The Delta Report

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At a glance

Brexit update

As the contours of Brexit start to become clearer through the negotiations between the EU and the British Government and the release of position papers from the two parties, the potential impacts on London based financial institutions, participants in the derivatives market and – more generally – contract parties using English law governed agreements is likewise beginning to emerge. In this edition of the Delta Report, our Brexit review outlines some of the key developments that have taken place since July 2017, analyses the position papers issued by the British Government and the EU on the cross-border enforcement of civil judgments and also outlines some of the key issues that are beginning to emerge in derivative documentation negotiations as well as commenting on the potential impact on the derivatives market more generally.

On the end of LIBOR

Preliminary reflections on its implications for derivatives

Following the announcement by the Financial Conduct Authority that it will not compel panel banks to submit quotations to LIBOR, this paper analyses the impact it is likely to have on the derivatives market, the Benchmark Regulation and generally the main commercial and legal issues around the replacement of LIBOR.

MiFID II/MiFIR – Outlook into 2018

This article examines some of the key issues looking ahead to the MiFID II/MiFIR implementation start date on 3 January 2018.

Regulators begin Volcker Rule review, signaling potential for needed clarifications

On 2 August 2017, the Office of the Comptroller of the Currency ("**OCC**") issued a notice and request for public input ("**Request**")[1] on potential revisions to the implementing regulations for the Volcker Rule. The OCC's action represents a preliminary step by the financial regulators in providing Volcker Rule relief.

In this article we set out a brief summary of the Request. For a more detailed explanation, please see our client alert on the Request available here.

1 OCC, Proprietary Trading and Certain Interests in and Relationships with Covered Funds (Volcker Rule); Request for Public Input, 82 Fed. Reg. 36692 (Aug 7, 2017).

Brexit update

Nathaniel Crowley

Overview

In the July 2017 edition of the Delta Report, we provided a snapshot update on Brexit and set out some of the key issues that were beginning to emerge as relating to the regulatory framework for the derivatives market once the UK has formally exited the European Union ("**EU**")[2]. Since July 2017, a number of significant developments have occurred that have provided some further colour on the respective negotiating positions of the EU and the British government and a degree of insight into what the next steps are for the regulatory and legal framework impacting derivatives users. In this article, we consider these developments, their potential impact on the derivatives market in the coming year and highlight some of the issues that counterparties are already seeking to address when negotiating core documentation such as the ISDA Master Agreement.

Key Developments: Summer 2017

Following the formation of a new coalition government in June, three rounds of negotiations between the British government and the EU's representatives have been held, the final round of which concluded at the beginning of October 2017. The British government's strong desire, following the conclusion of such talks, was to move to discussing the future relationship between the UK and the EU, providing much needed clarity for, among others, the financial sector. In order to address some of the concerns raised by the EU that might have prevented negotiators approving a move to this next step, British PM Theresa May gave a speech in Florence on 22 September 2017 (the "**Florence Speech**"), which outlined some of the key positions of the British government including (i) the desire for an 'implementation period' of around two years from the exit date, (ii) payments into the EU budget and the ability of the UK courts to take into account judgments of the European Court of Justice (the "**ECJ**") during such period and (iii) offering certain guarantees around the rights of EU citizens. While generally welcomed for its constructive tone, on 3 October 2017, the European Parliament voted to approve the lead negotiators' view that there had not been *'sufficient progress'* on key issues such as the UK's existing and contingent liabilities to the EU, the rights of EU citizens and resolution of the border issue in Northern Ireland to move to the next phase of talks regarding future relations. However, the draft text for a recent summit of EU Member States (which took place in late October 2017) indicates some scope for consideration of transitional arrangements[3], agreement of which would greatly assist, among others, financial institutions concerned about the impact on their operations based in the UK should the UK exit the EU without an agreement in approximately 18 months' time.

Over the course of the recent rounds of talks, the British government has also issued a series of *'Position Papers'* and *'Future Partnership Papers'*. Key papers of note include those on *'Ongoing Union Judicial and administrative proceedings'*[4], *'Privileges and Immunities'*[5], *'Providing a cross-border civil judicial cooperation framework'*[6] and *'Enforcement and dispute resolution'*[7]. A summary of the key points for consideration for derivative market participants currently negotiating and with existing English law governed documentation is set out below. However, it remains difficult to predict with any certainty the likely route that will be taken in ensuring the continuity of current arrangements as relating to cross-border enforcement of English law judgments, the future role of the ECJ (on a short term and long term basis) and the impact on ongoing judicial proceedings as the shape of an agreement between the EU and UK is yet to emerge. Such uncertainty looks set to continue, given the EU's principle that "nothing is agreed until everything is agreed".

Choice of law, jurisdiction and enforcement of judgments

As noted above, one of the key papers published by the British government over the summer of 2017 was *'Providing a cross-border civil judicial cooperation framework'*. The paper published in response to a corresponding position paper published by the EU Commission entitled *'Judicial Cooperation in Civil and Commercial Matters'*[8].

