ISDA® Safe, Efficient Markets

6th October 2020

ISDA's Response to the European Commission's Proposal to amend Regulation (EU) 2016/1011 ('EU BMR') to exempt certain third country foreign exchange benchmarks and designate replacement benchmarks for certain benchmarks in cessation.

ISDA is grateful for the opportunity to provide comments on the European Commission's proposal to amend BMR in order to provide it with powers:

(a) to mandate replacement of a benchmark whose cessation may result in significant disruption in the functioning of financial markets in the Union (the 'Statutory Fallback Power'); and

(b) to designate as being out of scope certain third country fx benchmarks which reference a currency that is not freely convertible (the 'Non-deliverable FX Exemption Power').

Statutory Fallback Power

(i) Background: The ISDA IBOR Fallbacks

As you are aware, ISDA is about to launch a supplement to the 2006 ISDA Definitions which will allow parties to derivatives contracts which reference certain major interbank offered rates[1] ('IBORs') to incorporate robust fallback provisions (the 'ISDA IBOR Fallbacks'). These will be triggered by certain announcements regarding the cessation of the relevant IBOR and, in the case of LIBOR (but not any other rate), certain announcements regarding LIBOR becoming non-representative. The fallbacks are based on the risk free rates selected by the relevant Risk Free Rate Working Groups, adjusted to reflect certain differences between those risk free rates and the IBORs which they would replace. Once effective, the supplement will mean new transactions which incorporate the 2006 ISDA Definitions will incorporate these provisions unless the parties agree otherwise.

At the same time, ISDA will also launch a 'protocol' to facilitate incorporation of the ISDA IBOR Fallbacks into transactions that were entered into before the supplement becomes effective. The protocol is a voluntary process which allows parties that adhere to it to incorporate the fallbacks into their legacy transactions with all other adhering parties. Parties may also choose to incorporate the fallbacks into their legacy transactions bilaterally. Further information on the ISDA IBOR Fallbacks, including as to the timing of the launch of the supplement and protocol, as well as their likely effective date can be found at www.isda.org.

It is against this background that our feedback on the Legislative Proposal should be read.

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[1] The ISDA IBOR Fallbacks cover LIBOR rates denominated in EURO, USD, JPY, GBP and CHF, as well as EURIBOR, TIBOR, Euroyen TIBOR, BBSW, CDOR, HIBOR, SOR and THBFIX.

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(ii) Benchmarks in scope of the powers. Some members have fed back to ISDA their strong concern with the broad drafting used to describe the benchmarks in scope of the powers. Their preference would be for it to be narrowed to systemically important EU or third country interbank offered rates and overnight interest rates. Given the importance of ensuring that market participants have visibility of which rates would be in or out of scope, it is suggested that the EC publish and maintain a list of those benchmarks.

(iii) Territorial scope of the powers. Given the complexity of conflict of laws rules and the consequent uncertainty which would be generated if the power were purported to extend to third country law governed contracts, we believe the scope of the power should be limited to contracts governed by the laws of the EU27 member states.

(iv) Products in scope. The scope of the BMR has long been seen as an area of particular difficulty and market participants may, therefore, struggle to understand whether their products are in scope of this power or not. There are also certain products which are not in scope of BMR (such as loans) but which are hedged using OTC derivatives. It is possible, therefore, that this power would dislocate hedges from these instruments. We recognise the suggestion that national laws be used to fill these gaps but these would not be effective in relation to contracts governed by third country laws and would result in a patchwork of regimes which EU supervised users and their counterparties would need to navigate.

(v) Suitable Fallbacks. It is unclear what constitutes a ‘suitable’ fallback provision. It would be helpful to further clarify that industry standard fallbacks (such as the ISDA IBOR Fallbacks and those set out in the 2018 ISDA Benchmarks Supplement, which responds to Article 28(2) of BMR) would qualify as suitable fallbacks for these purposes and to provide a safeharbour for those who use them. Some members have also suggested that the provision should be reframed to apply to contracts without fallbacks which contemplate the permanent cessation or non-representativeness of the benchmark (as applicable). Either way, it will be critically important that the final text of the Legislative Proposal does not cut-across the new robust fallbacks which are being created following long and intense efforts by market participants.

