The EU Benchmarks Regulation and Asia:
Hurdles Rise as the 2020 Deadline Nears

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1 EXECUTIVE SUMMARY

The EU Benchmarks Regulation (the **BMR**) took effect on 1 January 2018, and will prohibit EU supervised entities from "using" an unregulated third country (i.e. non-European) benchmark in the EU from 1 January 2020.

As such, we are rapidly approaching the halfway point of the two-year transitional period established under the BMR for administrators to seek to register their benchmarks for use within the EU post-1 January 2020. However, there have to date been no successful applications for registration by non-EU benchmark administrators (**Non-EU Administrators**) of their benchmarks for use within the EU post-1 January 2020 and, as discussed in ASIFMA and HSF's previous reports on this subject, considerable concern remains among administrators about how to apply for registration and what the impact will be if they fail to do so.

This is consistent with the results of the second survey by ASIFMA and HSF of benchmark administrators across the Asia-Pacific (**APAC**) region. Conducted in August 2018, the survey found that while 86% of administrators intend to seek to register their benchmarks for use, there is still widespread uncertainty as to which of the registration options are most feasible. The uncertainty associated with these options has been compounded further by continued delays by European bodies in relation to the adoption of technical standards relevant to these options. As such, there is a significant risk that a number of Non-EU Administrators will fail to obtain registration of their benchmarks by 1 January 2020.

This paper considers each of the three options available to Non-EU Administrators – namely, equivalence (as addressed in Section Two), recognition (Section Three) and endorsement (Section Four) – and the issues encountered by administrators during the course of 2018 in grappling with each of these potential options. In short:

- it appears unlikely that even those jurisdictions that have announced plans to seek equivalence will successfully obtain an equivalence decision by 1 January 2020, and as such many administrators in these jurisdictions are actively considering recognition and/or endorsement as fall-back plans;
- Non-EU Administrators still struggle to identify their EU Member State of reference, as well as to engage a legal representative located within that Member State. These difficulties have been compounded by uncertainties around the impending exit of the United Kingdom (**UK**) from the EU (**Brexit**), particularly as a number of Non-EU Administrators have identified the UK as their most likely Member State of reference; and
- while endorsement may appear more flexible than recognition, Non-EU Administrators are sceptical about the ability of potential endorsing entities to discharge the stringent obligations required by this option. Further, the significant liability imposed on endorsing entities means that the number of firms willing to act as an endorsing entity is likely to be very low.

The difficulties Non-EU Administrators have experienced in navigating both recognition and endorsement is consistent with recent remarks by Tilman Leuder of the European Commission's Directorate General for Financial Stability, Financial Services and the Capital Markets Union (**DG FISMA**). Leuder noted that recognition and endorsement "have not performed according to expectations," leaving Non-EU Administrators to fall back on equivalence.

Given the continued difficulties experienced by administrators in navigating the registration options, we are deeply concerned that very few Non-EU Administrators will successfully obtain registration by 1 January 2020. As set out in our earlier reports, if large numbers of APAC benchmark administrators are unable to obtain registration by 1 January 2020, markets globally and across the APAC region are likely to suffer a significant impact. This impact includes reducing the number of benchmarks in the region and denying EU firms, and potentially some of their affiliates, access to financial instruments and contracts that reference non-EU benchmarks, including derivatives, loans, bonds and mortgages.

We therefore encourage regulators across the APAC region to engage further with their European counterparts regarding the difficulties facing Non-EU Administrators. We also encourage those market participants to take steps to review their use of benchmarks, including by identifying fall-back rates that could be used in the event currently used benchmarks fail to obtain registration by 1 January 2020.

2 ISSUES WITH EQUIVALENCE

While a number of APAC jurisdictions have introduced legislation they can use to apply for equivalence or have indicated that they will do so, it is highly unlikely that all APAC jurisdictions will be willing or able to do so before the BMR takes full effect from 1 January 2020. This is particularly problematic given statements by ESMA that the transitional period will not under any circumstances be extended beyond 1 January 2020. As such, our view is that equivalence is unlikely to be a viable solution for Non-EU Administrators in APAC, at least before the end of the transition period.

Even those jurisdictions that have already introduced benchmarks legislation are unlikely to obtain an equivalence decision by 1 January 2020, given the delays at a European level in relation to the BMR (as discussed further below). These concerns appear to be shared among administrators. While 43% of those surveyed indicated that they understood that their regulator had begun equivalence discussions with the European Commission (**EC**), these discussions were at varying stages of progress. While some regulators have been requested to submit their equivalence application and have been provided with guidelines for the application process by the EC, others have only recently commenced discussions with the EC.

While the European Commission's DG-FISMA has said it is "devoting considerable resources to equivalence," there remains significant doubt among administrators as to whether their jurisdictions will obtain an equivalence decision, with 72% responding that they either weren't sure or didn't believe that their jurisdiction would obtain an equivalence decision by 1 January 2020. Some administrators indicated that they were therefore considering recognition or endorsement as a "stopgap" measure and had begun preparing contingency plans.

