

Financial Markets Law Committee (“FMLC”)

Infrastructure Scoping Forum

Date: Thursday 8 March 2018

Time: 2.00pm to 3.15pm

Location: Bank of England, Threadneedle Street, London, EC2R 8AH



In Attendance:

John Ewan (Chair)

Antony Beaves

Nick Carew Hunt

Thomas Donegan

Emma Dwyer

Adam Eades

Iona Levine

Alex Rutter

Mitja Siraj

Paul Watkins

Bank of England

Shearman & Sterling LLP

Allen & Overy LLP

CBOE Europe

Minerva Chambers

Tradeweb

FIA

Blue Nile Training

Venessa Parekh

FMLC

Thomas Willett

FMLC

Guest Speakers:

Ciarán McGonagle

International Swaps and Derivatives Association (“ISDA”)

Regrets:

Damian Carolan

Allen & Overy LLP

Mark Evans

Travers Smith LLP

William Ingram

CME Group

Nathaniel Lalone

Katten Muchin Rosenman U.K. LLP

Barnabas Reynolds

Shearman & Sterling LLP

Martin Sandler

PricewaterhouseCoopers LLP

Keti Tano

The London Metal Exchange (“LME”)

Christopher Twemlow

Euroclear SA/NV London

Paul Vine

Norton Rose Fulbright LLP

Registered Charity Number: 1164902.

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Minutes:

1. Introduction.

1.1. John Ewan opened the meeting and delivered a brief introduction.

2. Administration: a short presentation on the FMLC Radar Function – Revisited (Venessa Parekh)¹

2.1. Venessa Parekh outlined the remit of the FMLC and its radar function, defined as the manner in which the FMLC identifies appropriate issues to analyse. The function can be broken down into three initiatives: (i) scoping forums; (ii) the relationship management programme; and (iii) radar meetings. She explained that the radar programme guarantees that the FMLC addresses those issues that are of most concern to stakeholders in the financial markets, ensuring that the FMLC’s work is current and has impact.²

3. The European Commission’s proposal to amend Article 4 and Article 39 of the European Market Infrastructure Regulation (Mitja Siraj)

3.1. Mitja Siraj introduced the European Commission’s proposed amendments to Regulation (EU) No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (the “**European Markets Infrastructure Regulation**” or “**EMIR**”) which are currently under review. The FIA had been in contact with the Commission to provide feedback on a limited number of amendments, specifically in relation to Article 4 and Article 39.³

3.2. Mr Siraj referred to the European Commission’s impact assessment that evaluated the extent to which specific policy requirements in EMIR have met their objectives.⁴ The assessment concluded that EMIR may impose disproportionate costs and burdens in

¹ Please see Appendix I below.

² If you would like to learn more about the FMLC radar programme, or become involved in one of the three initiatives, please contact Debbie Steen at secretarial@fmlc.org.

³ European Commission, “Amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories”, (2017), available at: http://eur-lex.europa.eu/resource.html?uri=cellar:b12bb02d-30ba-11e7-9412-01aa75ed71a1.0001.02/DOC_1&format=PDF.

⁴ European Commission, Impact Assessment: “Amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories”, (2017), available at: <http://eur-lex.europa.eu/mwg-internal/de5fs23hu73ds/progress?id=ITv7fgD38OPadUsWXa6-OPhRiSi3FM10qL3CFOlEr6E.&d>.

some specific areas and that some requirements could be simplified to achieve financial stability. Access to clearing was identified as one of those requirements which could benefit from simplification.