In comparing the two papers, we note that the British government paper is broadly in alignment with the Commission's proposals in terms of separation issues where assuming no agreement on future relations between

2 At present, the UK will formally exit the EU on 29 March 2019, absent any agreed transitional arrangements.

3 https://uk.reuters.com/article/uk-britain-eu/eu-to-offer-may-hope-of-post-brexit-talks-at-summit-draft-text-idUKKBN1CH317

4 See document at link: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/627910/FINAL_OFF_SEN_Position_paper_HMG_Ongoing_Union_judicial_and_administrative_proceedings_Position_Papers_FINAL_120717__2___1_.pdf

5 See document at link: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/627908/FINAL_HMG_Privileges_and_immunities_Position_PapeR.pdf

6 See document at link: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/639271/Providing_a_cross-border_civil_judicial_cooperation_framework.pdf

7 See document at link: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/639609/Enforcement_and_dispute_resolution.pdf

8 See document at link: https://ec.europa.eu/commission/publications/position-paper-judicial-cooperation-civil-and-commercial-matters_en

the EU and the UK is reached. However, it is also wider in scope than the Commission's in that it posits what a future relations arrangement should include as well as noting certain key points that could be covered in a withdrawal agreement with EU. The comparison does offer some level of insight into what such a withdrawal agreement may contain (and therefore some indicative preliminary guidance for parties using (or seeking to negotiate) English law governed contracts. We would caveat this, however, by noting that the British government paper remains aspirational and generalist in nature as opposed to providing a set framework that it wishes to see adopted. A number of the posited future arrangements are also, in large part, dependent upon the consent of third parties (including the EU and individual Member States in the EU and EEA).

The key points in the paper are as follows:

- As consistent with the '*Repeal Bill'* which is currently making its way through the UK Parliament[9], the Rome I and Rome II Regulations[10] (the "**Regulations**") will be incorporated directly into UK law following repeal of the European Communities Act 1972. Upon the UK's exit from the EU, this should therefore mean that English courts (and those in the remaining EU member states) will be applying the same body of rules to determine the governing law of the relevant parties' relationship. The British government paper does not state how courts should interpret the Regulations post exit, but presumably, as per section 6(3) of the Withdrawal Bill, English courts (other than the UK Supreme Court) should apply EU law in accordance with retained case law and retained principles of EU law pre-dating the formal date of the UK's exit. Section 6(4) of the Withdrawal Bill states that the UK Supreme Court will not be so bound but it must apply the same test as it would apply in deciding to depart from its own case law. In respect of EU case law decided post the formal date of the UK's exit, the Withdrawal Bill is clear that UK courts may ignore such jurisprudence.
- The British government paper indicates that the UK will seek to continue to participate in the Lugano Convention[11], which itself contains reciprocal rules on jurisdiction and cross-border judgment enforcement between the EU and Norway, Switzerland and Iceland. The Lugano Convention is open to participation by sovereign states that are or become members of the European Free Trade Association (EFTA) and also by other sovereign states. Other states wishing to accede can, however, only do so with the unanimous agreement of the existing signatories to the convention. Even assuming that consent is provided, we would view it as likely that there will be a gap between the UK's formal date of exit and formal accession to the Lugano Convention, particularly if the formal date of exit remains March 2019. Likewise, the Lugano Convention does not provide (unlike the Regulations) that where proceedings are commenced in a EU Member State court in breach of an exclusive jurisdiction clause, the EU Member State court is required to stay its proceedings to allow the chosen court to rule on jurisdiction (which may well lead to increased delay). Adoption of this position by the British government is, however, significant given Lugano Convention members are required to *'pay due account to'* ECJ rulings, something that the British government has previously indicated would not be acceptable (although during the Florence Speech, a softening of this position was also eluded to).[12]
- The paper also indicates that the UK intends to participate in the Hague Convention on Choice of Court Agreements 2005 (the "**Convention**") which sets out jurisdiction and cross-border enforcement rules where there is an exclusive choice of court agreement. The UK is currently a party to the Hague Convention by virtue of its EU membership, as are all EU Member States. Further, the UK will be free to accede to the Convention without the need for the consent of other parties. However, it will likely only apply to agreements made after the UK accedes to the Convention in its own right. Such arrangement in itself would, while welcome, also be inferior to the current enforcement regime under the Regulations. For example, the Hague Convention requires each contracting state to designate a 'Central Authority' to receive and execute requests for service originating in other contracting state; a process likely to be slower than service pursuant to the Regulations.
- With regards to enforcement of judgments between the UK and the remaining EU Member States following the UK's exit, the paper does not otherwise provide any specific proposals. The paper states only that it is the government's intention that a future framework will be agreed *"which reflects closely the substantive principles of cooperation under the current EU framework"*. This is obviously not something that is within the complete control of the UK given it requires an actual agreement with the EU. Should the UK leave the EU with no such agreement in place (and assuming consent to the Lugano Convention was not

