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Contents

Foreword

As we come to the end of 2016 we reflect on a year characterised by events that have sent political shockwaves through the world's major markets and consider what this may mean for the coming year.

The surprise may be just how stable and resilient markets have been. The UK referendum decision in June to exit the EU, a continuing economic slowdown in China and the election of Donald Trump as US President were all predicted to lead to significant issues for financial markets. In reality markets have survived relatively untroubled. Growth remains stable and equity markets have hit new highs.

The issues for financial markets have rather focused on continued structural change driven by regulation and technology. Large financial institutions have continued to downsize under the pressure to reduce cost-to-revenue ratios, while dealing with change to business processes and operations and revised capital requirements. Application of technology has risen up the executive agenda and many new FinTech firms are entering the once impenetrable financial services sector.

In this issue we look at some of the ways in which technology is impacting the finance markets. We reflect on how funds are playing an increasing role in credit markets and how fund structures can use leverage. In the realms of regulation we consider issues around the implementation of MiFID II, the European Banking Authority's guidelines on implicit support and the impact of "dark pools". In relation to bonds we examine what makes a bond "green" and what to consider when taking security over bonds.

Technological advances are generating new opportunities but the main hope for markets in 2017 must be that the major regulatory initiatives announced post financial crisis are now largely settled and in the process of implementation. The political upheaval of 2016 may however lead to a new period of regulatory change. If so, we can only hope that it will account for industry experience of regulatory reform so far and help economies to return to a period of sustainable growth.

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UK digital banks open for business

The outlook for retail banking as the first all-digital banks are licensed in the UK

In brief...

2016 has seen the first all-digital banks open for business in the UK. The advent of digital banking has the potential to revolutionise the way we bank, and also reduces some of the historical barriers to entry for new competitors in the retail banking market. The challenges for the new banks will include gaining consumers' trust and (as for the already-established banks) overcoming any data and cyber security risks.

Before the launch of Metro Bank in 2010, no new banking licences had been issued in the UK for over 100 years. Since 2008 there has been a steady stream of applications from so-called challenger banks responding to the UK financial services authorities' efforts to increase competition in the sector. Whereas most of the first wave of challenger banks targeted niche markets, there is now the possibility of real change across the sector as a result of a new wave of banks with business models that are based on digital technology and mobile applications (apps).

'Appy days for consumers

Earlier this year Atom Bank became the first app-based bank to receive a banking licence from the Bank of England. It is joined by a host of other FinTech companies such as Fidor Bank, Monzo, Starling and Tandem seeking to shake up the UK banking market with new approaches to personal banking.

These companies are coming to market with a range of different business models and products, but one thing that they have in common is that they are seeking to take advantage of the way people increasingly rely on mobile technology.

Historically the barriers to entry in the retail banking sector have been extremely high. In addition to meeting capital requirements, the need to invest in a branch network, technology and substantial workforce were all factors that limited the number of new competitors in the market. Digital banks operate from a much lower cost base than their traditional high-street counterparts, so the prospect of new entrants mounting a genuine challenge to traditional banks is very real. Digital banks avoid large real estate overheads as well as the costs involved in maintaining legacy systems. In addition, the launch of the PRA and FCA's New Bank Start-up Unit this year as well as the FCA's Project Innovate and Regulatory Sandbox reflect the fact that above all there is now a supportive regulatory environment for new market entrants and digital innovation.

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Keeping pace with digitisation

The truly digital banks aim to digitise all aspects of the customer's experience - from account opening to the granting of secured and unsecured loans, including the identification and verification process. However, completely removing the need for customers to present themselves at a branch or send in physical documents with 'wet-ink' signatures is challenging when the legal system is itself trying to keep pace with advances in technology. As a result, certain aspects of the customer-bank relationship, such as evidencing a power of attorney, still need documentary evidence. As the Land Registry requires a wet-ink signature on a paper version of any document submitted to it for registration, electronic signatures are still not an option for most mortgage deeds.

Biometrics over passwords

Consumers are understandably cautious when it comes to trusting a bank with their salary and personal savings. This is another factor underpinning the major banks' dominant position in the UK and elsewhere. Winning trust and confidence is particularly challenging for new market entrants that are also trying to convince people to adopt a completely new approach to banking. The digital banks will look to alleviate any security concerns by offering options for using biometric technology (such as the face and voice biometrics already used at airports) as authentication methods, rather than the traditional password and PIN. It will be critical to ensure that digital processes throughout the organisation are secured by the most advanced cryptographic techniques. Breaches of cyber security would severely undermine customer confidence in any bank - but particularly a digital bank.

The end of the Big Five?

Consumers have increasingly taken advantage of digital technologies across other sectors, e.g. when shopping, booking holidays or finding a taxi. An 'Uber moment' in financial services seems unlikely; but as credible digital banking propositions take shape, market commentators expect customer adoption to follow fast.

That said, overcoming customer inertia, particularly in current accounts, continues to be an obstacle for all challenger banks. This may mean that the traditional banks still have time to respond to the new challenge. Some are doing so through acquisitions (such as BPCE and BBVA buying stakes in Fidor and Atom respectively) whereas others are adapting and developing their own digital solutions.

One thing is clear: as digital natives and the digitally savvy represent an ever-increasing proportion of the population, the ability to develop an efficient, profitable and agile model that delivers a smooth customer experience will be critical to both the survival of the high street banks and the rise of the digital challengers.

Prepare for margining

An update on the new EU margin rules and the ISDA 2016 Variation Margin Protocol

In brief...

New EU margin rules are now final, subject to ratification. They are part of a global initiative regulating the posting of initial and variation margin when trading non-cleared OTC derivatives. 1 March 2017 is the key implementation date for variation margin (with accelerated implementation timing for the largest financial counterparties).

This article was written and updated as at 22 November 2016 and first published in Regulatory Intelligence by Thomson Reuters.

There has been significant progress on the EU margin rules in recent months. This article is intended to supplement 'EMIR - The new margin landscape' published in Global Financial Markets Insight issue 10 (Q2 2016) to give an overview of the new industry documentation as you consider how best to update your collateral arrangements in order to be ready for 1 March 2017.

Anticipated timetable

Following the European Supervisory Authorities publishing their Opinion on 8 September 2016, the European Commission formally adopted the EU margin rules on 4 October 2016. These were subsequently ratified by the European Parliament on 26 October 2016 and, at the time of writing, we await their ratification by the Council of the European Union. Following ratification, the EU margin rules will be published in the Official Journal of the European Union, and will come into force 20 days thereafter.

The largest financial counterparties (i.e. those with aggregate month-end average notional amounts (AANA) of non-centrally cleared derivatives for March, April and May 2016 exceeding €3 trillion) will then have one month to implement the rules (with respect to both initial and variation margin). For all other in-scope counterparties, the new variation margin rules will apply from 1 March 2017, while there will be a phased-in implementation with respect to initial margin from 1 September 2017 through to 1 September 2020 (depending on AANA).

The current expectation is that the Council of the European Union will ratify the EU margin rules on 21 November 2016. In which case, it is likely that the largest financial counterparties will face a mid-January 2017 implementation date. A mid-January implementation would be favoured by the market as there had been some concern (voiced by ISDA among others) over implementation during the end of year 'code freeze' (as it is traditionally difficult for the banks to make changes to their systems and models during this period). A mid-January implementation would avoid this, and at the same time should allow for a smooth transition before the general 1 March 2017 implementation deadline.

VM Protocol

In preparation for this regulatory change, on 16 August 2016, ISDA published the ISDA 2016 Variation Margin Protocol (the VM Protocol). The VM Protocol is intended to facilitate compliance with the new global rules relating to variation margin (including for the US, Canada and the member states of the EU).

The intention is that ISDA will produce separate supplements for each underlying regulatory regime (each such regime being a Protocol Covered Regime). At the time of writing, the VM Protocol covers the US (the PR and CFTC rules), Japan (the JFSA rules) and Canada (the OFSI rules), but importantly, not yet Europe.

The VM Protocol is a Questionnaire Protocol: in other words, adherents will need to complete the ISDA 2016 Variation Margin Protocol Questionnaire and elect one or more of the following three methods to match with counterparties. Note that the VM Protocol is only designed to work where there is a single Credits Support Annex (CSA) with respect to the underlying Master Agreement:

- **Amend Method -** If the parties to a swap match under the Amend Method, and are parties to an existing CSA, then such CSA will be amended by the terms set out in the applicable form of amendment to the VM Protocol (being Exhibit NY-AMEND or Exhibit English-AMEND (each, a VM Amendment). The Amend Method would be used if the parties desire to use the terms of their existing CSA, as amended by the applicable VM Amendment, for all swaps, including swaps entered into before the applicable compliance date, with effect on the earliest applicable compliance date.

- **Replicate-and-Amend Method -** If the parties match under the Replicate-and-Amend Method, and are parties to an existing CSA, then such CSA will be replicated to produce a separate CSA with the same terms as the existing CSA, plus the terms set out in the applicable VM Amendment. That is, if the parties match under the Replicate-and-Amend Method, the existing CSA (without any amendments) would apply to pre-compliance swaps and a new CSA (in the form of the existing CSA plus the terms set out in the applicable VM Amendment) would apply to post-compliance swaps.

- **New CSA Method -** If the parties match under the New CSA Method, and the governing law of the underlying ISDA Master Agreement is the laws of the State of New York, then the parties are deemed to have entered into a new CSA with Paragraphs 1 through 12 being in the form of the [2016 CSA Form (NY law)] and Paragraph 13 being in the form of the [Exhibit NY-NEW] to the VM Protocol (which contains a completed Paragraph 13 to the 2016 CSA Form (NY law) (see below)). The New CSA would apply to all post-compliance swaps, and if the parties seek to elect, pre-compliance swaps.

  Similarly, if the parties match under the New CSA Method, and the governing law of the underlying ISDA Master Agreement is English law, then the parties are deemed to have entered into a new CSA with Paragraphs 1 through 10 being in the form of the [2016 CSA Form (English law)] and Paragraph 11 being in the form of the [Exhibit English-NEW] to the VM Protocol (which contains a completed Paragraph 11 to the 2016 CSA (VM) Form (English law) (see below). The New CSA would apply to all post-compliance swaps, and if the parties seek to elect, pre-compliance swaps.

