Quadrilateral 2016
Wednesday 20 July

The Financial Markets Law Committee

The Financial Markets Lawyers Group

The European Financial Markets Lawyers Group

The Financial Law Board
Introduction

Lord Walker

Chairman

Financial Markets Law Committee
FinTech: Block Chain Technology and Digital Currencies

Chair: Lord Walker (FMLC)

Terence Filewych, UBS (FMLG)
Kunihiko Morishita, Anderson, Mōri & Tomotsune (FLB)
Dr Joanna Perkins, FMLC
FinTech: Block Chain Technology and Digital Currencies

Terence Filewych, UBS (FMLG)
Japan:
Regulatory Reform to Meet the Challenges of FinTech

Quadrilateral Meeting in London, 2016

Kunihiko Morishita, FLB
July 20, 2016
Recent Legislation in Japan to Cope with FinTech

- Introduction of new licensing system for “Virtual Currency Exchange Services”

- Relaxation of bank holding company regulation under the Banking Act

- The Bill to Address Advances in Information Technology and Other Changes was passed at the Diet in May 2016
  - Amendments to be enforced within one year
Regulation on Virtual Currency Exchange Services

Backdrop

- Declaration at G7 Elmau Summit (June 8, 2015)
- FATF Guidance (June 26, 2015)
- Mt. Gox – a “bitcoin exchange” based in Tokyo went insolvent in February 2014; CEO was arrested in August 2015 on suspicion of fraud
Regulation on Virtual Currency Exchange Services

- Introduction of new licensing (registration) system for “Virtual Currency Exchange Services”
  - “Virtual Currency Exchange Service Provider” needs to be registered
  - The registered service providers are subject to KYC / AML obligations as well as certain codes of conduct
Regulation on Virtual Currency Exchange Services

“Virtual Currency” is defined as follows:

(i) proprietary value that may be used to pay an unspecified person the price of any goods purchased or borrowed or any services provided and may be sold to or purchased from an unspecified person (limited to that recorded on electronic or other devices by electronic means and excluding Japanese and other foreign currencies and currency denominated assets; the same applies in the following item) and that may be transferred using an electronic data processing system; or

(ii) proprietary value that may be exchanged reciprocally for proprietary value specified in the preceding item with an unspecified person and that may be transferred using an electronic data processing system.
Relaxation of bank holding company regulation

■ Background circumstances

- Rapid development of FinTech on a global basis
- To catch up with FinTech movements, banks must make a huge investment in IT
- Under the current Banking Act, it is difficult for a bank group to have IT subsidiaries
- Operation of a bank holding structure is inflexible
Relaxation of bank holding company regulation

- Relaxation of regulation

- Allowing for the possibility of a bank holding company / bank to have an IT business company as subsidiary, subject to regulatory approval (see next page)

- Relaxing the “arms-length” rule among bank group entities

- Relaxing rules regarding “outsourcing” of business operations (e.g., supervision requirement)
Scope of permitted subsidiaries

Bank Holding Company

Bank

Subsidiaries

Securities/Insurance/Trust

(e.g. leasing, investment advisory, Islamic financing, servicer, credit card, etc.)

Financial related businesses

Operational businesses

Venture Capital

IT companies

(e.g. data processing, system development / maintenance, etc.)

Post Reform
Contact

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Legal Aspects of Virtual Currencies

Dr Joanna Perkins, Financial Markets Law Committee

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The Classification of Private Law Rights in English Law

- **Real property**
  - Chattels real
    - e.g. land
  - Chattels personal
    - Tangible property/chooses in possession (e.g. leasehold interests)

- **Personal property**
  - Chattels personal
  - Intangible property/chooses in action
    - Documentary intangibles
      - Non-negotiable chattels
        - e.g. cars, chairs, ordinary "things"
      - Negotiable chattels
        - e.g. money (coins)
      - Negotiable instruments
        - e.g. promissory notes
      - Negotiable securities
        - e.g. bearer bonds and notes
      - Non-negotiable choses in action
        - e.g. non-bearer shares and debts

- **Non-property**
  - e.g. quotas, permissions licences
Virtual Currencies

Background

- What are virtual currencies?
  - Virtual currencies are currencies that can be held and used only electronically (in the context of computer games or as an electronic reflection of “real world currency”)
- The best-known virtual currencies are: Bitcoin, Litecoin, Nemcoin, Ether and Ripple
- The majority of virtual currencies that interact with the real world economy share some common characteristics:
  - they are created through a process called “mining”
  - they are incorporated in a network supported by “distributed ledger technology” (DLT), also “blockchain”
  - they rely on cryptographic techniques to record transactions in DLT and to identify the unique character of individual coins
- Some virtual currencies platform (Ether) offers programmable, automated transaction functionality (smart contracts)
Virtual Currencies
Property and Personal Right

• What is the legal character of virtual currencies?
• Are they property or personal rights under the common law?

Before a right or an interest can be admitted into the category of property, or of a right affecting property, it must be definable, identifiable by third parties, capable in its nature of assumption by third parties and have some degree of permanence or stability (Lord Wilberforce in National Provincial Bank v Ainsworth [1965] 1 AC 1175 at 1247-8)

• Licenses, certain quotas, permissions will not qualify as property within the above definition
• Recent judicial decisions have tended to support the categorization of rights as property when they acquire economic value and show themselves susceptible to transfer and trade
• It seems likely that units of virtual currency which have both economic value and transferability among participants (i.e. are robust and well-engineered) will be categorised as a type of property
Virtual Currencies

“In action” or “In possession”?

• How can we “possess” virtual currencies?

• If virtual currencies are property they should be considered personal property, namely chattels personal.

• If so, the question arises whether virtual currencies should be considered “chooses in possession” (tangible) or “chooses in action” (intangible) property?
  
    • If choses in possession, then how can we obtain possession?
    • If choses in action, than against whom does the action to enforce the rights of owner lie?

• Virtual currencies are commonly understood to be intangible objects which can be possessed in the way dematerialised cash can be possessed.

• Might they be a kind of hybrid “virtual choses in possession”?
Virtual Currencies

Documentary intangibles

- What kinds of intangible things can be possessed?

- One category of property that shares some of the characteristics of both choses in possession and choses in action is “documentary intangibles”
- The document is tangible (i.e. “in possession”) but the debt or interest that it represents is intangible (i.e. “in action”)
- A documentary intangible is therefore both an intangible thing and a thing that can be possessed
- Negotiable instruments and negotiable securities are both documentary intangibles
- Negotiable things are valuable tools in commerce because delivery, or a transfer of possession, is sufficient to transfer ownership. That means that a good faith acquirer has no need to make laborious enquiries as to the title of the transferor
Virtual Currencies
Possession, delivery and ownership

• Should a good faith acquirer of virtual coins be able to rely on his possession as evidence of ownership?

• Negotiable instruments and negotiable securities are unlikely to extend to new types of assets, such as electronic assets…

• A third category of property which has a negotiable quality is that of “negotiable chattels”

• The commonest examples of “negotiable chattels” are coins and bank notes (which are also negotiable instruments!), i.e. money...

• Might virtual coins be “negotiable chattels”, too?
Virtual Currencies
Money, money, money

- What is money?

- “The Societary theory of money” suggests that the negotiability of coins and notes stems from their ability to “pass in currency”, i.e. commonly and continuously to be accepted as payment in exchange for articles of commerce.
- It is unclear which, if any, virtual currencies have achieved the status of money “passing in currency” in this way.
- The European Court of Justice has classified virtual currencies as means of payment.
Virtual Currencies

E-money: It’s money, Jim, but not as we know it

• What kind of thing is electronic money? Is it “money” or a claim against the issuer?

• The case of so-called e-money has implications for virtual currencies: if e-money (defined in EU legislation) is indeed money than some objections to accepting some virtual currencies as money may fall away (i.e. that they cannot be possessed, that they are not legal tender and that they are not issued by the State)
Virtual Currencies
Foreign Exchange?

- What about the virtual currencies that have not (yet) gained widespread acceptance

- Foreign money may prove a useful analogy.
- Foreign currency cannot purchase articles of commerce or satisfy a debt unless expressly stipulated for by the creditor.
- Foreign money is not sovereign currency or legal tender
- There is no social practice of accepting foreign money in payment
- Ordinary debts within the jurisdiction are, by law, denominated in domestic currency unless another currency is stipulated for.
- Yet, under English law, foreign money is still regarded, in its legal aspect, as “money”.*
- If foreign money is money than the fact that a virtual currency has only limited acceptance should not necessarily preclude its being money

*Court of Appeal in Camdex International Ltd v Bank of Zambia [1997] CLC 714
Virtual Currencies

A constant measure of value

• How do virtual currencies measure value?

• According to economic theory, money: (i) serves as a medium of exchange; (ii) serves a store of value; and (iii) serves a unit of account

• Risks such as the “double spending” of coins can undermine the ability of a virtual currency to act as a store of value

• The “store of value” concept may be similar the threshold test for “property” (i.e. does the thing have real economic value?)

• There is a distinction between this concept and “constant measure of value”

• Being a “constant measure of value” is sometimes said to be a necessary characteristic of sovereign currencies but it is not a characteristic of money per se (viz foreign currencies)

• A virtual currency may be a store of value but it cannot be a constant measure of value unless it is pegged to a sovereign currency
Virtual Currencies
Regulatory Aspect

• If virtual currencies qualify as money, does that mean they must be regulated as money, rather than commodities or securities, say?