9 For further detail, please see the July edition of the Delta Report. The bill is now formally known as the European Union (Withdrawal) Bill 2017 (the "**Withdrawal Bill**")

10 Such regulations cover choice of law and applicable law in contractual and non-contractual matters

11 See document at link: http://ec.europa.eu/world/agreements/prepareCreateTreatiesWorkspace/treatiesGeneralData.do?redirect=true&treatyId=7481

12 See PM Theresa May's 'Lancaster House Speech' in October 2016

forthcoming), the enforcement of English law judgments in EU member states could become much less streamlined than is the case at present under the Regulations.

- In the event that no agreement is reached with the EU, contract parties who have existing or soon to be concluded English law governed agreements subject to the jurisdiction of the English courts should note, for the moment, that the existing EU rules: (i) should continue to apply to judicial decisions made before the UK's formal exit date and to proceedings instituted before that date, (ii) on applicable law for contractual and – based on the UK Government's indications – non-contractual obligations should continue to apply to contractual agreements that have been concluded before the formal exit date and (iii) where a choice of court has been made prior to the formal exit date, the current rules should continue to apply to the establishment of jurisdiction and recognition and enforcement of any resulting judicial decision, albeit that there remains some uncertainty as to the precise position that will apply in respect of jurisdiction over claims and enforcement proceedings that post-date the formal exit date.
- Regarding the longer term arrangements, further clarity is still needed, although as a general principle, the UK appears to be looking to replicate its existing arrangements (albeit without the directly applicable recourse to the ECJ that is currently available along with the obligation to apply its jurisprudence). For parties negotiating English law governed agreements at present, the issue to be considered is really whether the ability to quickly and easily enforce a UK judgment across EU Member States or a judgment given in an EU Member State in the UK) is a key aspect in the decision as to which court should have jurisdiction. If enforcement without delay across EU Member States is a key factor, then the differences between the EU and the UK positions could lead to some uncertainty, requiring more detailed jurisdiction-specific consideration than jurisdiction provisions have previously been accorded.

Issues emerging in core derivatives documentation negotiation

Given the widespread assumption until very recently that the UK and EU would reach an agreement on a form of transitional arrangement, the need to consider further amendments in English law governed derivatives documentation has been limited. However, given the pace at which negotiations between the EU and UK have progressed, it is becoming apparent that a number of counterparties are preparing, in their documentation, for a scenario in which the UK exits the EU without an arrangement that broadly preserves the status quo in the near future. Some key examples of this are as follows:

- We have noted an increasing number of queries around the jurisdiction clause in the ISDA Master Agreement and whether parties should be looking to amend Section 13 (*Governing law and Jurisdiction*). Given the uncertainty around future arrangements, parties have broadly continued to opt for the status quo, however, certain counterparties have considered (i) inserting a fully exclusive jurisdiction clause that dispenses with the current references to European legislation, (ii) inserting an arbitration clause which would be unaffected by the UK's withdrawal from the EU, or (iii) inserting a fully non-exclusive jurisdiction clause which would also remove any uncertainty as to exclusivity/non-exclusivity in the EU and gives parties a full range of options as to where to bring proceedings.
- We are also starting to see requests to incorporate the ISDA 2015 Universal Resolution Stay Protocol (as published by the International Swaps and Derivatives Association, Inc. on 4 November 2015)[13] which allows for the contractual recognition of cross-border application of special resolution regimes, into the ISDA Master Agreement given that the UK will upon exit become a 'third country' for the purposes of the Bank Resolution and Recovery Directive (and as is mandated by Article 55 of the same)[14].
- We have seen a much deeper analysis given by counterparties in negotiations of certain representations (e.g. Section 3(a)(iii) (*No violation or Conflict*) or Section 3(a)(iv) (*Consents*)), termination events (*Force Majeure and Illegality*) and events of default (*Breach of Agreement*) in the ISDA Master Agreement.

Potential impact on the derivatives market more generally

As noted in our July 2017 article on Brexit in the Delta Report, with regards to the derivatives market, attention thus far has focused on the future role of clearing houses and the indications by the EU that it intends to mandate clearing of euro denominated derivatives to be conducted within the

13 https://www2.isda.org/functional-areas/protocol-management/protocol/22

14 Directive 2014/59/Eu of the European Parliament and of the Council of 15 May 2014

geographical confines of the EU. However, given a large portion of derivative contracts are still conducted over-the-counter and, in the event of the UK exiting the EU without an agreement (and therefore the loss of passporting rights that allow financial institutions to conduct business, including entry into derivative contracts, across the EU), this could present issues both for the signing of new derivative contracts and for existing contracts. While existing contracts would have been entered into prior to the UK's exit date, regularly conducted exercises such as compression (where some (or all) offsetting contracts are terminated to be replaced with a new contract), novations to another counterparty or even 're-setting' of trade terms could constitute 'regulated activities' that a UK based financial institution may no longer be authorised to conduct in the EU.

