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Financial Markets Law Committee[1]

This paper has been prepared by the FMLC Secretariat.[2]

[1] In view of the role of the Bank of England, the Financial Conduct Authority and HM Treasury in the U.K.'s preparations for withdrawal from the E.U., Sinead Meany, Sean Martin and Peter King took no part in the preparation of this paper and the views expressed should not be taken to be those of the Bank of England, the FCA and HM Treasury.

[2] Joanna Perkins (FMLC Chief Executive) and Venessa Parekh (FMLC Research Manager). The FMLC is grateful to Annabelle Whitby-Smith (Allen & Overy LLP) for her assistance in drafting and reviewing this paper.

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1. EXECUTIVE SUMMARY AND 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. In June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (known colloquially and in this paper as "**Brexit**"). On 29 March 2017, HM Government took the first step in the withdrawal process and officially served notice to the E.U. of the U.K.'s withdrawal under Section 50 of the Treaty on European Union ("**TEU**"), beginning a two-year "notice" and negotiation period, and setting the date on which the U.K. was to withdraw from the E.U. ("**Exit Day**") as 29 March 2019.[3] Over that period, although negotiations for a Withdrawal Agreement progressed, HM Government continued to prepare for a possible "No Deal" eventuality with respect to domestic law. A key element in HM Government's plan to ensure continuity in law during and after Brexit in the U.K. is the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**") which aims, *inter alia*, to incorporate into U.K. law all applicable E.U. legislation and to give powers to Ministers to make such amendments to retained law as are necessary to deal with any deficiencies arising from withdrawal.[4] In furtherance of these aims, HM Treasury has published statutory instruments ("**SIs**") which "onshore" E.U. legislation related to the financial markets.[5]

1.3. HM Government requested two extensions from the E.U. to the Article 50 notice period, subsequently agreeing a new Exit Day of 31 October 2019. A change of leadership ensued in the U.K. New British Prime Minister Boris Johnson has stated that his preference is for the U.K. to leave the E.U. on 31 October, whether or not a Withdrawal Agreement is signed. In a series of votes on 22 October 2019, Parliament indicated support for the Withdrawal Agreement negotiated between the U.K. and E.U. on 17 October 2019 but rejected the Prime Minister's proposal to review related

[3] Legislative provisions defining Exit Day as 29 March 2019 can be found in the European Union (Withdrawal) Act. Section 20(4) of that Act gives a Minister of the Crown the power to amend the definition of Exit Day so that it correctly refers to the day and time on which the E.U. Treaties cease to apply to the U.K.

[4] Text of the European Union (Withdrawal) Act 2018 is available at: http://www.legislation.gov.uk/ukpga/2018/16/pdfs/ukpga_20180016_en.pdf.

[5] A list of the statutory instruments published in relation to financial services and including those which have been put before Parliament for approval can be found on the following webpage: HM Government, *Financial services legislation under the E.U. (Withdrawal) Act 2018,* (first published 9 August 2018, last updated 21 February 2019), available at: https://www.gov.uk/government/collections/financial-services-legislation-under-the-eu-withdrawal-act?utm_source=ed3e24c1-615b-4397-a940-f10eb4c57fcd&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate.

legislation over a compressed timeline. As a result, a further extension to the Article 50 notice period until 31 January 2020 seems likely. Although, in principle, the Withdrawal Agreement has Parliament's support, its ratification remains subject to Parliamentary scrutiny and potential political changes over the next three months. A no deal Brexit remains a possibility. The FMLC understands that HM Treasury had planned to update the SIs enacted in preparation for the March 2019 Exit Day to take into account any developments and better reflect the realities of an October Exit Day. It can be inferred that such an exercise will be carried out for the new Exit Day too. The Committee is grateful for this opportunity to draw attention to some legal and operational uncertainties arising from the onshoring framework.[6]

1.4. The Benchmarks (Amendment and Transitional Provision) (EU Exit) Regulations 2019 (the "**BMR SI**") onshores Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "**BMR**"), the primary objective of which is to ensure the accuracy, robustness and integrity of financial benchmarks.[7] The BMR places requirements on administrators, supervised users of, and supervised contributors to, benchmarks. The BMR regulates the governance and controls administrators must have in place, the quality of input data and methodologies used by benchmark administrators and the conduct of contributors to benchmarks. The BMR SI seeks to provide a framework that ensures the continued functioning of the BMR and related U.K. legislation in the U.K. in the case of a no-deal Brexit.