- **2016 CSA (VM) Forms -** As noted above, as part of this exercise, ISDA has further produced new credit support documentation for the posting of variation margin. Namely, on 16 August 2016, ISDA published the 2016 CSA (VM) Form (NY law) and the 2016 CSA (VM) Form (English law). Each new CSA is based on the existing ISDA 1994 CSA (Bilateral Form; ISDA Agreements Subject to New York Law Only) and the ISDA 1995 CSA (Bilateral Form - Transfer; ISDA Agreements Subject to English Law Only), as applicable. Key additional points to note are:

  - There are separate regulatory-compliant CSAs/CSDs for both initial and variation margin.
  - Each 2016 CSA (VM) Form is designed to be used for multiple regulatory regimes and capable of addressing different and potentially inconsistent regulations.
  - Each 2016 CSA (VM) Form incorporates the amendments introduced by the 2002 Master Agreement Protocol.
  - Modular approach - each 2016 CSA (VM) Form is designed to operate in combination with existing CSAs/CSDs under a single ISDA master.

This is only an introduction to some of the issues to be considered by in-scope entities in anticipation of the new margin rules. We have produced a more detailed analysis of the global margin rules and the impact of the VM Protocol to assist clients when considering how best to repaper their contractual documentation, and we are always happy to discuss this further.

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What to consider when taking security over bonds

Clarifications on the issues around granting security over bonds and other securities, with a particular focus on the Euroclear system

In brief...

Taking security over bonds (and other securities) held in a clearing system raises a number of legal issues. Understanding these legal issues is a pre-requisite to structuring an appropriate security package. This article addresses some of the key questions to consider before taking security over bonds and other such securities.

Jargon Buster

Clearing is the process of managing a range of actions, including transmitting, reconciling and confirming the obligations of the buyer and seller, between the time of execution and settlement of a trade. Clearing enables each party to understand the obligations of the other and to anticipate the amount which they can expect to receive upon settlement of the trade. Clearing plays a central role in the over-the-counter (OTC) derivatives market where the period of time between execution and settlement can be substantial, and during which the obligations of either party may vary. Clearing is less significant in relation to the issuance of securities, where there is greater certainty as to the assets to be transferred between the parties.

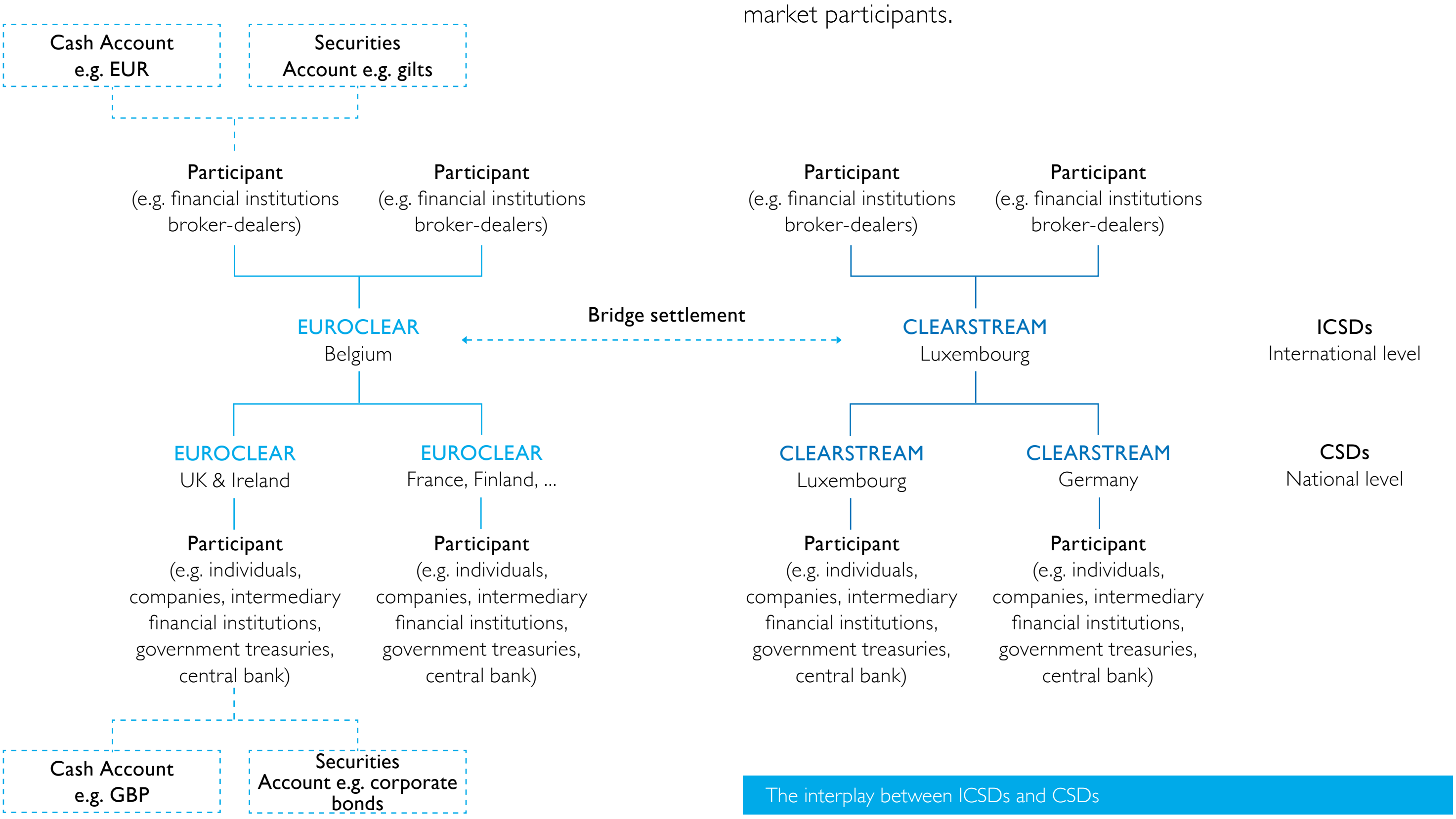
Settlement is the process flow whereby the buyer receives purchased securities and the seller receives the corresponding cash proceeds for those securities.

Question 1: In which clearing system are the securities being held?

Most debt securities (securities) are held by central securities depositaries, whose role is to facilitate the transfer of securities (and related cash proceeds) between participants. Securities depositaries are commonly referred to in the market as "clearing systems" due to their role in both the clearing and settlement process (see the 'Jargon Buster' box). Securities depositaries are either operated on a national scale (by central securities depositories (CSDs)) or on an international scale (by international central securities depositories (ICSDs)).

Internationally traded securities will be held by (or on behalf of) one of the ICSDs, Euroclear or Clearstream, which provide a range of clearing, settlement and other services. By contrast, domestically-traded securities will be held by (or on behalf of) a CSD, such as Euroclear UK & Ireland, which operates the CREST system in the UK. In each member state of the EU, only one CSD will normally exist.

ICSDs were borne out of the traditional CSD in response to the changing nature of the international securities market. There remains a connection though, as the operators of Euroclear and Clearstream own a number of CSDs: the Euroclear group owns CSDs in Belgium, Finland, France, Ireland, Sweden and the UK, and Clearstream owns CSDs in Germany and Luxembourg. Given the international nature of most debt issued in today's market, this article focuses primarily on issues concerning the ICSDs - and in particular Euroclear, which is of greater relevance to UK market participants.

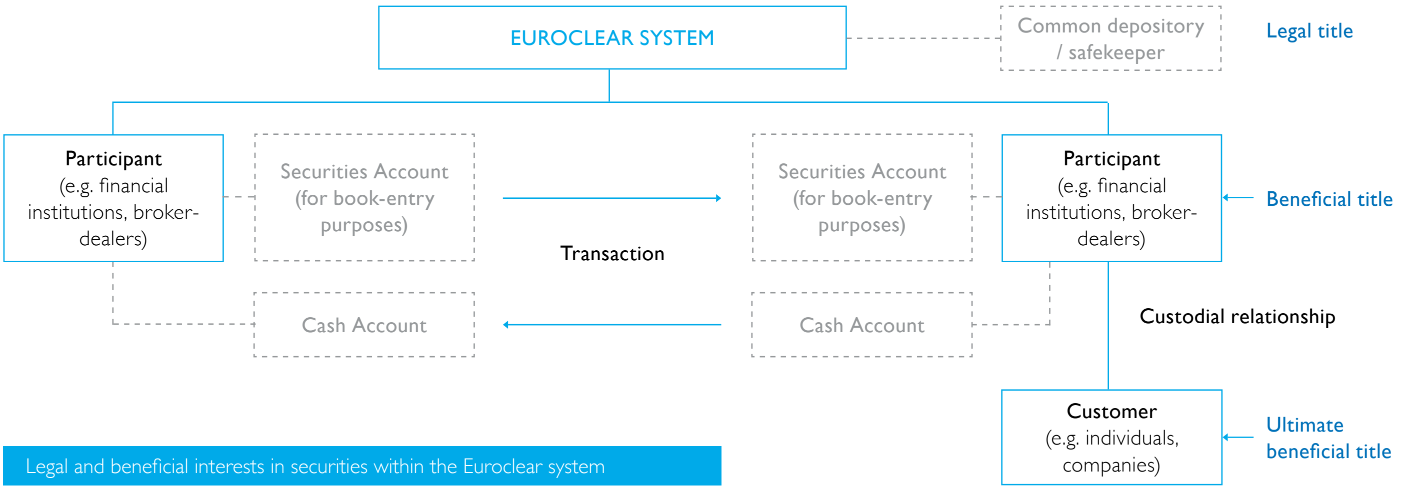


The interplay between ICSDs and CSDs

The majority of ICSD participants are financial institutions, broker-dealers and other professional institutions who specialise in new issuances, market-making and secondary trading. Each participant will maintain and operate a securities account within the relevant ICSD for the purposes of recording their interests and book-entry transfers. By contrast, CSD participants may also include individuals, companies, government treasuries and central banks. Of these participants, each financial institution and most large corporations will maintain and operate their own securities account with individual participants acting through a "sponsor" (such as a financial institution). Such sponsor financial institutions in this instance will be acting as a custodian on behalf of its individual customers (see below).