Adding further complexity, there also appears to be considerable uncertainty in the market as to precisely what is required to obtain equivalence, and, in particular, whether a code of conduct or a set of guidelines for benchmarks administrators might be deemed sufficient. In this respect, the BMR itself is of some assistance, in that it provides that the EC may adopt an equivalence decision stating, relevantly, either that:

- a jurisdiction's legal framework and supervisory practice ensures that administrators in that jurisdiction are subject to binding requirements equivalent to those of the BMR and that those requirements are subject to effective supervision and enforcement on an ongoing basis; or
- binding requirements in a jurisdiction with respect to specific administrators, benchmarks or families of benchmarks are equivalent to the requirements of the BMR and that those administrators, benchmarks or families of benchmarks are subject to effective supervision and enforcement on an ongoing basis.

This suggests that the EC could consider a code of conduct sufficient, provided that the administrators, benchmarks or families of benchmarks covered by that code are subject to effective ongoing supervision and enforcement. However, in the absence of further guidance from the EC on this point, it is difficult to assess what degree of supervision and enforcement would be considered effective.

Finally, a number of administrators expressed concerns that the regulatory regimes being established in their home jurisdictions may only cover a certain sub-set of the benchmarks provided in that jurisdiction (for example, interest rate benchmarks), and as such an equivalence decision with respect to that jurisdiction may not cover all administrators.

What the above suggests is that, while some APAC jurisdictions may manage to obtain an equivalence decision by 1 January 2020, the number of jurisdictions that succeed in doing so may be small.

3 ISSUES WITH RECOGNITION

The July 2017 survey undertaken by ASIFMA and Herbert Smith Freehills prior to the coming into effect of the BMR suggested that most Non-EU Administrators surveyed would pursue recognition. However, the recent August 2018 survey indicated that while recognition remained a popular option, Non-EU Administrators have begun to move away from seeing recognition as the most feasible option, with only 14% of those surveyed identifying recognition as their clear, first preference for seeking registration.

This growing uncertainty on the feasibility of recognition reflects a number of significant hurdles. In particular, we understand that Non-EU Administrators considering recognition have encountered difficulties identifying their Member State of reference, as well as engaging a legal representative located in that Member State of reference. Additional complications stem from Brexit as well as timing issues, as discussed further below. The cumulative effect of these difficulties means that it is unlikely that a large number of non-EU Administrators will successfully obtain recognition before 1 January 2020.

Identification of Member States of reference

Article 32(4) sets out a cascading series of tests for the identification of a Member State of reference. 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. Where the Non-EU Administrator is part of a group with multiple EU-regulated firms, the Member State of reference is the jurisdiction in which the most EU-regulated firms are based;

b) where the Non-EU Administrator is not part of a group, and where one or more benchmarks provided by that Administrator are referenced in financial instruments that have been 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;

c) Where neither (a) nor (b) apply, and 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.

As the BMR requires Non-EU Administrators to appoint a legal representative based in their Member State of reference, the identification of the Member State of reference is an essential first step in the recognition process. However, it is clear from the August 2018 ASIFMA-Herbert Smith Freehills survey that many Non-EU Administrators have struggled to clear this hurdle due to a lack of data regarding the location of:

- the EU trading venue on which instruments referencing their benchmarks were admitted to trading or traded on a venue for the first time and the volume of instruments traded on those venues; and
- EU supervised entities using their benchmarks and the volume of financial instruments traded by those entities.

Only 20% of Non-EU Administrators surveyed indicated that they were already in possession of this type of data, while only 25% indicated that they were in the process of trying to obtain such data. This suggests that for a number of Non-EU Administrators, this first step in the recognition process may well pose a significant roadblock.

Engaging a legal representative in the Member State of reference

Although a number of the Non-EU Administrators surveyed indicated that they had begun searching for a legal representative in their Member State of reference, none had yet successfully engaged a legal representative. A number of those surveyed indicated that cost, as well as a lack of interest from potential legal representatives, had been significant obstacles in their search for a firm to take on this role.

This is consistent with recent comments by DG-FISMA that the status and scope of the tasks required by a legal representative are proving impractical and expensive, leading DG-FISMA to conclude that recognition (as well as endorsement, discussed further below), have not performed "according to expectations."

Impact of Brexit

A number of the Non-EU Administrators surveyed indicated that they considered their Member State of reference to be the UK. This raises a number of issues for these Non-EU Administrators, and in particular raises the question of whether they should apply to the UK Financial Conduct Authority (**FCA**) in advance of the UK's exit from the EU on 29 March 2019. As there is still significant uncertainty in relation to the transitional arrangements that will apply after 29 March 2019, it is unclear whether those Non-EU Administrators that successfully obtain recognition from the FCA before 29 March 2019 will be considered to have obtained registration under the BMR post-Brexit. If there are no transitional arrangements in place for those Non-EU Administrators registered with the FCA, it seems likely that these administrators will need to seek recognition from the EU member state that becomes their Member State of reference after Brexit.