• Virtual currencies share certain key characteristics with commodities, securities and instruments of payment
• The CFTC has concluded that Bitcoin is a commodity*
• A US court has ruled, in an action brought by the SEC, that Bitcoin-denominated units or shares are securities*
• Virtual currencies have a strong claim to be “money” at law but this does not entail that they should be treated as “money” or “cash” in a regulatory context.
• A clear definition of the legal aspect of money may assist regulators in predicting the outcomes of proposed regulatory approaches

*(Order of the CFTC (Docket No. 15-29) in the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan)
**SEC v Shavers (No-4-13-CV-416) Eastern District of Texas, September 18, 2014
Conclusions
Developments in Financial Markets
Global FXC Preamble

Chair: Akihiro Wani, Morrison & Foerster LLP (FLB)

Maria Douvas, Morgan Stanley (FMLG)
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Lisa Shemie, Bats Global Markets (FMLG)
FX Global Code (Phase 1)

July 2016
Maria Douvas, Morgan Stanley
Quadrilateral Presentation
FX Global Code (Phase 1) Overview

**Purpose**

- Establishes global conduct principles for the institutional foreign exchange market, including all OTC FX products and listed futures
  - Intended to “promote a robust, fair, liquid, open, and appropriately transparent market”
  - Supplements local laws, rules & regulations
- Applies to all market participants, including dealers, buy-side, brokers, trading platforms and central banks (except for monetary policy actions)

**Phases**

- Phase 1 (May 2016) contains 4 leading principles: Ethics, Information Sharing, Execution, and Confirmation & Settlement
- Phase 2 (expected May 2017) to cover: Governance, Risk Management & Compliance, Electronic Trading, Trading Venues, FX Brokers, FX PB, and Specific Features of FX Transaction Types (in particular, forwards and options)

*Morgan Stanley*
FX Global Code (Phase 1) Overview cont’d

**Sponsorship**

- Developed by a BIS Foreign Exchange Working Group (16 central banks and private sector participants)
- Endorsed by 8 Foreign Exchange Committees (“FXCs”) in the US, UK, Europe, Hong Kong, Australia, Canada, Japan and Singapore

**Adherence**

- Full compliance expected in 2017 (following Phase 2 publication), although Market Participants now expected to evolve current practices to comply with Phase 1
- Method of adherence under consideration by BIS central bank participants
  - FXC members expected to “evolve” FX practices in order to comply with Phase 1 principles
FX Global Code: Ethics

**Integrity, Professionalism & Business Conduct**

- FX professionals should:
  - Act honestly, fairly and with integrity when dealing with clients and other market participants, and
  - Strive to maintain the highest degree of professionalism and standards of business conduct

**Conflicts of Interest**

- Market participants should identify actual and potential conflicts of interest, and eliminate or manage these conflicts to promote fair treatment of clients and other market participants

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Handling Confidential Information

- “Confidential Information” is FX trading information of clients or the Firm, including any related sensitive information
  - Includes order book details, clients/other market participants axes or spread matrices and benchmark orders
  - May not be disclosed internally, except to personnel who have a valid reason for receiving such information, including for risk management, legal and compliance purposes
  - May not be disclosed externally without consent, unless to market intermediaries to the extent necessary for trade processing/novation/settlement or required under applicable law or by a regulator
  - May be used only for the specific purpose given, with limited risk management exceptions

- “Designated Confidential Information” is any client information that is subject to a higher standard of confidentiality, whether under the terms of a NDA or by being material non-public information (“MNPI”) that a reasonable investor would likely consider important in making an investment decision

FX Global Code: Information Sharing
Bank research analyst to hedge fund: Our view on USD/JPY has shifted in line with our new central bank rate forecasts and I’m publishing a new bullish trade recommendation later today.

Asset manager to bank market maker: Bank ABC just called me with an axe to buy EUR/SEK. Are you seeing buying as well?

Bank market maker to another bank market maker: I’m being asked to quote a two-way price in USD 150m in USD/MXN. What does your bank’s pricing matrix show in terms of spread?
Bank research analyst to hedge fund: I’m calling to check that you’ve received our bullish USD/JPY trade recommendation published an hour ago in line with our new central bank forecasts.

Asset manager to bank market maker: Thanks for calling to see if we have interested in EUR/SEK. We don’t have interest today and I will keep the information to myself.

Bank market maker to another bank market maker: We don’t market make in USD/MXN. Can you quote me a two-way price in USD 150 m
FX Global Code: Information Sharing (cont’d)

**Market Color**

- **Communications** should be clear, accurate, professional and not misleading
  - Attribute information from 3rd parties to such parties (e.g., a news source)
  - Identify opinions as opinions
  - Exercise judgment when discussing rumours that may be driving price movements/don’t start rumours with intent to move markets or deceive others
  - Do not communicate false information or misleading information (even if to protect Confidential Information, such as whether the size of a trade they are discussing is the full amount they seek to execute in the market)

- **Market Colour:**
  - Market colour should be sufficiently aggregated and anonymized
  - Communications should not include specific client names or code names
  - Client groups, locations and strategies should be sufficiently general
  - Individual trading positions should not be disclosed
  - Flows should be disclosed only by price range and volumes in general terms
  - References to time of execution should be broad
  - Option interest should be disclosed in terms of broadly observed structures and thematic interest
  - Status of orders should be carefully communicated so as to protect confidentiality of order book
Communications: FX Global Code Examples

Bank Salesperson to hedge fund: We’ve just seen large USD/KRW demand from XYZ (where ‘XYZ’ is a code name for a specific client).

Asset manager to Bank market maker: I hear that you’ve been a big buyer of GBP/USD. It is for the same U.S. corporate again?

Broker to Bank market maker: European banks are currently bidding for 1-month at-the-money USD/JPY volatility in size.

Corporate to Bank market maker: If you sold 500m EUR/USD for me now, how much do you think you could move the rate?
| Bank salesperson to hedge fund: We saw large USD/KRW demand from real money names this morning. |
| Asset manager to Bank market maker: Can you give me some color around the 100 point rally in GBP/USD in the past hour? |
| Broker to Bank market maker: We’ve seen strong demand for 1-month at-the-money USD/JPY volatility from European banks this morning. |
| Corporate to Bank market maker: What is liquidity like in EUR/USD at the moment in terms of market depth for EUR 50m, 100m, or 200m? |
Communications Channels

- Defines standard for approved communications channels as follows:
  - Market Participants should communicate with other firms using approved methods of communication that allow for traceability, auditing, recordkeeping and access control
  - Only in limited circumstances (e.g., emergency or business continuity) should unrecorded lines be used
**Principal & Agents**

- Defines “Principals” & “Agents” (which should be defined in a standing agreement or per trade)

- When receiving a client order, a market participant may act either as:
  - Agent – executes orders on behalf of a client pursuant to a client mandate and without taking market risk, OR
  - Principal – takes on one or more risks, including market and credit risk. No obligation to execute the order until both parties are in agreement. When acting with discretion, must act reasonably, fairly and not with intent to disadvantage the client

- Role as principal or agent should be clearly defined either in a standing agreement or on a trade by trade basis

- Regardless of role, all market participants should “exercise care when negotiating and executing FX trades in order to promote a robust, fair, open, liquid and appropriately transparent market”
FX Global Code: Execution cont’d

**Order Handling** - standards defined based on role

- **Principals and agents:**
  - Fair and transparent outcome for client
  - Clarity on firm or indicative pricing
  - Reject orders believed to be inappropriate for client
  - Not execute trades with intent to disrupt the market
  - Disclose order handling practices, including whether aggregated or time prioritized, as well as factors that may impact an order (e.g., positioning, liquidity and market conditions, other client orders and trading strategy)

- **Principals** must disclose how conflicts are addressed, when market risk transfers and that it trades on its own behalf as counterparty
  - Market making/risk management must be commensurate with trading strategy, risk assumed, prevailing liquidity & market conditions

- **Agents** must seek to obtain result requested by client, have a transparent order execution policy (including execution venues and factors impacting choice of such venues), disclosure on how it intends to provide prompt and fair execution
**Pre-Hedging**

- Defines pre-hedging as the management of risk associated with one or more anticipated client order, designed to benefit the client in connection with such orders/resulting trades

- Pre-hedging permissible only when acting as principal (and not as agent)

- Must be in a manner that is not meant to disadvantage the client or disrupt the market
  - Pre-hedging should take into account market conditions, liquidity and size of transaction with client, as well as the market maker’s overall portfolio exposure
  - Market participant may continue market making and risk management
  - Pre-hedging practices should be disclosed to clients

**Disrupting the Market**

- Market participants should not request FX trades with intent to disrupt the market. Large size trades should be appropriately monitored & executed
Pre-Hedging: FX Global Code Example

XYZ Fund indicates to a salesperson at ABC Bank that it needs to buy 500m EUR/USD at the market and shortly after sends a trade instruction to ABC Bank requesting execution of the specified FX transaction. ABC Bank accepts the order request but enters the market and begins to buy 200 m EUR/USD for its own account ahead of working the Client’s order while ignoring XYZ Fund’s order request and without filling any of the Client’s order.
Stop Loss Orders

- Standards for stop loss orders include:
  - Terms for each such order must be fully defined with client (e.g., reference price, order amount, time period and trigger)
  - Disclosure must be provided to client regarding execution of risk management transactions and potential impact on price
  - Trading activity that is designed to move the market to a stop loss level is not acceptable
Stop Loss Orders: FX Global Code Examples

Asset manager leaves an order with XYZ Bank to sell 50m USD/CAD at 1.27 on a stop loss with vague or no instructions. XYZ Bank helps trigger the stop loss by selling ahead of the level and informs the Client 30 minutes after the order is executed that it was done at 1.2685, citing gappy price action when in fact a lot of volume went through between 1.27 and 1.2685.

Asset manager leaves an order with XYZ Bank to sell 50m USD/CAD at 1.27 on a stop loss with instructions to execute the order once 1.27 trades. XYZ Bank starts executing the order once 1.27 trades in the market. XYZ Bank immediately notifies the Client that the stop loss order has been executed and is filled at 1.2695, which is in line with Client’s expectation based on the time of the day and the volume traded at the time the order is executed.
FX Global Code: Execution cont’d

*Benchmark (Fixing) Orders*

- Principles for handling benchmark fixing orders are:
  - Do not share Confidential Information, or trade in any direct or indirect way, to manipulate or attempt to manipulate the fix
  - Fixing trades should be priced in a manner that is transparent and consistent with risk taken
  - Dealers should have separate processes for handling fixing orders, in accordance with the Financial Stability Board’s (FSB’s) “Foreign Exchange Benchmark Report Recommendations”
Benchmark (Fixing) Orders: FX Global Code Examples

Transacting an order over time before, during or after its fixing window, so long as not to intentionally negatively impact the market price and outcome to the client.  

Collecting all client interest and executing the net amount.

Buying or selling a larger amount than the client’s interest within seconds of the fixing calculation window with the intent of inflating or deflating the price against the client.

Showing large interest in the market during the fixing calculation window with the intent of manipulating the fixing price against the client.
Benchmark (Fixing) Orders: FX Global Code Examples

- Informing others of a specific client-dealing at a fixing rate.
  - 

- Acting with other market participants to inflate or deflate a fixing rate against the interests of a client.
  - 

Morgan Stanley
FX Global Code: Execution cont’d

**Filling Client Orders**

- Principles for filling client orders are:
  - Must be fair and reasonable based on market conditions and any other conditions disclosed to client
  - Decision not to fill (or partially fill) must be communicated to client as soon as practicable
  - Must fully fill orders capable of being filled, subject to dealer’s prioritization rules and available credit

**Mark Up**

- Defines “Mark Up” and the standards for when it may be applied:
  - Definition – Mark Up is the spread or charge that may be included in the final trade price in order to compensate the market participant, including for risks taken, costs incurred and services rendered to a client
  - Disclosures should be provided to clients regarding mark up practices, including that the final price may include mark up, that different clients may receive different prices for similar trades, the factors contributing to mark up, and how mark up may impact pricing and execution of an order linked to a specific level
  - Mark up should be fair and reasonable (taking into account market conditions and internal risk management policies/practices)
  - Mark up must not be misrepresented to a client
  - Mark up should not be decided by the daily range of the day
A Market Participant receives a client order to stop sell GBP/USD at 1.5000. As 1.5000 was traded in the market, the Market Participation executes the stop loss order covering at 1.4998. The Market Participant fills the client at a rate at 1.4990 after taking mark up and without disclosure to the client that the all-in price may include mark up.