(vi) Use of the replacement rate. We note that Recital 9 suggests that use of the replacement benchmark should only be allowed for contracts that have not been renegotiated prior to the cessation date of the benchmark concerned. However it is vitally important that those who have had their exposures transitioned to the replacement benchmark by means of this power remain able to enter into new trades which reference the benchmark. This is so that they are able to reduce their exposure to that benchmark (for example, by entering into equal and offsetting trades or novating their positions) or to manage the risk which they now bear (for example by entering into derivative hedges). In some cases, the replacement benchmark may be one which is the market’s (and regulator’s) preferred alternative rate. Provided such rate is IOSCO compliant, it would not make sense to prevent its use. On this basis, it is not only vital that the replacement benchmark is not prohibited but also that its use is specifically authorised for new and legacy transactions in the Union.

(vii) Interaction with other global ‘tough legacy’ solutions. Other ‘tough legacy’ solutions are being developed in New York and the United Kingdom. It will be vitally important that market participants clearly understand the potential interaction between these proposals and that they are developed in such as way as to complement, rather than conflict with, each other.

Non-deliverable FX Exemption Power

(i) Third Country Regime. While ISDA welcomes the EC's recognition of the problems which would be caused to EU users of third country fx rates which reference currencies which are not freely convertible, those issues would also afflict users of any type of third country benchmark which are prohibited from use under BMR, including other types of fx rates as well as interest rate, equity, commodity and credit benchmarks. As set out in the advocacy paper[2] annexed to this response, holistic reform is required to the third country regime in order to provide a proportionate, practical and robust regime which does not unnecessarily disadvantage EU users of these benchmarks in comparison to their non-EU peers[3]. Failure to use the current BMR review process to address these wider issues will inevitably mean that the transition period relating to third country benchmarks will need to be further extended when it is due to expire at the end of 2021. In order to ensure there is sufficient time for a holistic review of BMR in general and the third country regime in particular, transition period should be extended until 31 December 2025[3].

(ii) Non-Designatory Regime. If the proposed narrower reform is to be pursued, it would provide market participants with more certainty if all non-convertible fx rates were removed from the scope of BMR. The current Legislative Proposal only allows the EC to designate benchmarks which are used on a 'frequent, systematic and regular basis in derivative contracts for hedging against third country currency volatility.' This represents a reversal of BMR's proportionality principle in that the most widely used benchmarks would be eligible for removal from the scope of BMR but benchmarks which are less widely used (and therefore pose lower systemic risk) would remain in scope. Most benchmarks of this type are, by their nature, illiquid. This does not lessen their importance to those EU industrial exporters and investors who use them. There is also little reliable and comprehensive data to show which benchmarks are used in the EU or for which purpose.

(iii) Alternative Designatory Regime. If a designatory regime is to be pursued, it would mitigate some of the above concerns if non-convertible fx benchmarks were out of scope unless designated as in scope by the EC. This would allow the EC to designate systemically important benchmarks as in scope of BMR where it was appropriate to do so.

(iv) Currency which is not freely convertible. In determining whether a currency is 'freely convertible', it would be important for the EC to consider legal, operational and other practical impediments that may exist to convertibility.

Relief from Clearing and Margining Obligations for benchmark reform actions.

The Benchmark Regulation Review process provides a vital opportunity to amend the clarificatory text to be added to EMIR under the CCP Recovery and Resolution File on relief from clearing and margining obligations. First, to include embedding fallbacks for all benchmarks (given that the requirements of Article 28(2) apply beyond interest rate benchmarks) in the scope of the relief, rather than just fallbacks for interest rate benchmarks. Second, the relief currently only contemplates

[2] https://www.isda.org/2020/06/29/the-importance-of-reforming-the-eu-benchmarks-regulation/

[3] Note that ISDA's position is based on member feedback, the overwhelming majority of which was in favour of reforming BMR in the manner proposed in the Advocacy Paper. It is important to note, however, that ISDA also received feedback from some members which opposed this view and which would not be in favour of further extension. Further information can be found here: https://www.isda.org/a/26QTE/ISDA-Response-to-BMR-Review-submitted.pdf

contracts being ‘novated’ in order to embed fallbacks or to replace interest rate benchmarks in pursuit of global benchmark reform initiatives. We understand that in at least some jurisdictions ‘novation’ is interpreted as being broader than just replacing one or more parties to a contract and extends to replacing one obligation between the parties with another obligation between the parties. However, market participants and their clients would find it extremely helpful in their efforts to transition off IBORs like LIBOR and embed fallbacks if the text were amended in each relevant provision to read ‘are replaced, amended or novated’

