Freshfields Bruckhaus Deringer

Finance Newsletter

Financial supervisory law 2020

Dear Readers,

In our special series of the Finance Newsletter, we provide you with the 2020 outlook on financial supervisory legislation.

While the past year was dominated by the adoption of the EU banking package, regulatory projects in the area of sustainable finance will increasingly come to the fore in 2020. The far-reaching transformation of global economy over the coming decades triggered by climate change and the fight against it will naturally have a massive impact on the financial sector. In this respect, the current regulatory initiatives on sustainability are probably only the beginning of the adaptation process that the financial sector, too, will have to undergo.

Another global "megatopic", namely digitisation, will be reflected in new legislative measures in 2020 as well. For example, in Germany – going beyond its obligations when implementing the 5th Anti-Money Laundering Directive – a new financial service requiring a licence will be introduced in the form of what is referred to as crypto custody.

However, the work in the traditional regulatory areas did not stop either. In 2020, the focus will be, for instance, on the implementation of the above-mentioned EU banking package, in particular the implementation of the new requirements under the CRD V and the BRRD II, the reform of the European System of Financial Supervision (ESFS), and further work on the EU's non-performing loan (NPL) action plan. Last, but not least, Brexit – after several postponements last year – will still remain a permanent issue in 2020.

Given the large number of regulatory projects, it is not easy to keep an overview. We have therefore summarised what we consider to be the most relevant regulatory developments in financial supervisory law in 2020.

As the introduction of many measures, e.g. within the framework of action plans, has now extended over several years, we additionally refer to our Financial Supervisory Law Outlook 2019.

Your Freshfields Finance Newsletter Team, Frankfurt

Please note: This is a selection of information in the area of financial supervisory law that we have compiled in this special edition of our Finance Newsletter. It contains non-official summaries and makes no claim to completeness.

Contents

Anti-Money Laundering Regulations

As part of the transposition of the 5th Anti-Money Laundering Directive (2018/843), the new Money Laundering Act came into force on 1 January 2020.

In addition to an expansion of the group of obliged entities under anti-money laundering law, the new regulations prescribe, among other things, increased due diligence obligations with regard to high-risk countries and amend group-wide obligations. Furthermore, the group of "politically exposed persons" is specified. In future, access to the electronic transparency register introduced in 2017 will be possible for the entire public without having to prove a legitimate interest. The central Financial Intelligence Unit (FIU) will moreover be equipped with further competences.

As regards services related to crypto assets, the legislator has anticipated a uniform European regulation. The introduction of a new regulated activity in the German Banking Act (KWG) ("crypto custody") goes well beyond the requirements of the 5th Anti-Money Laundering Directive, which only provides for an extension of the group of obliged entities (more on this under the keyword "Crypto custody").

In addition, the Money Laundering Directive Implementation Act will also amend the Payment Services Supervision Act (ZAG). A subsequent amendment request made by the Federal Ministry of Finance (BMF) now regulates access to technical infrastructure services in the field of payment transactions (more on this under the heading "Payment Services").

Since money laundering scandals have recently become more frequent in the EU, the finance ministers of several Member States, including Germany, have called for the creation of a uniform supervisory mechanism to prevent money laundering. The published position paper calls for the establishment of an EU body or the transfer of powers to existing EU authorities, such as the ECB or the EBA, which would be responsible for monitoring fund transfers instead of national authorities.

In order to effectively combat money laundering, the proposal also calls for the harmonisation of national anti-money laundering legislation. This would be possible by converting the Anti-Money Laundering Directive into a directly applicable regulation. A specific timetable for the implementation of the proposals has not yet been set, but the preparation of a draft anti-money laundering regulation as early as this year may be realistic.

Basel III/IV

In December 2017, the final Basel III reform package (also known as "Basel IV") was published as the preliminary cornerstone of Basel III and thus of the post-financial market crisis reforms. It will generally apply from January 2022 onwards.

The planned introduction of the so-called output floor is at the centre of the discussion on the European implementation of Basel IV. This means that banks that use internal models to calculate their capital adequacy requirements will have to hold a regulatory minimum capital based on the calculation according to the standardised approach. The aim is to set a capital floor for the own funds requirements, which are usually lower if internal models are used. Should a bank calculate its regulatory capital ratios using internal models, then it needs to determine its minimum capital requirements with reference to the lower limit of the output floor. If the capital value calculated using the internal model is below this value, the bank must use the (higher) output floor value. The output floor will be specified step-by-step from 1 January 2022 to 1 January 2027 on the basis of 72.5% of the value obtained according to external rating (standard approach).

