Issues of Legal Uncertainty Arising in the Context of the Reform of Financial Benchmarks Regulation

January 2018

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THE ROLE AND REMIT OF THE FINANCIAL MARKETS LAW COMMITTEE

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 following is a selection of publications by the FMLC on issues of legal uncertainty arising in the context of the reform of financial benchmarks regulation. This includes analyses of various aspects of the proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts, published by the European Commission on 18 September 2013.¹

The FMLC wishes to thank the individuals credited in the subsequent pages for their assistance in the preparation of the publications included herein. Note that members of FMLC Working Groups act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

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://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52013PC0641
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PREFACE: THE FMLC’S ENGAGEMENT IN THE REFORM AND REGULATION OF FINANCIAL BENCHMARKS

The scandals caused by the manipulation of financial benchmarks such as LIBOR and the WM Reuters London 4pm Fix drew widespread attention to shortcomings in the regulation of indices used as reference rates for financial instruments. In the aftermath, regulators have been tasked with re-evaluating the way in which they ensure proper governance and scrutiny of these rates.

The FMLC has a long-standing history of engagement with issues of legal uncertainty arising in the context of proposals for benchmark reform. This booklet currently consists of 13 sections and contains, in reverse chronological order, the work undertaken by the Committee on the topic, including its correspondence with U.K. and international authorities.¹

The most recent inclusion is a letter commenting on a White Paper entitled “SONIA as the RFR and approaches to adoption”, published in June 2017 by the Bank of England’s Working Group on Sterling Risk-Free Reference Rates. In the paper the Working Group raises several issues of interest and recommends further exploration of the potential transition of legacy contracts—which currently reference LIBOR—to the Sterling Overnight Index Average (“SONIA”). The FMLC Chief Executive wrote to the Working Group to draw attention to the Committee’s previous comments on legal risk arising in the context of benchmark reform. The letter makes a number of recommendations to ensure the smoothest possible transition to a replacement benchmark.

Section 2 of this volume contains a letter written in March of 2017 from the FMLC to the U.K. Debt Management Office (the “DMO”), highlighting concerns regarding the short transition period between the provision of end-of-day reference prices for gilts and Treasury bills by the DMO to a joint venture between FTSE Russell and Tradeweb. The letter concludes with a recommendation that the DMO extend the parallel run of the new and existing benchmarks to market maturity or, if this is unfeasible, that the DMO supplement its proposal for a cut-over transition with a clear announcement stating that it considers the FTSE Russell-Tradeweb collaboration to be a suitable successor to its withdrawn end-of-day reference prices for gilts.

In October 2016 the Bank of England published a Consultation Paper on the evolution of the SONIA benchmark. The Consultation Paper sets out proposals for reforming the SONIA calculation methodology and addresses the question of how these changes can be implemented with minimum market disruption. In a subsequent letter to the Bank of England (included in section 3), the FMLC agrees with the approach set out in the Consultation Paper, but notes that the change in publication times for SONIA may affect the projected values for certain lesser-known swap rates.

Section 4 of this volume contains a letter from the FMLC to the European Securities and Markets Authority (“ESMA”), responding to the Consultation Paper on the draft technical standards under the Benchmarks Regulation published in September 2016. The FMLC comments on oversight function requirements, verifiability of input data and use of expert judgement, and Third Country benchmarks and compliance with IOSCO Principles. The FMLC welcomes clarification on all three of these subjects in the Consulting Paper. The FMLC’s

¹ A complete account of the FMLC’s work on Benchmark Reform—as well as frequent updates on new publications, working groups and events—can be found on our website at: http://www.fmlc.org.
comments on a previous Discussion Paper published by ESMA are contained in section 6 of this volume.

Section 5 contains a letter sent by the FMLC in April 2016 to the European Money Markets Institute ("EMMI") responding to its October 2015 Position Paper on the reform of the European Interbank Offered Rate, or EURIBOR. The FMLC refers to relevant information in publications by other bodies including the Market Participants Group, and concludes that the perception of economic disadvantage could render benchmark transition arrangements for major interest rate benchmarks contentious and even litigious, despite every indication that the legal risks are remote.

In March 2016, the FMLC responded to the aforementioned Discussion Paper by ESMA entitled “Benchmarks Regulation” (section 6). In particular, the FMLC identified several issues of legal uncertainty in relation to 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.

Section 7 contains an October 2015 letter from the FMLC to the European Commission, commenting on the agreed text of the European Commission’s proposal for a Regulation of the European Parliament and of the Council on indices used as benchmarks in financial instruments and financial contracts ("the Proposed Regulation"). Earlier correspondence and a paper by the FMLC relating to previous iterations of the Proposed Regulation are also included in this volume, in sections 9 and 12 respectively. On this occasion, the FMLC took the opportunity to draw attention to legal uncertainty that may arise in respect of the scope and application of the Proposed Regulation in the context of foreign exchange rate sources, with particular reference to non-deliverable forward contracts referencing emerging markets currencies.

Section 8 contains a letter sent in April 2015 from the FMLC to the Secretariat of the Financial Stability Board regarding the regulation of commodity benchmarks—attaching, inter alia, the letter to the Department of Energy and Climate Change ("DECC") contained in section 10 of this volume—and suggesting that a uniform international approach to setting regulatory standards for commodity benchmarks would be welcomed.

In February 2015 the Council of the European Union reached agreement on a Compromise Proposal pertaining to the Proposed Regulation discussed in section 7 of this volume. Section 9 contains the aforementioned correspondence sent by the FMLC to the Director General for Financial Markets at the European Commission. The letter considers the legal uncertainties on the regulation of Third Country benchmarks and suggests solutions where appropriate.

Section 10 consists of two letters sent in October 2014 to HM Treasury and the DECC, commenting on the DECC’s proposals relating to regulation of wholesale energy markets through new criminal offences, including a new offence in benchmark manipulation. In the letter the FMLC concludes that any issues of legal uncertainty that might arise in context of the DECC’s proposals are of insufficient materiality to warrant further action by the FMLC, but also identifies a number of anomalies—set out in an enclosed research paper—which it wishes to bring to the attention of both HM Treasury and the DECC.

Section 11 contains a letter sent in August 2014 from the FMLC to the Secretariat of the Financial Stability Board ("FSB") drawing attention to the FMLC’s work on contractual
continuity in the context of the FSB’s work on foreign exchange benchmarks and the WM Reuters Fix in particular.

In March 2014, after the European Commission announced a proposal for regulatory reform (first mentioned in section 7), the FMLC explored issues of interpretive uncertainty in the E.U.’s legislative proposal. This research, presented in a paper (section 12) entitled “Discussion of legal uncertainty arising from the proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts”, rigorously defines several key terms used in the draft regulation, highlights several concepts within the proposal that are not clearly delimited and therefore unsuited to the creation of legal obligations, and also raises serious concerns about legal uncertainty that might be created by benchmark withdrawal.

The earliest and final publication in this booklet is a paper published in December 2012 (section 13) entitled “Observations on Proposals for Benchmark Reform”, addressing the question of contractual continuity in the circumstances of benchmark transition.

The E.U. Benchmarks Regulation discussed in multiple sections of this volume came into effect on 1 January 2018. The FMLC continues to engage with issues of legal uncertainty arising in the context of the regulation of indices used as benchmarks in financial instruments. Related presentations, articles and speeches by FMLC Secretariat staff can be downloaded at http://www.fmlc.org/speeches-and-articles/category/benchmarks-reform.
LETTER TO THE BANK OF ENGLAND IN RESPONSE TO A WHITE PAPER ENTITLED “SONIA AS THE RFR AND APPROACHES TO ADOPTION”

OCTOBER 2017
9 October 2017

Will Parry Esq
Bank of England
Threadneedle St
London
EC2R 8AH

Dear Mr Parry

White Paper: SONIA as the RFR and approaches to adoption

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

The FMLC Secretariat has monitored the progress of the Bank of England’s Working Group on Sterling Risk-Free Reference Rates (the “Working Group”), and read its recent White Paper, *SONIA as the RFR and approaches to adoption*, with great interest.²

At point 64 of this paper, the Working Group invites suggestions of additional topics for discussion. Further to this invitation, the FMLC would like to draw the Working Group’s attention to its previous comments on legal risk arising in the context of benchmark reform in respect of legacy contracts.³ This extensive body of work includes the FMLC’s contribution to the *Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks*, dated 22 July 2014 (the “MPG Report”).⁴ The FMLC takes the view that the issues of legal risk which have been addressed by the FMLC over the past five years could usefully bear further discussion and consideration in the context of some of the issues addressed in the White Paper. That is, in particular, with respect to the Working Group’s recommendation that the potential scope for the transition of legacy contracts which currently reference LIBOR to the Sterling Overnight Index Average (“SONIA”) be explored. Such analysis is now particularly salient in light of the FCA’s recent announcement that, following end-2021, the FCA will no longer use its powers to persuade or compel banks to submit to LIBOR, which some commentators have taken—not necessarily accurately—to reflect “a decision to end LIBOR”.⁵

Contractual continuity and legal risk

SONIA (or rather, reformed SONIA, which is predicted to take effect from March or April 2018) is a measure of the rate at which interest is paid on sterling short-term wholesale funds in circumstances where credit, liquidity and other risks are minimal. It is measured on each London business day as the trimmed mean, rounded to four decimal places, of interest rates paid on eligible sterling denominated deposit transactions, where eligible transactions are executed between midnight and 18:00 and settled that same day, and are greater than or equal to £25 million in value.⁶ LIBOR is the rate at which an individual contributor panel bank could borrow funds, were it to do so by asking for and then accepting interbank offers in reasonable market size, just prior to 11.00 am London time.⁷ The conversion of legacy contracts from one to the other, as posited by the Working Group, would involve the incorporation of SONIA as the contractual reference rate, in place of LIBOR, in one or more existing contracts which have yet to reach maturity. The FMLC notes that the Working Group has

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invited comments on the voluntary—rather than the necessary or compulsory—incorporation of SONIA in legacy contracts. The question of the necessary transition of legacy contracts in a situation of benchmark withdrawal has, however, also been addressed—in respect of both orderly and unexpected withdrawal—by regulators on several other occasions.\textsuperscript{8} These include the observation by Andrew Bailey in his speech addressing the future of LIBOR, that there is no guarantee that beyond end-2021 LIBOR will continue to be calculated.\textsuperscript{9}

The MPG Report of 2014 identifies four alternative transition pathways for markets to follow in the case of benchmark reform: (i) a “seamless transition” from one methodology to another (later referred to as “evolution” rather than “transition”); (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 voluntary adoption of a different benchmark published in parallel to the legacy benchmark; and (iv) a “cut over” transition, whereby adoption of a new benchmark is encouraged by notice to users that the legacy benchmark will be withdrawn at a future date.\textsuperscript{10} It might be inferred from the White Paper that a transition from LIBOR to SONIA would necessarily incorporate elements of one or more of these pathways but this does not appear to have been decided by—or, indeed, to have been within the remit of—the Working Group. The FMLC takes the view that now would be an opportune time for the Bank of England and those with expertise in the area to give careful thought to the question of the most appropriate pathway or pathways for a market transition to SONIA.

In situations of benchmark withdrawal and transition, as flagged most recently in the letter sent to you on 30 December 2016 concerning proposed reforms to the SONIA methodology (the “Letter”), legal risk is considered to arise, if at all, in the form of either widespread market reliance on unsupported fallback rates or, ultimately, in the risk of contract frustration (or, in civil law jurisdictions—force majeure). You may recall that this latter risk was characterised by the FMLC in the Letter as one which is remote but not negligible.\textsuperscript{11}

In another context, however, the FMLC has also noted that the legal risks of transition are heightened wherever there is an economic differential as between the projected values of one benchmark and those of a successor rate.\textsuperscript{12} This is not because the chances of frustration are necessarily increased but rather because it is attractive in these circumstances for some counterparties to raise the possibility of litigation even where their chances of success are remote and because any litigation on the terms of standard market contracts has the potential to prove disruptive. (As you will recall, the MPG Report surveyed market participants and found that, in a situation where a reformed benchmark systematically varied from a current benchmark by more than five basis points, the vast majority of those surveyed were undecided or preferred to transition to a different rate despite the obvious difficulties of doing so.\textsuperscript{13})

FMLC recommendations

In terms of recommendations to alleviate any uncertainty that may arise in circumstances in which legacy contracts are converted to a new benchmark, the FMLC draws attention to its December 2012 paper “Benchmark Transition Report: Observations on proposals for benchmark reform” (the “Transition Paper”). Here, the FMLC makes a number of recommendations that could be implemented when transitioning to a replacement benchmark, observing:
a) that changing standard contracts by way of a protocol offers the brightest hope of a smooth transition from LIBOR to an alternative benchmark, and that a wide protocol will promote uniformity across back-to-back contracts and can prevent mismatching of interest rates (albeit this is by no means a panacea, as such protocols often involve lengthy negotiation periods and are not assured of universal accession);

b) that a strong legal opinion to the effect that a Court is unlikely to consider that existing contracts on standard terms have been frustrated in circumstances of benchmark transition could play a pre-emptive role in maintaining market confidence, particularly if published;

c) that the coordination of all relevant trade associations may be required;

d) that the transition to any new benchmark could be mapped, either by the authorities or trade associations (possibly through an auction process);

e) that a detailed timeline of planned developments is desirable for the sake of predictability; and

f) that documentation which is drafted for new contracts, if this proves desirable, may need to be incorporated into existing contracts on the same day to reduce any risk of uncertainty and a mismatch of back-to-back contracts. New contracts which are drafted in the period before the alternative benchmark is introduced should also be accounted for.

The Transition Paper also questions the palliative effect of existing fallback provisions in a situation involving benchmark withdrawal, observing that it is unlikely that such provisions will prove operable on a market-wide basis over the long-term. This is of relevance given Andrew Bailey’s (currently open) question as to whether the better approach to transition would be to amend contracts to reference an alternative rate, or to amend the definition of LIBOR through the fallback protocol to replace the current methodology with alternative reference rates.

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

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1 Sinead Meany took no part in the preparation of this letter, and the views expressed herein should not be taken to be those of the Bank of England.

The FMLC would like to draw the Working Group’s attention to the following publications:


See Article 28 of Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the “Benchmarks Regulation”) (Changes to and cessation of a benchmark). Article 28(1) requires administrators to publish a procedure concerning the actions to be taken by the administrator in the event of changes to or cessation of a benchmark. Article 28(2) requires supervised entities—other than administrators—to produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. See also the FSB’s report “Reforming Major Interest Rate Benchmarks” (22 July 2014) (link provided at endnote 4, supra).

See Andrew Bailey’s speech, endnote 5, supra.

See the MPG report, pp.13-14. See endnote 4, supra.

See the “Legal risk and financial contracts” section of the Letter to the Bank of England on Reform of SONIA (30 December 2016), link provided at endnote 3, supra.

See the Letter to the European Money Markets Institute on the Evolution of Euribor (12 April 2016), link provided at endnote 3, supra.

The MPG Report, p.136. See endnote 4, supra.
14 The FMLC observes that ISDA participates in the Working Group on Sterling Risk-Free Reference Rates in a non-voting capacity.

15 See Transition Paper pp. 25-26, and 28-32, link provided at endnote 3, supra.


17 See Andrew Bailey’s speech, endnote 5, supra.
LETTER TO U.K. DEBT MANAGEMENT OFFICE ON THE
WITHDRAWAL OF REFERENCE PRICES FOR GILTS

MARCH 2017
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. 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.

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

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 (the "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.

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

3 The text of the DMO’s announcement can be found at:

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
LETTER TO BANK OF ENGLAND ON THE REFORM OF SONIA

JANUARY 2017
CONSULTATION PAPER: THE REFORM OF SONIA

As you may know, 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. In light of its extensive work on this subject, the Committee welcomes the opportunity to respond to the consultation paper (the “Consultation Paper” or “CP”) published by the Bank of England in October 2016 on the evolution of the Sterling Overnight Index Average (“SONIA”). The Consultation Paper incorporates by reference certain proposals set out in an earlier consultation by the Bank of England in July 2015 (the “2015 consultation”). Collectively, these reforms will result in a redesigned SONIA benchmark, to which the Consultation Paper refers as “reformed SONIA”.

Changes to the SONIA Methodology

The Consultation Paper sets out proposals for reforming the SONIA calculation methodology. Following the 2015 consultation, the input data from which SONIA is calculated will be broadened to include bilaterally negotiated as well as brokered unsecured deposit transactions. According to the more recent proposals, SONIA, which is currently calculated as the volume-weighted mean of eligible transactions, will be calculated as the volume-weighted median. The relevant transaction window, which defines the temporal scope of the input data for SONIA and which was slightly adjusted earlier this year, will continue to run from midnight to 18.00 each London business day but, in consequence of other changes to the scope of input data, the publication time and date for SONIA will shift from same-day publication to next-day publication at 9.00.

In section 4, the Consultation Paper addresses the question of how these proposed changes can best be implemented with minimum disruption for the users of SONIA. It establishes, in section 4.1, that the Bank of England’s preferred approach to implementation of the reforms is “for a simple point-in-time switchover”. According to this approach, SONIA will be published under the current methodology, shortly after the close of the sterling money markets, on the day prior to the switchover and the next day no level will be published. On the third day, reformed SONIA will be published via existing publication venues at 9.00.

The question of implementation pathways 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” from one methodology to another; (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 voluntary adoption of a different benchmark published in parallel to the legacy benchmark; and (iv) a “cut over” transition whereby adoption of a new benchmark is encouraged by notice to users that the legacy benchmark will be withdrawn at a future date. 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.

