10 aspects of regulation every corporate board should know

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The six years following the global credit crisis have seen a blizzard of financial regulation hit Europe and wider global markets. As the regulatory landscape starts to settle, we consider the regulatory facts of life that can help companies of all sizes negotiate this new terrain successfully.

1. If you trade derivatives, you need to be very sure what your status is.

Derivative trading has been a core focus for regulation since the global credit crisis. Since mid-2012, European Market Infrastructure Regulation (EMIR) has imposed central clearing and reporting requirements for both OTC and standard derivatives. From 2018, the second Market in Financial Instruments Directive (MiFID II) will impose additional requirements in terms of documentation, reporting and risk management.

So it's now essential for companies to understand the full extent of their trading activity – including all trades conducted with clients, on an inter-group basis or on a market venue – and what regulatory burden this entails.

2. MiFID II extends the scope of financial markets regulation.

MiFID II has particular relevance for corporates active in commodity derivatives markets or trading emission allowances. Some firms with extensive commodity derivative trading activities may be required to become authorised as investment firms, bringing with it much more onerous regulatory requirements in terms of registration, internal governance and capital requirements.

Beside changing the definition of "ancillary activities", MiFID II also introduces new requirements for firms involved in high-frequency trading (HFT). This may not sound like something a corporate will be involved in. But it only takes 20,000+ quotes to a trading venue on any given day for a firm to find itself in scope of MiFID II's HFT regulation. A firm with lots of delivery points on multiple energy products, and which is requesting quotes throughout the day, could surprisingly fall into this category.

Companies unsure of their status should consult their bank and other advisers. It's also valuable to talk to peer companies of a similar size and nature to see what actions they are taking. Your bank may be able to connect you with relevant firms.

3. Once you ascertain your trading status, you have got very little time in 2017 to take appropriate measures.

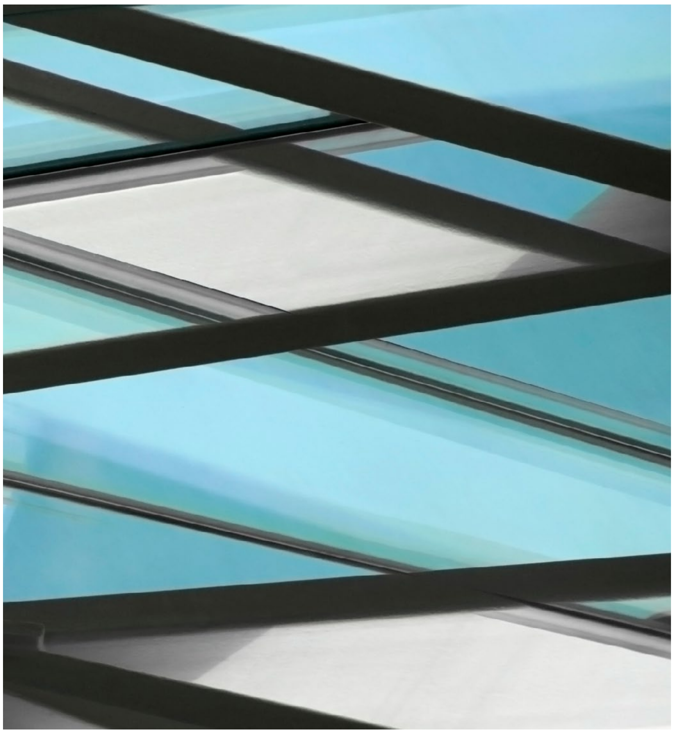
Having determined that your firm falls within scope of derivative trading regulation, there is much to do to demonstrate full compliance. Companies need to ensure proper management for their trading operations, including appropriately qualified staff, to ensure that trade confirmations, portfolio reconciliations and all necessary reporting are carried out fully and on time.

For the minority of firms whose trading activities qualify them as investment firms, full connectivity will be required between trading, cash management and reporting – bearing in mind that the regulator will expect to see the same levels of risk management and audit that a bank would apply.

The vast majority of corporates that don't classify as investment firms, but still have significant trading activity, may need to look at upgrading their trading and reporting infrastructure – introducing electronic interfaces, straight-through processing and automation wherever possible. This will help to ensure timely action and full documentation of trades while limiting the burden on a company's day-to-day activities.

While this may mean yet more paperwork to complete, it may also be an opportunity for a company to review thoroughly its use of financial instruments and consider which instruments are most appropriate for its needs, taking into account structure, risks and costs.

Finally, if a company determines it is out of scope of the derivatives trading regulation, it will still need to invest in compliance and documentation-keeping to be able to demonstrate this out-of-scope status on an ongoing basis.



4. Derivative trading is now a trade-off between full collateralisation or higher trading costs.

Regulation such as Basel III has significantly increased the capital adequacy requirements for banks involved in derivative trading. That in turn has led to an important choice for investors. Either an investor can participate in fully collateralised trading, which may require upgrading its trading operations to incorporate all the necessary liquidity and cash management processes. Or it can choose not to collateralise but instead pay a few extra basis points on each trade to reflect the higher risk of non-collateralised trading.

The right choice for a company will depend, of course, on the extent of its derivative trading activities and the upfront costs of implementing a fully collateralised trading system, versus the likely (but unknown) future costs of uncollateralised trading. There is no right or wrong answer, but an in-depth discussion with your trading advisers should help lead to the optimal solution.

