The EU Benchmarks Regulation

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DEVELOPING ASIAN CAPITAL MARKETS

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1 EXECUTIVE SUMMARY

This paper provides a high level summary for non-EU benchmark administrators (**Non-EU Administrators**) on how the EU Benchmarks Regulation (the **BMR**) will impact benchmark administrators and users (both in the EU and outside the EU) and how Non-EU Administrators can register in the EU in order to avoid disruption to their businesses and the markets.

The BMR prohibits EU regulated entities from "using" an unregulated third country benchmark in the EU from 1 January 2020. If regulated entities in the EU (e.g. banks, asset managers, funds, intermediaries and insurance providers) are unable to use unregulated benchmarks, EU end-users will also cease to have effective access, via EU market participants, to these benchmarks which could hinder inward investment into the Asia-Pacific (**APAC**) region (as such investment cannot be hedged). In addition, "use" of a benchmark is defined very broadly, meaning that APAC activities may be captured by the BMR, as we explain below.

The BMR enters into force on 1 January 2018. However, Non-EU Administrators will benefit from a transitional period allowing the use of non-EU benchmarks within the EU until 1 January 2020. The European Securities and Markets Authority (**ESMA**) has clarified that this transitional period applies to all benchmarks used in the EU on or before 1 January 2020. However, after 1 January 2020, only the benchmarks of Non-EU Administrators who have already obtained registration may be used within the EU. However, there may be a substantial lead time in obtaining registration. Additionally, regulated entities in the EU are required to put in place contingency plans from 1 January 2018 as to how they would address the cessation of the provision of a benchmark which they rely upon. Where Non-EU Administrators do not make significant progress towards registration in advance of the 1 January 2020 deadline, these contingency plans are likely to involve looking for alternatives to non-EU benchmarks.

In July 2017, ASIFMA and Herbert Smith Freehills conducted a survey of Non-EU Administrators in the APAC region to assess the extent to which their benchmarks are likely to be affected by the BMR and whether they intend to register their benchmarks in the EU. Three-quarters of the participating administrators have benchmarks used in the EU and yet it is unclear whether they will obtain registration. Further findings from this survey are highlighted below.

This paper therefore sets out: (1) an overview of the BMR for Non-EU Administrators; (2) the consequences of the BMR on EU and global markets if Non-EU Administrators do not successfully register their benchmarks; and (3) a roadmap for the different routes available for registration.

Ultimately, there is a risk that many firms and individuals will be denied access to financial instruments and contracts which reference non-EU benchmarks, including derivatives, loans, bonds and mortgages. In the short-term, this is likely to give rise to liquidity, market access and contractual issues. Longer term, there is a risk that EU market participants will switch to alternative benchmarks if administrators in the APAC region are unable or unwilling to register their benchmarks.

We urge Non-EU Administrators and APAC regulators to recognise these concerns and agree upon a path forward. We encourage dialogue with the European Commission, as well as with ESMA, in respect of the broader issues discussed in this paper.

2 OVERVIEW OF THE BMR

Summary of BMR

The BMR introduces a harmonised set of rules on benchmarks across the EU. It sets out an authorisation process for EU benchmark administrators, sets out rules applicable to those who contribute or provide submissions to a benchmark, and prohibits use in the EU of a benchmark that is not authorised or registered. Additional rules apply to benchmarks deemed to be significant or critical.

What is a benchmark according to the BMR?

The BMR generally defines a **benchmark** as any *index* which is referenced in a financial instrument (e.g. an option, forward, future or other derivative, note or equity product which is traded on a trading venue) or a financial contract (i.e. a regulated mortgage or credit agreement) in order to determine the amount payable under that contract or determine the value of a financial instrument. For investment funds a benchmark is any index referenced in a financial instrument to measure the performance of an investment fund (i.e. a UCITS or an Alternative Investment Fund) with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees.

An **index** is then defined to mean any figure that is published or *made available to the public*, that is regularly determined: (i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and (ii) on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values and surveys. Interest rate, fixed income and equity indices may be covered by this definition.