Notwithstanding the Consultation Paper refers to the preferred implementation pathway at section 4.1 as a “switchover transition”, the proposal arguably has more in common with the evolutionary or seamless approach than with any of the other pathways identified in the MPG Report. This is apparent from the fact that many of the core characteristics of SONIA—including the name, the publication venues, the administrator and, crucially, the broad, underlying economic reality the benchmark is trying to measure—will remain the same after the switchover. Projected values for reformed SONIA and for SONIA as it is currently calculated are also expected to be very similar, to within a maximum spread of one to two basis points.6

Legal risk and financial contracts (CP Questions 10 and 11)

It is sometimes said that benchmark transition gives rise to legal risk. Those who raise this concern are usually referring to frustration risk in relation to existing financial contracts which reference the benchmark.7 The FMLC has observed elsewhere that it would be highly unusual for a commercial contract to be frustrated,8 particularly where the parties have incorporated fallback provisions dealing with the eventuality of benchmark withdrawal.9 Even where the parties have made no express provision for changes to a benchmark, an agreement may be found, at common law, to incorporate an implied term which covers the eventuality: for example, by recognising the parties’ obvious, if implicit, intention that a new methodology is to apply in substitution for the original methodology where the latter has been superseded.

The majority of sterling interest rate contracts are likely to be governed by English law and the risk of these contracts being frustrated following a change to the methodology by which the rate is calculated is, in the view of the FMLC, remote.10 Moreover, although it is true to say that the risks of disruptive litigation will not always be as remote as the risks of contract frustration in cases of benchmark transition,11 history suggests that there are also grounds to be sanguine in this regard,12 particularly where the projected spread in values between the two methodologies is low, as here.

The legal and operational risks associated with benchmark reform are minimised where the proposed implementation can properly be characterised as evolutionary rather than transitional (i.e. from one rate to another). For this reason, the MPG report describes evolutionary change as “the most efficient possible transition”.13 In light of this, the FMLC agrees with the approach set out at section 4.1 of the Consultation Paper on the grounds that reformed SONIA will be materially similar to current SONIA.

Contractual definitions and next day publication (CP Questions 9 and 12)

Although it is not possible definitively to answer the question in abstract whether a contract will be disrupted by benchmark reform, it is useful to review market standard terms and see how these might accommodate benchmark evolution.
The Consultation Paper correctly observes, at section 3.4, that the standard definition for SONIA (“GBP-WMBA-SONIA-COMPOUND”) published by the International Swaps and Derivatives Association (“ISDA”) is commonly referenced in interest rate derivatives and Credit Support Annexes which constitute collateral agreements for the purpose of interest rate derivatives. This definition has no internal fallback and refers to a rate calculated by the Wholesale Markets Brokers Association (“WMBA”). The WMBA has transferred the administration of SONIA to the Bank of England and, while it remains the calculation agent for SONIA for the time being, the plan is for the Bank of England to assume this role eventually. ISDA has said it will address these developments by making changes to the definition, according to the Consultation Paper at paragraph 24.

Since SONIA is calculated as a volume-weighted average and does not reflect a snapshot of the market for sterling overnight deposits at any particular hour, the ISDA definition for SONIA does not refer to a publication time nor does it use the familiar “as of” drafting technique commonly associated with the contractual definitions of, say, the time-sensitive Interbank Offered Rate benchmarks. In that regard, the FMLC does not anticipate that the change to the publication day will cause significant legal issues for contracts which rely on the definition.

Other market standard terms, however, may possibly be affected by the change in publication day. In particular, a number of SONIA swap rate definitions published by ISDA in supplements to the 2006 ISDA Definitions refer to swap prices that are fixed in a time-sensitive manner, typically by taking a snapshot of real-time prices for SONIA swaps published on brokers’ screens “as of” either 11.00 or 16.15. The Committee wishes to draw to your attention the possibility that there may be a shift in the economics of the underlying market for SONIA swap deals around these times which occurs as a result of changing the publication times for SONIA and, in consequence, a possible change in the levels of the swap rates, as defined.

**Benchmark concepts (CP Question 5)**

As a final brief point, the Committee would like to express its support for the way in which the Consultation Paper, in section 3, aligns the analysis of SONIA with the conceptual schema now widely adopted in international regulation. Drawing a careful distinction between: (i) input data, (ii) the benchmark methodology and (iii) the economic reality or underlying market the benchmark is attempting to measure, is essential not only to ensure the correct application of law, regulation and best practice guidelines but also to promote a shared understanding of the risks associated with reform and an accurate analysis of its impact.

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

*cc. Ed Ocampo, Tim Taylor*


3 That is, it will be published under licence on screens maintained by, inter alios, Bloomberg and Thomson Reuters and also made freely available, with a time lag, via the Bank of England’s Interactive Statistical Database

4 Supra n.1.

5 See the Consultation Paper, page 7.

6 Frustration risk materialises at common law when the subject matter of a contract has been destroyed, or has otherwise become unavailable, and as a result performance by one or both of the parties to the contract is rendered impossible. It is often said that benchmark withdrawal would represent a frustration risk for financial contracts and occasionally the same thing is said of benchmark transition or evolution on the premise that the evolved benchmark no longer shares the identity of the original benchmark.

7 A similar issue, which is perhaps more prevalent in civil law systems, is the risk of force majeure, whereby a party is excused performance under a contract because performance has become impossible or impracticable owing to the intervention of an unpredictable and overwhelming supervening event. In common law systems, although there is no free-standing doctrine of force majeure, contracts sometimes include force majeure clauses contemplating events that may render performance impossible or impracticable and make provision for the parties to be excused further performance. When a force majeure clause is triggered it will normally bring an end to the contract.


9 Frustration 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 be taken to have allocated these risks in a number of different ways. (See FMLC report ibid, p.24 to 27, for more detail on the doctrines of frustration and implied terms.)

10 The precise risks will, however, depend on the terms of the parties’ contract and their circumstances as a whole. Parties should consult their lawyers on the implications of benchmark transition for their contracts referencing the benchmark. The views of the FMLC do not constitute legal advice to any person.


13 At page 42.

14 See, for example, “GBP-SONIA-OIS-11:00-ICAP” in Supplement no.13 and “GBP-SONIA-OIS-11:00-TRADITION” and “GBP-SONIA-OIS-4:15-TRADITION” in Supplement no.20.

15 In view of the fact that this letter responds to a consultation issued by the Bank of England, Sinead Meany took no part in the preparation or drafting of this letter.
RESPONSE TO ESMA CONSULTATION ON THE DRAFT TECHNICAL STANDARDS UNDER THE BENCHMARKS REGULATION

DECEMBER 2016
1 December 2016

European Securities and Markets Authority
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07
France

Dear Sirs,

DRAFT TECHNICAL STANDARDS UNDER THE BENCHMARKS REGULATION

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.

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”) 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. The FMLC commented extensively on the Legislative Proposal.¹

Regulation (EU) 2016/1011 (the “BMR”)—reflecting the Legislative Proposal as amended by co-decision of the European Council and Parliament—was published in the Official Journal on 29 June 2016. It requires the European Securities Markets Authority (“ESMA”) to develop a number of draft regulatory and implementing technical standards and provide technical advice to the Commission.

Before the BMR was published or entered into force, on 15 February 2016, ESMA published a Discussion Paper (the “DP”) putting forward a proposed approach for both draft technical standards and technical advice.² The FMLC responded to the DP in March 2016 (the “March Response”), analysing certain key issues: (i) ESMA’s definition of “available to the public” for the purposes of determining an “index”; (ii) the concept 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.³

More recently, ESMA has published a follow-up to the DP, in the form of a Consultation Paper published on 29 September 2016 (the “CP”) setting out draft technical standards (“Draft RTS”) under a variety of mandates. Not all topics addressed in the DP, however, are included in the CP. Certain key questions concerning definitions and transitional arrangements, for example, have been addressed in an earlier consultation.⁴ The FMLC takes this opportunity to offer a short response to the CP.

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Characteristics and procedures of the oversight function

In the March Response, the FMLC discussed the oversight function requirements and the proposals put forward by ESMA on this subject in section 3 of the DP. In particular, the FMLC highlighted passages in the DP where ESMA contemplated the possibility that independent members of the oversight function might include independent non-executive directors (INEDs), appointed to the board of the administrator, where “independent members” are described by ESMA as persons who are not otherwise directly affiliated with the administrator. The FMLC suggested that careful thought should be given to the role and independence of INEDs who would, as a matter of law, owe common law duties of care, skill and diligence to the administrator.

In the CP (at paragraph 11), ESMA explains that it has, on reflection, removed any provision which would allow INEDs of the administrator of the benchmark to serve on an oversight function as independent members and the new approach is reflected in Article 1(2) of the accompanying Draft RTS on the oversight function. The FMLC welcomes the adjustment and the revised approach.

In relation to the positioning of the oversight function, the CP (at paragraphs 17 and 18) refers to the importance of ensuring effective challenge of the management body, which is, in essence, the board of the administrator. In certain circumstances, a board may delegate management to executive and operational staff. The FMLC recommends that this possibility is reflected in the Draft RTS on the oversight function. Thus, Article 2 might provide:

> The oversight function shall … challenge the decisions of the management body … and of any staff of the administrator to whom the management body has delegated the responsibilities described in Article 3(1)(20) [BMR] with regards to benchmarks provision …

The FMLC notes, further, that ESMA has given additional consideration to the structures which reflect the independence of the oversight function (at paragraphs 21 and 22 of the CP) and has introduced restrictions which ensure the internal separation of the oversight function from the business of the administrator to avoid conflicts of interest. The FMLC welcomes this.

Verifiability of input data and use of expert judgement

The FMLC supports the proposals to provide for contingency measures or fall-back arrangements to ensure the provision of input data during conditions of market stress (at paragraph 75 of the CP). There may, however, be occasions when an administrator is unable to guarantee the provision of input data because s/he believes that the available data does not meet the threshold standards for adequacy set by Article 11 of the BMR. It is important that the requirement to “ensure the provision of input data” in Article 6(2)(d) of the Draft RTS on input data does not conflict with these standards and consideration could usefully be given, therefore, to qualifying the requirement. For example, Article 6(2)(d) could require contingency arrangements:

> to ensure, where possible and consistent with the requirements established by Article 11 [BMR], the provision of input data in the event of a disruption …
A similar point arises in the context of expert judgement. Although the proposals in paragraph 142 of the CP on the procedures for applying expert judgement are welcome, the FMLC suggests that it would be helpful if the Draft RTS were also to indicate the limits of contributors’ discretion in relation to benchmark inputs. Failing such clarification, there may be a risk that the use of expert judgement expands to fill the methodological vacuum caused by a lack of reliable transaction data. At this point, contributors will be concerned about their potential civil or criminal liability for the provision of false or misleading inputs. This issue was discussed in considerable detail by the FMLC in section 4 of the March Response, where the Committee pointed out that the BMR defines expert judgement exclusively in terms of adjustments to input data such as transactions, bids and offers and other value data. In order better to track the definition in the BMR, Article 3 of the Draft RTS on governance and control requirements for supervised contributors could be introduced with the words “Where input data is adjusted by expert judgement ...”

A final, short point on the Draft RTS on input data is that references to monitoring communications—at Article 6(3)(e) and (f)—will, in the view of the FMLC, be interpreted in accordance with the usual practice of recording communications and performing random spot checks. The Draft RTS should stipulate for a different standard if one is intended.

**Third country benchmarks and compliance with IOSCO Principles**

In a paper on the Legislative Proposal published in March 2014, the FMLC sought clarification from the European Commission as to the extent to which compliance with the *Principles for Financial Benchmarks* (the “*Principles*”), adopted by the International Organisation of Securities Commissions (“IOSCO”) on 17 July 2013, would assist the administrator of a third country benchmark in obtaining recognition for that benchmark under the proposed regulation.

In this regard, the FMLC welcomes ESMA’s decision to include specific points on a benchmark’s compliance with the *Principles* as information required to be provided in an application for recognition as a third country provider. The FMLC also welcomes the provision at Article 1(4) of the Draft RTS on recognition, which permits an applicant to dispense with providing this information where it is contained, instead, in an assessment by an independent auditor of the benchmark’s compliance with the *Principles*. These provisions go some considerable way towards clarifying the extent to, and means by, which compliance with the *Principles* will support an application for recognition.

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,

[Signature]

Joanna Perkins

FMLC Chief Executive"
The FMLC papers on the Legislative Proposal are as follows:


All FMLC publications are available at: http://www.fmlc.org/fmlc-papers.html


5 See Article 3(1)(20) of the BMR.

6 See also the Draft RTS on input data, Article 6(2)(d).

7 The administrator is required to disclose contingency measures which will be taken when the thresholds for minimum quantity and quality of input data are not met under Article 1(1)(15) of the Draft RTS on transparency of methodology.

8 See the Draft RTS on governance and control requirements for supervised contributors, Article 3.

9 Responsibility for contingency measures to be taken when the thresholds for minimum quantity and quality of input data are not met rests firmly with the administrator, see supra n.7.

10 See Article 3(1)(13) of the BMR.


12 Annex 1 to the Draft RTS on recognition lists the information to be provided in this context.

13 The FMLC is grateful to David Bunting (Deutsche Bank AG) for his comments on this letter and contributions thereto.
LETTER TO EUROPEAN MONEY MARKETS INSTITUTE ON
THE EVOLUTION OF EURIBOR

APRIL 2016
Dear Mr Ravoet,

EMMI Consultative Position Paper on the Evolution of EURIBOR

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 Committee has actively and regularly engaged with the subject of financial benchmark reform since 2012. In light of its extensive work on this subject, the Committee welcomes the opportunity to respond to the consultative position paper (the “Position Paper”) published by the European Money Markets Institute (the “EMMI”) on the evolution of the European Interbank Offered Rate (“Euribor”), dated 30 October 2015.

Changes to the Benchmark Methodology

The Position Paper provides proposals for reforming the Euribor calculation methodology. Currently, Euribor is calculated using quote-based submissions provided by panel banks. The EMMI is committed to ensuring that the methodology is brought into line with international regulatory recommendations by anchoring it in transactions to the greatest extent possible.

In briefest summary, the proposals, introduced in section 3 of the Position Paper, set out three phrases in the development of the new transaction-based methodology: a) calculating the benchmark from a sampling of data, supplied by Panel Banks, derived from “eligible transactions”; b) enhancements to guarantee data sufficiency, including the use of appropriately weighted historic data from days prior to the calculation; and c) the further elaboration of calculation methods, including techniques to smooth volatility by discarding outlying rate data. The EMMI also makes detailed proposals for data insufficiency contingency and fallback arrangements. The primary proposed fallback is to make greater use of historic data from prior days; the second is to revert to a quote-based methodology.

In section 4, the Position Paper addresses the question of how a transition to the new methodology can be achieved with minimum market disruption. This question had previously been addressed, in abstract, for key “IBOR” benchmarks as part of a report by the Financial Stability Board (the “FSB”) on Reforming Major Interest Rate Benchmarks. As part of its analysis, the Position Paper refers to various alternative transition pathways identified in the FSB Report and concludes that pursuing a “Seamless Transition”—whereby the identity of the existing benchmark is preserved to the greatest extent possible whilst the methodology is reformed—would be in the interest of the broad majority of Euribor stakeholders. The advantages of such a transition are that it offers reduced legal and operational risks compared to other alternatives. There are, however, some
disadvantages. As highlighted in the Position Paper, a Seamless Transition is only feasible if the “definition as well as the value and volatility of Euribor under the current and transaction-based determination methodologies are sufficiently similar” (p.21). Accordingly, the EMMI emphasises (p.22) the need “to achieve similarity in the essential characteristics of the benchmark” before and after transition.

In view of this concern to ensure continuity not only with respect to the identity of the benchmark but also with respect to the predicted values, it is noteworthy that the figures provided in Table 6 (p.23) of the Position Paper suggest that the new methodology could lead to a variation spread in values of more than ten basis points (although the Position Paper stresses that the quantitative analysis undertaken is not a prediction of actual changes when the methodology is introduced in 2016). There is good reason to infer that if this degree of divergence in projected values is substantiated, market participants will be apprehensive about the possibility of operational disruption and this may possibly have a negative impact on plans for a Seamless Transition.

Legal Risk and Financial Contracts

It is sometimes said that divergence in predicted values under a reformed benchmark methodology would give rise to legal risk. Those who raise this concern are usually referring to “frustration” risk in relation to existing financial contracts which reference the benchmark. Frustration risk materialises at common law when the subject matter of a contract has been destroyed, or has otherwise become unavailable, and as a result performance by one or both of the parties to the contract is rendered impossible. It is often said that benchmark withdrawal would represent a frustration risk for financial contracts and occasionally the same thing is said of benchmark transition or evolution on the premise that the evolved benchmark no longer shares the identity of the original benchmark.

A similar issue, which is perhaps more prevalent in civil law systems, is the risk of force majeure, whereby a party is excused performance under a contract because performance has become impossible or impracticable owing to the intervention of an unpredictable and overwhelming supervening event. In common law systems, although there is no free-standing doctrine of force majeure, contracts sometimes include force majeure clauses contemplating events that may render performance impossible or impracticable and make provision for the parties to be excused further performance. When a force majeure clause is triggered it will normally bring an end to the contract.

