NORTHERN TRUST

REGULATORY TRENDS IN NORTH AMERICA

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This newsletter outlines Northern Trust's thoughts about recent regulatory changes, and how they might affect your programs. It summarizes recent developments impacting the financial industry and how Northern Trust will support clients through this period. For more information, contact your Northern Trust representative or visit northerntrust.com.

REGULATORY OUTLOOK

As the U.S. along with the rest of the world continues to struggle with the effects of the pandemic we saw the greatest economic contraction since World War II, per a statement made on February 2 by the first ever female head of the U.S. Treasury, Janet Yellen (Treasury statement). Congress and other regulators are focusing their attention on rebuilding prosperity to our nation that highlights the future of regulations.

The Biden administration is working on enhancing the Department of Labor's recent rule that persuades a fiduciary not to select ESG investments unless there is economic benefit to the plan beneficiaries. The administration has rejoined the Paris Agreement and there are key indicators that ESG disclosures are on the horizon. In addition, there are focused discussions that have also started on applying a carbon tax to further help reduce the impact carbon has to our environment. While several states have an existing carbon tax it will take federal action to overcome the challenges other states have and a federal bill was proposed in 2019 but did not get any headway. However, new discussions are progressing and the U.S could be following suit as other developed countries have adopted or plan to implement a carbon tax. The U.S. Climate Finance Working Group has recently published a paper on their defined principles, Financing A U.S. Transition To A Low-Carbon Economy, which if adopted will make sweeping changes to the industry.

Crypto news is a trending topic as more financial institutions are partnering or developing asset servicing capabilities for digital assets. Members of the U.S. Congress announced on December 2 the proposal of a new consumer protection bill to increase the oversight and regulation of existing stablecoin issuers, potential stablecoin issuers, and stablecoin-related service providers known as the Stablecoin Tethering and Bank Licensing Enforcement (STABLE) Act, which was originally introduced in October 2020. The U.S. Treasury has proposed new enhanced Anti-Money Laundering (AML) standards that would require financial institutions and money services businesses (MSBs) to maintain records and submit reports to verify customer identities and counterparties for transactions involving convertible virtual currency (CVC) or digital assets with legal tender status (LTDA). As digital assets grow in popularity, new regulations are likely to emerge to govern the use and distribution of these assets.

IN THIS NEWSLETTER

We discuss the SEC's fund shareholder disclosure; update to their approach for regulating derivatives and ETFs; and the approved fair valuation. We will also provide you with updates to CSDR and LIBOR.

JOEL CRAIN
Senior Consultant
Regulatory Solutions,
Northern Trust

In other regulatory news building off the SECURE Act, the House Ways and Means Committee Chairman Richard Neal, D-Mass., plans to reintroduce to Congress the Securing a Strong Retirement Act of 2020, which would boost the required minimum pension distribution age from 72 to 75. It will strengthen and improve Social Security benefits, particularly for low-wage workers; protects Social Security disability benefits from harmful regulations and other attacks designed to reduce access to benefits; implements automatic IRAs and 401(k)s; and requires automatic enrollment in 401(k) type plans.

We cannot forget about the SEC. With the new administration came new SEC commissioners and a new head. They are currently under orders to review all proposed or adopted regulations which have not gone into effect and which have a significant impact – including, for example, the Derivative Modernization (18f-4) and the SEC Fund Disclosure rules, which are discussed further in this newsletter. It is clear that the SEC will need to provide guidance on these and other regulations in the coming months and firms will need to comply with these new regulations with more on the horizon. There are clear signals that enforcement actions will be a priority since a new law that went into force on January 1, 2021 amended the Securities and Exchange Act of 1934 that expressly provides statutory authority to the SEC to pursue disgorgement in federal court as part of the recently adopted National Defense Authorization Act (NDAA).

In addition, as part of the NDAA, the AML Act of 2020 was included and creates a broad range of new AML obligations for banks and other financial institutions; certain private investment structures; and even federal regulators. It creates a federal beneficial ownership registry; provides broader subpoena power over foreign banks; enhances enforcement powers, new crimes and new penalties; expands the scope of the Bank Secrecy Act (BSA); changes BSA/AML program requirements; provides the ability to share SARs with foreign banks; focuses on technology; provides safe harbors; and sets forth a new whistleblower regime.

