14 September 2012

**European Parliament**

By email to the **econ-secretariat@europarl.europa.eu**

**Response from the INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION Inc. ("ISDA") to the ECON public consultation on "Market Manipulation: Lessons and reform Post Libor/Euribor".**

## HIGHLIGHTS

ISDA appreciates the opportunity to respond to this questionnaire on "Market Manipulation: Lessons and reform Post Libor/Euribor". We have limited ourselves to commenting on those issues that are directly relevant to OTC Derivatives markets.

- ISDA generally supports the proposed changes to MAR and MAD put forward by the European Commission on 25 July in relation to the manipulation of benchmarks, provided that additional clarifications are given (notion of attempt, scope and notion of manipulation) (See Q3.1);

- We would encourage clarifying the scope of benchmark in order to capture all published, widely available benchmarks, as the current definition in the EU Commission proposals would capture all proprietary indices (firm sponsored and private indices) (See Q3.1);

- Given the cross-border nature of the financial services industry and in particular the global use of benchmark indices, any measures adopted should ensure regulatory consistency for the financial services industry on all continents (See Q3.1);

- In order to ensure continuity between existing contracts (e.g., relying on Libor and/or Euribor) and future contracts, there should be clear and long term arrangements in place to manage any transition to alternative rates to Libor and/or Euribor. Failure to achieve a smooth and progressive transition will result in major market dislocation and significant "jump risk" if there is an abrupt move from Libor and/or /Euribor to a successor. The rate of any transition will likely be chiefly determined by the speed of migration to an alternative in terms of liquidity as well the extent to which market participants have amended their documentation (See Q3.2);

- We believe that there is no need to take any additional and specific measures to enhance transparency and information quality in financial markets, since a great deal of initiatives has already been taken at the EU level (EMIR, MiFIR/D, and MAR/D). However, if new initiatives were to be put forward nonetheless, ISDA suggests that these should always be considered with a certain goal in mind and not only for the sake of transparency as such. (See Q4).

ISDA Safe, Efficient Markets

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## IDENTITY OF THE CONTRIBUTOR

- **Name of the person and/or organisation responding to the questionnaire:**

  International Swaps and Derivatives Association Inc. (ISDA)

- **Description of the main activities of the organisation:**

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org

Please indicate whether you object to the publication of the identity of the contributor:

☐ ~~yes, I object~~ X no, I do not object

If you object, an anonymous contribution may be published.

## TOPIC 1: TACKLING THE CULTURE OF MANIPULATION

**Q1: How widespread is the problem? Are there other financial instruments, markets and/or benchmarks vulnerable to potential manipulation?**

**What action should be taken to ensure these forms of market abuse are tackled?**

**Q2: What action should be taken to ensure the integrity and quality of all benchmarks, financial instruments and markets?**

a. **Do both benchmarks and those entities that input into the setting of the benchmark need to be regulated?**

b. **Are traded rates as opposed to offered rates a better basis for input? Or should a 'hybrid' approach be adopted?** At a high level with regard to methodology, we generally support the use of actual trade data (where available) in benchmarks' compilation. At the same time, we acknowledge that it will likely still be necessary to deploy algorithms or expert judgement to fill the gaps where no trade data exists. In fact, we would argue that expert judgment still plays a part even where actual trade data exists, given that the decision to transact the trade(s) depends upon the exercise of such expert judgment.

c. **Should the posters of rates be granted anonymity? What would be the potential downside to such an approach? Would such a status add or diminish the integrity of prices?**

d. **What kind of powers should regulators of the financial sector be given to set and introduce criminal sanctions for attempted or actual manipulation of benchmarks?**

## TOPIC 2: ESTABLISHING INTEGRITY AND TRUST POST LIBOR/EURIBOR

### Q3.1 What specific measures should be taken at European/Global level to improve investor confidence? How can cooperation between global regulators be improved?

Several measures could be taken to improve investor confidence to ensure that the setting of benchmark rates is credible.

EU

At the European level, we generally support the proposed changes to the Market Abuse Regulation (MAR) and Market Abuse Directive (MAD) put forward by the European Commission on 25 July, provided that additional clarifications are given on:

- **Intent.** Unlike the primary criminal offences (Art 4 (e) of MAD), the similar offences of "aiding, abetting and inciting, and attempts of manipulating a benchmark", do not appear to require proof of intention. ISDA is concerned that the element of 'intent' (purpose to commit an act) is absent when defining 'attempt'. We consider that 'intent' is one of the necessary elements of an offence, and it is required to determine whether or not or 'market manipulation' has been attempted. Otherwise, an inadvertent act or an intentional, deliberate attempt to engage in market manipulation would both be considered on an equal basis.