As such, if portfolios of legacy trades remain in the UK upon the date of exit, counterparties may be prevented from making the day-to-day adjustments that are common practice in the market where there is a contractual nexus with an EU based entity.

Solutions to such issues are not readily apparent. One that is oft-cited is that counterparties could look to novate legacy trades to a legal entity within the EU. However, this approach has two major shortcomings in that: (i) such legacy trades may then become subject to clearing or margining requirements pursuant to the European Market Infrastructure Regulation[15] (to the extent they have not already been subjected to such requirements) and (ii) this would also require the novating counterparty to have a suitable entity based within the EU to novate the trades to. While less of an issue for end-users of derivatives, for financial institutions, the requirements around novations may prove extremely challenging in view of the timeframe left prior to the UK's exit date and the apparent resistance of EU regulators to such entity being of a 'brass plaque' nature.

On the latter point, on 12 October 2017, the European Banking Authority provided guidance on certain issues related to the UK's departure from the EU[16] and emphasised that institutions lining up to be authorised who are seeking to implement 'post-Brexit' arrangements should have a proper risk management function based in the relevant EU member state and sufficient capital held in such member state to cover the entity including where it is looking to book 'back-to-back trades' with one of its other group entities based outside the EU (i.e. in the UK).

Clearly such requirements (and the other issues mentioned above) will prove extremely challenging to address in the time left prior the UK's exit date, again assuming that no transitional arrangements are agreed. We are actively working with clients to consider the potential impact of these issues on their existing portfolios and future trading arrangements.

On the end of LIBOR

Preliminary reflections on its implications for derivatives

Eduardo Barrachina

Background and how the London Interbank Offered Rate ("LIBOR") works

The financial crisis brought considerable changes to the entire financial regulatory environment and the way many financial instruments, especially derivatives, are traded. It also impacted LIBOR. LIBOR is an unsecured interbank rate used in the London lending and borrowing market. In 2012, regulatory investigations began to reveal manipulation of published LIBOR rates. This prompted a regulatory debate on benchmarks and the related regulatory and legal developments.

ICE LIBOR (formerly known as BBA LIBOR) is a benchmark rate produced for five currencies[17] with seven maturities quoted for each, ranging from overnight to 12 months, producing 35 rates each business day.[18] It is administered by ICE Benchmark Administration ("**IBA**"), the entity that took over the administration of LIBOR in 2014 (the "**Libor Administrator**"). There has traditionally been an element of subjectivity in LIBOR. For example, a panel bank may not necessarily have borrowed in the full spectrum of LIBOR maturities, which leaves room to estimate data. Furthermore, if, on a given day, a panel bank has not borrowed in a particular LIBOR currency, it would have to draw upon different data to produce the rate. Since the crisis, interbank lending has reduced considerably and thus has become less liquid.

On 27 July 2017, Andrew Bailey, Chief Executive of the Financial Conduct Authority (the "**FCA**"), announced that, by the end of 2021, the FCA will not use its legal powers to compel or persuade banks to submit to LIBOR.[19] The reason

15 http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32012R0648

16 http://www.eba.europa.eu/documents/10180/1756362/EBA+Opinion+on+Brexit+Issues+%28EBA-Op-2017-12%29.pdf

17 These include the Swiss Franc, Euro, Pound Sterling, Japanese Yen and US Dollar

18 ICE LIBOR provides an indication of the average rate at which a LIBOR contributor bank can obtain unsecured funding in the London interbank market for a given period, in a given currency. Essentially, each bank estimates how much it would cost to it to borrow money on that particular day. Individual ICE LIBOR rates are the end-product of a calculation based upon submissions from LIBOR contributor banks. The LIBOR administration maintains a reference panel of between 11 and 17 contributor banks for each of the calculated currencies. Further information available at: https://www.theice.com/iba/libor

19 Available at: https://www.fca.org.uk/news/speeches/the-future-of-libor

behind this decision is that banks are not comfortable providing submissions to LIBOR where there are only few eligible term borrowing transactions by large banks.[20] Mr Bailey described this situation as "potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them".[21] This does not necessarily mean that LIBOR will be discontinued. In fact, it is understood that the LIBOR Administrator has indicated its intention to continue producing LIBOR[22] although, as mentioned earlier, the FCA will no longer compel any bank to make submissions; as such, there is a material risk that LIBOR will not continue in its current shape.