Overall the pace of regulatory change is not slowing down, and firms will need to adapt to the new changes, which may come at a cost. The industry needs to provide greater transparency and help drive increased market stability, so we can expect more regulatory reporting. It is important to note that financial institutions can help support our clients to meet their regulatory obligations through new automation leveraging AI and clear, concise data when possible.

SEC FUND SHAREHOLDER DISCLOSURE OVERHAUL

On August 5, 2020 the SEC proposed shareholder disclosure amendments that would modernize the disclosure framework for open-end management investment companies. The SEC proposal provides for a layered disclosure framework for fund shareholders that would highlight key information for assessing and monitoring a fund investment and informing investment decisions (e.g. whether to buy additional shares, continue to hold, or sell a fund investment), with additional information available online and upon request. Funds' shareholder reports would serve as the central source of fund disclosure for existing shareholders that would be available online and delivered free of charge. The reports would be filed on a semi-annual basis on Forms N1-A and N-CSR.

The proposal would:

- require streamlined reports to shareholders that would include, among other things fund expenses, performance, illustrations of holdings, and material fund changes;
- significantly revise the content of these items to better align disclosures with developments in the markets and investor expectations;
- encourage funds to use graphic or text features, such as tables, bullet lists, and question-and-answers to promote effective communication;
- promote a layered and comprehensive disclosure framework by continuing to make available online information that is currently required in shareholder reports but will be less relevant to retail investors;
- require that a registered investment company or business development company (BDC) advertisement discussing fees and expenses include certain standardized figures and provide reasonably current information; and
- if a fund chooses to rely on rule 30e-3, beginning January 1, 2021, a shareholder who currently receives fund shareholder reports in the mail may begin receiving instead notices that a shareholder report is available on the fund's website.

While the proposal would exclude open-end funds from rule 30e-3, closed-end funds could still rely on this rule which currently allows a fund to satisfy its obligation to transmit the shareholder reports that rule 30e-1 and rule 30e-2 require if the fund complies with the conditions to:

- making the fund's shareholder report and other materials available on a website;
- providing notice to investors of the website availability of the shareholder report; and
- delivering paper copies of the materials that appear online, upon a shareholder's request.

"This amendment would help ensure that all open-end fund shareholders would experience the anticipated benefits of the proposal's modified disclosure framework, which contemplates direct transmission of concise shareholder reports that serve as the central source of fund disclosure for existing shareholders"

SEC Fact Sheet August 5, 2020

In addition, the proposed amendments would:

- replace the existing fee table in the summary section of the statutory prospectus with a simplified fee summary;
- move the existing fee table to the statutory prospectus; and
- replace certain terms in the current fee table with terms intended to be clearer to investors.

The proposed amendments would also permit funds that make limited investments (up to 10% of net assets) in other funds to disclose acquired fund fees and expenses (AFFE) in a footnote to the fee table and summary instead of requiring AFFE to be presented as a line item in the table. For Fund of Funds investments this would provide a clear representation of the fees charged that would impact the investment returns.

The SEC is rescinding rule 30e-1(d), which permits a fund to transmit a copy of its prospectus or Statement of Additional Information (SAI) in place of its shareholder report, if it includes all of the information that would otherwise be required to be contained in the shareholder report. The SAI would need to be available online.

The underlying theme of the proposal is to provide investors with information regarding their investment in a more tailored and cleaner representation and streamline the information to determine their future or continued investment into the fund.

Northern Trust Actions

Northern Trust is currently reviewing this proposal with our vendors. Once we receive the final ruling a change program would be implemented for those clients that will be impacted. The comment period was scheduled to close on January 4, 2020. However, as part of the Biden administration review of all regulatory proposals it may be subject to change. We will continue to monitor the outcome and take the appropriate actions to support our clients. If you should have any questions regarding this proposal, please contact your relationship representative.

