NORTHERN TRUST

REGULATORY TRENDS IN EMEA

VOLUME 1, 2020

CONTENTS

This booklet outlines our thinking about recent regulatory changes, and how they might affect your programs. It summarises recent developments impacting the financial industry and how we anticipate supporting our clients through this period. For more information, contact your Northern Trust representative or visit northerntrust.com.

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REGULATORY OUTLOOK

As the COVID-19 pandemic has deepened, it has resulted in unprecedented measures being introduced by governments. Currently one third of the world is on a form of lockdown, which has had the potential to spiral into mass unemployment, market failure and inevitable recession. The response to the economic downturn has seen important fiscal measures being introduced.

The majority of central banks have reacted quickly by reducing interest rates to floor levels and scaling up measures of quantitative easing (QE), to boost liquidity in the financial sectors and prevent the inevitable liquidity squeeze. The pace and scale of QE programmes being announced across Europe are much greater than those experienced in 2008, as there are few areas of the economy untouched by the current crisis. Similarly, we have seen the relaxing of capital adequacy requirements to maintain funding in the banking system. The scale of government intervention to support businesses has been likened to war-type conditions; large state support funded by increased borrowings.

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From a financial services' perspective, we have seen regulators focus on business continuity to ensure consumer protection and market stability while emphasizing a continued focus on controls. Regulators have been active in providing relief to near term implementation programmes by announcing delays so that banks can focus on the challenges posed by the coronavirus outbreak. Notable recent delays announced include;

- The European Securities and Markets Authority (ESMA) have announced a delay in implementing the requirements of Securities Financing Transaction Regulation (SFTR) from 13 April to 13 July 2020.
- The Basel Committee on Banking Supervision (BCBS) announced the deferral of Basel III implementation by one year to 1 January 2023.
- ESMA have announced a delay in the reporting timeline for Best Execution reporting required under articles 27 and 28 of MiFID II.
- ESMA have announced a delay in implementing the requirements of Money Market Fund Regulation (MMFR) from April to September 2020 due to xml updates required for reporting.

Aside from COVID-19, the core trends and focus of regulators (at both a local & EU wide perspective) remains the same i.e. transparency, accountability, outsourcing oversight & an increased focus on all things ESG. It is those trends plus action around money laundering & the world's increasingly aging population that we are still expecting most new regulation to focus on.

Lastly, we could not have a regulatory update without mentioning Brexit. We decided to give you all some relief and not write in detail about Brexit in this newsletter though. However, Brexit is still not done from the aspect of what agreement is or is not agreed between the UK and the EU at the end of the transitional period. As of now, the transitional period is due to end at the end of 2020. However, there is increasing pressure on that date due to the understandable focus on COVID-19, which has meant that the planned trade talks have slowed. Not only is the withdrawal agreement noticeably absent of any detail on financial services, the core trade deal is not expected to cover the provision of services. The latter will therefore need to be complemented by further agreements likely to be decided upon post-2020. What this means in terms of implications from a timing perspective for financial services entities post the transition period is unknown. We will stay close to any developments here & keep you all updated.

Whether change is initiated locally or not, the level of regulation that must be adhered to continues to require vigilant monitoring. Northern Trust dedicates significant time to tracking and analysing the implications of regulatory change; if you would like to discuss any of the items in this newsletter in more detail please do not hesitate to contact us.

TRANSITION AWAY FROM INTERBANK OFFERED RATES (IBORs)

On 25 March, the Financial Conduct Authority (FCA, the regulator of LIBOR) released a statement confirming that "The central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet." This was following discussions with the Bank of England and members of the Working Group on Sterling Risk-Free Reference Rates (RFRs) on the impact of the coronavirus on firms' LIBOR transition plans over the coming months,

Earlier in the year the UK Working Group on RFRs published its priorities and an updated roadmap for 2020, highlighting that "firms need to accelerate efforts to ensure they are prepared for LIBOR cessation by end-2021". The key milestones include:

- March-2020 change in Sterling swap conventions from LIBOR to SONIA;
- ceasing issuance of cash products linked to sterling LIBOR by end-Q3 2020;
- stock of LIBOR referencing contracts sufficiently reduced by end-Q1 2021.

The FCA's more recent statement has acknowledged that some of these interim milestones might now be delayed but the end target date remains the same.

In the U.S. the Alternative Reference Rates Committee continues to be active, releasing a proposal for New York State legislation for U.S. Dollar LIBOR contracts.