The EU Commission initially announced the publication of its proposal for implementing the Basel III reform package for the end of the second quarter of 2020. In preparation for this, it held a consultation, which ended on 3 January 2020.

Benchmarks

On 10 December 2019, the new Regulation (2019/2089) amending the Benchmark Regulation (2016/1011), which refers to climate-related benchmarks, entered into force. In the amended Art. 51 of the Benchmark Regulation, the regulation also includes an extension of the transitional period for the use of critical benchmarks (Euribor, Libor) until 31 December 2021. The original two-year extension period was to apply until 1 January 2020 in order to allow time to meet the requirements of the Benchmark Regulation. At the same time, the Brussels-based European Money Markets Institute (EMMI), which was approved by the Belgian Financial Services and Markets Authority as the Euribor administrator in 2019, is seeking to continue the Euribor. In the meantime, the Euribor Hybrid is considered a new methodology for calculating. This interest rate is calculated by EMMI on the basis of actual interbank loans and derived interest rates calculated from other transactions. As an alternative to the Euribor, an interest rate structure based on the €STR (Euro short-term rate), which the

ECB published on 2 October 2019, is also being discussed.

With a view to the United Kingdom's withdrawal from the EU announced for the end of January 2020 (more on this under the heading "Brexit"), the question also arises to what extent benchmarks from third countries, which as a result of Brexit would then include the United Kingdom, can be used for new contracts. The provisions of Art. 32 (Recognition of an administrator located in a third country) and Art. 33 (Endorsement of benchmarks provided in a third country) of the Benchmark Regulation list the requirements that must be met in relation to a third country. Pursuant to these provisions, in order to be used in the EU, benchmarks from third countries must either be subject to equivalent regulation in their home state, be recognised by the respective national supervisory authority, or be endorsed by an administrator established in the EU.

Brexit

In Germany, the legislator took preparatory measures in 2019 by passing the "Brexit Tax Accompanying Act" in case there would be a Brexit without a withdrawal agreement. The adopted transitional provision permits BaFin to issue an order, in the event the United Kingdom exits without a withdrawal agreement, that British providers of regulated banking, financial and payment services in Germany, are treated as financial service providers from the EU for up to 21 months (section 53b(12) KWG; section 39(8) ZAG; see, for British trading venues: section 102(4) WpHG).

Following the elections to the British House of Commons in December 2019, political expectations are that a withdrawal agreement will be passed by the British Parliament. Hence, the danger of a hard Brexit seems to have been averted for the time being. Subsequently, the EU and the UK will face the further mammoth task of negotiating their future relations by 31 December 2020. This is when the transitional period in the withdrawal agreement will end, during which European law continues to apply in principle.

The German transitional regime would not be applicable in this case according to its clear wording. If, for example, a free trade agreement with corresponding content is not concluded by the end of 2020 and the deadline is not extended by mutual consent, British financial service providers would be treated as third-country companies from January 2021 onwards and the danger of a hard Brexit would reappear.

Covered Bonds

The proposed regulations on covered bonds form an additional piece of the Capital Market Union. The new legal framework consists of a Regulation, 2019/2160, and a Directive, 2019/2162, which were published in the EU Official Journal on 18 December 2019. The EU Commission is pursuing the goal of minimum harmonisation for covered bonds in the EU as a way of refinancing that offers credit institutions a comparatively reliable funding option and contributes to financial market stability. Subject to certain conditions, the Regulation grants covered bonds a more favourable treatment with regard to own funds requirements. The Directive contains definitions for the purpose of minimum harmonisation. Differences between national rules and the absence of a generally applicable definition of "covered bonds" are considered as an obstacle to market development. Accordingly, the Directive defines "covered bonds" as debt obligations that are issued by a credit institution in accordance with the provisions of national law transposing the mandatory requirements of the Directive and that are secured by cover assets to which covered bond investors have direct recourse as preferred creditors. Furthermore, the Directive contains provisions on, inter alia, the requirements for issuing covered bonds, disclosure requirements, and structural features.

Within the framework of the provisions on structural features of covered bonds, a "dual recourse" is regulated. According to this, investors and counterparties of derivative contracts may assert claims both against the issuer of the covered bond and for the cover assets.

The Regulation and the Directive entered into force on 7 January 2020. The Regulation will apply as of 8 July 2022. Member States must adopt and publish the laws, regulations and administrative provisions necessary to transpose the Directive by 8 July 2021. These are to be applied from 8 July 2022 at the latest.

Crowdfunding

On 19 December 2019, a preliminary political agreement was reached between the EU Parliament and EU Council on a proposal to strengthen crowdfunding in the EU. According to the proposal, a harmonised legal framework will apply to crowdfunding platforms in the EU in the future. With a single licence, the platforms will be allowed to operate cross-border in the EU. Due to different crowdfunding regulations that apply throughout the EU, the EU Commission published a proposal for a Crowdfunding Regulation as early as in 2018 as part of the FinTech action plan.