Question 2: Which party holds legal and beneficial title to the securities?

Most securities held through an ICSD system are in global form, meaning that one note represents the entire issue of securities. The custody of the global note is entrusted to a common depository or common safekeeper (or in the case of registered securities, in the name of its nominee company) on behalf of Euroclear or Clearstream. The global note is effectively immobilised within the clearing system. Interests in the securities represented by the global note are traded within the relevant clearing system and pass by way of book-entry transfers. While securities are held in clearing systems, legal title to the securities rests with the common depository/safekeeper (or its nominee, as applicable) and beneficial title rests with the participant (and/or the ultimate client of the participant, as applicable). The nature of the interest held affects the type of security that can be granted, as will be explored further when considering question 3.



Legal and beneficial interests in securities within the Euroclear system

Question 3: What are the usual steps for taking security over securities held in a clearing system?

Unlike securities held in the CREST system, which may be secured by an account charge governed by English law, granting security over Euroclear assets will require a Belgian law pledge over the relevant assets. We have considered only the Euroclear system here as this will be the most common ICSD for UK corporates and financial institutions; Clearstream has a comparative system in accordance with Luxembourg law.

Pledges of securities that are held by Euroclear are dealt with expressly under Belgian legislation. Two discrete steps are required under statute in order to create a valid and enforceable pledge against third parties:

- the conclusion of a Belgian law-governed pledge agreement to which Euroclear will not be a party, and in respect of which the parties are free to agree their own form between themselves; and
- transfer of the pledged securities to a specially designated 'pledged account' opened with Euroclear in the name of the pledgee, or, where the collateral-taker or secured party is not a participant of Euroclear, in the name of another participant (commonly known as the pledgee's representative).

The security will be perfected at the point of transfer of the securities into the pledged account. Upon any event of default by the pledgor, assuming that the value of the pledged securities is readily ascertainable, the pledgee (or the pledgee representative) may immediately realise its rights over the pledged securities without the need to obtain prior authorisation of a Belgian court or, depending on the provisions of the pledge agreement, notifying the pledgor.

The pledgee or secured party should also consider:

- whether registration or filing of particulars of the pledge/other security interest may be necessary in its own jurisdiction; and
- whether a local-law charge or pledge should be taken alongside any Belgian law-governed pledge.

In the case of a UK pledgor, it would always be prudent in the circumstances to register such security interest at Companies House, regardless of the governing law of the instrument.

Question 4: What rights (if any) do the ICSDs have to the securities?

As a matter of Belgian law, a statutory lien is granted in favour of Euroclear which applies to both securities and cash held in the relevant participant's account, and permits the recovery of all debts to Euroclear related to securities clearance and settlement activity. However, Euroclear has agreed in its Operating Procedures to waive this lien in relation to any securities and/or cash identified in writing by participants as being held in an account solely on behalf of a participant's customers. Euroclear also waives its right of set-off in relation to any pledged account, save for any fees or expenses incurred in relation to the sale or realisation of pledged assets. Before exercising such set-off rights, Euroclear will obtain the consent of the pledgee or secured party.

Clearstream also benefits from a similar statutory lien under Luxembourg law. Additionally, the Clearstream general terms and conditions create a pledge in favour of Clearstream over all of a participant's assets held in the Clearstream system. Unlike Euroclear participants, Clearstream participants do not benefit from any waiver with regards to their customer securities accounts. However, Clearstream would normally agree to waive set-off rights upon request by a pledgee who has been granted security over assets held within Clearstream.

Question 5: If an ICSD becomes insolvent, what rights does a secured party in the securities?

The rights of ICSD participants over assets held in Euroclear and Clearstream are governed by similar concepts under the laws of Belgium and Luxembourg respectively.

Taking Euroclear as an example, participants of the Euroclear system agree that all securities held in its account are fungible with all other securities deposited with Euroclear of the same type and with the same common code. This is in accordance with the Royal Decree No. 62 on the Deposit of Fungible Financial Instruments and the Settlement of Transactions involving such Instruments and other applicable Belgian legislation.

When a participant deposits securities in the Euroclear system it receives a co-ownership right in a pool of fungible book entry securities of each category. In practical terms, this means that an ICSD participant will not have a sole right over its own assets, but over all of the assets of the same type within the ICSD, collectively with all other participants owning securities of that type. In the event of an ICSD insolvency or analogous process, each ICSD participant will have the right to enforce against the ICSD for return of an amount of such assets held in their account with the ICSD. Should there be insufficient assets or cash proceeds to satisfy the claims of each participant in relation to one type of asset, each participant will share equally in the losses incurred in relation to that asset. However before such losses are calculated, any securities of the same type which are held directly by the ICSD will be made available in the pool of assets to be shared between participants.

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Finance for funds

Alternatives in today's finance market for funds

In brief...

Funds are increasingly engaged in the finance market, on both the borrower and lender side, with products ranging from plain vanilla to more sophisticated alternatives. This article gives an overview of the finance market for funds, highlights some of the most common structures and considers where current trends may lead.

The fund perspective has long been equity-centric: traditional funds have issued equity, invested in equity and focused on equity earnings in assessing performance. However, as the fund sector matures, these models are changing. Investors accept fund and asset-level leverage as a regular part of investing; managers and general partners consider it essential to be able to compete.

In the last six years, the mainstream bank-sponsored funds finance market has expanded year-on-year. The subscription credit facility market - the traditional place for debt finance in the funds world - remains strong, and leveraged facilities for hedge funds, together with hybrid facilities have also become increasingly commonplace.

Traditional financing solutions

Subscription credit facilities have traditionally been used to enable funds' general partners to bridge capital calls and investments in private equity structures. Loans are made to the fund (which is most commonly structured as a partnership) and secured against the right of the general partner to call down commitments from limited partners. Proceeds are used to fund investments and can also be combined with letter of credit facilities to facilitate acquisitions. They are useful for:

- funds making investments in short timeframes, where drawdown periods mean that equity financing is not sufficiently flexible as an acquisition bridge to a future long - term asset finance arrangement (e.g. in the context of a real estate fund); and
- emerging markets managers who have to currency match between the amount being called and the amount required for investment, in often volatile exchange environments.

Funds wanting to borrow need to include certain provisions in their constitutional documents in advance. Many form limited partnership agreements, offering documents and subscription agreements already include the necessary terms permitting borrowing, providing appropriate powers to the general partner and/or investment manager, bankable drawdown terms, powers of attorney and third-party rights where appropriate. Side letters can still be controversial - terms need to be carefully considered as excused partners and partners with opt-out or transfer rights for their commitments will all impact the credit analysis.

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In the credit and security agreements themselves, relatively standard documents have been developed, and negotiated provisions include events of default such as key man terms, negative covenants including those dealing with alternative investment structures and co-investments and terms around delivery of notices to limited partners regarding the assignment of call rights. However, there are a number of sophisticated lenders in the market who understand the challenges faced by general partners and investment managers in this context and commercial solutions are generally available.

Alternative and hybrid financing solutions

In addition to the traditional subscription credit agreement market, bank lenders also regularly extend facilities to hedge funds, including asset-backed facilities and derivatives-based arrangements. Funds are increasingly using hybrid facilities to provide whole life-cycle leverage - subscription-credit facilities can be drawn for purposes of making investments up front and converted into asset-backed loans for continued financing through the fund's life cycle.

Market trends

Funds finance has enjoyed an excellent credit profile to date. Default rates are practically non-existent, except technical covenant-based defaults which have generally been easily remedied, and this has made it an attractive proposition for alternative credit providers. Financial commentators have highlighted a decrease in bank lending as a proportion of financial markets debt, while alternative credit provision is diversifying and expanding. In line with this general trend, leverage provision through the secondaries and fund of funds markets is growing fast, and in recent deals we have also seen funds using capital markets and securitisation-based structures to raise additional finance.

Administrators and other market participants are identifying opportunities in facilitating peer-to-peer lending arrangements which are attractive to funds as both borrower and lender. Lending platforms are becoming increasingly common, essentially electronic networks which connect potential finance providers with potential finance consumers for communication and trade purposes. These are often developed by banks or other large market participants, but funds are investing in them and managers are also using them to benefit from counterparty accessibility, open availability of pricing information and efficient trade generation.

The proliferation of financial technologies is breaking down traditional barriers to funding and generating opportunities in all corners of the market for alternative credit providers and alternative credit consumers. We expect that for the most agile fund managers, finding arbitrage between operations on both the lender and borrower side will be a lucrative source of income for the foreseeable future.

How to keep securitised assets off balance sheet

A review of the EBA's guidelines on implicit support for securitisations under Article 248 of the CRR

In brief...

Sponsors and originators may be tempted to give "implicit support" to issues which do not perform as expected, even when they are not legally obliged to - we saw this with some structured investment vehicles (SIV) after the 2008 financial crisis. Article 248 of the Capital Requirements Regulation (CRR) forbids implicit support, and an originator that provides it risks bringing assets it has securitised and removed from its balance sheet back on - because once implicit support has been given (unless in exceptional circumstances) there will be an expectation that it may be given again, and this is inconsistent with allowing off-balance sheet treatment.

As originally contemplated by Article 248, the European Banking Authority (EBA) has now issued related guidelines which apply from 1 March 2017. The guidelines include reasonably high-level principles and there is a severe sanction for non-compliance. Institutions are therefore likely to be cautious and may decide that it is safest to discuss and agree their approach with their regulator.

On 3 October 2016, the EBA published its final guidelines on implicit support for securitisation, as required by Article 248 of the CRR. They apply from 1 March 2017.

Background

When the CRR and CRD IV replaced the Banking Consolidation Directive and the Capital Adequacy Directive, it retained two key requirements applicable to the treatment of securitisations where the originator wished to achieve off-balance sheet treatment:

- Articles 243-4 of the CRR, which require institutions wanting off-balance sheet treatment for securitised loans to achieve significant risk transfer (SRT); and
- Article 248, which forbids institutions from providing "implicit support".