In other efforts to support the transition away from LIBOR the Federal Reserve Bank of New York now publishes 30-, 90-, and 180-day SOFR Averages and a SOFR Index. While the Federal Housing Finance Association has issued guidance for the purchase of LIBOR indexed investments and timelines to stop purchasing LIBOR adjustable rate mortgages.

In the Eurozone the European Overnight Index Average (EONIA) will cease publication at the end of 2021, being replaced by the Euro Short Term Rate (€STR, first published in Oct. 2019; €STR is also the proposed alternative RFR for EUR LIBOR). The Working Group on Euro RFRs has highlighted that contracts referenced to EONIA with maturities beyond 3 January 2022 would entail significant risks. It therefore recommends that market participants should replace EONIA products with €STR products and reduce their EONIA-linked legacy exposures as soon as possible.

LIBOR is produced for CHF, EUR, GBP, JPY and USD in seven tenors (Overnight/ Spot Next, 1 Week, 1 Month, 2 Months, 3 Months, 6 Months and 12 Months) based on submissions from a reference panel of between 11 and 16 banks for each currency, resulting in the publication of 35 rates every applicable London business day.

The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks held a public consultation on transition and fallbacks which envisage the permanent discontinuation of JPY LIBOR for financial products and transactions referencing JPY LIBOR. The results showed that most respondents supported the use of term reference rates based on an uncollateralized overnight call rate (TONA) but emphasized challenges in terms of the amount of time required to build liquidity in TONA to ensure its robustness and reliability.

A number of markets are expected to adopt a multiple-rate approach. For the Australian dollar, the key interest rate benchmarks are the bank bill swap rates (BBSW) and the cash rate. The Bank Bill Swap Rate (BBSW) is to be strengthened and co-exist alongside the AUD Overnight Index Average (AONIA, also known as the cash rate). The Financial Stability Board published a progress report on reforming interest rate benchmarks, stating that "whether moving away from one of the IBOR rates or still pursuing a multiple rate approach, there is a common view that the use of overnight risk-free rates (RFRs) should be encouraged across global interest rate markets where appropriate, and that contracts referencing IBORs should have robust fallbacks."

In the derivatives space, ISDA is re-consulting (deadline April 1) on how to implement pre-cessation fallbacks, meaning a delay to plans to publish amendments to their standard definitions and protocol. These are now expected to be finalized in q3-2020. Bloomberg, having been selected to calculate and publish adjustments related to the ISDA fallbacks, are continuing with their efforts to make adjusted rates available in q2-2020. The central counterparty (CCP) discounting switch from EONIA to the €STR is planned for July 2020, a delay from the original June date, with a switch from Fed Funds to SOFR discounting scheduled for October.

Northern Trust actions

Northern Trust has established an enterprise-wide LIBOR Transition Program to coordinate its LIBOR and IBOR transition efforts. This program is comprised of subject matter experts from across the organization who are developing and 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. More information and useful resources are available on our website.

IBOR	Alternative RFR
GBP LIBOR	Reformed Sterling overnight index average (SONIA)
USD LIBOR	Secured overnight financing rate (SOFR)
EURIBOR Euro LIBOR	Euro short-term rate (€STR)
CHF LIBOR	Swiss average rate overnight (SARON)
JPY LIBOR, JPY TIBOR, EUROYEN TIBOR	Tokyo overnight average rate (TONAR)

THE CENTRAL SECURITIES DEPOSITORIES REGULATION (CSDR)

Background

The Central Securities Depositories Regulation (CSDR) has been harmonizing the authorization and supervision of Central Securities Depositories (CSDs) within the EU since 2014. The regulation impacts instruments cleared at an EU central counterparty clearing house, or settled by any EU Trade Venue or CSD.

The next key requirement due to be implemented is Settlement Discipline Regime (SDR), under SDR, any instrument cleared at an EU central clearing house or settled by an EU trading venue or EU CSD is in scope. The goal is to reduce settlement fail rates by introducing cash penalties and mandatory buy-ins.

Key provisions Cash Penalties and compensation

The SDR will become applicable on 14 September 2020; ratification by the European Commission of an implementation delay proposed by ESMA to 1 February 2021 is pending. The rationale behind the proposed delay is that the SWIFT changes and T2S Penalty Mechanism shall not be available by September 2020, with necessary technology updates being implemented in November 2020.

SDR requires EU CSDs to calculate cash penalties for late matching and late settlement. In the case of the former, penalties will only apply to trades that are confirmed; when CSDR refers to 'matching' it relates to settlement matching. Any transaction that fails to settle on the intended settlement date will incur cash penalties.

