FINANCIAL MARKETS LAW COMMITTEE

ISSUES OF LEGAL UNCERTAINTY ARISING FROM A DISCUSSION PAPER ON BENCHMARKS REGULATION BY THE EUROPEAN SECURITIES AND MARKETS AUTHORITY

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FINANCIAL MARKETS LAW COMMITTEE

This paper has been drafted by the FMLC Secretariat.[1]

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The FMLC Secretariat is grateful for comments provided by Duncan Black (Fieldfisher LLP), David Bunting (Deutsche Bank) and Mark Campbell (Clifford Chance LLP) on definitions and *force majeure*, which have been incorporated into sections 2 and 5 of this paper.

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1. INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

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

1.2. On 18 September 2013, the European Commission adopted a proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts (COM (2013) 641 final) (the "**Legislative Proposal**")[2] in order to improve overall transparency and integrity in the way benchmarks are produced and used, with a view to increasing governance and controls over benchmarks, thereby strengthening the protection afforded to benchmark users.

1.3. This precipitated the publication of several presidency compromise texts and draft reports by the Council of the European Union and the European Parliament on the Legislative Proposal throughout 2014 and 2015. By 24 November 2015, the European Parliament and the Council had reached a preliminary agreement[3] on a compromise text (the "**Final Compromise Text**" or "**Draft Regulation**").[4] The agreement was confirmed by the Permanent Representatives Committee of the Council of the European Union on 9 December 2015.[5] The European Parliament has not yet voted on the Final Compromise Text and the text has not been published in the Official Journal of the European Union.

1.4. The FMLC has written extensively on the provisions of the Legislative Proposal as well as on provisions which subsequently appear in certain presidency compromise

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2 The Legislative Proposal is available at: http://ec.europa.eu/internal_market/securities/docs/benchmarks/130918_proposal_en.pdf.

3 See European Commission statement, available at:http://europa.eu/rapid/press-release_STATEMENT-15-6169_en.htm?locale=en.

4 Approval of the final compromise text (2013/0314 (COD)), dated 4 December 2015. The Draft Regulation is available at: http://data.consilium.europa.eu/doc/document/ST-14985-2015-INIT/en/pdf.

5 See Council statement, available at: http://www.consilium.europa.eu/press-releases-pdf/2015/12/40802206220_en_635852608200000000.pdf.

texts.[6] It is against this background that the Committee welcomes the publication of a Discussion Paper by the European Securities and Markets Authority ("**ESMA**") entitled "Benchmarks Regulation" (the "**Discussion Paper**"), dated 15 February 2016.[7] In particular, the FMLC would like to commend the breadth of analysis that ESMA has provided in its Discussion Paper within a very short timeframe.

1.5. The Discussion Paper examines ESMA's "policy orientations" and sets out initial policy proposals for Level 2 measures. It is based on provisions of the Final Compromise Text. It is intended that the measures proposed by ESMA will take the form of ESMA draft technical standards (and delegated acts of the Commission).[8] The Discussion Paper covers topics that will be included in the technical advice[9] that ESMA will submit to the Commission within four months after the entry into force of the Regulation.

1.6. As highlighted above, much of the Discussion Paper is focused on ESMA's policy orientations. The FMLC does not comment on issues of policy. The Committee does, however, welcome the opportunity to comment on key proposals set out in Discussion Paper and highlight potential areas of legal uncertainty for ESMA's consideration.

Executive Summary

1.7. This paper examines specific issues arising from proposals or commentary on the oversight function, input data and *force majeure* in the Discussion Paper. In particular, analysis is provided on the following key issues: (i) ESMA's definition of "available to the public" for the purposes of determining an "index"; (ii) the concept

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6 The FMLC papers on the Legislative Proposal are as follows: (i) letter to the European Commission on non-deliverable forward rate sources under the Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts, dated 16 October 2015, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_letter_to_commission_on_benchmark_reform.pdf; (ii) letter to the European Commission on a Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts, dated 3 March 2015, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_letter_to_european_commission_on_benchmark_reform.pdf and (iii) Paper on Discussion of Legal Uncertainty Arising from the Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts, dated 18 March 2014, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_issue_177_benchmark_reform_paper_2014_12.pdf. All FMLC publications are available at: http://www.fmlc.org/fmlc-papers.html.