In March 2019, the EU Parliament answered the open question of whether the scope of application of the Crowdfunding Regulation should be extended to also include ICOs in the negative. The background was that crowdfunding service providers should be allowed to raise capital through their platforms by issuing coins. The EU Parliament argued that ICOs were clearly distinct from crowdfunding as regulated by the Regulation. It stated that the two types of financing differed significantly in terms of the use of financial intermediaries and the amount of capital that is to be raised. The EU Parliament therefore recommends that the EU Commission examines whether an additional EU legal framework needs to be created for ICOs.

In Germany, crowdfunding has been fostered by amendments to the Capital Investment Act (VermAnlG) and new regulations on crowd financing. Following an evaluation of the exemption regulations for providers of investment products within the scope of crowdfunding, the limit for the obligation to publish a prospectus was raised from EUR 2.5 million to EUR 6 million in July 2019.

Directors' Dealings

Art. 19 of the Market Abuse Regulation (596/2014) (MAR) requires the notification and publication of directors' dealings.

This applies to directors (members of the management and of the supervisory body of an issuer) if they trade in financial instruments (e.g. shares, bonds or derivatives) issued by their own undertaking.

Since the MAR became applicable and the obligation to report directors' dealings was extended, BaFin has recorded a sharp increase in the number of reports within a period of two years. In October 2019 BaFin as the competent authority, raised the threshold with effect as of 1 January 2020. The threshold value, which previously was EUR 5,000, will now be EUR 20,000, meaning that directors will only have to report their transactions if a total transaction volume of EUR 20,000 is exceeded within a calendar year. BaFin states, that one of the reasons for the measure, was to simplify administrational procedures for persons subject to reporting obligations and for issuers, although it entails a reduction in market transparency.

EMIR

Last year was marked by numerous changes to the European Markets Infrastructure Regulation 648/2012 (EMIR), some of which will not be immediately applicable.

Regulation 2019/834 (known as EMIR Refit or EMIR 2.1), which provides for extensive changes to the EMIR, already came into force in June 2019. The different provisions, however, will start to apply on different dates up to 24 months after the Regulation entered into force. Amongst others, the obligation for financial counterparties to carry out the necessary reporting of OTC derivative contracts, provided that the transaction is with a non-financial counterparty and the latter does not voluntarily submit the report, will take effect in mid-2020. Moreover, the obligation to report transactions with regard to UCITS and AIFs is now clearly assigned to their management companies, unless otherwise agreed. A broad exemption from the reporting obligation for intra-group transactions already applies, provided that at least one counterparty is a non-financial counterparty and the parent company does not qualify as a financial counterparty.

In December 2019, the Federal Government published a draft bill to adapt the national regulatory framework to the EMIR Refit. At the same time, provisions on the resolution of central counterparties are to be introduced into the German Act on the Recovery and Resolution of Credit Institutions (SAG). The German legislator thus anticipates a regulation at the European level. This is because the Commission proposal on a framework for the recovery and resolution of central counterparties, which was presented as early as in 2016, has not yet been adopted.

Non-financial counterparties are already free to review on an annual basis whether they exceed the relevant clearing thresholds and thus become subject to the clearing obligation. If they do not undertake such review, they are subject to the clearing obligation for all transactions made since the amendment. However, if non-financial counterparties conclude, after conducting a review, that they exceed the relevant thresholds, the clearing obligation has been limited to OTC derivative contracts belonging to those categories of assets for which the thresholds are exceeded.

In December, ESMA furthermore published draft technical standards permitting counterparties to exempt physically settled FX swaps and FX forwards from the obligation to provide a variation margin where a counterparty is not an investment firm or a credit institution under the CRR. The obligation to provide collateral for intra-group transactions with counterparties from third countries for which an equivalence decision has not been adopted and for stock options based on individual shares and index options is postponed for one year.

In December 2019, moreover Regulation 2099/2019 (EMIR 2.2) was published. It fundamentally revises the regime for the recognition of central counterparties from third countries, including new requirements for their compliance. In addition, the cooperation

between national and European supervisory authorities with the CCP Supervisory Committee will be reorganised. This committee aims to achieve greater supervisory convergence among the central counterparties that continue to be supervised at Member State level. As delegated acts for a large number of regulations are not required to be published until the beginning of 2021, their start may be further delayed.