It would be wrong to suggest that an increase in projected values is likely to crystallise legal risks of this kind. The FMLC has observed elsewhere that it would be highly unusual for a commercial contract to be frustrated, particularly where the parties have incorporated fallback provisions dealing with the eventuality of benchmark withdrawal. Frustration 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 be taken to have allocated these risks in a number of different ways. A financial contract may make express provision for benchmark withdrawal—as with a fallback clause—or it may be found, at common law, to incorporate an implied term which covers the eventuality: for example, by recognising the parties' obvious, if implicit, intention that a new methodology is to apply in substitution for the original methodology where the latter has been superseded.

The likelihood of contracts governed by English law being frustrated following a change to the methodology of a specific benchmark is, then, very remote. It 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. It is self-evident that, where the contractual fallback is itself unavailable, there is necessarily an increased risk that a financial contract will be frustrated in the event of benchmark withdrawal. This increased risk could conceivably materialise in situations of benchmark withdrawal.

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5 See FMLC report ibid, p.24 to 27, for more detail on the doctrines of frustration and implied terms.
transition or evolution if a case can successfully be made that the evolved benchmark no longer shares the identity of the original benchmark which has, therefore, effectively been withdrawn. (One would expect the threshold to be met in establishing such a case to be a high one.)

The risks may be different under other European legal systems. A report published by a Market Participants Group (the "MPG") established under the auspices of the FSB in the context of its work on Reforming Major Interest Rate Benchmarks sets out legal risk factors for certain key jurisdictions in the Eurozone and provides that, in those jurisdictions, the doctrine of implied terms is not available. The risk that a contract comes to a disorderly end in the event of benchmark withdrawal or transition may, in light of this, be slightly higher in civil law systems, although fallback provisions will help to mitigate any risk.

Cost of Borrowing and Litigation Risk

The fact that the risks highlighted in the paragraphs above may be, de jure, remote does not necessarily mean that a benchmark transition will be an entirely smooth one. Wherever there is a change in market practice, those who perceive themselves to be economically disadvantaged are incentivised to challenge the new arrangements and/or the contracts which tie them to those arrangements. History may suggest that there are grounds to be sanguine about benchmark transition, but examples of a transition involving a benchmark which is the reference rate for over-the-counter derivatives valued at more than a hundred trillion euros (on a notional underlying basis) and a proposed core rate spread of over ten basis points are probably unprecedented.

Concerns regarding potential basis point variation in the context of benchmark transition were documented in the MPG report referred to above. The MPG surveyed market participants and found that, in a situation where a reformed benchmark systematically varied from a current benchmark by more than five basis points, the vast majority of those surveyed were undecided or preferred to transition to a different rate. One of the key concerns emphasised by those who expressed a view was the impact on the cost of borrowing. This work by the MPG suggests that a perception of economic disadvantage could render benchmark transition arrangements for major interest rate benchmarks contentious and even litigious, despite every indication that the legal risks are remote. This is a possibility which the EMMI will no doubt wish to consider.

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

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6 MPG, Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks, dated 22 July 2014, supra n.1; see p.43 and also the section entitled “Implied Terms” at p.66.


8 EUR interest rate derivatives figures for H1 2015 from the Bank for International Settlements.

9 See, in particular, p.37 of the report.

10 The FMLC also highlighted this issue in its report of 2012 by noting that rates based on actual transaction data may be higher than those determined under a quote-based methodology and, thus, a change may be perceived as economically disadvantageous to Borrowers, in particular. See FMLC report, supra n.4, see paragraph 5.12.
RESPONSE TO DISCUSSION PAPER BY THE EUROPEAN SECURITIES AND MARKETS AUTHORITY ON BENCHMARKS REGULATION

MARCH 2016
FINANCIAL MARKETS LAW COMMITTEE

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

MARCH 2016

www.fmlc.org
FINANCIAL MARKETS LAW COMMITTEE

This paper has been drafted by the FMLC Secretariat.  

Joanna Perkins (FMLC Chief Executive) and Sherine El-Sayed (FMLC Project Secretary).

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

1.1. Introduction

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”) 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 on a compromise text (the “Final Compromise Text” or “Draft Regulation”). The agreement was confirmed by the Permanent Representatives Committee of the Council of the European Union on 9 December 2015. 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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texts. 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. 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). The Discussion Paper covers topics that will be included in the technical advice 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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8 The draft technical standards will be submitted to the European Commission within 12 months of entry into force of the Regulation.

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, \textit{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, see Article 14a and Annex II); Article 5a(2)-(3) (applicable to all benchmarks except

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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 I 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) [where 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) in 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, this should not be taken to require an INED, once appointed, to act other than in the best interests of 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.

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.

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.
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. 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 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

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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.
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 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, 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 submission”. The Wheatley Report is available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf.

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” 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.

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.
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 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
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 348ff, 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 instruments referencing a benchmark has passed, market disruption is a much less significant risk for benchmark transition.

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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

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Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.
Dear Mr Guersent,

**BENCHMARK REFORM**

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 previously considered the European Commission's proposal for a Regulation of the European Parliament and of the Council on indices used as benchmarks in financial instruments and financial contracts ("the Proposed Regulation"). In a paper dated March 2014 and correspondence dated 3 March 2015, the Committee highlighted issues of legal uncertainty with regard to, *inter alia*, the proposed third country regime as provided in Article 20 and (in a later text of the Proposed Regulation) Article 21a.

A report of the European Parliament's proceedings, dated 20 May 2015, which incorporates an agreed text of the Proposed Regulation ("the May Compromise Proposal") has since been published.¹ The May Compromise Proposal is the text to which this letter refers. The FMLC considers that legal uncertainty may arise in respect of the scope and application of the Proposed Regulation in the context of foreign exchange ("FX") rate sources. This letter highlights these issues of legal uncertainty, with particular reference to non-deliverable forward ("NDF") contracts referencing emerging markets currencies ("EMCs").

**FX Rate Sources**

The FX rate sources discussed in this letter are used for currency derivatives referencing EMCS. The markets in these currency derivatives fulfil an important liquidity function for some emerging market economies. Financial activity and per capita GDP in emerging markets are positively correlated to the growth of derivatives markets referencing EMCS.²

The primary providers of FX documentation are the International Swaps and Derivatives Association ("ISDA") and the Emerging Markets Trade Association ("EMTA"). Some standard market definitions for FX rate sources have been established by virtue of the 1998 FX and Currency Option Definitions published jointly by ISDA, EMTA and the Foreign Exchange Committee (an industry group established by the New York Federal Reserve). Standard market terms for contracts will differ according to the type of instrument being created. The paragraphs below discuss NDF contracts.

For NDFs, contracts are likely to be concluded on the EMTA Template Terms. These set out, for each currency, a specific waterfall of non-discretionary valuation alternatives designed to address price source and market disruption scenarios in order to provide contractual certainty to the parties to the contract.

Typically (although not necessarily), FX NDFs will refer to several settlement rate sources or options in a waterfall: (i) a primary rate source; (ii) non-primary rate sources, including "fall-back rates", which may be published or unpublished; and (iii) finally, Calculation

¹ A final report from the European Parliament was also published on 10 April 2015.

Agent Determination, which is an unpublished determination made solely by the designated Calculation Agent. Primary rate sources in FX documentation are often official central bank rates but may be commercial or industry rates based on a survey or on another methodology (such as a transaction-based mechanism). Non-primary FX rate sources and fall-back rates, which are intended for use to cover operational or other disruption to the primary source, are usually published indicative survey rates, although they may be unpublished survey rates or rates based on other methodologies.

If FX rate sources are not excluded or exempted from the Proposed Regulation, it is unlikely that those deemed to be the administrators of the rates will be able to comply with the mandatory governance requirements set out in Title II for reasons provided below. This would have a significant negative impact on wholesale financial markets. These issues are examined below.

**Central Bank Rates**

Where primary rate sources are central bank rates, uncertainty arises as to whether these rate sources would fall within the scope of the Proposed Regulation. Article 2(1) of the May Compromise Proposal stipulates that the Regulation will apply to “the provision of benchmarks, the contribution of input data to a benchmark and the use of a benchmark within the Union”. Article 2(2) sets out certain exceptions, however. In subsection (a) of Article 2(2), it is made clear that the Regulation shall not apply to the provision of benchmarks by:

central banks, where they are exercising powers or carrying out the tasks and duties conferred on them by the Treaties and by the Statute of the European System of Central Banks (ESCB) and of the ECB, or for which their independence is inherent in the constitutional structures of the Member State or third country concerned.

As a preliminary point, the FMLC wishes to draw attention to the lack of clarity inherent in the concept of a central bank’s “independence”. An additional point is that, in light of the fact that central bank FX rate sources may be published by central banks on the basis of trading data, rather than as policy rates, it is often unclear whether the rates in question are compiled in the course of central banking activity or not.

Given these difficulties there is uncertainty as to whether central bank rate sources would fall within the Article 2(2)(a) exemption. Without an exemption, a central bank rate source would likely fall within the definitions of “index” and “benchmark” set out in Article 3(1)(1) and (2), respectively.\(^3\) The impact of the application of the Proposed Regulation in this regard is discussed further below.

Other FX rate sources—which may be industry rates or indicative survey rates—are also likely to fall within the scope of the Proposed Regulation. Further detail is provided below.

**Industry Rates and Survey Rates**

Non-central bank primary FX rate sources are likely to be published commercial or industry rates administered by third country entities (although they may also be indicative survey rates, discussed below). It should be noted that there may be little or no choice as to the published rate sources available for a specified EMC, particularly in the case of relatively illiquid currencies. Owing to this lack of optionality, NDFs for some EMCS may reference rates which are methodologically less robust than others.

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\(^3\) “Index” is defined as “any figure (a) that is published or made available to the public; (b) that is regularly determined, entirely or partially, by the application of a formula or any other method of calculation, or by an assessment; and (c) where this determination is made on the basis of the value of one or more underlying assets, or prices, including estimated prices, actual or estimate interest rates, or other values or surveys”.

“Benchmark” is defined as “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”.

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Non-primary and fall-back rates include published indicative survey rates. In NDF contracts, the latter may be administered by EMTA or, for Asian currencies, the Singapore Foreign Exchange Market Committee (“SFEMC”). Indicative survey rates are derived from indicative quotations received from dealers in both the onshore and offshore markets. Fall-backs promote contractual continuity in times of market stress and can avoid exacerbating market disruption. Because non-primary rates are only intended to be relied upon as a fall-back when other benchmarks are unavailable, the methodological architecture is calibrated to the circumstances under which they may be activated.

Published commercial/industry and indicative survey rates will prima facie fall within the scope of the Proposed Regulation. It does not seem likely that EMTA, or the SFEMC, or other third country entities which are deemed to be the administrators of commercial and industry FX rates will be able to meet either (i) the proposed standards for administering benchmarks in the EU; (ii) the tests for equivalence in Title V of the Proposed Regulation; or (iii) the threshold test for recognition by the European Securities and Markets Authority in Article 21a of the May Compromise Proposal (which requires a representative of the administrator to be established in the Union). In these circumstances, under Article 19 of the Proposed Regulation and of the May Compromise Proposal, the use of rates by supervised entities is prohibited.

**Impact**

If the May Compromise Proposal is adopted without further amendment and supervised entities are prohibited from “using” FX rate sources, there will have to be a significant realignment of market practice with possible attendant disruption to a large number of outstanding FX contracts. This may affect contractual continuity by causing parties to terminate contracts, unwind positions and dispose of instruments in great volume. In particular, supervised entities would be forced to divest themselves of derivatives referring to these terms which may cause undue market volatility. This may have a significant negative effect on wholesale financial markets.

**Proposed Solutions**

The appropriate regulatory policy vis-à-vis FX rate sources is not a subject on which the FMLC is able to comment. The Committee would, however, be happy to assist with drafting recommendations for any amendments which the EU Commission, Parliament and Council considered helpful to introduce to the May Compromise Proposal. Were it thought desirable to exclude FX rate sources from the scope of the Proposed Regulation, the Committee observes that a useful definition of FX rate sources is provided with the introduction of the term “Settlement Rate Option” in the 1998 FX and Currency Option Definitions published jointly by ISDA, EMTA and the Foreign Exchange Committee. The FMLC is aware that policy issues exist to weigh the balance of the value of robust benchmarks against the value of immediate market stability. Considerations of this nature fall outside the remit of the FMLC.

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

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5 Up to 30 randomly selected financial institutions that are participants in a reference currency market will be surveyed. Each participant will be asked to provide its reasonable judgment of what the current prevailing free market spot rate is for a standard size reference currency/settlement currency (e.g. Argentine Peso/US Dollar) financial transaction for same-day settlement in a particular local market.
LETTER TO THE FINANCIAL STABILITY BOARD

APRIL 2015
Dear Mr Thorne

FINANCIAL MARKETS LAW COMMITTEE—THE REGULATION OF COMMODITY BENCHMARKS

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 engaged, on a number of occasions, with the subject of benchmark evolution and transition. In this context, the Committee notes the excellent work of the Financial Stability Board (the “FSB”). As far as key market interest rate benchmarks are concerned, namely LIBOR, EURIBOR and TIBOR (the “IBOR" benchmarks), the FMLC was grateful for the opportunity to assist the FSB in analysing whether legal risk may arise in the context of benchmark transition in respect of legacy contracts and in identifying the principal ways in which such risk may be mitigated.

As far as the FMLC is aware, commodities benchmarks are not covered by the FSB’s previous work. The FMLC notes, however, that in his letter of 4 February 2015, the Chairman of the FSB, Mark Carney, stated that “[t]he FSB will consider reforms to reduce the likelihood of misconduct, including by… [a]ssessing reforms to benchmarks.” The FMLC infers from this that further work on benchmarks may be contemplated by the FSB. It is against this background that the FMLC would like to draw attention to certain reform initiatives in the field of commodity benchmarks.

International Efforts to Reform Currency Commodities

In July 2013, the International Organization of Securities Commissions ("IOSCO") published a final report, entitled Principles for Financial Benchmarks, which provides an overarching framework for benchmarks used in financial markets. It has also published a final report on Principles for Oil Price Reporting Agencies which sets out a framework intended to enhance the reliability of oil price assessments that are referenced in derivative contracts. Both IOSCO initiatives (collectively, “the Principles”) include commodities benchmarks within their scope.

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1 The FMLC has identified a number of issues of legal uncertainty arising from global benchmark reform in previous publications, all of which are attached and available on the FMLC website at: http://www.fmlc.org/fmlc-papers.html

“FMLC” and “The Financial Markets Committee” are terms used to describe a committee appointed by Financial Markets Law Committee, a limited company. Registered office: 8 Lothbury, EC2R 7HH. Registered in England and Wales: company number 8733443.
The FMLC endorses these initiatives but notes that the Principles are drafted at a high level.\footnote{Indeed, IOSCO acknowledges that “although the Principles set out uniform expectations, [it]... does not expect a one-size-fits-all method of implementation to achieve the objectives of the Principles.” See IOSCO, “Financial Benchmark Principles”, page 5.} Whilst the application of the Principles to commodities benchmarks may be desirable, detailed implementation may bear practical challenges and could require the development of separate regulatory tools.\footnote{See IOSCO, “Implementation of the Principles for Oil Price Reporting Agencies”, available at: http://www.isoasco.org/library/puidocs/pdf/IOSCOPD448.pdf and IOSCO, “Review of the Implementation of IOSCO’s Principles for Financial Benchmarks”, available at: http://www.isoasco.org/library/puidocs/pdf/IOSCOPD474.pdf.}

**Commodity Benchmark Reform in the EU and the UK**

In 2011, the EU introduced Regulation (EU) No 1227/2011 of the European Parliament and of the Council on wholesale energy market integrity and transparency (the “REMIT”). The REMIT prohibits market manipulation in wholesale energy markets. This measure was the subject of a consultation in the UK, published in August 2014, by HM Department of Energy and Climate Change (the “DECC”), in which the DECC indicated that “[t]he REMIT prohibition on market manipulation covers the manipulation of markets through the manipulation of benchmarks.”\footnote{DECC, “Strengthening the regulation of wholesale energy markets through new criminal offences”, paragraph 1.6., available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/341293/remit_criminal_sanctions_consultation_final.pdf.} In this consultation, the DECC proposed to create a new criminal offence of market manipulation in the context of wholesale energy markets, including a new offence of benchmark manipulation.\footnote{Ibid.} Following the conclusion of the consultation period the DECC has stated that it intends to implement “new criminal sanctions through regulations for the offences of insider dealing and market manipulation”.\footnote{DECC, “Strengthening the regulation of wholesale energy markets through new criminal offences”, paragraph 4.11., available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397367/government_response_to_consultation.pdf.} This will be separate and additional to the provisions of the REMIT. In this regard, the FMLC has drawn HM Government’s attention to certain inconsistencies between the new regime proposed for energy benchmarks and the existing regulatory regime for financial benchmarks.\footnote{Financial Markets Law Committee, Letter to HM Department of Energy and Climate Change, 28 October 2014, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/letter_to_department_of_energy_and_climate_change.pdf.}


The extension of recent financial benchmark reforms to commodities benchmarks has also been provided for by HM Treasury which, on 25 September 2014, proposed the classification of certain benchmarks—including commodity benchmarks (London Gold Fixing, LBMA Silver Price and ICE Brent)—as “relevant benchmarks”, in relation to which making...
misleading statements constitutes a criminal offence under section 91 of the Financial Services Act 2013. Following early recommendations by the “Fair and Effective Markets Review”, in late 2014, that seven major benchmarks are to be included in the domestic UK legal framework regulating financial benchmarks by means of a statutory instrument which took effect on 1 April 2015.

