6 October 2020

European Commission
Rue de Spa 2
1000 Bruxelles
Belgium

Dear Sir or Madam

Proposal for a Regulation amending 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.

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**") came into effect on 1 January 2018. The primary objective of the BMR is to ensure the accuracy, robustness and integrity of financial benchmarks, which it does by placing requirements on administrators, supervised users and contributors. 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**"). 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.[1] This transitional period has been extended to 31 December 2021.[2]

In July 2017, the Financial Conduct Authority ("**FCA**") announced that it would not guarantee the survival of London Interbank Offered Rate ("**LIBOR**") after the end of 2021.[3] The announcement came in the context of wide-ranging reform of financial benchmarks and a planned transition from interbank offered rates ("**IBORs**") to risk-free reference rates ("**RFRs**"). Markets, regulators and central banks in a number of jurisdictions have grappled with the uncertainty arising from the process of transition. In these circumstances, the European Commission has published a proposal to amend the BMR (the "**Legislative Proposal**") so as to ensure, *inter alia*, that

> regulators have adequate tools to guide and accommodate the transition avoiding contract frustration and financial instability.

The Legislative Proposal will give the European Commission powers to mandate the use of a statutory replacement rate ("**SRR"**) in relevant contracts if a major benchmark used in the E.U., such as LIBOR, is discontinued or becomes unrepresentative of its underlying market. Under the Legislative Proposal, the relevant SRR would automatically replace the outgoing benchmark by operation of law in all contracts which are (i) "financial instruments, financial contracts and measurements of the performance of an investment fund", as those terms are defined in the BMR (meaning that loan agreements other than consumer loan agreements would be excluded, but loan-linked agreements, such as hedging transactions, could be in scope *qua* financial instruments), and (ii) lacking any suitable fallback provisions (so-called "**tough legacy contracts**"). According to the recitals and the preamble to the Legislative Proposal, the contracts must also be: (iii) entered into by one or more BMR "supervised entities", although this restriction does not appear from the draft articles, other than indirectly by

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reference to the definitions of "financial instruments" and "financial contracts" in the BMR.

The FMLC would like to draw attention to some issues of uncertainty in relation to the Legislative Proposal.

Potential discrepancies with action taken in other jurisdictions

Any discussion of the financial markets in and after 2021 would be incomplete without at least a brief consideration of the possible consequences of the U.K.'s withdrawal from the E.U. Following the U.K.'s withdrawal from the E.U. in January 2020, it entered into a Brexit implementation period which ends on 31 December 2020 and after which the U.K.'s relationship with the E.U. will be governed by the provisions of a Free Trade Agreement, if one has been agreed. The regulatory framework in this area in the U.K., in the event no deal is agreed, will be provided by a so-called "onshored" version of the BMR—i.e., the BMR as amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018 to make adjustments for the U.K.'s position after Brexit (referred to hereafter as the "**U.K. BMR**").

As a result, the proposed amendment to the BMR will not be automatically implemented in the U.K. and it will not affect contracts with U.K. consumers or entities, except insofar as they are contracts with an E.U. supervised counterparty, unless the U.K. decides to mirror both the legislation and the subsequent SRR decision. This seems unlikely given the announcement by the Chancellor of the Exchequer that the forthcoming Financial Services Bill would include provisions to empower the FCA to help those who cannot amend their contracts by directing the administrator of LIBOR—Ice Benchmark Administration ("**IBA**")—to change the methodology used to compile the benchmark, creating a screen rate which, although it is fundamentally different from the LIBOR of old, still accords with the definition as it occurs in most contracts on market standard terms.[4] The differences in the two proposed approaches could potentially create difficulties where contracts exist between U.K. and E.U. entities in the absence of careful coordination. For example, "LIBOR" could be theoretically extant under English law as a screen rate but "in cessation" as a methodology and/or as a measure of London interbank unsecured lending rates and therefore replaceable by the SRR within the E.U. In the case of cross-border contracts, the question of what the terms of the contract mean should be decided according to governing law of the contract, which entails that the SRR will not be automatically incorporated into a contract with an E.U. supervised entity where that contract is governed by English law and that may cause a surprising and possibly chaotic result as far as the entity itself is concerned. Moreover, since the Legislative Proposal does not explain how "by operation of law" is to be interpreted, there may be some confusion as to whether the provisions impliedly derogate from the choice of law rules in Article 12 of Regulation (EC) No 593/2008 on the law applicable to contractual obligations (the "**Rome I Regulation**"), which provide that the interpretation and performance of a contract is governed by its applicable law.