UPDATE TO A MODERN APPROACH IN REGULATING A FUND'S USE OF DERIVATIVES AND ETFS

SEC APPROVES RULE 18F-4 TO INVESTMENT COMPANY ACT OF 1940

On December 21, 2020, the SEC approved their modernized version of rule 18f-4 under the Investment Company Act of 1940. The rule sets new conditions for funds to trade derivatives and financial commitment transactions. It was initially proposed in 2015 but was subsequently dropped. The SEC believes that 18f-4 along with the amendments to Rule 6c-11 will provide a modern framework.

Section 18 of the Act aims to prohibit or limit mutual funds from issuing senior securities. According to the SEC, a senior security includes reverse repurchase agreements, firm commitment agreements, standby commitment agreements, short sales, written options, forwards, futures, and other derivatives transactions involving senior securities issued on the fund's behalf. Rule 18f-4 supports section 18's objective by enacting investor protection measures to prevent excess leveraging of investment companies.

The rule would not apply to unit investment trusts, but it does require the following changes for ETFs, open-ended funds, and closed-ended funds:

- **A written derivatives risk management program** that would define risk guidelines, stress testing, internal reporting, escalation processes, how the fund uses derivatives and how derivatives affect the fund's investing.
- **An outer limit on fund leverage risk** based on value at risk (VaR) when funds engage in derivatives transactions. In a change from the proposal, funds can use their securities portfolio as a reference portfolio for the VaR test and increase the VaR limits from 150% and 15% to 200% and 20%, respectively.
- **A designated derivatives risk manager** with approval from the fund's board of directors. The risk manager would be responsible for implementing and maintaining the risk management program and would report directly to the board.
- **An exception for limited derivative users** from the derivative risk management program and the VaR-based limit on fund leverage risk.
    - In a change from the proposal, when calculating one's exposure to determine eligibility for the exception, a fund will be permitted to exclude derivatives that are used to hedge currency and interest rate risks.

- The final amendments to the proposal require a fund that relies on the limited derivatives user exception to report derivatives exposure information. A fund that relies on this exception will have to report:
  - its derivatives exposure;
  - its exposure from currency derivatives that hedge currency risks; and
  - its exposure from interest rate derivatives that hedge interest rate risks.
- In the final rule, funds relying on the exception will need to limit their derivative exposure to 10% or less of the net asset value of the fund.

- **An exception for certain leveraged/inverse funds with additional safeguards** from the limit on a fund leverage risk.
  - Under the sales practice rules, a new requirement to exercise due diligence on retail investors before approving their account to invest in the fund(s).
  - Preserves the right for investors to choose to believe that the investment advisor or broker-dealer has reasonably sufficient financial knowledge and experience to evaluation the risk of the funds.

- **Record-keeping requirements** designed to provide the SEC staff, the fund's board, and the internal compliance team with the ability to evaluate a fund's adherence to the 18f-4.
- **Permission for funds to enter into reverse repurchase agreements** as long as the fund meets the asset coverage requirements under section 18 and unfunded commitments or they can treat REPOs as a derivative contract under 18f-4.
- **Confidential SEC reporting** on Form N-LIQUID (to be renamed "Form N-RN") if the fund is out of compliance with the VaR-based limit on fund leverage risk for more than three consecutive business days.

The final rule also includes a new provision that will permit funds, as well as money market funds, to invest in securities on a when-issued or forward settling basis, or with a non-standard settlement cycle. Rule 18f-4 will require firms to enhance the existing SEC reporting requirements.

While VaR reporting is new under this framework, industry insiders believe additional guidance on the use of the VaR will be required. However, institutions will still need to work to adopt these changes.

RULE 6C-11

SEC amended rule 6c-11 of the Investment Company Act of 1940 and a stipulation which generally permits ETFs that are indexed-based and actively managed open-ended funds to operate with an exemption order. The amendment to the rule will instead allow ETFs who meet the laid-out criteria in 18f-4 to forgo applying for an exemption and instead go directly to market, saving time and expense for investors. In order to operate without applying for an exemption per the amendment, ETFs are subject to several conditions designed to address concerns for relevant statutory provisions and to allow the funds to operate in the public interest and consistent with the investor protection outlined in the Act:

- Disclosure of portfolio holdings each business day on its website before the market opening with the ETF NAV, market price, and the premium or discount.
- Disclosure of the ETF median bid-ask spread over the last 30 calendar days.
- Adoption and implementation of written policies and procedures that govern the construction of baskets, inclusive of custom baskets, and the process that will be used for the acceptance of baskets.
- Record retention for each basket exchange with an authorized participant.

