March 2014

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 177 – BENCHMARK REFORM

Discussion of legal uncertainty arising from the proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts

www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 177 WORKING GROUP

David Bunting	Deutsche Bank
Mark Campbell	Clifford Chance LLP
Michael Duncan	Allen & Overy LLP
Simon Firth	Linklaters LLP
Joanna Perkins	FMLC Chief Executive
Sherine El-Sayed	FMLC Research Assistant
Georgia Mantalara	FMLC Legal Intern

CONTENTS

1. INTRODUCTION

1.1 The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 The purpose of this paper is to highlight a number of legal uncertainties arising from the *Proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts* (the "Proposal"), published by the European Commission on 18 September 2013.[1] References to "the Draft Regulation" in this paper are references to the Proposal and not references to later texts from the Presidency of the Council of the European Union or the European Parliament.

2. BACKGROUND INFORMATION

2.1 Following the attempted manipulation of the London Interbank Offered Rate and Euro Interbank Offered Rate, the European Commission amended the existing proposals for a market abuse Regulation (MAR)[2] and criminal sanctions for market abuse Directive (CSMAD)[3] in order to tighten the administrative or criminal sanctions that apply to attempts to manipulate benchmarks.

---

1 The *Proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts* (COM (2013) 641 final) can be found at: http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52013PC0641:EN:NOT.

2 The text referred to here is the text of the political agreement reached between the European Parliament and the Council, not yet published in the Official Journal. The text of the political agreement can be found at: http://register.consilium.europa.eu/pdf/en/13/st12/st12906.en13.pdf. The European Commission also sent a mandate to the European Securities and Markets Authority for technical advice on possible delegated acts concerning the Regulation on insider dealing and market manipulation (market abuse) on 23 October 2013.

3 The proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation can be accessed here: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0654:FIN:EN:PDF and the amended proposal can be accessed here: http://ec.europa.eu/internal_market/securities/docs/abuse/COM_2012_420_en.pdf.

2.2 In order, however, to improve overall transparency and integrity in the way the benchmarks are produced and used, the European Commission adopted the Proposal on 18 September 2013 with a view to increasing governance and controls over benchmarks, thereby strengthening the protection afforded to benchmark users.

3. DEFINITIONS

3.1 The core of the Draft Regulation is Title II which sets out mandatory governance requirements for the administration of benchmarks, for input data and for the conduct of contributors. The governance requirements apply to "the provision of a benchmark", which activity is defined under Title I in Article 3(1)(3) by reference to "benchmark" (Article 3(1)(2)), itself defined by reference to the concept of an "index" (Article 3(1)(1)). The FMLC takes the view that greater clarity on these key definitions is desirable.

The definition of "index"

3.2 Article 3(1)(1) defines an index as any figure: (i) that is published or made available to the public; (ii) that is regularly determined, entirely or partially, by the application of a formula or any other method of calculation, or by an assessment; (iii) where this determination is made on the basis of the value of one or more underlying assets, or prices, including estimated prices, or other values. The context and syntax suggests that these characteristics are intended to apply cumulatively, although it would assist the reader if this were made explicit.

3.3 As regards the first limb of the definition, the terms "published" and "made available to the public" could also benefit from clarification, particularly as to whether an index which has limited accessibility and restricted circulation is within the scope of the Draft Regulation.

3.4 The FMLC notes in relation to the remainder of the definition that it is very broad indeed and includes any figure calculated to reflect an underlying interest or value. The comprehensiveness of the definition and, therefore, of the scope of the Draft Regulation places greater stress on the legal uncertainty and contractual continuity concerns outlined in this paper.

The definition of "benchmark"

3.5 Article 3(1)(2) of the Draft Regulation provides that

> *'benchmark' means any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument is determined or an index that is used to measure the performance of an investment fund.*

By this provision, an index becomes a "benchmark" by virtue of the fact that the amount payable under a financial instrument or a financial contract is determined by reference to it. This has the consequence that, even if an index is used as a reference by a single financial instrument or it was not published for the purpose of being used as a benchmark, it may nonetheless qualify as such. For example, an index of house prices that is directed at the housing market will become a benchmark if a single property derivative is executed which refers to the index.