- 3.3. In order to incentivise clearing and increase access to it, amendments to Article 4 were proposed. Article 4 requires a wide range of counterparties to clear through a central clearing counterparty (“**CCP**”) that the over-the-counter (“**OTC**”) derivatives relating to a class that has been declared subject to the clearing obligation. If no policy action was to be taken, difficulties in accessing clearing and the legal uncertainty concerning the interaction between the EMIR default management tools and the national insolvency laws would remain, as outlined by the Impact Assessment.
- 3.4. Mr Siraj explained that, under Article 4, the European Commission proposed to introduce provisions for clearing members and clients to offer more specific fair, reasonable and non-discriminatory (“**FRAND**”) access to clearing services. The Commission hoped the FRAND requirements would foster transparency with regard to the costs and other requirements of clearing services, therefore facilitating access to clearing.
- 3.5. Two issues concerning these proposed amendments were identified by Mr Siraj:
 - i. The difficulty in distinguishing these requirements from those that firms are already subject to under EMIR and Regulation (EU) No 600/2014 of 15 May 2014 on markets in financial instruments (“**MIFIR**”); and
 - ii. The vague nature of the current proposal, which makes applying FRAND to clearing firms challenging.
- 3.6. At this point, a participant mentioned that the then U.K. Competition Commission had included FRAND requirements as part of the terms of a deal approval to open up Eurex clearing, permitting access to other exchanges. Mr Siraj acknowledged this and added that smaller counterparties in smaller E.U. Member States welcomed these requirements so that they could grant access to clearing service for their clients.
- 3.7. Another participant stated that by employing FRAND, the requirements would provide an “uncomfortable” argument for mandatory clearing, stressing the need for the regulation to be clear when a firm can reject clearing access. Mr Siraj agreed and emphasised that the solution was too broad in scope. The Impact Assessment only examined OTC derivatives but the Commission’s proposed amendments cover all types

of derivative clearing, which could be seen as attempting to solve a problem that does not exist.

- 3.8. Ultimately, the participants were in consensus that FRAND might not be an appropriate remedy when amending Article 4 to increase access to clearing.
- 3.9. The changes to Article 39 were discussed next. The Impact Assessment highlighted concerns that EMIR fails to explicitly address for potential conflicts with Member States' national insolvency regime; specifically relating to requirements for CCPs to transfer client positions in the case that a clearing member defaults (“**portability**”) or to pay directly to clients the proceeds of a liquidation (“**leapfrog payment**”). As such, a new paragraph to clarify that assets covering the positions recorded in an account are not part of the insolvency estate of the CCP or clearing member that keeps separate record and accounts was proposed. Mr Siraj explained this offers the certainty to those who provide clearing services that they can meet their commitments with regard to EMIR default management procedures. This would also encourage them to offer access to central clearing of OTC derivatives contracts as a service.
- 3.10. Members discussed the uncertainties in the event a Member State's national insolvency laws act against a CCP and how clearing members ensure their actions are effective legally. As such, the members stressed the need for these amendments to work well.
- 3.11. The case study of the Lehman Brothers collapse in 2008 was brought to the group's attention. Without the correct amendments, a participant emphasised that a similar event could pose real risks to CCPs.
- 3.12. It was agreed that Mr Siraj would keep the group informed of any developments following the FIA's correspondence with the Commission.

4. **Roadmap from ISDA *et al* on interbank offered rate (“IBOR”) transition (Ciarán McGonagle)**⁵

- 4.1. Further to discussions about the London interbank offered rate (“**LIBOR**”) at the Q3 and Q4 2017 meetings of the Infrastructure Scoping Forum, Ciarán McGonagle delivered a talk on the recently published roadmap from ISDA *et al* on transition from IBORs.⁶

⁵ Please see Appendix II below.

⁶ Minutes from the Q3 and Q4 2017 meetings can be found at <http://www.fmlc.org/scoping-forums.html>.

