

16 October 2015

Olivier Guersent
Director General, DG Financial Stability, Financial
Services and Capital Markets Union
European Commission
1049 Brussels
Belgium

FINANCIAL
MARKETS
LAW
COMMITTEE

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.

² See Mihaljek and Packer, "Derivatives in emerging markets" (*BIS Quarterly Review*, 2010), available at: http://www.bis.org/publ/qtrpdf/r_qt1012f.pdf.

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

8 Lothbury
London EC2R 7HH
www.fmlc.org

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.

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”.

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").⁴ Indicative survey rates are derived from indicative quotations received from dealers in both the onshore and offshore markets.⁵ 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

⁴ Further details are available at: <http://www.sfemc.org/ndf.asp>.

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.