Given the interconnectivity of the bond and derivatives markets, following industry working groups, it is anticipated that bond markets will be guided by the International Swaps & Derivatives Association, Inc. ("**ISDA**") guidelines on fallbacks. This will ensure matching cash flows between bonds and derivatives. The pricing of many financial instruments depends on the accuracy and integrity of benchmarks. LIBOR rates have become widely referenced in major interest rate derivatives such as swaps, options and forwards. It is calculated that up to US$500 trillion of swaps rely on market indices. Since LIBOR will not be discontinued, it is unclear how many participants will cease using it. However, following responses from market participants to a questionnaire conducted by ISDA, it would appear that market participants endorse the Sterling Overnight Index Average ("**SONIA**"), an alternative benchmark to LIBOR.[23]

Market participants may, therefore, need to rely on alternative benchmark arrangements. The cessation of market-wide usage of LIBOR will obviously affect derivative contracts that rely on LIBOR as well as derivative contracts that rely, for example, on the 2006 ISDA Definitions (the "**2006 Definitions**") as published by ISDA. The 2006 Definitions provide for a set of definitions that are commonly incorporated into the trading terms for interest rate swap transactions. Other sets of definitions which also reference LIBOR include, but are not limited to, the 2002 ISDA Equity Definitions, 1998 Currency and FX Definitions and the 2005 ISDA Commodity Definitions, each as published by ISDA.

The Benchmark Regulation

The Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 (the "**BMR**"), which came into force on 30 June 2016, will apply from 1 January 2018. It is a direct consequence of the previous investigations into LIBOR and constitutes the legislative response of the European Union ("**EU**") to remove any uncertainty regarding the objectivity of LIBOR and other benchmarks. The BMR lays down a new harmonised regulatory framework that imposes conditions on benchmark contributors and administrators. To date, administrators and users of benchmarks have been subject to different rules in different EU Member States. As with all EU regulations, the BMR will have direct effect and will directly impose obligations on persons involved in the provision, contribution and use of benchmarks across the EU. It will not need to be implemented by individual EU Member States.

A "benchmark" is defined under the BMR as:

> *"Any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument, is determined, or an index that is used to measure the performance of an investment fund with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees".*[24]

An "index" is broadly defined as any figure which is:

(a) published or made available to the public; and

(b) regularly determined entirely or partially by the application of a formula or any other method of calculation, or by an assessment, and on the basis of the value of one or more underlying assets or prices including estimated prices, actual or estimated interest rates, quotes and committed quotes or other values or surveys."

Article 28(2) of the BMR sets out the general framework in the event that a benchmark materially changes or ceases to be provided:

> *"Supervised entities other than an administrator as referred to in paragraph 1 that use a benchmark shall produce and maintain robust written plans setting out the actions that they would take in the event that a*

20 Data provided by the LIBOR Administrator in the 2Q 2017 showed that the 5 benchmarks of LIBOR rely materially on market data and not on transaction data. Available at: https://www.theice.com/publicdocs/ICE_LIBOR_Quarterly_Volume_Report_Q2_2017.pdf

21 Please see footnote 19

22 Financial News, 11 August 2017. Available at: https://www.fnlondon.com/articles/ice-benchmark-chief-libor-is-not-dead-20170811

23 ISDA response to the Bank of England Working Group on Sterling Risk-Free Reference Rates White Paper: SONIA as the RFR and approaches to adoption, 29 September 2017 (not available as a link, as at the date of this Report)

24 Article 3(3) BMR

benchmark materially changes or ceases to be provided. Where feasible and appropriate, such plans shall nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. The supervised entities shall, upon request, provide the relevant competent authority with those plans and any updates and shall reflect them in the contractual relationship with clients."

The scope of Article 28(2) is limited to establishing the obligation on supervised entities to maintain contingency plans in the event that a benchmark materially changes or ceases to be provided. This obligation falls on supervised entities that use a benchmark. *"Use of a benchmark"* is defined in Article 3(1)(7) of the BMR in broad terms to include the following situations:

(a) issuance of a financial instrument which references an index or a combination of indices;

(b) determination of the amount payable under a financial instrument or a financial contract by referencing an index or a combination of indices;

(c) being a party to a financial contract which references an index or a combination of indices;

(d) providing a borrowing rate,[25] as defined in point (j) of Article 3 of Directive 2008/48/EC, calculated as a spread or mark-up over an index or a combination of indices and that is solely used as a reference in a financial contract to which the creditor is a party; and

(e) measuring the performance of an investment fund through an index or a combination of indices for the purpose of tracking the return of such index or combination of indices, of defining the asset allocation of a portfolio or of computing the performance fees.

