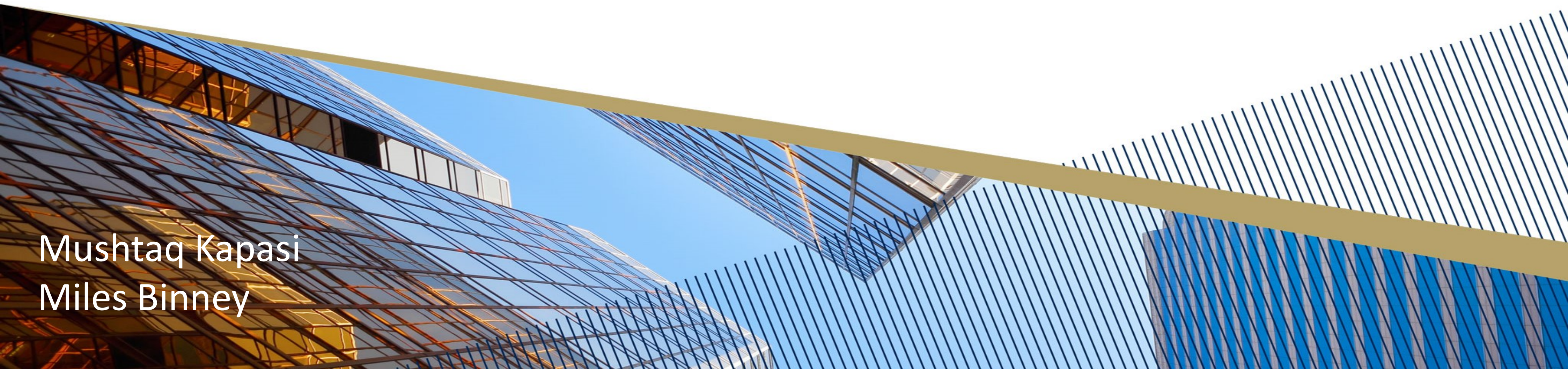
CLIFFORD CHANCE

ICMA International Capital Market Association

Trends and Developments in the European Bond Market

The Thai Bond Market Association

Bangkok, November 20, 2017



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Introduction

1. MiFID II/R implementation: practical implications for the Asia market
2. Electronification and Fintech
3. Brexit: addressing risks in international capital markets
4. Green and Social Bond Market / New Social Bond Principles and Sustainability Bond Guidelines