A client asks a Market Participant to fill an order to sell 50m USD/JPY and to confirm the details at a later time period. The Market Participant adds a higher mark up than normal, by filling the order further away from the actual executed rate, but within the day’s trading range.
FX Global Code: Confirmation and Settlement

- Market Participants should have efficient, transparent and risk-mitigating post-trade processes to promote the smooth and timely settlement of FX trades
  
  - **Confirmation Process**
    - FX trades should be confirmed as soon as practicable, in a secure and efficient manner
    - Block trades should be reviewed, affirmed, and allocated as soon as practicable
  
  - **Settlement Process**
    - FX trades should be settled directly with trading counterparties, rather than third parties – if third party payments are requested, firms should have policies and procedures in place to address the risks of such payments (operational, anti-money laundering)
    - Firms should perform regular and timely account and portfolio reconciliation to identify settlement discrepancies
Developments in Financial Markets
Global FXC Preamble

Jeff Lillien, Deutsche Bank (FMLG)
Global FX Code

Phase II

Topics and Themes

Quadrilateral Meeting of the FMLC/FMLG/FLB/EFMLG

Wednesday, July 20, 2016

Lisa A. Shemie
Bats Global Markets
Global FX Code – Phase II Topics

- Prime brokerage*
- Electronic trading*
- Asia/Australia
- Adherence
- Phase I Examples
- Interdealer broker
Prime Brokerage

Overview of typical PB structure
Prime Brokerage - Issues

- Confidentiality/separation
- Credit checks and risk controls to determine and monitor trading limits
- Pre- and post-trade monitoring of trading limits
- Disputes
Electronic Trading - Issues

- Last look – standalone principle?
- Single source of liquidity?
- Disclosures
- Transparency
- Governance standards
- Ensuring authorized access
- Controls
- Surveillance and monitoring
Developments in Financial Markets
Benchmark Reform

Chair: Akihiro Wani, Morrison & Foerster LLP (FLB)

Fernando Conlledo Lantero, Cecabank (EFMLG)
Dorothy Livingston, Herbert Smith Freehills LLP (FMLC)
Akihiro Wani, Morrison & Foerster LLP (FLB)
Current status of the Euribor project

Fernando Conlledo
General Counsel
cecabank
London, 20 July 2016
The Euribor project

- Enhancing transparency, governance and control framework
- Complying with the official sector guidelines of anchoring the benchmark in actual transactions
- Changes in definition and methodology

Public Consultation.

New EU legislation
- Regulation (EU)2016/1011 of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts.

Pre-live verification program

Current definition: Euribor is the rate at which Euro interbank term deposits are being offered within the EMU zone by one prime bank to another at 11.00 a.m. Brussels time

New definition: Euribor is the rate at which banks of sound financial standing could borrow funds in the EU and EFTA countries in the wholesale, unsecured money markets in euro
Timeline

- **Q2 2016**
  - Benchmark Framework
  - Transaction-Based Euribor Methodology
  - Infrastructure
  - Pre-Live Verification Program
  - Transition Execution
  - Communication Program

- **Q3 2016**
  - Develop updated Euribor CoC (transaction-based benchmark)
  - Publication of EMN’s white paper on the methodological development
  - Euribor Reporting Instructions (ERIS)

- **Q4 2016**
  - Panel Banks Infrastructure Development
  - Pre-Live Verification Program Guidelines

- **Q1 2017**
  - Revision of methodological parameters
  - Panel Bank solicitation
  - Pre-Live Verification Program
  - Data Analysis Exercise
  - Results shared with Competent Authorities
  - Decision made by EMN’s Governing Bodies

- **Q2 2017**
  - Implementation Updated CoC
  - Outreach to relevant public authorities and engagement of relevant stakeholders
  - Launch

Source: EMN Webpage
Legal workshop (I). Issues

- **Seamless transition**
  - Similarity of definition
  - Similarity of rate
  - Similarity of volatility

- **Duties of the administrator**
  - Is obliged to adapt the governance and features to recommendations of IOSCO/ESMA and Principles of EU Regulation
  - To give the stakeholders advance notice of the proposed changes/to consult on the proposed material changes
  - Standard of diligence. Prudent administrator

- **Liability of panel banks**
  - Administrator is entitled to decide and implement the changes without the consent of the panel banks
  - For the data they submit. Contribution models
Legal workshop (II). Frustration and continuity of contracts

- Mapping and preliminary analysis of the issue
  - Type of transaction, type of documentation, governing law, type of counterparty
  - Common law/civil law jurisdictions

- Conclusion: Building a robust legal strategy
  - Support by the official sector
    - EFMLG letter
Benchmarks Competition and Regulation

Dorothy Livingston, Herbert Smith Freehills LLP (FMLC)
Recent Examples of Antitrust Enforcement Action to Date

<table>
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<th>EU</th>
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<th>South Korea</th>
<th>Switzerland</th>
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| • European Commission fines  
• Yen LIBOR/ Euroyen TIBOR (Dec 2013/ Feb 2015)c. €0.7bn fines – 4 banks, 2 brokers  
• CHF LIBOR and bid-ask spreads (Oct 2014) €94m fines – 3 banks  
• EURIBOR (Dec 2013)c. £1bn fines, 3 banks; Soc Gen revision of fine | • DoJ fines in relation to LIBOR, TIBOR and EURIBOR e.g. Deutsche-Bank fined $775m as part of overall $2.5bn penalty imposed by multiple regulators  
• Extensive ongoing private damages claims with antitrust aspects argued by plaintiffs | • FCA LIBOR fines in excess of £750m (2012-2015)  
• Fines and criminal proceedings in relation to individuals  
• Further civil charges expected in conjunction with Commodity Futures Trading Commission (CFTC) | • Korean Fair Trade Commission reportedly launched a probe of 12 banks to determine the impact of LIBOR manipulation on South Korea’s finance industry and other businesses (opened 2015) | • Competition Commission investigation into LIBOR, TIBOR and EURIBOR manipulation by 12 banks (opened 2012)  
• Reportedly expected to conclude July 2016 and may include a number settlement fines |
Concerns of Competition Regulators

- Benchmarks historically vulnerable to manipulation and distortion due to limited oversight by regulatory authorities and voluntary nature of submissions.
- Potential for huge damages for users and customers.
- Antitrust one of many tools available to authorities to regulate benchmarks.
- Coordination: Agreements, concerted practices or decisions of association of undertakings – very broad concept.
- Information sharing: includes one-off disclosure of competitively sensitive information and information sharing via third parties – potentially fine line between necessary commercial communication and collusion.
EU Benchmarks Regulation

Regulation (EU) 2016/1011 comes into effect 1st January 2018

- Deals with EU Benchmarks
- Deals with Endorsement of Benchmark provided in a Third Country
- Principles:
  - Governance
  - Control of Conflicts of Interest
  - Oversight
  - Control homework
  - Accountability
  - Complaints handling
  - Transparency and Consumer Protection
  - Supervision

- Applies to:
  - Interest Rate Benchmarks
  - Commodity Benchmarks
  - Special rules for -
    - Critical Benchmarks
    - Significant Benchmarks
### Steps to Respected Benchmarks: Competition Law Perspective

<table>
<thead>
<tr>
<th>Setting of benchmarks</th>
<th>Conduct with competitors</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Administration of benchmarks</td>
<td>- No direct/indirect contact with object or effect of:</td>
</tr>
<tr>
<td>- Visibility over process</td>
<td>- Creating conditions not corresponding to normal competitive conditions</td>
</tr>
<tr>
<td>- Minimal discretion afforded to those who are setting benchmarks</td>
<td>- Influencing an actual/potential competitor’s conduct</td>
</tr>
<tr>
<td>Compliance procedures</td>
<td>- Disclosing to competitors a decided or contemplated course of conduct</td>
</tr>
<tr>
<td>- Training and safeguarding</td>
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</tr>
<tr>
<td>- Avoid incentive structures which encourage anti-competitive behaviour</td>
<td></td>
</tr>
</tbody>
</table>
Benchmark Reform: TIBOR

Akihiro Wani
Morrison & Foerster LLP (FLB)
a. First Stage Reforms:

1. New Administrator: JBA TIBOR Administration (JBATA) (April 1, 2014)

2. Governance (Conflict of Interest): JBA TIBOR Code of Conduct (April 1, 2014)

3. Challenges:

4. Regulations:
   Now TIBOR and JBATA are subject to the regulations under the Financial Instruments and Exchange Act.
1. JBATA launched “2\textsuperscript{nd} Consultative Document” in August 2015 and its feedback was completed in November 2015. The suggested waterfall is as per attached.

2. Introduction of the negative interest rate in February 2016 made it necessary to carry out further review of the proposed waterfall model. Such review was completed recently and JBATA continues its discussion with the regulators.

3. The implementation of TIBOR+ is scheduled to take place, but no timing is decided yet.

4. Maybe the 3\textsuperscript{rd} Consultative Document?
Still under discussion by the market participants and the regulators. It is still unclear how Japan will carry out this project.
From the 2nd Consultative Document

The Waterfall

<table>
<thead>
<tr>
<th>Proposed waterfall methodology for Japanese yen TIBOR (*1, 2)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1st Level</strong></td>
</tr>
<tr>
<td>1-1</td>
</tr>
<tr>
<td>1-2</td>
</tr>
<tr>
<td>1-3</td>
</tr>
<tr>
<td>1-4</td>
</tr>
<tr>
<td><strong>2nd Level</strong></td>
</tr>
<tr>
<td>Data of Japan Offshore Market and Interbank NCD market</td>
</tr>
<tr>
<td><strong>3rd Level</strong></td>
</tr>
<tr>
<td>①</td>
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<tr>
<td>②</td>
</tr>
<tr>
<td><strong>4th Level</strong></td>
</tr>
<tr>
<td>Not assumed to be applied in normal circumstances.</td>
</tr>
</tbody>
</table>

*1 The proposed design is for reference banks to determine the “Japanese yen TIBOR” submission rates. Underlying markets is therefore the Unsecured Call Market. On the other hand, with regard to the design of waterfall methodology to be used in submitting “Euroyen TIBOR” rates”, “Unsecured Call transactions” and “Unsecured Call Market” are assumed to be replaced with “Euroyen transactions” and “Japan Offshore Market”, respectively.

*2 The proposed design may be revised in light of comments received through the 2nd public consultation and future discussions with relevant authorities.

[[*1]] Dominant approaches are linear interpolation and retroactive use of data as well as parallel shift of 6 months and 12 months tenors.

