Financial Markets Law Committee ("FMLC")

Asset Management Scoping Forum

Date: Thursday 19 September 2019
Time: 2.00pm to 3.30pm
Location: Bank of England, Threadneedle St, London, EC2R 8AH

In Attendance:

Emma Rachmaninov (Chair) Freshfields Bruckhaus Deringer LLP
Antony Bryceson AB Trading Advisors
Richard Chapman AB Trading Advisors
Kirsten Lapham Ropes & Gray International LLP
Owen Lysak Clifford Chance LLP
Michelle Moran K&L Gates LLP
Ezra Zahabi Akin Gump Strauss Hauer & Feld LLP

Hwee Peng Ngoh FMLC Secretariat
Virgilio Diniz FMLC Secretariat

Regrets:

Phil Bartram Travers Smith LLP
Gregg Beechey Fried, Frank, Harris, Shriver & Jacobson (London) LLP
Iain Cullen Simmons & Simmons LLP
Julian Eustace Schroders Investment Management Ltd
David Gasperow Orbis Investments
Jon May Marshall Wace LLP
Leonard Ng Sidley Austin LLP
Martin Parkes Blackrock Investment Management (UK) Limited
Neil Robson Katten Muchin Rosenman UK LLP
Selina Sagayam Gibson, Dunn & Crutcher UK LLP
Palvi Shah JP Morgan
Sam Wilson Fried, Frank, Harris, Shriver & Jacobson (London) LLP
Minutes:

1. **Introductions**

1.1 Emma Rachmaninov opened the meeting and members introduced themselves.

2. **ESG and Stewardship (Michelle Moran)**

2.1 Michelle Moran started the discussion by observing that the topic of Environmental, Social and Governance ("ESG") has been gaining more attention and entering mainstream thinking—as can be seen from, for example, the recent ESMA’s technical advice to the European Commission on integrating sustainability risks and factors in MiFID II—when before, the perception was that ESG considerations was more of a free choice rather than a regulatory compliance obligation and clients are therefore now looking at ESG quite seriously. It is hoped that the Financial Conduct Authority ("FCA") would be looking at this but it appears that the FCA has yet to do so.

2.2 The European Commission adopted in May 2018 a package of measures on sustainable finance including a proposal for a regulation on the establishment of a framework to facilitate sustainable investment for, among other things, the purpose of creating a unified classification system ("taxonomy"). A uniform taxonomy and hence a common understanding of, for example, when an economic activity is environmentally sustainable is important as it gives legal certainty and could, as a result, address issues of “greenwashing”—being the practice of making a misleading claim about investment products having sustainability characteristics—as it is currently difficult for investors to differentiate between real sustainable products and those that only purport to be so. An example was given of certain fund managers who refrain from trying to make sustainable investments due to existing uncertainties. This highlights the importance of an agreed taxonomy so that fund managers are able to invest in accordance with clear ESG principles.

2.3 A brief introduction of “green bonds” was given. To be eligible for funding via an E.U. “green bond”, certain “clean” criteria needs to be satisfied. In this regard, the TEG released a report recently establishing clear and comparable criteria for determining the activities which should be eligible for funding via an E.U. “green bond”. The lack of standardisation of ESG ratings—frequently as a result of these ratings being market driven for particular products—was briefly considered. Such lack of standardisation can be seen in research which shows that ESG ratings from different sources are only
aligned in 6 out of 10 cases. This again highlights the importance of an agreed taxonomy.

2.4 Members then engaged in a discussion on sustainable finance and ESG integration. There is currently confusion as to how far one takes ESG. Therefore, although there is general consensus in Europe for ESG disclosure on investments, it is not clear if asset managers are actually allowed to invest in non-sustainable products, being those characterised by the ones with poor rating for ESG. This raises difficulties and uncertainties as there are two conflicting factors at play: an asset manager’s fiduciary duty to investors—often to maximise financial returns—and its obligation to comply with the law which might prevent or discourage it from making “unsustainable” investments which yield the financial returns it would otherwise pursue in discharge of its fiduciary duty. There is also confusion between ESG and its component parts such as diversity and governance but it appears that regulators are more focussed at the moment on climate change as opposed to, for example, social impact.