MiFID II/R implementation: practical implications for the Asia market

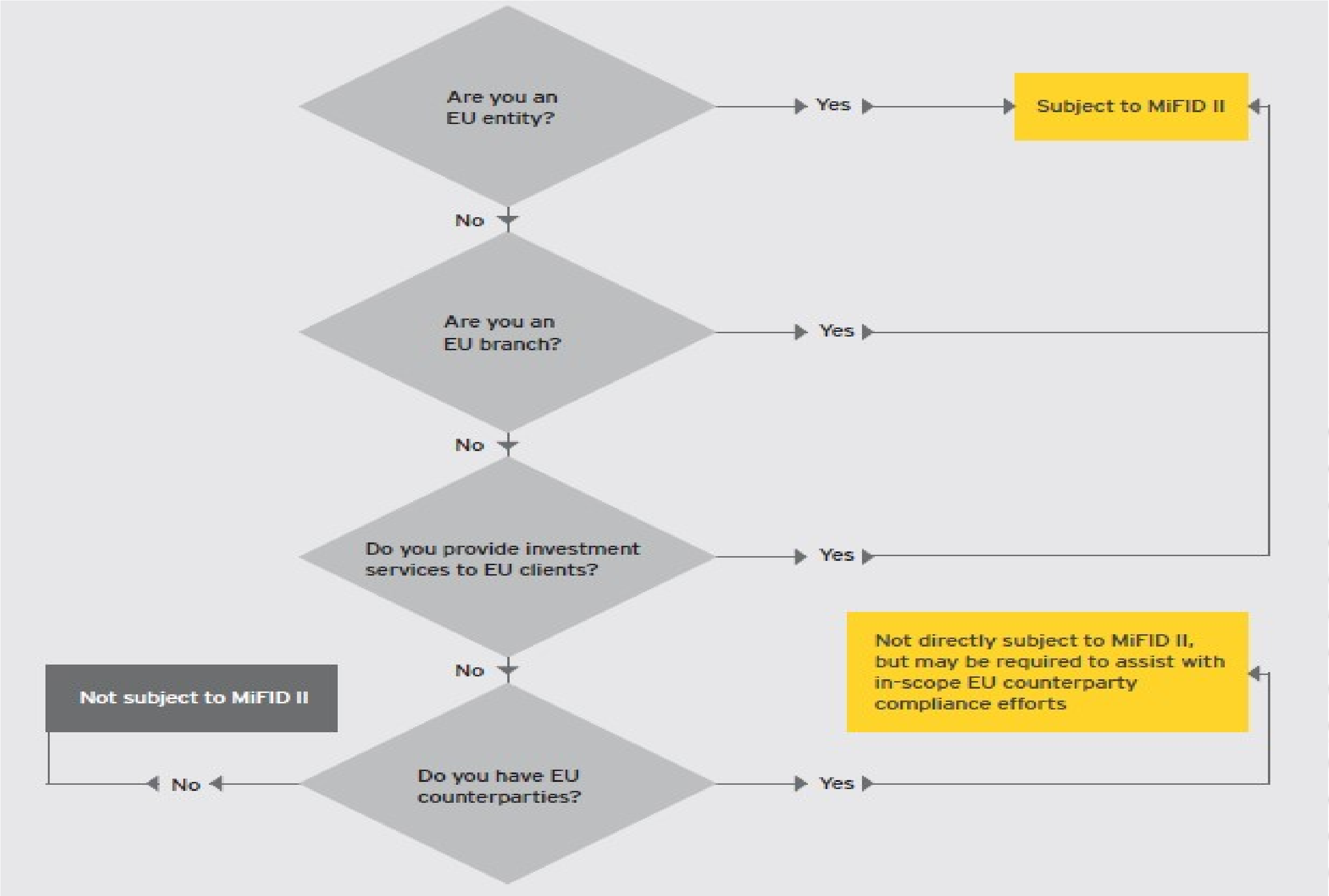
Key objectives of MiFID II/R

- **Key objectives of MiFID II:** Improve the functioning of financial markets making them more efficient, resilient and transparent.

- **Key objectives of fixed income transparency obligations under MiFID II:**
  - Create a price discovery mechanism in fixed income markets
  - Move fixed income trading practices (currently over the counter [OTC]) onto trading venues, such as *Regulated Markets* (RMs), *Organised Trading Facilities* (OTFs) and *Multilateral Trading Facilities* (MTFs)
  - Extend transparency obligations into the OTC space
    - Whilst not a trading venue in the classic sense of the term, the *Systematic Internaliser* (SI) regime (an investment firm that deals on its own account by executing client orders outside a trading venue) ensures the internalisation of order flow by investment firms, does not undermine the efficiency of price formation on RMs, MTFs and OTFs
  - Increase available reference data for fixed income instruments

- **MiFID II/R is scheduled to take effect from January 3 2018**

Does MiFID II/R impact you?



The new market structure paradigm

- **Regulated Market (RM)**

A multilateral system operated by and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments.

- **Multilateral Trading Facility (MTF)**

A multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments.

- **Organized Trading Facility (OTF)**

A multilateral system which is not an RM or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, and derivatives. Unlike RMs and MTFs, operators of OTFs will have discretion as to how to execute orders, subject to pre-trade transparency and best execution obligations.

- **Systematic Internaliser (SI)**

An investment firm that deal on its own account by executing client orders outside a trading venue.

- *RMs and MTFs are not allowed to execute client orders against proprietary capital, or to engage in matched principal trading.*
- *OTFs may deal on own account other than matched principal trading only with regard to illiquid sovereign debt instruments.*
- *OTFs and SIs cannot exist within the same legal entity, nor connect to enable orders or quotes to interact.*

Transparency regime

- **<u>Pre-trade requirements</u>**: extended to non-equities (including bonds, structured finance products, emission allowances and derivatives) which means RMs, MTF and OTFs are required to publish current bid and offer prices and depth of trading interest at those prices in electronic form (at least above SSTI – i.e. block size) and to the public

- **<u>Pre-trade transparency</u>** waivers available for (i) large in scale (LIS) orders; (ii) actionable indications of interest in RFQ and voice systems above size-specific to instrument (SSTI) threshold; and (iii) illiquid instruments. Thresholds to be set by ESMA.