3.6 Clearly, an index may qualify as a benchmark without any intention on the part of the administrator or contributors to establish the index as the basis of secondary financial activity. The case of the "unwitting" provision of a benchmark is dealt with under Article 4(1) of the Draft Regulation which provides that

> *This Regulation shall not apply to an administrator in respect of a benchmark provided by him where that administrator is unaware and could not reasonably have been aware that that benchmark is used for the purposes referred to [under the definition of "benchmark"].*

3.7 Strangely, however, there is no parallel provision disapplying the Draft Regulation in the case of an "unwitting" contributor to a benchmark (defined in Article 3(1)(7) as "a natural or legal person contributing input data"). It is hard to understand why this might be and the lacuna may have serious consequences for contributors to indices which have inadvertently become the reference index for a secondary market. Such contributors will be bound by many of the provisions of Chapters 2 and 3 of Title II on reliable input data, governance and code of conduct requirements, notwithstanding there is no reciprocal obligation on the administrator in such cases. For example, *prima facie* the "unwitting" contributor is bound to supply accurate and reliable transaction data under Article 7(1)(a), although the administrator is not subject to the

requirement in Article 7(1)(b) to appoint representative contributors. Similarly, an "unwitting" contributor is bound to sign a code of conduct under Article 9(2), although the administrator is not subject to the provisions of the Draft Regulation and therefore cannot be required to adopt any code of conduct.

3.8 Had the exclusion in Article 4(1) (set out above) been incorporated into the definition of "administrator" in Article 3(1)(4) so as to define the limits of the concept for the purpose of the Draft Regulation (i.e. were an unwitting administrator not, *de jure*, an "administrator" at all), these difficulties would not arise because "contributor" is defined by reference to "input data" which, in turn, is defined as data used by an "administrator". The FMLC recommends that further consideration be given to this approach.

3.9 A closely related issue is the case of the "involuntary" contributor who, although not unaware that his published transaction values have become input data for the purposes of a benchmark, does not intend or consent to make a submission or become a contributor to an index. The FMLC assumes that the legislative intent is to exclude such persons from, say, the obligation under Article 9(2) to sign a code of conduct. Thus, it infers that the concepts of "contributing" and "providing" in the definitions of "contributor" and "contribution of input data" respectively are to be construed narrowly so as to exclude involuntary inputs and it welcomes the clarification in recital (13) that "contributing to a benchmark is a voluntary activity".

The definition of "trading venue"

3.10 A benchmark is an index by reference to which the value of a financial instrument is determined. According to Article 3(1)(13), a financial instrument is one which is listed as such in Section C of Annex 1 to Directive 2004/39/EC on markets in financial instruments ("MiFID") and which is either trading on a trading venue or is the subject of a request for admission to trading on a trading venue.[4] It seems likely that the term "trading venue" here is intended to reflect that concept as it is defined in

[4] Proposal for a Directive of the European Parliament and of the Council on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and Council (COM (2011) 656 final). This text can be found at: http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:EN:PDF.

MiFID. According to MiFID Level II Directive[5] "trading venue means a regulated market, Multilateral Trading Facility ("MTF") or systematic internaliser acting in its capacity as such, and, where appropriate, a system outside the Community with similar functions to a regulated market or MTF".

3.11 Two other EU directives also define "trading venue" by reference to the MiFID definition: Regulation No 236/2012 on short selling[6] and Regulation No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (more commonly known as the European Markets Infrastructure Regulation).[7] However, both Regulations exclude systematic internalisers from the scope of the definition. More recently, the provisional text for a directive and regulation amending MiFID (collectively known as "MiFID II") has expanded the scope of "trading venue" so as to include Organised Trading Facilities ("OTFs"). This revision will, if passed through to the Draft Regulation, considerably expand the scope of "financial instrument". For example, OTC derivatives which do not trade continuously will be more commonly traded on OTFs than on multilateral trading facilities or regulated markets. This expansion will, in turn, widen the definition of "benchmark", capturing indices which may be referred to by a relatively small number of financial derivatives. In this regard, the FMLC would welcome further clarification from the European Commission as to whether this indirect expansion of the definition of "financial instrument" is intended.