- **Scope**. The Commission's proposed definition of benchmark is very broad, capturing 'any commercial indices' and raising a number of issues relating to enforcement.

- **Manipulation**. Behaviour which may be considered to be "manipulation" could cover a wide range of behaviours, which would not automatically be assumed to be wrongdoing (market manipulation). In our view, there are a number of reasons why a person may modify or change ('manipulate') the formula for calculating a benchmark, most of which would not involve abusive behavior.

Regarding the 25 July amendments, we consider that it is appropriate to explicitly prohibit and criminalise the wrongful manipulation of benchmarks, and provide regulators with specific powers of criminal investigation and prosecution in relation to such manipulation.

More precisely, ISDA welcomes these amendments aiming to clearly identify the actual or attempted manipulation of a benchmark itself, which would be an offence and include these kinds of behaviours within the general prohibition of market manipulation. This will increase legal certainty and deter manipulation of benchmarks given that competent authorities in Member States will be able to impose administrative and penal sanctions without the need to prove any effect on prices. In the European Parliament front, we support MEP Kay Swinburne's Amendment 8 to MAD in this respect, which is designed to achieve the same policy goal.

As mentioned above, we would encourage clarifying the scope of the term benchmark to capture all published, widely available benchmarks, as the current definition (in the Commission proposal) would capture all proprietary indices (firm sponsored, private indices) and there should be a regulatory distinction between firm sponsored 'private' indices and survey based 'public' indices in terms of the level of governance required. Some of our members publish thousands of indices and a protocol that may have been drafted from the perspective of survey based public indices may not be appropriate for all benchmarks. One suggestion would be for ESMA to develop a list of widely circulated / used benchmarks in Europe.

While we would support that all benchmark sponsors should be cognisant of future regulation on benchmark governance when designing a controlled environment, it should be proportionately applied depending on the nature and significance of a particular benchmark. Our members are mindful of the need for adequate systems and controls and feel that by retaining more flexibility, they can ensure governance is proportionate to the risks of the business. Requiring adherence to future regulatory arrangements for 'any commercial indices' is likely to be impractical, costly and potentially disproportionate to their market significance.

Global

Given the cross-border nature of the financial services industry and in particular the global use of benchmark indices, any measures adopted should ensure regulatory consistency for the financial services industry on all continents. We support legislation that mandates regulatory oversight of major benchmarks. Regulators will have an important role in establishing cross-industry fora where the issues around Libor can be discussed openly in order to ensure that consistent application occurs. It is likely that the Financial Stability Board (FSB) and/or the International Organisation of Securities Commissions (IOSCO) are best-placed to publish principles of global application. A broadly accepted set of best practice standards for conducting benchmark price assessments would serve to enhance confidence in such assessments and, more generally, to promote both the integrity and efficiency of global financial markets.

In relation to extraterritoriality and other markets, consideration is needed about how future regulation would apply where there are contributors from 3rd country firms, outside EU jurisdiction. Furthermore, we question how this will be enforced outside financial markets (i.e. physical markets) if the relevant regulator is not a financial supervisor.

## Q3.2 How can legislators ensure continuity between existing contracts which rely on Libor/Euribor (some $500 trillion of contracts) and future contracts?

In this response, we have limited ourselves to provide comments regarding Libor, since the review of Euribor is still in a very early stage.

As the trade association for OTC derivative products, our comments below relate solely to those products, whilst recognising that changes to Libor or a transition away from it will also impact other products in other markets which often underlie OTC derivatives transactions. Within the OTC derivatives markets, interest rate derivatives are the most heavily impacted asset class. We offer some detailed analysis of how trades might be affected by changes to or a move from Libor, according to the terms of their ISDA documentation and in the wider context of incident legal risk.

The majority of OTC interest derivatives transactions use Libor rates as the reference rate for floating legs of transactions. These transactions are typically documented under an ISDA Master Agreement and a trade Confirmation, which will reference the relevant published ISDA Definitions. The Definitions give formal and detailed descriptions for all of a transaction's variables that will be referenced in the trade Confirmation. In other words, the Definitions remove the need to restate the often lengthy descriptions of commonly-used trade attributes in Confirmations. This has an important risk reducing effect in that it enables rapid (often electronic) turnaround times, given that the Confirmations can be brief in that they refer to, rather than restate the Definitions. The main operative booklet of definitions with respect to Libor is the "2006 ISDA Definitions".

In essence the definitions of Libor rates are very much page-driven, by which we mean that the rate for (say) GBP Libor is defined as being the rate that appears on Reuters screen LIBOR01 (or an equivalent page in the case of the Bloomberg definition). Defining the rates in this way means that the Definition should be able to accommodate a certain amount of change to the rate in terms of methodology of compilation, for instance, so long as the rate still appears on the given page.