An index is **made available to the public** if it is made accessible to a potentially indeterminate number of people either directly or indirectly. Where a recipient of a benchmark provides this onwards to one or more of their own clients, and these clients may provide the benchmark to other third parties, the benchmark may be deemed to be made available to the public. This may raise issues in relation to the sharing of benchmarks with private wealth clients, depending on the number of clients the benchmark is shared with and the degree to which these clients might themselves disseminate it more broadly.

In summary the BMR is very broad in its approach to identifying benchmarks and the definitions would include proprietary indices, which are often used in the private wealth context. There is currently some uncertainty as to whether baskets, portfolios or strategies which are used to determine the value of a financial instrument are "benchmarks" within the meaning of the BMR.

Whom does the BMR apply to?

The BMR applies to EU "supervised entities" in relation to their "use" of a benchmark. These entities include EU banks, investment firms (broadly equivalent to entities regulated by the Securities and Futures Commission in Hong Kong or which hold a capital markets services licence in Singapore), UCITS, UCITS management companies, Alternative Investment Fund Managers (**AIFMs**), insurance providers and exchanges and markets. End-users of benchmarks, such as investors or consumers, will also be affected by extension.

What does "use of a benchmark" mean?

Use of a benchmark means:

- issuance of a financial instrument which references an index or a combination of indices;

- determination of the amount payable under a financial instrument or a financial contract by referencing an index or a combination of indices;
- being party to a regulated credit agreement or mortgage which references an index or a combination of indices;
- providing a borrowing rate in a regulated credit agreement or mortgage calculated as a spread or mark-up over an index or a combination of indices and that is solely used as a reference in a financial contract to which the creditor is a party; or
- measuring the performance of an investment fund through an index or combination of indices for the purpose of tracking the return of such index or combination of indices, of defining the asset allocation of a portfolio, or of computing the performance fees.

The "use" must occur in the EU. However, the meaning of "in the EU" is not clear and and as a result the APAC operations of EU supervised entities may be caught. For instance, the issuance of a note within the EU by an EU bank that is then sold into the APAC region could be caught, as even if the secondary market in the notes is in APAC, the initial issuance takes place in the EU. Similarly, derivatives contracts entered into by APAC counterparties with EU counterparties, or even APAC branches of EU counterparties, could also be in scope. It is not clear whether further guidance will be issued on what constitutes "use".

Based on ASIFMA's benchmarks survey conducted in August 2016, there are at least 55 important benchmarks used in the APAC region that stand to be affected by the BMR, including several in Asia's largest markets – Japan, Hong Kong and South Korea. We understand that many Non-EU Administrators within the APAC region currently administer non-EU benchmarks that are currently "used" in financial instruments in the EU, as well as by EU supervised entities outside the EU. We therefore expect that the BMR will have an impact on the markets for those products in the EU (and, ultimately, the end-users of benchmarks such as investors or consumers), if measures are not taken to permit the use of these non-EU benchmarks under the BMR.

ESMA has recently updated its Q&A to indicate that the BMR does not apply to the provision of benchmarks that are exclusively used outside the Union. The meaning of "exclusively used outside the Union" is unclear and remains problematic. This lack of clarity exacerbates the difficulty faced by Non-EU Administrators in understanding the impact of the BMR on their operations.

Do any exceptions apply?

The BMR will not apply to EU and non-EU central banks, and certain other limited persons, including public authorities such as national statistics agencies.

3 CONSEQUENCES OF NON-REGISTRATION

Based on the ASIFMA/Herbert Smith Freehills survey, there are concerns that a number of Non-EU Administrators will not register their benchmarks before 1 January 2020, or at all. This is due to a number of factors. For example, 18% of participants do not consider that their business models would be adversely impacted if their benchmarks are no longer used in the EU, whilst another 36% said that the impact was "*not possible to determine*". One participant took the view that its activities are not within the scope of the BMR. 36% of participants also consider that the process for seeking registration is unclear or too complex and one participant was disappointed with the lack of engagement by EU regulators on the impact of the BMR on Non-EU Administrators.

