



## Financial Markets Law Committee (“FMLC”)

### Infrastructure Scoping Forum

Date: Thursday 7 June 2018

Time: 2.00pm to 3.40pm

Location: PricewaterhouseCoopers LLP, 7 More London, London, SE1 2RT

#### In Attendance:

Martin Sandler (Chair)	PricewaterhouseCoopers LLP
Antony Beaves	Bank of England
Nick Carew-Hunt	
Mark Evans	Travers Smith LLP
John Ewan	
Iona Levine	Minerva Chambers
Keti Tano	The London Metal Exchange
Christopher Twemlow	Euroclear UK & Ireland
Paul Watkins	Blue Nile Training
Virgilio Diniz	FMLC
Thomas Willett	FMLC

#### Regrets:

Thomas Donegan	Shearman & Sterling (London) LLP
Emma Dwyer	Allen & Overy LLP
Adam Eades	Cboe Europe
Nathaniel Lalone	Katten Muchin Rosenman UK LLP
Barnabas Reynolds	Shearman & Sterling (London) LLP
Alex Rutter	Tradeweb Europe Limited
Michael Sholem	Davis Polk & Wardwell London LLP
Mitja Siraj	FIA
Arun Srivastava	Baker McKenzie LLP

Registered Charity Number: 1164902.

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## Minutes:

### 1. Introduction.

1.1. Martin Sandler opened the meeting and delivered a brief introduction.

### 2. Administration: the FMLC—a charity (Virgilio Diniz)<sup>1</sup>

2.1. Virgilio Diniz described to the members the FMLC's transition from an independent body established by the Bank of England to its current status as a registered charity under the Charity Commission. He elaborated on the ways in which the FMLC's charitable remit has an impact on its work and conduct, including very closely-guarded requirements to be transparent and impartial.<sup>2</sup>

### 3. Prospective developments affecting settlement finality in light of Brexit and the draft Withdrawal Treaty (Mark Evans)

3.1. Mark Evans began his talk by emphasising the fundamental importance of finality for underpinning the safe and efficient operation of systemically-important financial market infrastructure ("FMI"), as well as supporting the wider stability of the financial markets. Any subsequent reversal of a securities or payment transaction that parties had considered complete creates risk for investors, financial institutions and systems (including credit, liquidity and, potentially, systemic risk).

3.2. Mr Evans explained that under current law these risks are, for designated systems governed by the law of an E.E.A. state, materially mitigated through Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality as amended, the "SFD"). Specifically, the provisions of the SFD protect such systems from the invalidating, reversing or other adverse effects of a participant's insolvency proceedings subject to the law of an E.E.A. state.

3.3. Mr Evans made the following additional points:

- i. Under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (as amended, the "SFRs"), which implement the SFD in the U.K., a system designated in the U.K. receives a high level of legal certainty that if a financial institution enters insolvency proceedings governed by the law of another E.E.A.

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<sup>1</sup> Please see Appendix I below.

<sup>2</sup> For further information as to how you can support the work of the FMLC, please contact Thomas Willett at [forums@fmlc.org](mailto:forums@fmlc.org).

state, the insolvency courts of that E.E.A. state will apply U.K. settlement finality laws to determine the rights and obligations of the institution arising from, or in connection with, its participation in the system.

- ii. Correspondingly, systems designated in other E.E.A states have a high degree of legal certainty that an English insolvency court will apply the finality laws of that E.E.A state to determine the relevant rights and obligations of an insolvent U.K. participant in the E.E.A. system.
- iii. The SFD and the SFRs presently rely upon the governing law of a designated system being that of an E.E.A. state. In consequence, once the U.K. becomes a "third country" post-Brexit, it is likely that without appropriate amendments to the SFD and the SFRs the existing finality protections, as provided to a U.K. system (against the adverse effects of insolvency proceedings in respect of a participant under the law of an E.E.A. state) and to an E.E.A. system (against the adverse effects of insolvency proceedings in respect of a participant under U.K. law), will fall away.
- iv. This result would be highly damaging to public confidence in the safe operation of U.K. and E.E.A. FMIs. In addition, it might encourage the operators of such systems to impose potentially costly and burdensome access conditions, with regard to their requirements for a sound risk management framework for the comprehensive management of risk, on U.K. - based financial institutions (with respect to their participation in an E.E.A. system) or on E.E.A. state-based financial institutions (with respect to their participation in a U.K. system).
- v. In order to maintain the international standing of the U.K.'s financial system, the wider stability of the global financial markets and to support continuing high-levels of market access. It will be necessary and desirable for the SFRs to be amended for the post-Brexit period to recognise the finality laws of systems designated in an E.E.A. state (and, ideally, in any other non-U.K. country where warranted with regard to systemic risks) to protect such systems against the reversing effects of U.K. insolvency law in respect of a participant; and, likewise, for the SFD to be amended so as to recognise the finality laws of systems governed by the law of a non-E.E.A. state (where warranted with regard to systemic risks) to protect such systems against the reversing effects of E.E.A. insolvency law with respect to a participant.