As with other pieces of European legislation, a list of Questions & Answers has been published, albeit no questions on Article 28 have been raised to date.[26] In respect of subparagraph (b) above, it is not entirely clear what "*use of a benchmark*" will mean in the context of derivatives. The European and Securities Market Authority ("**ESMA**") has confirmed that the following will be considered supervised entities using a benchmark:[27]

(a) a trading venue, where the derivative is the subject for a request for admission to trading on such trading venue or is traded on such trading venue, to the extent terms of such trading venue specified a benchmark;

(b) an investment firm acting in the capacity of a systematic internaliser to the extent the terms of such internaliser specified a benchmark;

(c) a CCP, where the derivatives is cleared by such CCP to the extent the terms of such CCP specified a benchmark; and

(d) each party to a transaction of a derivative where none of (a) to (c) above applies.

Following this clarification there is no doubt that parties to a derivative transaction will be categorised as parties that use a benchmark.

It is important to highlight that Article 28(2) requires that any actions included in the contingency plans contemplate two triggers: (a) if a benchmark changes materially; or (b) if it ceases to be provided. It follows that any BMR-compliant fallback will have to expressly include these two triggers. It will not always be the case that current fallbacks under the different sets of definitions have these two triggers. These plans, which will be triggered by any of these two events, will have to be robust. ISDA has conducted a thorough review of the 2016 Definitions to establish whether the current fallbacks include these two triggers and the result indicates that amendments will be required.

Replacement of LIBOR

In the last few years, regulators, working groups of industry organisations and market participants have discussed how to effect the change from the existing LIBOR to a different benchmark. In particular, the Financial Stability Board (the "**FSB**") conducted a major review (the "**FSB Review**") of the major interest rate benchmarks which resulted in a report in which set out its recommendations.[28] In its review, the FSB noted that "shifting a material proportion of derivative transactions to a risk-free rate would reduce the incentive to manipulate rates that include bank credit risk and would reduce the risks to bank safety and soundness and to overall financial stability".[29]

25 This is defined as: "the interest rate expressed as a fixed or variable percentage applied on an annual basis to the amount of credit drawn down".

26 Questions and Answers on the Benchmark Regulation (BMR), last update 29 September 2017. Available at: https://www.esma.europa.eu/press-news/esma-news/esma-publishes-benchmarks-regulation-qa-transitional-provisions

27 Questions and Answers on the Benchmark Regulation (BMR), Q5.2

28 Available at: http://www.fsb.org/wp-content/uploads/r_140722.pdf

29 FSB Review, page 11

Following its meeting on 7 April 2017, each member firm of a working group set up by the Bank of England (the "**BoE**") to examine alternatives for LIBOR voted on its preferred near risk-free reference rate ("**RFR**").[30] On 28 April 2017, the BoE proposed[31] the replacement of LIBOR with SONIA, whose administrator is the BoE itself. Created in 1997, it reflects overnight funding rates in the Sterling unsecured market. SONIA is an overnight unsecured rate which is currently been reformed by the BoE and which has not yet been published. In principle, it is anticipated that SONIA will move to a new basis by April 2018.[32]

The BoE is currently working towards the adoption of SONIA as an alternative to Sterling LIBOR and in principle, the adoption strategy will have three strands: (a) development of interest rate derivative products referencing SONIA; (b) seeking feedback on the potential use of SONIA in instruments other than interest rate derivatives; and (c) discussion on the conversion of existing LIBOR contracts to reference SONIA.[33]

The BoE preferred reformed SONIA to the two available secured overnight rate candidate RFRs – the Sterling Repo Index Rate or Sterling SONET – since their collective assessment was that it best met the selection criteria.[34]

How is this likely to affect derivative documents?

The challenging question is how existing definitions of LIBOR will operate when the replacement occurs. ISDA has established a working group to lead discussions and propose changes. The BMR acknowledges that the cessation of the administration of a critical benchmark by an administrator could render financial contracts or financial instruments invalid, cause losses to consumers and investors, and impact financial stability.[35]

LIBOR is included as a benchmark in the 2006 Definitions which also contain fallback provisions to the benchmarks that will cease to continue. However, it is not clear whether a fallback benchmark may meet the criteria recommended by the FSB the Principles for Financial Benchmarks published by IOSCO on 16 April 2013 (the "**Principles**").[36] In particular, Principle 13 thereof requires procedures to be followed if a benchmark is discontinued.

ISDA is currently working on the necessary amendments to certain definitions of the different sets of ISDA definitions, most notably the 2006 Definitions. The strategy has three limbs and will aim to: (a) design fallback mechanisms in the event that LIBOR is permanently discontinued; (b) consider amendments to the 2006 ISDA Definitions to add additional fallbacks; and (c) discuss amendment of legacy contracts. Currently, market participants can rely on the existing fallbacks contained in the 2006 Definitions. For example, the parties can rely on the default fallback for LIBOR which, following a request for quotations by the party acting as calculation agent, will consist of the determination by four major banks of the London interbank market.