Rule 6c-11 also includes a condition that excludes ETFs that seek to provide investment returns over a period of time that corresponds to the performance of a market index by a specified multiple or which has an inverse relationship to performance of a market index (i.e. leverage/inverse ETFs). However, the rule does not include conditions relating to index-based ETFs with affiliated index providers ("self-indexed ETFs").

COMPLIANCE DATE

The rule became effective February 19, 2021 with an implementation period for firms of 18 months to adopt the reporting changes. Compliance is required by August 19, 2022.

Northern Trust Actions

Northern Trust has engaged with a consultant and our vendor to create a change program. We will communicate additional details as developments evolve. If you would like to know more about 18f-4 contact your Northern Trust representative. View all rule updates to N-PORT, N-LIQUID, and N-CEN reporting in the SEC's final rule that can be found here: SEC's final rule.

SEC FAIR VALUATION REGIME

On December 3, 2020 the SEC approved a long-awaited fund valuation rule regime ("rule 2a-5") under the Investment Company Act of 1940 with some modification from the proposal and adopts record keeping rule 31a-4. The regulation addresses valuation practices and the role of the board of directors with respect to the fair valuation of investments made by a registered investment company or business development company. It sets a minimum standard for assessing fair valuations in good faith when a pricing quotation is not readily available. The fund board, or in the case of a trustee for a unit investment trust (UIT), appoints their investment advisors to handle valuations, subject to a series of conditions and requirements. It also includes a provision related to the determination of the fair value of investments held by UITs, which do not have a board of directors.

BACKGROUND

The SEC has recognized there have been significant developments in how fund companies obtain and provide oversight for valuations over the last fifty years:

- Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB). The PCAOB oversees the audits of companies' subject to the federal securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports.
- The adoption in 2003 of compliance rules under the Investment Company Act and the Advisers Act (together, the "Compliance Rules"):
    - monitors for circumstances that may necessitate the use of fair value;
    - establishes criteria for determining when market quotations are no longer reliable for a particular portfolio security;
    - provides a methodology or methodologies by which the fund determines fair value;
    - regularly reviews the appropriateness and accuracy of the methodology used to determine fair value and make any necessary adjustment.
- Issuance and codification by the Financial Accounting Standards Board (FASB) of ASC Topic 820 in 2006 and 2009. ASC Topic 820 defines the term "fair value" for purposes of the accounting standards and establishes a framework for the recognition, measurement, and disclosure of fair value under U.S. generally-accepted accounting principles (U.S. GAAP).
- In 2018 FASB updated the ASC Topic 820 with revised disclosure requirements for fair valuation measurements.

FINAL RULE

Rule 2a-5(a) determines a set of principles for fair valuations in good faith that each fund board or UIT would need to adopt.

- Valuation risk – periodically assessing any material risks associated with the determination of the fair value of the fund's investments, including material conflicts of interest, and managing those identified valuation risks, including factors such as:
  - the types of investments held or intended to be held by the fund;
  - potential market or sector shocks or dislocations;
  - the extent to which each fair value methodology uses unobservable inputs, particularly if such inputs are provided by the adviser;
  - the proportion of the fund's investments that are fair valued as determined in good faith, and their contribution to the fund's returns;
  - reliance on service providers that have more limited expertise in relevant asset classes; the use of fair value methodologies that rely on inputs from third party service providers; and the extent to which third party service providers rely on their own service providers (so-called "fourth party" risks);
  - the risk that the methods for determining and calculating fair value are inappropriate or that such methods are not being applied consistently or correctly.

- Fair value methodologies in good faith – requires selecting and implementing a consistent methodology for calculating the fair valuation for assets a fund holds and will hold in the future. The requirement includes:
  - specifying the key inputs and assumptions for each asset
  - including new assets into the fund
  - at least quarterly review for fitness and accuracy
  - consistently applying the methodology, which includes back testing
  - Board, trustee, or advisor monitoring for circumstances that may necessitate the use of fair valuations on good faith, i.e. when price quotes are not readily available.