Unless action is taken, there will likely be fewer non-EU benchmarks available for reference purposes in the EU once the transitional period has expired. Indeed, it is likely that the move away from non-registered benchmarks will begin before 1 January 2020 as EU supervised entities pre-empt the consequences of the BMR and switch to alternative benchmarks. This gives rise to several significant issues set out below, several of which were highlighted by the survey participants.

Market liquidity and fragmentation

If certain non-EU benchmarks can no longer be used by affected EU entities, this may adversely affect the liquidity of APAC products which reference these benchmarks as a substantial portion of the relevant market for such products will disappear. This will further exacerbate market fragmentation issues currently arising from other regulatory developments such as MiFID II. It is anticipated that even a small decrease in the number of available benchmarks will have a significant impact on liquidity.

Market power and access issues

A reduction in the number of non-EU benchmarks in an EU jurisdiction may increase the market power of those "surviving" benchmark administrators. However, this will be less problematic in jurisdictions where benchmarks are provided by industry associations free of charge.

It is likely that EU entities will end up switching to alternative benchmarks, moving away from indices like the Hang Seng and Nikkei indices, further exacerbating market fragmentation issues. However, in many instances there may not be a suitable alternative benchmark and the EU participants may therefore withdraw from the market.

Market expectations and reputation risk

Financial institutions (including those in APAC) are increasingly expecting benchmark administrators to meet global standards, namely the IOSCO *Principles for Financial Benchmarks* or, where applicable, with the IOSCO *Principles for Oil Price Reporting Agencies* (together the **IOSCO Principles**). Significant global divergence may result in market participants globally reducing their exposures to non-compliant benchmarks. Conversely, administrators which already meet these requirements may benefit from a “first mover” advantage. In light of past issues with benchmark manipulation, there is increasing scrutiny on a benchmark’s governance, quality and accountability mechanisms from both regulators and financial institutions.

Concentration risk

There are a number of ways in which concentration risk may develop. A decrease in the number of benchmarks being relied upon or referenced will increase concentration risk associated with each of the "surviving" benchmarks as the volume of transactions using these benchmarks increase. Similarly, where only some Non-EU Administrators in the APAC region seek registration, this will lead to concentration risk as EU firms shift towards using registered benchmarks.

In addition, EU firms may increasingly rely on benchmarks administered by EU benchmark administrators while entities outside the EU rely on those benchmarks administered by Non-EU Administrators, thereby potentially resulting in the build-up of systemic risk at a regional level in relation to those benchmarks.

Hedging risk

The ability of EU banks, corporates and investment institutions to hedge interest rate and other risks may be severely impacted as important products currently used for hedging purposes will no longer be available. If EU registered administrators respond to the BMR by launching new benchmarks to replace those

benchmarks which are currently administered by Non-EU Administrators, then this decreased ability to hedge may only cause problems in the short term.

However, during this period of uncertainty, while banks may be able to bear this risk (potentially at a capital cost), many end-users may choose not to take on such risks and may pass the underlying and associated costs onto their commercial contractual counterparties who presumably have an APAC nexus. The building of liquidity in new EU-compliant benchmarks may lead to either whole market shifts or market fragmentation.

Loss of investment

An EU investment fund investing in Asian stock markets may traditionally buy a put option on an Asian stock index to hedge against the risk of the index falling. If the put option is classified under the BMR as a financial instrument and the Asian stock index is not registered as a benchmark for use in the EU under the BMR, that fund's manager may not be able to buy the put option. Deprived of that hedging opportunity, the fund may have to reconsider how much it invests in Asian stock markets.

Contractual issues

The BMR raises complex questions in relation to existing bespoke contracts involving EU supervised entities which "use" non-EU benchmarks. The transitional provisions may mitigate this issue by providing a grace period for existing benchmarks until 1 January 2020, by which point many of these existing contracts may have expired.

However, this does not address the issue of new contracts which extend beyond the end of the transitional period. If non-EU benchmarks are no longer permitted to be used beyond the end of this period, then this may, depending on the relevant contractual documentation, constitute a termination event. Additionally, where benchmark administrators respond to the BMR by simply ceasing to supply specific benchmarks (on the basis, for example, that seeking registration is not cost-effective), this may potentially also constitute a termination event. We note that renegotiating contracts to mitigate the impact of a change in benchmark is likely to be complex and time-consuming.