Contracts involving E.U. entities with overseas elements could, in theory, be subject to competing interpretations as to which floating price can be strongly supported (the screen price established under the Financial Services Bill or the SRR), leading to confusion and possible litigation. This concern is exacerbated for market participants by the fact that other jurisdictions, including, for example New York, are also considering legislation to incorporate a successor rate by operation of law into contracts.[5] The proposed legislation will establish, for the purposes of any dispute, that a recommended benchmark replacement is a commercially reasonable substitute to LIBOR. It will, for example, override existing fallback language that references a

LIBOR-based rate and instead require the use of the legislation's recommended benchmark replacement. While this does not raise factual questions about whether LIBOR has been discontinued, the application of the legislation may be questioned in cases where, as described above, there are conflicting positions taken between regulators in the E.U. and U.K. about whether or not LIBOR has been discontinued.

The FMLC takes the view that careful coordination between regulators in the E.U., U.K. and Third Countries around the discontinuance of LIBOR and the exercise of any powers to alter the identity of the benchmark and/or the terms of financial transactions is essential to avoid significant market confusion.

Proposed Exemption for Spot FX Rates in Restricted Currencies

The Legislative Proposal provides an exemption from the regime for spot FX rates in restricted currencies. One criterion which needs to be satisfied to fall under the exemption is that

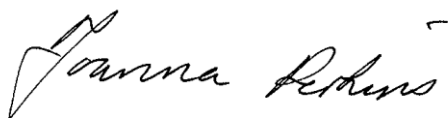
> supervised entities use the foreign exchange benchmark on a frequent, systematic and regular basis in derivative contracts for hedging against third country currency volatility.

This is to be further defined in another Delegated Act. The criteria is, however, likely to give rise to a lack of clarity as to which rates will qualify for the exemption under the European Commission's initial assessment and until the further Delegated Act is adopted. This will leave market participants little time to prepare for the end of the transitional period if key rates are not included in the exemption.

The Legislative Proposal also places a reporting requirement upon Competent Authorities to support the determination of which spot FX rates are to be included in the exemption.[6] The data on which Competent Authorities will base their reports is unclear. Industry bodies have previously drawn attention to challenges in respect of the quality of data reported under other pieces of existing E.U. legislation.[7] Additional uncertainties will arise in relation to non-deliverable contracts, such as a non-deliverable forward ("**NDF**"), which may be used for different purposes that are not recorded at the time of execution. The Legislative Proposal's requirement that it be demonstrated where spot FX rates are used to hedge against adverse foreign spot exchange rate movements will be difficult to satisfy and will, consequently, require the development of a new test by which the purpose for which NDF contracts is determined.

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 should you wish to arrange a meeting or if you have any questions.

Yours sincerely,



Joanna Perkins
FMLC Chief Executive

[1] During the transitional period, E.U. benchmark providers may apply for authorisation 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.

[2] 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.

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

[4] Rishi Sunak (The Chancellor of the Exchequer), *Financial Services Regulation: Written statement - HCWS309*, (23 June 2020), available at: https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS309/

[5] See *ARRC Executive Summary of Proposed Legislative Solution to LIBOR Transition*, (NY, 6 March 2020) available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf and *ARRC Proposed Legislative Solution Press Release*, (NY, 6 March 2020), available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Proposed_Legislative_Solution.pdf.

[6] The FMLC has commented previously on issues of legal uncertainty arising in the context of the then-proposal for the BMR, with particular reference to non-deliverable forward ("NDF") contracts referencing emerging markets currencies ("EMCs"). FMLC, *Letter to European Commission: Non-deliverable Forward Rate Sources* (16 October 2015), available at: http://fmlc.org/letter-to-european-commission-benchmark-reform-16-october-2015/

[7] This includes reporting under Regulation (EU) No 600/2014 on markets in financial instruments ("**MiFIR**") and under Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**").