The EU Benchmarks Regulation and the APAC Region: Keeping Up the Momentum

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1 EXECUTIVE SUMMARY

The two year extension to the EU Benchmarks Regulation (**BMR**)'s transitional period for third country benchmark administrators (**Non-EU Administrators**) to 31 December 2021 has given some welcome breathing space to both these administrators and users of their benchmarks within the European Union (**EU**). As highlighted in our earlier reports, the complexity and uncertainty surrounding the three avenues for third country registration – equivalence, recognition and endorsement – had generated significant industry concern about whether it would be possible to achieve a smooth transfer to the BMR before the original end to the transition period on 31 December 2020. However, this extension has created new difficulties, with the transition period now scheduled to end on the same day as LIBOR is due to be discontinued. This will create a "perfect storm" of regulatory change for benchmark administrators and users as we approach the end of 2021.

Despite the extended transition period, seeking registration for benchmarks still remains a significant challenge. This was made clear by the results of the third survey by ASIFMA and HSF of Non-EU Administrators across the Asia-Pacific (**APAC**) region. Our October 2019 survey indicated that although Non-EU Administrators have warmly welcomed the two year grace period, there is still a clear need for more guidance from the European Securities and Markets Authority (**ESMA**) and the European Commission (**Commission**), particularly given that the proposed changes to the regime under the European Supervisory Agencies Review have yet to come into force under EU law.

As such, Non-EU Administrators who wish to become BMR-compliant continue to encounter practical difficulties in relation to equivalence, recognition and endorsement. This is concerning for both regulators and the market, given the potential for significant disruption if widely used third country benchmarks are no longer available. In the APAC region, a recent survey of members of the Executives' Meeting of East Asia-Pacific Central Banks (**EMEAP**) showed that regulators are concerned that the failure of Non-EU Administrators to seek registration under the BMR could potentially force EU supervised entities to exit certain markets due to the unavailability of funding and hedging instruments in EMEAP markets.

Likewise, Non-EU Administrators surveyed by ASIFMA and HSF indicated that the most likely impact if they were not able to obtain registration for their benchmarks before the end of the transition period was that some funding and hedging instruments would no longer be issued, given that a significant majority of counterparties to these instruments are EU supervised entities.

This paper considers each of the persistent difficulties encountered by Non-EU Administrators in relation to each of the three options available to them for seeking registration of their benchmarks: equivalence (as addressed in Section 3), recognition (Section 4) and endorsement (Section 5).

It is clear from the results of our survey that Non-EU Administrators continue to face many of the same issues that they have struggled with our first survey in 2017. However, the complexities of the issues encountered by these Non-EU Administrators as they seek to have their benchmarks registered for use within the EU from 1 January 2022, have been further magnified against a backdrop of major market uncertainty relating to Brexit, the current status of the ESA Review and the upcoming discontinuation of major interest rate benchmarks such as LIBOR.

2 EU CONSULTATION PROVIDES AN OPPORTUNITY FOR FURTHER CHANGE

While the two year extension to the BMR transition period has given the industry and regulators a very welcome grace period to grapple with the reforms, many questions still remain, as discussed further below. Although the Commission has previously indicated that it does not intend to make any significant revisions to the rules under the BMR, there does appear to be some regulatory appetite to explore ways to make the regime more effective, efficient and simple to administer for Non-EU Administrators.

To this end, the Commission in October 2019 released a consultation paper (**October 2019 Consultation Paper**) on the effectiveness of the BMR regime, as part of its preparation of a report for the European Parliament and the Council due on 1 April 2020 (as mandated by article 54(1)(b) of the BMR). This October 2019 Consultation Paper is aimed at assessing the need for amendment of the BMR, although we note that the Commission has previously indicated that it does not intend to propose significant reforms to the substance of the BMR. Responses to the Consultation Paper are requested by 31 December 2019 and we would encourage interested parties to make submissions.

In light of the above, regulators and Non-EU Administrators across the APAC region are encouraged to continue with their efforts to engage further with their European counterparts regarding the difficulties facing Non-EU Administrators, in order to bolster market awareness and readiness for the reforms. Market participants are also encouraged to take steps to review their use of benchmarks, including by identifying fall-back rates that could be used in the event that currently used benchmarks fail to obtain registration by 1 January 2022.