In December, ESMA finally provided legal certainty for the transitional recognition of the three British central counterparties (LCH Limited, ICE Clear Europe Limited and LME Clear Limited) in the event of a hard Brexit. The temporal scope of application of the equivalence decision was – in accordance with the Commission's new requirements – variably set at one year from the point in time when the European Treaties will no longer be applicable in the United Kingdom.

ESFS Reform

On 1 January 2020, the legislative package for the revision of the European System of Financial Supervisors (ESFS) entered into force and is now largely applicable, with the exception of, among other things, the amendments to the Benchmark Regulation, which will not apply until 1 January 2022.

The ESFS, established in 2011, consists of the three European Supervisory Authorities (ESAs), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA), as well as the European Systemic Risk Board (ESRB) and the national supervisory authorities (NCAs). The legislative package comprises several (amending) regulations and a directive.

The EU revised the European financial supervision system created in the aftermath of the financial market crisis for the first time with this reform. The revision is intended to adjust the governance structures, the tasks and powers of the ESAs to the needs of FinTech and sustainability and with a view to completing the Capital Market Union. Consumer protection and the fight against money laundering are also in focus. According to these provisions, the ESAs are entitled to carry out certain analyses of consumer trends with regards to costs and fee developments. Furthermore, they are entitled to provide risk indicators to identify developments that are harmful to consumers.

The EBA is given additional powers to combat money laundering. It will have a leading and supervisory role in promoting security in the financial system. Where evidence is available to the EBA, it will have the power to request a competent authority to investigate and consider sanctions for possible breaches of EU law by entities of the financial sector. (see also under the heading "Anti-Money Laundering Regulations").

The powers of ESMA will be selectively extended, too, and in the future, it will directly supervise, for example, the administrators of critical benchmarks and benchmarks from third countries. By October 2020, ESMA will prepare a series of drafts on regulatory technical standards (RTS), which will set new requirements within the framework of the Benchmark Regulation.

EU Banking Package (CRD V, CRR II, BRRD II, SRM II)

In May 2019, the EU published the banking package consisting of four legal acts. Among other things, the CRD V (2019/878) and the CRR II (2019/876) implement large parts of Basel III into European law. The BRRD II (2019/879) and the SRM II (2019/877) implement the TLAC (Total Loss Absorbing Capacity) standard into European law and revise the existing rules on MREL (Minimum Requirements for Eligible Own Funds and Liabilities).

The CRR II and the CRD V introduce also the licensing requirement for (mixed) financial holding companies and the obligation for banking groups from third countries with significant activities in the EU to establish a single intermediate EU parent undertaking. The rules on the recognition of capital instruments as own funds are also readjusted. Among other things, these amendments create legal certainty as to the circumstances under which the conclusion of profit and loss transfer agreements will not affect an institution's own funds, thus putting an end to the disagreement between the EBA and BaFin on this issue.

In addition, the calculation of capital requirements is modified. Although the new Basel standard for market risk calculation (Fundamental Review of the Trading Book, FRTB) is currently only implemented in the form of additional reporting obligations, this does not imply any change in the calculation of own funds. However, the standard methods for calculating the counterparty risk will be replaced. The reduction of non-performing risk exposures shall be facilitated by the option to ignore losses incurred in the event of "massive disposals", except for the calculation of credit risk.

For the first time, a binding maximum leverage ratio and an additional buffer for globally systemically important institutions will be created, non-compliance with which can limit distributions from capital instruments. Selective regulatory relief for smaller insti-

tutions will be introduced for reasons of proportionality.

The CRD V is to be transposed into German law by 28 December 2020 and largely to be applied as of the following day. It is therefore to be expected that a ministerial draft bill of the German Ministry of Finance (BMF) for the transposition of the CRD V will soon be presented. The CRR II partially entered into force as early as June 2019; however, most of the amendments will only take effect on 28 June 2021.

The implementation of TLAC and the revision of MREL in the BRRD II and the SRM II have also resulted in important changes in the law governing bank resolution. For globally systemically important institutions that fall under the scope of TLAC, there are now rigid minimum ratios for liabilities eligible for bail-in. Rigid minimum ratios are also established for so-called "top tier" institutions that belong to a group of institutions with total assets of more than EUR 100 billion. Apart from TLAC, a rigid minimum requirement of 8% of the total liabilities for globally systemically important institutions and top-tier banks will be introduced (Total Liabilities and Own Funds, TLOF). For other institutions, however, MREL will continue to be set on an institution-specific basis. In addition, an MREL market confidence buffer can be ordered for all institutions. Under certain circumstances, authorities may impose distribution restrictions for falling below MREL ratios. Furthermore, the criteria for setting off liabilities for MREL/TLAC purposes will be modified.