Given this, we encourage Non-EU Administrators that do consider the UK to be their Member State of reference to take steps to identify what their Member State of reference will be post-Brexit. However, as the BMR provides that an application for recognition can only be made to an administrator's Member State of reference, Non-EU Administrators that identify their post-Brexit Member State of reference as being, for example, France or Germany, will not be able to formally apply for recognition from the NCAs of these jurisdictions until after 29 March 2019. That said, this does not preclude administrators engaging with these NCAs on an informal basis, or taking steps to prepare an application for submission post-29 March 2019.

However, as the UK's Great Repeal Act imports existing, directly applicable EU law into UK law, and as such imports the BMR, Non-EU Administrators should also consider whether they wish for their benchmarks to be used within the UK (as well as within the EU) post-Brexit. Given London's status as a financial centre, we anticipate that many Non-EU Administrators are likely to do so. If the Brexit deal negotiated between the UK and the EU does not provide for recognition of those benchmarks registered in the EU under the BMR, then Non-EU Administrators that want their benchmarks to be usable within the UK will likely need to seek recognition by the FCA under the UK's "imported" BMR. Unless a deal is reached to the contrary between the UK and the EU, this recognition by the FCA would presumably be in addition to recognition by the NCAs of the post-Brexit EU Member State of reference.

Timing and delay

A number of Non-EU Administrators are concerned about potential delays in the recognition application process, and in particular whether these delays may mean that any approval is received only shortly prior to 1 January 2020 (causing market upheaval) or is not received before 1 January 2020.

The BMR does provide some certainty around the timing of the recognition approval process, as it gives NCAs 90 working days to assess an application for recognition, which can be extended by one additional month. However, this means that Non-EU Administrators that aim to be recognised by 1 January 2020 at latest will need to submit an application by approximately July 2019 at the latest. Given that we anticipate that in the lead up to 1 January 2020 there is likely to be significant market upheaval as market participants complete their final preparations for the full impact of the BMR and move away from those benchmarks that have not obtained registration in advance of 1 January 2020, we strongly recommend Non-EU Administrators apply well in advance.

These concerns around timing have been compounded by continued delays to the EC's adoption of the regulatory technical standards (**RTS**) specifying what information Non-EU Administrators need to provide as part of their recognition application. While the draft RTS prepared by ESMA was submitted to the EC in March 2017, the EC has yet to endorse the RTS. We anticipate that continued delays in the endorsement of the RTS will continue to delay the publication of application recognition forms by Member State NCAs.

4 ISSUES WITH ENDORSEMENT

The final registration option available to Non-EU Administrators is endorsement. This option requires an administrator located within the EU, or another EU supervised entity with a "clear and well-defined role" within the accountability framework of the relevant Non-EU Administrator (**EU Endorsing Entity**) to "endorse" a non-EU benchmark.

Unlike recognition, endorsement does not require that an EU Endorsing Entity be located in a Member State of reference, and from this perspective endorsement may appear to be a more viable option for Non-EU Administrators than recognition, particularly given the issues outlined above in relation to identifying a Member State of reference.

However, as discussed in our earlier papers, endorsement imposes significant obligations on the EU Endorsing Entity, including that:

- 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 at least as stringent as those set out in the BMR; and
- 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.

Given these obligations, it is unsurprising that 86% of administrators surveyed said that they believed either that no entity eligible to act as an EU Endorsing Entity would be willing to act as their EU Endorsing Entity, or that they "weren't sure" if any eligible entities would be willing to do so. Further, none of the administrators surveyed said they considered it feasible for an EU Endorsing Entity to discharge the above objectives in practice. Navigating these obligations is further complicated by a lack of guidance as to what constitutes a “clear and well-defined role within the control or accountability framework of the benchmark” and the criteria EU NCAs will use to evaluate whether an entity discharges this obligation and can be considered an EU Endorsing Entity.

While many Non-EU Administrators have had preliminary discussions with firms that could potentially act as EU Endorsing Entities, such discussions have been hampered further by concerns about the legal liability associated with acting in this capacity. Under article 33(4) of the BMR, an endorsed benchmark shall be considered to have been provided by the EU Endorsing Entity, which will be considered “fully responsible for the benchmark and for compliance with the obligations” imposed by the BMR. We anticipate that this responsibility will continue to be a significant deterrent to would-be EU Endorsing Entities, or, the extent that firms are willing to act in this capacity, we expect them to come at a significant price. This is consistent with recent remarks by DG-FISMA that not "many" firms were willing to take on this responsibility and that "endorsement has not gone to plan." Our view is that it is likely that the majority of firms willing to act as an EU Endorsing Entity are those EU benchmark administrators or EU-supervised entities that are part of a corporate group containing a Non-EU Administrator. We anticipate that pricing and liability issues will be significantly less likely to be roadblocks in this context.

We note that there are also additional concerns among administrators of interest rate and currency indexes regarding the viability of pursuing endorsement on the basis that outsourcing of these indexes may raise sovereignty issues.

What the above suggests is that, while endorsement may have some superficial appeal over recognition because it does not require Non-EU Administrators to identify a Member State of reference, it is highly unlikely to be a viable registration option for a large number of Non-EU Administrators.