1.5. This paper considers the challenges of providing a new benchmark into the E.U. once the U.K. is a Third Country post-Brexit and the legal uncertainties arising from the changes proposed by the BMR SI.

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[6] The Committee does not comment on matters of policy or the form that future regulatory approaches, if any, should take and this report should not be understood to constitute comments thereon.

[7] See The Benchmarks (Amendment and Transitional Provision) (EU Exit) Regulations 2019 available at: https://www.legislation.gov.uk/ukdsi/2019/9780111179208/data.pdf.

See Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1011&from=EN.

2. LEGAL UNCERTAINTIES AND IMPACT

Providing New Benchmarks as a Third Country

2.1. The main consequence of Brexit for the financial services industry is that the U.K. will be, for the purposes of E.U. law, a Third Country and, in the event a deal is not agreed between the U.K. and E.U., U.K. market participants will have to depend on the Third Country regimes written into E.U. law for access to the E.U. market. The BMR permits financial institutions in the E.U. to use only those benchmarks which are registered with the European Securities and Markets Authority ("**ESMA**"). Administrators of benchmarks in the U.K., will have to register their benchmarks with ESMA on the basis of: (i) a positive equivalence decision; (ii) recognition of the Third Country administrator by the competent authority of its "Member State of Reference"; or (iii) endorsement by an E.U. administrator, with full authorisation, of the Third Country benchmark(s).[8] The latter two means of access are provided in addition to equivalence perhaps because no Third Country has enacted a comprehensive code like the BMR for benchmark regulation (although that will change when the U.K. leaves the E.U. and onshores the BMR). In these circumstances, providing additional means of recognition can avoid any adverse impact resulting from a possible abrupt cessation of the use in the E.U. of benchmarks provided from a Third Country. The BMR lays down, in Articles 32 and 33, specific requirements which must be fulfilled for either recognition or endorsement to occur and which may, in part, be satisfied by demonstrating compliance with certain international standards.[9]

2.2. In order to mitigate the impact of a failure by benchmark providers to secure recognition at the date of the application of the BMR, the Regulation also includes transitional provisions in Article 51, the first of which is a two-year grandfathering or grace period (the "**transitional period**"), following the entry into application of the BMR in January 2018. This transitional period was to end on 1 January 2020 according to the BMR. During the transitional period, E.U. benchmark providers may apply for authorisation

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[8] In a Statement published in March 2019, ESMA stated that ICE Benchmark Administration Limited and other administrators located in the U.K. (or whose applications for recognition or endorsement were approved by the Financial Conduct Authority ("**FCA**")) which currently appear on ESMA's register of approved benchmarks/administrators will be removed from the register in the case of a no-deal Brexit unless and until they obtain recognition, endorsement or equivalence. See, ESMA, *Statement on its approach to the application of some key MiFID II/MIFIR and Benchmark (BMR) provisions should the UK leave the EU under a no-deal Brexit* (7 March 2019), available at https://www.esma.europa.eu/sites/default/files/library/esma70-155-7253_public_statement_mifidii_bmr_provisions_under_a_no_deal_brexit.pdf.

[9] I.e. those standards established by the International Organisation of Securities Commissions ("**IOSCO**") in its *Final Report of July 2013 on Principles for Financial Benchmarks*, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf.

or registration and Third Country benchmarks may, subject to conditions, be referenced in legacy contracts. In the latter case, where benchmarks provided by administrators located in Third Countries, are "already used in the Union" as a reference for legacy financial instruments, financial contracts, or for measuring the performance of an investment fund ("**in-scope instruments**"), Article 51(5), as an additional stability measure, permits the use of such benchmarks after the end of the transitional period for such in-scope instruments that already reference such benchmarks on, or which add a reference to such benchmarks prior to, 1 January 2020. In a question-and-answers document, ESMA had clarified that "already used in the Union" would be interpreted to mean that the benchmark is already in use in the E.U. on or before 1 January 2020.[10] On 26 March 2019 the European Parliament adopted a legislative resolution on low carbon and positive carbon impact benchmarks (the "**low carbon legislative resolution**"), which will, if it comes into effect, extend the 1 January 2020 deadline for Third Country benchmarks to 31 December 2021.[11] It remains unknown whether ESMA is of the view that the meaning of "already used in the Union" will accommodate this extension but the better view is that "already used" is intended to imply "in use before the end of any effective transitional period".