CSDR SDR states a requirement to facilitate partial settlement if holdings are available, in order to mitigate exposure to the total penalty, where the counterparty has sufficient assets to settle part of the transactions.

- Late matching penalties can only be calculated once the match has occurred (as it is then known how many days late the matching was beyond the set timeframe), and will be calculated for all days of the late match period, at the individual day's closing price. Late matching penalties will be charged to the party who was last to submit or modified the instruction which enabled the transaction to match.
- Late settlement penalties will be calculated daily for each business day the transaction fails to settle post intended settlement date and the penalty will be imposed against the failing party. It should be noted that the reason for a failed settlement could change throughout the fail period, meaning a penalty could be imposed against both parties.

A failing transaction could incur both late matching and late settlement penalties, however, both penalties will not be levied for the same date.

CSDs will send notifications of the penalty amounts payable to their participants on a daily basis. The mechanism for this notification is still to be determined. On at least a monthly basis, CSDs will pass on a net amount to the participant's cash account in monies owed from penalties. There is a fixed formula used for both late matching and late settlement penalty calculation, which takes into consideration the elements of the trade, asset type and closing daily prices. There is an opportunity to appeal a penalty from the date the CSD issues the penalty notification until the eleventh business day of the month following that within which the penalty was applied. If a dispute remains open, a bilateral arrangement to resolve the penalty between the two counterparties must be sought.

Mandatory buy-ins and cash compensation

CSDR SDR will impose mandatory buy-ins, for all instruments cleared at an EU Central Counterparty (CCP) or settled by any EU trade venue or CSD. If a transaction has still failed to settle within certain timeframes then a buy-in process must be initiated. The relevant timeframes are:

- Four business days beyond the intended settlement date (ISD+4) for equities trading on a liquid market
- ISD+7 for bonds and less liquid securities
- ISD+15 for securities traded on SME growth markets

The business day following the above timeframes, the party due to receive the instrument must appoint a buy-in agent to purchase the securities elsewhere. If a CCP has been used for clearance of the trade, the CCP will be responsible for initiating this buy-in process. The failing party must place the original settlement instruction on hold; the same will be cancelled once the buy-in transaction settles. Any price increase, FX cost, corporate event or buy-in agent fees must be paid by the failing party. A price drop will be deemed to have already been paid; the 'failed to' party will not have to compensate the failing party. The key process steps involved in the buy-in process are:

- Upon expiry of the extension period the failed-to trading party must appoint a buy-in agent and advise the failing trading party of the same.
- The failing party must put the failing instruction on-hold upon receipt of the buy-in notification.
- Once the buy-in execution has been completed the failed-to trading party must notify the failing party of the outcome of the buy-in including all associate costs.
- If the buy-in could not be executed in full then cash compensation will be due, this must be calculated and the failing party must be notified of the same.
- Upon settlement of the cash difference between the initial trade and the buy-in, the underlying failing trade must be bilaterally cancelled.
- If the buy-in execution cost is less than the initial trade price then the cash settlement is deemed to have been paid.
- The failed-to party must notify the respective CSDs of the buy-in results.

Industry Challenges

Further to the delay mentioned above, a letter from AFME endorsed by 14 other industry associations was sent to ESMA in January 2020 requesting additional delays, highlighting the current challenges on both penalties and buy-ins. These include;

- Cash penalties to be introduced once market infrastructures, banks and their clients have built the technology required to process the fines, and not before the market has had an opportunity to test the required new messaging and technology.
- Deferral of the mandatory buy-in regime until the effects of penalties and other measures to promote settlement efficiency are implemented, and in-depth impact analysis is undertaken on the potential effects of a mandatory buy-in.
- Implement monitoring processes to measure the impact of the penalty regime on settlement efficiency.
- As part of the CSDR review, the mandatory buy-in should be amended to an optional right of the investor, underpinned by law, to allow a buy-in of a failing counterparty. Additionally, the asymmetrical issues relating to buy in costs should be amended so that each party is restored to its original position. The topic of cash compensation should be thoroughly reassessed.

Northern Trust actions

Northern Trust's CSDR implementation programme remains committed to ensuring we effectively manage all change, and provide our clients with sufficient information in a timely manner to enable them to do the same. As an entity within the trade settlement process, we will receive notification of any fines imposed or due to be received from the relevant EU CSD or Sub-Custodian. We initiated our global CSDR SDR programme last year, as soon as the technical standards were published and the relevant compliance date became known. As we move closer to implementation we are working with a third party vendor to optimize our processes and effect all operational change required. You will shortly be hearing from us with more detail on the implications resulting from CSDR SDR.in a timely manner to enable them to do the same. As an entity within the trade settlement process, we will receive notification of any fines imposed or due to be received from the relevant EU CSD.