Clearly, however, there are limits to this and as changes become more economically significant, and to the extent that Libor is fundamentally changed into something else (even if its description does not change and even if it continues to fall within the strict wording of the definition), so the risk increases that parties may claim, under doctrines of frustration or otherwise, that the contract is not what they bargained for. (see below). The definition provides that where the rate is not published at all, parties will revert to the polling of specified numbers of so-called "Reference Banks" to arrive at a rate themselves.

In respect of the large "back book" of transactions, we offer now a description of how these definitions would "cope with" changes to scope or method Libor or to its disappearance. In practice the effects of any changes would be in proportion to the significance of such changes. We understand that the BBA had, prior to recent events, long been considering changes to Libor that would have included the deletion of certain currencies and tenors. We believe these changes were on the point of being put out to public consultation. As to the currencies, the discontinuation (over time) of the AUD, CAD, DKK, NZD and SEK Libor rates has been and continues to be proposed. Of these 5 currencies, ISDA only published definitions for the AUD and CAD rates. Parties using any of the other 3 rates will presumably have had to define these rates in their own bespoke

documentation and would need to act in accordance with its terms in the event of discontinuation. That said, we would suspect that trade volumes here would be very low. With respect to AUD and CAD, data from the DTCC Global Trade Repository indicates there is only a handful of extant trades, meaning that the Reference Banks fall-back should work effectively i.e. that firms should be able to conduct polls, albeit manually, in order to calculate a rate.

Regarding Libor's tenors, uncertainty persists as to the future of the 12 and 6 month tenors. It should be noted that many hundreds of thousands of Libor-referencing trades, perhaps in excess of 40% of the entire Libor-referencing trade population, use the 6 month tenor. If the 6 month tenor were to be stopped, or indeed Libor were to be totally discontinued significant levels of market disruption would be introduced, given that the Reference Banks mechanism would come under strain and may not be workable in practice. This is because of the sheer number of Reference Bank polls which would need to be conducted. The party responsible for conducting the poll in respect of an affected trade is the Calculation Agent (as defined in the 2006 Definitions) and specified in the trade Confirmation. Typically in customer trades, the bank party would be the nominated Calculation Agent, however in interbank trades often provision is made for co-Calculation Agents. On any given day the Calculation Agent(s) in respect of every trade resetting against an affected Libor rate will need to conduct a poll in respect of that rate.

An initial obstacle here in the interbank market will be that the parties will need to agree upon which Reference Banks to approach. Once agreed, polling can take place, however it is possible that strictly speaking thousands of polls may need to be conducted on a trade by trade basis and it is highly unlikely the market could support this burden of activity. Even if all the polls were conducted in a timely and orderly manner, each would yield a different result. This would mean that a party with (say) 2 GBP Libor resetting trades with 2 banks would see those trades reset at different levels.

Changes would be required to the standard ISDA documentation to give effect to changes, once their details were known, or to address the consequences of the outright discontinuation of Libor, both in respect of the "back book" of legacy trades and to cover new trades on a going forward basis. The market would need to migrate to a successor rate or rates (pre-existing or otherwise) in respect of each Libor rate that was discontinued, be that a more minor rate such as AUD or a major one such as GBP. ISDA could publish Supplements to its Definitions to facilitate changes to contracts necessary to reference any newly-published successor rates.

To facilitate the use of successors in legacy trades, ISDA would likely publish a Protocol which would have the effect of amending OTC derivatives contracts between adhering parties so as to convert their back book trades to reference the agreed successors. It would be absolutely vital to have clear and long term transition arrangements in place, given that the market will take time to migrate liquidity to new rates. It is important to note that adherence to an ISDA Protocol is entirely voluntary, and market participants will only adhere if they perceive that it is in their interest to do so. For the Protocol to be as effective as possible a significant period of time is required so that as many market participants as possible can participate, and can have the opportunity to do so as they see liquidity migrating to the new rate sources. Without such transition arrangements, the ensuing market disruption could be potentially unmanageable.

We have mentioned the risk of claims of contractual frustration a number of times, and now turn to cover this in more detail in the context of OTC derivatives portfolios covered by English law-governed ISDA Master Agreements. As suggested above, there is likely to be something of a continuum from minor changes that could most likely still be regarded as falling within the existing definitions of the floating rates, through to more significant changes that could lead some market participants to claim under doctrines of contractual frustration or otherwise, that the nature of their contract had changed fundamentally from what they had originally intended. It is certainly unclear at which point one becomes the other, and we hope that changes could be managed in such a way that it is not tested.