7 The Discussion Paper is available at: https://www.esma.europa.eu/sites/default/files/library/2016-288_discussion_paper_benchmarks_regulation.pdf.

8 The draft technical standards will be submitted to the European Commission within 12 months of entry into force of the Regulation.

9 On 11 February 2016, ESMA received a request from the European Commission for technical advice on possible delegated acts. The mandate for technical advice is available at: http://ec.europa.eu/finance/securities/docs/benchmarks/160211-mandate-esma-request_en.pdf.

of "independence" as part of the oversight function requirements; (iii) inconsistencies between proposals on the "appropriateness" and "verifiability" of input data and the definition of "expert judgement" in the Draft Regulation; and (iv) transitional arrangements for the cessation of an existing benchmark, including analysis on contract frustration and *force majeure*. Where possible, solutions have been recommended in the paper. The paragraphs below examine these issues in detail.

2. DEFINITIONS

2.1. Section 2 of the Discussion Paper raises for consultation the question of how ESMA may fulfil its mandate to specify in greater technical detail three definitions set out in Article 3 of the Draft Regulation: (1) "index", which is defined by reference to the concept, *inter alia*, of "[a figure] published or made available to the public"; (2) "provision of a benchmark" which is defined by reference to the concept of "administering the arrangements of determining a benchmark"; and (3) "use of a benchmark" which is defined by reference to the concept of the "issuance of a financial instrument".

2.2. At this stage, the Discussion Paper is focused on ESMA's policy orientations and no technical advice has been supplied by ESMA, either in draft or in final form. The FMLC may wish to comment on such advice when it is published. For the time being, however, the Committee has only a few brief observations to make:

(a) "[A]vailable to the public" is key wording in relation to the breadth of indices to be covered. It is important to delimit the perimeter of the Regulation with as much certainty as can be achieved and, therefore, the FMLC urges ESMA to produce as clear a definition as possible.

(b) The thrust of ESMA's analysis concerning indices made "available to the public" is not entirely evident at present. The point of the discussion of similar concepts in the Undertakings for the Collective Investment in Transferable Securities Directives (Directive 2014/91/EU (amending Directive 2009/65/EC) and Directive 2009/65/EC (amended by Directive 2014/91/EU) in paragraphs 6 to 10 of the Discussion Paper—only for ESMA to reject the analogy in paragraph 12—is unclear. Earlier, the logic of ESMA's point, (at paragraph 5), that the restricted definition of "benchmark" should qualify the definition of

"made available to the public" as a component of the definition of "index" (which is itself a component of the definition of "benchmark") appears a little circular. If the circularity is indeed a flaw, then the reliance which ESMA places on the concept of the "use" and a "user" of a benchmark, in attempting to provide a treatment of "made available to the public" at paragraphs 16 to 18, may itself be flawed.

(c) At paragraph 15, ESMA states that its technical advice "could at least address the area of the channels to be used". In this regard, one specific situation which might helpfully be considered in an attempt to bring clarity to bear is the situation in which an index is made available to a very limited number of subscribers but is subsequently disseminated to a wider public by those subscribers.

(d) The FMLC agrees with the observation, (at paragraphs 24 and 25), that "it can be helpful to consider the… IOSCO Principles"[10] when elaborating concepts defined in the Draft Regulation such as the concept of "administering the arrangements of determining a benchmark".

(e) "Issuance" has historically been taken to refer to marketable equities and debt instruments but in recent EU legislation, as the Discussion Paper notes, it has been given a broader meaning. In Directive 2014/65/EU ("**MiFID II**") the concept—which is not defined but appears most closely reflected in the definition of "execution of orders on behalf of clients"—encompasses the creation of any and all financial instruments listed in Section C of Annex 1 to that directive. The FMLC, as a general rule, takes the view that it is helpful for terms to be used consistently across different pieces of EU legislation.