SECURITIES FINANCING TRANSACTION REGULATION (SFTR)

Background

SFTR aims to increase the transparency of certain transactions which currently fall outside the traditional banking sector, to enable better monitoring of securities financing transactions (SFTs). SFTs allow market participants to access secured funding and are defined broadly within SFTR to include any transaction which utilizes securities in borrowing or lending cash. This includes: Securities Lending transactions and Securities Lending collateral allocations, repurchase and reverse repurchase transactions, buy-sell back or sell-buy back transactions as well as margin lending transactions (which are not traditionally considered to be SFTs).

As an EU regulation, all EU entities are in scope of the requirements, but there will be indirect implications for non-EU entities trading with EU entities as the EU entities will require certain data to fulfil their reporting obligations. This includes a Legal Entity Identifier (LEI) which most non- EU counterparts will already have been disclosing by virtue of the same being required for MiFID II since January 2018 (as articulated in previous versions of this newsletter).

Key provisions

Although many of the disclosure requirements required under SFTR are already applicable, these are generally not substantially onerous to comply with. The industry has been awaiting publication of the regulatory technical standards for transaction reporting requirements, set to significantly enhance reporting obligations for all who use SFTs. These technical standards were published in March and will become applicable for different entities at different times. Reporting will go live for banks and investment firms on 11 July 2020 (recently delayed by ESMA from 11 April 2020), CCPs and CSDs will also need to begin reporting from 11 July 2020, and most Northern Trust clients (including pension funds, insurance companies, AIFs and UCITS) will be brought into scope of the reporting requirement from 11 October 2020. For non-financial counterparties the applicable date is 11 January 2021.

The key aspects of the new reporting requirements are:

- Both counterparties to an SFT will need to report details on the transaction at individual transaction level to a Trade Repository
- All firms will need an LEI
- Reporting by both counterparties to a trade must match at the Trade Repository
- Every transaction must be given a Unique Transaction Identifier used by both counterparties
- Reporting data will include all loan and return transactions and collateral positions. Additionally many life cycle events will also need to be reported such as changes in value or quantity to open positions

- New trade details must be reported to Trade Repositories on Trade Date +1
- Modifications of open trades, trade terminations and certain information surrounding collateral transactions must be reported to Trade Repositories on Settlement Date +1
- Responsibility to report sits with the beneficial owner to the transaction, but the reporting requirement can be delegated to the other counterparty or a third party
- Records of any SFTs concluded, modified or terminated must be kept for at least five years following the termination of the transaction

Northern Trust Actions

Northern Trust's SFTR programme has been in place for 18 months. We believe that our role as Securities Lending Agent sets us in an ideal position to provide a comprehensive and robust solution for Securities Lending transaction reporting. Northern Trust will therefore be offering a SFT reporting service to our Securities Lending clients, which will include generation of a UTI for every trade, sharing the UTI with the borrower, reporting collateral positions and providing full visibility of the reports being submitted on your behalf through online portals.

Northern Trust is also working with industry bodies to create a new Master Delegated Reporting Agreement, the purpose of which is to provide for both mandatory and delegated reporting of SFTs under SFTR. We will be providing further updates in due course.

Members of our SFTR programme are engaged in industry wide working groups led by ISLA (International Securities Lending Association), to create industry best practices for SFTR. These best practices will be essential in ensuring that the industry as a whole is able to deal with the challenges SFTR presents.

We will also be offering a data only solution for our IOO clients trading repos or engaged with Northern Trust for active collateral management. The relatively low data coverage quashed feasibility for a full end-to-end reporting offering, particularly as some of the fields captured may not be in the SFTR reporting format.

Recent update

ESMA have delayed the Day 1 Reporting Start Date by 3 months, from 11 April to 11 July 2020 to give banks and investments firms, who were due to go live in April additional preparation time for go live. This delay was announced in response to the ongoing COVID-19 pandemic. ESMA have not delayed any other Reporting Start Date, these remain as; CCPs and CSDs will start from 11 July 2020, and most Northern Trust clients (including pension funds, insurance companies, AIFs and UCITS) will be brought into scope of the reporting requirement from 11 October 2020. For non-financial counterparties the start date remains 11 January 2021.