- 4.2. Mr McGonagle began his talk by explaining that IBOR transition is being led by public-private sector working groups established by central banks (the “Risk Free Rate Working Groups”) in the U.S., the U.K., Japan, Switzerland and in the E.U., and that ISDA sits as observer on all of the groups.
- 4.3. The following two primary challenges arise in the context of the transition from IBORS to a nearly risk free rate (“**RFR**”) were identified: (i) creating the infrastructure for a new RFR; and (ii) amending the legacy trades to reference a new rate.
- 4.4. IBOR fallbacks were briefly touched upon by Mr McGonagle. The work led by ISDA at the request of the Official Sector Steering Group (“**OSSG**”), the creation of fallbacks will improve contractual robustness of derivatives that reference an IBOR by providing emergency provisions triggered by the permanent discontinuation of a relevant IBOR.
- 4.5. Mr McGonagle turned to the ISDA roadmap which he described as an educational resource for the market with centralised information about the challenges of global IBOR transition. He explained that this was the first step in a comprehensive project by ISDA and other associations to analyse how IBORs are currently used across financial markets and to assess transition readiness. Mr McGonagle explained that this analysis will inform and support transition planning by proposing potential solutions to identified challenges. The IBOR transition project has the following three parts:
 - i. the ISDA roadmap;
 - ii. a global survey of buy- and sell-side institutions and infrastructure providers to gather information on transition planning and readiness while gauging how firms are approaching the various challenges across a range of product and functional areas; and
 - iii. a final report that will analyse the survey results and propose potential solutions for market transitions from IBORs to RFRs.
- 4.6. Raising awareness of the issues of transitioning IBORs to RFRs was identified as the primary challenge. Market participants will be required to address a number of challenges, which include:
 - i. Liquidity: there is a need to establish derivatives markets in the new RFRs;
 - ii. Valuation: unlike the current IBORS, RFRs do not include bank credit risk, which could result in a value transfer when transitioning legacy contracts that

reference the IBORs. The lack of term fixing structures may also be an issue for end users;

- iii. Infrastructure: exchanges need to list products based on the new rates. CCPs will also need to clear these products and use the new rates for discounting price alignment interest; and
- iv. Legal and documentation: market participants may need to amend a large volume of contracts across multiple products.

4.7. These are, however, just a selection of the issues identified to date. Mr McGonagle highlighted that there may be further challenges to overcome in the future as this is a considerable undertaking that requires much cross-geographical work.

4.8. When participants were offered the opportunity to ask questions, the Regulation (EU) 2016/1011 of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the “**European Benchmark Regulation**”) was mentioned. The Benchmark Regulation applied from 1 January 2018 and obliges supervised entities which use benchmarks to have in place a robust written plan to negotiate material changes to, or the termination of, such benchmarks. One member stressed that such robust backup plans do not exist, which makes meeting the regulators’ requirements difficult.

4.9. One Forum member asked what the current thinking is behind the exchange’s obligation to establish the infrastructure for transition to a new benchmark. Another participant contributed by asking if links could be formed between the old and new benchmark. Mr McGonagle highlighted this as one of the key issues facing the IBOR transition and will be addressed as part of the survey and final report mentioned in point 4.5. (ii) and (iii).

4.10. Mr McGonagle stated that he would be happy to return and speak at a future meeting of the Infrastructure Scoping Forum after the next steps have been completed.

5. Any other business.

5.1. One participant raised the issue of Directive 98/26/EC on settlement finality in payment and securities settlement systems (the “**Settlement Finality Directive**” or the “**SFD**”) and how settlement finality would work after Brexit. In response, another attendee mentioned the FMLC paper on “Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—the Impact on Cross-Border Insolvency Proceedings” in which the SFD was considered in the context of corporate insolvency

after Brexit.⁷ The participant agreed to review the paper and inform the Secretariat if they thought this topic should be discussed at the next Forum meeting.

⁷ FMLC, “Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—the Impact on Cross-Border Insolvency Proceedings”, (2017), available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_paper_on_brexit_and_eu_insolvency_regulation.pdf.

The FMLC Radar Function: *revisited*



Venessa Parekh, Research Manager

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FMLC Remit

“The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.”