Next Steps
It is clear from what has been said above that a number of measures are being taken at the national or regional level in relation to the regulation of commodities benchmarks. Unilateral national or regional action of this sort can lead to inconsistencies, gaps, overlaps, duplicative requirements and other legal uncertainties, as the FMLC has often observed. In these circumstances an overarching international enquiry into the appropriate objectives to be pursued by regulatory reform initiatives can assist in promoting inter-jurisdictional cohesion and legal certainty.

The FMLC takes the view that the FSB is well-placed to undertake such an inquiry and understands that further work of this nature is within the scope of the reforms presaged by Mark Carney in his letter, quoted above. The FMLC would encourage the FSB, were it to initiate such work, to give further consideration to adopting the approach which was taken in relation to the study on IBOR benchmarks referred to above. In that instance, the FSB managed its work in this area through the agency of the Official Sector Steering Group (the “OSSG”), comprising capital markets regulators and representatives of central banks, and garnered relevant industry expertise by establishing the Market Participants Group (the “MPG”) to undertake research. Thus, when the FSB came to make its recommendations it had the benefit of detailed input and guidance from another international standard-setting body and a wide array of regulators and supervisors from multiple jurisdictions, as well as the expertise of industry participants to draw upon. Given the high degree of market sensitivity on the subject of benchmark transition, this “bottom up” approach (to which the FMLC has recently referred in its Discussion Paper entitled “Coordination in the Reform of International Financial Regulation”) may be regarded as having been successful.

If the FSB were to determine that further work on the topic or points raised in this letter would be desirable, the FMLC would be pleased to assist in any way possible.

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 Officer

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17 Information about the Fair and Effective Markets Review is available at: http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx.


21 Ibid. at section 4.1.

22 Disclosure: Joanna Perkins is affiliated with ICE Benchmark Administration Ltd.
Dear Mr Faull,

Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts

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 published a paper in March 2014 on the European Commission's proposal for a Regulation of the European Parliament and of the Council on indices used as benchmarks in financial instruments and financial contracts ("the Proposed Regulation"). In that paper, the FMLC highlighted issues of legal uncertainty with regard to, inter alia, the proposed third country equivalence regime (Article 20). Several presidency compromise texts have since been published by the Council of the European Union. A compromise proposal, on which the Council has reached agreement, was published as an annex to the Negotiating Mandate, dated 6 February 2015 ("the Compromise Proposal"). This is the text to which this letter refers. The Committee on Economic and Monetary Affairs ("ECON") of the EU Parliament has also published a draft report ("the Draft Report") and subsequent amendments dated 23 January 2015 ("the Proposed Amendments") on this topic. Both the Compromise Proposal and the Proposed Amendments seek to amend the equivalence regime provided in the Proposed Regulation by virtue of Article 21a: recognition of an administrator located in a third country.¹

Whilst the FMLC welcomes the Compromise Proposal and the inclusion of recognition requirements for administrators located in third countries, it considers that legal uncertainty would arise in respect of: (i) the methodology for establishing the Member State of reference; (ii) the obligations imposed on a legal representative in the Member State of reference; and (iii) a lack of transitional provisions for non-EU benchmarks. Analysis of these uncertainties and their impact on wholesale financial markets if they are not addressed is provided in the paragraphs below. To ameliorate these uncertainties, the FMLC considers that the approach taken in the Proposed Amendments published by ECON provides a more pragmatic approach with respect to the third country equivalence regime and the drafting of Article 21a.

Suggested solutions are also provided in this letter, where appropriate.

Recognition of an Administrator Located in a Third Country

The equivalence regime in Article 20 of the Compromise Proposal sets out certain conditions which must be met in order for a benchmark provided by an administrator established in a third country to be a permissible reference rate for transactions by EU entities i.e. for an equivalence decision to be given by the European Commission. Article 21a allows administrators located in a third country to acquire recognition, prior to the adoption of an equivalence decision by the European Commission. Article 21a(1) stipulates:

Until such time as an equivalence decision in accordance with Article 20(2) is adopted, benchmarks provided by an administrator located in a third country may be used by supervised entities in the Union provided that the

¹ Many of the points in the FMLC's Paper of March 2014 remain valid notwithstanding substantial amendments to the Proposed Regulation, including points on Article 3(1) (see section 3 of the paper) and Article 4 (see section 3.6 to 3.8).
In order to acquire prior recognition in accordance with Article 21a(1), a third country administrator must, among other things: (i) apply for recognition with the competent authority of its Member State of reference; and (ii) obtain the services a legal representative established in the Member State of reference. Uncertainties regarding these provisions are examined in the sections below.

Criteria for Identifying the Member State of Reference (Article 21a(4))

Article 21a(4) of the Compromise Proposal sets out how the Member State of reference shall be determined. The methodology depends upon (a) the location of the first trading venue in which the financial instruments in question were admitted to trading; (b) upon the Member State where the highest number of supervised entities using the relevant benchmarks are located; or (c) if neither of the conditions under points one and two above apply, the Member State where the supervised entity is located, “as long as the administrator entered into an agreement to consent the use of a benchmark it provides with a supervised entity”.

With regard to both the first and second points above, it will not always be possible for a third country administrator to be certain as to which is the Member State of reference under these tests, because an administrator is not necessarily either in control of the trading venues in which financial instruments using its benchmarks are traded, or aware of all of the supervised entities using the relevant benchmarks. A single benchmark provided by a third country administrator may be used in a variety of different financial instruments, some of which may be initially traded for the first time on a trading venue in one Member State and some of which may be traded on a trading venue in one or more other Member States for the first time. This may result in there being more than one Member State of reference.

Furthermore, in instances where a financial instrument was admitted to trading simultaneously on more than one trading venue, Article 21(a)(4)(a) may require extensive due diligence from the third country administrator to determine liquidity as the administrator itself will invariably not be the issuer of the relevant financial instruments. Where trading occurs on other organised trading facilities, this could create a further layer of difficulty in determining liquidity with any degree of precision.

Similarly, Article 21(a)(4)(b) of the Compromise Proposal would require an identification of all entities who constitute supervised entities for the purposes of the Regulation and who may be using the relevant benchmark in (private) financial contracts which may be difficult for a third country administrator to determine. The use of the criteria provided by virtue of Article 21(a)(4) may identify a Member State of reference that, when the same test is taken at another relevant time, would be different.

Delegated Representative Provisions

Article 21a(3) of both the Compromise Proposal and the Proposed Amendments requires a third country administrator to have a legal representative established either in its Member State of reference or in the Union. If there is more than one Member State of reference (see above) then this would appear to require legal representatives to be appointed in each such Member State. It would be preferable for the requirement simply to be that a third country administrator should have a representative established in the Union (as provided in the Proposed Amendments). In addition, the Compromise Proposal requires the legal representative to act on behalf of the third country administrator with regard to all of the third country administrators' obligations under the Regulation and to perform the oversight function together with the administrator.

Such obligations would effectively require a legal representative to replicate the functions of the third country administrator which would likely be significantly difficult to achieve. Without a specific exclusion, this also introduces the risk that the legal representative itself could be deemed to be performing the activity of administrating a benchmark. The FMLC would recommend that the obligations of the legal representative should be limited to those receiving and making communications on behalf of the relevant third country administrator.
Whilst the Proposed Amendments go some way toward achieving this, legal certainty would be bolstered if they were expressly amended to state that the legal representative should have no other obligations than those associated with these communications.

Transitional Provisions

The Proposed Regulation and Compromise Proposal provide transitional provisions relating to existing EU benchmarks (by virtue of Article 39). There are no corresponding transitional provisions for existing non-EU benchmarks, however, despite the fact that many non-EU benchmark administrators will need to apply for recognition under Article 21a. The FMLC would, therefore, recommend the inclusion of provisions allowing for a window during which equivalence decisions can be made and following which third country administrators would have an opportunity to seek recognition or endorsement.

Impact

Although Article 21a allows administrators located in a third country to acquire recognition, such third country administrators may in practice have little incentive to apply for recognition. One would expect that many EU entities currently use benchmark rates provided by third country administrators without paying a licence fee and, if this is the case, there will be no financial incentive for those administrators to apply for recognition. Indeed, recognition will result in additional obligations for those third country administrators. If third country administrators do not apply for recognition and, as a result, supervised entities within the EU are not able to use the relevant benchmarks, this may give rise to considerable legal risk and disruption to a huge number of outstanding contracts. Although the lack of a positive equivalence decision in relation to a benchmark is unlikely to give rise to claims that contracts have been 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. In particular, supervised entities would be forced to divest themselves of derivatives or exchange-traded funds referring to common foreign benchmarks, which may cause undue market volatility. This may have a significant negative effect on wholesale financial markets.

Solutions

In order to mitigate the impact of the uncertainties set out above, it would be preferable for there to be a simpler method of seeking recognition such as the one set out in amendment 566 of the Proposed Amendments to the effect that the administrator should seek prior recognition from the European Securities and Markets Authority (“ESMA”).

Supervised entities will need to know whether an application has been made or refused. Competent authorities cannot publish lists of applications and refusals without an explicit direction to do so (because of duties of confidentiality). It is, therefore, recommended that, unless the approach in the Proposed Amendments is adopted (as the FMLC recommends), the Proposed Regulation include an express direction to the relevant competent authorities to notify ESMA of all applications and, in any event, directions to ESMA to publish details of the applications received.

I would be grateful if you would draw the points raised in this letter to the attention of the Council if you think it appropriate and useful to do so. 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.

Yours sincerely,

Joanna Perkins
FMLC Chief Executive

Copied to: Maria Teresa Fabregas Fernandez, Uwe Eiteljorge and Stephane Amoyel
28 October 2014

Department of Energy and Climate Change
3 Whitehall Place
London
SW1A 2AW

Dear Sirs,

Strengthening the regulation of wholesale energy markets through new criminal offences

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 takes note of the consultation published on 6 August 2014 by the Department of Energy and Climate Change (the "DECC") proposing to create new criminal offences of insider trading and market manipulation in the context of wholesale energy markets, including a new offence of benchmark manipulation (the "DECC Consultation").

The FMLC has considered whether any issues of legal uncertainty arise in the context of the DECC Consultation, and concluded that any such issues that do arise are of insufficient materiality to warrant further action by the FMLC at this stage. The FMLC has, however, identified a number of anomalies, set out in the enclosed research paper, which it wishes to bring to the attention of the DECC for its consideration in the context of the DECC Consultation. In light of these anomalies, the FMLC also wishes to draw the attention of the DECC to the proposals of HM Treasury, in the context of the Fair and Effective Markets Review, to bring seven additional benchmarks within the scope of the UK regulatory framework for benchmarks.

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

Yours faithfully,

Joanna Perkins
FMLC Chief Executive Officer

2 Available at: https://www.gov.uk/government/consultations/fair-and-effective-market-reviews-benchmarks-to-bring-into-uk-regulatory-scope

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28 October 2014

Charles Roxburgh
Director General, Financial Services
HM Treasury
1 Horse Guards Road
London
SW1A2HQ

Dear Mr Roxburgh,

Recommendations of the Fair and Effective Markets Review

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 takes note of the proposals of HM Treasury, in the context of the Fair and Effective Markets Review, to bring seven additional benchmarks within the scope of the UK regulatory framework for benchmarks (the "Benchmark Consultation"). The FMLC also takes note of the consultation published on 6 August 2014 by the Department of Energy and Climate Change (the "DECC") proposing to create new criminal offences of insider trading and market manipulation in the context of wholesale energy markets, including a new offence of benchmark manipulation (the "DECC Consultation").

The FMLC has previously considered whether any issues of legal uncertainty arise in the context of the DECC Consultation, and concluded that any such issues that do arise are of insufficient materiality to warrant further action by the FMLC at this stage. The FMLC has, however, identified a number of anomalies, set out in the enclosed research paper, which it wishes to bring to the attention of HM Treasury for its consideration in the context of the Benchmark Consultation.

I and Members of the Committee would be delighted to meet with you to discuss the issues regarding the proposals. 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 Officer

1 Available at: https://www.gov.uk/government/consultations/fair-and-effective-market-reviews-benchmarks-to-bring-into-uk-regulatory-scope


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FINANCIAL MARKETS LAW COMMITTEE

Research Note

Department of Energy and Climate Change – Consultation on Strengthening the Regulation of Wholesale Energy Markets Through New Criminal Offences

**EU Regulation No 1227/2011 of 25 October 2011 on Wholesale Energy Market Integrity and Transparency** (the “REMIT”) prohibits insider trading and market manipulation relating to “wholesale energy products” (“WEPs”). WEPs are defined in the REMIT to include “derivatives relating to electricity or natural gas produced, traded or delivered in the Union” and “derivatives relating to the transportation of electricity or natural gas in the Union”.

The REMIT excludes from the scope of application of the prohibitions on insider trading and market manipulation WEPs which are financial instruments to which Article 9 of Directive 2003/6/EC (the “Market Abuse Directive”) applies, i.e. “any financial instruments admitted to trading on a regulated market […], or for which a request for admission to trading on such a market has been made”. *A contrario*, financial instruments neither admitted nor subject to a request for admission to trading on a regulated market (for example, financial instruments traded on a multilateral trading facility) fall within the scope of the REMIT prohibitions.

The REMIT provides that Member States shall lay down the rules on penalties applicable to infringements of its requirements, provided that such penalties are “effective, dissuasive and proportionate”. The **Electricity and Gas (Market Integrity and Transparency) (Enforcement etc.) Regulations 2013** (the “Regulations”), which came into force on 29 June 2013,

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1. Articles 2(4)(b) and (d) of the REMIT.
2. Article 1(2) of the REMIT.
3. **Regulation (EU) No 596/2014** of 16 April 2014 on market abuse (the “Market Abuse Regulation”) will, from 3 July 2016, extend the European insider dealing and market manipulation regimes to cover, *inter alia*, financial instruments (as defined in **Directive 2014/65/EU of 15 May 2014** (“MiFID II”)) traded on a regulated market, multilateral trading facility or organised trading facility (and instruments the price or value of which depends on or has an effect on the price or value of a such financial instruments). If the exclusion from the scope of the REMIT is similarly extended, this will also exclude such financial instruments from the scope of the offences currently proposed in the Consultation, reducing their application with respect to derivatives.
4. Article 18 of the REMIT.
established in the UK a civil enforcement mechanism for the REMIT. On 6 August 2014, the Department of Energy and Climate Change (the “DECC”) published a consultation proposing to strengthen the REMIT enforcement regime in the UK through the creation of new criminal offences of insider trading and market manipulation in the context of wholesale energy markets (the “Consultation”). Such regime would be policed in Great Britain by the Office of Gas and Energy Markets (“Ofgem”).

The FMLC is of the view that the Consultation gives rise to a number of anomalies, as further set out below.

1. Legal Basis

The legal basis for certain elements of the proposed new offences is unclear. Article 18 of the REMIT grants the power for Member States to “lay down the rules on penalties applicable to infringements […]”. The DECC is proposing to introduce the new offences using the power conferred under section 2(2) of the European Communities Act 1972, (the “ECA”), which is exercisable only “for the purpose of implementing any Community obligation of the United Kingdom”, under section 2(2)(a), or “dealing with matters arising out of or related to any such obligation”, under section 2(2)(b). Where the proposed new offences differ materially from the prohibitions set out in the REMIT, it is unclear whether they will satisfy this test.

In addition, differences between the proposed new offences and the prohibitions set out in the REMIT may have the effect that the scope of the civil enforcement mechanisms under the Regulations differs from that of the proposed new criminal offences: the Regulations provide civil remedies for breaches of “REMIT requirements”, defined by way of cross-reference to the text of the REMIT itself.

Examples of such material differences include the following requirements set out in the Consultation.

a. The proposed offences of insider trading and market manipulation set out in the Consultation only apply where the relevant conduct is carried out “intentionally or recklessly”. The REMIT does not restrict the prohibitions of insider trading or market manipulation by requiring the presence of such mental element, which arguably, therefore, results in the offences failing to meet the “effective, dissuasive and proportionate” criteria required by the REMIT.

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5 Paragraph 3.20 and 4.8 of the Consultation.
b. The Consultation defines the offence of market manipulation as where a person “makes a false or misleading statement, conceals a fact or creates a misleading impression which is liable to induce another person to take certain actions relating to a wholesale energy product or the rights it confers”. This wording is not contained in the REMIT and arguably unduly narrows the scope of the offence (in particular through the wording “is liable to induce […]”).

c. The Consultation proposes that the offence of energy market manipulation include the manipulation of benchmarks, i.e.:

i. “providing false information to undertakings which provide price assessments or market reports with the effect of misleading market participants acting on the basis of those price assessments or market reports; or

ii. offering, buying or selling wholesale energy products with the purpose, intention or effect of misleading market participants acting on the basis of reference prices”.

The REMIT does not specifically provide for a prohibition on the manipulation of benchmarks. To the extent that this type of activity already falls within the other limbs of the offence of market manipulation (and therefore within the scope of the REMIT prohibition), it is arguably otiose; if, on the other hand, it does not, then the legal basis for extending the offence is unclear.

2. Overlap with Existing Financial Services Offences

2.1. Market Manipulation

There is overlap between the proposed new offence of market manipulation and the offences relating to financial services set out in Part 7 of the Financial Services Act 2012 (the “FSA”). The latter carry a maximum penalty of imprisonment for a term of seven years and/or a fine, while it is proposed for the former to be punishable by a

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6 Paragraph 4.2 of the Consultation.
7 Paragraph 4.11 of the Consultation.
8 S.92 of the FSA.
maximum two-year prison sentence. To the extent of the overlap, the same criminal conduct would incur two differing sanctions.