3. OVERSIGHT FUNCTION REQUIREMENTS

3.1. The third section of the Discussion Paper deals with oversight function requirements. These are prescribed, in the Draft Regulation, by Article 5a(1) (applicable to all benchmarks except certain commodity benchmarks—as to which,

[10] The International Organization of Securities Commissions' Final Report entitled "Principles for Financial Benchmarks" (dated July 2013) is available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf. The International Organization of Securities Commissions also published a Second Review of the implementation of its principles for financial benchmarks (dated February 2016) which is available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD526.pdf.

see Article 14a and Annex II); Article 5a(2)-(3) (applicable to all benchmarks except certain commodities benchmarks but optional in the case of non-significant benchmarks—as to which see Article 14d(1)); Article 5a(4) (applicable to all benchmarks except certain commodities benchmarks and interest rate benchmarks—as to which see Article 12b and Annex I paragraph 7—but optional in the case of non-significant benchmarks); Article 5a(5) (concerning ESMA's mandate to draft technical standards other than for non-significant benchmarks—applicable to all benchmarks except certain commodities benchmarks and interest rate benchmarks, as above); Article 5a(5a) (concerning ESMA's mandate to draft guidelines for administrators of non-significant benchmarks—applicable to all benchmarks except certain commodities benchmarks and interest rate benchmarks, to which provisions on non-significant benchmarks do not apply under Article 12b); Annex I (applicable to interest rate benchmarks) and Annex II (applicable to commodities benchmarks).

3.2. It follows from these provisions that ESMA's technical standards, when adopted, will not apply to certain commodities benchmarks, interest rate benchmarks or non-significant benchmarks. The Discussion Paper, however, explores several concepts—including those relating to "**membership**", "**integrity**", "**conflicts of interest**" and "**independence**"—which are also incorporated in the oversight provisions of Annex I to the Draft Regulation and which are likely, therefore, to have relevance for interest rate benchmarks. It would be helpful, in the view of the FMLC, if ESMA were to clarify the extent, if any, to which the conclusions it draws on the basis of responses to the Discussion Paper are intended to be "read across" so as to substantiate the provisions of Annex 1 on the oversight of interest rate benchmarks.

3.3. The concepts listed above are reflected in ESMA's discussion of the function, composition, and positioning of the oversight arrangements. A degree of confusion arises here, exemplified in the following excerpts, among others:

> (a) [w]here the administrator is wholly owned or controlled either by contributors or by users, an independent committee may be established with respect to that benchmark, the composition of which would ensure a balance of the users and the contributors with other relevant stakeholders… and, where appropriate/possible, independent non-executive directors (INEDs)… The committee could also include

persons involved in the provision of the relevant benchmarks in a non-voting capacity (at paragraph 43);

(b) ESMA considers that the term "independent" with reference to an oversight committee should be interpreted as a committee that includes natural persons who are not otherwise directly affiliated with the administrator. These persons could also include independent non-executive directors (at paragraph 44);

(c) [i]n ESMA's view, an oversight function could be embedded with an administrator's organisational structure in order to operate effectively… This would be the case even when an independent oversight function was required (at paragraph 47); and

(d) [a] comparable governance function is the risk or the remunerations committee (at paragraph 47).

3.4. ESMA here introduces the idea of independent non-executive directors or "INEDs" as a potential guarantee of the independence of the oversight function. This concept derives from corporate governance rules for companies set out in, among other texts, a non-binding Commission Recommendation (2005/162/EC). These rules will, generally speaking, be legally enforceable only for listed companies (i.e. through the listing rules in force in Member States) but are normally regarded as best practice for all companies.

3.5. Although criteria for independence established by the Commission Recommendation require a prospective INED to have been, at the date of his or her appointment "free of any… relationship" with the company,[11] this should not be taken to require an INED, once appointed, to act other than in the best interests of

[11] Non-binding Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies (2005/162/EC); Article 13 stipulates that

> [a] director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement

and urges Member States to implement stringent criteria for the assessment of independence.

the company. If it were otherwise, a director's obligation to remain independent would conflict directly with his or her ordinary duties of care, skill and diligence.[12]

3.6. An independent benchmark oversight function, on the other hand, is necessarily and logically one which is free of any interests or duties which might interfere with its duty to safeguard the integrity of the benchmark.

3.7. The primary duty of an INED on the board of the benchmark administrator, subject to any overriding law or regulation, is to the interests of the administrator-company. The primary duty of a voting member of an oversight committee is to safeguard the integrity benchmark. Although these two duties will be closely aligned for most purposes, circumstances in which the immediate objective of securing the integrity of the benchmark to the highest possible standard is in conflict with the long-term interests of the administrator-company are not impossible or even difficult to imagine.[13] The possibility of conflict increases where the administrator-company provides more than one benchmark because the objective of securing the integrity of one benchmark will not necessarily always converge with the objective of securing the integrity of another, particularly where resources—including the secretariat resources supplied to the oversight function—are limited. In light of this, close consideration should be given to the proposed role and number of persons affiliated with the administrator-company, including INEDs, in constituting an independent oversight function.