FMLC Foundational Documents, September 2002



FMLC Mission



- According to the remit, the FMLC has a tripartite mission:
 - to identify relevant issues (the **radar** function);
 - to consider such issues (the **research** function); and
 - to address such issues (the **public education** function).
- The **radar function** relies on the FMLC’s **scoping forums** and other horizon-scanning, advisory bodies. It also relies on a **relationship management programme** which the FMLC Secretariat maintains with Patrons and Stakeholders.
- The **research function** is addressed by the FMLC Secretariat and by highly-focused working groups who work to draft papers and correspondence on behalf of the FMLC.
- The **public education function** is furthered when the FMLC publishes these letters and papers. It is also addressed by the regular programme of events organised by the FMLC Secretariat, including: roundtables, seminars and conferences. These feature high-profile guest speakers.

Breaking down the radar function

The FMLC's radar function is (broadly) broken down into three initiatives:

1. **Scoping forums**
2. **Relationship management programme; and**
3. **Radar meetings**



Scoping Forums

“Scoping forums serve as an avenue for the FMLC to engage with focus groups on legal issues affecting specific segments of the financial markets.

The forums serve as spaces for discussion of broader issues of legal uncertainty. Members formulate and propose to the FMLC issues considered by them to cause substantive legal uncertainty to their industry.”

FMLC Brochure, January 2017



Scoping forums in practice

- A scoping forum establishes a **pool of expertise** available to the FMLC. That pool can guide the FMLC by **recommending specific issue to the FMLC for analysis**.
- Scoping forum members can make non-binding suggestions as to the manner of the FMLC's engagement and nominate experts for working groups.
- Meetings include presentations from industry experts, individuals with first-hand experience of legal uncertainty and those at the cutting edge of their respective fields.
- Scoping forums discuss all manner of topics, issues and solutions within their sector.
- Not every issue discussed will go on to become an issue adopted by the FMLC. Scoping forums are horizon-scanning bodies and places to share and compare knowledge. They are about **learning and discovery** as much as they are about **identifying specific issues for further consideration**.
- Information about the FMLC's scoping forums—as well as the agenda and minutes of all 2017 meetings—can be found on our website at: <http://www.fmlc.org/scoping-forums.html>

Relationship management

- Another key aspect of the radar function, the FMLC's **relationship management programme**, ensures regular communication and information exchange between the FMLC Secretariat and Patrons, Members or other stakeholders.
- Relationship management calls provide a valuable opportunity for participants to highlight issues—both present and future—for the FMLC to investigate, providing the FMLC with up-to-date and market-relevant information. They also allow the FMLC Secretariat to update Patrons and stakeholders on the Committee's recent work.
- FMLC Patrons have calls monthly. We organise calls with a predetermined list of stakeholders according to their appetite for engagement.
- Monthly relationship management calls normally last around 15 minutes. If you're a Patron who'd like to participate in your firms' monthly call (as an alternate perhaps), or if you'd like to receive a stakeholder call, let us know!

Radar meetings

- FMLC Chief Executive Joanna Perkins regularly meets with financial markets participants to discuss issues of legal complexity.
- These meetings are an excellent opportunity for the exchange of information. Participants can:
 - raise issues of concern or interest in relation to legal complexity, and
 - learn about the FMLC’s recent work and insights, get updates on forthcoming publications or—in the case of new contacts—learn more generally about the work and remit of the FMLC.
- Please speak to a member of the Secretariat if you are interested in arranging a meeting with your firm or organisation.

Information exchange

- The Radar programme guarantees that the FMLC addresses those issues that are of most concern to stakeholders in the financial markets, across the public and private sector.
- It also helps to ensure that the FMLC only addresses in depth issues that are material and may have an appreciable impact on the international wholesale financial markets.
- Together, these three Radar initiatives ensure our work is current and has impact.



Summary and Conclusion



To sum up...