The proposed new offence of market manipulation has three limbs, namely where a person

i. makes a false or misleading statement (“Limb A”);

ii. conceals a fact (“Limb B”); or

iii. creates a misleading impression (“Limb C”),

in each case, which is liable to induce another to take certain actions relating to a WEP or the rights it confers. As noted above, a WEP includes “derivatives relating to electricity or natural gas produced, traded or delivered in the Union” and “derivatives relating to the transportation of electricity or natural gas in the Union”.

Limbs (a) and (b) of this new offence appear partially to overlap with section 89 of the FSA, under which a person (“P”) commits an offence, inter alia,

“If P makes [a statement which is false or misleading in a material respect, being reckless as to whether it is] or conceals [any material facts] with the intention of inducing, or is reckless as to whether making it or concealing them may induce another person […]

i. to enter into or offer to enter into, or to refrain from entering or offering to enter into, a relevant agreement; or

ii. to exercise, or refrain from exercising any rights conferred by a relevant investment.”

The definitions of “relevant agreement” and “relevant investment” are broad, and cross refer to the Financial Promotion Order and the Regulated Activities Order. Relevant investments therefore include, for example, commodity futures (including

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9 Paragraph 4.2 of the Consultation.
10 The two regimes are not, however, coextensive: physically-settled derivatives, as well as derivatives entered into for commercial, as opposed to investment, purposes probably do not fall within the scope of the FSA offences.
forwards)\textsuperscript{13} made for investment (but not commercial\textsuperscript{14}) purposes, and contracts for differences (broadly defined to capture most cash-settled derivatives).\textsuperscript{15}

Equally, under section 90 of the FSA, P commits an offence if P

“does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any relevant investment […] if P intends, by creating the impression, to induce another person to acquire, dispose of, subscribe or underwrite the investments or to refrain from doing so […]”.

This appears to overlap with Limb C of the proposed new offence of market manipulation in relation to WEPs.

2.2. Benchmark Manipulation

As set out above (see paragraph 1(c)), the Consultation proposes an offence of benchmark manipulation.

Making misleading statements in relation to “relevant benchmarks” is a criminal offence under section 91 of the FSA. To date, only LIBOR has been specified as a “relevant benchmark”.\textsuperscript{16} In the context of the Fair and Effective Markets Review, HM Treasury has, however, proposed\textsuperscript{17} to specify further benchmarks as “relevant benchmarks”, including certain commodity benchmarks (London Gold Fixing, LBMA Silver Price and ICE Brent). The current proposals do not appear to consider there to be a case to extend, within the universe of commodity benchmarks, the regulatory regime to sectors other than precious metals and crude oil at present.\textsuperscript{18} As a consequence, (i) manipulating a “relevant benchmark” (e.g. ICE Brent, should the current proposals be adopted) would incur a maximum seven-year prison term, but per the Consultation the same conduct in relation to an electricity or natural gas benchmark would incur a maximum sentence of two years (see paragraph 3 below in

\textsuperscript{13} Broadly defined as “rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made”.

\textsuperscript{14} Article 22(2) of Part 2, Schedule 1 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005.


\textsuperscript{16} Under Article 3 of the Financial Services Act 2012 (Misleading Statements and Impressions) Order 2013.

\textsuperscript{17} Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. X) Order 2014.

\textsuperscript{18} Recommendations on additional financial benchmarks to be brought into UK regulatory scope, Report to HM Treasury, Fair and Effective Markets Review, August 2014.
relation to penalties for further discussion); and (ii) should electricity and/or natural gas benchmarks ever be specified as “relevant benchmarks”, the two offences would overlap.

3. Penalties

In the context of financial markets, the maximum prison sentence that can be imposed under the UK regime for misleading statements (including in relation to benchmarks), misleading impressions and insider dealing is seven years.19 The penalties for the new criminal offences proposed under the Consultation are instead subject to a two-year cap on the term for imprisonment. This is because no new offence punishable by a prison sentence in excess of two years can be created under the power conferred by section 2(2) of the ECA,20 under which the new offences are proposed to be introduced, for reasons of expediency (as explicitly recognised in the Consultation21). Absent a clear justification for the difference in treatment vis-à-vis the financial markets offences, it is unclear whether a maximum two year penalty will meet the “effective [and] dissuasive” requirement set out in the REMIT.

19 Under s.61 of the Criminal Justice Act 1993 and s.92 of the Financial Services Act 2012.
20 Schedule 2, paragraph 1(1) of the ECA.
21 As set out in paragraph 2.12 of the Consultation, “putting in place criminal offences with longer maximum sentences would require primary legislation, and that would take considerably longer to implement”.

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13 August 2014

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs,

Benchmark Reform


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 give rise to material risks, and to consider how such issues should be addressed.

The FMLC welcomes the Financial Stability Board’s (“FSB”) initiative to review foreign exchange (“FX”) benchmarks and analyse market practices in relation to their use and the functioning of the FX market and its consultation paper on this topic.

As part of this review, the calculation methodologies of FX benchmarks has been examined in the FSB’s consultation paper. The FMLC would like to draw the FSB’s attention to its previous comments on legal risk arising in the context of benchmark reform in respect of legacy contracts, where methodology changes have been proposed. The FMLC has: (i) published a paper in 2012 following the publication of the Wheatley proposals in the UK; (ii) published a paper in 2014 on legal uncertainty arising from the European Commission’s proposals to reform indices used as financial benchmarks; and (iii) contributed to work of the Market Participants Group by managing the global legal work streams established and preparing reports on legal risk arising in the context of English law, which have been published in the MPG’s report on the Reform of Major Interest Rate Benchmarks.

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

Yours faithfully

Joanna Perkins
FMLC Chief Executive

1. The Wheatley Review of LIBOR: final report, 28 September 2012, which can be found at: http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf

2. 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://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52013PC0641:EN:NOT
PAPER ENTITLED “DISCUSSION OF LEGAL UNCERTAINTY ARISING FROM THE PROPOSAL FOR A REGULATION ON INDICES USED AS FINANCIAL BENCHMARKS”

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

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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. 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) and criminal sanctions for market abuse Directive (CSMAD) 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.


2.2 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. It seems likely that the term “trading venue” here is intended to reflect that concept as it is defined in

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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

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\(^5\) 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.


investment funds managers (the “AIFMD”); or (ii) Collective Investment Undertakings (“UCITS”) falling within the scope of Directive 2009/65/EU relating to undertakings in collective investments in transferable securities. 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.

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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.\textsuperscript{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

\textsuperscript{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.
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FINANCIAL MARKETS LAW COMMITTEE

BENCHMARK TRANSITION

Observations on proposals for benchmark reform

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1. EXECUTIVE SUMMARY

1.1. The London Interbank Offered Rate ("LIBOR") is the benchmark against which payment obligations are measured in markets comprising financial transactions worth trillions of pounds. It has recently been the subject of close scrutiny in the context of on-going investigations into the alleged attempted manipulation of the benchmark by one or more credit institutions. In response, HM Treasury commissioned an independent review of LIBOR ("the Wheatley Review") on 2 July 2012 which published its final report on 28 September 2012, setting out a comprehensive plan for reform.\(^3\)

1.2. The report ("the Wheatley Report") makes proposals which broadly relate to the administration of the benchmark, the range of tenors and currencies for which it is published, the basis on which submissions are made and the participation of banks in the process. This paper argues that these proposed reforms must be carefully structured if significant legal uncertainty is to be avoided as a consequence of their impact on existing contracts ("the legacy issue").

1.3. In considering, below, whether the "legacy issue" may give rise to unintended consequences in the context of the proposed reforms, the FMLC draws comfort from the fact that the Wheatley Report does not advocate changes to existing contracts. Moreover, the FMLC believes that there is universal agreement amongst the authors of the report, the Tripartite Authorities, panel banks, users of LIBOR and the British Bankers’ Association ("the BBA") that the continuity of LIBOR should be preserved as far as possible in order to minimise the impact on financial instruments which have already been issued.

2. INTRODUCTION: BENCHMARKS

2.1. Benchmarks provide standardised ways of agreeing on prices and offer a statistical measure, typically a price or quantity calculated from a representative group of underlying data. Benchmarks often include an element of discretion, judgement or subjectivity. The parameters within which various benchmarks are calculated vary depending on the needs of

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that market and the availability of data. Thus, some benchmarks are based on expert judgement or estimates and others on actual transactions.\(^4\)

2.2. **LIBOR** functions as the primary benchmark, along with the Euro Interbank Offered Rate (“EURIBOR”), for short-term rates globally and is intended to reflect the cost of borrowing unsecured funds in certain interbank markets. It is currently calculated for 15 different maturities and for 10 different currencies.

2.3. **LIBOR** is administered and quoted by the BBA, which defines the benchmark as:

> the rate at which an individual contributor panel bank could borrow funds, were it to do so by asking for and then accepting interbank offers in reasonable market size, just prior to 11.00 am London time.\(^5\)

2.4. On every working day the member banks of a panel inform Thomson Reuters (“Reuters”) for each maturity and currency at what interest rate they would expect to be able to raise a substantial loan in the interbank money market at that moment if they sought offers for such a loan from other banks operating in London. Once Reuters has collected the rates from all panel banks, the highest and lowest submissions are eliminated. An average is calculated of the remaining “mid values” in order to produce the official LIBOR rate for the given day. For some currencies, more outliers are discarded than others owing to a higher number of contributing banks. Once calculated, this average is published as the BBA sponsored rate on the Reuters Screen LIBOR01 Page.

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\(^5\) See the BBA website: [http://www.bbalibor.com/bbalibor-explained/definitions](http://www.bbalibor.com/bbalibor-explained/definitions).
3. **PROPOSED REFORMS**

3.1. The Wheatley Report makes the following proposals for the reform of LIBOR:

i. The authorities should introduce statutory regulation of the administration of and submission to LIBOR, including an Approved Persons regime, to provide oversight and enforcement, both civil and criminal.

ii. The BBA should transfer responsibility for LIBOR to a new administrator. This should be achieved through a tender process to be run by an independent committee. The new administrator will be responsible for compiling and distributing the rate as well as providing credible internal governance and oversight.

iii. The new administrator should fulfil specific obligations as part of its governance and oversight of the rate, having due regard to transparency and fair and non-discriminatory access to the benchmark. These obligations will include the surveillance and scrutiny of submissions, the publication of a statistical digest of rate submissions and periodic reviews addressing the issue of whether LIBOR continues to meet market needs effectively and credibly.

iv. Submitting banks should, where possible, make explicit and clear use of transaction data to corroborate their submissions.

v. The new administrator should as a priority introduce a code of conduct for submitters.

vi. The BBA should cease the compilation and publication of LIBOR for those currencies and tenors for which there is insufficient trade data to corroborate submissions:

   a. the publication of Australian Dollars, Canadian Dollars, Danish Kroner, New Zealand Dollars and Swedish Kronor should be discontinued;

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6 It has now been announced that the independent panel is to be chaired by Baroness Hogg.
b. for the remaining currencies, publication of LIBOR for four, five, seven, eight, ten and eleven month tenors should be discontinued; and

c. the continued publication of overnight, one week, two weeks, two months and nine months should also be reconsidered.

vii. The BBA should publish individual LIBOR submissions after three months to reduce the potential for submitters to attempt manipulation and to reduce any potential interpretation of submissions as a signal of creditworthiness.

viii. Banks, including those not currently submitting to LIBOR, should be encouraged to participate as widely as possible in the LIBOR compilation process, including, if necessary, through new powers of regulatory compulsion.

ix. Market participants using LIBOR should be encouraged to consider and evaluate their use of LIBOR, including the consideration of whether LIBOR is the most appropriate benchmark for the transactions that they undertake and whether standard contracts contain adequate contingency provisions against the possibility that LIBOR becomes unavailable for any reason.

x. The UK authorities should work closely with the European and international community and contribute fully to the debate on the long-term future of LIBOR and other global benchmarks, establishing and promoting clear principles for effective global benchmarks.

3.2. The report recommends that some of these reforms should be implemented immediately; whilst others might be implemented following a six to twelve month transition period (flexibility on this point is indicated).

3.3. HM Government has responded by agreeing with the Wheatley Report and specifically by stating that:

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a. The BBA should give up its operational role with regards to the computation, administration and governance of LIBOR.

b. Other urgent reforms should be implemented—such as phasing out the benchmark rates for certain currencies and tenors “wherever they are not heavily used by the market and there is an available alternative”.

c. The recommendation to consider the use of alternative benchmarks should be taken forward through the relevant international bodies.  

3.4. It is unclear to what extent this response reflects an intention to allow for flexibility in the implementation of the proposed reforms. Although the detail of the proposals’ implementation is yet to be determined, it is, in some cases, already subject to consultation.

3.5. To create a legal framework for the implementation of the proposals, the Financial Services Bill, which is currently before Parliament, will be amended:

a. to bring LIBOR activities within the scope of statutory regulation, including submission and administration of LIBOR;

b. to create a new criminal offence for misleading statements in relation to benchmarks such as LIBOR, as well as amending the language of existing offences; and

c. to provide the new Financial Conduct Authority with a specific power to make rules requiring banks to submit to LIBOR, with reference to a code of practice produced by the rate administrator.

The Bill is scheduled to receive royal assent in late 2012 or early in 2013.

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10 Proposals to amend secondary legislation (to bring LIBOR within the scope of regulation and to make the manipulation of LIBOR a criminal offence) are set out in HM Government’s consultation paper “Implementing the Wheatley Review: draft secondary legislation”, 28 November 2012: [http://www.hm-treasury.gov.uk/d/implementing_wheatley_review281112.pdf](http://www.hm-treasury.gov.uk/d/implementing_wheatley_review281112.pdf).
3.6. The FMLC recognises that LIBOR faces a reputational problem which, as the authorities have correctly identified, may undermine market confidence in the benchmark. The rehabilitation of LIBOR is therefore an urgent priority, which may necessarily entail reforms that are structural rather than cosmetic. Nevertheless, the FMLC is concerned that the implementation of some of the proposals in the Wheatley Report may give rise to contractual uncertainty unless the transition is structured carefully and proceeds at a manageable pace.

3.7. The general nature of the legal uncertainty with which the FMLC is here concerned is the kind which arises when it can be said that a contract does not expressly cater for a change in circumstances upon which certain of its terms are premised. In this case the term in question is the contract’s definition of the applicable interest rate and the putative change in circumstances is the implementation of certain proposed adjustments to LIBOR. Whether or not any contractual uncertainty arises will depend, first, on whether the adjustments take the benchmark outside the contractual definition of the applicable interest rate and, second, whether, if they do, the contract makes provision for this outcome, either expressly or impliedly. The discussion below explores these questions and begins with a brief account of certain contractual terms that reference LIBOR in the prevailing market standard documentation.

4. STANDARD CONTRACTS

4.1. Standard market documentation referring to LIBOR is produced by the International Swaps and Derivatives Association (“ISDA”) and the Loan Market Association (“LMA”). Contracts on both ISDA and LMA terms provide contingency (or “fall-back”) arrangements that address the possibility of LIBOR becoming unavailable. Further detail of market standard terms defining the applicable interest rate as well as those making provision for adverse contingencies is given below for specified categories of financial instrument. It should be borne in mind that parties may agree to vary these standard terms and that many existing contracts may reflect such variations.

11 LMA terms are used primarily for loans to UK residents (see Appendix 3 for a profile of the UK loan market). A brief discussion of the standard market terms commonly found in loans to US residents is to be found in n.55.
4.2. A wide variety of derivative contracts incorporate the ISDA Definitions, including interest rate swaps. The parties will identify a Floating Rate in their transaction confirmation by selecting an index from a list in the ISDA Definitions. The most common index chosen in the UK interest rate swaps market is “GBP-LIBOR-BBA”, and:

“GBP-LIBOR-BBA” means that the rate for a Reset Date will be the rate for deposits in Sterling for a period of the Designated Maturity which appears on the Reuters Screen LIBOR01 Page as of 11:00 a.m., London time, on that Reset Date. If such a rate does not appear on the Reuters Screen LIBOR01 Page, the rate for that Reset Date will be determined as if the parties specified “GBP-LIBOR-Reference Banks” as the applicable Floating Rate Option.

4.3. As outlined above, if the Floating Rate (“GBP-LIBOR-BBA”) is not available, the Definitions provide a fall-back to “GBP-LIBOR-Reference Banks”, which means that:

the rate for a Reset Date will be determined on the basis of the rates at which deposits in Sterling are offered by Reference Banks at 11:00 am London time on that Reset Date to prime banks in the London interbank market.

If the “GBP-LIBOR-Reference Banks” fall-back provision applies, the Calculation Agent will request that the principal London office of each of the Reference Banks provide a quotation and if “at least two quotations are provided” the rate for that Reset Date will be “the arithmetic mean of the quotations”. If fewer than two quotations are provided, the “rate for that Reset Date” will be:

the arithmetic mean of the rates quoted by major banks in London selected by the Calculation Agent, at approximately 11:00 a.m., London time, on that Reset Date for loans in Sterling to leading European banks for a period of the Designated Maturity commencing on that Reset Date and in a Representative Amount.