Given the potential impact on contractual arrangements, users of benchmarks must put in place certain written plans setting out the actions that they would take in the event that the benchmark materially changes or ceases to exist. Where possible and appropriate, these plans should identify a replacement benchmark and explain why such replacement benchmarks are deemed suitable alternatives. The BMR requires that these contingency arrangements be reflected in contracts with clients.

These contingency arrangements must be in place by **1 January 2018**. As a result of this requirement, financial institutions must look at alternative APAC benchmarks and review whether they are suitable for use to meet regulatory and market expectations, as noted above.

Impact on asset managers

The BMR is also likely to impact on asset managers operating in the APAC region, who will need to review their funds to assess whether they are "using" any benchmarks within the meaning of the BMR.

Funding issues

The BMR may cause funding issues for APAC banks where those banks raise funding from EU regulated entities through swaps based on non-EU benchmarks.

4 REGISTRATION OPTIONS FOR NON-EU ADMINISTRATORS

What are the options for obtaining registration of a non-EU benchmark within the EU?

There are three options to obtain registration of a non-EU benchmark in the EU. Each of these mechanisms will permit a non-EU benchmark to be "used" by EU firms and funds and are as follows:

- **Equivalence**: the European Commission can adopt an equivalence decision which declares that the legal framework and supervisory practice of the local jurisdiction is "equivalent" to the regime established by the BMR;
- **Recognition:** a "home" EU Member State regulatory authority can "recognise" a specific Non-EU Administrator if an application is successful. This will require substantial compliance with the BMR; or
- **Endorsement:** a non-EU benchmark or group of benchmarks can be "endorsed" by an EU benchmark administrator, or another regulated entity within the EU that has a clear and well-defined role within the accountability framework of the relevant Non-EU Administrator.

Recognition was the option most Non-EU Administrators who participated in the ASIFMA/Herbert Smith Freehills survey said that they would pursue, although an equal number were still unsure. One participant felt that the three options were not defined clearly enough whilst another said that they are "*difficult and costly for us to proceed*". All three options raise their own challenges and further dialogue will be needed to ensure all administrators can successfully register.

In relation to equivalence, while some APAC regulators have introduced legislation to facilitate seeking equivalence, it is unlikely that all APAC regulators are either willing or capable of doing so before 1 January 2020. As such, equivalence is unlikely to be a viable solution for all Non-EU Administrators in APAC. This is the case even though equivalence requires adherence to certain IOSCO principles which banks and other institutions are already considering as constituting market practice and which Non-EU Administrators should already be reviewing and working towards.

As discussed further below, both recognition and endorsement require a representative in the EU to be accountable to EU regulatory authorities for the conduct of a Non-EU Administrator and it will be difficult for Non-EU Administrators without EU affiliates to find anyone willing to take on this role. This is particularly likely to be the case in relation to endorsement, given the significant obligations imposed on the EU representative (as discussed further below). It is still unclear as to how onerous the requirements will be for EU representatives of firms which seek and obtain recognition.

Further, the ASIFMA/Herbert Smith Freehills survey of Non-EU Administrators indicated that there was significant variation in relation to the data available to these administrators as to the use of their non-EU benchmarks within the EU. In particular, only 18% of participants indicated that data regarding the location of EU trading venues on which instruments referencing their benchmarks were admitted to trading or traded for the first time was available; the same figure said that they knew the location of EU supervised entities using their benchmarks. As discussed below, this information is an important part of applying for recognition and as such, lack of knowledge will raise further challenges in applying for recognition. This may be mitigated by recent EU proposals which suggest that recognition of third country benchmarks may be overseen directly by ESMA so that Non-EU Administrators need not have to choose a Member State for application and supervision purposes. However, these proposals are not finalised and need to be monitored.

Equivalence: what are the requirements?

