easy to analyse and enables investors to make an informed investment decision. It shall be a single document with the minimum information established in Annex Va and a maximum length of 30 sides of A4-sized paper when printed, without the information incorporated by reference being taken into account regarding the maximum length, and issuers may decide the order in which the information referred to in Annex Va is presented (new Article 14a.2 of the Prospectus Regulation). The prospectus shall include a summary on two sides of A4-sized paper with an introduction and key information on the issuer, the securities and the offer or admission to trading (new Section 12a of Article 7 of the Prospectus Regulation). The time for the examination of the prospectus by the NCAs is reduced to five business days. The issuer must inform the competent authority at least five business days in advance of the presentation of a request for approval of the prospectus (new Section 6a of Article 20 of the Prospectus Regulation).

This measure is temporary as the possibility of issuing this prospectus expires 18 months after the date of application of this amendment to the Prospectus Regulation (new Article 47a of the Prospectus Regulation).

The amendment to paragraph 2 of Article 48 of the Prospectus Regulation, on the review report on the application of the Prospectus Regulation to be prepared by the European Commission, includes an analysis of the application of the EU Recovery Prospectus (number of prospectuses approved, the evolution of this number, comparative cost and cost savings and an analysis of whether it strikes a proper balance between investor protection and the reduction of the administrative burden).

2.2.) Reduced obligations for financial intermediaries: publication of supplements and non-equity securities issued by credit institutions

2.2.1.) Publication of supplements

Financial intermediaries will have a period of one business day in which to comply with the obligation to notify investors who have purchased and subscribed securities through them of the publication of a supplement, to be taken from the date of publication, provided that the purchase or subscription has been made between the moment the prospectus was approved and the closing of the offer period or the start of trading on a regulated market, whichever occurs later. Investors who have accepted the acquisition or subscription of securities before the publication of the supplement will have a period of three business days from the publication of the supplement in which to withdraw their acceptance (amendment of certain paragraphs of Article 23.2 and 3 of the Prospectus Regulation).

These amendments are not temporary in nature since they permanently solve compliance difficulties and free up resources of intermediaries while maintaining a high level of investor protection.

2.2.2.) Non-equity securities (securities other than shares) issued by credit institutions

The issue of non-equity securities on a continuous or repeated basis by a credit institution, when the total aggregate consideration for the securities offered is less than €150 million calculated over a period of 12 months will not be subject to the obligation to publish a prospectus, provided that these securities (a) are not subordinated, convertible or exchangeable and (b) do not give the right to subscribe or acquire other types of securities and are not linked to a derivative. This measure, directly related to the COVID-19 recovery phase, has a limited duration of 18 months (new Section k of Article 1.4 of the Prospectus Regulation).

3) *Amendments to the Regulation laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation and to the Regulation on prudential requirements for credit institutions and investment firms*

The amendments are intended to increase the ability of banks to grant loans to households and companies (in particular SMEs) by allowing simple, transparent and standardised securitisation (STS) on the balance sheet as well as facilitating the securitisation of unprofitable loans.

3.1.) Specific amendments to the securitisation rules

The EC proposes both the creation of a specific framework to extend simple, transparent and standardised securitisation (STS) to on-balance-sheet synthetic securitisation in order that banks may transfer the credit risk of the loans that they grant to companies (including SMEs) to the markets through credit derivatives and other financial guarantees and the elimination of obstacles to securitising non-performing exposures (NPEs), which are expected to grow due to the COVID-19 crisis. These changes are based on the extensive analysis carried out by EBA in 2019 and 2020.

3.1.1.) Creation of a specific framework for on-balance-sheet synthetic STS securitisations

As is the case with traditional or true sale STS securitisations, where ownership of the exposures is transferred, the synthetic STS label should not be understood to mean that the securitisation is risk-free, but rather that it respects a number of criteria supervised by an NCA.

The proposal includes a new Section 2a (Article 26 a-e) with the requirements for the new on-balance sheet synthetic STS securitisation in which the securitised exposures remain the property of the originator and appear on its balance sheet. In addition to the criteria required in order to hold the STS label, further requirements are established for the protection of the credit risk through a credit protection agreement between the originator (who will also be an investor in the senior tranche) and the investor (who will be primarily an institutional investor). This agreement allows the transfer of the credit risk of the securitised exposures from the originator to the investor through the use of credit derivatives or financial guarantees, ensuring that the originator is thus obliged to pay a credit protection premium to the investor, with the investor in turn undertaking to pay an amount to the originator if any of the credit events defined in the contract occur.

The originator will appoint an external verification agent before the closing date of the transaction to verify a series of facts for each exposure for which a credit event is notified. These include confirmation that the credit event notified is specified in the protection contract, that the exposure was part of the reference portfolio when the credit event occurred and the allocation of losses to investors when the credit protection is paid (Article 26e.4 of Regulation 2017/2402).