3.8. This observation bears on the claims made, and the questions asked, by ESMA in the Discussion Paper. ESMA observes, in paragraph 37, that the main purpose of the oversight function is to ensure there is an effective challenge to the Board or equivalent management of the benchmark administrator and that it is necessary to consider which structure would be best placed to offer this challenge, free of unmanageable conflicts of interest. Conflicts of interest, however, do not exclusively comprise conflicts between a duty and a personal interest: they can also include conflicts between two duties to which the individual is subject. In light of this and of

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12 Whether a director acts in an executive or a non-executive capacity, his or her duties are owed to the company. It is principally in order to ensure that proper regard is had to the company's interests, that corporate boards are required to have the appropriate degree of independence from the personal or vested interests of any other closely-related constituency. Once appointed, a director will be accountable in the exercise of his or her duties primarily to the company's shareholders but s/he may also, depending on the circumstances, have appropriate regard to the concerns of other providers of capital, the company's employees, the company's trade creditors and/or certain other stakeholders.

13 Interests may diverge, for example, where the administrator believes that the costs of scrutiny are commercially prohibitive and/or where the administrator wishes to allocate available resources to the oversight, audit or scrutiny of a different benchmark.

the comments above, ESMA's apparent view (in paragraph 44) that persons "not otherwise directly affiliated with the administrator" could include "independent non-executive directors" and (in paragraph 47) that an independent benchmark oversight function is "comparable" to a "risk or remunerations committee"—particularly in view of the fact that the latter board committees, although they are constituted to offer challenge to the company's management, do so in order to serve the best interests of the company—may fairly be said to give rise to some confusion.

3.9. An in-depth analysis of the "independence" requirement in this context and of the conflicts of interest which it is sought to eliminate from the oversight function may bear on questions 6, 9, 10, 11, 15, 16 and 18 of the Discussion Paper. The FMLC does not, however, comment on issues of policy.

4. INPUT DATA

4.1. Under Article 7(5) of the Draft Regulation, ESMA has a mandate to develop draft regulatory technical standards to ensure the "**appropriateness**" and "**verifiability**" of input data, in respect of critical and significant benchmarks, other than those commodities benchmarks governed by Annex II. "**Input data**" means data "used by the administrator to determine the benchmark" according to Article 3(10) and so the obligations set out in Article 7, as well as any standards developed by ESMA, are to be fulfilled by the administrator but "**verification**" is to also to be undertaken internally by contributors to the benchmark and ESMA is required to develop technical standards to cover these procedures, too.

4.2. ESMA's standards will apply to interest rate benchmarks—along with the rest of Title II, by virtue of Article 12b—but Annex I to the Draft Regulation establishes additional requirements for "accurate and sufficient data" in respect of these benchmarks, laying down provisions to determine "the priority of use of input data". One of the curiosities of the Final Compromise Text is that, although nominally addressed to the administrator (both by virtue of the express wording and the definition of "input data"), the provisions of Annex I, paragraph 1 are, perhaps, more easily comprehended as a set of requirements to be met by a contributor in compiling a benchmark submission.

4.3. Another of the curiosities of the Draft Regulation is the confusion caused by a lack of specificity as regards the role of "expert judgement" in benchmark determination

and this is somewhat exacerbated by comments in the Discussion Paper, which is also unclear on the point.

4.4. The first attempt by national authorities to set out a regulatory framework for the administration of, and participation in, financial benchmarks was made in the U.S. by the Commodities Trading and Futures Commission ("**CFTC**"). In a penalty notice to Barclays PLC, Barclays Bank PLC and Barclays Capital Inc. (collectively, "Barclays") dated 27 June 2012,[14] the CFTC set out a waterfall of data sources to be used in Barclays' submissions to LIBOR in descending order of merit based on

(i) the organisation's own transactions; but also,

(ii) observable third party transactions; and allowing, too, for the use of

(iii) third party offers as input data, where necessary.