- The FMLC is tasked with identifying, considering and addressing **legal uncertainty**...
- ...which is sometimes better thought of as “legal risk”.
- The **radar function** is the manner in which the FMLC identifies appropriate issues to analyse.
- The radar function is fulfilled through **scoping forums, relationship management calls, and radar meetings**.
- At this time, the FMLC Secretariat would be grateful for help with **assessing legal risks, identifying priorities and selecting issues for further work**.

Benchmarks



Differentiating IBOR Benchmark Initiatives

LIBOR Transition

- Led by the Risk Free Rate Working Groups (Public sector-Private sector)
- Selection of nearly risk free rate (RFR) as alternative to LIBOR
- Voluntary transition process during the lifetime of LIBOR.
- For transition of legacy portfolio only, spread may be required to compensate for lack of IBOR-style bank credit spread RFR.
- On-going debate on whether term products need developing for the RFR.

IBOR Fallbacks

- Led by ISDA at request of the OSSG
- Improve contractual robustness of derivatives referencing an IBOR
- ‘Emergency’ provisions triggered by the permanent discontinuation of the relevant IBOR
- Fallback to a nominated alternative rate (RFRs) plus a spread and subject to adjustments to address term fixings (as applicable)
- Spread designed to compensate for lack of IBOR-style bank credit spread in alternative rate.
- Lack of IBOR-style term fixing structure in alternative rate to make fallback effective.

Article 28(2) European Benchmark Regulation

- Led by ISDA for derivatives
- Requires supervised users to plan for cessation or material change of any benchmark (large or small across all products) and reflect in contracts.
- Nomination of alternative rates where feasible and appropriate
- Different approaches for different products.
- For Rates, Spread and term structure issues.

ISDA and other trade associations are working on a comprehensive study that will propose potential solutions to identified challenges in transitioning from IBORs to RFRs

- ISDA and other associations have begun a comprehensive project to analyze how IBORs are currently used across financial markets, including markets for derivatives, loans, mortgages and bonds. The analysis will inform and support transition planning by proposing potential solutions to identified challenges
- The IBOR transition project has three parts:
 - A benchmark transition [roadmap](#) that outlines how the IBORs are used, describes the reform efforts to date and outlines preliminary challenges to transitioning away from IBORs
 - A global survey of buy- and sell-side institutions and infrastructure providers to gather input on transition planning readiness and to gauge how firms are approaching the various challenges across a range of products and functional areas. The survey will also ask for input on potential solutions to these challenges. The survey will launch on February 26th
 - A final report will analyze the survey results and propose potential solutions for market transitions from IBORs to RFRs. It is expected to both build on and inform the ongoing work of the public-private sector RFR working groups

The transition of existing IBOR contracts to RFRs requires market participants to address a number of challenges

- **Market take up of the new RFRs**
- **Liquidity:** There is a need to establish derivatives markets in the new RFRs. This is a particular issue for RFRs that do not yet exist (eg, SOFR)
- **Valuation:** Unlike IBORs, RFRs do not include bank credit risk, which could result in a value transfer when transitioning legacy contracts that reference the IBORs. Also unlike IBORs, RFRs do not have term fixings, which is a key challenge for end users and other hedgers
- **Infrastructure:** Exchanges need to list products based on the new rates. CCPs need to clear these products and use the new rates for discounting and price alignment interest
- **Regulation:** To enable a smooth transition, there is a need to ensure the current regulatory framework does not inadvertently subject trades that have transitioned to RFRs to new requirements

IBOR Transitions – Potential Challenges (continued)

The transition of existing IBOR contracts to RFRs requires market participants to address a number of challenges

- **Legal and documentation:** Market participants will need to efficiently amend a large volume of contracts across multiple products
- **Risk management**
- **Accounting:** There is a need to ensure that hedge accounting is preserved and the transition of legacy contracts does not otherwise trigger unfavorable accounting treatment
- **Tax**
- **Governance and controls**