In respect of legacy trades, ISDA has warned that *"switching the reference rate for existing transactions would likely result in shifts in valuations, which could be disruptive to the market."*[37] There have been suggestions of a protocol published by ISDA to help firms alter their legacy contracts to incorporate the fallbacks in an efficient way. Separately, in his speech, Mr. Bailey queried *"whether the better approach to transition would be to amend contracts to reference an alternative rate, or amend the definition of LIBOR through the fallback protocol to replace the current methodology with alternative reference rates."*[38] This is a question which is still being considered by the market, particularly ISDA, and which may eventually involve a protocol.

Conclusions

Pursuant to the BMR, it is obvious that market participants will have to select a replacement benchmark and design replacement mechanics that work smoothly. Following the BoE's endorsement and the latest ISDA survey, there seems to be a developing consensus that SONIA will be the replacement benchmark. However, a benchmark in respect of Sterling is only a contractual term and this will be a voluntary process. There is a risk of market fragmentation if a majority of market participants fail to adhere to a universal benchmark rate.

30 The other two overnight RFRs were Sterling SONET, and Sterling Repo Index Rate (RIR)

31 Bank of England Press Release, 28 April 2017. Available at: http://www.bankofengland.co.uk/publications/Documents/news/2017/033.pdf

32 Bank of England, http://www.bankofengland.co.uk/markets/Pages/benchmarks/soniareform.aspx

33 The Working Group on Sterling Risk-Free Reference Rates, SONIA as RFR and Approaches to Adoption, June 2017. Available at: http://www.bankofengland.co.uk/markets/Documents/sterlingoperations/rfr/rfrwgwhitepaper0617.pdf

34 SONIA as RFR and Approaches to Adoption, page 1

35 BMR, Recital 37

36 Available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf

37 Benchmark Transition Plans will be Critical, 29 June 2017. Available at: http://isda.derivativiews.org/2017/06/29/benchmark-transition-plans-will-be-critical/

38 Please see footnote 19

MiFID II/MiFIR – Outlook into 2018

Richard Blackburn

Commodity Position Limits (Article 57 of MiFID II/RTS 21)

- **28 September 2017** – ESMA and the national competent authorities ("**NCAs**") published an updated work plan for the opinions on pre-trade transparency waivers and position limits that are to be issued under MiFID II and MiFIR.
- MiFID II requires ESMA to publish opinions on the position limits notified by NCAs for commodity derivative contracts, the compatibility of the limits proposed with MiFID II and the methodology set out in RTS 21[39].
- Since ESMA has announced that it will not be able to finalise and publish all the position limit opinions for liquid commodity derivative contracts by the end of 2017 and since MiFID II does not contain any transitional provisions, ESMA and the NCAs have agreed that NCAs will publish limits ahead of the publication of any opinions by ESMA.
- The position limits published by the NCAs will enter into force on 3 January 2018. However, the NCAs will modify their position limits following the publication of the relevant opinions by EMSA so as to conform those limits with such opinion, or otherwise provide ESMA with a justification for why the changes are not necessary.
- **10 August 2017** – ESMA has published only three opinions so far, which agree with position limits proposed by the Autorité des Marchés Financiers (AMF) relating to (i) rapeseed; (ii) corn; and (iii) milling wheat. No further opinions have been published to date.
- **26 October 2017**
  - The FCA has set certain commodity position limits for specific contracts, as listed on the following web page: https://www.fca.org.uk/markets/mifid-ii/commodity-derivatives/position-limits
  - Any other commodity derivatives traded on a UK trading venue which are not specifically identified in the table mentioned above on the FCA website will have a limit of 2,500 lots, unless the position limit is set by another competent authority in another Member State.

Trading Obligation (Articles 28 & 32 of MiFIR/draft RTS)

- **29 September 2017** – ESMA issued its final report and submitted a final draft to the European Commission of RTS for implementing the trading obligation for derivatives under MiFIR[40].
- **17 November 2017** – The European Commission published its form of RTS on the trading obligation for derivatives[41]. The European Parliament and Council are now required to scrutinise the draft RTS. The period for scrutiny is one month however this is also extendable by a further month. The RTS are broadly similar to those proposed by ESMA.
- **Draft RTS**
  - **Classes of derivatives subject to Trading Obligation:** The draft RTS specify that the following fixed-to-float IRS and CDS indices would be subject to on-venue trading:
    - Fixed-to-float interest rate swaps denominated in EUR;
    - Fixed-to-float interest rate swaps denominated in USD;
    - Fixed-to-float interest rate swaps denominated in GBP; and
    - Index CDS – iTraxx Europe Main and iTraxx Europe Crossover.