[[*2]] Out of the methodologies of linear interpolation and linear extrapolation, JBATA considers that it is reasonable to select the linear interpolation method.
Developments in Financial Markets
Negative Interest Rates

Chair: Akihiro Wani, Morrison & Foerster LLP (FLB)

Nuria Alonso, BBVA (EFMLG)
Asmaa Cheikh, Société Générale (EFMLG)
Negative Interest Rates: a few legal considerations
“Chapter: Japan”

Akihiro Wani
Morrison & Foerster LLP (FLB)
a. Some Materials

1. Introduction of a Negative Interest Rate by the Monetary Policy Meeting of the Policy Board of the Bank of Japan (effective 16 February, 2016) (http://www.boj.or.jp/en/announcements/release_2016/k160129a.pdf)

2. FLB Paper: “Outline of the Approaches to Issues in Interpreting Contracts that Arise in Connection with the Introduction with the Introduction of a Negative Interest Rate” (Japanese version was published on 19 February, 2016) (http://www.flb.gr.jp/epage/edoc/publication44-e.pdf)

3. Financial Services Agency’s no-action letter in regard to non-application of loss compensation prohibition or special treatment provision prohibition under the Financial Instruments and Exchange Act (22 April, 2016)
b. Reality

1. “Freedom to contract” jurisdiction

2. No explicit provision existing in the terms and conditions of loans, bonds, deposits, etc. to cover the negative interest situation, except for some terms and conditions of *samurai bonds*. 
c. Legal Issues

1. The meanings of “interests”. Is legal character of the interest under a loan agreement different from that of a deposit agreement?

2. Practical Solutions
   1) Loans - “Zero floor” approach. Namely an interest rate does not go below zero.
   2) Bonds – “Zero floor” approach.
   3) Derivatives – No “zero floor” approach.
   4) Structured products (combination of loans/bonds and derivatives) – Various approach

3. Reasonings – Reasonable intent of the parties when they entered into the transaction.
c. Legal Issues (cont.)

4. Accounting issues
   Zero floor – A grant of option?
   Hedge accounting – Can we continue to apply?

- End -
Developments in Financial Markets
Negative Interest Rates

Nuria Alonso, BBVA (EFMLG)
Developments in Financial Markets
Negative Interest Rates

Asmaa Cheikh, Société Générale (EFMLG)
Developments in Financial Markets
Legislative Developments with an Impact on Asset Management and Securities Financing

Nuria Alonso, BBVA (EFMLG)
Habib Motani, Clifford Chance (FMLC)
The effects of the EU Securities Financing Transactions Regulation

Nuria Alonso, BBVA (EFMLG)
1. Background: Shadow banking

**Shadow banking**: non bank credit activity, that has not been the prime focus of prudential regulation and supervision. It performs important functions in the financial system, it creates additional sources of funding and offers investors alternatives to traditional bank deposits but it is also a threat to long-term financial stability.
2. Objectives / Obligations of SFTR

**Objectives**

**Improving transparency / preventing systemic risks**

**How**

1. Reporting and recordkeeping of SFTs (art. 4 SFTR)
   - Repurchase transactions
   - Buy-sell back & sell-buy back transactions
   - Securities and commodities lending & borrowing
   - Margin lending transactions
   - Transparency for authorities

   **In scope entities: both financial and non-financial (FC/NFC), SFTR applies to:**
   - Counterparty of an SFT:
     - Established in the EU (including branches outside)
     - Established in a third country if SFT concluded in the course of operations of branch in EU
   - A counterparty may delegate the reporting
   - If SFT of FC with NFC (small/medium), FC is responsible for BOTH reporting
   - Management companies of UCITS and AIFs report on their behalf

2. Conditions for re-use of financial instruments received under a collateral agreement (art 15 SFTR). Not limited to SFTs
   - Transparency towards counterparties

3. Disclosure to investors in UCITS and AIFs (art. 13 and 14): pre contractual and periodical disclosure. – SFTs and Total Return Swaps
   - Transparency towards investors

   **Counterparty engaging in reuse that is established:**
   - In the EU, (including all branches outside the EU)
   - In a third country, where either: a) reuse effected in the course of operations of a branch in the EU or, b) reuse concerns financial instruments provided by a counterparty established in EU or a branch in the EU of a counterparty in a third country

   - (a) Management companies of UCITS and UCITS investment companies
   - (b) Managers of AIF
3-Reporting to trade repositories (art. 4)

**What?**
- Conclusion. Details Modification Termination
- All SFTs, even if non EU count./certain count. not subject to report

**Who?**
- Both counterparties (although delegation, not small medium sized, managers of UCITS, AIFs)
- EU counterparties (+branches outside)
- EU branches of third country counterparties (course of operations): confidentiality issues. Agreement Some exceptions

**When?**
- D+1 to a trade repository (phase-in/backload). Different reporting dates depending on kind of counterparty.

**Records**
- 5 years after termination

**Others**
- Need to avoid duplicity/overlap/inconsistencies with other regulations
4. Re-use of financial instruments (art.15)

Right to reuse subject to:

a) Informing collateral provider of risks (at least in case of default of the receiving counterparty) when:
   - Granting a right of use under a security collateral arrangement
   - Concluding a title transfer arrangement
   Statement of the industry: effective transparency when both sided?

b) Prior express consent
   - Signature: writing or similar binding manner (in security collateral arrangement)
   - Counterparty has agreed to provide collateral by way of a title transfer arrangement

Exercise of reuse:

a) In accordance with terms of agreement

b) Financial instrument received transferred from the account of the providing counterparty (or in case of account of provider in a third state, reuse evidenced by other appropriate means)

- Article 15 shall not affect national law concerning the validity or effect of the transaction
- Not restricted to SFTs. Better in Collateral Directive?
- Applies also to counterparties in a third country (even with no branches in EU) when receiving collateral from the EU. How to know? Sanctions?
- Applies from 13 July 2016 including for collateral arrangements existing on that date
  Overlaps/Inconsistencies with Collateral Directive, MiFid 2 (prevent the use of a client's financial instrument without express consent, title transfer prohibited with retail clients, additional risks disclosure...
5- Transparency of collective investment undertakings

What?

Inform investors about their use of SFTs and Total Return Swaps:
   a) In periodical reports (half-yearly and annual for UCITs/ annual for AIFMs)
   b) In prospectuses: pre-contractual documents

Who?

UCITS management companies, UCITS investment companies and AIFMs authorised in the EU.

When?

Periodic reports: obligation applies from 13 January 2017
Pre-contractual information: applies from 13 July 2017 if undertakings constituted before 12 January 2016/ Otherwise, application from 12 January 2016

Other regulations

Very extensive information required; in countries like Spain, nearly no impact as obligations already covered by existing regulation (ESMA Guidance)
Useful for investors? (too technical)
Better addressed in other regulation?
6. Conclusions/Issues to be considered

1. The SFTR deals with transparency as regards authorities (SFTs reporting) together with transparency for investors and counterparties: it may have been better to incorporate the latest in the relevant rules. Comprehensive regulation and more clarity would have been achieved.

2. Are all measures effective? a) transparency: disclosure of reuse when both sided? ; b) extraterritoriality: how can third parties comply with the reuse risk disclosure? Are sanctions possible? c) Are all obligations possible to fulfill for example, reporting for small/medium sized companies. How do we know? d) disclosure UCITS/AIFs effective?

3. Different reporting requirements (criteria) depending on regulation: increases difficulties to manage obligations.

4. Overlap with other regulations such as MiFid 2 /Collateral Directive

5. Other aspects: different time-frame applies depending on counterparty (FC/NFC...)

6. Increases operational costs: reporting of SFTs and delegation, obligation to notify for small/medium, delivery of risk disclosure notice, etc...

7. Different in-scope transactions/counterparties... depending on type of obligation: more difficult to manage.
Developments in Financial Markets
Legislative Developments with an Impact on Asset Management and Securities Financing

Habib Motani, Clifford Chance (FMLC)
Margin under EMIR

QUADRILATERAL MEETING OF THE FMLC/FMLG/FLB/EFMLG – LONDON
20 JULY 2016
Margin under EMIR

1.1 – Basics – Margin did not make it into Pittsburg 2009… but was added in Cannes 2011

• The Group of Twenty (G20) initiated a reform programme in 2009 to reduce the systemic risk from OTC derivatives. As initially agreed in 2009, the G20’s reform programme comprised four elements:
  • All standardized OTC derivatives should be traded on exchanges or electronic platforms, where appropriate.
  • All standardized OTC derivatives should be cleared through central counterparties (CCPs).
  • OTC derivatives contracts should be reported to trade repositories.
  • Non-centrally cleared derivatives contracts should be subject to higher capital requirements.

• In 2011, the G20 agreed to add margin requirements on non-centrally cleared derivatives to the reform programme.
Margin under EMIR

1.2 Basics – Policy objectives - the BCBS – IOSCO framework

• Understanding the global nature of the OTC derivatives market and in order to reduce systemic risk and promote central counterparty clearing, the G20 called upon the BCBS and IOSCO to develop, for consultation, consistent global standards for margin requirements.

• BCBS – IOSCO Key Principles:
  • All financial firms must exchange initial and variation margin.
  • The methodologies for calculating initial and variation margin should (i) be consistent across entities and (ii) ensure that all counterparty risk exposures are fully covered with a high degree of confidence.
  • Eligible collateral should be highly liquid and should be able to hold their value in a time of financial stress.
  • Initial margin should be exchanged by both parties on a gross basis, and held in such a way as to ensure that (i) the margin collected is immediately available; and (ii) subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy.
  • Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions.
  • Margin requirements should be phased in over an appropriate period of time
Margin under EMIR

1.3 – Scope and Requirements

• Applies to Financial Counterparties (FC) and Non-Financial Counterparties “plus” (NFC+).

• Requires FC and NFC+ to have risk management procedures that require exchange of both Initial Margin and Variation Margin with respect of non-cleared OTC derivatives entered into with counterparties that are (or would be if they were established in the EU) FC or NFC+

• Applies to all non-cleared OTC derivatives. However, physically settled Foreign Exchange swaps and forwards plus currency swaps would not require collection of initial margin. Likewise, during the first three years following the publication of the Regulatory Technical Standards (RTS) single-stock equity options and index options would not require collection of initial margin.
Margin under EMIR

1.4 – Timing

- On June 9 the European Commission confirmed that the RTS would not be published on time to align application of the margin rules with those of other regulators, probably pushing the start date of the European regulation to mid 2017.

- Once the RTS is published a phased-in approach will follow:

<table>
<thead>
<tr>
<th>Year</th>
<th>IM Exchange between cpties with notional higher than €2,25 Trillion</th>
<th>VM Exchange between cpties with notional higher than €3 Trillion</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>€3 Trillion</td>
<td>€3 Trillion</td>
</tr>
<tr>
<td>2018</td>
<td>€2,25 Trillion</td>
<td>€0</td>
</tr>
<tr>
<td>2019</td>
<td>€1,5 * Trillion</td>
<td>€0,75 Trillion</td>
</tr>
<tr>
<td>2020</td>
<td>€8 Billion</td>
<td>€0 (i.e. all FC y NFC+)</td>
</tr>
<tr>
<td>2021</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>
Margin under EMIR

1.5 Initial Margin

- Covers the potential future exposure resulting from a counterparty default.
- Only counterparties (FC or NFC+) with gross notional outstanding amount in OTC derivatives above EUR 8 billion.
- Phased-in compliance depending on the aggregate notional amount over a period of time.
- A threshold amount of up to EUR 50 million may be bilaterally agreed between counterparties, provided that such threshold amount would need to be distributed between all entities of the same group, to avoid entity dissemination to circumvent the rule.
- A second threshold, in the form of a minimum transfer amount of up to EUR 500,000 (to be “shared” with VM) may be bilaterally agreed between counterparties, in order to reduce operational burden.
- Initial Margin must be segregated from own assets and should therefore be placed with a third party custodian.
- IM shall not be re-hypothecated, re-pledged or otherwise re-used.
- IM in the form of cash may be reinvested by the third party custodian.
Margin under EMIR

1.5 Initial Margin

- IM exchange should be effected on the day after the closing of the relevant transaction.