The two provisions inevitably overlap: for example, Article 243(5) makes it a condition of SRT treatment that the documentation makes it clear that any purchase or repurchase of securitisation positions by the originator or sponsor beyond its contractual obligations (this being, of course, implicit support) is "exceptional and may only be made at arm's length", partly echoing the requirements of Article 248. The distinction is that Articles 243-4 look at the contractual arrangements put in place for the securitisation, whereas Article 248 looks at any actual arrangements which are subsequently entered into by the sponsor or the originator beyond its contractual obligations. Therefore, any support provided for in the initial documentation is not "implicit" for Article 248 purposes and falls to be considered only under the SRT provisions.

Implicit support was not an issue for the vast majority of securitisation asset classes, but it was encountered after the onset of the financial crisis for SIVs. The rationale for Article 248 is that implicit support signals to the market that some of the contractually transferred credit risk is still with the institution and has not really been transferred.

If an institution provides implicit support once, it creates an expectation that it may do again. This is also currently being considered in parallel by the Basel Committee on Banking Supervision. The consequence of breaching Article 248 is severe: the securitised assets in effect remain on the originator's regulatory balance sheet.

The CRR introduced an exclusion for transactions done at "arm's length", but did not explain what this meant. Article 248 contemplated that the EBA would publish guidelines about this. It now has.

What is "support"?

The guidelines explain that contractual support includes:

- overcollateralisation;
- credit derivatives;
- spread accounts;
- contractual recourse obligations;
- subordinated notes;
- credit risk mitigants provided to a specific tranche;
- the subordination of fee or interest income; and
- the deferral of margin income.

Implicit support includes:

- buying deteriorating credit-risk exposures from a securitised pool;
- substituting higher-quality risk exposures into the pool;
- selling exposures into the pool at a discount;
- buying exposures from the pool at above market price;
- ad hoc credit enhancements provided to one or more tranches; and
- agreeing to a larger first loss position.

Article 248
Implicit support
1. A sponsor institution, or an originator institution which in respect of a securitisation has made use of Article 245(1) and (2) in the calculation of risk-weighted exposure amounts or has sold instruments from its trading book to the effect that it is no longer required to hold own funds for the risks of those instruments shall not, with a view to reducing potential or actual losses to investors, provide support to the securitisation beyond its contractual obligations. **A transaction shall not be considered to provide support if it is executed at arm's length and taken into account in the assessment of significant risk transfer.** Any such transaction shall be, regardless of whether it provides support, notified to the competent authorities and subject to the institution's credit review and approval process. The insitution shall, when assessing whether the transaction is not **structured to provide support**, adequately consider at least all the following:
(a) the price of the repurchase;
(b) the institution's capital and liquidity position before and after repurchase;
(c) the performance of the securitised exposures;
(d) the performance of the securitisation positions;
(e) the impact of support on the losses expected to be incurred by the originator relative to investors.

"Arm's length"?

This is perhaps the key principle in Article 248. The guidelines specify that "arm's length" means that the terms of the transaction are as they would be in a normal commercial transaction. The guidelines helpfully emphasise that this will be judged only by reference to the information available to the parties at the time the transaction is entered into, and not with the benefit of hindsight. They elaborate that arm's length means that:

- the parties had no relationship to each other (including, but not limited to, any special duty or obligation and any possibility to control or influence each other); and

- each party:

  - acted independently;

  - entered into the transaction of its own volition;

  - acted in its own interests; and

  - did not enter into the transaction on the basis of extraneous considerations not directly connected with the transaction in question (such as any reputational risk which might arise if it did not proceed with the transaction).

"Structured to provide support"?

This is a key phrase in Article 248, and the guidelines emphasise that a transaction will not be regarded as "structured to provide support" if:

- where carried out by a sponsor, it is on arm's length conditions or better; and

- where carried out by an originator which initially met the SRT conditions, it is on arm's length conditions or better, and either (i) the securitisation still meets the SRT conditions, or (ii) if not, the transaction was not done with a view to reducing potential or actual losses to investors.

When considering whether a transaction invalidates the SRT conditions (in which respect the EBA's guidelines on significant risk transfer, published in July 2014, also apply), the regulator should consider whether the initial reduced risk-weighted exposure of the originator remains appropriate, taking into account (a) its post-transaction credit risk, and (b) the extent to which its capital or liquidity position has been affected. The exception in (ii) above - that the transaction was not done with a view to reducing losses to investors - would exclude activities conducted by the originator concerning the continuation or liquidation of a transaction or of the issuer SPV.

The guidelines state that, to determine whether a transaction is "structured to provide support", all relevant factors must be considered, and the substance of the five factors mentioned in Article 248 in respect of repurchases should be applied:

- **The price of the repurchase -** whether or not any amounts payable or, as the case may be, receivable by the originator institution or by the sponsor institution, are materially different from the relevant market value (the EBA refused to elaborate on what constituted materiality). Measures of market value include quoted prices in active markets for similar transactions that the institution can access at the measurement date, if available. If not, inputs other than quoted prices that are directly or indirectly "observable" should be considered, failing which, then unobservable inputs should be (in which case the institution should provide evidence to its regulator of how the amounts have been valued and which inputs were used). The institution should demonstrate that its assessment is in line with its credit review and approval process.

- **The institution's capital and liquidity position before and after repurchase -** In considering whether the institution's capital and liquidity position is materially and adversely affected, directly or indirectly, by the transaction, the corresponding accounting entries that the participants make, and changes in their liquidity position, should be considered.

- **The performance of the securitised exposures -** If underlying exposures being repurchased have been underperforming relative to other securitised exposures or been reported as non-performing, the transaction is not at arm's length if the underperformance (or the foreseeable future performance of such exposures as a result of the circumstances having caused such underperformance) is not adequately reflected in the price.

- **The performance of the securitisation positions -** If the securitisation positions being subject to the transaction have been underperforming relative to other securitisation positions or have been reported as non-performing, it should be considered (i) whether the cost of measures taken to improve the performance of these securitisation positions has been fully borne by the relevant securitisation investors and (ii) whether the institution which participated in the transaction is negatively affected, directly or indirectly, by the transaction.

- **The impact of support on the losses expected to be incurred by the originator relative to investors -** It should be considered whether the expected losses of a securitisation position are materially increased or reduced, having regard, among other things, to changes in the market price of the position, in the risk-weighted exposure amounts and in the ratings of securitisation positions.

If the originator or sponsor wishes to make a market in the securitisation bonds, these provisions directly impact it, and they will need to ensure their internal systems are adequate to demonstrate that purchases are made on arm's length terms.

Notification and documentation

The Article 248(1) notification requirement applies to transactions entered into by:

- the sponsor;

- the originator;

- entities in the same group as the originator (parents, subsidiaries and subsidiaries of parents); and

- by way of anti-avoidance, any entity to which the originator or an entity in its group provided, directly or indirectly, any financing, support or instructions or with which it entered into any arrangement in relation to the transaction, which would be subject to the guidelines if entered into by the originator (and where these conditions are met, the transaction should be assessed as if it had been entered into by the originator itself).

If the institution considers that a transaction does not constitute implicit support, it must provide its regulator with adequate evidence that it meets the relevant conditions set out in the guidelines.

The guidance goes beyond Article 248(1) itself, which applies the notification requirement only to the originator and sponsor. Article 248(1) is badly worded: it is clear that a transaction must be notified even if it does not provide support, but it is unclear if the apparently-wide term "transaction" is to be narrowed, or, if it is, how. It does not make much sense for a regulator to need to be told about every proposed arm's length purchase of securities, and it seems unlikely that regulators would want to be told either, but Article 248 says what it says, and it is primary legislation, and the guidelines cannot alter it, and the sanction in Article 248(3) for failure to comply is severe. Weighing all this up, institutions are likely to want to be cautious and to try to establish a sensible balance by agreement with their regulator.

Conclusion

It is understandable that the EBA would not be more precise about what would be a "material" divergence from market price; and both this, and the actual methodology to be used by an institution when calculating the fair market price (when comparable market quotations are not available or are not reliable), will have to be determined with the regulator. Rating agency methodologies do not permit substitutions which cause any deterioration in the credit quality of the securitised pool, and institutions wishing to consider a substitution will need to ensure they can satisfy both the agencies and their regulator that the repurchase price and the substitution are neither overpriced nor under priced. Bearing in mind the Article 243(5) documentary requirement that any such ad hoc substitution should only be done exceptionally, institutions contemplating making a substitution may decide the only safe approach is to notify. As for market-making, it would be logical for the EBA not to want to know about arm's length purchases of securities as part of normal market-making, but Article 248 is not well worded, and a conversation with the regulator and agreement on the approach to be followed seems wise.

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What makes a bond "green"?

Guidelines and market trends for green bonds

In brief...

With increasing demand for, and increasing issuances of, green bonds, it is important for market participants and particularly new entrants to keep up-to-date with the applicable principals, guidelines and standards which are developing alongside the green bond market.

This article highlights global market trends as well as notable examples of existing regimes (such as the ICMA's Green Bond Principles, Climate Bonds Standard and Certification scheme and Moody's Green Bond Assessment) and indices which are tracking the performance of green bonds.

In February this year, Apple issued its first labelled green bond. The launch, which raised US$1.5 billion, was reportedly the largest green bond to have ever been issued by a US corporation and a clear sign of green bonds' increasing popularity in financial markets. Another sign came in July, when the Government of Victoria became the first Australian government to join the growing list of green bond issuers; the AU$300 million issuance by the Treasury Corporation of Victoria is another of a number of notable "firsts" in green bond listings to have occurred this year.

In light of the recent flurry in market activity, it seems timely to revisit the topic of green bonds, for which we provided an overview in Global Financial Markets Insight issue 5 (Q4 2014). The reference to a "labelled green bond" in this article refers to a bond that has been labelled by the issuer as "green".