vi. Finally, Mr Evans noted that the effect of the draft Withdrawal Treaty will be to preserve the status quo as to finality laws during the proposed implementation period. However, he expressed the view that this should not encourage delay in resolving the finality issue, both at the U.K. and E.U./E.E.A. level. The speedy resolution of this issue was in the interests of the high degree of legal certainty that systemically-important FMIs and their participants require; and would help to preserve market confidence in the stability of, and open access to, U.K., E.E.A and other international financial markets.

#### **4. Update on the Central Securities Depositories Regulation (“CSDR”) (Christopher Twemlow)**

4.1. Christopher Twemlow delivered to members an update on Regulation (EU) no 909/2014 on improving securities settlement in the European Union and on central securities depositories (the “**CSDR**”) and began by stressing that a large number of uncertainties are still evident in the text.

4.2. Mr Twemlow provided background information on Euroclear U.K. and Ireland (“**EUI**”) and the CSDR. He explained that EUI is the central securities depository (“**CSD**”) for the U.K. and Ireland and is regulated by the Bank of England. Concerning the CSDR, Mr Twemlow outlined that the regulation is designed to improve securities settlement in the E.U. and on CSDs. Level 2 technical standards were finalised in March 2017 and introduced three regulatory standards on authorisation, prudential requirements and internalisation along with additional implementing standards. Level 2 settlement discipline standards are expected in December 2018 with a European Securities and Markets Authority (“**ESMA**”) Q&A to follow.

4.3. When addressing key U.K. legal changes, Mr Twemlow noted that while the final changes to the Financial Services and Markets Act 2000 were published in September 2017, the final changes to the Uncertificated Securities Regulations (“**USRs**”) are yet to be published. He explained that there remains an outstanding issue of implementation of CSDR Article 49 that enables any E.U. issuer to issue in any E.U. CSD. The USRs only currently enable EUI to hold or settle U.K. securities. As such, the USRs require amendment to enable the effective implementation of Article 49.

4.4. Next, Mr Twemlow addressed the definition of a CSD, defining it as a legal person that operates a securities settlement system and provides at least one other CSDR core service, either: (i) initial recording of securities in a book-entry system (“notary service”); (ii)

providing and maintaining securities accounts at the top tier level (“central maintenance service”); and/or (iii) operating a securities settlement system (“settlement service”).

- 4.5. At this point, one participant highlighted the issue of applying these definitions in practice and that by defining CSD the definition of central clearing counterparty (“**CCP**”) should also be considered. For example, the participant queried how to analyse a new service or utility as a CCP or CSD. The Forum members agreed, emphasising that the developing finance technology (“**FinTech**”) and blockchain environment puts these definitions into question. Cross-jurisdictional definition issues were also raised, with a member observing that multiple jurisdictions employ varying definitions of CCPs.
- 4.6. The EUI as a systemic risk manager was discussed next. Mr Twemlow articulated that regulators expect financial market infrastructures (“**FMI**s”) to take an active role in managing systemic risk in financial markets. The risks that can accumulate between the system and participants, between different participants and between FMIs are considered, monitored and managed.
- 4.7. Mr Twemlow then identified the key issues facing the CSDR as governance, conflicts of interest, control of outsourcing, integrity of the securities in issue, policies and Prudential requirements.
- 4.8. Participant issues were also raised and included legal entity identifiers (“**LEI**s”), U.S. dollar payment arrangements, the requirement to offer individual/omnibus segregation choice, reconciliation requirements and settlement discipline. The Forum members discussed the issue that some participants do not have LEIs and that greater clarity on this would be beneficial.
- 4.9. Concerning Britain’s secession from the E.U. (“**Brexit**”), Mr Twemlow mentioned that EUI intend to exercise CSDR Article 23 passporting rights into Ireland for as long as possible, and that they intend to continue to provide Irish securities services during the transition period. After Brexit, Mr Twemlow described the possibility of using equivalence provisions to continue business in Ireland, with longer term solutions for Irish securities settlement currently being discussed by Irish stakeholders and authorities. Certainty, however, is not promised.