2.3. The primary problem arising in the context of Brexit, which the FMLC has analysed in previous publications, is that in the absence of registration by one of the three means provided, E.U.-supervised entities will be prevented from using a U.K.-administered benchmark in the E.U. This may be a cause for concern in respect of the overall market stability in the region given that the administrators of several key benchmarks are located in the U.K. The extension of the transitional period for Third Country benchmarks has been widely considered helpful as it provides certainty by maintaining the *status quo*—although market participants have noted the need for the low carbon legislative resolution to enter into force before the expiry of the original transitional period on 1 January 2020. The FMLC observes, however, that the situation is complicated further by the move in the U.K. to transition markets away from certain established benchmarks.

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10 ESMA, Questions and Answers On the Benchmarks Regulation (version 14, last updated 11 July 2019), available at: https://www.esma.europa.eu/sites/default/files/library/esma70-145-114_qas_on_bmr.pdf, Question 9.3.

11 See, European Parliament legislative resolution of 26 March 2019 on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks (COM(2018)0355 – C8-0209/2018 – 2018/0180(COD)), available at: http://www.europarl.europa.eu/doceo/document/TA-8-2019-0237_EN.html.

2.4. In July 2017, the FCA announced that it would not guarantee the survival of LIBOR after the end of 2021.[12] Since the announcement, the transition from LIBOR to the Secured Overnight Financing Rate ("**SOFR**"), Sterling Overnight Index Average ("**SONIA**") and the other chosen risk-free rates has occupied the derivatives, securities and loan markets, although no successor rate has been adopted on a market-wide basis yet and the question of establishing term rates has proven particularly challenging. Three dates have therefore emerged as key: (1) Exit Day, (2) the day the new transitional provisions for Third Country benchmarks end on 31 December 2021 and (3) the date (if any) on which LIBOR gives way to another benchmark. The degree of uncertainty which might arise depends on the sequence in which these events occur. The paragraphs below set out what the FMLC considers are the more likely scenarios.[13]

Brexit before end of extended transitional period

2.5. Should Brexit occur before the end of 2021, which seems likely, U.K.-administered benchmarks may be used in the E.U. by supervised entities—subject to what is said below concerning central banks—in the period between Exit Day and the day on which the new transitional provisions end—i.e., 31 December 2021—if (1) they were already in use in the E.U., and (2) only insofar as they are referenced in legacy contracts. In order to be relied upon by E.U. supervised entities for new contracts, benchmarks provided by administrators in the U.K. will have to apply for equivalence, recognition or endorsement.

LIBOR transition after Brexit but before end of extended transitional period

2.6. If the transition from LIBOR occurs *after* Brexit but *before* the end of the transitional period, it will be necessary for any wholly new successor rate (for example, new term rates), provided by a commercial entity,[14] to meet the requirements of Article 51(5) of the BMR in order to ensure continued use in legacy contracts after 31 December 2021. The new successor rate will need to be established as "already used" in the E.U. and contracts which currently reference LIBOR will need to reference the new rate before 31 December 2021. Given that LIBOR will be phased out "at the end of 2021", there may

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[12] See, FCA, "The future of LIBOR": Speech by Andrew Bailey, Chief Executive of the FCA, at Bloomberg London, (27 July 2017), available at: https://www.fca.org.uk/news/speeches/the-future-of-libor.

[13] For example, the scenario that the LIBOR transition will occur *before* Brexit has not been considered in this paper as it appears to be an unlikely scenario.

[14] It has been suggested that SONIA might replace LIBOR in the U.K. SONIA is currently administered by the Bank of England. Article 2 of the BMR states that the Regulation does not apply to central banks.

be a vanishingly small period of time during which legacy contracts will have to begin to reference the new rate so as to be able to continue to do so after 31 December 2021 (in the absence of registration). For the legacy contract market, which relies upon continuity, this could cause systemic problems. At any rate, the new successor benchmark may only be used in new contracts after an equivalence decision has been adopted by the European Commission, the U.K. administrator has been registered or the U.K. benchmark has been endorsed.

LIBOR transition after Brexit and after extended transitional period

2.7. If, on the other hand, the transition from LIBOR takes place in 2022, *after* Brexit and *after* the extended transitional period, successor rates will not benefit from any transitional period. E.U.-supervised entities will be unable to reference a U.K.-administered, unregistered benchmark in new or legacy contracts. The inability of E.U. market participants to reference in the E.U. a benchmark administered by a commercial entity in the U.K., especially when it is one as critical as a replacement to LIBOR, would have substantive impact on the market.[15] In these circumstances, it might be of great importance that the U.K. ensures alignment in its framework for regulating benchmarks with the BMR so that a positive equivalence determination can be made quickly.