4.4. The Definitions state that “Reference Banks” for the purposes of “any “LIBOR” Floating Rate” means four major banks in the London interbank market. These banks will typically be appointed by the Calculation Agent.
Cleared derivatives

4.5. The rulebook for a central counterparty usually contains procedures for determining the interim and final settlement prices for a cleared derivative. Under the General Regulations of LCH.Clearnet, “GBP-LIBOR-BBA” is listed as one of the “acceptable” indices for interest rate swaps. The definition for this is similar to that in the ISDA Definitions set out above. Under the SwapClear procedures, the Reset Rate will be published by the Clearing House via the Rate Reset reports. The following principle is applied in calculating the Reset Rate:

“GBP-LIBOR-BBA” means that the rate for a Reset Date will be the rate for deposits in Sterling for a period of the Designated Maturity which appears on the Reuters Screen LIBOR01 Page as of 11.00 hours, London time, on that Reset Date.12

4.6. There is a fall-back arrangement that provides:

in the event of no rate being available the Clearing House will, at its sole discretion, determine an applicable rate.13

In the case of a cleared derivative, the relevant central counterparty or exchange has discretion unilaterally to designate a replacement benchmark applying to all contracts under its authority if the contractual benchmark is unavailable. Exchange-traded Eurodollar futures and options (Liffe, CME) also have fall-back provisions which allow the exchange discretion to determine an applicable rate in these circumstances.

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12 SwapClear is LCH.Clearnet’s global clearing service for interest rate swaps.
Loans

4.7. In the UK, most syndicated loan agreements incorporate LMA standard terms. Under these terms, the applicable interest rate is the “Screen Rate” defined by the following clause:

“Screen Rate” means:

a. in relation to LIBOR, the British Bankers Association Interest Settlement Rate for the relevant currency and period; and

b. [in relation to EURIBOR, the percentage rate per annum determined by the Banking Federation of the European Union for the relevant period.]

displayed on the appropriate page of the Reuters screen. If the agreed page is replaced or service ceases to be available, the Agent may specify another page or service displaying the appropriate rate after consultation with the Company and Lenders.

4.8. LMA standard terms contain Market Disruption provisions which provide alternatives for calculating the rate of interest in the event that the settlement rate is unavailable. The majority of bilateral loan agreements will have similar Market Disruption provisions.

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It is noted that the LIBOR definitions in typical US commercial loan agreements often operate in a similar way as the ISDA Definitions, with some variations in successor provisions (see paragraph 5.6.) and fall-back provisions. US commercial loan agreements will typically incorporate the following definition:

“LIBO Rate” means, in respect to any Eurodollar Borrowing for any one month interest period, the rate appearing on the Reuters “LIBOR01” screen page (also known as Reuters BBA Libor Rates 3750) (or on any successor or substitute page providing rate quotations comparable to those currently provided on such a page, as determined by the Administrative Agent from time to time for the purposes of providing quotations of interest rates applicable to Dollar deposits in the London interbank market) at approximately 11:00 a.m., London time, on the Business Day for the commencement of such interest period, as the rate for Dollar deposits with a maturity comparable to such interest period.

This clause includes a fall-back arrangement which provides:

In the event that such a rate is not available as such time for any reason, then the “LIBO Rate” with respect to Eurodollar Borrowing for such interest period shall be the rate at which Dollar deposits of $5,000,000 and for a maturity comparable to such interest rate period are offered by the principle London office of the Administrative Agent in immediately available funds in the London interbank market at approximately 11:00 a.m., London time on such Business Day.

A “Eurodollar Disaster Clause” will often be triggered if LIBOR cannot be determined from the Administrative Agent’s London office or if the LIBOR determined under the loan agreement “will not adequately and fairly reflect the cost to [the Lenders] of making or maintaining” their loans (i.e. if the BBA rate is unrealistically low). Once this clause is triggered, the LIBOR interest rate option becomes unavailable to the Borrower who must instead borrow at rates that are typically based on the Lender’s or Administrative Agent’s announced “base rate” or “prime rate”.

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4.9. The fall-backs for loans are, principally: initially, “Reference Banks” (as with derivatives) and ultimately, “cost of funds”. If the Reference Banks mechanism then fails to generate an applicable rate, or if LIBOR does not reflect the cost of funds for a significant percentage of banks, a Market Disruption Event is triggered and the cost of funds fall-back is implemented.

4.10. In summary, a Market Disruption Event will be triggered if:

   a. the Screen Rate (i.e. LIBOR) is not available and none or only one of the Reference Banks provides a quotation; or

   b. if more than a specified percentage of Lenders say that their cost of obtaining matched funding in the relevant market would be higher than LIBOR.

4.11. The Reference Banks are appointed by the Agent in consultation with the Borrower, on an individual basis. Commonly, three or four Reference Banks will be appointed and these banks will be named in the relevant loan documentation.

4.12. Once a Market Disruption Event is triggered, the rate of interest payable to each Lender is the aggregate of the Margin, the Mandatory Cost (if applicable) of the Lender’s participation in the loan and the rate notified to the Agent by the Lender as the Lender’s actual cost of funding for that loan from “whatever source it may reasonably select”.

4.13. There is scope within Market Disruption clauses to agree an alternative arrangement; the “alternative basis of interest or funding” clause provides that:

   a. If a Market Disruption Event occurs and the Agent or the Company so requires, the Agent and the Company shall enter into negotiations (for a period of not more than thirty days) with a view to agreeing a substitute basis for determining the rate of interest.

   b. Any alternative basis agreed pursuant to paragraph (a) above shall, with the consent of all of the Lenders and the Company, be binding on all Parties.

(See paragraph 5.6. below for further discussion).
LMA alternative provisions

4.14. In response to market disruption which occurred in 2008-2009, the LMA made extensive amendments to the Market Disruption provisions outlined above. The amendments are designed to interpose an additional safety net before the cost of funds contingency provisions are activated.

4.15. Under the alternative provisions, if the Screen Rate is unavailable and the contractually required number of Reference Banks cannot provide quotations, a Market Disruption Event will occur. In these circumstances, the applicable rate will be that quoted by the “Alternative Reference Banks”. This is a wider pool of banks intended to reflect more closely the likely composition of a lending syndicate.

4.16. Under the alternative provisions, the Lenders’ cost of funds fall-back will only apply if an “Alternative Market Disruption Event” subsequently occurs (i.e. an event such that the contractually required number of Alternative Reference Banks cannot provide quotations).

Floating rate notes

4.17. In the documentation on which participants in the market for “floating rate notes” (or “FRNs”) typically rely, issuers elect a particular route for ascertaining the interest rate: commonly, by reference to a particular Screen Rate, at a particular time, a particular number of days prior to each relevant interest period. Fall-back provisions are also incorporated in case the specified rate of interest is unavailable. These will usually contemplate an entire series of contingencies: for example, if the LIBOR Screen Rate is unavailable at the relevant time on a particular day, the Calculation Agent will ask for quotations from four named Reference Banks. If fewer than two such quotations are given, the Calculation Agent would then ascertain the rate from four "major banks" operating in that area or financial centre; and, finally, if the Calculation Agent is not able to determine a rate through any of these options, the ultimate fall-back is that the rate of interest will be the same as in the preceding interest period. FRNs can be issued on a standalone basis or in the context of programmes, such as Medium Term Note (“MTN”) programmes. The interest rate provisions tend to be very similar in both.
Collateralised loan obligations

4.18. For a typical collateralised loan obligation ("CLO") transaction, the fall-back arrangements often specify that if the Calculation Agent cannot determine the applicable rate, the Trustee will do so instead, incorporating any necessary amendments to the terms and conditions of the bonds.

5. LIBOR REFORM: SHORT-TERM PROPOSALS

5.1. It will readily be seen, from the account given above, that the touchstone for market standard definitions referring to LIBOR is often the publication of the rate on the Reuters Screen LIBOR01 Page. This should provide comfort that minor adjustments to the rate-setting process for LIBOR will not give rise to contractual uncertainty for so long as the rate which is set by that process is published on the LIBOR01 Screen. Moreover, where a rate is unavailable on the LIBOR01 Screen, contingency provisions will almost certainly apply. It is safe to say, therefore, that market standard contracts do make broad provision for the outcomes contemplated by the Wheatley Report. Given the size of the markets in question, the FMLC finds this reassuring from the perspective of a concern for legal certainty.  

5.2. However, not all market standard definitions rely exclusively on the virtual locus of publication: some incorporate a reference to the sponsorship of LIBOR ("the British Bankers Association Interest Settlement Rate"), which is expected to change. Moreover, not all of the proposals set out in the Wheatley Report can necessarily be described as minor adjustments: the report contemplates the withdrawal of certain currencies and tenors and the increased use of transaction data to corroborate banks’ submissions, which latter reform may conceivably result in a change to the value of LIBOR vis-à-vis the value derived from submissions which would otherwise be made. The paragraphs immediately below examine the legacy issue in the light of these proposals and the section which follows thereafter considers the extent to which the contingency provisions identified above can mitigate any negative consequences which may arise.

15 Data on the size of relevant markets can be found in Appendix 2.
5.3. The paragraphs below examine aspects of the legacy issue which, in the view of the FMLC, should be carefully considered by HM Government and, if necessary, addressed in the implementation of the proposals recommended by the Wheatley Report.

**Sponsorship of the benchmark**

5.4. According to HM Government’s response to the Wheatley Report, the new rate administrator will be sought by a tender committee, chaired by Baroness Hogg. Meanwhile, it is expected that the BBA will continue to sponsor LIBOR until new legislation is passed (see paragraph 1.2.). Many standard documents expressly refer to the BBA in defining the applicable interest rate by which payment obligations are measured. The possible consequences for particular financial contracts are considered below.

5.5. In LMA standard documents, as noted above at paragraph 4.7., the Screen Rate is defined as the British Bankers Association Interest Settlement Rate. An abrupt withdrawal of the BBA’s sponsorship of LIBOR could arguably result in parties contending that the contractually-defined benchmark is unavailable and that the fall-back provisions should apply. In other words and subject to what is said below, if parties come to believe they have been disadvantaged by changes to the administration of LIBOR and the parameters within which it is calculated, they may oppose the application of the reformed benchmark to their own contracts by contending that the new arrangements are not consistent with the contractual definition of the applicable rate. Given the significant number of contracts which refer to LIBOR, there must logically be a concern that this could lead to commercial disputes. This concern may, however, prove to be unjustified if the new arrangements:

   a. result in no apparent change to the value of LIBOR vis-à-vis the value derived from submissions which would otherwise be made; or

   b. receive the imprimatur of the BBA, albeit under new administration; and/or

   c. are approved by the LMA.

The FMLC finds these considerations reassuring.

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16 See The Financial Times, “Libor rates cut proposed”, 8 November 2012: [http://www.ft.com/cms/s/0/0741e55a-29c4-11e2-a5ca-00144feabdc0.html](http://www.ft.com/cms/s/0/0741e55a-29c4-11e2-a5ca-00144feabdc0.html).

17 In the worst case scenario, following a failure of contingency arrangements, parties to loan contracts may possibly elect to argue that their contracts have been frustrated (see section 6 for further analysis).
5.6. The FMLC places less confidence, however, in reports that loan contracts make provision for the Agent to certify an alternative service for quoting LIBOR if the BBA ceases to provide this and in the implied suggestion that such contracts will not, for this reason, give rise to any legacy issue. These reports may refer to one of two provisions:

a. the “alternative basis of interest or funding” clause as set out in paragraph 4.13., which provides that the prior consent of all of the Lenders and the Borrower is required to agree a substitute basis for determining the rate of interest; or

b. the successor source clause which often provides for:

any successor or substitute page providing rate quotations comparable to those currently provided on [the Reuters] page, as determined by the Administrative Agent from time to time for the purposes of providing quotations of interest rates applicable to [Dollar] deposits in the London interbank market at 11.00 am London time.

In the FMLC’s view, the first clause merely makes it clear that the Agent’s agreement to substitute the basis for determining the rate of interest will not be binding on the Borrower or Lender without their prior consent. This may be difficult to obtain. As regards the second clause, the better view may be that it is intended to allow the Agent to specify an alternative published source rather than to redefine the applicable Screen Rate.

5.7. If the parties to a loan contract take the pragmatic view that the LMA terms are sufficiently flexible to accommodate a settlement rate administered by a new sponsor, the Agent and Lenders may still adopt the conservative attitude that the existing contract terms are best amended to eliminate references to the BBA. The Agent to a syndicated loan is commonly among the largest lending banks within the syndicate and it has a strong commercial incentive to achieve the best practical outcome. In this respect, it is well-placed to negotiate any revisions. Moreover, there are clear commercial incentives for Borrowers to agree revisions given that the “cost of funds” fall-back might result in a higher applicable rate.\textsuperscript{18} However, to agree new terms, the Agent must obtain the consent of all the Lenders, as well as the

\textsuperscript{18} For further discussion see below, paragraph 6.11.
Borrower. Such a process is likely also to be administratively burdensome and difficult to achieve within a short period.\(^{19}\) A key factor will be the approval of the LMA. If a new benchmark is introduced which is approved by the LMA it will probably be accepted by Borrowers and Lenders especially in the Investment Grade loan market.

5.8. The case for contractual certainty and continuity is stronger in the case of derivative contracts, which often refer to the Floating Rate as “GBP-LIBOR-BBA” (or the equivalent for another currency). The contractual definition, as set out in paragraph 4.2., refers to “the rate for deposits in Sterling” which appears on the Reuters Screen LIBOR01 Page rather than to the rate administered by the BBA. It seems likely, therefore, that anything published as LIBOR on the Reuters Page would satisfy the relevant provisions, as long as it represents the rate at which Sterling deposits are, or are estimated to be, made. In light of the fact that the BBA is referenced in identifying the “GBP-LIBOR-BBA” Floating Rate, some parties to derivative contracts may consider raising the question whether the benchmark, as defined, has become unavailable once the BBA is no longer a sponsor. However, the FMLC takes the view that this argument is unlikely to succeed given that “BBA” is referenced exclusively in the name of the benchmark, i.e. the defined term, rather than the definition itself.

5.9. FRN documents often contain similar provisions to those set out at paragraph 5.6., regarding an alternative service for quoting LIBOR. In contrast to an Agent to syndicated loan, the Trustee to a FRN will not have any commercial incentive to achieve a profitable outcome when identifying possible courses of action to foster and protect contractual continuity. It will, however, be required to consider and implement the course of action which is in the interests of noteholders. (The risk of liability (discussed further below) will also be relevant from the viewpoint of the Trustee.) Where noteholders’ instructions are required, the difficulty in coordinating a noteholders’ meeting and reaching consensus in such circumstances is worthy of note.

5.10. The FMLC takes the view that this proposal—transferring the supervision of LIBOR from the BBA to a new administrator—is an aspect of the reforms which requires careful planning in order to avoid creating contractual uncertainty. It is important to ensure that references to the benchmark incorporated into existing financial contracts will capture the new (i.e. non-BBA)

\(^{19}\) It has been suggested to the FMLC that Lenders may capitalise on a perceived chance to renegotiate a variety of other terms in their contracts (although this is likely to consist of only a minority of Lenders in the market) and this could unwind the entire structure of the loan. (It is also noted that the Capital Requirements Directive IV may incentivise some Lenders to reconsider their exposure during a negotiation process.)
LIBOR. From the perspective of contractual certainty, every effort should be made in implementing the Wheatley Report’s recommendations to obtain the continuing imprimatur of the BBA for the benchmark notwithstanding the supervisory and operational responsibility of the new administrator.

Transaction data

5.11. Another solution proposed in the Wheatley Report is that submitting banks should, where possible, make explicit and clear use of transaction data to corroborate their submissions. Under proposed submission guidelines (in the absence of a code of conduct, the Wheatley Report recommends that panel banks comply with these guidelines at [4.7]), LIBOR submissions should be based on a hierarchy of transaction types and:

in the absence of transaction data relating to a specific LIBOR benchmark, expert judgement should be used to determine a submission.\(^\text{20}\)

Implementing this proposal will mean that LIBOR will remain, in the final analysis, a rate determined by contributors’ best assessment of the rate at which they could borrow in the interbank market. The proposal is intended to combine the benefits of increased reliability, afforded by the link to transaction data, with the safety net of judgement-based submissions where transaction data are in short supply. Concerns are commonly expressed regarding the feasibility of basing submissions on transaction data, given the potential for illiquidity in the unsecured lending market, but the safety net alluded to is intended to meet those concerns. If, however, the concerns materialise and the safety net is relied upon as a matter of course, the benefits of corroboration will be lost.\(^\text{21}\)

5.12. Perhaps of greater concern is the possibility—frequently alluded to but rarely, if ever, substantiated—that rates based on actual transaction data are likely to be higher than those determined in the absence of such data (and may thus be disadvantageous to Borrowers, in particular). While this does not create legal uncertainty, it may possibly provide parties with an incentive to challenge the terms of their agreements and lend colour, even perhaps

\(^{20}\) See the Wheatley Report, page 28 (at Box 4.B)).