3 RECENT CHANGES TO THE SCOPE AND OPERATION OF THE BMR

Since our October 2018 report, the Commission has helpfully clarified various aspects of the operation of the BMR, following widespread feedback from both EU and non-EU market participants.

The European Supervisory Authorities Review

In April 2019, the EU Parliament approved the Commission's proposed further changes to the ESA Regulations (the **ESA Review**). Relevantly, the ESA Review provided ESMA with new supervisory powers, including the power to act as sole authorising body for Non-EU Administrators. Once enacted, this will remove the need to identify a Member State of Reference as part of the process for applying for recognition. As discussed further below in section 3, the ESA Review has also resulted in proposed changes to the equivalence regime set out in the BMR.

However, as at the date of publication of this report, the European Council has yet to approve the final version of changes to the ESA Regulations for publication in the Official Journal of the European Union, and it is unclear exactly when the Council intends to do so. In any event, the removal of the requirement to identify a Member State of Reference will not take effect until after the end of the transition period for Non-EU Administrators and as such will not benefit these administrators in their efforts to obtain recognition before the end of the transition period.

Exceptions to the BMR – public authorities

Section 2 of the BMR provides an exemption for central banks, as well as public authorities (such as national statistics agencies) and persons or entities performing public administrative functions or providing public services (such as measures of employment and economic activity) under the control of a government entity.

However, the scope of this exemption has been the subject of frustration across the APAC region. This is because it is not uncommon for benchmarks in APAC to be administered by bodies that, whilst they have traditionally had close engagement with central banks, and/or were established specifically to assume the role of benchmark administrator from central banks and/or regulators, are not in fact public authorities under the current BMR definition. As such they will fall outside the scope of the exemption under the BMR.

For this reason, ASIFMA and its members have warmly welcomed the Commission's September 2019 indication that it would introduce an amendment to the definition of '*public authorities*' which would expand the definition to include Non-EU Administrators of FX spot rates in relation to currencies which are not fully convertible. This is in recognition of the fact that emerging market currency FX spot rates are often the result of sovereign interventions (such as exchange controls, currency pegs or FX management by local central banks), such that local central banks should be considered the de facto administrator of the rate.

While the Commission is in the process of consulting (through the October 2019 Consultation Paper) on this proposed amendment, we consider the Commission's earlier observation that it considers such an amendment necessary to '*align the playing field*' between Non-EU Administrators and EU Administrators to be a promising indication that this amendment will be included in the broader package of amendments which are likely to be forthcoming as a result of the consultation process. The enactment of this

amendment is of particular relevance to the APAC region and will mean that EU supervised entities will be able to continue using FX spot rates for a number of emerging market currencies across the region after 31 December 2021, regardless of whether their administrators seek registration of these rates.

4 ISSUES WITH EQUIVALENCE

Given the difficulties associated with recognition and endorsement, as discussed below, equivalence has emerged as the most feasible option for Non-EU Administrators seeking registration of their benchmarks in the EU, with 50% of Non-EU Administrators surveyed indicating that they understood that their regulator intended to apply for equivalence.

However, while the Commission has helpfully published equivalence decisions for a number of APAC jurisdictions, most notably Australia and Singapore, there are still a number of challenges associated with this avenue.

Scope of equivalence decisions

The legislative and regulatory regimes implemented in Australia and Singapore only cover a certain sub-set of the benchmarks provided in those jurisdictions (mainly systemically important interest rate benchmarks), and as such, the equivalence decisions issued by the Commission do not cover all benchmarks provided in these jurisdictions. We note that Australia's regime, like New Zealand's recently enacted regime, does allow administrators to opt-in to the regime, which we consider a welcome feature of both regimes. However, regulators in jurisdictions such as Korea and India, which are currently in the process of implementing benchmarks legislation, have indicated that they intend to limit the scope of their regulatory oversight to a very small number of benchmarks considered by these national regulators to be domestically significant. Notably, only 33% of Non-EU Administrators surveyed who indicated that their jurisdiction would seek equivalence indicated that all their rates would be covered by the proposed equivalence decision, with 66% indicating either that only some or none of their rates would be covered. Given these survey results, it is hard to escape the conclusion that a significant number of Non-EU Administrators are likely to need to rely on recognition and endorsement. This issue was identified by the Commission in its October 2019 Consultation Paper, which noted that equivalence may not allow for continued use of 'the majority of indices administered outside the Union'.