2.5 Members agreed that it is a priority to clarify the duties of an asset manager to make investments in compliance with ESG requirements as this is potentially one of the most litigious area for asset managers. It is not currently clear whether ESG considerations should override an asset manager’s fiduciary duties to investors as there are no clear standards of compliance. Determining the precise requirements is also made difficult by unclear definitions in guidelines/regulations and various interconnected regulations. A member observed that it appears at this stage to be one of showing best efforts to comply and that ESG development could take a similar approach to that of the Shareholder Rights Directive II. Another member observed that there is no concept or sense of proportion when taking into account ESG considerations and its impact on financial returns.

2.6 Members agree that legal certainty is lacking when there is a conflict between an asset manager’s fiduciary duty to maximise financial returns for its investors and taking ESG into consideration. Although an asset manager who invests in accordance with investment objectives could amend its investment objectives to include ESG considerations, asset managers should ultimately be given clear directions by regulators to move in favour of ESG when faced with financial returns conflict so that asset managers can provide a legitimate and valid explanation to its investors and properly discharge its duty to investors. Members also agree that ESG has an economic cost that should be factored into asset management modelling.
2.7 There are therefore two main questions facing asset managers which needs clarification: Is it clear what duties they have towards their investors when there is potential conflict with any of its ESG legal obligations and whether it is clear to the asset managers which regulatory authority is imposing on it such legal obligations.

2.8 Members recognise that it will be helpful for the FCA to issue guidance in this area and hope to take steps to start a dialogue with the FCA.

3. Plenary discussion on recent and anticipated legislation and developments, including Brexit issues—potential areas of focus for future meetings (Emma Rachmaninov)

3.1 Emma Rachmaninov led a discussion on the status of implementation of the onshoring of E.U. legislation into U.K. domestic law. Members discussed that buyside have appeared to be more passive in this regard and that market participants are likely, for now, to have focussed only on key issues—with smaller issues to be dealt with in due course—and that they are mainly concerned with whether trading will be affected. It will also be necessary to consider the impact of the Brexit “in flight” bill known as the Financial Services (Implementation of Legislation) Bill (if this bill is passed). “Onshoring” could be an agenda item at the next meeting.

3.2 Members also raised the potential “liquidity mismatch” risk issue for funds, which was raised at the last meeting—key issue being that there is a mismatch of the liquidity of the underlying assets and a fund’s redemption policy. It was noted that there has not been any recent new legislation but that it would be useful to keep a watching brief on this and have this on the agenda at the next meeting.

3.3 Some other areas of interest were discussed:

3.3.1 Potential issues relating to prudential consolidation requirements under the Proposal for a regulation on the prudential requirements of investment firms (IFR) and the Proposal for a directive on the prudential supervision of investment firms (IFD), which were discussed at the last meeting. It was agreed that there is no immediate need to do work in this area but it would be useful to keep a watching brief on this.

3.3.2 The PRA has issued a policy statement on “Enhancing banks’ and insurers’ approaches to managing the financial risks from climate change” in April 2019 which requires firms to allocate responsibility for identifying and managing financial risks from climate change to relevant senior management. It was noted that the FCA has not issued any
communication regarding this and that it would be useful to keep a watching brief on this.

4. **The FMLC’s Public Education Function: Speeches (Virgilio Diniz)**

4.1 Virgilio Diniz delivered a short presentation on the FMLC’s Public Education Function and encouraged Forum members to get in touch with the Secretariat if they wish to have a member of the Secretariat visit their offices to speak with them about any legal uncertainties in a relevant area of financial markets.¹

5. **Any other business**

5.1 No other business was raised.

¹ Please see Appendix I
The FMLC’s Public Education Function: Speeches

Virgilio Diniz
Project Manager
The FMLC’s charitable remit

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.
The Public Education Function

• Along with publications and events, the FMLC Secretariat furthers the Committee’s education function by giving speeches about legal developments and issues of legal uncertainty in the financial markets.