Regulators begin Volcker Rule review, signaling potential for needed clarifications

Kevin Petrasic, Duane Wall, Glen Cuccinello

Background

Broadly, the Volcker Rule prevents insured depository institutions, their parent holding companies and foreign banks that have US subsidiary banks or US banking offices, as well as the affiliates or subsidiaries of any of the foregoing, from (i) engaging in "proprietary trading" in securities, derivatives or commodities futures contracts and options on futures contracts, (ii) acquiring or retaining any equity, partnership or other ownership interest in hedge funds or private equity funds, or (iii) sponsoring such funds. The Volcker Rule regulations were jointly issued by five federal regulators – the OCC, the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the

39 Commission Delegated Regulation (EU) 2017/591 of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits to commodity derivatives

40 https://www.esma.europa.eu/sites/default/files/library/esma70-156-227_final_report_trading_obligation_derivatives.pdf

41 https://ec.europa.eu/info/law/markets-financial-instruments-mifir-regulation-eu-no-600-2014/amending-and-supplementary-acts/implementing-and-delegated-acts_en

Federal Deposit Insurance Corporation and the Securities and Exchange Commission (together, the "**Agencies**"). As such, any changes to the Volcker Rule regulations would require joint action by the Agencies. Nonetheless, the issuance of the Request by the OCC appears to be an effort to pave the way for a rewrite or clarification of at least some discrete sections of the Volcker Rule regulations. Comments to the Request were requested by 21 September 2017.

Particular Areas of Focus

In recognition that the term "Volcker Rule" is commonly used to refer to both the statutory provisions included in the Dodd-Frank Act and the implementing regulations, the OCC specifies in the Request that it is "not requesting comment on changes to the underlying Volcker statute" but rather only those changes that could be implemented through action at the regulatory level. The Request notes that many banking entities find the Volcker Rule regulations to be "overly complex and vague" such that it is at times difficult to distinguish if particular trading or fund activity is permitted or prohibited under the regulations, as well as being overly broad in terms of the trading and fund activities that are subject to the Volcker Rule's prohibitions. The Request did not propose any specific changes to the existing Volcker Rule regulations, but rather included questions seeking public comment on various aspects of the regulations. The Request identified the following topics as being of particular interest to the OCC.

1. **Scope of Entities Subject to the Volcker Rule.** The OCC recognised that the Volcker Rule definition of banking entity captures entities that may not pose a systemic risk concern or that do not engage in the types of activities that present the type of risk that the Volcker Rule was designed to restrict (e.g., foreign subsidiaries of foreign banking entities). The Request sought comment on how the banking entity definition in the Volcker Rule regulations could be refined to include exemptions for these entities and others in a manner consistent with the purposes of the Volcker Rule and the statutory definition of banking entity.

2. **Proprietary Trading Prohibition**. The Request noted that complying with the short-term trading prong of the trading account definition in the Volcker Rule regulations presents a significant compliance burden for banking entities. It further noted that the rebuttable presumption in the regulations that positions held for fewer than 60 days fall within this prong covers trades not intended to be covered by the proprietary trading prohibition. The Request sought public comment as to whether the rebuttable presumption should be eliminated or how it could be changed, including whether a reverse presumption should be adopted to make clear that positions held for 60 days or more are not proprietary trading. The Request also asked for comment on how the requirements for permissible trading activities in the Volcker Rule regulations could be revised to make compliance less burdensome, as well as whether other types of trading activities should be permissible under the Volcker Rule.

3. **Covered Fund Prohibition.** The OCC recognised that defining a "covered fund" (which is the term used in the Volcker Rule regulations for hedge funds and private equity funds subject to the covered fund prohibition) by reference to certain exemptions in the US Investment Company Act may have resulted in capturing issuers that were not intended to be covered by the Volcker Rule. The Request asked for comment on whether replacing the US Investment Company Act references with a definition of covered fund focusing on the particular characteristics of hedge funds and private equity funds would yield a less burdensome alternative. The Request also sought comment on whether additional categories of transactions or relationships between banking entities and covered funds should be permitted under the Super 23A prohibition of the Volcker Rule.

4. **Compliance Program and Metrics Reporting Requirements.** The OCC acknowledged that smaller banking entities and those not engaged in significant levels of trading and fund activities have indicated that even the simplified compliance program available to smaller institutions under the Volcker Rule regulations presents a substantial compliance burden. The Request asked whether there are any categories of entities for which the compliance program requirements should be reduced or eliminated. Finally, the Request sought comment on the effectiveness of current metrics for measuring compliance and the ways in which technology-based systems used by banking entities could be incorporated into Volcker Rule compliance.

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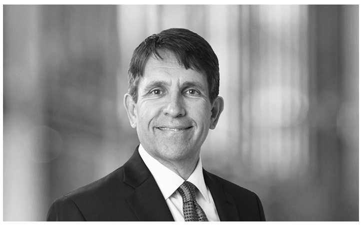

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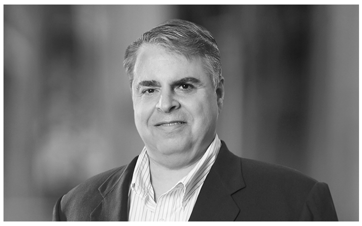

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