Conclusion

We agree with the EC’s statement that the main goal of the Statutory Fallback Power should be “to ensure legal certainty for existing contracts referencing the benchmark whose cessation would result in significant disruption”. This need for certainty also extends to transactions which reference non-convertible fx benchmarks.   Market participants should be left in no doubt about the scope of these powers, their application to their products, whether any triggers which apply have been satisfied, the outcomes under their contracts and the interaction of the Statutory Fallback Power with other global benchmark reform initiatives. For this reason, it will be vitally important to ensure that the precise and coherent drafting required is maintained as the proposal makes its way through the trilogue process.

Annex – Advocacy Paper on the Need to Reform the BMR’

[Starts on following page]

Briefing Paper

The Importance of Reforming the EU Benchmarks Regulation

June 2020

Table 1. High level comparison of the reforms proposed within this paper against the existing provisions of the European Benchmark Regulation.

Characteristics	Existing BMR	Reformed BMR
Use of benchmarks	Prohibited unless specifically qualified	Permitted unless specifically prohibited
Scope	All benchmarks regardless of size or systemic importance with very limited exemptions	Only benchmarks whose failure would threaten the systemic stability of the EU (based on qualitative assessment) would be subject to mandatory compliance via designation by the appropriate central authority (such as the EC or ESMA) Non-significant and potentially significant benchmarks, public policy and regulated data benchmarks and their third country equivalents removed from scope for mandatory compliance Voluntary regime for non-designated benchmarks
Means of qualification	EU: authorization or registration by NCAs Third country: Equivalence, Endorsement, Recognition	EU and Third Country: Authorization, Registration, Equivalence, reformed Endorsement or reformed Recognition
Powers to prohibit use of non-qualifying benchmarks and powers to allow continued use for legacy	Powers to allow continued use in legacy contracts provided that poorly defined contingencies are met (frustration, force majeure, breach) Powers do not encompass all circumstances in which a benchmark may become prohibited Inability to use non-qualifying benchmarks in new transactions to manage legacy risk creates cliff-edge risks for EU investors	BMR to allow continued use of non-qualifying benchmarks (including in new transactions) to manage or reduce existing exposure but not (subject to the below) to acquire new exposure Use of such non-qualifying benchmarks to be permitted for such purposes without any need for an NCA to exercise power and without need to show frustration, force majeure or breach. This removes cliff-edge risks for EU investors Client-facing entities allowed to acquire new exposure but only to facilitate their client's use of non-qualifying benchmarks to manage or reduce exposure
End user visibility of application process for qualifying benchmarks	Very limited data on ESMA's register, insufficient to allow end users to understand whether the benchmark they want to use qualifies or has become prohibited	Enhanced visibility for end users with more comprehensive data on ESMA's register

Introduction

European retail and institutional investors use European Union (EU) and third-country benchmarks for a variety of critical commercial purposes, from hedging their exposures to converting overseas revenue and repatriating funds. The EU Benchmarks Regulation (**BMR**) was intended to protect European investors from the risks and disruption posed by poorly governanced or failing benchmarks. Instead, fundamental flaws in its conception have made the Regulation itself a threat to the financial well-being of benchmark-users in the EU and put them at a significant competitive disadvantage.

The current BMR Review[1] process represents a vital opportunity to reform the BMR so that it:

- provides protection to investors on a proportionate basis, in alignment with global standards;
- imposes the highest compliance burdens in respect of the most important benchmarks;
- encourages administrators with benchmarks that are used on a more minor scale in the EU to adopt similarly high standards without creating unwarranted barriers to entry;
- ensures EU investors have visibility over the application process to allow them to reduce their exposures to non-qualifying benchmarks ahead of and/or over time.

<u>Proposal for Reformed BMR</u>

We propose that BMR is reformed so as to:

(1) Allow benchmarks to be used in the EU unless specifically prohibited (i.e., a reversal of the current general prohibition of benchmarks unless specifically authorized).