- **<u>Post-trade reporting requirements</u>** near-real time (within 15mins) to the public by venue or via APA.

Best Execution Reporting

- **RTS 27:** Data to be published by execution venues on the quality of execution of transactions
  - **Who:** Trading venues, systematic internalisers (SIs), and execution venues

  (including market makers and other liquidity providers)
  - **What:** report (publicly available in machine-readable electronic format) that includes details about price, costs, speed, and likelihood of execution for individual financial instruments
  - **When:** information quarterly and no later than three months after the end of each quarter, as follows:
    - 1 Jan to 31 Mar: by 30 Jun
    - 1 Apr to 30 Jun: by 30 Sep
    - 1 Jul to 30 Sep: by 31 Dec
    - 1 Oct to 31 Dec: by 31 Mar

- **RTS 28:** Annual publication by investment firms of information on the identity of execution venues and on the quality of execution

  - **Who:** investment firms who execute client orders
  - **What:** for each class of financial instrument, top five execution venues in terms of trading volumes where those firms executed client orders in the preceding year, as well as information on the quality of the execution obtained, and
  - **When:** annual basis

LEIs

- **No LEI, No Trade**
- **Rationale:** identification of parties involved in each transaction regardless of who reports to regulators – enable regulators to better assess systemic risk
- **When:** Implementation on 3 January 2018
- **Requirements:**
  - All entities trading with European counterparties across all asset classes must obtain LEI
  - LEIs must be stored in reporting systems
  - Maintenance procedures must be in place to ensure renewal of LEIs

Electronification and Fintech

International approaches to Fintech & innovation

- Range of approaches:
  - Encouraging innovation – dedicated jurisdictional regulatory initiatives, light-touch initial regulation, national and local incentives.
  - Positive signals – No central support or regulatory changes (yet), but indications of support and development through localised innovation hubs, subsidies etc.
  - Toleration – Mostly driven by the private sector, national authorities/regulatory agencies offer no real assistance but do not regulate heavily. Some local support.
  - Lack of interest – No regulatory support (either currently or hinted at).
  - Hostility – Heavy regulation (either existing or proposed).

Key Technology: Blockchain/Distributed Ledger Technology

- DLT is a data structure that records successive transactions. It is one way of creating an electronic ledger to record transactions. A simple form of transaction might be the transfer of a token of value (e.g. a Bitcoin).
- Important concepts:
  - De-centralised but shared ledger
  - Transaction linkage and the blockchain
  - Consensus mechanism
  - Trustless transactions
  - Immutability
  - Encryption
  - Permissioned vs. Permissionless
  - Without borders

Key Technology: Smart Contracts

"A smart contract is an agreement whose execution is both automable and enforceable. Automable by computer, although some parts may require human input and control. Enforceable by either legal enforcement of rights and obligations or tamper-proof execution."

Smart Contract Templates: foundations, design landscape and research directions (Clack, Bakshi and Braine)

Contractual obligations	Computer code
Embodied in human language text	Embodied in machine-readable data
Drafted using (specialised) human language	Coded in machine-executable software language
Takes effect on the basis of parties agreeing	Takes effect by being executed electronically
Executed by the parties	Executed by computers/software agents
Execution subject to interpretation of human language	Execution follows machine execution process
Parties can disregard errors	Code executes "literally"
Provisions can remain ambiguous	Ambiguous code cannot be executed

Combining technologies

Example – Diamler AG (June 2017)

- Part of €100m corporate bond (Schuldschein) floated using blockchain technology
- Mechanics:
  - Borrower, bank and investors access decentralized customer portal (DCP)
  - Drawing certificates and contracts confirmed in DCP
  - Smart contract automatically manages order book
  - Once loan contract is signed, digital token is generated on blockchain
  - Smart contract allocates number of tokens to investors
- Benefit: potential for significantly faster issuance process, no need for bank to provide central control unit