The originator can assign an amount (the synthetic excess spread) that is available as credit enhancement to investors when a number of conditions are met, including the requirements that the amount be a fixed percentage of the total outstanding balance of the portfolio at the beginning of the relevant payment period and that the amount not used to cover losses be returned to the originator.

3.1.2.) Addressing shortcomings in the regulatory framework for the securitisation of non-performing exposures

The proposal facilitates the securitisation of NPEs, which are expected to grow due to the COVID-19 crisis. To this end, it defines an NPE securitisation, in the new point 24, Article 2 of Regulation 2017/2402, as one backed by a pool of non-performing exposures that meet the conditions set out in Article 47a(3) of Regulation 575/2013, the value of which makes up at least 90% of the pool's value at the time of origination. The proposal establishes a special regime for compliance with the risk retention requirement in which this will not be less than 5% of the discounted value of the securitised exposures (Article 6.3a of Regulation 2017/2402). In addition, the special servicer in the NPE transaction should fulfil the requirement to retain a significant net economic interest (new paragraph added to Article 6.1 of Regulation 2017/2402).

3.2.) Specific amendments to capital requirements to carry out the proposed changes

The proposal allows a prudential treatment that entities would benefit from, reflecting the real risk of the synthetic on-balance-sheet STS securitisation instruments by establishing a specific and limited-scope preferential treatment (for the senior tranche), calculating the amount of the weighted risk of the exposure of a synthetic STS securitisation that meets a series of requirements such as mitigation of the counterparty credit risk that such synthetic structures entail (Article 270 of Regulation 575/2013).

It also establishes a specific treatment for NPE securitisations: institutions shall assign a 100% risk weight to the senior tranche in a traditional NPE securitisation provided that the exposures in the pool backing the securitisation have been transferred to a Securitisation Special Purpose Entity (SSPE) at a price reduced by at least 50% of the nominal amount of the exposures. The remaining tranches would be subject to the general framework with specific adjustments (Article 269a of Regulation 575/2013).

Finally, it is proposed to introduce a third paragraph in Article 249 of Regulation 575/2013, within the framework of the standardised calculation of capital requirements for risk-weighted securitised exposures, in such a way that only a Step 3 credit assessment or higher assigned by an External Credit Assessment Institution (ECAI) will be required of eligible providers of unfunded credit protection listed in point (g) of Article 201.1 of Regulation 575/2013.

4) ***Consultation on possible changes to Delegated Directive (EU) 2017/593 for the non-application of unbundling in financial analysis services on SMEs and fixed income instruments***

Consultation on the amendment of Delegated Directive (EU) 2017/593 on MiFID II was held between 24 July and 11 September this year. The proposed changes, which are based on the previous analysis carried out in the early-2020 public consultation on MiFID II/MiFIR, are intended to increase the financial analysis of SMEs and fixed income instruments to attract new investors.

The proposal adds two new paragraphs 10 and 11 to Article 13 of Delegated Directive (EU) 2017/593. The former (Article 13.10) allows an IF to choose not to comply with the unbundling rule (separation of the cost of research from the cost of execution at the trading venue and other intermediation) in the following circumstances (a) the research is carried out on issuers that do not exceed €1 billion in market capitalisation in the 12-month period prior to the research and (b) the research is carried out exclusively on fixed income instruments. The latter (Article 13.11) establishes the joint payment for research and execution services provided that the following conditions are met (a) there is a prior agreement between the IF and the research provider that identifies which part of the joint payment is attributable to research, (b) the IF informs the client of the joint payment and (c) in the case of research on issuers, the execution services for which the joint payment is made refers exclusively to those that do not exceed €1 billion in market capitalisation in the 12-month period prior to the issue of the financial analysis.

Links of interest:

Amendments to MiFID II: proposal for a Directive of the European Parliament and of the Council amending Directive 2014/65/EU as regards information requirements, product governance and position limits to help the recovery from the COVID-19 pandemic

Amendments to the Prospectus Regulation: proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2017/1129 as regards the EU Recovery prospectus and targeted adjustments for financial intermediaries to help the recovery from the COVID-19 pandemic

Amendments to the Securitisation Regulation: proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2014/2402 laying down a general framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 pandemic

Amendments to the Capital Requirements Regulation: proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No. 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 pandemic

Amendments to Delegated Directive 2017/593: proposal for a Commission Delegated Directive (EU) amending Delegated Directive (EU) 2017/593 as regards the regime for research on small and mid-cap issuers and on fixed income instruments to help the recovery from the COVID-19 pandemic