Existing regimes

The term "green bond" remains a generic term used to describe bonds issued for the purpose of financing or re-financing projects that have positive environmental or climate-related benefits. In the absence of a market standard definition of "green", the market is witnessing the organic development of a framework of principles, guidelines and standards.

Such guidance is particularly important to promote transparency and integrity within the market, especially for investors who have to conduct their own due diligence in assessing the green criteria of the bond. Notable examples of these include:

- **Green Bond Principles -** These are voluntary principles, initially developed by a group of leading banks, and which are now being maintained by the International Capital Market Association (ICMA) serving as Secretariat of the Executive Committee to the Green Bond Principles. The four core components of these principles are:
  - use of proceeds;
  - proceeds for project evaluation and selection;
  - management of proceeds; and
  - reporting.
- **Climate Bonds Standard and Certification scheme -** This standard/scheme is maintained by the Climate Bonds Initiative, a not-for-profit organisation which focuses on mobilising the green bond market. These environmental standards outline the criteria for assessing the "green" credentials of a bond. In conjunction with these standards, the certification scheme provides participants, such as investors, with comfort that bonds meet certain standards regarding climate integrity, management of proceeds and transparency. The previously mentioned bond issued by the Treasury Corporation of Victoria, for example, was Climate Bond Certified pursuant to this scheme.
- **Moody's Investor Service (Moody's) Green Bonds Assessment methodology -** Moody's finalised its assessment methodology earlier this year after previously issuing a form for comment by market participants. Pursuant to the methodology, a Green Bond Assessment (GBA), ranging from GB1 ("Excellent") to GB6 ("Poor"), will be assigned to issued bonds assessed on five key criteria including use, disclosure and management of proceeds. Such ratings are expected to be updated annually on the basis of reports to be provided by the issuer. Moody's assigned its first GBA of GB1 to Green Storm 2016 B.V., a Dutch green residential mortgage-backed securitisation in May 2016.
- **Country-specific guidance -** These include the Preparation Instructions on Green Bond Endorsed Project Catalogue published by the People's Bank of China and the Green Finance Committee of China Society of Finance and Banking, and also the official green bond requirements finalised in January 2016 by the Securities and Exchange Board of India. Indeed, the development of these guidelines should be seen as a positive response to the increased green-bond issuance activities in those respective countries.

Importance of a framework

With "green" being a label that issuers give to bonds that they issue themselves, it is critical that issuers are transparent about the process that they use for such self-assessment. Before 2014, issuances by the Multilateral Development Banks and Multilateral Financial Institutions such as the World Bank and the European Investment Bank accounted for the majority of green bond issuances. These entities are therefore more likely to be familiar with market expectations for green bond issuances than, for example, newer market entrants such as corporates and governmental entities. The principles, standards and guidelines, whilst important to all participants, are particularly important for the new market entrants.

Why are they important? To put it simply, from the perspective of both issuers and investors, there is a reputational risk involved in green bond issuances. In connection with this, for the green bond market to remain robust there must be transparency and confidence that proceeds raised are actually used for the intended purpose and that the ultimate outcomes of projects have a positive environmental impact. This means that issuers will need to undertake an additional assessment as to whether their bond meets criteria required for it to be labelled "green", following which they will have ongoing disclosure requirements to track the progress of the project. This additional diligence is necessary, even though it may increase the cost of the bond issuance.

As such, we expect to continue to see further development of such principles, standards and guidelines. It is pleasing to find that existing principles are starting to be cross-referred to each other, bringing a level of consistency in the evaluation process across the market. We note that, for example, the Securities and Exchange Board of India's official green bond requirements reflect some of ICMA's Green Bond Principles.

Green bond indices

Beyond the continued monitoring and reporting requirements referred to above, green bond indices have also been developed to track green bonds' performance.

Green bond indices are maintained by banks and credit agencies, often with input from third parties such as research organisations. They are designed to track the performance of green bonds which have been accepted for inclusion in the relevant index. One example is the S&P Green Bond Index, launched in July 2014. To be included in the index, bonds must meet a set of prescribed eligibility criteria which take into account factors such as disclosure and country/currency, and must be flagged as "green" by the Climate Bonds Initiative for index inclusion. Other indices include the Solactive Green Bond Index and the Barclays MSCI Green Bond Index.

Global trends

The Climate Bond Initiative tracker showed that as at 15 October 2016 there had been a year-to-date issuance of green bonds of US$59.9 billion (already up from the 2015 end-of-year figure of US$41.8 billion, and the 2014 US$36.6 billion and 2013 US$11 billion figures respectively). It is evident from the figures that the labelled green bond market really started to flourish in 2014, and since then the market has continued to grow.

While the Climate Bond Initiative reported a drop in the volume of green bond issuances in 2015, the aggregate issued amount in that year exceeded that in 2014. The Climate Bond Initiative reports:

- a continued growth in investor demand evidenced by, amongst other things, oversubscription in green bond issuances;
- a significant growth in green bond market size in certain existing participating countries; and
- the entrance by seven new countries (notably Brazil, in the spirit of the Olympics, and India) to the green bond market.

However, eyes are most firmly on the Chinese and Indian markets where each of the respective governments are demonstrating continued investment in going "green". Investments into green initiatives and announcements of targets, such as the Indian government's target to increase its solar power capacity five-fold to 100GW (currently 20GW) by 2022, are becoming increasingly frequent.

One of the more recent developments in the market is the launch of the Luxembourg Green Exchange (LGX) at the end of September 2016. The LGX has been launched for green securities which are required to comply with certain industry best practice criteria.

We expect to see growth in both the demand for and issuances of green bonds, and concurrently the further development in the framework regulating the green bond market.

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Back to the future of projects

Ways in which the HM Treasury could back project bonds for new infrastructure to help the UK's post-Brexit economic revival

In brief...

While the EIB has confirmed that Brexit will not affect its existing loans to UK infrastructure projects, any post-Brexit EIB funding seems questionable. This article reviews the UK government's commitment to the infrastructure sector, the capacity of its Guarantee Scheme and ways in which backing could come in future, e.g. through senior-tranche guarantees, junior-tranche investment and hedging arrangements.

This article was written and updated as at 15 November 2016.

Theresa May, the UK Prime Minister, has pledged that she will boost infrastructure investments and projects in the UK, which are to be funded with the help of "more Treasury-backed project bonds for new infrastructure". This is consistent with her belief in building "a country that works for everyone, not just for the privileged few".

Although at the time of writing no project bonds backed by the HM Treasury (Treasury) have been issued to support infrastructure projects, it is worth considering how the Treasury might choose to give such support.

The UK project pipeline

According to the government's National Infrastructure Delivery Plan 2016 to 2021, published before the Brexit vote, the UK is expecting a project pipeline of £483 billion, with over £100 billion to come from public capital investments.

It is as yet unclear whether (and how) Brexit will affect the infrastructure projects pipeline. Projects in their early planning stages may lose some momentum as the government focuses its efforts on the unavoidable Brexit negotiations, but there are still some positive signs - most notably the (delayed) green light given to the Hinkley Point C nuclear power project (estimated cost of £18 billion), the government's endorsement to expand Heathrow Airport (estimated cost of £17.6 billion) as well as the go-ahead of the Silvertown tunnel (estimated cost of £1 billion) signalled by the Mayor of London Sadiq Khan.

The UK government's commitment

In recent years the government has been consistent in its determination to deliver better infrastructure. A financial guarantee scheme (Guarantee Scheme) was introduced through the passing of the Infrastructure (Finance Assistance) Act 2012, under which up to £40 billion of financial guarantees would be issued for qualifying projects up to the end of 2016. The capacity of the Guarantee Scheme has recently been expanded to £60 billion, with its closing date extended from December 2016 to March 2021.The most recently reported figures available on the uptake of the Guarantee Scheme show that the total value of commitments entered into by the Treasury stands at £3.7 billion (as of November 2015), £2 billion of which is earmarked for the Hinkley Point C project. There is certainly room for further use of the Guarantee Scheme.

According to George Freeman, head of Theresa May's Policy Board, the UK government is ready to borrow cheaply to fund infrastructure. The form of borrowing however remains uncertain - it appears that sceptics in the government may not overly welcome the idea of project bonds, given that they normally come with higher coupon than ordinary UK government gilts.

Although the Autumn Statement, one of the two statements made annually by the Treasury to the Parliament, has not yet been published at the time of writing, infrastructure is expected to be its main theme, with a possible indication of a spending programme for new infrastructure. It is also rumoured that the UK government could be planning to set up a new infrastructure bank, which will aim at increasing finance available for infrastructure projects.

Forms of Treasury backing

At the time of writing, it is unclear how the Treasury is expecting to back project bonds - possibly it would come in one (or a combination) of the following forms. The intended outcome is to enhance the credit rating of project bonds, which would result in such bonds becoming a more attractive investment to investors, and therefore reduce project financing costs.

Treasury to provide financial guarantee

The Treasury could provide a guarantee for the whole or a part of the payment obligations of the issuer project company under the senior tranche(s) of the project bonds. This would have the effect of enhancing the credit rating of the project bonds by taking into account the creditworthiness of the UK government rather than relying solely on that of the project company.

It is, however, hard to see how different this would be from the ongoing Guarantee Scheme. While Theresa May's new initiative targets project bonds specifically, the Guarantee Scheme offers a high degree of flexibility and project bonds were by no means excluded.

Treasury as junior debt investor

The Treasury may be an investor in the junior tranches of the project bonds to be issued. This would enhance the credit rating of the senior tranche(s) of the bonds as this provides a subordinated buffer before the investors in the senior tranche(s) have to suffer any losses in their investments.

One concern the Treasury may have with being a junior debt investor would be the requirement to inject liquidity into the project from day one, as opposed to only getting involved as a primary debt obligor under a financial guarantee when the project company fails to meet its payment obligations to the senior project bondholders (which would be unlikely to happen until a later stage if the project becomes unsustainable).

Treasury to provide hedging/swap arrangements

One other way which the Treasury may back the project bonds is to act as a swap counterparty under the project bond structure. This may be effected through structuring a liability swap with the issuer project company, such that the Treasury would pay a fixed amount reflecting the periodic interest payments throughout the life of (or part of the life of) the project bonds in exchange for a fee and a floating payment from the project company. This could ensure that if the project company could not meet its ongoing payment obligations under the project bonds, such obligations could be met by the payments from the Treasury as swap counterparty.