Under the English law doctrine of frustration a contract may be discharged if broadly speaking, after its formation supervening events occur which have the effect of either (i) frustrating the contract's commercial object or purpose or (ii) making its performance impossible. It is unclear whether major changes to Libor, or its discontinuation, would be grounds for a valid claim of frustration or under some other doctrine but it will be clear those changes to or discontinuation of a rate potentially brings us into this territory and indeed some of the decided cases touch on these very points. As mentioned above, the 2006 ISDA Definitions provide a fall-back to Reference Bank polling in the event that a given rate disappears from a page, so to a degree direct contractual provision has been made for the eventuality of Libor's discontinuation. On the other

hand, as noted above, that fall-back might not prove workable in practice. We believe that there is a risk that discontinuation of Libor or changes other than those that are clearly economically immaterial to its calculation, could give grounds for claims of contractual frustration. We urge the authorities to bear this in mind as they contemplate the future of Libor, both in its current form or some other, in order to avoid the major market disruption that the uncertainty of any such claims would cause.

Additional analysis would be required to assess the risk of claims under doctrines such as contractual frustration (or any local equivalent) in respect of ISDA Master Agreements governed by anything other than English law. We understand that concerns similar to those noted above could arise under New York law. New York or English law is the governing law for most OTC derivatives contracts.

## Q4: What specific measures could be taken to enhance transparency and information quality in the financial sector?

ISDA believes that there is no need to take any additional specific measures, because, since the beginning of the crisis a number of EU legislative measures, placing significant emphasis on transparency and information quality, have been already published. This set of legislative instruments adopted or under discussion (i.e. EMIR, MiFIR/D, MAR/MAD and PRIPS) provides a comprehensive approach, covering transparency and information quality from a wide range of perspectives (i.e., OTC derivatives; trading venues; market abuse and benchmarks; private investors.)

In relation to the legislative instruments already adopted, EMIR and the Short Selling Regulation (SSR) stand out by some of their prescriptions enhancing transparency and information quality. EMIR stipulates provisions on reporting OTC derivatives transactions to trade repositories. SSR prescribes reporting obligations for short positions in securities and derivatives, making it easier for regulators to detect possible cases of manipulation linked to short selling.

When it comes to legislative instruments under discussion, the following ones can be noted:

- **MiFIR/D** proposals include a number of measures, such as:
    - The creation of a new category of trading venue, the Organised Trading Facility (OTF), to bring additional trading platforms within the scope of rules on market structure, including associated rules on pre-trade transparency;
    - An extension of pre-trade transparency requirements for trading venues into the non-equities space;
    - A requirement that clearing eligible and sufficiently liquid OTC derivatives are executed on a trading venue;
    - A wide-reaching post-trade reporting regime, that will require the publication of trade data as close to real-time as technically possible; and
    - A more extensive transaction reporting regime that will provide regulators with greater detail regarding firms' activity in OTC derivatives.
- **MAR/D**. The new Market Abuse Regulation (MAR) and the revised Markets Abuse Directive (MAD) increase the levels of transparency by:
    - Applying market abuse rules to financial instruments admitted to be traded on EU MTFs and OTFs, as well as financial instruments OTC, which can have an effect on financial instruments traded on EU Regulated Markets, MTFs or OTFs.
    - Extending the requirements of public disclosure of inside information to 'issuers' of derivatives subject to MAR. They shall inform the public as soon as possible of inside information, which directly concerns the

originator.

- Issuing a list of all persons working for 'issuers' of derivatives subject to MAR, who have access to inside information.
- Assigning national authorities with new powers to obtain information and data from market participants. Additionally, there is an obligation of cooperation between national authorities and ESMA to exchange information and render assistance.

- **PRIPS.** With the adoption of this proposal, the European Commission envisages a new Key Information Document (KID) that every manufacturer of investment products (e.g. investment fund managers, insurers, banks) will have to produce before its product is sold to a retail client. Each KID will provide information on the product's main features, as well as the risks and costs associated with the investment in that product.

In addition to the legislative instruments outlined above, the European Commission has recently launched a consultation to identify the key issues and shortcomings in production and use of benchmarks. In this consultation, transparency issues have received significant attention, with one whole chapter devoted to it. ISDA expects that based on the responses received, the Commission will probably make an additional initiative on enhancing transparency and information quality, this time regarding indices.

To reiterate, we believe that there is no need to take any additional and specific measures, since a great deal of initiatives to enhance transparency and information quality has already been taken at the EU level. However, if new initiatives were to be put forward nonetheless, ISDA suggests that these should always be considered with a certain goal in mind and not only for the sake of transparency as such. We believe that the goal of building robust and stable financial markets should always be kept in mind when deciding whether or not the additional and specific measures enhancing transparency and information quality, are necessary.

**Q5: What future action could be taken to achieve better governance in order to prevent future manipulation and establish integrity, trust and fairness in the financial services industry?**

**For further information, please contact David Fernandez Valdes (dfvaldes@isda.org)**