4.5. In addition to these data sources, the CFTC waterfall recognised the legitimacy of techniques of "***adjustment***". At page 33, the Penalty Order specifies that the approved data sources listed in the paragraph above may be adjusted in order to reflect the following considerations: (a) time (i.e. the proximity of the transaction or quote to the time of the submission); (b) the likely measurable effects of market-moving events on data acquired before those events took place; (c) interpolation or extrapolation from data sources with a non-coextensive tenor or maturity; (d) the spread between an entity's credit standing and the available third party data; and (e) the need to eliminate or downgrade non-representative (i.e. clearly anomalous) transaction data.

4.6. All these techniques are to be applied to the three approved data sources and the phrase "expert judgement" is not used in the CFTC Penalty Order. In September of the same year, however, in the UK, the Wheatley Review final report produced its own waterfall of data sources, in response to the same events, and this expressly permitted the use of "expert ***judgement***" as a fourth and separate data source—in addition to the three data sources listed above—stating (at box 4.B) that "in the absence of transaction data… expert judgement should be used to determine a

[14] The penalty notice is available at: http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfbarclaysorder062712.pdf.

submission".[15] Under the list of four data sources, including expert judgement, the Review then goes on, in terms similar to those set out in the CFTC Penalty Order, to talk about "adjustments" to the data obtained from these sources which may be made to accommodate considerations identical to those listed by the CFTC. In this way, the Wheatley Review introduced a contrast between (i) "expert judgement" as a data source in its own right; and (ii) educated adjustments to the objective data, which may be made at the discretion of the benchmark submitter. The latter technique has occasionally been referred to by commentators and those familiar with financial benchmarks as "expert ***adjustment***". When contrasted with "expert adjustment" and viewed as a *sui generis* data source, one may reasonably suppose that "expert judgement" is a matter of the submitter's opinion, based on experience of the market, and informed by market data which is not otherwise listed as an approved data source. As such, it is likely to be more subjective than other data and, arguably, less susceptible to the kind of input controls which are designed to promote benchmark integrity and accuracy. On this analysis, both "expert judgement" and "expert adjustment" incorporate an element of discretion but the distinction between them is that techniques of adjustment can only be applied to objective, approved data whereas expert judgement is put forward in the absence of such data.

4.7. The Final Compromise Text does not recognise any distinction between expert judgement and expert adjustment. Rather, it conflates them in a confusing way. "Expert judgement" is defined in Article 3(9b) as the

> exercise of discretion by an administrator or contributor with respect to the use of data in determining a benchmark, including extrapolating values from prior or related transactions, adjusting values for factors that might influence the quality of data such as market events or impairment of a buyer or seller's credit quality, or weighting firm bids or offers greater than a particular concluded transaction.

4.8. It will readily be seen that the three techniques listed in this paragraph (extrapolating, adjusting, weighting) are, in fact, paradigmatically techniques of adjustment but the non-exhaustive approach to the definition—the word "including"

[15] The Wheatley Report is available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf.

is employed—leaves it unclear whether the exercise of discretion in other ways is also contemplated and, specifically, whether the opinion of an expert is a permissible data source. Annex I paragraph 4 to the Draft Regulation, on the other hand, expressly retains "expert judgement" as an appropriate category of input data for interest rate benchmarks, which arguably suggests that something more than a technique of adjustment is intended and this impression is reinforced by separate provisions on how "input data may be adjusted" in paragraph 4a of the same Annex.

4.9. Article 7(1) on input data, which applies to all benchmarks except certain commodities benchmarks, including interest rate benchmarks (although regulated data benchmarks are exempt from a number of its requirements under Article 12(a)(1)), makes no mention of expert judgement as a source of "input data" but again adopts an apparently non-exhaustive approach to listing the approved data sources ("...including committed quotes, indicative quotes and estimates") that may qualify in the absence of sufficient transaction data. It goes on to require, in sub-paragraph (aa), that input data "shall be verifiable" but this does not so much reduce interpretive uncertainty as raise the question whether expert opinions are auditable for this purpose. (A similar question might be said to be raised at paragraph 75 of the Discussion Paper, where ESMA expresses the view that an exercise of expert judgment is "appropriate" if it is, *inter alia*, documented, objective and transparent.) References in the remainder of Article 7, which requires the administrator to publish "clear guidelines" on the exercise of "expert judgement", do not offer additional clarification.

