Financial Markets Law Committee ("FMLC")

Infrastructure Scoping Forum

Date: Thursday 7 February 2019

Time: 2.00pm to 3.30pm

Location: Katten Muchin Rosenman UK LLP, Paternoster House, 65 St. Paul's Churchyard, London, EC4M 8AB

In Attendance:

Nathaniel Lalone (Chair)	Katten Muchin Rosenman UK LLP
Antony Beaves	Bank of England
Nick Carew-Hunt	
Emma Dwyer	Allen & Overy LLP
John Ewan	
Rachel Pearson	ICE
Barney Reynolds	Shearman & Sterling LLP
Michael Sholem	Davis Polk & Wardwell LLP
Mitja Siraj	FIA – Futures Industry Association
Julia Smithers-Excell	White & Case LLP
Paul Watkins	Blue Nile Training
Virgilio Diniz	FMLC

Guest Speaker

David Bunting	Deutsche Bank AG
Michael Kent	Linklaters LLP
Helen McGrath (dial-in)	Stripe

Regrets:

Mark Evans	Travers Smith LLP
Iona Levine	Minerva Chambers
Hannah Meakin	Norton Rose Fulbright LLP
Keti Tano	LME
Christopher Twemlow	Euroclear UK and Ireland

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Minutes:

1. Introductions

1.1. Nathaniel Lalone opened the meeting.

2. Transposition of the EU Benchmarks Regulation into UK law—the Benchmarks (Amendment) (EU Exit) Regulations 2018 (David Bunting)

2.1. David Bunting opened his remarks by reminding Forum members that Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "**BMR**") was a response to the benchmark manipulation scandal. He stressed that the BMR has raised the bar on standards for administrators and that only E.U. Benchmarks that are authorised, or Third Country benchmarks which are approved for use via one of the prescribed routes set out in the BMR, may continue to be used within the E.U. by supervised entities after the end of the transitional period on 1 January 2020. In addition, he mentioned that the draft Benchmarks (Amendment) (EU Exit) Regulations 2018 is a 28 page document which will "onshore" the BMR in the U.K. in the event of a "hard Brexit". The onshored legislation will, in effect, make all E.U. Member States Third Countries vis-à-vis the U.K. and, necessarily, the U.K. will become a Third Country vis-à-vis the E.U. when it loses Member State status on "exit day".

2.2. He described three main points of possible uncertainty, contained in the Benchmarks (Amendment) (EU Exit) Regulations 2018:

- Benchmark administrators that have already been authorised or registered in the E.U. as of 20 March 2019, would be automatically added to the U.K. register, for a temporary period of two years. However, the BMR is unusual in that it is partway through its implementation period, which ends on 31 December 2019. This means many administrators are still only partway through their application process, and are unlikely to be authorised or registered in the E.U. until after 29 March 2019. U.K. supervised entities could therefore find themselves prevented from using benchmarks of administrators which have become registered or authorised in the E.U. after 29 March 2019, but which have not had time to complete the equivalent U.K. application before 31 December 2019. Ideally, the U.K. register would duplicate the E.U. register not only as it stands on 29 March 2019, but on all dates up to 31 December 2019.

- Third country benchmark administrators that are located outside the U.K. will be required to become approved by equivalence, recognition or endorsement. Pending any equivalence decision, recognition represents an attractive route for E.U. benchmark administrators. However, as third country administrators, they will not be simply named on the U.K. register, but they will have to list every benchmark to benefit from recognition. This represents an additional compliance burden for E.U. administrators, because their list may be long, and it will need frequent updating. This may be a faithful transposition of BMR, but in context, it does not seem an entirely logical outcome.

- An administrator located in the E.U., but employing administration staff in the U.K. and willing to provide services in the U.K. may be subject to legal uncertainty about registration requirements. Also, in regards to registration of a benchmark in the U.K., it is not clear if it is sufficient for registration of a benchmark family or each benchmark individually must be registered.

3. Preparation for transitional provisions on clearing in both E.U. and U.K. (Barney Reynolds)

3.1. Barney Reynolds delivered a talk on the preparation for transitional provisions on clearing in both E.U. and U.K. and pointed out the measures which have been taken in both jurisdictions.