• These speaking engagements may be at high-profile events or at a smaller gathering of an interested audience at a stakeholder firm.

• Members of the Secretariat have presented to audiences, within law firms for example, which are interested in learning about current issues facing the financial markets.

• The FMLC used to be CPD-qualified and such talks presented excellent training opportunities.

• Example of topics on which the Secretariat has presented are set out in slides below.
Transitional Period: “Fourth” Country-Status

- Another uncertainty arising in the context of a transitional period could be a result of the U.K.'s status during the period as a non-Member State.
- While the U.K. will continue to be considered a part of the European Union for the purposes of intra-E.U. business, such businesses may not legally continue to be party to the E.U.'s regulations.
- For example, U.K. CCPs may not automatically benefit from the substituted compliance concessions available to CCPs in the U.S. under the CFTC.
- It will be necessary for businesses to negotiate bilateral-making arrangements with each Third Country jurisdiction in the E.U. and substitute CCPs, if necessary.

Brexit, FinTech and FinTech Regulation After Brexit

FinTech Today

- At the end of 2018, Blockchain and cryptocurrencies entered the main financial systems
- According to a report by the European Banking Association (EBA), over 2000 types of for cryptocurrency are in use today.
- In March 2019, the European Union launched a trial of cross-border central bank digital currency.
- On 28 June 2019, Facebook announced the launch of a “stable global cryptocurrency” on the Blockchain.
- Blockchains are being used for venture capital financing and the recording of financial transactions.

Post-Brexit U.K. FinTech Regulation

- **HM Treasury Consultation on Transposition of 5th Money Laundering Directive**
  - Expands regulatory perimeter to include virtual currencies and custodian wallet providers.
- **FCA Cryptoassets Taskforce Report**
  - Sets out measures that the U.K. authorities intend to take regarding cryptoassets, including regulating financial instruments that reference cryptoassets and consulting on extending the regulatory perimeter for FCOIs.
- **FCA’s Feedback Statement (FS17/4) on its Discussion Paper (DP17/3) on DLT**
  - Suggests current rules are flexible enough to accommodate use of DLT and that the FCA will continue to monitor DLT-related market developments.
- **FCA’s Guidance (FG16/5) for firms outsourcing to the “cloud”**
  - Lists areas of guidance that firms should consider when outsourcing to the cloud and other third-party IT services, including legal and regulatory measures and effective access to data.
IBOR Transition (at the P.R.I.M.E Finance Conference 2019)

The definition of SONIA has two elements:

1. SONIA is a measure of underlying interest rates, which reflects SONIA at any one time as an Overnight Index Average (OIA) of EURIBOR.
2. The statement of SONIA is financial market practice and is an overnight rate.

SONIA is a rate which represents the overnight inter-bank lending rate for a particular currency, currently the EURIBOR. It is used to price floating rate liabilities, such as in mortgage lending.

The overnight index average (OIA) is the average of the best observed rates for a particular currency. In the case of EURIBOR, it is the average of the best rates observed during a specific period, typically one day, from a group of banks.

The definition of SONIA is:

1. The average of the best rates observed during a specific period, typically one day, from a group of banks.
2. The rate is calculated daily, and the average is used to set the SONIA rate for that day.

The SONIA rate is used in a variety of financial instruments, including interest rate swaps, and it is an important reference rate for setting the interest rate on floating-rate loans and other financial products.

The transition from LIBOR to SONIA is being implemented in stages, with the aim of ensuring a smooth transition and minimizing disruption to financial markets.

The key dates for the transition from LIBOR to SONIA are:

- 2021: The first cut-off date for LIBOR
- 2023: The last cut-off date for LIBOR
- 2024: The first full day of SONIA

The transition to SONIA is expected to be completed by 2024, with all LIBOR-based contracts being replaced by SONIA-based contracts.

The transition from LIBOR to SONIA is an important step in the evolution of financial markets, and it is expected to have a significant impact on the way financial institutions operate and manage their risk.