The BRRD II is to be transposed into national law by 28 December 2020 and is also to be largely applied as of that date. The SRM II will be directly applicable as of that date. A draft for a corresponding implementation act has not yet been published. It can be assumed that the BMF will combine the transposition of the CRD V and the BRRD II in one draft bill.

The German Financial Investments Agency Ordinance (FinVermV)

As of 1 August 2020, financial investment brokers and fee-based financial investment advisors will have to adapt to new regulations. This is when the Second Amendment Ordinance to the German Financial Investments Agency Ordinance (FinVermV) will come into force. At the same time, the provisions of the FinVermV are planned to be adopted into the Securities Trading Act (WpHG) in the medium term. In addition, the competence for granting licences and the supervision of financial investment brokers and fee-based financial investment advisors is to be transferred to BaFin. At present, this is the responsibility of the federal states.

To this end, the BMF on 23 December 2019 published the draft bill – in the form of an omnibus act – for the transfer of the supervision of financial investment brokers to BaFin, as already announced in its position paper. In the course of transferring supervision to BaFin, a new section on financial investment brokers and fee-based financial investment advisors will be introduced in the WpHG, which regulates the requirements and procedures for granting licenses to financial investment brokers and fee-based financial investment advisors. This also means that – according to the draft – sections 34f to 34h of the German Commercial Code (GewO) and the FinVermV will cease to apply on 1 January 2021.

The draft legislation is based on the desire to take account of the increasing complexity of the applicable supervisory law, which is due, among other things, to interference with European legal foundations. Furthermore, it is intended to avoid a fragmented supervisory structure.

In addition, the legislator is pursuing further changes in content – partly in order to implement the MiFID II requirements – e.g. with regard to the adjustment of the minimum insurance sum of professional liability insurance for financial investment brokers, the obligation to avoid conflicts of interest, the suitability test and target market provisions, the disclosure of benefits, and the obligation to record telephone conversations and electronic communications. The latter has led to considerable discussions in practice; in some cases, conformity with the General Data Protection Regulation is questioned.

Incidentally, the transfer of supervision regarding financial investment brokers, which is governed by the FinVermV, to BaFin is also part of the package of measures published by the Federal Ministry of Finance and the Federal Ministry of Justice and Consumer Protection (BMJV) in August 2019 to further strengthen investor protection, comprising a catalogue of nine initiatives in total. Furthermore, that list also abolition of so-called incomplete sales prospectuses, the consistent use of powers of product intervention regarding investments, and the prohibition of what is known as blind pool constructions for investments.

IFD and IFR – new rules for investment firms

In early December 2019, the Investment Firm Directive (IFD) (2019/2034) and the Investment Firm Regulation (IFR) (2019/2033) were published, which create a separate set of rules for investment firms and largely replace the existing reference to the CRD and the CRR. According to the Commission', the requirements of the CRD and CRR have proved to be disproportionate for most investment firms.

The IFD and the IFR contain, inter alia, rules on own funds and governance. Own funds requirements are calculated using so-called K-factors, which take into account, the value of the funds and securities held for clients or securities managed as part of portfolio management. The future governance obligations are based on the current obligations under the CRD.

Whether and to what extent certain obligations are relevant for an individual investment firm will be determined by a new classification of investment firms providing for four different categories. The new rules are thus intended to take account of the principle of proportionality. The classification is mainly based on the balance sheet size and the type of business activity.

Against this background, the IFR and the IFD distinguish between systemically important investment firms (with a consolidated balance sheet total of more than EUR 15 billion). Only for systemically important investment firms the reference to the CRD and the CRR continues to apply. Certain systemically important investment firms whose consolidated balance sheet total exceeds EUR 30 billion must even apply for a licence as credit institutions.

In addition, only certain minimum requirements apply to small and non-interconnected investment firms that do not reach certain thresholds (including a consolidated balance sheet total of less than EUR 100 million).

Member States still have 18 months until mid-2021 to transpose the new rules into national law, although market participants will start preparing for the new rules as early as in 2020. Corresponding national legislative efforts and the publication of draft bills as well as the adoption of delegated legal acts are expected for 2020 as well. However, systemically important investment firms will have to licence as credit institutions by 27 December 2020.

Crypto assets

Many current regulatory developments are driven by a visible effort to prepare German (and European) financial market law for the digital revolution and to make it future-proof. This may be demonstrated, for example, by the "Second Notice on Prospectus and Permission Requirements in Connection with the Issue of Crypto Tokens" of August 2019, in which BaFin describes its current – and still developing – administrative practice regarding the regulatory classification of crypto tokens.