## 5. Blockchain and financial market infrastructure (Martin Sandler)

- 5.1. Martin Sandler led a roundtable discussion on blockchain and FMIs. He began by citing the ESMA Report: *The Distributed Ledger Technology Applied to Securities Markets*, mentioning that it provides a useful guideline to the benefits, risks and uncertainties innovation in finance technology presents to FMIs.<sup>3</sup> In his opening remarks, Mr Sandler also observed that market infrastructure is concerned with centralisation while distributed ledger technology (“**DLT**”), on the other hand, is a decentralised process.
- 5.2. One participant stressed the need to isolate which FMIs to address before analysing the effect of finance technology. Identifying the *situs* for securities, which law governs the transfer and charge are important facts to consider. Before looking at any physical impacts, the participant highlighted the importance of understanding what sort of FMI this new technology can assist with.
- 5.3. Another member mentioned the Australian Stock Exchange’s (“**ASX’s**”) new system that will replace the Clearing House Electronic Subregister System (“**CHESS**”) using blockchain technology. CHESS currently provides clearing, settlement and other post-trade services for the Australian exchange. Replacing this system with a blockchain based system is believed to offer a range of benefits from more efficient clearing, settlement and other post-trade services through improved record keeping, reduced reconciliation and better quality data.
- 5.4. The uncertainties surrounding Initial Coin Offerings (“**ICOs**”) were also considered by members. It was stressed that there is a lack of attention from regulators concerning the way the market is moving with financial instruments such as ICOs that exist outside of conventional financial systems. Alternative unregulated FMIs are being created and as such, legislation such as Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (the “**European Market Infrastructure Regulation**” or “**EMIR**”) could become redundant. Some members, however, disagreed, articulating the view that CCPs might not be disrupted in light of technological innovations and that there will always be a demand to accept and buy market credit risk.
- 5.5. CLS’ investment in R3 was also brought to the table. The foreign exchange settlement provider, CLS, had invested \$5 million in the blockchain start-up, R3, creating a link between the cash markets and payment systems. Members agreed to keep a watching brief for similar case studies to discuss at future meetings.

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<sup>3</sup> ESMA, Report: *The Distributed Ledger Technology Applied to Securities Markets* (7 February 2017), available at: [https://www.esma.europa.eu/system/files/force/library/dlt\\_report\\_-\\_esma50-1121423017-285.pdf](https://www.esma.europa.eu/system/files/force/library/dlt_report_-_esma50-1121423017-285.pdf).

5.6. Concluding the discussion, Mr Sandler resolved to shorten the ESMA list to create a watching brief for the Forum members to address at future meetings, contemplating, for instance, the benefits, challenges, risks and regulatory responses to new technologies, such as DLT, Blockchains, cryptocurrencies and tokens.

## **6. Issues of legal uncertainty concerning the European Benchmarks Regulation**

6.1. Keti Tano presented to members issues of legal uncertainty concerning Regulation (EU) 2016/1011 of the European Parliament and of the council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts to measure the performance of investment funds (the “**Benchmarks Regulation**” or the “**BMR**”).

6.2. The potential issues of legal uncertainty were identified as:

- a. the scope of the definition of financial instrument;
- b. the conditions for reliance on the CCP exemption;
- c. the scope of the “single reference price” exemption;
- d. the concepts of “contributor” and “contributor of input data” in the context of an auction-derived price; and
- e. the proxy data sets that are being used to determine the significance of specific benchmarks.

6.3. Members formed a consensus over the issues presented; specifically highlighting the lack of certainty as to what a benchmark and financial instrument is defined as under the BMR. They noted that other industry groups such as the International Swaps and Derivatives Association (“**ISDA**”) are further ahead in tackling some of these issues and that work conducted by the FMLC should focus on issues that are yet to be addressed.

6.4. Ultimately, the members agreed that the FMLC should consider conducting further work into the legal uncertainties concerning the BMR as well as in the proposed markets transition to alternative reference risk-free rates, as a substitute to LIBOR, as some commentators have suggested this could represent a cliff-edge scenario.

## **7. Any other business**

7.1. Forum members noted that the next meeting of the Infrastructure Scoping Forum will be held on Thursday 13 September between 2.00pm and 3.30pm.