2.8. There is the possibility that ESMA might not follow the better view on the date by which the benchmark must be "already" used in the E.U.—i.e., that it corresponds with the end of the extended transitional period.[16] In those circumstances, the successor rate to LIBOR will be unable to avail itself of the transitional provisions of Article 51(5) which, much like the situation described in the previous paragraph, could potentially have significant consequences for the financial markets.[17]

2.9. A similar situation will arise, subject to what is said below about central banks, in respect of benchmarks provided by administrators located in the U.S. and the E.U. which will replace USD LIBOR and EUR LIBOR.[18] In order for U.K. supervised

[15] This problem might not arise if the successor rate is administered by the Bank of England as central banks are not subject to the BMR. See, *supra*, n. 14. There are, however, some uncertainties regarding the central banks exemption – see paragraph 2.10 below.

[16] See, *supra*, paragraph 2.2.

[17] The successor rate will be unable to avail itself of Article 51(5) as the original transitional period would have expired on 1 January 2020 , a date likely to occur prior to the availability of such successor rate.

[18] The onshored BMR retains the central bank exemption. Much like SONIA, SOFR, which is likely to replace $LIBOR, and €STR, which might replace Euro LIBOR, are currently administered by central banks—the New York Federal Reserve and the European Central Bank respectively.

entities to be able to reference successor rates to USD LIBOR and EUR LIBOR *after* Brexit but *before* the end of the Article 51 transitional period, the successor rates will have to establish themselves under Article 51 of the onshored BMR. In onshoring the BMR, HM Government has adopted the extensions to the transitional period proposed by the low carbon legislative resolution and, in fact, extended the grace period so that it ends on 31 December 2022.[19] It has also adopted the better view on the date by which the benchmark must be "already" used in the U.K. and amended it (from 31 December 2019, per the BMR) so that it is aligned with the end of the transitional period (31 December 2022). It is hoped that, by 1 January 2023, when the new transitional period under the U.K. onshored BMR ends, legacy contracts will have been amended to refer to the successor rates to USD LIBOR and EUR LIBOR. In any event, if the successor rates are to be administered by central banks, as is currently predicted, they will be outside the scope of the onshored BMR.

Exemption for central banks

2.10. On the topic of benchmarks administered by central banks, the FMLC observes that HM Government has onshored without amendment the provision in Article 2 which states that the BMR—and consequently the onshored BMR—does not apply to central banks. This exemption raised several questions in the period immediately after the BMR entered into force owing to a lack of specificity concerning the immunity provided to other entities engaging with central bank-administrated benchmarks. For example, if the BMR excludes central banks from its scope when they are administrators of benchmarks, it is unclear whether the exemption extends to other requirements placed on users and contributors. If benchmarks administered by central banks need not be recorded on ESMA's register as per the requirements of Article 36, that raises further questions in relation to the "use of a benchmark" as set out Article 29 of the BMR which states that a supervised entity may use a benchmark in the E.U. "included in the register referred to in Article 36". Similar questions arise in relation to rates administered by central banks to the extent they rely on submissions from, or delegations to, commercial entities. The questions arise both in relation to E.U. and Third Country central banks. Given the likelihood that the key benchmarks which will replace LIBOR are likely to be provided by central banks, it might assure legal certainty if the exemption is clarified in the onshored BMR.

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[19] The extension to the grace period was implemented in the U.K. by regulation 20 of the Financial Services (Electronic Money, Payment Services and Miscellaneous Amendments) (EU Exit) Regulations 2019, available at: http://www.legislation.gov.uk/uksi/2019/1212/made/data.pdf.

Transitional provisions in the BMR SI

2.11. As stated above, Article 51 of the BMR provides transitional provisions for E.U. index providers or benchmarks administrators enabling them to apply for authorisation or registration under the BMR until 1 January 2020. The BMR SI amends Article 51 to incorporate clarifications provided by ESMA[20] and to provide further transitional provisions for benchmark administrators in the U.K. on Exit Day.[21] These latter amendments introduce an issue of uncertainty which might be characterised as an unintended change in scope.