EIB funding and Brexit

Post-Brexit, the infrastructure industry may be concerned whether it could continue to obtain low-cost funding from the European Investment Bank (EIB), of which the UK is a 16% shareholder. EIB investments in the UK economy came to about €7.8 billion in 2015. This was approximately 10% of the total lending made by the EIB in 2015 - the EIB's largest-ever engagement in the UK. While the EIB has confirmed that the existing loans provided to UK infrastructure projects will not be affected by Brexit, it is doubtful if the same level of support will be afforded to UK projects post-Brexit, which could happen as soon as 2019.

With the likely reduced support from the EIB, Treasury-backed lower-cost funding options, in whatever form, will become essential. Given the government's support, and the generally low interest rates in the lending market, infrastructure development may become a leading force for the UK's post-Brexit economic revival.

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Rise of the robot

How the use of technology is changing due diligence processes in portfolio sales

In brief...

Technology is evolving at a rapid rate within the legal sector, and is increasingly affecting the way in which deals are conducted. Law firms have found particular applications for augmented intelligence technologies in portfolio transactions, where machine learning software can assist with large-scale document review and similar due-diligence processes. This article considers how machine learning software is changing these processes, and discusses the potential value that it can add.

Artificial intelligence (AI) and the ground-breaking Internet of Things (IoT) continue to hit headlines. Back in 2014, Stephen Hawking stated that success in the creation of 'true' AI could spell the end of the human race. However, while AI is popularly portrayed as the dawn of human-like robots, those in the industry often prefer the term "augmented intelligence" for machine-learning technologies which are not meant to replicate full human-decision making, and probably will not for some time.

Law firms are increasingly using such augmented intelligence technologies to improve and change the way in which they conduct deals, such as portfolio transactions. The licence agreement between DLA Piper and Canadian technology firm Kira Systems (Kira) is one such example of our ventures into the world of augmented intelligence. Kira is a contract review and data extraction tool. It 'learns' to accurately identify provisions in large numbers of documents and rapidly presents them to the reviewer on a user-friendly platform - allowing faster document analysis by lawyers.

The transfer of large volumes of loans or other financial assets will often require extensive document review by law firms acting for both vendors and purchasers. This article considers how machine learning could change this process.

How does augmented intelligence add value?

Augmented intelligence software allows the rapid review of large volumes of data to reveal patterns, trends and interrelationships. The performance of this software improves with exposure to data; the more transaction data it processes, the more accurate the software becomes, and the better risks can be mitigated. Kira, for example, can accurately identify information by learning from examples; this is in stark comparison to its predecessors, which could only identify pre-programmed clauses. Indeed, technology is now sufficiently advanced that it is possible for people with limited software-specific knowledge to train Kira and other such software to meet particular project needs.

To fully determine the benefits that machine learning can bring, it is necessary to consider the current method of reviewing large volumes of documents. Traditionally, transactions which involved the sale of large portfolios of loans (as part of a securitisation or a more conventional sale) have, to varying extents, required a review of the underlying contracts which documented those assets. Review of these documents is inevitably a time-consuming, and accordingly, costly process (even with the efficiencies achieved by employing junior lawyers).

There is a clear advantage in deploying software to review, analyse and report on the contents and key terms of thousands of documents within minutes or hours (rather than a manual review taking days or even weeks).

As well as increased efficiencies, machine-learning software may provide law firms with an opportunity to conduct document review on a far larger scale than has previously been practicable. Constraints of time and cost have meant that traditionally, some reviews have adopted a sampling approach, assuming a degree of uniformity among documents and assessing risk accordingly. In theory at least, document review software now makes more comprehensive large-scale review achievable. Moreover, developers and users of this software claim it limits the margin for error that any human review may present.

Are there any limitations?

While further technological advances may present opportunities for efficiencies and the scope of reviews to be expanded, it seems that there are still limitations. Crucially, machine learning in this context needs lawyers to teach the relevant technology to identify the relevant provisions. This takes time and resources. Moreover, a machine can only highlight provisions as being problematic or concerning to the extent that it has been taught to recognise them as such. Accordingly, without the fall back of a human double-checking (which may reduce efficiencies), document review software could overlook problematic or onerous document terms. It is here that flexibility in software development combined with a focus on legal input and management are vital to ensure best practice and accuracy.

Conclusion

Managed well, machine learning will make document review faster, more efficient and more economic - all of which is of benefit to clients. However, law firms still need to support software set-up and provide significant and ongoing legal input to ensure that processes account for the evolving issues and risks that businesses face. So far, augmented intelligence remains a tool rather than a replacement for lawyers.

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ABS terms fix below-zero rates

Positive fixes for negative interest rates in liability swaps supporting asset-backed securities

In brief...

Issuers of asset-backed securities (ABS) face an increasingly-common problem where cash flows under structured swap transactions may not match the payments to noteholders which the swaps are intended to support, due to the treatment (or lack of treatment) of negative interest rates in the swap documents. This article outlines some of the key considerations and practical solutions.

Negative interest has become an increasingly familiar concept in Europe, with the European Central Bank (ECB) and other central banks charging negative rates on their deposits since 2014. The Bank of Japan followed suit in early 2016, and even the US Federal Reserve has commented that negative interest in the US could be "on the table".

According to Moody's Investors Service, there will be around 550 rated residential mortgage based securities (RMBS) or ABS tranches with coupons that are theoretically negative by the end of 2016.

Trends in contractual terms

In our experience, swaps documents entered into before the current negative-interest environment have typically required a fixed-rate payer to pay the absolute value of the floating rate leg. This contractual requirement tends to arise through one of two ways, either through the:

- incorporation of the 2000 or 2006 ISDA Definitions, which apply the "Negative Interest Rate Method" in the absence of express agreement to the contrary, and which requires swap counterparties receiving a floating rate to pay the absolute value of that rate to their counterparty, should it have a negative value; or
- general absence of a specific interest-rate floor provision, in which case it is usually difficult to assert that such a floor should be an implied term of the contractual documents.

In many cases this outcome will reflect the commercial agreement that was knowingly struck between the counterparts at the time of execution. However, there will no doubt be instances where the parties simply did not envisage the possibility of negative interest, or the need to include specific terms dealing with the treatment of negative interest rates in the legal documentation.

Ground zero for securitisation vehicles

This has been a particular challenge for special-purpose securitisation vehicles (and their cash managers) who pay a floating rate of interest to noteholders that is floored at zero. For the most part, this approach is taken irrespective of whether or not the transaction documents expressly provide for such flooring of interests - ABS issuers are not generally seeking to charge negative interest to noteholders, instead electing to floor coupons at zero. Indeed, the ECB eligibility rules for ABS require that interest rates are floored at zero (an implied floor is generally sufficient), and notes with negative interest rates are generally considered to be ineligible for clearing by Euroclear and Clearstream, since there is no mechanism for noteholders to make payments to the issuer.

Cash-flow mismatches

Negative interest rates may also be an issue for cash deposits in the deal structure, including where collateral is posted by a swap provider. Again, a structural shortfall may arise where the transaction cash flows do not account for payment of negative interest to the bank holding the collateral. Pre-negative interest era legal documents often do not address this issue, with the default position usually being the absorption of any payments due to the collateral bank by the structure (although the specific contractual terms should be examined closely).

The rating agencies are also taking notice of this cash-flow mismatch issue. In a market announcement in July this year, Moody's noted the cash-flow mismatch for issuers having to pay the absolute value of negative interest rates to swap counterparties, although ultimately concluded that the effect on cash flows would be negligible. Among other things, they noted that swap curves indicate that negative interest rates are not expected to last longer than three years. Under its criteria for interest rate stresses in structured finance transactions, Fitch acknowledges that it will take into account negative interest rates on cross-currency swaps, where the swap documentation does not provide for a floor on the swap counterparty's paying leg.

Fixes for new transactions

For new transactions, the fixes are relatively simple. For example, the ISDA Definitions include a "Zero Interest Rate Method", which the parties may expressly elect to apply in the swap documents. This has the simple effect of flooring the applicable floating leg under the swap at zero, although it is likely to increase the price of the swap.

ISDA also provides a solution for transactions where collateral is provided by a swap counterparty, this time through the "Negative Interest Rate Protocol". Parties may adhere to the Protocol, or alternatively agree to set out the language in full in the relevant credit support documentation. Where the Protocol applies, the collateral provider will agree to pay the absolute value of any negative interest amounts to the issuer. The Protocol also introduces supplemental terms, for example in relation to the timing of the absolute value payments (which follows the timing of the positive interest payments).

Parties should be aware that the Negative Interest Rate Protocol does not apply in certain circumstances, for example where credit support is "one-way" i.e. only ever posted by one party. It also does not provide for treatment of negative coupon securities (sometimes known as "nega-coups"), although it is unlikely that these would constitute eligible collateral under the terms of the credit support documentation. Swap providers should also ensure that their operational systems are capable of dealing with negative interest payments on collateral accounts before agreeing to incorporate these provisions.

For existing transactions, there are a few options available to the parties. In some instances, we are seeing parties amending their swap documentation to clarify the treatment of negative interest, although this may have pricing implications where a swap provider is being asked to recognise a floor on the floating leg where no such floor existed previously. Where the negative interest amount is de minimis, a swap provider may agree to waive the payment, although caution should be taken to ensure that this doesn't give rise to a 'course of dealing' implied term which could tie the swap provider's hands for future payments. A similar approach may be to settle the negative interest payments outside of the structure.

It should also be noted that many structured swap transactions are entered into on a back-to-back basis with the transaction sponsor, in which case it should be easier for the parties to reach an agreement, as the swap provider is more likely to accept a floor on the floating leg if the impact can be passed on to the sponsor (as back-swap provider).