- Recalibrating: every time the parties enter into a new non-cleared OTC derivative or at least 10 business days after the last IM calibration was effected.

- Two allowed ways to calculate IM:
  - **Standardized Approach**, fallback method established in the RTS which determines the amount of IM on the basis of the notional amount of the non-cleared OTC derivatives.
  - **Initial Margin Model**: internal model to be developed by counterparties for the determination of IM. Those models would need to comply with certain requirements established in the RTS.

  ISDA is working on an industry wide internal model to be used across the market, the so called “SIMM model”.
Margin under EMIR

1.6 Variation Margin

- Covers mark-to-market exposure of the OTC derivative contracts.

- Phased-in compliance depending on the aggregate notional amount over a period of time.


- No threshold amount permitted.

- Minimum Transfer Amount of up to EUR 500,000 permitted, to be shared between Variation Margin and Initial Margin
Margin under EMIR

1.7 Eligible collateral

- Initial Margin and Variation Margin:
  - Asset classes for which the counterparty has no access to the market or is unable to liquidate in a timely manner would not be considered as eligible collateral.
  - Eligible collateral:

    Cash, gold, debt securities issued by Member states, debt securities issued by multilateral development banks, debt securities issued by third country government and central banks as well as regional governments provided certain requirements are met, debt issued by credit institutions or investment firms, covered bonds, certain securitization bonds, equities included a main index, convertible bonds, UCITs shares.
Margin under EMIR

1.8 Issues and Challenges

• Timing, market fragmentation – the EU delay.

• Complexity of rules and models may drive away market participants

• Documentation – need to repaper with all FC and NFC+ at a time when all market is doing the same. ISDA Protocol

• Impact on liquidity
Thank you

Our purpose is to help people and businesses prosper.

Our culture is based on the belief that everything we do should be

Simple | Personal | Fair
Regulatory Technical Standards

Simon Firth, Linklaters LLP (FMLC)
Introduction

- Implement EMIR by setting out the standards that risk management procedures must comply with
- Final draft published
- Numerous problems of both drafting and policy
Problem areas: (1) collection timing

- Art 13(2): VM must be collected within one business day (based on portfolio at 4pm in the earliest time zone on the previous business day)
- Extended to 2 business days if certain (quite onerous) conditions are met
- Difficult or impossible for some market participants to comply (funds may not hold sufficient cash and repo market operates on T+2 basis)
Problem areas: (2) collecting margin in non-netting jurisdictions

- Art 11(2): EU counterparty not required to “collect or post” IM or VM if:
  - a legal review confirms that netting is not enforceable or IM cannot be validly segregated
  - the review confirms that “collecting collateral in accordance with this Regulation is not possible”
  - the ratio of contracts for which no margin is collected to all the group’s contracts (unless intra-group) is less than 2.5%
Problem areas: (2) collecting margin in non-netting jurisdictions (cotd.)

- Why does the regulation refer to posting collateral? Art 11(1) provides a broader exemption and so it seems otiose.
- What is meant by collecting collateral in accordance with the Regulation not being possible? The legal review does not address this – it only covers netting and IM segregation.
- The policy objective appears to be that a counterparty from a non-netting jurisdiction must post (on a gross basis) unless this is prohibited in the local jurisdiction.
- 2.5% threshold perceived to be too low (5% has been suggested).
Problem areas: (3) margining after an Event of Default

- Under Section 2(a)(iii) of the ISDA Master Agreement, if a party commits a (Potential) Event of Default, the other party’s obligations are suspended.
- Is this incompatible with the RTS?
- This is the FCA’s view (which appears to be correct) but there are no current plans to disapply Section 2(a)(iii).
Problem areas: (4) IM cash accounts

- Art 23(d)(1): initial margin in cash must be held with a bank that is “authorised in accordance with [the Capital Requirements Regulation]”
- The CRR does not require authorisation of banks
- Capital Requirements Directive does require authorisation but only of EU incorporated institutions
- Appears to prohibit cash accounts with non-EU banks
Problem areas: (5) intra-group exemption

- No practical or legal impediments to the prompt transfer of own funds/repayment of liabilities
- What does “own funds” mean in this context?
- What liabilities are covered?
US Uncleared Margin Rules

Sarah Donnelly

This is a summary Bank of America Merrill Lynch’s understanding of US regulators’ implementation and rulemaking in connection with Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted into US federal law on July 21, 2010, and the EU regulators implementation and rulemaking in connection with the European Market Infrastructure Regulation published on July 27, 2012. This information represents Bank of America Merrill Lynch’s current understanding of these regulations but is subject to change.
**Product and Entity Scope**

**Prospective Trades Only:** Rules apply only to post-effective date transactions – legacy transactions are excluded if subject to a separate netting portfolio.

**Treatment of FX:** Physically-settled FX swaps and forwards and the exchange of principal under cross-currency swaps exempt for IM and VM under US; only exempt for IM only under EMIR – must count physical FX in material swaps exposure threshold calculations.

<table>
<thead>
<tr>
<th>Entity Categories</th>
<th>Uncleared Swaps</th>
<th>Uncleared SBS</th>
<th>Other EMIR &quot;OTC Derivatives&quot;</th>
<th>Cleared Derivatives</th>
<th>Inter-Affiliate Derivatives</th>
<th>Physically-Settled FX Swaps &amp; Forwards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PR (US)</strong></td>
<td>✓</td>
<td>✓</td>
<td>×</td>
<td>×</td>
<td>✓</td>
<td>×</td>
</tr>
<tr>
<td><strong>CFTC (US)</strong></td>
<td>✓</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>✓</td>
<td>×</td>
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<tr>
<td><strong>SEC (US)</strong></td>
<td>×</td>
<td>✓</td>
<td>×</td>
<td>×</td>
<td>✓</td>
<td>×</td>
</tr>
<tr>
<td><strong>EMIR (EU)</strong></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>×</td>
<td>(At national regulators’ discretion)</td>
<td>× (IM) ✓ (VM)</td>
</tr>
</tbody>
</table>

**Entity Categories**

- **US:**
  - PR Rules apply if at least one counterparty to the transaction is (i) an SD/SBSD/MSP/MSBSP and (ii) prudentially regulated.
  - CFTC or SEC Rules apply if at least one counterparty to the transaction is (i) an SD/SBSD/MSP/MSBSP and (i) is not prudentially-regulated.

- **EU:** EMIR Rules apply to counterparties that are (or would be if in EU): (i) a financial counterparty (FC); or (ii) non-financial counterparty with group uncleared derivatives exceeding (on a 30-working-day rolling average basis) gross notional threshold of EUR 1B for CDS or equity derivatives or EUR 3B for IRS, FX or commodity derivatives (NFC+).

**Key Exceptions**

- **US Rules:** Non-financial end-users, small banks (<$10bn assets), and exempt cooperatives.
- **EMIR:** Non-financial counterparties below the clearing threshold (NFC-s).
- **Sovereigns/Multilaterals:** All regimes exclude sovereigns, certain central banks & multilateral development banks, BIS – sovereign wealth funds not excluded.
Margin Collection and Posting Requirements

**IM Requirements**
- IM calculated using a risk-based calculation or standardized grid
- Two-way IM posting when a counterparty has “**material swaps exposure**” – entity and its affiliates have an average daily aggregate notional amount of uncleared swaps (including foreign exchange forwards and foreign exchange swaps) with all counterparties for March, April, May of the current calendar year that exceeds USD 8B (US)/EUR 8B (EMIR)
- **Threshold**: All regimes have bilateral threshold applied on consolidated group basis for both parties – USD 50MM (US)/EUR 50MM (EMIR)
- **Settlement Timing**: T+1 under all regimes (EU requirement is to collect by T+1)
- **IM Segregation**: required with 3rd party custodians; no re-hypothecation

**VM Requirements**
- Two-way exchange based on current mark-to-market valuation of all derivative contracts in the netting set
- **Threshold**: Zero threshold for VM for all regimes
- **Settlement Timing**:  
  - T+1 under US rules – T is latter of two business days if different time zones or if swap executed after 4pm  
  - T+3 permitted under EMIR Rules where IM is required but the Margin Period of Risk for IM calculation must be increased by the number of days equaling the extension beyond one business day

**Minimum Transfer Amount (combined VM and IM)**
- **US**: USD 500,000
- **EMIR**: EUR 500,000
Eligible Collateral

VM Eligible Collateral

- PR & CFTC:
  - If CSE faces Swap Entity: Cash in major currency (USD, CAD, EUR, GBP, JPY, CHF, NZD, AUD, SEK, DKK, NOK) or currency of transaction settlement
  - If CSE faces FEU: Cash in major currency or currency of transaction settlement and IM collateral eligible
  - EU: Same as collateral eligible for IM

IM Eligible Collateral

- PR & CFTC: Cash (major currency or currency of transaction settlement), US treasuries, agencies, some GSEs, securities issued or guaranteed by ECB or a sovereign entity (with capital risk weighting 20% or less), securities issued or guaranteed by BIS, IMF or multilateral development bank, certain publicly traded debt and listed equities, and gold. Excludes: Pledgor and affiliate-issued corporate securities, securities of bank holding companies, savings and loans, non-US banks, depository institutions, market intermediaries and foreign equivalents
  - EU: Cash, government debt, gold and a variety of bank and corporate bonds and equities, as well as senior tranches of securitization

Haircuts

- US VM: No haircuts unless mismatch between currency of non-cash collateral and swap settlement currency
- US IM/EU VM and IM: Regimes have schedule depending on asset class and remaining maturity
  - US ranges from 0.5% to 25%; EMIR ranges from 0.5-24%
  - EMIR allows for possibility of using model based haircuts as an alternative to schedule based haircut

Currency Mismatch Haircuts:

- US VM: Additional 8% FX mismatch haircut where currency of non-cash collateral differs from settlement currency
- US IM: Additional 8% FX mismatch where currency of collateral differs from settlement currency, except where collateral is denominated in a single “termination currency” (of ISDA Master Agreement)
- EU IM: Additional 8% FX mismatch haircut where currency of collateral differs from termination currency
- EU VM: Additional 8% FX mismatch haircut where currency of non-cash collateral differs from the “transfer currency” (base currency of CSA)

Concentration, Credit Quality & Wrong Way Risk

- EU: Collecting party required to assess collateral for (a) credit quality risk – either by reference to approved internal models or recognized credit agency, (b) “wrong way” risk and (c) concentration risk – concentration limits apply based on non-cash collateral classes, on systemic importance of counterparty entities, and on amount of collected collateral
- US: No prescriptive requirements, however eligible collateral rules exclude assets giving rise to wrong way risk
Netting, Segregation & Re-hypothecation

**Netting:** CSE may net exposures/risks to calculate margin under an Eligible Master Netting Agreement or netting set

- **Eligible Master Netting Agreement (EMNA):** An agreement which creates a single legal obligation for individual transactions with the right to close out on an event of default.