The future regulation of crypto assets will be decisively influenced by the implementation of the 5th Anti-Money Laundering Directive (more on this at the keyword "Anti-Money Laundering Regulations"), which for the first time legally defines crypto assets. In particular, crypto assets do not have the legal status of a currency or money but are accepted by agreement or in actual practice as means of exchange or payment or serve investment purposes (section 1(11) sentence 4 KWG). In addition to what is referred to as virtual currencies or payment tokens, so-called security tokens, which may qualify as debt instruments, capital investments or investment funds, may be covered as well. The legislator equates these with financial instruments under the KWG (section 1(11) sentence 1 no. 10 KWG). The German legislator thus goes beyond the requirements of the 5th Anti-Money Laundering Directive, which only covers payment tokens. Due to the classification as a financial instrument within the meaning of the KWG – another excessive implementation of the 5th Anti-Money Laundering Directive – exchange service providers are thus subject to comprehensive licensing obligations in accordance with section 32 KWG.

The blockchain strategy of the Federal Government, which was passed in September 2019, sets the course for the tokenisation of securities and thus for 'securities tokens'. While securities currently still must be embodied in a physical document, German law is to be opened in the future for electronic securities issued on a blockchain. As a first step, it is intended to permit electronic bonds. Moreover, in a second step, it is to be examined whether a legal basis will be created for electronic shares and fund units. There are also plans for a national regulation of the public offering of certain crypto tokens that are neither securities nor investments. Both draft bills were originally planned to be published as early as in 2019.

Preparatory work is also taking place at the European level, which may result in a legislative procedure. The EU Commission is currently considering a common regulatory framework for crypto tokens in order to address risks to consumer and investor protection and to market integrity. To this end, a public consultation is being held until March 2020. According to the

Commission's website, a draft is expected to be submitted in the third quarter of 2020.

Crypto Custody Business

The Act Implementing the 5th Anti-Money Laundering Directive, which came into force on 1 January 2020, introduces crypto custody as a new financial service. Pursuant to this Act, a licence is required for the custody, management and protection of cryptographic values or private cryptographic keys which are used to hold, store or transfer cryptographic values, if this activity is performed on behalf of third parties. This ultimately leads to regulation of an IT service by financial market legislation. Crypto assets are always stored decentralized on a blockchain and not stored in a central ledger. Cryptographic keys in the form of series of letters or numbers are only used to prove the authorisation for these crypto assets to the blockchain. Crypto custodians store or keep these digital keys safe from loss or third-party access. (for more information on crypto assets, see the relevant keyword).

The first government draft stipulated that crypto custodians were not permitted to provide any further banking activities or financial services. This aimed to prevent IT risks associated with the crypto custody business from "spilling over" to other regulated services. The provision was abandoned in the legislative procedure, inter alia on the initiative of the German Federal Council (Bundesrat). It pointed out, that the handling of sensitive data was part of the day-to-day business of financial institutions and that there were no indications of significantly increased IT risks in connection with the crypto custody business.

The implementation act does not contain any tailor-made obligations for crypto custodians in terms of organisation or conduct. Instead, the general obligations under the KWG apply. Hence, BaFin is instructed to develop a comprehensive supervisory practice. BaFin's request that undertakings already providing crypto custody services may send expressions of interest and brief descriptions of their business models to BaFin should be seen in the light of that fact. Moreover, crypto custodians are obliged to notify BaFin in writing by 31 March 2020 of their intention to apply for a licence and to actually submit such a licence application by 30 November 2020. Only in this case, the licence will be deemed to have been provisionally granted. (see also Freshfields Blog, January 2020)

Non-performing loans and risk exposure (NPL/NPE)

An important part of the Capital Market Union are the provisions aiming at the reduction of the high levels of non-performing loans (NPL) and non-performing risk exposure (NPE). The aim is to enable the further reduction of risks, which is necessary for a stable banking sector.

Regulation 2019/630, which was initiated by the EU at Level 1 for this purpose, amending the CRR II with regard to the minimum coverage of non-performing risk exposures (prudential backstop), came into force in mid-2019. It applies since 1 January 2020. The regulation contains minimum requirements for compensating for non-performing risk exposure by means of equity capital backing. This means that banks are obliged to make adequate provisions if new loans become non-performing. This is intended to proactively prevent an excessive accumulation of NPLs. This final regulatory safeguard applies in the event that the sum of provisions and other adjustments is not sufficient to cover losses from NPEs up to the jointly agreed minimum level. Accordingly, the prudential backstop provides for a deduction from own funds if NPEs are not adequately covered (Pillar 1). The ECB has decided to review and adjust its regulatory expectations for the provisioning of NPEs under its Pillar 2 powers in order to take account of the adoption of the Regulation. For that purpose, it published its Communication on supervisory coverage expectations for NPEs in August 2019. In this communication, it also announces the development of comprehensive rules on reporting in 2020. In the course of its action plan to reduce non-performing loans, the EU Commission also submitted a proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral (COM (2018) 135) on 14 March 2018. Its implementation in the Member States is planned to take place by 31 December 2020 after the Directive entered into force.