4.10. The only other substantive reference to expert judgement in the Draft Regulation appears in Article 11 (*Governance and controls requirements for supervised contributors*), which addresses benchmark contributors directly and requires, in paragraph 2b, that those supervised contributors who supply input data which relies on expert judgment establish policies "guiding any use of judgment [*sic*] or exercise of discretion". This provision fails to shed any light on the role of expert opinion and suggests a confusing distinction between "judgement" and "discretion" which is repeated nowhere else in the Draft Regulation and, moreover, contradicts the definition in Article 3(9b), where "expert judgment" ***means*** just exactly "the exercise of discretion by an administrator or contributor" and nothing else. The best interpretation of Article 11(2b) of the Draft Regulation may possibly be that "use of judgement" and

"exercise of discretion" are to be regarded as synonyms, although this regrettably leads to the conclusion that one or other term is redundant in this paragraph.

4.11. ESMA's Discussion Paper not only perpetuates but also develops—at paragraphs 155, 166, Q56 and 184 to 185 (principally concerning contributors' codes of conduct and governance and control procedures for supervised contributors)—this confusing duplication of "an exercise of discretion" and "use of judgement" which first appears in Article 11(2b) of the Final Compromise Text. The Discussion Paper elevates it to a clear contrast between "discretion" and "expert judgement", notwithstanding the distinction is incompatible with the definition of "expert judgement" in Article 3(9b). In Section 6 (*code of conduct*) at paragraph 166, for instance, ESMA appears to distinguish between contributors' records of any inputs subject to discretionary adjustment (such as the discarding of non-representative data) and contributors' records of expert judgement.

4.12. The question whether a benchmark contributor may rely entirely upon its own expert opinion in formulating a benchmark submission in the absence of any other approved input data would seem to be an important one which could usefully be tackled head-on in the context of ESMA's mandate to develop regulatory technical standards on the appropriateness and verifiability of input data. Yet it is not addressed directly in the Discussion Paper, where much of the analysis of the input data requirements centres on the topic of record-keeping. ESMA implies, but does not state, that expert judgement is a substitute for transactions where no approved input data is available, although it is not clear that the Draft Regulation permits the use of expert opinion in this way and despite the fact that Article 3(9b) defines expert judgement in terms of adjustments to transaction data, bids and offers. This implication on the part of ESMA is most plausibly to be read in at paragraph 184, where ESMA says:

> The mandate requires ESMA to develop draft RTS to further specify requirements for policies guiding any use of expert judgement or exercise of discretion as required by Article 11(2b). While transactions should be the preferred input to a contribution, ESMA recognises that there may be cases where transactions are not available… Where discretion or expert judgement are used, supervised contributors should create or enhance existing policies…

and earlier, where, at paragraph 66, ESMA includes "judgements" as an item in its own right in a list of non-transaction input data.[16]

4.13. In any event, the question whether a benchmark contributor may rely exclusively upon its own expert opinion in formulating a benchmark submission in the absence of (other) qualifying and verifiable input data has not been answered clearly or definitively by either the Draft Regulation or the ESMA Discussion Paper. Clarity on this point would be helpful to benchmark contributors, administrators and users.

5. TRANSITIONAL ARRANGEMENTS

5.1. Transitional arrangements for the "cessation or changing of an existing benchmark" are the subject of Article 39 of the Draft Regulation and Section 14 of the Discussion Paper. Under Article 39(3) a national competent authority may permit the continuing use of a non-compliant benchmark where

> ceasing or changing that benchmark to conform with the requirements of this Regulation would result in a *force majeure* event, frustrate or otherwise [*sic*] breach the terms of any financial contract or financial instrument which references that benchmark[.]

5.2. The European Commission has invited ESMA to provide technical advice, for the purpose of drawing up delegated acts under Article 39(6), on how to determine the conditions on which the relevant competent authority may assess whether the cessation or the changing of an existing benchmark could reasonably result in a *force majeure* event, frustrate or breach the terms of financial contracts referencing non-compliant benchmarks. The FMLC wishes to comment briefly on ESMA's analysis and proposals in this regard.