Equivalence requires an application to be made to the European Commission by the regulator in the relevant non-EU jurisdiction (**Non-EU Regulator**). In order to adopt an equivalence decision, the European Commission has two options.

First, it can declare equivalence on the basis that administrators authorised in the relevant non-EU jurisdiction comply with binding requirements which are equivalent to the requirements under the BMR, in particular taking into account whether the legal framework and supervisory practice of the non-EU jurisdiction ensures compliance with the IOSCO Principles. These binding requirements must be subject to effective supervision and enforcement on an on-going basis in the relevant non-EU jurisdiction.

The second option for equivalence is where the European Commission is satisfied that binding requirements with respect to specific Non-EU Administrators or non-EU benchmarks (or families of benchmarks) are equivalent to the requirements under the BMR, and that those requirements are subject to effective supervision and enforcement.

The need for equivalence between the BMR and the relevant local regime under both options requires binding requirements in respect of benchmark regulation in the third country jurisdiction. A "binding" requirement could mean that overarching benchmark regulation is needed in the jurisdiction in which the Non-EU Administrator is located. Such regulation does not exist in many APAC jurisdictions.

In addition, ESMA is required to establish cooperation arrangements with relevant Non-EU Regulators in the relevant non-EU jurisdiction. The purpose of these cooperation arrangements is, very broadly, to establish mechanisms for the exchange of information between ESMA and Non-EU Regulators, and to allow ESMA to be notified in the event that a relevant Non-EU Administrator is in breach of local requirements. However, as discussed above, it is unlikely that cooperation agreements will be entered into with all APAC regulators before 1 January 2020.

Recognition: what are the requirements?

In order to use the recognition route, the Non-EU Administrator needs to be recognised by the regulator located in the "Member State of reference". There are a number of criteria for identifying the Member State of reference, set out in the BMR. These are relatively complicated, but in short:

a) where the Non-EU Administrator is part of a group that contains an EU regulated firm, the Member State of reference is the jurisdiction in which that firm is located;

b) where the Non-EU Administrator is not part of a group, where one or more benchmarks provided by that Administrator are referenced in financial instruments which are admitted to trading in one or more Member States, the Member State of reference is the jurisdiction in which the relevant financial instrument was admitted to trading or traded for the first time and is still traded. We would recommend Non-EU Administrators contact trading venues in the first instance to obtain any information needed in this regard, although for over-the-counter contracts such information may be difficult to obtain;

c) Where neither (a) nor (b) apply, where one or more benchmarks provided by the Non-EU Administrator are used by entities in more than one Member State, the Member State of reference is the jurisdiction in which the highest number of those entities are located. Non-EU Administrators will need to ensure that they have the relevant data available in order to determine their Member State of reference, if they seek recognition.

There is a draft European Commission proposal dated 20 September 2017 to amend the BMR to establish ESMA as the competent authority for the recognition and approval of endorsements of third country administrators and benchmarks. Whilst these proposed amendments would benefit Non-EU

Administrators, they are still in a proposal stage and cannot be relied upon. There is unlikely to be clarity as to whether these proposed amendments will be adopted until the latter half of 2018 at the earliest.

Once the Member State of reference is identified, the Non-EU Administrator must apply directly to the regulator of that Member State for recognition. The applicant Non-EU Administrators must have appointed a legal representative within their Member State of reference to act on their behalf in respect of the EU regulatory and other authorities and to perform an oversight function over the Non-EU Administrator.

Once recognised, a Non-EU Administrator will be required to comply with most of the requirements of the BMR on an ongoing basis. The administrator can meet this requirement by applying the relevant IOSCO Principles provided such application is equivalent to the BMR. However, compliance with the IOSCO Principles is itself not sufficient. Certification of compliance with the relevant IOSCO Principles must be provided by either an independent external auditor or, if the administrator is supervised by a competent authority of a third country, certification from that competent authority.

Endorsement: what are the requirements?

An administrator located within the EU, or another regulated entity within the EU that has a clear and well-defined role within the accountability framework of the relevant Non-EU Administrator (each an **EU Endorsing Entity**) can "endorse" a non-EU benchmark, such that the relevant non-EU benchmark is considered to be a benchmark provided by the EU Endorsing Entity.