\(^{21}\) In an illiquid unsecured lending market, there may be insufficient market capacity to generate reliable and representative transaction data. In times of market disruption in particular, unsecured lending in some currencies will be very low. Commentators claim that in the current market environment borrowing by banks for more than one week is almost exclusively secured lending in the City of London. The new Basel III requirements discourage unsecured lending and thereby bring into question the viability of any unsecured lending benchmark tied to a transaction analysis too. It is noted that this is not merely a problem for LIBOR; there are interbank offered rates in other markets for which the same issues arise, such as EURIBOR.
substance, to the argument that the parameters of the reformed benchmark were not within the parties’ contemplation or intentions when the contract was concluded. However, in the case of loans on LMA standard terms, it should be noted that the Borrower has agreed, in circumstances where LIBOR and Reference Banks’ quotes are both unavailable, to pay the agreed Margin over cost of funds. Thus the contract already contemplates the possibility that, in the event of disruption to LIBOR, the rate to be applied is one which is likely to be higher than LIBOR itself and, indeed, extrapolated from transaction data.\textsuperscript{22}

**Loss of tenors and currencies**

\textbf{5.13.} The Wheatley Report advocates a reduction to the number of tenors and currencies linked to LIBOR; it identifies that there is a lack of regular transactions for many of the currencies and tenors for which LIBOR is calculated and that the usage of LIBOR is concentrated in a few core currencies. A period of six or twelve months to phase out the specified tenors and currencies is recommended (at [5.12]) and this recommendation is reflected in a recent paper by the BBA.\textsuperscript{23} The Wheatley Report states that in “due course” the new LIBOR administrator, through an open process of consultation with LIBOR users and submitting banks, should work towards implementing this recommendation (at [5.13]). The report goes on to argue that, in the absence of certain tenors, interpolation and extrapolation techniques could be used to create intermediate maturities between existing data points. In order to implement the Wheatley Report’s recommendation, the BBA has proposed that the phased discontinuation of 120 tenors and specified currencies should be completed within a six month timescale from the publication of the Wheatley Report, by the end of March 2013 (see n.23).\textsuperscript{24} This is subject to consultation and feedback submitted by 8 December 2012.

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\textsuperscript{22} It is noted that for some Borrowers the fall-back to cost of funds might be positively advantageous. If the LIBOR rate is withdrawn and deals “fall back” to cost of funds, banks will be reluctant to certify that their cost of funds is high and, in some cases, their cost of funds may fall below LIBOR as a matter of course. Conceivably, Borrowers could be better off than if a LIBOR rate based on actual transaction data was introduced.

\textsuperscript{23} See “Strengthening LIBOR – proposal to implement number 6 of ‘The Wheatley Review of LIBOR’”, ibid. The BBA has proposed a phased removal of the below maturities and currencies by March 2013, in line with the Wheatley Report’s recommendation. In summary, the BBA has recommended:

i. by end January 2013, the removal of ten currencies within the current LIBOR framework should be implemented;

ii. by end February 2013, the compilation and publication of all remaining tenors pertaining to Australian Dollar (AUD) and New Zealand Dollar (NZD) may be fully discontinued; and

iii. by end March 2013, the streamlining of LIBOR can be fully implemented; this will involve the discontinuation of all rates relating to the Canadian Dollar (CAD), the Danish Krone (DKK) and the Swedish Krona (SEK).

\textsuperscript{24} See supra n.23. It is noted that the Wheatley Report recommends the discontinuation of potentially 130 tenors, as mentioned earlier in this paper.
5.14. The FMLC is of the opinion that the projected period for phasing out potentially 130 (or 120, as the case may be) tenors and certain specified currencies is too short, particularly for currencies. For some of the less liquid currencies, benchmarks calculated in domestic jurisdictions tend to be preferred to LIBOR due to the greater liquidity in domestic markets. The Stockholm Interbank Offered Rate (“STIBOR”) for instance, is used more frequently than the corresponding Swedish Krona LIBOR benchmark. Nevertheless, as the Wheatley Report acknowledges (at [5.11]), there are likely to be at least some outstanding contracts referencing every LIBOR rate. It is noted that for these outstanding contracts, counterparties will likely argue that their fall-back provisions apply. However, the FMLC has been given to understand that in circumstances where a discontinued currency (such as Australian Dollar LIBOR, as proposed by the BBA) is used for a limited number of contracts for a tenor of, for instance, six months, the Reference Banks to a contract will likely provide quotations (as it would not seem too burdensome if the cases are very limited).

Compelling panel banks to participate in the LIBOR setting process

5.15. There are arguably minimal incentives for panel banks to participate in the LIBOR setting process. Since the publication of the Wheatley Report, banks have greater reassurance over the viability of continuing their participation, but there is, nonetheless, some (slight) risk that this position could change and some panel banks will choose to withdraw from LIBOR before the appointment of the proposed replacement administrator or change to the fall-back arrangements in existing contracts. The Wheatley Report stipulates that, if necessary, a regulatory rule compelling banks to make submissions should be introduced (at [5.28]). This rule would, presumably, be accompanied by disciplinary sanctions for breach. However, the introduction of such a rule, and the attendant threat of sanctions, is not, perhaps, as significant as may first appear: banks may be familiar with regulatory and market rules which not only require disclosure but go further and require price-setting (for example stock exchange rules relating to market-making).

25 As mentioned above (n.22), following a failure of contingency arrangements, parties to loan contracts may possibly elect to argue that their contracts have been frustrated (see section 6 for further analysis).


27 Legal compulsion in the form of injunctions and other litigious remedies would seem unpalatable if imposed indefinitely. However, it seems more likely that disciplinary sanctions are intended.
6. THE POTENTIAL IMPACT OF THE PROPOSALS

Increased reliance on fall-back provisions

6.1. It has been suggested that the implementation of some of the short-term proposals for the rehabilitation of LIBOR, if not carefully structured, may result in parties arguing that the fall-back provisions in their contracts have been triggered. The clearest case in which increased reliance on fall-back provisions can be predicted is in contracts incorporating those currencies and tenors due to be discontinued. This may amount to a relatively small number of contracts. 28 It has also been suggested above that the abrupt withdrawal of the BBA’s sponsorship of LIBOR could result in parties to some loan contracts adopting a similar position but only if the reassuring factors listed above (at paragraph 5.5.) cannot be said to apply.

6.2. Increased reliance on contingency provisions across larger markets, as the FMLC understands, would be unworkable, particularly if those fall-backs were expected to apply permanently (i.e. following the withdrawal of LIBOR or a contractually-material change in its identity). The implications of this are that, in the absence of amendments to the contingency provisions in existing contracts, parties may not be confident that an existing fall-back arrangement would be operable for the remaining life of their contract. The following paragraphs discuss the impact of increased reliance on fall-back arrangements. In what is said below about derivative contracts on ISDA standard terms, the FMLC bears in mind its view (at paragraph 5.8. above) that a change of sponsor is unlikely to affect the application of the “GBP-LIBOR-BBA” index.

6.3. As discussed in section 4 above, the typical fall-back provisions found in loan contracts on LMA standard terms, derivative contracts on ISDA standard terms and in FRNs stipulate that if LIBOR becomes unavailable, quotations from Reference Banks will be sought. In most cases, there are often around three or four Reference Banks appointed and a minimum of two quotations from these banks is required. With so few Reference Banks appointed, there is a possibility that none or only one of these banks will be able to provide quotations—particularly if the Reference Banks are also panel banks participating in the LIBOR setting process. 29 This problem is likely to be particularly acute where LIBOR has ceased to exist as

28 The FMLC understands that there are very few trades in the currencies and tenors that are proposed for discontinuance.

29 Indeed, the Wheatley Report also discusses this possibility (at [5.32]).
the Reference Banks (in common with other banks in the market) are likely to receive a large number of requests for quotations. Their response may be to decline to provide any further quotations.

6.4. In contracts on ISDA standard terms, if fewer than two quotes are provided by the Reference Banks, the Calculation Agent will determine the rate by reference to quotations from other banks. This is unlikely to be achievable for the long-term, given the huge volume of existing derivative contracts pegged to LIBOR. In addition:

widespread use of these contingencies would mean that different contract provisions may lead to different interest rates payable in place of LIBOR between counterparties.30

Mismatching of back-to-back contracts in this way would itself create increased credit risk for parties and may possibly increase systemic risk overall. Back-to-back contractual arrangements likely to be affected include interest rate swaps used to hedge against interest payments on other facilities, such as loans and derivatives subject to clearing. In the latter case, if the interest rate applicable under the underlying contracts is not matched by the interest rate applicable between the clearing member and the central counterparty, the exposure to movements in LIBOR or “basis risk” increases for the clearing member. This risk also arises if the fall-back provision discussed above, which provides that the central counterparty will determine the applicable rate at its discretion, is triggered without a corresponding adjustment to the applicable rate in the underlying contract.

6.5. In LMA standard loan contracts, if Reference Banks cannot provide a quotation, the Lenders’ cost of funds will apply.31 Loan market participants commonly suggest that this could be disadvantageous to the Borrower as it may lead to higher borrowing costs. In any event, the increased administrative burden on the Agent of coordinating the application of the “cost of funds” provisions will be significant, even perhaps unmanageable. The fall-back arrangement will only prove workable if banks are prepared to be wholly transparent about their cost of

30 Ibid.
31 As the FMLC is given to understand, the alternative provisions highlighted in paragraphs 4.14 to 4.16 of this paper have failed to gain general acceptance among Lenders. Some banks may feel that widening the group of Reference Banks would not necessarily solve the problem if the Reference Banks provisions prove unworkable. Some other banks may simply feel more comfortable being able to resort to the cost of funds fall-back straightaway without interposing an intermediate step. Therefore, as previously discussed, the majority of existing LMA standard loan contracts will likely revert to the cost of funds fall-back straightaway, if the appropriate number of Reference Banks cannot provide quotations.
funds. Even in this situation, it is noted that there could be scope for plenty of argument between Lenders and Borrowers about how a bank’s actual cost of funds should be calculated.

6.6. In the case of CLOs, the fall-back arrangement common to many contracts provides that if the Calculation Agent cannot determine LIBOR, the Trustee will do so instead (see paragraph 4.18). One may expect the Trustee to take a conservative approach in exercising this power, and it may follow that this fall-back cannot be relied upon for the long-term.

6.7. In circumstances where LIBOR is no longer available overall, it would seem to be in the interests of all parties to the contract to agree a new benchmark and renegotiate their contracts to reflect such an agreement, rather than rely on fall-back provisions. Renegotiation would have to be undertaken on a case by case basis and would likely prove to be a greater administrative burden than that noted above (particularly with regards to syndicated loans which have numerous Lenders, often based in different regions across the world). Transition to a new benchmark is discussed below in section 7.

6.8. The paragraphs below consider the litigious consequences which may possibly arise following the failure of fall-back arrangements.

**Litigation – frustration**

6.9. In circumstances of increased market reliance on fall-back provisions, it is unlikely that such provisions would prove operable over the long-term. (Contracts such as Project Finance Loans may have a life of twenty-five or thirty years, see Appendix 3.) Where fall-back arrangements fail, parties may seek to argue that their contracts have been frustrated. This latter possibility is considered in the paragraphs below.

6.10. The doctrine of frustration operates to discharge a contract where:

> after the formation of the contract, something occurs which renders performance of contractual obligations impossible, illegal, or something radically different from that which was in the contemplation of the parties at the time of entry into the contract.\(^{32}\)

If the doctrine is applied, the contract will automatically be brought to an end, irrespective of the wishes of the parties, and both parties will be released from their obligations to perform the contract. Demonstrating a concern for commercial certainty, the courts have adopted a restrictive approach to the operation of this doctrine.\(^{33}\) Frustration will not apply where:

a. express provision has been made in the contract for the event that is argued to have frustrated the contract (since force majeure and hardship clauses seek to capture events which may impede performance of the contract, the impact of such events is likely to be regulated by the terms of those clauses rather than the doctrine of frustration);

b. the event alleged to have frustrated the contract was foreseen, or clearly foreseeable, by the parties; and

c. the alleged frustrating event was caused by the conduct of the party to the contract seeking to invoke frustration, rather than a supervening event.\(^ {34}\)

6.11. In the financial markets, fall-back provisions are set out in standard form contracts to cater for circumstances in which LIBOR becomes unavailable. The FMLC takes the view, therefore, that provision has been made for the unavailability of the benchmark and frustration will probably not apply. Given reason to do so, some parties may argue that standard fall-back provisions should be restrictively construed such that they apply exclusively to situations in which the applicable reference rate becomes temporarily unavailable, rather than a situation in which the benchmark is withdrawn or fundamentally altered. However, an argument of this nature is premised on the withdrawal or transformation of LIBOR and the risk that such an event occurs may be addressed by there being, following the proposed reforms, a revised or rehabilitated benchmark which impliedly still satisfies the contractual definition. Parties are more likely to argue that the fall-back provisions have been triggered by the changes to LIBOR and only later that the contract has been frustrated, should the fall-back provisions fail to work after a period of time. In either case, a strong legal opinion to the effect that a Court is unlikely to consider that existing contracts on standard terms have been frustrated in

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\(^{33}\) For further detail, see cases regarding the conditions (impossibility, illegality, and frustration of purpose) which must be satisfied for the doctrine of frustration to apply: i) impossibility: Taylor v. Caldwell (1863) 3 B & 826, ii) illegality: Fibres Spolka Akcyjna v. Fairbairn Lawson Combe Barbour Ltd [1943] AC 32 and iii) frustration of purpose: Krell v Henry [1903] 2 KB 740.

\(^{34}\) McKendrick, 2004, page 849.
circumstances of benchmark transition could play a pre-emptive role in maintaining market confidence, particularly if published.

**Implied terms**

6.12. The implementation of the proposals in Wheatley Report will not represent the first occasion on which the authorities have acted to revise a benchmark. In 1981, the Minimum Lending Rate (“MLR”)—the minimum rate at which the Bank of England announced that it would make short-term money available to the market—ceased to be published.

6.13. The Bank of England announced that after 20 August 1981, it would no longer post the MLR. For existing contracts, i.e. those predating 21 August 1981, there was a very serious risk of contractual uncertainty and even market disruption given that standard form contracts did not, at the time, contain fall-back provisions as a matter of course. In advice to the Law Society considering what effect a Court might give to a contractual term referring to the MLR following this change, Leonard Hoffmann QC (as the FMLC Chairman then was) identified two alternative possible constructions. The first would have accepted that the interest period had become inoperative and that, accordingly, no ascertainable rate of interest was payable under the contract, leading to a frustration of the contract. The second required the implication of a new term into the contract in order to fill the perceived gap.\(^35\) Hoffmann advised that a Court could be expected to treat a contract containing a reference to the MLR as subject to an implied term, i.e. one to the effect that, if MLR ceased to exist, there would be a substituted rate—the prevailing clearing bank rate.\(^36\) This opinion was instrumental in garnering broad acceptance for the view that contracts would transition smoothly to the prevailing clearing bank rate.\(^37\)

6.14. This case study may be relevant to the process of reforming LIBOR today even though fall-back provisions in modern standard market contracts largely forestall arguments, still of concern in 1981, about the frustration of the contract. First, it is a useful reminder that the courts are very reluctant indeed to accept that a commercial agreement has been frustrated: as Leonard Hoffmann QC opined, a Court would likely make every effort to find some answer

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\(^{35}\) The common law doctrine of implied terms has since been restated on several occasions, including by Lord Hoffmann—as he now is—in *Attorney-General of Belize v Belize Telecom Ltd* [2009] UKPC 10.

\(^{36}\) The base rates published by members of The Committee of London Clearing Bankers. At that time this was deemed to be the rate which came closest to sharing those features of the MLR that made it a suitable benchmark for contracts.

\(^{37}\) Contents of the Opinion have been disclosed with the kind permission of The Law Society.
so that the criterion for determining a term could be implied into the contract, “rather than accept the consequences of declaring itself defeated”. Second, it suggests that a strong legal opinion—or, indeed, an early court ruling on the issue—could play a role in maintaining market confidence.

Non-contentious responses to change

6.15. The previous paragraphs have considered how benchmark transition may conceivably become contentious for some parties. However, non-contentious outcomes may still have a significant impact if they result in market participants bearing a much larger burden of costs in order to minimise contractual uncertainty and the risks that it may import.

6.16. As discussed briefly above, parties may take the view that, no matter how small the risk of contractual uncertainty, it would be prudent to renegotiate the benchmark definition in their existing contracts. Alternatively, parties may take the view that fall-back provisions in existing contracts should be strengthened and broadened. Indeed, the Wheatley Report itself proposes that contingency or fall-back arrangements in market standard form contracts should be reconsidered (and redrafted, it is implied at [5.34]), albeit exclusively for new contracts. Negotiations to amend provisions in existing standard market contracts may, however, prove difficult and time-consuming. The mechanisms by which existing market contracts may be amended wholesale (i.e. across markets for multiple participants) are discussed in the next section of this paper.

6.17. On this point regarding the renegotiation of existing terms, it is noted that, in the case of FRNs and CLOs Trustees often take a conservative approach to making any amendments in order to avoid liability (despite the fact that, in general, the documentation confers on Trustees the discretion to agree in formal, minor or technical amendments to the terms and conditions of the bond).38 In practice, the agreement of all noteholders is likely to be required but coordinating such a meeting and reaching the requisite majority could prove difficult. In the case of LMA loan documentation, the Agent could also encounter difficulty in securing agreement to any amendments. (As discussed, the Agent may have discretion to specify another published service displaying the applicable Screen Rate under the terms of the loan but this is unlikely to be interpreted by the Agent as permitting it to make wholesale changes.)

38 See Ashurst brief, “LIBOR is changing – how will it affect financial contracts?”, October 2012, page 10.
The next section of this paper will consider the appropriate method of transitioning to a new benchmark.

7. TRANSITIONING TO A REPLACEMENT BENCHMARK

7.1. The Wheatley Report recommends that users of LIBOR should ensure that they are using the most appropriate reference rate for their purpose and, where this is not LIBOR, they should look to transition to a new reference rate where feasible (at [6.6]). In addition, it is suggested that the UK authorities work closely with the European and international communities and contribute fully to the long-term debate on the future of LIBOR and other global benchmarks.\(^{39}\) It is not entirely clear whether this recommendation concerns existing standard market contracts or applies exclusively to new contracts.