3.2. As regards measures in the U.K., he mentioned the following:

- The Temporary Permissions Regime ("**TPR**") for non-U.K. Central Counterparties ("**CCPs**") and Trade Repositories ("**TRs**"), by which CCPs and TRs may continue carrying out business in the U.K. for a limited period after withdrawal while seeking authorisation/recognition from U.K. regulators, which would last for three years, extendable by the Treasury in increments of twelve months;

- The Bank of England's list of Third Country CCPs, which, he said, may need to be supplemented by additional CCPs in some categories, including E.U. CCPs;

- Mutual, permanent "equivalency" decisions between the E.U. or the U.K. will be important post-Brexit but these have not been agreed and the schedule for their adoption is still unclear;

- A new regime in the U.K. based on Directive 98/26/EC on settlement finality in payment and securities settlement systems (the "**SFD**") will provide for the continuation of the U.K. settlement finality protections post-Brexit given the automatic recognition of the U.K designated systems by the E.U. member states will cease. The new regime will allow designations of non-U.K. Financial Market Infrastructures ("**FMIs**") under the U.K.'s existing settlement finality regulations and give the BoE functions and powers to designate these FMIs; and provide for a temporary designation regime to enable non-U.K. FMIs to get access and to continue to benefit from U.K. protections currently provided for by the SFD.

3.3. As regards E.U. measures, Mr Reynolds pointed out that the E.U. has also started to push through temporary equivalence recognitions for U.K. market infrastructure. He commented that neither the U.K. nor E.U. has yet, however, recognised any exchange on the basis of equivalence for over-the-counter purposes, which, as of exit day, may have a potential knock-on impact on the clearing obligation. Also, he observed that there is no E.U.-wide equivalence regime for third-country exchanges, and these require national authorisation from each member state. Equally, there is no third country equivalence regime in the SFD and therefore some national regimes have been expanded to allow third country registrations, though it is unclear whether infrastructure entities will register under the new national regimes.

4. "SCA: A Cinderella Story"—Strong Customer Authentication under PSD2 (Helen McGrath)

4.1. Helen McGrath opened her remarks by stating that the E.U. implementation of the Strong Customer Authentication ("**SCA**") regime under Directive (EU) 2015/2366 on payment services in the internal market ("**PSD2**") is still uncertain, and is supposed to be completed in September 2019. The package of reforms will require two factor authentication, which is a global trend (i.e. India, Australia, Brazil, Mexico, Singapore, all have implemented, or are looking at implementing, two factor authentication). She explained that the meaning of the two factor authentication is based in the match of two or more factors from different buckets: "knowledge" (something you know), "possession" (something you have) and "inherence" (something you are).

4.2. Subsequently, Ms McGrath stressed that implementation presents a few challenges. She mentioned that SCA applies only to payments initiated by the payer, not the payee and accordingly many transactions are out of scope of the regulation. She also mentioned the varying levels of preparedness within Europe, with some market participants being

unprepared. Finally she mentioned that the application of SCA to cross border trade is likely to prove challenging, as some issuers may apply SCA regardless of merchant location--in cases where there is a non-E.U. element that means there is a risk of payments being declined, so the application of SCA may prove disruptive.

4.3. Finally, in regards to authentication factors themselves, Ms McGrath summarised the approach taken by the European Banking Authority ("**EBA**") in its Opinion of June 2018 on authentication factors.[1] Prior to the EBA opinion, the preferred card industry option relied on use of card details as a knowledge factor but according to the opinion, card details cannot be considered a knowledge factor. Although some E.U. regulators have said that card details could still be considered as a possession factor. Varying approaches has given rise to possible legal uncertainty.

5. Impact of Brexit on market infrastructure—open or closed markets? (Michael Kent)

5.1. Michael Kent presented remarks on the impact of Brexit on market infrastructure covering exchanges, trading platforms and clearing/CCPs.

5.2. Mr Kent started by considering the different approaches in the U.K. and the E.U. in relation to the necessity for exchanges to be licensed (exemptions, characteristic performance contrasted with "solicitation" test). In particular, the U.K. operates a liberal approach, allowing Exchanges in third countries to admit trading participants based in the U.K. without requiring them to be authorised/exempted in the U.K., whereas the E.U. typically see a third country exchange seeking members/participants in the EU as triggering a licensing requirement.

5.3. Post-Brexit, absent recognition as "equivalent", U.K. exchanges will not qualify as places where E.U. firms can execute trades and thereby fulfil their mandatory trading obligation. Thus adequate liquidity in relevant instruments would need to be created in existing or new E.U. exchanges. There is relatively little systemic exposure, or E.U. client risk, caused by recognising non-E.U. exchanges, particularly those in the U.K., but it is not very obvious that the E.U. will be prepared to recognise the U.K. as equivalent for the purposes of Directive 2014/65/EU on markets in financial instruments ("**MiFID II**"), or that the U.K. will want to adopt rule-taker status for the whole of MiFID II so as to support the strongest possible case for equivalence.

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1 EBA, Opinion of the European Banking Authority on the elements of strong customer authentication under PSD2, (21 June 2018), available at: https://eba.europa.eu/documents/10180/2622242/EBA+Opinion+on+SCA+elements+under+PSD2+.pdf.