- **Multiple Netting Sets Likely:** EMNA may identify separate netting sets (CSA) compliant with the rules

- **Legacy Uncleared Swaps:**
  - **US:** Separate netting sets containing legacy swaps are not subject to rules

**Segregation of IM Required**

- **US:** IM must be segregated with third-party custodian and IM re-hypothecation is prohibited.

**Rehypothecation of VM Permitted**

- Under both EU and US proposals VM may be re-hypothecated.
Implementation Phase-In

**PR & CFTC Rules**

- **VM:** Phased in between Sept. 2016 and Mar. 2017, where if both counterparties’ group average daily notional of non-cleared trades exceeds relevant threshold below:
  - Sept. 1, 2016: Counterparties exceeding $3 trillion average notional
  - Mar. 1, 2017: For all other counterparties

- **IM:** Phased in between 2016 and 2020, where if both counterparties’ group average daily notional of non-cleared trades for the specified 3 month period exceeds relevant threshold below:
  - Sept. 1, 2016: $3 trillion average notional Mar. through May 2016
  - Sept. 1, 2017: $2.25 trillion average notional Mar. through May 2017
  - Sept. 1, 2018: $1.5 trillion average notional Mar. through May 2018
  - Sept. 1, 2019: $0.75 trillion average notional Mar. through May 2019
  - Sept. 1, 2020 and beyond: $8 billion average notional Mar. through May of the relevant year
Industry Challenges & Initiatives

- **Extraterritorial Scope**: Uncertain timing and availability of equivalence/substituted compliance will require simultaneous compliance with multiple regimes; multiple netting sets may be required for single counterparty relationship – leading to increased documentation, operational risk, settlement risk, and disputes.

- **New Documentation**:
  - **ISDA Protocols**: May be leveraged for papering new rules-compliant CSAs and custodial documents and amending existing documentation.
  - **ISDA Self-Disclosure Tool**: Industry standard document for selfdeclaring counterparty regulated status, relevant regulatory regime(s), group and branch information, etc.

- **Validation & Testing of IM Model (ISDA SIMM)**: ISDA developing standard risk-based IM model to compute regulatory IM to achieve consistency across firms on product taxonomies / risk factors / reference obligations and to obtain regulatory approvals.
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UNCLEARED MARGIN RULES: THE FX PERSPECTIVE

David Buchalter
Managing Director, Associate General Counsel
BNY Mellon
July 20, 2016

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## Underlying BCBS Guidance

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td><strong>(The “FX Guidance”)</strong> ¹</td>
<td><strong>(The “Margin Guidance”)</strong> ²</td>
</tr>
<tr>
<td>• A bank <em>should</em> exchange variation margin:</td>
<td></td>
</tr>
<tr>
<td>- Necessary to collateralize the mark-to-market exposure</td>
<td>• Initial and variation margin requirements <em>do not</em> apply to physically settled FX forwards and swaps</td>
</tr>
<tr>
<td>- Of its physically settled FX forwards and swaps</td>
<td>- However, supervisors should implement variation margin requirements “in a manner consistent with [this] policy framework, after taking into account the recommendations contained in the FX guidance</td>
</tr>
<tr>
<td>- When trading with “Financial Institutions and Systemically Important Non-Financial Entities”</td>
<td>• Non-deliverable forwards and FX options are subject to <em>both</em> initial and variation requirements</td>
</tr>
</tbody>
</table>

¹ Adopted by the US Federal Reserve via the issuance of SR 13-24 in December 2013. “Covered Institutions”, as defined in SR 13-24, includes Large Institution Supervision Coordinating Committee firms, large banking organizations, U.S. operations of large foreign banking organizations, and any other banking organization that engages in significant foreign exchange activities, as defined in SR letter 12-17/CA letter 12-14.

² “Covered Entities” include financial firms and systemically important non-financial entities.
National Requirements for Variation Margin ("VM") on Physically Settled FX Forwards and Swaps

Guidance-Covered Jurisdictions

US – VM is out of scope under the Prudential Rules, but the Federal Reserve has adopted the FX Guidance*

Canada – VM is out of scope under the final rules, but Canada has adopted the FX Guidance

Japan – VM is out of scope under the final rules, but Japan is adopting the FX Guidance

Singapore – VM is out of scope under the proposed rules, but Singapore is adopting the FX Guidance

Rules-Covered Jurisdictions

EU – VM is in scope under the proposed rules, but a transitional exemption is in place until the earlier of December 2018 or entry into force of the MiFID amendments defining FX spot and forward contracts

Hong Kong – VM is in scope under the proposed rules

Australia – VM is in scope under the proposed rules

* Note: Non-Bank Swap Entities registered with the CFTC, rather than subject to prudential regulation, may not be subject to the FX Guidance.
Securities Conversion Transactions

**US CFTC & SEC Dodd-Frank Product Definitions**

The CFTC will consider as Spot FX any securities conversion transaction where:

- The FX trade is entered into *solely* to effect the purchase or sale of a foreign security,
- The FX and securities transactions are equal in face amount,
- The FX and securities transactions are executed contemporaneously, and
- The FX currencies are actually exchanged by the securities settlement date (although unintended operational delays are unlikely to undermine spot status)

**EC’s Recently Published Definition of a Spot FX Contract Under MiFID**

The EC will consider as Spot FX any contract for the exchange of one currency against another...where:

- The exchange of those currencies is used for the *main purpose* of the sale or purchase of a transferable security or interest in a UCITs fund, and
- The FX trade settles within the generally accepted settlement period for the security or UCITs fund or 5 trading days, whichever is shorter
Open Implementation Timetable Questions

- When will the new MiFID FX Spot & Forward Definitions go into effect?

- Will the EC’s implementation delay be expanded to encompass FX Swaps?

- What will the new EC implementation timetable look like?

- Will the US and other jurisdictions harmonize their implementation timetables with that chosen by the EC?

- What if “re-synchronization” does not come about?
Financial Markets Infrastructure and Financial Stability
Emerging Issues for Execution: Electronic Trading, Prime Brokerage and Best Execution

Chair: Jeff Lillien, Deutsche Bank (FMLG)

Dr Joanna Perkins, FMLC
Jeff Lillien, Deutsche Bank (FMLG)
MiFID II—Best Execution

Dr Joanna Perkins, Financial Markets Law Committee
According to Article 21(1) of Directive 2004/39/EC on markets in financial instruments (“MiFID I”):

- A firm must take all reasonable steps to obtain, when executing orders, the best possible result for its clients (professional and retail)* taking into account the execution factors.

**Article 21**

*Obligation to execute orders on terms most favourable to the client*

1. Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

Directive 2014/65/EU (commonly referred to as “MiFID II”) is due to become applicable on 3 January 2018 (by virtue of a Commission delegated act delaying application) and, together with Regulation (EU) No 600/2014 (“MiFIR”), replace MiFID I.

*The best execution obligation does not apply to eligible counterparties.
There will be significant regulatory continuity under MiFID II...

**Article 27**

Obligation to execute orders on terms most favourable to the client

1. Member States shall require that investment firms take all **sufficient** steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

[...].

For the purposes of delivering best possible result in accordance with the first subparagraph where there is more than one competing venue to execute an order for a financial instrument, in order to assess and compare the results for the client that would be achieved by executing the order on each of the execution venues listed in the investment firm's order execution policy that is capable of executing that order, the investment firm's own commissions and the costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.
Changes introduced by MiFID II—Information for clients

Firms will continue to be subject to an obligation to establish an order execution policy but they will be required to provide clients with more specific information about the policy:

**Article 27**

4. **Member States shall require investment firms to establish and implement effective arrangements for complying with paragraph 1. In particular, Member States shall require investment firms to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result in accordance with paragraph 1.**

5. **The order execution policy shall include, in respect of each class of financial instruments, information on the different venues where the investment firm executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders.**

**Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. That information shall explain clearly, in sufficient detail and in a way that can be easily understood by clients, how orders will be executed by the investment firm for the client. Member States shall require that investment firms obtain the prior consent of their clients to the order execution policy.**
Changes introduced by MiFID II—Mandatory publication

Publication of data relating to execution quality provided by execution venues is now mandatory and there is a new obligation for investment firms to summarise data on their use of execution venues:

Article 27

3. Member States shall require that for financial instruments subject to the trading obligation in Articles 23 and 28 Regulation (EU) No 600/2014 each trading venue and systematic internaliser and for other financial instruments each execution venue makes available to the public, without any charges, data relating to the quality of execution of transactions on that venue on at least an annual basis and that following execution of a transaction on behalf of a client the investment firm shall inform the client where the order was executed. Periodic reports shall include details about price, costs, speed and likelihood of execution for individual financial instruments.

4. […]

5. […]

6. Member States shall require investment firms who execute client orders to summarise and make public on an annual basis, for each class of financial instruments, the top five execution venues in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained.
Changes introduced by MiFID II—Scope of obligations

There have also been changes to the scope of the best execution rules in respect of the financial instruments covered.

MiFID I set out a table of financial instruments at Annex 1, Section C. It includes

4. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;

It does not include spot forex contracts.

The definition of ‘Execution of orders on behalf of clients’ in Article 4 MiFID I is “acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients”. This entails that execution of spot forex is not an investment service within the meaning of the directive and that the activity of executing spot forex contracts for clients is not, therefore, within scope of the best execution obligation.

Annex 1, Section C MiFID II has a similar, if expanded, list of financial instruments.

The Commission has now, however, introduced a definition of spot forex (through a delegated act) which may have the indirect effect of altering the scope of the best execution obligation in some Member States.
Changes introduced by MiFID II—Scope of obligations (cont.)

A new Commission Delegated Act of 25.4.2016 defines a spot contract in Article 10(2) as:

A contract for the exchange of one currency against another currency, under the terms of which delivery is scheduled to be made within the longer of the following periods:

a. 2 trading days in respect of any pair of the major currencies set out in paragraph 3;

b. for any pair of currencies where at least one currency is not a major currency, the longer of 2 trading days or the period generally accepted in the market for that currency pair as the standard delivery period

c. where the contract for the exchange of those currencies is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, the period generally accepted in the market for the settlement of that transferable security or a unit in a collective investment undertaking as the standard delivery period or 5 trading days, whichever is shorter.

And goes on to specify…

A contract shall not be considered a spot contract where, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the currency is to be postponed and not to be performed within the period set out in the first subparagraph.

Recital 12 provides that non deliverable forwards, options and swaps on currencies are not spot contracts.
Changes introduced by MiFID II—Scope of obligations (cont.)