Endorsement imposes some fairly material obligations on the EU Endorsing Entity, as follows:

- The EU Endorsing Entity needs to have verified, and be able to demonstrate on an ongoing basis to its own regulator, that the provision of the non-EU benchmark fulfils requirements which are at least as stringent as those set out in the BMR;
- The EU Endorsing Entity needs to have the necessary expertise to monitor the activity of the provision of the non-EU benchmark by the Non-EU Administrator, and manage the associated risks;
- There needs to be an objective reason to provide the non-EU benchmark in a third country and for that benchmark to be endorsed for use in the EU – the Commission is empowered to make regulations as to when such an objective reason may be deemed to exist.

Applications for endorsement are made by the EU Endorsing Entity itself.

The endorsement route is dependent on an EU Endorsing Entity coming forward to provide the relevant endorsement, and in the absence of any affiliated entities seeking to take on this role, then this route may be of less use, especially given the requirement on the EU Endorsing Entity to verify and demonstrate compliance by the Non-EU Administrator with the BMR, monitor the Non-EU Administrator's activities and manage the associated risks.

What is the approach of the APAC and EU regulators?

APAC

A number of APAC regulators are currently considering this area. However, the only APAC regulator to have publicly announced plans to regulate benchmarks is the Australian Securities and Investments Commission (**ASIC**), which has recently concluded its consultation process in relation to the introduction of benchmarks regulation. ASIC has stated that the expeditious implementation of an Australian benchmarks regulation regime is intended to ensure that there is adequate time to seek equivalence with EU regulators.

The Australian regime will focus, at least initially, on five significant benchmarks. ASIC has stated that it does not consider there to be a sizeable number of non-significant benchmarks which will fall outside the scope of its regulatory regime (and therefore may not be able to establish equivalence for the purposes of the

BMR). Administrators of non-significant benchmarks will be able to apply for a licence. However, ASIC has indicated that in deciding whether to grant a licence, it will take into consideration whether the benchmark has some connection to Australia, or has some potential benefit for the Australian financial system or Australian investors. This is on the basis that the decision to grant a licence to the administrator of a non-significant benchmark will require the dedication of regulatory resources.

EU

ESMA has drafted technical standards for cooperation agreements with third countries but these are not yet endorsed by the European Commission. The ESMA Securities and Markets Stakeholder Group have recommended that ESMA should provide a quarterly progress report on third-country benchmark recognition from 1 January 2018 and ideally provide transparency to the market on pending approvals before that date.

As noted above, there is a proposal to establish ESMA as the competent authority for the recognition and approval of endorsements of third country administrators and benchmarks. However, this is still in a proposal stage and cannot be relied upon.

The EU's impact assessment document on this proposal states that the endorsement or recognition of third country benchmarks by ESMA would therefore avoid national competent authorities having to develop and maintain capacities for these tasks. Such capacities would instead be pooled in one authority which would allow to benefit from economies of scale and to exploit learning curves. This would ensure a harmonised approach vis-à-vis administrators of third country benchmarks, their contributors and their users in the EU. Also, in view of the United Kingdom leaving the EU, a smooth but reliable third country regime would be crucial to ensure that the use of third country benchmarks by supervised entities in the EU is not unnecessarily disrupted once the transitional period of the BMR expires.

4 IMPACT

As set out above, the wide-ranging impact of the BMR and the difficulties involved in each of the registration options means that there is ultimately a risk that many firms and individuals will be denied access to financial instruments and contracts such as derivatives, loans, bonds and mortgages which reference non-EU benchmarks. This is likely to give rise to, in the short term, liquidity, market access and contractual issues. In the longer term, there is a risk that EU market participants will switch to alternative benchmarks if administrators in the APAC region are unable or unwilling to register their benchmarks.

We urge Non-EU Administrators and APAC regulators to recognise these concerns and agree upon a path forward. We encourage dialogue with the European Commission, as well as with ESMA, in respect of the broader issues discussed in this paper.