(2) Provide designatory powers to an appropriate central authority (such as the European Commission (EC) or the European Securities and Markets Authority (ESMA)) to mandate compliance for those EU and third-country benchmarks that are most systemically important to investors in the EU.

(3) Allow third-country administrators to obtain authorization from an appropriate central authority (such as the EC or ESMA), or to qualify via Equivalence, or via reformed Endorsement or Recognition processes, each within a fixed period of time.

(4) Exempt EU **non-significant benchmarks** and their equivalent third-country benchmarks from mandatory designation.

(5) Consider exempting EU **significant benchmarks** and their equivalent third-country benchmarks from mandatory designation in order to better align the BMR with the scope of benchmark regulations globally.

(6) Exempt public policy benchmarks (e.g., FX rates used in non-deliverable forwards (NDFs) and certain interest rate swaps) and regulated data benchmarks.

[1] See the European Commission's recent Public Consultation Document – Review of the EU Benchmark Regulation at https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-benchmark-review-consultation-document_en.pdf

(7) Provide a voluntary labelling regime to allow administrators to comply with the BMR and market their benchmarks as BMR-compliant.

(8) Provide regulators with the power to prohibit the acquisition of new exposure to benchmarks that fail to comply with the BMR, but permit the use of such benchmarks for managing or reducing legacy positions (including undertaking new transactions for such purposes).

(9) Provide end users with greatly enhanced visibility on whether benchmarks have qualified (or been disqualified) for use under the regime via a more usable ESMA register.

These proposals represent a practical, proportionate regime that respects the overarching aims of the EU BMR, as further detailed in the rest of this paper.

Problems with the EU BMR

The BMR was introduced to complement the civil and criminal sanctioning regime provided by the Market Abuse Directive, the Market Abuse Regulation and member state legislation that together outlaw and punish attempts to manipulate benchmarks. Nothing in this proposal is designed to weaken or narrow the laws relating to manipulation of benchmarks. They provide vital protection for investors and users of financial products, and the broad application of these laws should remain as currently in force.

The BMR set out to protect European investors and users of the estimated 3 million benchmarks in existence worldwide[2] by enhancing the governance and oversight of benchmark production, as well as promoting transparency on the construction and evolution of benchmark methodologies. To this extent, it represents a codification of the widely implemented International Organization of Securities Commissions' (IOSCO) *Principles for Financial Benchmarks* (**IOSCO Principles**).

However, the BMR also regulates use of benchmarks by supervised entities in the EU by:

- Requiring them to have contingency plans (reflected in their client contracts) against material change to a benchmark or its cessation (referred to in this paper as the **Contingency Plan Requirement**); and

- Prohibiting the use of benchmarks that have failed to qualify under the BMR (referred to in this paper as the **General Prohibition on Use**).

IOSCO subsequently published a recommendation replicating the Contingency Plan Requirement in its *Statement on Matters to be Considered for Use of Benchmarks*[3].

However, as illustrated in Table 1, the General Prohibition on Use is unique to the BMR. It does not feature in any recommendation by IOSCO and no other jurisdiction globally has introduced it.

[2] http://www.indexindustry.org/2019/10/15/index-industry-associations-third-annual-survey-finds-2-96-million-indexes-globally/

[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD589.pdf

Table 1

Major Features of Benchmark Reform	BMR	IOSCO Principles
Governance procedures for Administrators (including conflict of interest management)	✓	✓
Benchmark methodology design, evolution and transparency	✓	✓
Quality of data sources	✓	✓
Submitter code of conduct	✓	✓
Contingency Plan Requirement	✓	✓
General Prohibition on Use of benchmarks unless they qualify	✓	✗

Scope of the BMR

The Index Industry Association estimates that there are 2.96 million benchmarks in use globally, the vast majority of which pose no systemic or material risk.

The extremely broad scope of the BMR, combined with its considerable extraterritorial reach, has resulted in a disproportionate compliance burden being placed upon benchmark users, administrators and contributors.

The benefits of regulating against a benchmark's potential future development do not justify the cost and complexity for those the regulation is intended to protect.

Adverse impact of the General Prohibition on EU investors

The effect of the General Prohibition on Use has been to turn the BMR from an important regulatory protection for European investors into a source of uncertainty, disruption, competitive disadvantage and potential systemic risk.

