Structural Change on the Horizon: Brexit and Benchmarks

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BREXIT – WHERE ARE WE NOW?

23 June 2016: Referendum

29 March 2017: Article 50-procedure started

22 May 2017: EC appointed as negotiator on behalf of EU

8 December 2017: Agreement between EU and UK on conditions Brexit process

19 March 2018: Agreement between EU and UK on transition period Brexit

30 March 2019: UK leaves EU

Transition period until 31 December 2020

1 January 2021: End of transition period – new relationship between UK and EU
TRANSITION PERIOD

- EU law remains applicable in UK
- EU courts continue to have jurisdiction
- UK does not participate in decision making of EU
- UK does not enter into trade agreements for transition period without EU approval
IMPLICATIONS FOR EUROPEAN PASSPORTS

Point of departure hard Brexit:

- No European passports from and to UK

EU to UK:

- Incoming passports valid during transition period
- Thereafter license or equivalence required

UK to EU

- No assurances for transition period
- UK firm must apply for license in EU Member State. License can be passported

Limited exceptions possible – following equivalence decision (Art. 46 – 47 MiFIR)

- MiFID-services to professional clients and eligible counterparties
IMPLICATIONS FOR EU FIRMS

**Services provided by UK financial undertakings**

- ISDA MA with UK investment bank: client relationship?
- Prime Brokerage: MiFiD service?
- Equivalence under UK law for services to professional clients?

**UK Subsidiaries**

- Services to other member states

**UK Products**

- Investment funds
- Financial instruments / structured products
IMPLICATIONS FOR TRANSACTIONS - TRADING

**Shares**
- Art. 23 MiFIR: Trading obligation for investment firms
- Regulated market, MTF, OTF or equivalent platform

**Derivatives**
- Art. 28 MiFIR: trading obligation for derivatives
- Regulated market, MTF, OTF or equivalent platform

**UK platforms**
- Not assessed as equivalent yet
- Equivalence uncertain
- Move trading to EU platform?
IMPLICATIONS FOR TRANSACTIONS – CLEARING

Clearing obligation

- Article 4 EMIR:
- OTC derivatives transaction for which a clearing obligation applies
- CCP with a license or recognised as third-country CCP

UK CCP

- Not recognised as third-country CCP yet
- EU firms no longer allowed to clear via UK CCP
- Higher risk weighting for positions of EU banks in CCP (20% instead of 2%/4%)
- Transfer of positions to EU CCP – or equivalent CCP?

EMIR II

- More powers to ESMA
- More stringent requirements on third-country CCPs
IMPACT ON CONTRACTS

Choice of law
Choice of forum

Recognition and enforcement of judgments

BRRD: Art. 55

ISDA MA governed by French or Irish law?
BREXIT – TAKE AWAYS

- Providing financial services in UK?
- Providing financial services from UK?
- Assess important contracts with UK counterparties
- Measures concerning trading and clearing
- Monitor developments in equivalence
- Check on forum choices for UK courts
- Keep calm and carry on
BENCHMARK INITIATIVES: HOW DID WE GET HERE?

- 2008 Financial Crisis Exposed Structural Weakness In IBOR Benchmarks
  - E.g., In re LIBOR-based financial instruments antitrust litigation, MDL No. 2262 (S.D.N.Y.) -- $120M settlement

- 2013: International Organization Of Securities Commissions (IOSCO) Issues Principles To Develop Sustainable And Credible Benchmarks (IOSCO Principles) ¹

- Mid 2013-2014: Financial Stability Board Considers Applying IOSCO Principles To London Interbank Offered Rate (“LIBOR”) and Other IBORs, And Recommends Reforms²

- June 2016: EU Benchmarks Regulation (BMR) Creates Standards For Benchmarks In Use In The EU As Of January 1, 2020³

- July 2017: UK Financial Conduct Authority (FCA) Announces That It Will Not Compel LIBOR Submissions As Of Year End 2021⁴
  - Market developments contribute to this decision: banks have moved from primary reliance on unsecured, overnight borrowing to use of repos and other financing vehicles; post-crisis liquidity rules penalize use of unsecured financing, collectively leading to fewer underlying LIBOR transactions

Footnotes:
BENCHMARK INITIATIVES: CURRENT STATUS

- Now Clear That IBORs Will No Longer Be Broad-Based Benchmarks After 2020
- Working Groups Created To Identify Alternative Reference Rates (ARRs) To Replace IBORs
  - New IBORs must be derived from transactional data to comply with IOSCO Principles\(^1\), leading to ARRs based on risk-free or near risk-free rates derived from transactions in overnight funding markets
  - Alternative Reference Rate Committee adopts paced transition plan for SOFR (2017)\(^2\); Sterling Risk-Free Working Group publishes provisional timeline for SONIA (2018)\(^3\)
- Market Participants Begin To Embrace New Instruments Based On ARRs
  - Launches pegged to SONIA: ICE (1 and 3-month contracts, Dec. 2017 and Jun. 2018 respectively)\(^5\)
  - S&P classifies SOFR as an “anchor market reference rate” allowing money market funds to invest in SOFR-linked notes\(^6\)

Footnotes:
BENCHMARK INITIATIVES: LITIGATION RISK

Challenges Contributing To Litigation Risk

- **Legacy Arrangements Will Likely Have Winners And Losers**
  - Notes issued with a floating rate, unless amended, will effectively shift to a fixed rate; future interest rate movements determine winners and losers
  - ARRs may not act as perfect hedges – thereby creating financial statement volatility for corporate users that can lead to stock volatility
    - ARRs not one-for-one substitutes for current reference benchmarks

- **Legacy Contracts Without Appropriate Fallback Provisions Are Susceptible To Enforcement Challenges**

- **Volume/Scope Of Required Work Is Daunting And The Industry May Not Meet The 2020 And 2021 Deadlines**
  - ARRs/BMR-approved benchmarks still a work-in-progress
    - Pace of progress varies among jurisdictions
    - Potential for large “bulge in the pipe” at ESMA, slowing down approval of benchmarks targeted for use in the EU
  - Arriving at agreed upon terms
    - Assessment and negotiations of terms (e.g., acceptable ARR, credit premiums, fallback provisions), especially when ARRs/BMR-approved benchmarks are still a work-in-progress
    - Securing consent to amendments, especially where consent is required of a retail investor or unanimity is required
  - Exchange transactions (legacy securities for ARR-based securities) take time and are not foolproof