The definition of "investment fund"

3.12 Under Article 3(1)(2), a "benchmark" is also any index which is used to measure the performance of an investment fund. According to Article 3(1)(16), the term "investment fund" means either: (i) Alternative Investment Funds ("AIFs") as defined in point (a) of paragraph 1 of Article 4 of Directive 2011/61/EU on alternative

---

5 It is noted that an agreement in trilogue on updated rules for markets in financial instruments ("MiFID") was reached between the European Parliament and Council on 14 January 2014.

6 Regulation No 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF.

7 Regulation (EU) No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories. This text is available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

investment funds managers (the "AIFMD");[8] or (ii) Collective Investment Undertakings ("UCITS") falling within the scope of Directive 2009/65/EU relating to undertakings in collective investments in transferable securities.[9] What remains unclear, however, is whether a fund which is *prima facie* AIF but exempt from regulation as such under Article 2(3) of the AIFMD, for example by virtue of being a securitisation special purpose entity, is an investment fund under the Draft Regulation.

4. TITLE II: BENCHMARK INTEGRITY AND RELIABILITY

4.1 The Draft Regulation's core provisions on governance requirements for administrators and contributors are set out in Title II. The FMLC is concerned that this section of the Draft Regulation relies on concepts which reflect the tenor of the Principles for Financial Benchmarks (the "Principles") adopted by the International Organisation of Securities Commissions ("IOSCO") on 17 July 2013 but which are ill-defined and therefore unsuited to the creation of legal obligations. Examples of concepts in Article 5(1)(a) which are not clearly delimited include "robust governance arrangements"; a "clear organisational structure"; "well-defined roles" and "consistent roles". The broad meaning of these concepts is plain and, therefore, accessible in a non-legal context but the question whether any particular set of arrangements complies with the legal obligation may invite debate.

4.2 Other concepts introduced in this section are at best ambiguous and at worst unintelligible. Such concepts include that of a "transparent role": it is not easy to understand how a role can be "transparent", particularly in any sense which goes beyond the additional requirement of its being "well-defined". If the intention is to require that the roles of persons involved in the provision of the benchmark be published, communicated or recorded, the Draft Regulation should make express provision for this.

---

[8] Directive 2011/61/EU on Alternative Investment Fund Managers amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) 1060/2009 and (EU) No 1095/2010. This text can be accessed at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:01:EN:PDF.

[9] Directive 2009/65/EC on coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). The text can be found at: http://ec.europa.eu/internal_market/investment/docs/ucits-directive/directive_2009_65_ec_en.pdf.

4.3 A more particular concern relates to the use of reliable input data and the provisions of Article 7(1)(c) of the Draft Regulation. The administrator is required to verify that the input data represents a market subject to competitive supply and demand forces in cases where the input data of a benchmark is not transaction data and a contributor is a party to more than 50% of the value of transactions in the market which the benchmark intends to measure. Where an administrator is unable to verify this, it must change the input data, the contributors or the methodology; or cease to provide the benchmark.

4.4 Quite clearly, the extent to which a market may be said vigorously to reflect supply and demand forces will vary depending on the specific conditions which affect the operation of each market at any given time. The strength of supply and demand and the competitiveness of the market will fluctuate with market liquidity and be vulnerable to temporary market disruption. In this regard, the FMLC would welcome greater clarity as regards the obligations of the administrator in circumstances where supply and demand forces are weakened for a period which is likely to prove temporary. As an alternative approach, the FMLC suggests that the paragraph might provide that the administrator must cease to provide the benchmark *only* if the prescribed changes to the input data, the contributors or the methodology cannot restore the integrity of the measure *within a reasonable period of time*.

5. THE 5% THRESHOLD UNDER ARTICLE 39(4)

5.1 Under the transitional requirements provided for by Article 39 of the Draft Regulation, the use of a benchmark will be permitted only until such time as the benchmark refers to financial instruments and financial contracts worth no more than 5% by value of the financial instruments and financial contracts that referred to this benchmark at the time of entry into force of this Regulation. The FMLC understands that the 5% threshold is intended to operate as a trigger for a clean-up of indices falling into disuse. It is concerned, however, that the compulsory withdrawal of any benchmarks may raise the very considerable legal risks associated with contractual discontinuity and, in particular, present the risk that legacy contracts will be frustrated

by the withdrawal of the benchmark.[10] This would cause uncertainty not only in the market in instruments referring to the benchmark subject to withdrawal but also, more widely in other markets where usage of the benchmark in question, although still common, is declining rapidly.

