31 March 2017

Sir Robert Stheeman
U.K. Debt Management Office
Eastcheap Court
11 Philpot Lane
London
EC3M 8UD

Dear Sir Robert,

Withdrawal of end-of-day reference prices for gilts and Treasury bills

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.

The FMLC has actively and regularly engaged with the subject of financial benchmark reform since 2012.[1] In light of its extensive work on this subject, the Committee welcomes the opportunity to comment on the final report (the "**Final Report**") of the Independent Reference Prices Review (the "**Review**"), undertaken by Professor David Miles CBE at the behest of HM Treasury to evaluate the future provision of gilt and Treasury bill reference prices, published on 11 October 2016.[2]

Currently, the U.K. Debt Management Office (the "**DMO**") publishes end-of-day reference prices for gilts and Treasury bills, covering all outstanding gilts in issue, gilt strips and Treasury bills. The DMO calculates these reference prices using pricing information provided by each of the 19 Gilt-edged Market Makers (the "**GEMMs**"). On 21 January 2015, the DMO announced that it intended to withdraw in due course from the provision of these prices.

The Review was launched to identify and implement successor arrangements for end-of-day reference prices and facilitate the transition to the successor arrangements. The Review culminated in a recommendation, presented in section 3 of the Final Report, for the adoption of the joint proposal from FTSE Russell and Tradeweb to provide end-of-day reference prices for gilts, gilt strips and Treasury bills. Under the proposal, FTSE Russell will operate as the administrator of the reference prices, taking overall responsibility for their provision, while Tradeweb will operate as the calculation agent. The main input data will come from executable quotes which GEMMs stream to the Tradeweb platform and which, it is proposed, will be collected over a two-minute window around 4:15pm, cleaned to remove outliers and averaged to produce the

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1 The FMLC has published several papers on benchmark reform (which can be accessed at www.fmlc.org). Members of the FMLC Secretariat also contributed to the work of a Market Participants Group ("**MPG**"), established by the Financial Stability Board (the "**FSB**") and to the MPG's *Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks,* dated 22 July 2014. The report is available at: http://www.fsb.org/wp-content/uploads/r_140722b.pdf. The findings of the MPG Report were considered by the Official Sector Steering Group (the "**OSSG**") of the FSB. Accordingly, the FSB published its own recommendations in a report entitled *Reforming Major Interest Rate Benchmarks,* dated 22 July 2014. The FSB Report is available at: http://www.fsb.org/wp-content/uploads/r_140722.pdf.

2 The Final Report, entitled *Valuing Gilts—The Way Ahead,* is available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/558928/final_report.pdf.

+44 (0)20 7601 4286
chiefexecutive@fmlc.org

8 Lothbury
London
EC2R 7HH
www.fmlc.org

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reference prices. A Tradeweb trial of a close variant of this methodology has produced prices that are very close to those produced by the DMO with the largest variations, the Report notes, appearing at the long end of the yield curve.

The Report also addresses the question of transition in section 4, where it indicates the need for a six-month lead time and at least a month-long parallel run of the DMO and FTSE Tradeweb reference prices. In February 2017, the DMO announced that FTSE Russell and Tradeweb would begin to publish reference prices from 20 March 2017, leaving the DMO in the position to cease its provision of reference prices by July 2017.[3]

The question of implementation pathways for benchmark transition has previously been addressed, in abstract, as part of a report by a Market Participants Group (the "**MPG Report**") supporting work by the Financial Stability Board on *Reforming Major Interest Rate Benchmarks* (the "**FSB Report**"). Broadly, the MPG Report considers four alternative transition pathways: (i) a "seamless transition", according to which an existing benchmark transitions from one methodology to another;[4] (ii) a "successor rate" pathway, whereby one benchmark is withdrawn and replaced by another with a different but similar identity; (iii) a "market-led" transition, involving the gradual, voluntary adoption of a different benchmark published in parallel to the legacy benchmark; and (iv) a "cutover" transition, whereby adoption of a new benchmark is encouraged by notice to users that, after a finite parallel run, the legacy benchmark will be withdrawn at a future date.

The FMLC notes that the proposal for transition in the Final Report has much in common with the cutover approach, albeit the proposed parallel run is very short indeed.

It was observed in the MPG Report that a parallel transition period would be appropriate in some cases to reduce

> the risk of market disruption and legal challenges by providing time for outstanding contracts to mature, thereby reducing the stock of outstanding contracts at the final discontinuation date.[5]

In respect of the market maturity profile of contracts referencing the DMO's gilt prices, information received by the FMLC suggests that there exist Gilt Total Return Swap ("**TRS**") contracts which have maturity of up to five years. In this situation, the

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3 The text of the DMO's announcement can be found at: http://www.dmo.gov.uk/documentview.aspx?docname=/gilts/press/pr010217.pdf&page=PriceProvision/Information.

4 By the time the FSB Report was published, the first of these pathways was commonly referred to as "evolution" rather than "transition", because it involves no material shift in the identity of the benchmark.

5 MPG Report, p. 44. Those who raise the concern of legal risk in the case of benchmark transition normally refer to "frustration" risk in relation to existing financial contracts which reference the benchmark, or to the broadly comparable civil law doctrine of force majeure. The FMLC has observed elsewhere (see papers and letters at www.fmlc.org) that it would be highly unusual for a commercial contract to be frustrated, particularly where the parties have incorporated provisions dealing with the eventuality of benchmark withdrawal. The likelihood of contracts governed by English law being frustrated following the withdrawal of a specific benchmark and a simultaneous transition to another is not, however, wholly negligible. One reason why frustration risks deserve continued attention is that fallback clauses in market standard contracts typically refer to mechanisms (e.g. "reference banks") which are unlikely to prove workable on a market-wide basis over the long term. Another is that legal challenges may prove disruptive even where the challenge ultimately has little chance of succeeding.

FMLC is concerned that the short period of continued publication which is envisaged for gilt prices by the DMO fails to accommodate the stock of outstanding contracts which reference those prices.

Gilt TRS contracts typically incorporate fallback clauses which, as is common in derivative contracts, ultimately make reference to the calculation agent. They may also, albeit less commonly, include an interim fallback which references a "successor rate" in the event that the primary rate is withdrawn.

Fallback clauses, which are widespread in financial instruments incorporating reference rates, can mitigate the legal risks referred to in the MPG report by attempting to provide for the circumstances of benchmark withdrawal. It is also important to note that the Gilt TRS market, which is anecdotally estimated at £25-30 billion, does not rely on standardised market definitions and this fact alone would reduce the market impact of a successful legal challenge to one or more outstanding contracts. Nevertheless, while the risks highlighted in the MPG report may be, *de jure,* remote, this does not necessarily mean that every reference rate transition will be an entirely smooth one. In the present case, the FMLC considers that the DMO would ensure a greater degree of legal certainty if it extended the parallel run of the existing and new benchmarks to market maturity (i.e., to 2021).

In the event that this seems impractical, the Committee would recommend that the DMO supplement its proposal for a cut-over transition with a clear indication that it considers the FTSE Russell-Tradeweb collaboration to be a suitable successor to its withdrawn end-of-day reference prices for gilts. In cases where interim fallback provisions make reference to a successor rate, an authoritative announcement of this kind may eliminate residual uncertainty.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins

FMLC Chief Executive