3 March 2015

Jonathan Faull
Director General, DG Internal Market and Services
Rue de Spa 2
1000 Brussels, Belgium

FINANCIAL MARKETS LAW COMMITTEE

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).

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administrator acquires prior recognition by the competent authority of its Member State of reference in accordance with this Article.

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.

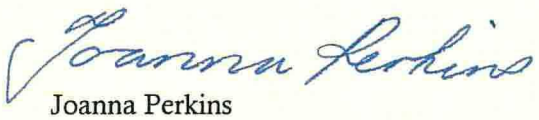
Solutions

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,



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