EUROPEAN MARKETS INFRASTRUCTURE REGULATION (EMIR/REFIT)

Initial Margin on Uncleared Derivatives Summary

The Uncleared (swaps) Margin Regulations mandate the exchange of Variation Margin (VM) and the exchange of Initial Margin (IM) on Over-the-Counter (OTC) bilateral derivatives, the aim of which is to cover the credit risk of any potential future losses resulting from OTC bilateral derivatives exposure.

The regulations restrict the eligible forms of collateral to be exchanged as IM to highly liquid assets and prescribe methods from which to derive related haircuts. Two-way exchange of IM is required based on a risk based model or standardized table (or grid), and collateral must be segregated with prohibitions on the same for rehypothecation as well as limitations on cash reinvestment. Specific Credit Support Annexes (CSAs) and custodial documentation will govern new collateral relationships and the compliance dates for IM are based on OTC notional exposure, the definitions of which vary in different jurisdictions.

Industry Challenges

In March 2020 in response to the COVID-19 pandemic, ISDA submitted a letter on behalf of 21 industry associations and their members requesting BCBS, IOSCO and global regulators suspend the current timeline for the initial margin phase-in to allow market participants to focus their resources on ensuring continued access to the derivatives market. Key points of the letter include;

- In light of the pandemic members do not believe it is possible or practicable to meet documentation and operational requirements for the regulatory initial margin (IM) compliance dates on September 1, 2020 (Phase 5) and September 1, 2021 (Phase 6).
- In advance of 1 September 2020 firms need to complete custodian documentation. The ability of global custodians to facilitate client onboarding is already being impaired, extending further the lengthy process to establish compliant custodial accounts.
- Use and legitimacy of electronic execution as a means of signing virtually rather than by way of a usual 'wet ink' signature which is scanned and exchanged. Electronically-executed agreements may not be enforceable in every counterparty jurisdiction (as a matter of local company law) and would need diligence on a case-by-case basis.

Timeline for implementation

The thresholds are measured using Aggregate Average Notional Amount (AANA) of uncleared derivatives, to determine if and when an institution will need to comply with the requirements. Both counterparties must be above the relevant threshold in order for the IM requirements to apply.

On 3 April 2020 in response to the COVID 19 pandemic and the ISDA letter highlighting the challenges to implementation of Phase's 5 & 6 BCBS and International Organization of Securities Commissions (IOSCO) issued a press release where they announced a revised timeline for implementation.
[Source: https://www.iosco.org/news/pdf/IOSCONEWS560.pdf]

The revised timeline for implementation is noted below:

PHASE	DATE	THRESHOLD
Phase I	4 Feb 2017	AANA threshold of EUR/USD* 3 trillion
Phase II	1 Sept 2017	AANA threshold of EUR/USD 2.25 trillion
Phase III	1 Sept 2018	AANA threshold of EUR/USD 1.5 trillion
Phase IV	1 Sept 2019	AANA threshold of EUR/USD 750 billion
Phase V	1 Sept 2021	AANA threshold of EUR/USD 50 billion
Phase VI	1 Sept 2022	AANA threshold of EUR/USD 8 billion

*local currency equivalent in other jurisdictions

Northern Trust actions

NT's strategy is to support buy side clients in all middle- and back-office aspects in complying with the Uncleared Margin Regulations. The extent of the support can be categorized in 5 services that may be bundled or offered separately:

- Margin segregation: NT will support third-party model for margin segregation.
- Euroclear Representative: NT will act as representative for Euroclear margin segregation service for you to access Euroclear as secured party.
- Operations Outsourcing: NT will provide full collateral management services.

Northern Trust continues to evolve our derivatives services. Combined with our custody and collateral management operations outsourcing capabilities, these services help clients respond to the new regulatory requirements and reduce the burden of the transition to a cleared derivative environment. As a first step, we encourage interested parties to reach out to their Relationship Manager to obtain further information on the Northern Trust offerings.

FUND REGULATION

Watching Brief

We are aware of a number of consultation papers (CPs) which have recently been published by ESMA, particularly impacting existing fund regulations. We continue to impact assess the implications of these CPs and will provide further updates upon publication of any relevant RTS in further communications.

These include;

- Consultation on Guidelines on art 25 of AIFMD
- ESMA consults on guidance to address leverage risk in the AIF sector
- Consultation on cross border distribution of funds
- Consultation on Central Clearing Solutions for Pension Scheme Arrangements
- Consultation on post trade risk reduction services with regards to the clearing obligation (EMIR Article 85(3a))
- Consultation on MiFID II/ MiFIR review report on the transparency regime for equity and equity-like instruments, the double volume cap mechanism and the trading obligations for shares