The SEC removed from the final rule the proposed specific requirement that a board or adviser specify in advance the fair value methodologies that will apply to new types of investments in which the fund intends to invest.

- Testing of fair value methodologies would ensure appropriateness of the methodology and ensure adjustments are made when necessary.
  - The requirements specify the board or advisor should identify the testing methods to be used and the frequency for each test.
  - The testing should identify poor performing securities and or potential conflicts of interest.

- Pricing services – the provision allows for third party pricing vendors that the board or advisor would need to approve, monitor, and evaluate on a determined frequency.

- Fair value policies and procedures
  - Rule 2a-5 would require written policies and procedures addressing the determination of the fair value of the fund's investments.
  - The proposed rule would require the fair value policies and procedures to be reasonably designed to achieve compliance.
  - Current rule 38a-1 requires the board to approve all policies and procedures, by adapting to rule 2a-5 a fund would be considered fulling the regulatory obligation required by 38a-1.

- Record keeping
  - The regulation requires the fund to maintain supporting documentation to support a fair value determination: specific methodology used, including assumptions and inputs into the calculation.
  - The record keeping should be maintained for fund audits, financial statements, and to help support the CCO's compliance report to the board.

The new 2a-5 and 31a-4 rule would supersede the SEC's Accounting Series Release (ASR) 113 and 118, since determining fair valuations requires greater resources and expertise then what was identified in the ASRs.

A key component of the new regulation is to ensure board's oversight and ensuring their appointed advisors are adhering to the regulation. While board members may not actively perform the day to day task in calculating the fair valuations, they are ultimately responsible for ensuring there is a robust fair valuation methodology, policies, and oversight.

Northern Trust Actions

Northern Trust is closely monitoring this regulation and our fund governance team is assessing the impact this will have on the business we support.

To learn more, please refer to the SEC final rule: Good Faith Determination of Fair Valuation If you have any questions regarding this article or if you have general questions regarding regulatory changes, please contact your Northern Trust representative.

THE CENTRAL SECURITIES DEPOSITORIES REGULATION (CSDR)

INDUSTRY AND REGULATORY DEVELOPMENTS

The European Central Securities Depositories Regulation (CSDR) is one of the key regulations adopted in the aftermath of the 2008 financial crisis.

The Central Securities Depositories Regulation (CSDR) aims to increase the safety and improve settlement efficiency as well as providing a set of common requirements to ensure the safety of EU CSD's. To support this CSDR has been harmonizing the authorization and supervision of Central Securities Depositories (CSDs) within the EU since 2014.

Since 2014 there has been a phased introduction of the requirements including:

- T+2 settlement cycle
- Authorization including strict prudential and conduct rules for CSDs
- Internalized settlement reporting
- Omnibus and segregated accounts including risk and cost disclosures

As with other EU regulations, Article 75 of CSDR requires the European Commission (EC) to prepare a report on its implementation and submit it to the European Parliament and Council including any proposed legislative changes if necessary. To support this in December 2020, the EC issued a targeted consultation for stakeholders to provide input on the implementation to date. The feedback is sought on a wide range of specific areas where targeted action may be necessary to make the objectives of the regulation more proportionate, efficient and effective. The consultation also requests that feedback takes account of recent developments in particular pressure put on the market by the COVID-19 pandemic. The consultation closed on February 2, 2021 and we anticipate any proposed legislation to be published in quarter 4 2021.

SETTLEMENT DISCIPLINE REGIME UPDATE

The next key requirement due to be implemented is the Settlement Discipline Regime (SDR), under which, any instrument cleared at an EU central clearing house or settled by an EU trading venue or EU CSD is in scope. The primary objective of the enhanced SDR is to incentivize timely trade settlement, reduce settlement risk and ultimately increase safety of securities across the European Economic Area (EEA) markets. This is to be achieved by the introduction of cash penalties and mandatory buy-ins. In our Q2 2020 newsletter, we highlighted that European Securities and Markets Association (ESMA) has proposed a delay in the implementation timeline of settlement discipline to February 2022 due to continued industry challenge and the operational impacts of COVID-19. This delay has been approved by the EC.