5.2 A further concern is that ambiguities in determining when the 5% threshold has been reached may lead to the inconsistent application of Article 39(4) across jurisdictions. The FMLC considers that further guidance is desirable as to how competent authorities are expected to determine the value of financial instruments for the purposes of Article 39(4) and apply the 5% threshold.

6. THE EQUIVALENCE REQUIREMENT

6.1 Article 20 of the Draft Regulation provides that benchmarks provided by an administrator established in a third country may be used by supervised entities in the Union provided that the European Commission has adopted an equivalence decision recognising that a regulatory framework and supervisory principles equivalent to those provided for in the Draft Regulation are in place in the third country. Decisions of this kind are likely to be informed by the IOSCO Principles, which set common standards on the determination and use of benchmarks by its members. If so, reference to these Principles might be made in Article 20 of the Draft Regulation. It is currently unclear whether a country which complies with IOSCO's Principles will have done enough to generate a positive equivalence decision by the European Commission.

6.2 Since supervised entities are prohibited from using benchmarks which are not regulated within an equivalent regulatory regime, the provisions of Article 40 have the potential, if positive equivalence decisions are not forthcoming in respect of regulation in force in third countries, to jeopardise the use of a number of important benchmarks in the European Union. Although the lack of a positive equivalence decision in relation to a benchmark is unlikely to give rise to claims that contracts have been

[10] The legal risks associated with contractual discontinuity following the withdrawal of a benchmark were examined in the FMLC's paper on Benchmark Transition: *Observations on proposals for benchmark reform*, December 2012. The paper can be found at: http://www.fmlc.org/Documents/BenchmarkReformDec2012.pdf.

frustrated (as would, say, the wholesale withdrawal of a benchmark) it may nonetheless affect contractual continuity by causing parties to terminate contracts, unwind positions and dispose of instruments in great volume. Supervised entities would be forced to divest themselves of derivatives or exchange-traded funds referring to common foreign benchmarks, thereby potentially exacerbating market volatility. Given the effects that the equivalence requirement might have on markets participants and investors, the FMLC would welcome further clarification as to whether the implementation of the IOSCO principles would be sufficient for a third country to be considered as equivalent under the Draft Regulation.

7. CONCLUSION

The FMLC welcomes legislative efforts to improve the transparency and integrity of systemically important benchmarks and to strengthen the protection afforded to their users. It is concerned, however, that a number of legal uncertainties may arise from the provisions of the Draft Regulation. For the purposes of this paper, these uncertainties are broadly identified as those: (i) regarding key definitions in the Draft Regulation which require further consideration or clarification; (ii) arising from a failure accurately to account for the difficulties inherent in measuring the underlying interest; and (iii) which may lead to contractual instability or discontinuity.

It is the third of these categories which gives the FMLC greatest cause for concern. The withdrawal of certain benchmarks (i.e. those which breach the 5% minimum threshold) or restrictions on the use of certain benchmarks (owing to the equivalence regime) may, in particular, be said to give rise to significant legal risk. The legal risks associated with contractual discontinuity following benchmark withdrawal have been extensively examined in previous papers by the FMLC. Throughout this paper possible solutions, such as drafting or other recommended approaches are highlighted for the consideration of the European Commission.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS[11]

Lord Walker (Chairman)

David Greenwald (Deputy-Chairman)

Andrew Bagley, Goldman Sachs

Charles Barter, Bridgepoint

Sir William Blair

Hubert de Vauplane, Kramer Levin Naftalis & Frankel LLP

Simon Dodds, Deutsche Bank AG

Michael Duncan, Allen & Overy LLP

Simon Firth, Linklaters LLP

Bradley Gans, Citigroup

Kate Gibbons, Clifford Chance LLP

Richard Gray, HSBC Bank plc

Wim Hautekiet, Bank of New York Mellon SA/NV

Mark Kalderon, Freshfields Bruckhaus Deringer LLP

Robin Knowles QC

David Lawton, Financial Conduct Authority

Jon May, Marshall Wace LLP

Sean McGovern, Lloyd's of London

Chris Newby, AIG

Graham Nicholson, Bank of England

Stephen Parker, HM Treasury

Sanjev Warna-kula-suriya, Slaughter & May

Geoffrey Yeowart, Hogan Lovells International LLP

Chief Executive: Joanna Perkins

[11] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.