To that end, the Commission has called for suggestions to improve the equivalence procedure under the BMR. Given that the scope of third country legislative regimes is a matter for third countries rather than the Commission (and given the Commission's apparent level of interest in the issue, as noted above), opportunities to improve the equivalence procedure may be limited. However, it does highlight the need for recognition and endorsement to serve as feasible alternatives for those Non-EU Administrators which may fall outside the scope of their national regimes. Non-EU Administrators face further difficulties in countries where multiple domestic regulators have jurisdiction over different types of benchmarks; for example, where equities benchmarks are supervised by a securities regulator and interest rate benchmarks are supervised by a banking regulator. These jurisdictions are likely to require separate equivalence decisions covering the different categories of benchmarks, which adds to the complexity and timeframe for any equivalence decision.

Assessing equivalence

Adding further complexity is the considerable uncertainty in the market as to precisely what is required to obtain equivalence, and the criteria the Commission will use in determining whether the relevant legislation or regulation is equivalent to the BMR.

Whilst the ESA Review has helpfully clarified that ESMA's role will be to provide advice to the Commission in preparing equivalence decisions when requested, there still remains some confusion as to the exact criteria the Commission will apply in making those decisions, beyond the IOSCO Principles for Financial Benchmarks. Worryingly, neither the Commission nor ESMA have publicly released any guidance that sets out what regulators must do in order to demonstrate that the regime ensures compliance with the IOSCO Principles. There are some limited indications that the Commission is providing such assistance privately and on an ad hoc basis, with one Non-EU Administrator surveyed indicated that the Commission had so far been '*very helpful*' in assisting with the equivalence process. However, one other Non-EU Administrator indicated that it would welcome more detailed guidance regarding the factors the Commission and ESMA will consider in relation to equivalence decisions.

5 ISSUES WITH RECOGNITION

While a majority of Non-EU Administrators surveyed by ASIFMA and Herbert Smith Freehills in July 2017 indicated that recognition was their preferred option for seeking registration, just 14% of those surveyed just over a year later in August 2018 indicated it was their preferred option. However, it is apparent from our October 2019 survey that sentiments have shifted yet again, with 50% of those surveyed Non-EU Administrators who indicated that they would seek registration indicating that they preferred recognition. Positively, the same proportion also indicated that they had taken significant steps towards recognition by engaging an external auditor to conduct an assurance review on compliance with the IOSCO Principles for Financial Benchmarks.

However, it is clear that recognition still presents significant challenges, including in relation to identification of a Member State of Reference and engaging a legal representative located in that Member State of reference.

Notably, the German Federal Financial Supervisory Authority (**BaFin**) (which we understand to be currently assessing a number of recognition applications from Non-EU Administrators across APAC) has stated that identification of the Member State of reference continues to be the main obstacle for national competent authorities and Non-EU Administrators. BaFin has also noted that communication challenges with ESMA have posed difficulties from a timing perspective.

While the ESA Review has proposed (as discussed above) that ESMA will act as the sole competent authority for Non-EU Administrators, eliminating the requirement to identify a Member State of reference, it does not appear that this will take effect until after the end of the transition period for Non-EU Administrators. Importantly, ESMA's 11 December 2019 briefing on the recognition process clearly still contemplates the identification of a Member State of reference in the recognition process, given that the briefing provides welcome guidance to administrators in identifying their Member State of reference. Additional complications stem from Brexit as well as timing issues, which are discussed further below.

Engaging a legal representative in the Union

As discussed in our previous reports and noted by the Commission in its October 2019 Consultation Paper, the type and scope of roles and responsibilities which must be assumed by a legal representative has had a significant impact of the feasibility of recognition for most Non-EU Administrators. In our most recent survey, while 50% of Non-EU Administrators surveyed indicated that they had begun searching for a legal representative in their Member State of reference, only 16% had 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.

Impact of Brexit

Consistent with the results of our previous surveys, a number of Non-EU Administrators indicated that they considered their Member State of reference to be the UK. This creates an added level of complexity for these Non-EU Administrators, given the continued uncertainty regarding the timing of the UK's departure from the EU, as well as the duration of any transitional arrangements. As at the time of publication of this report, the UK had been granted a ‘flextension’ until 31 January 2020 to allow for the passage of the withdrawal agreement by the UK Parliament. The withdrawal agreement itself provides for a transition period (during which, relevantly, the EU BMR will continue to apply in the UK) until 31

December 2020, with the possibility of this transition period being extended for up to two years.