Article 10(1) also exempts any “derivative contracts relating to a currency” that are a means of commercial payment, in the following terms:

For the purposes of Section C (4) of Annex I to Directive 2014/65/EC, other derivative contracts relating to a currency shall not be a financial instrument where the contract is one of the following:

(a) a spot contract within the meaning of paragraph 2 of this Article,

(b) a means of payment that:

i. must be settled physically otherwise than by reason of a default or other termination event;

ii. is entered into by at least a person which is not a financial counterparty within the meaning of Article 2(8) of Regulation (EU) No. 648/2012 of the European Parliament and of the Council 19;

iii. is entered into in order to facilitate payment for identifiable goods, services or direct investment; and

iv. is not traded on a trading venue.
Changes introduced by MiFID II—
Scope of obligations (cont.)

Recital 10 of the Commission Delegated Act of 25.4.2016 offers further explanation:

*Foreign exchange contracts may also be used for the purpose of effecting payment and those contracts should not be considered financial instruments provided they are not traded on a trading venue. Therefore it is appropriate to consider as spot contracts those foreign exchange contracts that are used to effect payment for financial instruments where the settlement period for those contracts is more than 2 trading days and less than 5 trading days. It is also appropriate to consider as means of payments those foreign exchange contracts that are entered into for the purpose of achieving certainty about the level of payments for goods, services and real investment. This will result in excluding from the definition of financial instruments foreign exchange contracts entered into by non-financial firms receiving payments in foreign currency for exports of identifiable goods and services and non-financial firms making payments in foreign currency to import specific goods and services.*

In the UK the test for whether a foreign exchange contract is a spot or forward contract has been whether the contract is made for investment purposes or commercial purposes. The carve-out for “means of payments” contracts is largely intended to reflect the “commercial purposes” test but it may allow some contracts to fall within scope which were previously excluded. Other Member States may see greater changes to the scope of their investment service obligations since the definition of “spot” had not been harmonised.

NB. The “means of payment” exemption is only available for transactions with non-financial clients.
Changes introduced by MiFID II—
“Execution on behalf of clients”

Some instances of dealing on own account have been reclassified under MiFID II and now fall within scope of the best execution obligation to clients.

MiFID II, Article 4 definitions

5. “Execution of orders on behalf of clients” means acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients and includes the conclusion of agreements to sell financial instruments issued by an investment firm or a credit institution at the moment of their issuance;

Thus the sale to an investor of shares in a firm’s own capital is now the execution of a client order. Does a firm which enters into an interest rate swap as contractual counterparty thereby “conclude an agreement for the sale, at time of issuance, of a financial instrument issued by an investment firm? Probably.

MiFID II, Recital 24

24. Dealing on own account when executing client orders should include firms executing orders from different clients by matching them on a matched principal basis (back-to-back trading), which should be regarded as acting as principal and should be subject to the provisions of this Directive covering both the execution of orders on behalf of clients and dealing on own account.

Thus, facilitating simultaneous matched trades as intermediary is now covered by the best execution rules (as well as by the rules for dealing on own account).
Changes introduced by MiFID II—Transaction reporting by broker

Under MiFID I Article 25, the transaction reporting obligation applies only to firms trading in investments on Regulated Markets. Under Article 25(5) the obligations of firms may be waived where reports are provided by the venue, by third parties or by an approved “reporting system”. Thus, in the UK, under the current FCA rules, a “portfolio manager” is exempt where it has reasonable grounds to believe that the executing broker or other third party will report the transaction.

Under Article 26 MiFIR, the reporting obligation will be extended to instruments traded on a Multilateral Trading Facility (“MTF”) or Organised Trading Facility (“OTF”). ESMA has proposed that the number of reporting fields should be increased from 23 to 65.

The reporting obligation will also extend to all investment firms, subject to a narrower exemption in for transmitting orders in Article 26(4). This may apply to a fund manager transmitting an order on behalf of a fund, say. ESMA has proposed that the transmitting firm should be relieved from the reporting obligation only if certain conditions are met: (i) the information must have been sent to the receiving firm by the transmitting firm, (ii) the receiving firm must agree to make the report pursuant to written agreement with the transmitting firm, and (iii) the transmitting firm must have the systems and controls to ensure accurate and complete reports.

Firms have expressed concern about the scope of clients that Article 26(6) of MIFIR requires them to identify with a Legal Entity Identifier.
Changes introduced by MiFID II—
Transaction reporting by broker (cont)

Submission of reports

Under MiFID I Article 25(5), the transaction reporting obligation may be waived where reports are provided by the venue, by third parties or a trade repository. As we have seen, equivalent exemptions in MiFIR are much narrower.

Article 26(7) MiFIR permits a broker or other firm to rely on an Approved Reporting Mechanism (“ARM”) or the trading venue where the transaction was executed to submit a transaction report. This is not equivalent to an exemption or safe-harbour—the broker or firm retains responsibility for the completeness, accuracy and timely submission of the reports.

Location—branches

Where an EU firm operates in another EEA member state through a branch, the branch will be required to make transaction reports under Article 26 MiFIR and the responsibility for supervising this responsibility—and, one infers, receiving the reports—lies with the host state competent authority under MiFID II Article 38(5).

For third-country firms carrying out business in a particular Member State through a branch, host state authorisation is dependent (under Article 41 MiFID II) on compliance with the transaction reporting obligation in Article 26 MiFIR and monitoring and supervision of the obligation is the responsibility of the host state competent authority.
Changes introduced by MiFID II—Client order handling

In addition to rules on best execution, MiFID I also sets out rules, in Article 22, on client order handling, which are designed to guarantee the treatment received by the client’s order within the firm.

These remain largely unchanged in MiFID II…

Article 28

Client order handling rules

1. Member States shall require that investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm. Those procedures or arrangements shall allow for the execution of otherwise comparable client orders in accordance with the time of their reception by the investment firm.

2. [Provisions on client limit orders]

…but the scope of the obligation has been extended under Article 1(4)(b) so as to apply to firms selling or advising clients in relation to structured deposits.
Conclusion

- Conclusions
Appendix—Market structure

Four types of organised trading under MiFID II (see Article 4 definitions):

"regulated market" means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with Title III of [MiFID II];

"multilateral trading facility" or "MTF" means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of [MiFID II];

"organised trading facility" or "OTF" means a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of [MiFID II];

Unlike regulated markets and MTFs, operators of OTFs will a) have discretion as to how to execute orders, subject to pre-trade transparency and best execution obligations and b) be permitted to undertake matched principal trading with client consent.

"systematic internaliser" means an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system;

Unlike trading venues, a systematic internaliser can execute client transactions against its own proprietary capital.
Best Execution for Foreign Exchange Transactions: A U.S. Perspective

Jeff Lillien
Overview

• **Background:** “Best execution” is a concept that originated for equity securities and that has been applied across fixed income securities as well – taking into account product and market differences – but has not been a direct standard for foreign exchange or swaps under U.S. laws or regulations.

• **Core concept:** “Best execution” was developed by U.S. securities regulators as a standard to ensure fair execution of customer orders, and remains a core part of regulation of order handling. To accomplish fairness, dealers have a duty to obtain the most favorable terms for their customers so that the price obtained for the security that is the subject of the customer order is as favorable as possible under prevailing market conditions.
Standards Under U.S. Securities Regulations

• **Core Regulatory Standard:** FINRA Rule 5310 requires dealers to use “reasonable diligence” to ascertain the best market for execution of a customer order. One of the factors FINRA applies to determine if a member has used “reasonable diligence” is the accessibility of the quotation (whether quotations were available).

• **Measurement under the standard:** “Reasonable diligence” is a retrospective measure that depends upon specified factors. In fixed income markets, where there is no national market quotation system and price discovery remains fragmented, demonstrating reasonable diligence can present challenges. A dealer may have chosen to refrain from accessing a market where quotations might have been available for reasons that may be valid.

  – **Aggregate vs. individual order measurement:** While measurement has typically been on an aggregate basis over a specified period, going forward, there are proposals to require more granular review for block trades and internalized execution.
Execution Standards for OTC Products

- **CFTC:** As part of the implementation of Dodd-Frank, the CFTC considered the application of best execution standards to certain swaps. The CFTC’s proposed external business conduct rules included a duty to obtain the best possible result for swaps executed on certain organized markets – but the CFTC withdrew this proposal and omitted it from the final external business conduct rules.

- **Good faith Standard under Contract Law:** For financial products (other than securities) governed by N.Y. law, there is an implied contract law duty of good faith. For the purposes of order execution, this implied duty may be understood to require transparency and truthfulness, along with a responsibility to refrain from acting in a manner designed to materially disadvantage a counterparty.
Financial Markets Infrastructure and Financial Stability
CCP Recovery and Resolution

Chair: Jeff Lillien, Deutsche Bank (FMLG)

Barney Reynolds, Shearman & Sterling LLP (FMLC)
Financial Markets Infrastructure and Financial Stability
CCP Recovery and Resolution

Barney Reynolds, Partner, Shearman & Sterling LLP
Introduction

• Increased focus on CCP recovery and resolution due to mandatory clearing

• Key question - what happens if a CCP fails?

• Key concepts
  • **Recovery** – restore CCP to “balanced book” and resources to permit continued clearing operations
  • **Wind-down** – orderly termination of some / all clearing services by CCP outside of formal insolvency / resolution proceedings
  • **Resolution** – termination or transfer of activities in formal proceedings supervised by regulators / resolution authorities
Recovery
Risk Categories and Failure Scenarios

- Recovery plans should address the following risks and failure scenarios requiring use of recovery tools:
  
  - **Uncovered losses caused by participant default** – key risk for CCPs is credit risk of a participant
  
  - **Uncovered liquidity shortfalls** – liquidity shortfall due to participant default or default/failure of liquidity provider
  
  - **Losses from custody and investment risks** – risks due to custodial failure (e.g. insolvency, negligence, fraud etc.) and losses from decline in value of investments
  
  - **Losses from general business risk** – any other risks
Recovery
Managing Early Warnings

- CCPs can take steps to mitigate losses prior to and at the point of member default

<table>
<thead>
<tr>
<th>Action prior to default</th>
<th>Action at point of default</th>
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<tbody>
<tr>
<td>- Collateralisation (margin, default fund)</td>
<td>- Issue notice of default</td>
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<tr>
<td>- Stress tests to ensure the right amount of margin / default fund</td>
<td>- Activate default management committee</td>
</tr>
<tr>
<td>- Position limits</td>
<td>- Liquidate defaulter's collateral</td>
</tr>
<tr>
<td>- Information-gathering powers (e.g. financial information)</td>
<td>- Macro hedge</td>
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<tr>
<td></td>
<td>- Idiosyncratic hedge</td>
</tr>
<tr>
<td></td>
<td>- Liquidation sale, porting or auction</td>
</tr>
<tr>
<td></td>
<td>- Communicate details of and conduct default auction</td>
</tr>
</tbody>
</table>
Recovery
Initial Response to Default Event

• Goal is to return to a “matched book” by liquidating the defaulter’s portfolio and establishing new positions with clearing members using only funded resources.