5. A corporate needs to identify itself for every security transaction – not just derivative-based ones.

If you're a corporate that doesn't conduct any derivative transactions, don't assume you're off the regulatory hook. Under MiFID II, every entity that conducts any security transaction – be that trading their own shares or holding bonds for cash management purposes – must by January 2018, have a Legal Entity Identifier (LEI) in place. This is a unique 20-character code that will identify any party to a financial transaction and can be issued by any of around 30 Local Operating Units (LOUs) around the world, which include national stock exchanges and central clearing organisations. A LEI must be renewed annually.

The establishment of a global LEI system is intended to help monitor and manage systemic risk. EMIR has required derivative traders have a unique identifier code in place for some time. But given the sheer number of other entities that still have to apply for theirs (two million in Germany alone) and processing capacity constraints, there is a growing concern that many entities won't have their LEI in place by the 2018 deadline – and might find themselves unable to trade.

6. Be aware of all the details about corporate structure.

From FATCA in the US to the draft of a new Anti-Tax avoidance law in Germany, every corporate must be prepared for greater scrutiny regarding their global sources of income, their corporate structure and use of third-country subsidiaries, in addition to existing tax disclosure and anti-money laundering rules. Banks in many cases have to enact and support these initiatives aimed at preventing tax avoidance and anti-money laundering.

At the moment, there are a number of requirements from different regulators, which means that some of these disclosure requirements can be duplicated. Banks are working hard to make 'Know Your Client' requirements streamlined and efficient.

But equally, corporates have a role in facilitating proper disclosure using digital and online systems. From now on, corporates and banks have to work in partnership if the global burden of disclosure is not to become overwhelming.

7. Capital raising is set to get easier.

But the regulatory outlook is not solely about increasing the disclosure burden for banks and corporates. The European Commission's Capital Markets Union (CMU) action plan is set to put in place a number of initiatives to make access to capital markets funding – particularly for SMEs – easier. The CMU's Prospectus Directive, for example, intends to make prospectuses for share and bond issuance shorter and therefore simpler and cheaper to produce, as well as exempting smaller capital raisings (e.g. below €500,000) from producing a prospectus at all.

Companies that frequently use the capital markets are also set to enjoy a quicker and simplified disclosure regime and 'fast track' approval. Plus the prospectus requirements are set to be the same for bond issuances, regardless of size. This will hopefully encourage issuers to offer minimum denomination sizes that can appeal to retail as well as institutional investors, thereby allowing issuers to broaden their investor base and enable direct corporate bond holdings to become a standard instrument for retail investors once again.

Securitisation is also coming under renewed focus, with CMU proposing a simple, transparent, and standardised securitisation regime, which should enable corporates with diversified receivables, such as auto-makers, to broaden their financing through the securitisation market.

As things stand, these proposals look generally positive as a means to enable corporates to diversify and optimise their sources of capital-raising. But as always with regulation, it is in the practical application that the challenges often arise. As a bank, we will be watchful for details or anomalies in the final requirements that corporate clients need to be alert to.

8. Some regulation that is targeted at banks will ultimately be paid for by corporates.

In a company's monitoring of regulation, it's vital to be mindful of future or potential legislation that may be intended to curb or control the activities of the banking industry but which would, at the end of the day, be paid for by its clients.

One example is the CRR regime for measuring and managing bank counterparty concentration risk. As prudent as this may sound, a recent EBA technical standard aims to extend the scope of an exposure to a counterparty to its securitised vehicles. Although securitised vehicles are, by definition, bankruptcy-remote, this may ultimately limit the ability of banks to lend to certain entities and make bank financing less efficient for such entities (which also is at odds with the plans for simple and transparent securitisation under Capital Markets Union, mentioned above).

What's the solution? Basically, to be mindful of such regulatory initiatives and how they may affect your business. Then to make your voice heard to ensure that corporates can continue to manage their key financial aspects in a proportionate and efficient way.

9. New market abuse regulation means what was acceptable in the past may not be now.

Market Abuse Regulation (MAR) took effect across the EU in July 2016, to prevent and detect insider dealing and market manipulation of financial instruments.

Under MAR, the definition of what can constitute insider dealing or market manipulation has been widened to include, for example, emissions allowances, market benchmarks and even spot commodity contracts in some situations. This, together with the criminal sanctions for contravention, makes it vital for companies to know which of their day-to-day activities have the potential to influence markets and could therefore be illegal under MAR.

For example, it may have been perfectly legal in the past for an electronics company to take physical possession of a few thousand tonnes of copper, then put some of that aside for future use or to feed back into the market in the future at a higher price. Now, however, such behaviour could constitute market manipulation and could entail substantial fines and a jail term of up to 10 years.

Under MAR, the potential to influence a market unintentionally has expanded massively. Maintaining the discipline to keep reviewing and revising all trading activities as well as to establish effective Chinese Walls throughout a business is now essential.

10. Fewer regulatory initiatives are on the horizon – but the devil is now in the detail.

As the international response to the 2008/9 global credit crisis works its way through the system, companies will be relieved to see that we are now starting to see a drop in the pace and scale of new regulatory initiatives. At the same time, new announcements have become more specific and targeted as the practical details of implementing initiatives such as MiFID II and Basel III are unveiled.

But again, the devil is in the detail. For the next few years, dealing with regulation will be less about getting to grips with new high-level principles, and more about assessing how such regulation is likely to work in practice and how the minutiae is likely to vary across the different markets and jurisdictions in which your company operates.

This requires corporates to understand fully their regulatory status, know what regulation is applicable to them and be mindful of subtle changes to the rules that could have an impact on their day-to-day activities.

Ultimately, much of the major regulation we have seen affects corporates and banks equally. A partnership dialogue where each can learn from the other's regulatory experience and knowledge remains the most practical way forward.

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