5.4. In relation to clearing services, Mr Kent explained that their provision is regulated under EMIR and stressed the complexity of moving trades executed pre-Brexit ("**back book**") from one clearing house to another, as it requires extensive co-operation and planning, involving huge costs if done in an uncoordinated way. In this regard, he mentioned that there is temporary recognition already given to U.K. CCPs which could enable an orderly transfer of the back book—though it is likely that movement of the back-book will only be organised if and when it becomes clear some form of more permanent recognition under the European Parliament legislative resolution of 18 April 2019 on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs ("**EMIR 2.2**") is not going to be forthcoming.

5.5. EMIR 2.2 does reflect the fact that, unlike trading platforms such as exchanges and MTFs, clearinghouses create concentrated systemic risk, and hence there is a greater policy need to ensure adequate supervision/control over the part of business if it affects the Eurozone in a material way. Some of the most important clearinghouses in the U.K. have already taken steps to move repo business to the E.U.

5.6. Mr Kent highlighted that achieving true inter-operability between clearing houses, without creating additional risk, is challenging and has not been achieved to any material extent in practice, meaning that if the current European risk pool is split between two clearing houses (one in the U.K. and one in the E.U.) that would split the (currently netted) risk pool and be costly in terms of lost netting benefits.

5.7. Finally, Mr Kent stressed that the proposed solution under reformed EMIR would be to allow an U.K. CCP to be fully licensed within the E.U., but without having to move its head office, and would be fully regulated as a clearinghouse wherever it carries out its business. That would allow the current global model of clearing of OTC derivatives to survive, albeit with a consequent increase of regulatory control over a systemically important business.

5.8. He noted that there remains a concern in relation to the provision of clearing services by clearing members to clients post Brexit, in the same way as the provision of trading services for clients He highlighted that even though temporary permission has been given to U.K. clearing houses, no similar cover has been provided to UK based clearing members, who

therefore are expected to be obliged to transfer that clearing activity for E.U. clients to a suitably licensed entity in the event of a no-deal scenario on Brexit

6. RTS 27 MiFID II: Best Execution issues (Nathaniel Lalone)

6.1. Nathaniel Lalone provided remarks on the quality of execution reports required under RTS 27 (MiFID II), in particular the extent to which such reports are being made available and whether they achieve their intended regulatory purpose.

6.2. As regards the former point, he noted that the RTS 27 requirements apply to all "execution venues", a term which includes both trading venues as well as systematic internalises. He then cited reports that a significant percentage of execution venues – including in particular systematic internalises – are reportedly not publishing their quality of execution reports. It is not clear whether this is because they are unaware of the requirement.

6.3. He noted that the challenges associated with venue quality of execution reports share certain features with the challenges faced earlier in the year when investment firms were first required to publish their own best execution reports. The advent of investment firm best execution reporting demonstrated that, despite *bona fide* best efforts by firms to gather, retain and input the relevant data into the disclosure templates, subtle differences between business models meant that firms often had to make judgement calls regarding how best to conform their activities to the available data fields. The more such judgement calls are made, he noted, the greater the likely "drift" in the reports away from a single, consistent approach, making it difficult for regulators or market participants to treat the information in the reports on an "apples-to-apples" basis.

6.4. Mr Lalone also noted a second challenge that has presented itself following the publication of trading venue execution reports. While these reports faithfully reflect the requirements of RTS 27, including in particular the obligation to make such reports available for public download in a "machine-readable electronic format", he noted that many of the reports are enormous Excel files with hundreds, and sometimes tens of thousands, of line items that reflect numerical data in a largely context-free spreadsheet. If the regulatory objective of publishing these reports is for the public to have meaningful information about execution quality, it is far from clear that the required format of the reports is adequate to achieve this result. He finally noted that only the largest market participants would likely have the resources to integrate and interrogate the information being made available, potentially providing these incumbent firms – rather than the public at large – the benefit of making such information more widely available.

7. Plenary discussion on recent developments and legal uncertainties concerning financial market infrastructures (Nathaniel Lalone) and any other business

7.1. A member raised for discussion the question of direct electronic access ("DEA") in trading venues. It was suggested that there was a divergence in Member State implementation of the MiFID II requirements applicable to DEA trading, with some countries (such as the U.K.) permitting both third-country DEA providers and their third-country clients with generous exemptions from MiFID licensing obligations, whereas other Member States impose such licensing requirements on all DEA providers and their clients, including third-country firms. Even so, the U.K. has established a robust set of ongoing compliance requirements for DEA providers that *de facto* imposes rigorous standards on members that provide DEA to U.K. trading venues.

7.2. Another member pointed out that the question of how best to regulate DEA trading requires an assessment of whether to place the compliance burden and legal responsibility on the underlying principal (i.e., the DEA client) which is historically not always disclosed, or the agent (i.e., the DEA provider) who has a contractual connection with the trading venue as a member.

8. Any other business

8.1. No other business was raised.