• Resources are applied as follows:
Recovery
Overview of Recovery Tools

- CPMI-IOSCO sets out categories of recovery tools:
  
  - Allocate uncovered losses caused by participant default
  - Allocate losses not caused by participant default
  - Address uncovered liquidity shortfalls
  - Re-establish matched book following participant default
  - Replenish financial resources
Recovery
Recovery Tools – Allocation of Uncovered Losses

Allocate uncovered losses caused by participant default

- Cash calls/assessments
- Variation margin haircutting
- Use of initial margin
Recovery

Recovery Tools – Re-establish Matched Book

Re-establish matched book following participant default

- Forced allocation of contracts
- Contract termination: tear-up (complete, partial and voluntary)
Recovery

Recovery Tools – Uncovered Liquidity Shortfalls

Address uncovered liquidity shortfalls

- Obtain liquidity from third-party institutions
- Obtain liquidity from participants e.g. collateralised loans, repos, swap transactions
Recovery

Recovery Tools – Other Tools

- Replenish financial resources and allocation of losses not caused by participant default
  - Capital *e.g.* under EMIR

- Allocate losses not caused by participant default
- Allocate uncovered losses caused by participant default
- Re-establish matched book following participant default
- Address uncovered liquidity shortfalls
- Replenish financial resources
Wind-Down and Resolution

Summary of Wind-Down and Resolution

- Wind-Down:
  - Recovery plan and tools may not succeed
  - CCP should also have plans for winding-down operations in an orderly fashion:
    - Approach is equivalent to “complete tear-up”
    - Recapitalisation and restart can be considered
    - Possibility of winding-down certain business lines

- Resolution:
  - Overseen by regulator / resolution authority under applicable special resolution regime
  - May result in termination of all contracts / transfer of business to another entity or “bridge” entity
  - Cross-border considerations
  - Need for additional funding / resources for effective resolution?
Resolution
Process Flow of a Resolution

• Right to suspend clearing services in extremis e.g. when measures up to but not including termination of product set are insufficient
• Changes in IM and default fund payable but not new contracts / MTM
Recovery and Resolution
Current and Forthcoming Legislation

• EU Recovery and Resolution
  • Proposal for CCP recovery and resolution due end of 2016

• UK Recovery
  • Recognition Requirements for Investment Exchanges and Clearing Houses
    SI 2001/999: CCPs must have allocation rules for default / non-default losses and recovery plans

• UK Resolution
  • Banking Act 2009: special resolution regime for CCPs
  • Stabilisation options are transfer to: (i) private purchaser; (ii) bridge CCP; and (iii) any other person. Regulators likely to only use private purchaser
  • Regulators intend to apply CCP rulebook within the resolution framework and intervene when cash call option is available
Financial Markets Infrastructure and Financial Stability
The Concept of Financial Stability in EU Legislation

Chair: Jeff Lillien, Deutsche Bank (FMLG)

Inigo Arruga Oleaga, European Central Bank (EFMLG)
The concept of financial stability under EU Law

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Quadrilateral 2016, London 19-21 July
Recent EU financial legislation can be construed as leading to a negative definition of financial stability with a forward-looking element:

→ absence of financial distress (and prevention of financial distress)

- The definition legitimates conferrals of powers not only for the management and solution of a crisis, but also for the monitoring and assessment of the risks to the financial system in a preventive manner;

- For ECB and IMF, financial stability as a broad, more complex, concept (relationships among financial markets, infrastructures, institutions and macroeconomic dimension).

- In addition, in the EU legislation, there is the geographical dimension: financial stability of the single MS, the euro area or Union as a whole.
Primary Law

- Article 127 (1) TFEU: primary objective of ECB is price stability

- Article 127 (5) TFEU: ECB contributes to the stability of the financial system

- Amendment of Article 136 (3) TFEU: the establishment of a permanent stability mechanism without infringing Article 125 TFEU, safeguarding the stability of the euro area as a whole;

- Article 3 ESM Treaty: “… indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.”
Financial Legislation

- **Definition! SRMR, Article 10 (3):** threat to financial stability is “a situation where the financial system is ... exposed to a disruption that may give rise to financial distress liable to jeopardize the orderly functioning, efficiency and integrity ... of the financial system of one or more Member States”;

- **BRRD, Article 31 (2):** objective of resolution is to avoid a significant adverse effect on the financial system, especially by preventing contagion in relation to the Member State or the Union as a whole;

- **ESRB Regulation, Article 3(1):** macro-prudential oversight of the financial system within the Union ... to contribute to the prevention or mitigation of systemic risks to financial stability in the Union;

- **EBA Regulation, Article 1:** EBA’s main task is to “protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system...” (same applicable to all European Supervisory Authorities);
Capital Requirements

• CRD IV, Article 7: “The competent authorities in each Member State shall... duly consider the potential impact of their decisions on the stability of the financial system in the other Member States concerned...”

• CRR, Recital 76: “For the purposes of strengthening market discipline and enhancing financial stability it is necessary to introduce more detailed requirements for disclosure of the form and nature of regulatory capital...”
Work ahead

• A definition of financial stability which helps to the following: to capture the right amount of risks that the financial system can be exposed to.

• To what extent does the definition in the EU legislation help to this objective?
Developments in Sovereign Debt

Chair: Otto Heinz, European Central Bank (EFMLG)

Andrew Shutter, Clearly Gottlieb Steen & Hamilton LLP (FMLC)
David Beers, Bank of England (FMLC Guest)
Developments in Sovereign Debt

Andrew Shutter, Clearly Gottlieb Steen & Hamilton LLP (FMLC)
The views expressed are solely those of the author and cannot be taken to represent those of the Bank of England.
The Case for Issuing Sovereign State Contingent Instruments

Examples:
- Catastrophe (CAT) bonds – issued by Mexico, World Bank, commercial insurers
- Commodity price derivatives – Mexico, Chile, other commodity producers
- GDP linked warrants – issued by Greece, Argentina, Ukraine
- Automatic maturity extensions – Proposed by the IMF
- Automatic debt service suspensions – under discussion

Advantages:
- Can smooth volatility of public tax revenues.
- Can better align public debt service to fluctuations in capacity to pay.
- Can facilitate debt restructurings

Disadvantages:
- Existing instruments are bespoke (not standardized), some difficult to price, illiquid.
What are GDP-linked bonds?

• A bond where the interest coupon and final principal are both indexed to the level of nominal GDP.
• So when GDP falls, interest costs and accrued redemption principal also fall.
• And they also rise in step with rising nominal GDP, giving the instrument equity-like characteristics.
• GDP-linked bonds and other state-contingent instruments are natural complements:
  • The latter mostly tackle liquidity crises; while GDP-linked bonds help reduce likelihood of solvency crises.
• And GDP linkers differ strongly from existing GDP linked warrants -- the latter are bespoke add-ons in restructuring deals, are illiquid for that reason, and offer limited upside.
Key benefits of GDP-linked bonds

• Recession insurance for issuers
  – Extra fiscal space in a downturn
  – Do not replace need for sound fiscal policy, but help protect against shocks
  – Large issuance would reduce the likelihood of future sovereign debt crises

• A new equity-like instrument for investors
  – Potential cost-effective opportunities for regional, global diversification
  – Exposure to labour income, as well as corporate profits

• System-wide
  – Issuance on similar terms promotes liquidity, cross-border investment, as with conventional bonds
  – Greater international risk-sharing
  – Fewer, less costly contractual sovereign defaults and restructurings
  – Reduced reliance on international official sector financial support
Practical impediments to take-up and issuance

Some specific to the instrument’s design:

- Examples include GDP data quality and revisions, seniority vs. conventional bonds

Others relate to government bond markets generally:

- Innate conservatism of sovereign debt issuers and fixed income investors
- (Even broad adoption of inflation linked bonds took decades!)
- Post GFC low-for-long yields on conventional sovereign bonds
- And globally, the challenge of building consensus for collective government actions
The London Term Sheet: background


• More than a decade ago, related work by the UN and others identified the need to establish legal and technical standards by drafting a model term sheet.

• But no action was taken.

• In 2015, a small ad hoc group of Bank staff and market participants formed to do that work.

• The result is the London Term Sheet, published in Nov. 2015 and now being updated, which aims to:
  – Propose plausible and replicable terms governed, at least initially, under English law.
  – Make design choices that encourage a more focused debate on key issues.
  – Generate stronger awareness of GDP linkers among market participants and in the official sector.
London Term Sheet: Payment structure

- Semi-annual coupon and redemption principal indexed to GDP
- Index to level rather than growth of GDP
- Nominal not real GDP

**Indexation**

- \( \text{Index Ratio}_{\text{Date}} = \frac{\text{Ref GDP}_{\text{Date}}}{\text{Ref GDP}_{\text{Issue}}} \)

**Redemption (per 100 nominal domestic currency)**

- Redemption value = 100 × Index Ratio\(_{\text{Issue}}\)

**Interest (per 100 nominal domestic currency)**

- \( \text{Interest payment}_{\text{Dividend Date}} = \frac{c}{2} \times \text{Index Ratio}_{\text{Dividend Date}} \)
London Term Sheet: Other Key Terms

- Domestic currency - protects Issuer against exchange rate risk
- Term of 10+ years
- Data revisions - Interest and principal payments based on 6-month-lagged GDP data, with subsequent revisions ignored
- No call option - No early redemption by the issuer
- Negative pledge - Protects investors from the government creating new secured debt, subordinating their holdings
- Calculations - made by the issuer
- Major revisions – chain linking new series to old
- Alternative data providers – GDP as published by the central bank, or by the IMF, or 1.05 penalty x preceding GDP calculation
London Term Sheet: Other Key Terms, cont.

• Put events - issuer or issuer's central bank fails to publish GDP data by the agreed date (with grace period); IMF fails to publish an Article IV report for the issuer for two consecutive payment periods prior to calculation date; the issuer ceases to subscribe to the IMF's Special Data Dissemination Standard; IMF Executive Board issues a declaration of censure; issuer ceases to be member of the IMF.

• Default events - Failure to pay principal or interest on any GDP Bond (with grace periods); breach of covenants (with grace periods), excluding covenants relating to put event; cross default in respect of non payment of other "relevant indebtedness" or cross acceleration of any "relevant indebtedness"; declaration of a moratorium; repudiation or expropriation; laws preventing the issuer from performing its payment obligations.

• CACs – twin-limbed structure covering GDP linkers, excluding holdings by issuer and related parties, GDP warrants, and conventional bonds.
GDP linked bonds – progress so far, next steps

- Bank stakeholder meeting last November; workshop of UK-based CIOs in April; and bilateral meetings with London-based asset managers.

- Term sheet working group is finalising recommended instrument structure governed by both English and New York law that can be adapted by other jurisdictions.

- Engaging with industry bodies – ICMA, IIF, and EMTA – to gain their endorsements of the London term sheet later this year.

- Bank research on models to estimate price premia of linkers vs. conventionals.

- IMF staff study on GDP linkers, other state contingent debt, underway and goes to Board by year-end.

- GDP linkers on G20 agenda -- a report by GFA group due by year-end, and work looks set to continue under Germany’s presidency in 2017. The Bundesbank is organising a conference in late August.
Thank you
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For additional information on GDP linked bonds:
http://www.bankofengland.co.uk/research/Pages/conferences/301115.aspx