(a) <u>Disruptive Effect of Prohibition of a Benchmark</u>

Cessation of a benchmark has been flagged by global regulators as a source of disruption and uncertainty and could pose a threat to financial stability if it happens to widely used benchmarks. There is no reason why prohibition on use of a benchmark would be less disruptive or dangerous than its cessation – in fact, it could be worse.

Prohibition of a benchmark that continues to be published could leave prohibited parties stuck in a position of limbo, unable to:

- Use the benchmark to perform their obligations or receive performance of their counterparty's obligations;

- Terminate their transactions or use the benchmark to calculate the termination amounts payable;

- Value their positions, meaning they are unable to margin them or calculate any capital requirements attributable to them.

By their nature, benchmarks tend to be constructed using unique methodologies and on the basis of particular sources of data. This means that alternative rates are rarely available. Prohibition of a non-IBOR benchmark would require EU supervised entities to engage in a similar effort but without the kind of global co-ordination and resourcing that has been dedicated to the IBOR transition process.

In contrast, competitors in other jurisdictions that are not subject to a prohibition would continue to be able to use the benchmark for any of these purposes. This will negatively impact EU firms, who will be unable to service their clients' needs, and their clients (including retail investors and institutional investors such as insurers and pension funds).

(b) Scaling Up the Disruptive Effect of Prohibition

Prohibition of a benchmark would be a poor outcome for EU users, particularly if it is a systemically important benchmark. The BMR defines such 'critical' benchmarks as those that are directly or indirectly used in financial instruments with a total value of at least €500 billion. Fortunately, all EU critical benchmarks have now complied with the BMR, and will therefore be permitted for use after the end of the transition period at the end of 2021.

However, there are a number of third-country benchmarks which are not expected to qualify for use under the BMR that would exceed the quantitative threshold applicable to critical benchmarks under BMR if they were administered by EU institutions. For example, GFMA recently analyzed figures from the 2019 BIS Triennial Survey and found that transactions referencing the US dollar/Korean won spot FX rate had open interest attributable to EU counterparties of US$931 billion, while the US dollar/Taiwanese dollar spot FX rate had open interest attributable to EU counterparties of US$585 billion.

On this basis, both rates would exceed the current threshold required to be designated as critical if they were administered by EU institutions. Neither are expected to qualify for use in the EU after the end of the extended transition period on January 1, 2022. Their prohibition would expose EU investors to exactly the risks of uncertainty and disruption that the BMR was intended to avoid.

The expiry of the transition period is unlikely to result in only these benchmarks becoming prohibited. The GFMA is monitoring five other spot FX benchmarks used in NDFs that would likely become prohibited[4]. Given the all-encompassing scope of the BMR, many other large and small benchmarks across FX, interest rates, equities, commodities, credit and other asset classes

[4] FX rates for the currencies of the Philippines, Argentina, Nigeria and Kazakhstan, in addition to South Korea and Taiwan. The Indian rupee was also considered to be at risk, but regulations introduced by the competent authorities in India mean it may benefit from any equivalence decision provided by the EU

are at risk of the General Prohibition on Use because of the flaws in the third-country benchmarks regime that mean they are unlikely to be willing or able to qualify in time.

The effect on end users of prohibiting a large number of benchmarks at the same time is unknown, but is likely to be serious. For example, the GFMA estimates that prohibiting EU use of the eight benchmarks identified in its paper is likely to have a similar impact on those benchmarks to the observed impact of the corona virus in terms of their liquidity. Multiplied across the unknown population of benchmarks at risk, this could represent a very significant issue.

(c) Failure of Mitigating Provisions

The BMR contains provisions that were designed to mitigate these issues. National competent authorities have the power to permit supervised entities to continue to use a prohibited benchmark in legacy transactions. However, there are some significant shortcomings.

- These powers are only available in limited circumstances (for example, where a benchmark administrator's authorization has been suspended, but not where it has been withdrawn entirely[5]).