This second extension, as well as the results of the UK election held on 12 December 2019, make a no-deal exit significantly less likely, although it still remains a possibility.

Helpfully given this uncertainty, both the UK Financial Conduct Authority (**FCA**) and ESMA have issued guidance clarifying the impact of a no-deal Brexit for Non-EU Administrators, since our October 2018 report.

In March 2019, ESMA stated that in the event of a no-deal Brexit, any third country benchmarks recognised or endorsed in the UK before 31 October 2019 will be removed from the ESMA Register, and EU supervised entities will only be able to use these benchmarks until 31 December 2021. If there are no transitional arrangements in place for those Non-EU Administrators registered with the FCA, it seems likely that these administrators will either need to seek recognition from the EU member state that becomes their Member State of reference after Brexit, or ESMA once the ESA Review becomes enacted into EU law. Given this current state of uncertainty in relation to the timing of both Brexit and the enactment of the ESA Review's reforms to ESMA's role, it is unsurprising that none of the Non-EU Administrators surveyed had identified their Member State of reference post-Brexit.

However, Non-EU Administrators will also need to 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.

The FCA has stated that in the event of a no-deal Brexit, the UK will introduce a 'UK Benchmark Regulation' (**UK BMR**), which will replicate the existing EU BMR framework but will apply only in the UK. Under the UK BMR, a new UK register will be established by the FCA and will operate in parallel with the existing ESMA Register. From Exit Day (and subject to the proposed transitional provisions discussed below) UK supervised entities will only be able to use benchmarks which are on the UK register. Practically, this means that Non-EU Administrators will also have to seek registration to have their benchmarks used in the UK, in addition to the EU – essentially doubling registration and compliance costs for Non-EU Administrators.

However, at the time of publication of this report, the UK Parliament had recently enacted a transitional period for the UK BMR, which will allow UK supervised entities to continue to use EU27 and other third country benchmarks until 31 December 2022. While this transitional period will not remove the additional burdens imposed on Non-EU Administrators as a result of needing to register their benchmarks in both the UK and the EU, it will at the very least provide a reasonable grace period to allow them to pursue registration in the UK. This is likely to mean that we see Non-EU Administrators pursue registration in the EU as a priority before 31 December 2021, with applications for registration in the UK taking place during the course of 2022 prior to the end of the UK transition period on 31 December 2022.

6 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 on paper 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, at the time of publication, only one Non-EU Administrator had achieved registration through endorsement, and the administrator in question relied on its Dutch affiliate in doing so. Further, based on the results of our October 2019 survey, it appears unlikely that we will see a significant number of Non-EU Administrators pursue this option, with none of the survey participants indicating that they intended to pursue endorsement. This limited interest is consistent with the level of attention paid to endorsement by the Commission in its October 2019 Consultation Paper, which only refers to endorsement very briefly, and clearly portrays it as the least significant or popular of the three options for registration for Non-EU Administrators.

As set out in our earlier papers, endorsement imposes the significant obligations on the EU Endorsing Entity under the BMR, 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 none of the Non-EU Administrators surveyed said they considered it feasible for an EU Endorsing Entity to be able to demonstrate that the provision of the non-EU benchmark fulfils requirements at least as stringent as those set out in the BMR, while just 16% of Non-EU Administrators surveyed considered it feasible for the EU Endorsing Entity to monitor the activity of the provision of the non-EU benchmarks.

Further, while 16% of Non-EU Administrators surveyed said that they 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 that taking on such endorsement will mean that the prices they charge to take on such a role are significant. The degree of responsibility which Non-EU Administrators would need to surrender to EU Endorsing Entities was also identified by some of the Non-EU Administrators surveyed as a deterrent from

pursuing endorsement, particularly given that EU Endorsing Entities may in some cases be competitors of the Non-EU Administrators. For this reason, we consider it likely that endorsement will be a viable option only for those Non-EU Administrators with EU benchmark administrators or EU-supervised entities within their corporate groups, as seen in the case of the only Non-EU Administrator to successfully rely on endorsement to date.

Given the above, endorsement remains highly unlikely to be a viable registration option for a large number of Non-EU Administrators.