5.3. The first of these comments is that ESMA is in danger of overstating, at paragraphs 341 and 342, the case for contract frustration. It is not correct to say or to imply, as ESMA does, that replacing a non-compliant benchmark with a compliant benchmark will result in frustration unless the contract provides for a substitute benchmark. Frustration may be one possible outcome in a case of benchmark transition—although it would be a very unusual one for commercial contracts—but

[16] Paragraph 75 stipulates that an exercise of expert judgement is "appropriate" if it took into account transaction data but, in the absence of any indication to the contrary, this may perhaps be taken to mean that appropriate expert judgement will take into account all available transaction data, without necessarily condemning as inappropriate an exercise of expert judgment in the absence of transaction data.

it will only occur where the parties to the contracts can be said to have wholly failed to allocate the risks of benchmark withdrawal. The parties may, however, be taken—either expressly or impliedly, in common law—to have allocated these risks in a number of different ways, of which reference to a substitute benchmark is only one. The FMLC and members of the FMLC Secretariat have elaborated this point elsewhere, including for the purposes of the GPB-related legal analysis in the *Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks* of March 2014, to which ESMA draws attention in paragraph 344.[17]

5.4. The second observation concerns the discussion of *force majeure*. The doctrine of *force majeure* has its origins in French law (derived from the Roman law doctrine of *vis maior*), where it has been given the characteristics set out in the Discussion Paper at paragraph 345, including the characteristic of being triggered by an event "which the parties to the contract could not reasonably have foreseen". The doctrine is not, however, recognised in Common law jurisdictions—here, unforeseen circumstances rendering performance impossible may, instead, frustrate the contract—other than as the simple rule that courts will give effect to any *force majeure* clause which the parties have incorporated in their contract to reflect their commercial agreement. *Force majeure* clauses are increasingly common in market standard financial contracts. They are, however, likely to differ—one from the other—with respect to their drafting and, in some cases, will include a list of specific events that the parties anticipate will render performance of the contract impossible or highly impracticable. Such clauses will be applied by the courts notwithstanding the parties have apparently foreseen that certain kinds of events may occur and have made contractual provision for them. This is a small point in the context of Article 39(3). The FMLC raises it in case ESMA wishes to consider further the situation where benchmark transition is likely to trigger *force majeure* clauses in market standard financial contracts but falls short of the "unforeseeable" requirement proposed by ESMA in paragraph 346.

5.5. The final observation is that the concept of a market maturity profile, which ESMA introduces at paragraph 348*ff*, is likely to be a useful one in determining the transitional period for which supervised entities may continue to use a non-compliant benchmark. Once the maturity date for the large majority of financial

[17] The Market Participants Group report is available at: http://www.fsb.org/mwginternal/de5fs23hu73ds/progress?id=L7w9Od5pH1at3Mc3nYwOFij9j3eOTSIeNQCNv4rtz0E. See also FMLC paper entitled "Benchmark Transition Report – Observations on Proposals for Benchmark Reform", dated 1 December 2012, at paragraph 6.9. to 6.14. The report is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/011212.pdf.

instruments referencing a benchmark has passed, market disruption is a much less significant risk for benchmark transition.

6. CONCLUSION

6.1. This paper has identified several issues of legal uncertainty in respect of ESMA's proposals for technical standards on the oversight function of benchmarks, the use of input data for determining benchmark values and the transitional arrangements for the Draft Regulation. The FMLC notes that ESMA's Discussion Paper primarily deals with policy orientations. The FMLC does not comment on policy but has taken the opportunity to provide preliminary remarks on key proposals and considerations set out in the Discussion Paper, which ESMA may wish to consider when drawing up its draft technical standards. Where possible, clarifications have been proposed accordingly.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS[18]

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Sir William Blair

Sonya Branch (Bank of England)

Hubert de Vauplane, Kramer Levin Naftalis & Frankel LLP

Simon Dodds, Deutsche Bank AG

Michael Duncan, Allen & Overy LLP

Simon Firth, Linklaters LLP

Bradley J Gans, Citigroup

Kate Gibbons, Clifford Chance LLP

Richard Gray, HSBC Bank plc

Mark Kalderon, Freshfields Bruckhaus Deringer LLP

Sir Robin Knowles CBE

Piers Le Marchant, JPMorgan Chase Bank, N.A.

Sean Martin, Financial Conduct Authority

Jon May, Marshall Wace LLP

Sean McGovern, Lloyd's of London

Chris Newby, AIG

Stephen Parker, HM Treasury

Barnabas Reynolds, Shearman & Sterling LLP

Sanjev Warna-kula-suriya, Slaughter and May

Geoffrey Yeowart, Hogan Lovells International LLP

Antony Zacaroli QC, South Square

Joanna Perkins (Chief Executive)

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