- They are subject to poorly defined contingencies – for example, the requirement to demonstrate that 'cessation of the benchmark would result in a force majeure event, or frustrate or otherwise breach the terms of any…financial instrument'. It is unclear how the competent authority with responsibility for the benchmark administrator would determine whether those events would occur in relation to users of the benchmark (who may not be located in their jurisdiction). For instance, it is uncertain whether the competent authority would take a contract-by-contract approach, whether a single instance of one contract would suffice, or whether an abstract analysis should be undertaken. It is also unclear whether a legal opinion would be required (which no law firm would provide cleanly for frustration or force majeure) and, if so, whether this would need to be under the laws of all 27 member states plus the governing laws of affected contracts (which may not be the laws of European member states).

- They are unfit for purpose. For example, typically users of benchmarks need to be able to undertake new transactions in order to manage or reduce their legacy exposures. One of the most common ways of exiting a position is to enter into a new transaction that has an equal and offsetting exposure. This is not possible under the current provisions of the BMR.

(d) Investors Unable to See Which Benchmarks Will Qualify

Given the likely disruption, it might be expected that investors would use the extended transition period to reduce their exposure to benchmarks under threat of prohibition. However, there is no visibility over which administrators will be likely apply under the BMR. In relation to third country benchmarks, there is no transparency over whether administrators have applied and if so, whether their application is pending or has been rejected. In many cases, alternative benchmarks

[5] In this regard, we welcome the proposal in the EC's Consultation on the Review of the EU Benchmarks Regime that withdrawal of authorization also triggers this power, although note our proposal in this paper that permission to use a prohibited benchmark should not be subject to any contingencies (including the exercise of any power) and should cover all of the circumstances in which a benchmark may become prohibited and not just withdrawal or suspension of an EU administrator's registration or authorisation

may not exist or may not comply with the BMR, or alternatives may not be comparable in terms of liquidity, providing little option for investors looking to transfer positions. European investors may therefore be in a position where they are unable to adequately mitigate their risks ahead of the relevant benchmarks becoming prohibited.

It was in recognition of these issues that the transition period for EU critical and third-country benchmarks was extended by two years in 2019[6]. This provided a period of calm during which EU critical benchmark administrators were able to ensure the benchmarks qualified for use under the BMR. However, flaws in the third-country benchmark regime mean that time alone will not resolve the problems faced by European investors.

Why Will Third-country Administrators Not Comply with the BMR?

Under the BMR's third-country benchmark regime, benchmarks can qualify for use in the EU under one of three routes: Equivalence, Endorsement or Recognition. This regime was constructed on the basis of some underlying assumptions that have turned out to be incorrect, as acknowledged by the EC in its recent draft Inception Impact Assessment in relation to the Review of the BMR.

First, it was assumed that the EU was leading the way with an all-encompassing benchmark regulation and that other jurisdictions would follow suit.

Second, it was assumed that benchmark administrators would want to comply with the BMR in order to have their benchmarks used in Europe.

Third, it was assumed that Equivalence would provide a scalable regime that could be used to qualify the majority of third-country benchmarks for the purposes of BMR.

In reality, many jurisdictions (such as the US) have not introduced any such framework, and those jurisdictions that have developed benchmark regulations have tended to limit them to cover only their own critical benchmarks. For example, Japan has introduced regulations that only cover major interest rate benchmarks. The draft equivalence decision for Japan[7] that has was released on April 4, 2020 would not benefit their equity benchmarks, such as the Topix indices, at all.

While some third-country administrators derive significant financial gain from having their benchmarks used in the EU, others do not. The EC's consultation on the BMR Review says "in absence of licensing income from EU users, many third-country benchmark administrators might not have the incentive to seek…[to qualify]…their benchmarks for use in the Union. This would mean that many third-country benchmarks could no longer be used in the Union after the expiry of the (extended transition period, by the end of 2021)"[8].

These administrators are therefore unlikely to qualify by means of Equivalence and are not incentivized to go through the significant cost and administrative burdens associated with

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[6] By means of the Regulation on Low Carbon Benchmarks that entered into application on December 10, 2019 (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2089&from=EN)

[7] https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12330-Equivalence-decision-for-a-third-country-Japan-under-the-Benchmarks-regulation-BMR-

[8] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-benchmark-review-consultation-document_en.pdf

Endorsement or Recognition. Even those that do have incentives face significant impediments to using them.