2.12. Regulation 42 of the BMR SI amends Article 51. This was subsequently amended by regulation 20 of the Financial Services (Electronic Money, Payment Services and Miscellaneous Amendments) (EU Exit) Regulations 2019. The onshored Article 51 requires index providers providing a benchmark to apply for authorisation or registration in accordance with Article 34 on or before 31 December 2019 to enable the benchmark to be used on or after 1 January 2020. During the period beginning after such an application for authorisation or registration has been made and ending either when the application is approved or rejected on 31 December 2019, new Article 51 (1A) provides, a supervised entity may use a benchmark in the United Kingdom that

(a) is provided by a U.K. index provider who was providing a benchmark *in the United Kingdom* on 30 June 2016, or

(b) is a benchmark (to which paragraph (a) does not apply) that was provided by a U.K. index provider *in the United Kingdom* in the period beginning with 1 July 2016 and ending with 31 December 2017. (Emphasis added.)

2.13. The requirement that the U.K. index provider must have been providing the benchmark in the U.K. is new. The equivalent BMR provisions apply to index providers located in the E.U., who are eligible to apply for authorisation or registration,[22] but they do not stipulate that such index providers must have been providing a benchmark in the E.U. on the relevant dates to benefit from the transitional provisions. It is not clear why a

[20] ESMA, *Questions and Answers On the Benchmarks Regulation* (version 14, last updated 11 July 2019), available at: https://www.esma.europa.eu/sites/default/files/library/esma70-145-114_qas_on_bmr.pdf.

[21] These provisions were further amended by regulation 20 of the Financial Services (Electronic Money, Payment Services and Miscellaneous Amendments) (EU Exit) Regulations 2019, which extended the transitional period for benchmarks provided by Third Country administrators in the U.K. to 31 December 2022.

[22] Article 51(2) provides: "… the competent authority of the Member State where an index provider applying for authorisation in accordance with Article 34 is located …"

territorial limitation has been added to the transitional provision (which already refers to U.K. index providers).

Scope

2.14. The BMR SI creates a snapshot of the BMR which will regulate the activities of the provision of, contribution to and use of benchmarks in the U.K. The BMR SI limits the scope of the BMR, once onshored, by amending the Article 1 (*Subject-matter*) of the BMR so that it applies "in the United Kingdom" instead of "in the Union". Market commentators have observed, however, that the scope of the BMR was unclear as it applied across the E.U. and it has been left unclear when onshored in the U.K. One example of this uncertainty is the question of whether the use of a benchmark "in the United Kingdom" under the onshored BMR SI includes the use of the benchmark by branches based inside and outside the United Kingdom. Another question is whether the supervised entity using the benchmark needs to be located in (and have its registered or other official address in) the U.K. and/or be supervised by the FCA to meet BMR user obligations.

2.15. This territorial uncertainty is further compounded by the fact that the definition of "supervised entity" in the BMR does not explicitly refer to entities which are authorised or regulated in the E.U. By way of example, a supervised entity may be an alternative investment fund manager ("**AIFM**") "as defined in point (b) of Article 4(1) of Directive 2011/61/E.U."[23] Given that the scope of the BMR, once onshored, was to be limited to the U.K., market participants had expected that the list of entities falling within the definition of "supervised entity" would be limited to U.K. authorised and regulated entities only—perhaps including branches to the extent that such branches are regulated in the U.K.—so as to clarify the territorial scope of the user obligations. The BMR SI makes this change in some cases—for example, by requiring the supervised entity if it were an insurance or reinsurance undertaking to have the relevant Part 4A permission under The Financial Services and Markets Act 2000 and/or have its head office in the United Kingdom. There remain a few limbs of the definition, however, where there do not appear to be any territorial restriction, such as the definitions of trade repository, central counterparty, market operator and AIFM. The FMLC understands that some of these uncertainties existed in the context of the BMR. It considers, however, that the onshoring programme may provide an opportunity to ensure that the scope of the onshored BMR is interpreted consistently. It would be helpful to receive clarification

[23] Directive 2011/61/EU on Alternative Investment Fund Managers (the "**AIFMD**").

on the scope of the definition of "supervised entity" in the context of the onshored BMR.

3. RECOMMENDATIONS AND CONCLUSION

3.1. In this paper, the FMLC has highlighted the challenges of providing a new benchmark into the E.U. once the U.K. is a Third Country post-Brexit and the legal uncertainties arising from the BMR SI which included uncertainties related to: (1) the central bank exemption; (2) transitional provisions in the BMR SI; and (3) scope. In view of the substantial work which has evidently gone into drafting the BMR SI, the FMLC is certain that HM Treasury has already taken into account both the drafting and policy issues highlighted above. The FMLC would, nevertheless, encourage HM Treasury and HM Government to publish, wherever possible, guidance which might enable affected benchmark administrators to begin planning for the future.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS[24]

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