The key challenges for the transition from LIBOR to SONIA are:

1. Determining the appropriate methodology for calculating SONIA
2. Ensuring the reliability and consistency of the SONIA rate
3. Transitioning contracts and other financial instruments from LIBOR to SONIA

The transition from LIBOR to SONIA is expected to be a complex process, and it will require significant effort and resources from financial institutions and regulators.

The key benefits of transitioning from LIBOR to SONIA are:

1. Increased transparency and comparability of financial data
2. Improved resilience of financial markets
3. Reduced risk of disruption to financial markets

The transition from LIBOR to SONIA is a key priority for financial markets, and it is expected to have a significant impact on the way financial institutions operate and manage their risk.
Brexit and finance: the legal framework

Covering note on the Financial Regulators’ Powers (Technical Standards) (Amendment etc.) (EU Exit) Regulations 2018

5. Following this model will mean that EU ‘Level 1’ legislation (which was developed by the European Commission and negotiated through the Council and European Parliament) and ‘Level 2’ legislation (apart from BTS and certain other technical elements of Level 2), will become the responsibility of the UK Parliament. This body of EU legislation includes provisions which set the policy direction for financial services, so it is appropriate that responsibility for deciding how deficiencies are fixed in this legislation should rest with Parliament. HM Treasury will propose amendments to this legislation, using the powers under the EUUVB, ensuring that Parliament is able to scrutinise all of the changes. It is expected that the majority of the statutory instruments needed to correct deficiencies in this legislation will be laid under the affirmative procedure.

6. For certain EU ‘Level 2’ technical rules, known as Binding Technical Standards (BTS), HM Treasury proposes to transfer ongoing responsibility from the European Supervisory Authorities to the UK financial regulators – the Bank of England, the PRA, the FCA and the Payment Systems Regulator (PSR). BTS, running to several thousand pages, do not set overall policy direction but fill out the technical detail of how the requirements set at Level 1 are to be met. Having played an important role in the EU to develop these standards, through their membership of the Boards and working groups of the European Supervisory Authorities, UK regulators have the necessary expertise and resource to maintain them after the UK’s exit from the EU. This allocation of responsibility would be consistent with the general rule-making responsibilities already delegated to the FCA and PRA by Parliament under FSMA.

7. As HM Treasury proposes to transfer ongoing responsibility for BTS to the UK regulators, it also makes sense that the regulators perform the task of making corrections to deficiencies in existing BTS so that these rules operate effectively in the UK at exit. HM Treasury therefore proposes to delegate to UK financial regulators the power to correct deficiencies in BTS arising from EU withdrawal.
Conflicts of laws on securities and claims: collateralisation

Collateralisation and the assignment of claims

- The Commission proposal insures that retail deposits retained as collateral against banks by natural persons deposits in the law of the underlying country of the depositor.
- This is the correct rule: banks are not collateralised under the law of their habitual residence.
- Situations in which individual claims include the taking of security under a security relationship, the assignment of a security to a company on the bank account from one spouse to another may, matters are excluded from the possibility of competing entitlements or residence, it may be that only the assignor generate a legally certain result.

Collateralisation and the assignment of claims

- Further, with regard to bank accounts in general, it is often argued that banks should be able to take a charge over their own indebtedness vis à vis their clients under the law of the assigned claim and irrespective of any rule to the contrary in the law of the latter’s habitual residence.
- The question arose for consideration in the U.K. courts in two cases: *In re Charge Card Services Ltd* [1987] Ch 150, where it was held to be “conceptually impossible” that banks should take a charge in these circumstances, and *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, where the House of Lords settled the question and upheld the charge. In between these case decisions, legislation was enacted in several jurisdictions with common law influence (including the Cayman Islands, Bermuda, Singapore and Hong Kong) providing for the validity and enforceability of charges of this kind, which were common at the time and continue to be prevalent as a means of taking security today.
Summary and Conclusion

• The Secretariat is happy to visit your organisation and introduce legal uncertainties in a relevant area of the financial markets.

• This helps us get reach a wider audience of stakeholders, learn about the questions occupying their time and fulfil our public education.

• If you are interested, get in touch with Debbie Hayes at: secretarial@fmlc.org or with Venessa Parekh at: research@fmlc.org