Brexit: addressing risks in international capital markets

Brexit: addressing risks in international capital market

Introduction

Soft Brexit

Option 1: EEA membership — Ruled out by UK Govt

Option 2: Bilateral agreements — Unique to Switzerland

WTO / GATS — If negotiations fail

Hard Brexit

Greater market access in return for free movement of people, budget contributions, regulatory equivalence and institutional oversight

Less market access with reduced free movement of people, no budget contributions, possibly diverging regulation and little institutional coordination

- *Theresa May sets Brexit course away from EU single market – Financial Times, 2 October 2016

Option 1: The EEA

- When the UK leaves the EU, it would be possible to maintain European capital market integration if the UK were to join the EEA
  - EU would accept capital market regulation without a vote
  - UK would continue to be a member of the EU Single Market and have unrestricted free rights of access through the single passport
- But there would be a number of potential difficulties with this approach:
  - In order to join the EEA, the UK would need to join EFTA. The UK would also need to sign an EEA accession treaty, which would have to be ratified by all 30 EEA Member States
  - The EU27, may be unwilling to grant unrestricted free access to the EU Single Market if the UK Government takes steps to control immigration from the EU27
  - The UK Government has also stated that it will give priority to the primacy of UK law over EU law in the UK, whereas membership of the EEA effectively provides for the opposite.
  - Members of the EEA contribute to the EU budget, and the UK Government may not wish to contribute to the EU budget when it leaves the EU
- For all these reasons, **the UK Government is not expected to join the EEA when the UK leaves the EU**

Option 2: bilateral agreement between the UK and the EU27

- Main alternative is **bilateral agreement with the EU27** which would be "unique" to the UK and take effect as soon as possible after the UK leaves the EU. The UK would no longer be a *member* of the EU Single Market, but the UK would seek *access* to the EU Single Market on favourable terms.
- Equivalence and Reciprocity
  - For capital markets, a key element in any bilateral agreement is expected to be "**equivalence**" (UK regulatory regime deemed to be equivalent to EU27 regulatory regime) in exchange for "**reciprocity**" (EU27 would have direct access to UK domestic market on same terms that UK had access to Single Market of the EU27).
  - The UK's legal and regulatory system, and in some cases also its supervision regime, would have to be deemed "equivalent" to the EU regime, on the basis of the technical advice of the relevant ESA to the European Commission, subject to a vote of EU Member States.
  - Issues:
    - Inconsistent levels of equivalence in EU capital market legislation (eg MiFID II vs CRD IV).
    - Subject to the political negotiations between the UK and the EU27 more generally.
    - UK Government must keep UK legislation up to date with EU legislation in future - problematic if UK Government wants to demonstrate that UK law is not subject to EU law in future.
- Concerns – possible? Length of negotiations? Level of possible reliance?

Option 3 – fall back provisions

- The UK would need to fall back on trading with the EU27 under the rules of the **World Trade Organisation** (WTO) and **General Agreement on Trade in Services** (GATS)
- The implications of providing services from the UK to the EU27 under GATS are unclear, and could create market uncertainty.
- There is, however, the possibility that an **interim arrangement** between the UK and the EU27 can be agreed to cover the period between UK withdrawal from the EU and the introduction of a bilateral agreement - would be designed to minimise market disruption and reduce the risk of "cliff effects"(ie a sudden change in the regulatory regime when the UK withdraws from the EU and another sudden change when the bilateral agreement between the UK and the EU27 takes effect later).

Implications for capital market integration in Europe

- It is not clear to what extent a bilateral agreement between the UK and the EU27 would preserve capital market integration between London and financial centres in the EU27
  - Whether banks would have to maintain two **separate balance sheets**, one for the UK and one for the EU27, which would be more expensive – in terms of capital and liquidity – than the single balance sheet they need within the EU at present.
  - What proportion of market firms' **operations** would need to be located in the EU27 by their supervisors in order to obtain authorisation and to maintain it
  - To what extent market firms would choose to base their **capital market activities** in the EU27 or in New York or even Asia, as opposed to basing them in London.
- Decision to move from London to EU27 depends on costs, but also on assessment of the future viability of their capital market business in Europe and on their perceptions of London's future as a stable and predictable centre for international business that is competitive in global terms.
- Many market firms are currently in "wait and see" mode, while undertaking contingency planning.