Even though the SDR has not yet been implemented the survey published by the EC has included questions on the framework which is seen as a positive step in addressing some of the industry concerns which are being raised. Of particular challenge is the implementation of buy-ins which, in light of increased settlement failures experienced during market volatility resulting from the pandemic could be seen to have a negative impact on the market at times of stress, further clarity on the roles of buy-in agents is required.

Northern Trust Actions

Northern Trust has a formal execution program in place to ensure we meet our obligations under the settlement discipline regime as well as supporting our clients. Our CSDR implementation program is committed to effectively managing this change, providing timely information to enable clients to assess impacts to their business. Our core impacted products and services have identified service offering changes for cash penalties to support readiness activities. We have commenced on-boarding an external third-party system for the management of messaging, cash penalties as well as daily and monthly reporting.

Northern Trust representatives are actively engaged in industry associations AFME, AGC and the IA to ensure we continue to monitor regulatory developments, support ongoing industry lobbying and development of market practice guides where open questions remain. We continue to monitor any developments resulting from the EC survey and will provide any updates to you on these as they arise.

MORE CLARITY ON LIBOR'S END GAME

THE END TO LIBOR IS DRAWING NEAR

More clarity on how and exactly when LIBOR will cease has emerged with an announcement from the Financial Conduct Authority (FCA) on March 5 of the dates that panel bank submissions for all LIBOR settings will cease, after which representative LIBOR rates will no longer be available.

"The FCA has confirmed that all LIBOR settings will either cease to be provided by any administrator or no longer be representative:

- immediately after December 31, 2021, in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month U.S. dollar settings; and
- immediately after June 30, 2023, in the case of the remaining U.S. dollar settings."

In an accompanying press release, Andrew Bailey, Governor of the Bank of England urged market participants to prepare for the cessation of LIBOR - "...With limited time remaining, my message to firms is clear – act now and complete your transition by the end of 2021."

This announcement follows the conclusion of consultations by ICE Benchmark Administration (IBA), LIBOR's administrator, who's proposals were broadly supported by regulatory authorities.

"Together with the actions taken at the end of last year, these announcements provide a clear end-date for USD LIBOR and a clear path for the change to alternative reference rates... In the months ahead, supervisors will focus on ensuring that firms are managing the remaining transition risks," said Randal K. Quarles, Vice Chair for Supervision at the Federal Reserve Board and Chair of the Financial Stability Board.

The later June 30, 2023 end-date for USD LIBOR settings is intended to allow for more legacy LIBOR-linked contracts to mature on their existing terms. U.S. supervisory guidance is clear that firms should not enter into new transactions referencing USD LIBOR after December 31, 2021, given potential "safety and soundness concerns". On the launch of the consultations, the FCA issued a statement pledging to coordinate with U.S. authorities and those in other jurisdictions to consider how to limit new use of USD LIBOR. ISDA hosted a webinar with the FCA, Federal Reserve Board of Governors and Chairman of the Alternative Reference Rates Committee (ARRC), providing more detail on what this means for the market and next steps.

"The LIBOR transition is a significant event that poses complex challenges for banks and the financial system. The agencies encourage banks to cease entering into new contracts that use USD LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021, in order to facilitate an orderly—and safe and sound— LIBOR transition".

Statement from LIBOR Transition from Board of Governors of the Federal Reserve System Federal Deposit Insurance Corporation Office of the Comptroller of the Currency

Also on March 5, ISDA confirmed that the FCA's announcement "..constitutes an index cessation event under the IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol" thereby fixing the fallback spread adjustment published by Bloomberg. The fallbacks (i.e., to the adjusted risk-free rate plus spread) will automatically occur for outstanding derivatives contracts that incorporate the supplement or are subject to adherence of the protocol in line with the above cessation dates

While the ARRC expects that many more legacy USD LIBOR contracts will mature by mid-2023 under IBA's proposals, a number will remain including those lacking effective means to replace LIBOR ("tough legacy" contracts). The ARRC confirmed in its Guide on the Endgame for USD LIBOR that it will continue to pursue a legislative proposal with New York State, expressing a strong belief that such legislation remains necessary – similar federal legislation is being contemplated. Seeking to solve a comparable challenge, the European Council has agreed to an amendment to the EU Benchmark Regulation providing for a statutory replacement of a critical benchmark with an alternative risk free rate in case of that benchmark's cessation. The mechanism is similar to that proposed by the ARRC, though it remains unclear how approaches in different jurisdictions will interact.