Market view

Our experience to date suggests that the markets are not unduly concerned by mismatch in ABS cash flows caused by negative interest rates. We consider this to be attributable to the relatively small size of the payments, the abilities of transaction parties to come up with pragmatic solutions, and the expectation that negative interest rates are not a long-term phenomenon. In the meantime, we would advise parties that are structuring (or restructuring) ABS transactions to give some consideration as to how negative interest rates should be treated.

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FCA readies the UK for MiFID II

A summary of the FCA's third consultation on implementing MiFID II in the UK

In brief...

The Financial Conduct Authority (FCA) has published consultation paper CP16/29 'Markets in Financial Instruments Directive II implementation—Consultation Paper III' on the implementation of the revised Markets in Financial Instruments Directive 2014/65/EU (MiFID II).

The consultation seeks views on the proposed changes to the FCA Handbook and makes key proposals concerning conduct of business issues, product governance, telephone taping for financial advisers and knowledge and competence requirements. The consultation closes on 4 January 2017. This article considers the proposals of the consultation and potential implications.

This article was first published on Lexis®PSL Financial Services on 25 October 2016. Click for a free trial of Lexis®PSL."

What are the FCA's proposals in this consultation?

On 29 September 2016, the FCA took another step in the implementation process of MiFID II and Regulation EU 600/2014 on Markets in Financial Instruments (MiFIR) by publishing its third Consultation Paper (CP16/29).

The FCA focuses on conduct of business issues, including:

- inducements (such as adviser charging);
- inducements and research;
- client categorisation;
- disclosure requirements;
- independence;
- suitability;
- appropriateness;
- dealing and managing;
- underwriting and placing; and
- investment research, as well as other conduct matters.

The FCA's proposals also touch on:

- product governance;
- knowledge and competence requirements;
- recording of telephone conversations and electronic communications (taping); and
- supervision manual, authorisation and approved persons and perimeter guidance (PERG).

What is the purpose of the proposals?

FCA CP16/29 is a necessary step for MiFID II's implementation. Covering conduct of business issues, as well as certain issues that remained outside the scope of the previous consultation, the FCA and the UK government proposals are published to work towards implementation of MiFID II so that the UK is compliant with the legal obligations deriving from EU law on the implementation date of 3 January 2018.

The FCA also is considering exercising its discretion to regulate further than what is required by MiFID II in some respects. As MiFID II is a Directive there is scope in certain respects for 'super-equivalence' (see the requirements on taping discussed further below).

How does the FCA plan to treat the following topics?

Inducements and research

In CP16/29, the FCA proposes a new Conduct of Business sourcebook (COBS) rule 2.3B which transposes article 13 of the Commission Delegated Directive C(2016) 2031 supplementing Directive 2014/65/EU (the MiFID II Delegated Directive). It will also transpose (as guidance) certain recitals of the MiFID II Delegated Directive on how firms should operate a research payment account and collect charges. Firms that wish to use client funds to obtain client-specific research reports should pay close attention to these requirements in COBS 2.3B, in particular the requirements of oversight, audit and controls regarding any research payment account. Clients must agree to any charges on the account and arrangements must be put in place to remit any unused funds back to the relevant clients.

The FCA proposes to incorporate the MiFID II investment research provisions into a single COBS chapter as well as adding guidance to clarify that the new rules will apply to both investment research and non-independent research. The current rules require firms to manage conflicts of interest in relation to the financial analysts involved in the production of investment research and other relevant persons whose responsibilities or business interests may conflict with the interests of the persons to whom research is disseminated. A particular change in MiFID II is a requirement not just to manage conflicts but also to prevent them.

The new rules put in place a number of requirements on firms to put in place safeguards and arrangements on the production of investment research. For example, an investment firm will need to ensure that:

- financial analysts do not undertake personal trades in the investment to which the research relates;

- a physical separation exists between financial analysts who produce the investment research and others whose responsibilities may conflict with the interests of the recipients of the research putting in place appropriate information barriers;

- the firm itself as well as analysts do not accept any inducements from those with a material interest in the subject-matter of the research;

- the firm itself, financial analysts, and other relevant persons involved in the production of the investment research do not promise issues favourable research coverage; and

- before dissemination of investment research issuers, relevant persons other than financial analysts, and any other persons, are not permitted to review a draft of the investment research for the purpose of verifying the accuracy of factual statements made in that research, or for any purpose other than verifying compliance with the firm's legal obligations where the draft includes a recommendation or a target price.

Costs and charges disclosure

The FCA proposes to amend COBS in line with the provisions in MiFID II and the MiFID II Delegated Directive. These changes will require:

- the disclosure of appropriate information to clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges (see new COBS 2.2A); and

- additional disclosures in respect of safeguarding client instruments and funds as well as information about costs and associated charges.

The new disclosure requirements are primarily applicable to firms doing MiFID business.

Fair treatment of customers

Fair treatment of customers constitutes an overarching theme for both MiFID II and CP16/29 and as such it can be traced throughout the FCA consultation.

Disclosure requirements, as well as independence requirements both serve the policy aim of fair treatment of customers.

Firms providing independent advice will have to "assess a sufficient range of financial instruments available on the market which must be sufficiently diverse with regard to their type and issuers or product providers to ensure that the client's investment objectives can be suitably met". The FCA states that it intends to implement the MiFID II standards to all retail investment products for UK retail clients. Rules in the MiFID II Delegated Directive in relation to the robustness of a firm's product selection process, will also be applied to non-MiFID II business. For professional clients and non-UK retail clients, the FCA will only apply the MiFID independence standard on MiFID financial instruments and structured deposits.

Moreover, both the suitability and the appropriateness requirements support the fair treatment of customers and ensure that they are not misled or confused when choosing a financial product.

Rules transposing the MiFID II suitability requirements will be set out in a new COBS 9A. The new rules include more specific requirements to ensure suitability of personal recommendations, such as the obligation to ensure information about the client is up-to-date where the firm is providing ongoing advice or a discretionary management service. Additionally, the rules clarify that, where advice or a discretionary management service is provided wholly or partly through an automated system, the firm remains responsible for the suitability assessment. Responsibility is not diminished by use of an automated system.

The FCA proposes to add two new criteria to the list of non-complex criteria in COBS 10.4.1 R (3), namely that the product does not:

- contain a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay out profile; and

- include exit charges that have the effect of marking the investment illiquid even though the client may have frequent opportunity to dispose, redeem or realise the product.

The FCA will also include in COBS 10:

- a rule that where a bundle of services or products is envisaged, the firm must consider whether the overall bundled package is appropriate; and

- a specific requirement for firms to keep records of appropriateness assessments, including, where a warning was given to a client, whether the client decided to go ahead despite the warning and whether the firm accepted the client's request to go ahead with the transaction.

Telephone taping

MiFID II introduces for the first time an EU-wide requirement for firms to record telephone conversations and electronic communications when providing specific client order services that relate to the reception, transmission and execution of orders, or dealing on their own account. The FCA will consolidate the rules into Senior Management Arrangements System.

The FCA proposes to apply the MiFID II taping regime to a wider range of situations than those required by MiFID II, namely:

- the service of portfolio management, including removing the current qualified exemption for discretionar investment managers;
- corporate finance business;
- energy market activity or oil market activity; and
- the activities of collective portfolio managers (full-scope UK alternative investment fund managers (AIFMs), small authorised UK AIFMs and residual collective investment scheme operators, incoming EEA AIFM branches and undertakings for collective investment in transferable securities management companies).

How do these proposals differ from existing FCA practice?

Many of the concepts introduced by the FCA consultation are familiar to its existing practice and some are not expected to drastically change the regulatory requirements for firms. However, there are also certain proposals that will have significant practical implications.

Third party research, being an important tool for investment firms, will still be available. However, firms wishing to use client funds to obtain client-specific research reports should pay close attention to requirements in COBS 2.3B - in particular the requirements of oversight, audit and controls regarding any research payment account. There is considerable concern among fund managers about the practicality of the requirement for research payment accounts.

The appropriateness test is introduced for a wider range of products than at present.

Product governance also reflects the FCA's revised approach in being more willing to directly intervene in the market in cases of potential customer harm.

A significant change is proposed regarding perimeter guidance. The FCA introduces the scope of the expanded financial derivatives category, notably in relation to FX products, as provided in article 10 of the MiFID II Delegated Regulation. In particular FX forwards will now fall within MiFID II in the UK. The FCA has, up to now, treated FX forwards as out of scope of the current MiFID requirement.

Do any of these proposals go beyond what is required by MiFID II?

The FCA explicitly states that in most areas the regulator is not convinced of the need to extend the MiFID approach beyond the scope of MiFID. Unless the new MiFID provisions have broadly the same effect as existing non-MiFID provisions, the FCA is not proposing a wider application.

An exception to the above is the limited extension of the MiFID II rules to non-MiFID business, when the same risks apply in the provision of designated investment business, whether for MiFID or non-MiFID business.

What are the next steps?

The FCA is planning to publish a fourth consultation later in 2016. All investment firms are expected to be 'MiFID II ready' by 3 January 2018 and compliant with the enhanced regulatory regime.

How should lawyers and their clients prepare for the proposed changes?

Both lawyers and their clients should establish a deep understanding of both the currently applicable provisions, as well as the suggested amendments. It is important that firms ensure that they are compliant in light of the proposed new regulatory framework and do so in a timely manner. MiFID II and MiFIR require significant changes to systems and procedures, so it is vital that firms consider how the changes affect their business and take legal advice, where appropriate, in order to be 'MiFID II ready' for 3 January 2018.

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FCA shines a light on dark pools

Findings from the FCA's thematic review of UK equity market dark pools

On 21 July 2016, the Financial Conduct Authority (FCA) published the results of a thematic review, in which it examined 'dark pools', which include broker crossing networks (BCNs) and 'dark' Multilateral Trading Facilities (MTFs). Dark pools are trading venues with no pre-trade transparency, where the price and volume of all orders are hidden and anonymous. The FCA found that users welcome the additional liquidity, the lower risk of information leakage and the potential beneficial impact on pricing and costs that dark pools offer. The FCA thematic review did not observe any failures to comply with regulatory requirements but did identify a number of areas where improvement is required by dark pool operators.