# Financial Markets Law Committee: a charity (And what that really means)

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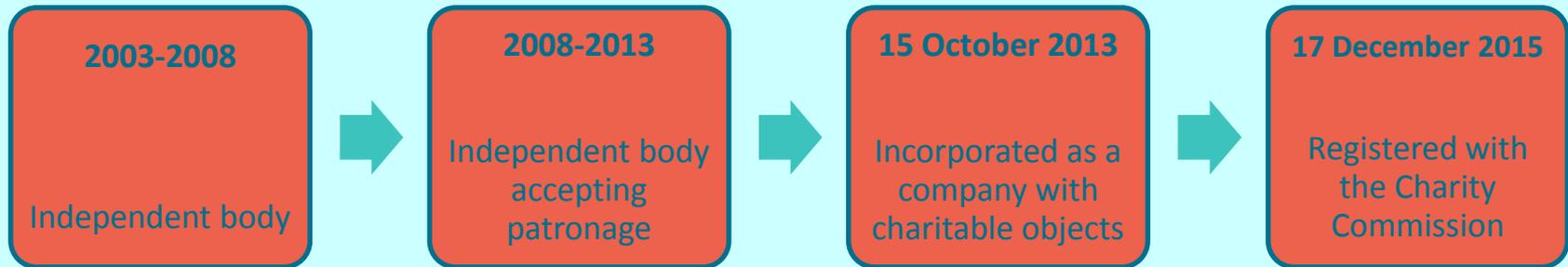
Virgilio Diniz, Project Manager

**Registered Charity Number: 1164902.**

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# The road to incorporation

- In **2003** the Bank of England established the FMLC as an independent organisation solely responsible for its own recommendations.
- In **2008**, the FMLC took a step towards greater independence by accepting funding from patrons.
- In **October 2013** the FMLC achieved structural self-sufficiency by **incorporating under charitable articles of association**.
- In **December 2015** the Charity Commission accepted the FMLC's application to **register as a charity**.



# The FMLC's charitable remit

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According to the charitable 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).

**Reduced legal uncertainty and risk is in the public good;** the *radar* and *research* functions are somewhat self-explanatory in this regard. The *public education* function is a key aspect of the FMLC's status as a charity, and is addressed in the following ways:

- All FMLC papers, presentations/speeches and correspondence are freely available via the FMLC website.
- The FMLC seeks to raise the profile of its research with those who are best positioned to implement solutions.□This is achieved primarily through correspondence: the FMLC maintains active correspondence with regulatory and legislative groups around the world, particularly HM Treasury and the European Commission.
- Most FMLC events (with the exception of Patrons' events) are free to attend by members of the public.
- The FMLC also acts as a bridge to the judiciary, a task it carries out primarily by organising seminars to brief senior members of the judiciary on aspects of wholesale financial markets practice.

# Transparency...

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The FMLC follows the Charity Commission's guidance with the aim of maximising transparency. To this end, the FMLC:

- is registered with—and submits financial data to—the European Transparency Register;
- publishes full lists of both Patrons and Members on its website;
- is regularly audited by an independent accountancy firm;
- provides funding/expenditure breakdowns on request;
- publishes the minutes of Committee meetings to its website;
- publishes the agendas/minutes of every Scoping Forum meeting on its website;
- maintains policies governing conflict of interest, risk management and volunteer management; and
- remains independent from the Bank of England, government or legislative bodies and the financial sector itself..



# ...and impartiality

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Since its creation the FMLC has been an independent body solely responsible for its own views and research. The Bank of England does not guide or submit input to the FMLC's reports. Anyone—including members of the general public—can raise issues of legal uncertainty for the Committee to investigate.

**The FMLC does not comment on or seek to influence matters of policy.** Issues relating to policy rather than solely to legal uncertainty are rejected.

The FMLC is dedicated to impartial consensus; for this reason the absolute maximum number of members from a single organisation is two individuals for a Scoping Forum, and one for a Working Group.

Scoping Forums have no *vires* to initiate projects or pass resolutions affecting the FMLC. Substantive issues of legal uncertainty are proposed by the Secretariat to the FMLC as a topic which may require further action.

Papers drafted by Working Groups are submitted to the entire Committee for review to ensure accuracy, objectivity and impartiality.

**The FMLC is supported entirely by patronage.** Patronage relates to funding only, there are no further contribution expectations or requirements and no special treatment for Patrons apart from seasonal social events.

# Future endeavours/ can you help?

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The FMLC's educational remit is theoretically endless: there are always more financial markets participants, regulatory/government bodies and members of the public to keep informed of our work.

To that end, the FMLC is currently researching or pursuing the following:

- A full revamp of the website, focusing on accessibility and greater sharing of materials.
- Boosting attendance of FMLC events by members of the general public.

The FMLC is also considering new ways to disseminate its research, and in future may investigate:

- Recording/broadcasting solutions for events to allow greater access.
- Summarising and disseminating the FMLC's work in easily digestible media formats such as short videos or podcasts.

**The FMLC is grateful for suggestions on how to amplify its message, better to serve its charitable function and the general public. Can you help?**