7.2. The Wheatley Report questions what role the authorities should play in facilitating and encouraging any transition to an alternative benchmark (at [6.17 to 6.21]). It recommends that authorities should take forward discussion on this issue at an international level. Reference is made to several responses to the initial discussion paper, which had suggested that the choice of alternatives should be market-led (at [6.20]); however, it is not clear whether it is envisaged that transition will be led by the authorities or whether it will in fact be market-led.\(^{40}\) Examples of a large scale market transition (to amend existing market standard contracts) include ISDA’s Big Bang and Small Bang protocols which increased the standardisation of documentation for credit derivatives and introduced new settlement arrangements for those contracts. The FMLC takes the view that changing standard contracts by way of a protocol in this way offers the brightest hope of a smooth transition from LIBOR to an alternative benchmark. It is noted that market input of this kind was also touched upon in an address to the European Parliament by Gary Gensler, Chairman of the US Commodity Futures Trading Commission (who will also co-chair the International Organisation of

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\(^{39}\) The Wheatley Report states (at [6.21]) that at an international level, authorities:

should take forward a discussion of existing applications of inter-bank rates such as LIBOR, the merits of alternative reference rates for certain applications, and the role, if any, that the authorities should play in facilitating or encouraging transition to these reference rates. In the first instance this should be the Financial Stability Board (FSB), working in conjunction with IOSCO [i.e. the International Organisation of Securities Commission], the European and other interested regional and domestic authorities.

\(^{40}\) It is however noted that conclusions and recommendations on the “Alternatives to LIBOR for the longer-term” are beyond the scope of the Wheatley Review”. See the Wheatley Report (at [6.2]).
Securities Commission Task Force examining financial benchmarks). If this kind of transition is planned, market participants may rely constructively on the anticipated transition and refrain from undertaking administratively burdensome and difficult renegotiations. A wide protocol also promotes uniformity across back-to-back contracts and can prevent mismatching of interest rates. By way of example, counterparties to existing contracts who hedge their loans on interest rate swaps, may be incentivised to adopt such a protocol to avoid any mismatch.

7.3. To achieve these benefits, the coordination of all relevant trade associations may be required. This could include consultation between inter alia, ISDA, the LMA and the Securities Industry Financial Markets Association or the Association for Financial Markets in Europe.

7.4. Transition to any new benchmark could be mapped, either by the authorities or trade associations. The mapping for each of the currencies and maturities under LIBOR may be determined for the currencies and maturities of any alternative benchmark; one way in which this could be achieved is through an auction process. The categorisation and grouping of different instruments or facilities might be considered. Certain markets are enormously diverse and mapping should therefore be detailed enough to account for the different kinds of facilities which are available. If an alternative benchmark were mapped to a secured rate, funding would be at a lower cost than the existing unsecured rate (LIBOR) and the addition of a constant or variable may be a desirable or necessary part of the mapping.

7.5. A detailed timeline of planned developments is desirable for the sake of predictability. Documentation which is drafted for new contracts, if this proves desirable, may need to be incorporated into existing contracts on the same day to reduce any risk of uncertainty and a mismatch of back-to-back contracts. New contracts which are drafted in the period before the alternative benchmark is introduced should also be accounted for. One way in which this might be achieved is that early in the lead-in period to the transition the identity of the proposed benchmark is announced so that it can be incorporated into new contracts.

41 It is noted that Chairman Gensler of the Commodity Futures Trading Commission remarked that if the market were to move to a replacement benchmark “Broad market input would be necessary to establish protocols and market mechanisms for such a transition”. See “Remarks of Chairman Gary Gensler, European Parliament, Economic and Monetary Affairs Committee”, 24 September 2012: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-121.pdf.

42 It is noted that the LMA may also need to consult (as it has done historically) the Association of Corporate Treasurers since Borrowers to loan facilities are not included under its membership.

43 The Wheatley Report suggests that amongst other things, a transition to a secured rate might also be possible (at [6.41]).
Key reasons for a longer transition period

7.6. The FMLC welcomes the Wheatley Report’s statement that international coordination is essential for any longer-term transition from LIBOR to an alternative rate. It is however noted that such a transition will need to be very carefully structured. A planned consultation process in which the terms of market contracts are changed will take time to complete. Moreover, ideally, the transition should take place outside the lifetime of as many outstanding contracts as possible. The FMLC notes that as regards the loan market Real Estate, Investment Grade Revolving Credit Facilities and Leveraged Loan Revolving Credit Facilities are generally committed for around five years (see Appendix 3). Therefore, a period of around five years is arguably desirable for a transition to an alternative benchmark. Other key reasons for a generous transition period include the following:

a. Obtaining the agreement of the trade associations (and potentially, international authorities) listed above is likely to take time and require significant resources. Furthermore, in reaching agreement for a market-wide protocol, trade organisations must consider anti-competition rules and cartel prohibitions, although this may not be an issue in practice.

b. Contracts incorporating LMA documentation tend to be less standardised, containing more bespoke provisions, than contracts incorporating ISDA documentation. This suggests that the maturity profile of the loan markets should be considered when determining the transition period.

c. There is a risk that members of trade associations may not sign up to a protocol voluntarily since it could prove advantageous for some counterparties to rely on fallback provisions or argue that their contracts have been frustrated. Counterparties may also be inclined to move to a new protocol at a time when it would seem most advantageous for them, rather than on any date scheduled by the trade associations.

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44 It is noted that some of these are committed for a period of two years. Although the majority of Project Finance Loans tend to be committed for fifteen to twenty-five year periods, a five year transition is thought to capture at least the majority of existing contracts.

45 Some market participants have indicated that a period of five years for transition would be too short (and perhaps, a seven year transition would be more desirable). Other market participants have indicated that a period of five years would be too long.

d. Although it may be possible to incentivise or even compel regulated entities to move to a new benchmark, it may be more difficult to do so for those peripheral, non-regulated entities.

8. CONCLUSION

8.1. LIBOR faces a reputational problem which may critically undermine market confidence in the benchmark. Reform of LIBOR has therefore been identified as a key priority by the authorities. The FMLC is strongly of the view that any reform proposals must take stock of the legacy issue which is set out in this paper.

8.2. It is clear that agreeing any market standard amendments to relevant contingency provisions in existing contracts will take time. An important consideration in assessing the degree of contractual uncertainty that may result from the withdrawal or fundamental alteration of the benchmark in the meantime is the fact that, as the FMLC has been given to understand, existing fall-back arrangements in standard contracts are unlikely to be workable on a market-wide scale, at any rate over an extended period.

8.3. If the identity of the benchmark is significantly altered as a result of reform initiatives before existing contracts can be amended it is to be expected that contractual uncertainty may result. Of greatest concern in this regard is the proposed change of sponsor in the context of loan contracts on the LMA standard terms and the sponsor-based definition of the Screen Rate that those terms incorporate. This concern may, however, be greatly mitigated, and even eliminated, if the new arrangements:

a. result in no apparent change to the value of LIBOR vis-à-vis the value derived from submissions which would otherwise be made; or

b. receive the imprimatur of the BBA, albeit under new administration: and/or

c. are approved by the LMA.

8.4. A further concern is the withdrawal of certain tenors and currencies, particularly in the context of existing derivatives contracts which refer to these LIBOR categories, as—for example—certain cross currency swaps may do. In this regard, however, the FMLC takes
comfort from the fact that, as it has been given to understand, there are relatively few derivatives trades in the indices proposed for withdrawal.

8.5. The analysis above amounts to a pressing case for work to ascertain a means by which the identity of LIBOR, as it is defined in market standard contracts, can be reliably preserved in the short-term. In the longer-term, the FMLC has formed the view that the best method for achieving a smooth transition is the introduction of a market-wide protocol following consultation by the main trade associations. The period for such a transition should, from the perspective of contractual continuity, exceed the life of as many outstanding contracts as possible.
APPENDIX 1

It is not for the FMLC to suggest which reference rate should replace LIBOR for certain markets; however, a list of existing benchmarks which commentators and market participants have suggested as viable alternatives to LIBOR is provided in this Appendix.

1. UNSECURED OVERNIGHT INDEX SWAPS

1.1. Overnight Index Swaps (“OIS”) are interest rate swaps between a fixed rate and the overnight cash lending rate (e.g. Sterling Overnight Index Average (“SONIA”) or Euro Overnight Indexed Average (“EONIA”)), for a specific maturity. Overnight unsecured lending is the representation of the central bank policy rate. In the UK, this is measured by the SONIA, which is comprised of the weighted average of all overnight Sterling trades, reported by the Wholesale Markets Brokers’ Association (“the WMBA”). Transactions in the swap market can then be used to generate a maturity curve for overnight interest rates. OIS as a benchmark would be heavily dependent on the robustness of the overnight cash rate.47

SONIA

1.2. SONIA tracks actual Sterling overnight funding rates experienced by market participants. The development of SONIA led to product developments which reduce risk and increase transparency. SONIA is the weighted average rate to four decimal places of all unsecured Sterling overnight cash transactions brokered in London by the Wholesale Markets Brokers’ Association (“WMBA”) member firms between midnight and 4.15pm with all counterparties in a minimum deal size of £25 million48.

EONIA

1.3. EONIA is the effective overnight reference rate for the Euro. It is computed as a weighted average of all overnight unsecured lending transactions undertaken in the interbank market, initiated within the Euro area by the contributing banks. EONIA is computed with the help of the European Central Bank and the banks contributing to this benchmark are the same as those contributing to EURIBOR.49

47 See The Wheatley Review: initial discussion paper (at [4.14]).
2. SECURED RATES (REPURCHASE AGREEMENTS)

2.1. Repurchase ("Repo") agreements are a form of short-term secured borrowing whereby a bank sells debt securities (often government securities) to another institution on the basis that it will agree to repurchase them on a set date and price in the future. The duration of these transactions typically ranges from overnight to 30 days. Some commentators have argued that repo markets are not always transparent. The Collateral Requirements Directive aims to curtail the circumstance in which one bank is repo-ing with a “friend”, i.e. the bank takes another institution’s collateral if the institution takes the bank’s collateral.\(^{50}\)

**Repo Overnight Index Average**

2.2. RONIA is a new repo-based rate for the UK interbank market. RONIA is the weighted average rate to four decimal places of all secured Sterling overnight cash transactions brokered in London by contributing WMBA member firms between midnight and 4.15pm with all counterparties with no minimum deal size. RONIA eligible transactions are Delivered by Value and this is a mechanism whereby a CREST member who has borrowed money against overnight gilt collateral may have gilts on its account to the required value delivered automatically by the system to the CREST account of the money lender. This index tracks actual market overnight funding rates.\(^{51}\)

**General Collateral Financial Index**

2.3. The General Collateral Financial index is a short-term interest rate benchmark based on an index of rates at which actual, fully collateralised and centrally cleared financing transactions (repurchase agreements) are executed.

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APPENDIX 2

Instruments linked to LIBOR include interest rate swaps, cross currency swaps and other derivatives, FRNs, CLOs, a wide variety of loans including mortgages and bilateral and syndicated loans and other diverse contracts such as securitisation and as a performance benchmark for hedge funds.

- Interest rate swaps are agreements to exchange interest rate cash flows, calculated on a notional principle amount, at specified payment dates during the life of the agreement. Each party’s payment obligation is computed using a different interest rate. In an interest rate swap, the notional principle is never exchanged. Although there are no standardised swaps, a plain vanilla swap typically refers to a generic interest rate swap in which one party pays a fixed rate and one party pays a floating rate (usually LIBOR). 52 Interest rate swaps allow for the management of interest rate risk. Over-the-counter interest rate swaps comprised almost $400 trillion in notional value in June 2012. 53

- Cross currency swaps are agreements between two parties to swap interest payments denominated in two different currencies for a specified term. During the life of a swap, each party pays interest to the other in the currency of the principle received. At the swap’s maturity, the parties make one last exchange of the initial principle amounts. 54

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54 See ISDA “Product Descriptions”, *ibid.*
Bilateral and syndicated loans are frequently linked to LIBOR, as are some mortgages. The size of lending by UK banks to UK residents and businesses as of September 2012 is valued to be approximately £2.5 trillion, including commercial and retail mortgages. A large proportion of these loans are thought to be based on LMA standard terms.

FRNs are medium to long-term debt obligations with variable interest rates that are adjusted periodically (typically every one, three or six months). The interest rate is usually fixed at a specific spread over a specified rate. LIBOR is one of the most common benchmarks linked to FRNs. The value of FRN contracts pegged to the LIBOR benchmark globally, is estimated to be $1.5 trillion.

MTN programmes are created by agreeing a set of issue documentation in advance in order to create a platform from which issuers may issue a range of notes or bonds (whether bearing a fixed or a floating rate of interest) at very short notice, simply by selecting from a menu of pre-agreed terms and conditions.

A CLO is a type of debt security where payments from corporate loans are pooled together and passed on to different classes of owners in tranches.

For the purposes of comparison, the FMLC has been given understand that residential mortgage loans using one year US Dollar LIBOR as a reference comprise of around $1 trillion, and that there are also large values of Student Loans in the US which use one month US Dollar LIBOR as a reference rate. It is noted that US mortgage loans may have greater variation in their terms than other classes of instruments. The terms of the Freddie Mac form of LIBOR-based residential mortgage loans define LIBOR as “the average of the interbank offered rates for [six-month] US dollar-denominated deposits in the London market as published in The Wall Street Journal”. In practice, the rates published in the Wall Street Journal are those taken from the Reuters Screen LIBOR01 Page. The Freddie Mac form includes a fall-back arrangement which provides that if LIBOR as published by The Wall Street Journal “is no longer available”, the holder of the mortgage note “will choose a new index which is based upon comparable information”.


APPENDIX 3

In view of the fact that the FMLC has been asked to consider the period within which a transition to a new benchmark may be implemented and the impact of transition on existing loans, a loan maturity profile is provided below.  

Debt Maturity Profile

Virtually all loans falling under the categories listed below are floating rate and use LIBOR as the interest rate benchmark.

Investment Grade Term Loans

![Investment Grade Term Loans](chart.png)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Loan Volume (GBP billions)</th>
<th>Project Finance Subset (GBP billions)</th>
<th>Real Estate Subset (GBP billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>9.2</td>
<td>2.9</td>
<td>0.8</td>
</tr>
<tr>
<td>2011</td>
<td>29.5</td>
<td>3.7</td>
<td>1.4</td>
</tr>
<tr>
<td>2010</td>
<td>39.2</td>
<td>5.4</td>
<td>1.1</td>
</tr>
<tr>
<td>2009</td>
<td>9.6</td>
<td>3.6</td>
<td>1.0</td>
</tr>
<tr>
<td>2008</td>
<td>37.4</td>
<td>10.3</td>
<td>2.9</td>
</tr>
</tbody>
</table>

Facility data was extracted from Dealogic. Dealogic data was provided in EUR so the GBP equivalent is derived by using an exchange of 1.1.
**Project Finance**

- The FMLC understands that virtually all syndicated Term Loans are floating rate and, in the UK market, use LIBOR as the interest rate benchmark.

- The Project Finance Loans tend to be committed for long periods, typically between ten and thirty years. The majority fall into the fifteen to twenty-five year period. The amounts vary from tens to hundreds of millions Sterling.

- For many Project Finance Facilities, the Borrower is required to hedge into a fixed rate interest rate swap.

- Other Term Loans tend to be for periods of up to five years.

**Real Estate**

- Virtually all syndicated Real Estate Finance Term Loans are floating rate loans and, in the UK market, use LIBOR as the interest rate benchmark.

- Real Estate Finance Term Loans are typically committed for periods of up to five years. The amounts vary from tens to hundreds of millions Sterling.

- For many Real Estate Finance Facilities, the Borrower is required to hedge into a fixed rate interest rate swap. Other hedge products, such as caps, are occasionally used.
Leverage Term Loans

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Loan Volume (GBP billions)</th>
<th>Term &gt; 5 yrs (GBP billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>17.2</td>
<td>7.9</td>
</tr>
<tr>
<td>2009</td>
<td>4.7</td>
<td>0.4</td>
</tr>
<tr>
<td>2010</td>
<td>15.7</td>
<td>7.4</td>
</tr>
<tr>
<td>2011</td>
<td>14.9</td>
<td>9.1</td>
</tr>
<tr>
<td>2012</td>
<td>10.4</td>
<td>7.5</td>
</tr>
</tbody>
</table>

- Virtually all syndicated Leveraged Term Loans are floating rate loans and, in the UK market, use LIBOR as the interest rate benchmark.

- During 2008/2009, original Term Loan maturities were between six and ten years but in recent years, new Term Loan maturities have been shorter.

- Many of the facilities are refinancings of earlier deals.
### Revolving Credit Facilities

#### Year | IG Loan Volume (GBP billions) | Leveraged loan volumes (GBP billions)
---|---|---
2008 | 35.3 | 4.8
2009 | 28.4 | 5.3
2010 | 63.7 | 5.3
2011 | 68.8 | 7.8
2012 | 24.2 | 2.8

- The FMLC understands that, in the UK market, virtually all syndicated Revolving Credit Facilities use LIBOR as the interest rate benchmark.

- Investment Grade Revolving Credit Facilities are generally committed for two to five year periods. Average drawings of around 20 to 25% are typically estimated.

- Leveraged Loan Revolving Credit Facilities are generally committed for two to five year periods. Average drawings of around 30% are typically estimated.
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