ICMA response to Brexit

- ICMA has created a "resource hub" on www.icmagroup.org where members can conveniently source relevant Brexit-related papers from ICMA, the authorities and other bodies such as UK and Continental law firms.
- ICMA has completed a thorough review to identify any immediate changes which might be required as a result of the referendum (none as of end-October 2016) and will keep them under review to ensure they are amended as and when needed in consultation with members.
- ICMA has interacted intensively with the UK and European authorities, both to update them with input from our membership and to discern their approach, to the extent that they know it.
- ICMA is also liaising with other trade bodies and sharing information both at a European and UK level.
- ICMA is an international association and not involved in any of the many lobbying efforts to promote one financial centre over another.

Green and Social Bond Market / New Social Bond Principles and Sustainability Bond Guidelines

Green, social and sustainability bonds – hosted by ICMA

The Green Bond Principles

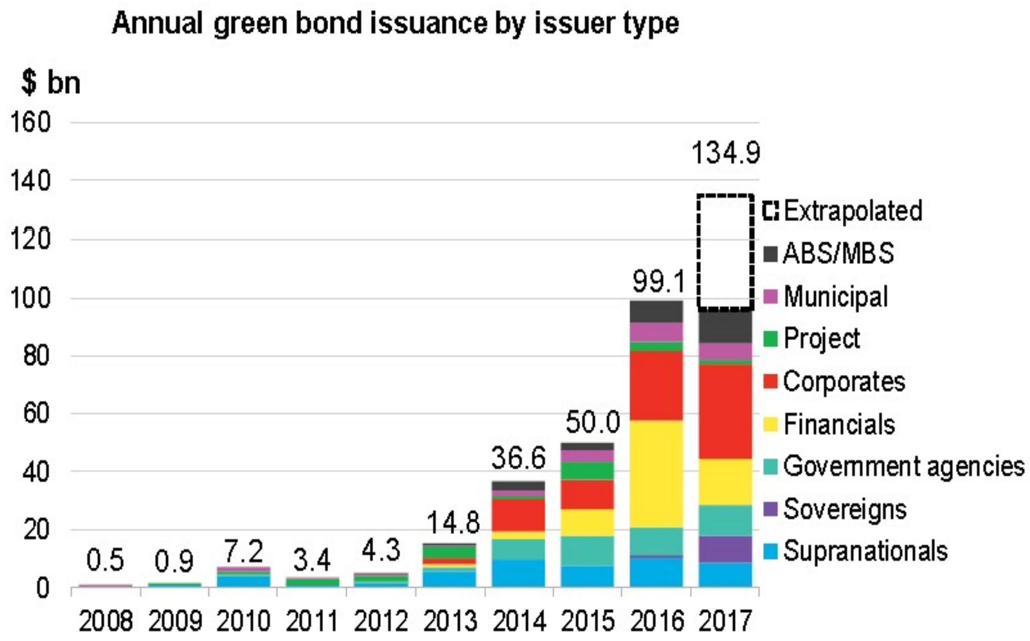
The Social Bond Principles

- **Green Bonds** enable capital-raising for projects with environmental benefits
- **Social Bonds** aim to deliver positive social outcomes
- **The GBP and SBP are voluntary process guidelines** that recommend transparency and disclosure and promote market integrity, by clarifying the approach for issuance
- **Sustainability Bonds** are bonds aligned to both the GBP and SBP

Green and Social Bond Principles are based on a "use of proceeds" concept

- The GBP/SBP have four core components:
    1. Use of Proceeds
    2. Process for Project Evaluation and Selection
    3. Management of Proceeds
    4. Reporting
- GBP explicitly recognise several categories of eligibility for Green Projects to address key areas of environmental concern such as climate change, natural resources depletion, loss of biodiversity, and air, water or soil pollution.
- It is recommended that issuers use an external review to confirm the alignment of their Green Bonds with the key features of the GBP – this can be in the form of a consultant review, verification, certification, or rating

Green bond volume growth



Source: Bloomberg New Energy Finance

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