In light of the FCA's findings, dark pool operators should:

- review promotional materials to ensure they clearly and consistently explain pool operation to users and ensure there is a robust internal governance process for the review and approval of marketing material with legal/compliance oversight;
- improve the monitoring of activity in their pools with a focus on operational integrity, best execution, client preferences and unwanted trading activity including market abuse; and
- do more to identify and manage conflicts of interest, including strengthening policies and procedures for escalation and oversight, as well as regularly refreshing independent assessments.

Dark pools, market fragmentation and regulatory change

Dark pools provide users with an alternative trading venue to public exchanges, such as the London Stock Exchange. By trading 'in the dark' as opposed to on 'lit' markets, dark pool users do not disclose the size or the price of their trades to the wider market. Historically, this enabled institutional investors to execute large block orders at better prices than was possible on lit markets, where the size of their order would result in an unfavourable price movement against them.

Today, dark pool users may have a mix of orders with differing objectives underway at any point in time and spread across a number of dark and lit trading venues. The breaking up of a single order (parent) into smaller (child) orders, once the preserve of more sophisticated traders, is now common practice and built into the vast majority of automated trading activity. Dark pool users are wholesale investors. The FCA noted that while retail investors may have all or part of their order processed by a broker in a dark pool, there are no operators who provide retail clients with direct access to UK dark pools.

The FCA's thematic review comes in the context of increasing technological advances in electronic trading, and significant fragmentation of the UK equity market. Whilst the FCA noted that electronic trading across multiple trading venues, including dark pools, has led to higher speeds and lower costs, the regulator acknowledged concerns that price transparency and price formation may be at risk if dark markets, which derive their prices from lit markets, become disproportionally large compared to lit markets. The FCA stated that at present, dark market volumes are considered too small to pose an imminent threat to the price formation process, but that they would continue to monitor market developments.

The FCA reminded dark pool operators that the upcoming MiFID II regulations will have a significant impact on wholesale markets, including a direct impact on BCNs, which represent a sizeable component of market liquidity. Whether and how firms may choose to restructure their existing businesses, including dark pools, remains uncertain pending the finalisation of MiFID II rules.

Thematic review

The FCA thematic review involved a desktop review of practitioner and academic research, as well as marketing materials produced by dark pool operators since 2014. The FCA then sought detailed information from a sample of dark pool users and operators. After reviewing this information, the FCA met buy-side investors who are significant users of dark pools. From these discussions, the regulator sought to understand the user experience as these markets have evolved, the role of dark pools in their trading activities and specific issues that they thought worthy of note.

The FCA then met with operators of dark trading venues, primarily focusing on BCNs, but also meeting dark MTF operators, to evaluate the products and services they provided, their governance structure and the identification, management and disclosure of conflicts of interest.

Areas for improvement

The FCA found that dark pool operators have responded to public concern and regulatory interventions by addressing business model design, promotional materials in use, and the management of conflicts of interest. Nonetheless, poor practices and areas for improvement were identified. A number of these areas are highlighted below.

Client onboarding and preferences

Users are sensitive to who is in the pool with them. BCN operators generally offer their users the ability to restrict counterparties or counterparty types against whom their orders are allowed to execute. For example, users may choose to restrict or wholly avoid interaction with high frequency traders (HFT) or electronic liquidity providers. Whilst operators noted that the number of users making use of these restrictions was small, the FCA found that the collection, storage and processing of these preferences was difficult to audit, and systemically weak across the industry. The FCA also found that dark pool operators were not sufficiently systemic in ensuring the prevention of trades with restricted counterparties. As a result, a user may find its order being matched with a counterparty that it has a clear preference not to trade with. Weak processes may give rise to the risk that the dark pool operators are not meeting their best execution obligations. Best execution obligations include the obligation to ensure that orders are executed in line with specific client instructions where provided.

Operational design and integrity

The FCA also considered how dark pool operators managed the conflict between routing a client's order in the best interest of the client and operating a dark pool. The FCA noted that bank operators consistently route orders to their own BCN pool before routing elsewhere. The FCA stated that this was acceptable, provided that operators adhere to best execution obligations, avoid positive or negative venue discrimination, manage resting times and support and evidence all of the above by actively monitoring trade activity.

The FCA also observed that some operators sent client orders to their own BCN pool and then forwarded orders automatically (partially executed or otherwise) to other BCNs under a Reciprocal Access Agreement. Router technology can stipulate basic order instructions but may not necessarily preserve specific client preferences. The FCA observed that users were not clear on whether their preferences were preserved under onward routing and had no way to monitor or verify if those preferences were honoured.

The FCA also identified the poor practice of in-house trading desks being granted access to BCNs via different infrastructure to clients, which gave operators a potential latency advantage, constrained only by management controls.

Monitoring of activity in the pool

The FCA stated that monitoring capacity was the weakest area of the end-to-end trading process related to dark pools that the regulator identified in the thematic review. The regulator noted that the ability to analyse and report on individual client transaction-level trading activity on the same day is beyond the technical capacity of most operators; as most take several days or a week to generate reports. Whilst the regulator acknowledged the challenge of trade monitoring in an ultra-fast environment, the regulator stated that all operators must be able to monitor and ensure that they are meeting their best execution obligations, and correct any deficiencies where appropriate.

All pool operators have responsibilities to monitor for market abuse, the integrity of their operational platform and those features which they have promoted as attributes of their pool. Where operators purport to be able to identify and protect against unwanted activity ('toxicity' or 'aggressive HFT' for example) they must ensure that they have in place appropriately and clearly defined metrics and controls in order to be able to effectively monitor and take action against firms that exhibit unwanted types of activity.

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Lehman decision clarifies ISDA meaning of "Default Rate"

An analysis of the High Court's decision in Waterfall IIC on the meaning of Default Rate in the ISDA Master Agreements

In brief…

On 5 October 2016, the High Court provided clarity on the meaning of "Default Rate" in the ISDA Master Agreements. The Court held that the cost of funding in the definition of Default Rate is limited to the cost to the original counterparty to the agreement of borrowing the relevant amount for the period it is required. Cost of funding does not extend to the cost of funding of a transferee who has taken an assignment of an Early Termination Amount or to the cost of other types of funding (such as equity funding).

While the decision remains subject to appeal, it is significant for all users of the ISDA Master Agreements, as it provides direction on what can be certified as cost of funding for the purpose of Default Rate, when this rate applies. In addition, proposed transferees should consider the potential effect on them of being entitled to a Default Rate calculated on the transferor's cost of borrowing, which could be significantly lower than their own.

The decision is one of a series in the Lehman Waterfall II litigation, which seeks to determine how a large surplus in the insolvency of Lehman Brothers International (Europe) (In Administration) should be distributed. The issues determined by Mr Justice Hildyard in this case, known as Waterfall IIC, are significant to the parties as they go to the rates of post-insolvency interest which creditors will receive.

Definition of Default Rate

Under the ISDA Master Agreements, interest is payable from one party to another in a variety of situations and at a variety of different rates, including the Default Rate.

Default Rate is defined in the 1992 and 2002 ISDA Master Agreements as "a rate per annum equal to the cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum".

Meaning of 'cost of funding'

The judgment considers the meaning of "cost… to the relevant payee… if it were to fund or of funding the relevant amount". It was argued that the "cost" could refer to the cost of raising funds, however that was achieved, and that it could include the cost of funding a larger sum than the relevant amount. Mr Justice Hildyard, however, did not accept that the words went that far and concluded that only the cost of borrowing the relevant amount is covered. Accordingly, "cost" does not include the cost of raising funds other than through borrowing; for example it would not include the cost of raising equity, nor does it include the cost of raising a sum beyond that required to fund the relevant amount.

The parties gave an example where the average cost of debt was 6.1% whereas the average cost of equity was 10.4%. Mr Justice Hildyard said this illustrated how different the proposition of borrowing an amount for a limited time is from equity where a person is funding in return for a reward by participation in the fortunes of the company. In his view, "risk capital" is not funding within the purview of the cost of funding language".

Meaning of "relevant payee"

Mr Justice Hildyard concluded that "relevant payee" means the original counterparty to the ISDA Master Agreement and not a third party to whom the original counterparty had transferred its interest in an Early Termination Amount. He reached this conclusion as a matter of construction of the transfer provisions in section 7 of the ISDA Master Agreements, which prohibits transfer without the prior written consent of the other party with two exceptions, being (1) change of control of one party and (2) transfer by a party of its interest in any Early Termination Amount payable to it by a Defaulting Party together with interest and other associated rights or remedies. He agreed with the submission that the purpose of the restrictions on transfer in those provisions is to protect the parties against unknown credit risks on assignment, which would be undermined if the Default Rate could refer to an assignee's cost of funding.

Accordingly, for the purpose of Default Rate, it is the cost to the original counterparty of funding the relevant amount that needs to be certified, irrespective of whether or not that original counterparty has sold its interest in any Early Termination Amount in the secondary market. This can be significant as there may be a large discrepancy in the costs of funding of the original counterparty and that of the assignee, as was the case with the parties involved in the Lehman Waterfall II litigation.

Application of the judgment to New York law governed ISDA Master Agreements

The parties to the Waterfall II litigation were agreed that their positions on interpretation of the relevant provisions of the ISDA Master Agreements would be the same if the ISDA Master Agreements were governed by New York law, as opposed to English law. The parties' New York law experts were largely in agreement on the principles of contractual interpretation that would apply in New York law.

The Court adopted the parties' agreed position and accordingly, the judgment applies to both the English law governed ISDA Master Agreements as well as to the New York law governed Master Agreements. Subject to appeal, the judgment has, therefore, set a precedent for the English courts to follow and will be of persuasive value for the New York courts if they were going to consider the meaning of Default Rate.

Conclusion

Clarity in interpretation of contractual terms is never more important than in a default situation. While this judgment remains subject to appeal, it provides some clarity as to what can be certified as the Default Rate, which will be helpful to prospective ISDA parties and prospective assignees of the Early Termination Amount in assessing their negotiation and risk positions.

DLA Piper's contentious restructuring team are advising the administrators of Lehman Brothers Limited (In Administration) in the Waterfall I and II proceedings.

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