The FCA began consultations and released more details on proposed new powers, including creation of a synthetic LIBOR, under the Financial Services Bill. Use of synthetic LIBOR is for "tough legacy" contracts – use in new contracts will be prohibited. Publication of synthetic LIBOR depends on an announcement that LIBOR has or will become unrepresentative as a benchmark; ISDA fallbacks would still be triggered. New powers will only be applied for the LIBOR settings most commonly used in "tough legacy" contracts (e.g. GBP LIBOR) and where the inputs are available. EUR LIBOR and CHF LIBOR are likely to cease completely. The FCA will publish further details in Statements of Policy after various consultations conclude.

With more to come, there have also been significant accomplishments. In a progress report, the FSB highlighted that national working groups remained focused on LIBOR transition throughout 2020 despite challenges arising from COVID-19, and pointed to good progress in work on supporting infrastructure, market conventions and systems upgrades. Global lending markets were highlighted as an area that has lagged the pace of progress, with the FSB encouraging market participants to "act quickly to move new business onto alternative rates".

More positively, the ISDA launched updated definitions and a protocol that will embed appropriate contractual language and a 'fallback' alternative Risk Free Rate (RFR e.g. SONIA, SOFR) plus a spread in new and existing LIBOR linked swap contracts, a significant milestone for the industry supported by global regulators. As of the end of January more than 13,000 parties had adhered to the protocol (list of adherents). Derivatives clearing houses transitioned to using the €STR rate in discounting calculations July 27. A similar transition happened in the U.S. on October 16, from Fed Funds to SOFR, impacting a larger volume of swap contracts and triggering an increase in liquidity in that market. Term SONIA rates have recently gone live in the UK and plans remain for Term RFRs in the U.S. and Japan by mid-year.

Northern Trust Actions

At Northern Trust, there is an enterprise-wide program to guide the LIBOR and IBOR transition. This program has organizational subject matter experts who are implementing a multi-year plan, driven by client- and product-focused work streams, to manage the transition from the IBORs to alternative RFRs or other benchmark rates. Northern Trust is monitoring and participating in industry forums to evaluate alternative reference rates, fallback language and best practices to prepare for upcoming changes. Quarterly meetings are ongoing with the Federal Reserve Bank of Chicago and Prudential Regulatory Authority (U.K.). For Northern Trust's Asset Servicing business, the scope of impacts and high-level requirements have been documented by product. The program performed a detailed gap analysis and has developed execution plans. Development to ensure robust and scalable support for alternative RFRs is in progress. Client-specific engagements to discuss LIBOR transition planning are continuing through Q1 2021.

Other developments in the U.S. include the ARRC releasing conventions for using SOFR in arrears in bilateral business loans. The Internal Revenue Service published a Revenue Procedure providing guidance on the transition away from IBORs. The guidance generally provides that modifying contracts to incorporate the ISDA Protocol and ARRC-recommended fallback language will not result in a realization event.]

They key message from regulators globally is to keep up the pace of transition efforts. Key milestones on the ARRC's paced transition plan still stand as they remain relevant to the goal of moving away from LIBOR in new business as soon as practical, for example the end of Q2 2021 target for no new USD LIBOR business loans, securitizations or derivatives that increase LIBOR risk. A priority on the UK working group's roadmap is for firms to complete identification of all legacy GBP LIBOR contracts expiring after 2021 that can be actively converted by end-Q1, and progress active conversion where viable through to completion by end-Q3 2021. More intervention from regulators can be expected if they do not see progress against these targets.

All source documents referenced within this newsletter can be directly accessed using the hyperlinks contained within the electronic edition of the newsletter. To access the electronic edition please go to:

www.northerntrust.com/insights-research/regulatory-developments

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