The Directive provides for a licensing process for credit service providers that have so far been unregulated at European level. In addition to certain information rights for the benefit of credit purchasers, the directive also contains requirements regarding the content of contractual agreements between credit servicers and lenders, as well as for outsourcing agreements with credit service providers.

An additional central pillar in combating the accumulation of non-performing loans is the effective Accelerated Extrajudicial Collateral Enforcement (AECE). The directive therefore also covers the realisation of collateral. The Council initially did not reach an agreement with regard to the AECE part of the directive. At the end of November 2019, the European Council (Committee of Permanent Representatives of

the Member States, Coreper) was able to agree on a position on the so far omitted AECE part of the proposed Directive (proposal for a Directive on an out-of-court mechanism to recover the value from loans guaranteed with collateral). This new mechanism intends to accelerate the out-of-court enforcement of collateral realisation by, for instance, providing specific payment deadlines, rights of appeal against collateral realisation and - at the member states' discretion - rules for distribution of a surplus. This extensive and not yet completed NPL legislative package at Level 1 is expected to be continued in 2020.

At Level 2, the EBA final guidelines on the *administration* of non-performing or deferred receivables (NPL Guidelines) entered into force at the end of June 2019. In addition to introducing a threshold value for the NPL portfolio (5%), the NPL Guidelines also contain requirements for strategy, governance and process organisation, forbearance measures, the accounting treatment of NPE, the valuation of decreases in value and write-downs. The guidelines on the *publication* of non-performing and deferred receivables submitted by the EBA in 2018 have also been applicable since 31 December 2019. According to these, the scope of the publication requirement depends to a large extent on compliance with the 5% ratio, but the guidelines also aim to increase transparency for market participants and to give them additional insight into the banks' assets and their distribution as well as the value and quality of collateral provided by them.

Another novelty with regard to Level 2 NPL regulation projects relevant for 2020 is the EBA's consideration of providing specific conditions for the securitisation of NPLs (see the "Opinion of the European Banking Authority to the European Commission on the Regulatory Treatment of Non-Performing Exposure Securitisations" of October 2019).

Outsourcing

Since 30 September 2019, the revised outsourcing guidelines of the EBA (Guidelines on outsourcing arrangements, EBA/GL/2019/02) are applicable. Amongst others, the guidelines contain definitions and distinguish between the outsourcing of critical and important functions. Institutions have a duty to inform the supervisory authorities about the planned outsourcing of such a function. In addition, numerous new requirements are introduced, e.g. for outsourcing agreements and IT security. However, the review of existing material outsourcing agreements is generally subject to an implementation period ending on 31 December 2021.

The guidelines commit supervisory authorities to either comply with the guidelines or explain their non-compliance ("comply-or-explain-mechanism"). It is expected that the ECB and BaFin will incorporate the guidelines into their administrative practice in 2020.

The EBA's revised outsourcing guidelines may be implemented as part of the MaRisk amendment. A possible need for change was discussed at the meeting of the MaRisk expert committee on 3 May 2019 with regard to the notification requirements for planned material outsourcing and existing outsourcing that has become material, as well as with regard to the minimum requirements of the EBA guidelines for the use of certificates or audit reports by third parties.

SFTR

On 11 April 2020, the 9-month introductory phase for the reporting obligations for securities financing transactions under the Securities Financing Transactions Regulation (SFTR) (2015/2365) and the accompanying RTS/ITS will begin. The SFTR, which affects so-called shadow banks, already came into force at the beginning of 2016. The technical standards (RTS/ITS) developed by ESMA at Level 2 regarding the content of notifications required under the SFTR were published in the EU Official Journal in March 2019 and entered into force in April 2019. ESMA also published its SFTR guidelines on 6 January 2020.

The introduction of the reporting obligations will be phased in over four stages: from 11 April 2020 for credit institutions and investment companies, from 11 July 2020 for CSDs and CCPs, from 11 October 2020 for insurance undertakings, UCITS and AIFs, and from 11 January 2021 for non-financial counterparties.

Sustainable Finance

As early as in March 2018, the EU Commission published the "Action Plan for Sustainable Finance", which aims to promote investment in a more sustainable economy and to make the financial sector more robust against sustainability risks. The action plan was the initial spark for a wide range of legislative projects and subordinated legal acts, most of which are still in the draft stage. However, individual legal acts have already been published. The Regulation amending the Benchmark Regulation (2019/2089) introduces, amongst others, new categories of benchmarks for low CO_2 emissions and positive CO_2 effects. If benchmark administrators introduce such benchmarks they must comply with their requirements by 30 April 2020. The benchmark statement should then also explain how benchmarks take ESG (environmental, social and governance) factors into account. The

regulation on sustainability-related disclosure requirements in the financial services sector (2019/2088) will require financial market participants to disclose sustainability risks and adverse impact of investment decisions on sustainability factors from 10 March 2021. To this end, corresponding information will be mandatory, e.g. on the undertakings' websites, in pre-contractual information, and in annual or other regular reports. Sustainability refers not only to ecological but also social sustainability and sustainability of corporate governance.

Preliminary work by the EU Commission have been carried out for an obligation to obtain customer preferences regarding sustainability in the context of investment advice, portfolio management and insurance distribution and to take such preferences into account in the investment decisions. In the context of collective asset management (i.e. for UCITS and AIF), sustainability risks and adverse impacts on sustainability factors would also have to be considered. Further, an UCITS or AIF should exercise appropriate influence on the undertakings in which it is invested. This is expected to be adapted in 2020. For the time being, undertakings regulated under the KWG, KAGB and VAG are only required to deal with sustainability risks and to document this in an appropriate manner. A guidance notice published by BaFin in December 2019 contains a large number of examples of good practice.

The core of the action plan is the planned Taxonomy Regulation. It aims at determining which economic activities are, for investment purposes, considered as ecologically sustainable. In the future, it needs to be stated to which extent the criteria of the Taxonomy Regulation have been taken into account when selling financial products. This shall avoid "greenwashing". However, this is not linked to a mandatory EU label. Individual issues of the draft were controversially discussed in the trilogue. In December 2019, the trilogue parties reached a compromise that delegates the decision about whether nuclear energy is a "sustainable" source of energy to subordinated regulatory levels. An adoption of the Taxonomy Regulation in the near future is therefore likely.

Corporate Criminal Law

In 2020, the new Act on Combating Corporate Crime may be passed. It would then enter into force in 2022.

At the end of August 2019, the Federal Ministry of Justice and Consumer Protection (BMJV) presented a draft bill of the Act on combating corporate crime, which has not yet been published. However, the matter already causes lively debate in legal practice. The introduction of a law on corporate sanctions lays at the centre of the envisaged legislation.

Stricter penalties for companies (corporate sanctions of up to 10% of worldwide group revenues), the introduction of the principle of legality as well as the creation of incentives for carrying out internal investigations and the weighting of compliance measures are some of the planned regulations. Pursuant to the legality principle, it will be mandatory to initiate sanction proceedings against the undertaking if there is a suspicion of company-related offences (corporate offences). Internal investigations may lower the level of sanctions by 50 %, provided that there is comprehensive cooperation with the investigating authorities and the new legal requirements are observed. In the future, compliance measures shall be considered comprehensively when deciding whether to discontinue proceedings and when assessing sanctions. In addition, the courts may order compliance measures and its monitoring.

Should the law be adopted in 2020, corporations would have time until 2022 to prepare for the new regulations by intensifying their compliance measures. The law on corporate sanctions would apply only to offences committed after that date.

Law on Payment Services

Far-reaching changes in the law governing payment services are not expected in this year. The Payment Services Supervision Act (ZAG), which transposed Directive 2015/2366 (PSD II), already came into force on 13 January 2018. Secondary regulatory standards such as the Delegated Regulation 2018/389 on strong customer authentication had to be implemented by 14 September 2019. However, against the background of difficulties with technical adjustments, BaFin, in coordination with the EBA, has announced that it will not object if German payment service providers execute card payments on the internet without the required strong customer authentication until 31 December 2020.

Moreover, in 2020, BaFin is expected to specify its administrative practice on reporting and organisational obligations under section 53 ZAG and section 54(5) ZAG, which have been introduced as part of the transposition of PSD II. Furthermore, pursuant to the Act implementing the 5th Anti-Money Laundering Directive, a new provision, section 58a ZAG, has been introduced into the ZAG and taking effect on 1 January 2020. According to this provision, undertakings that contribute to the provision of payment services and have control of interfaces of (mobile) terminal devices by means of technical infrastructure services, are required to provide access to their infrastructure services to all requesting payment service providers against an appropriate fee and appropriate conditions. Exceptions may be made for objectively justified rea-

sons such as threats to IT security. Without mentioning them expressly, the explanatory memorandum to the Act addresses large digital companies that offer mobile payment solutions in Germany. The new regulation intends to provide payment service providers access to technical infrastructure services.

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