Endorsement requires a third-country administrator to have its benchmarks endorsed by an EU supervised entity as being compliant with the BMR on an ongoing basis. In the absence of a supervised affiliate to perform this role, Endorsement effectively requires third-country administrators to divulge information to third party EU firms who may be competitors, or even effectively cede control of their benchmark governance process.

Recognition requires the appointment of a legal representative in the administrator's 'member state of reference'. This suffers from two distinct problems:

- This is a complex regime that relies on administrators having access to trade volume or licensing data that does not exist in any reliable form. In the absence of such data, administrators that do not have EU-supervised affiliates are unable to use Recognition. While the European supervisory authorities' review offers a welcome simplification of the recognition process by transferring responsibility for recognition decisions to ESMA, the proposal is not expected to be adopted before the transition period is due to expire.

- The legal representative is required to perform the oversight function of an administrator and is held accountable to the competent authority of the member state of reference, but precise responsibilities and potential liabilities are unclear.

Breaches of the regulation are accompanied by fines of up to 10% of global annual turnover. While we understand commercial providers are ready to provide Endorsement and Recognition services, we cannot be sure that third-country benchmark administrators will be willing to pay the price of using them.

Two and a half years after the main provisions of the BMR became effective, only two Equivalence determinations (for Singapore and Australia) have been made, which together cover seven benchmarks. One draft Equivalence determination was published in respect of Japan on April 4, 2020, which will cover a further two benchmarks. Seven administrators have qualified their benchmarks via recognition, while two have qualified their benchmarks via Endorsement. The fact that the seven administrators that have used Recognition account for 19,781 benchmarks and the two administrators that have used Endorsement account for 65,564 benchmarks suggest that only large global administrators have so far managed to navigate the complexities and cost of the regimes, and that they represent a significant barrier to entry for less well-resourced administrators.

Although these may seem like issues for third-country administrators, it is actually EU investors such as retail investors, pension funds, EU manufacturers and other financial and non-financial institutions that will be the major casualties because of the General Prohibition on Use. It was for this reason that the transition period applicable to third-country benchmarks required the two-year extension. Without reform, the same risks are likely to require an additional extension to the transition period at the end of 2021.

The Problem with Data

Industry associations have been consistently asked by European regulatory authorities for data that illustrates the adverse impacts of an unreformed BMR.

However, reliable publicly available data on how benchmarks are used in the EU is not available. For example, there is no data on how many benchmarks are used by which EU institutions and for what purposes. There is also no data on the number of benchmarks that are on track to qualify under the BMR by the end of the transition period, and very little information on how the prohibition on using benchmarks that will fail to qualify will impact EU investors and end users.

For example, the Bank for International Settlements (**BIS**) publishes a survey on benchmark use for the FX and interest rate markets, but the complexity of compiling this information means it is only completed every three years. The survey requires the involvement of central banks globally and 1,300 dealers. Some of the published data is useful in setting out the issues caused by the BMR, but most is not.

These issues are exacerbated by fundamental uncertainties over what is in and out of scope of BMR, and whether that status can change during the lifetime of a financial instrument. For example, an index is deemed to have been 'made available to the public' (and, therefore, potentially a 'benchmark') if it can be reverse engineered from the coupon payable on a financial instrument. Every user of such a rate must make its own determination as to whether this is possible. In the face of such uncertainty, it is difficult to conduct a data collection exercise.

This data would also have been absent at the time of the original impact assessment for the BMR. Lack of data, therefore, should not be used to fight reform – it should be a strong reason not to allow expiry of the BMR's transition period to change the status quo.

Proposal to Reform BMR

The BMR urgently needs to be reformed. In particular, the General Prohibition on Use should be reversed in order to protect EU investors, and the scope of the BMR needs to be narrowed so that the compliance burdens fall where there is most risk.

The following proposal represents a practical, proportionate regime that respects the overarching aims of the EU BMR, while allowing EU investors to continue to use benchmarks to hedge their naturally occurring risks or make investments in the same way as their non-EU peers:

- **General Permission for Use.** EU and third country benchmarks should be permitted to be used in the EU unless specifically prohibited. This reverses the current regulation's General Prohibition.

- **In-scope benchmarks.**

  - Mandatory compliance by designation. An appropriate central authority, such as the EC or ESMA, should be given the power to designate EU and third-country benchmarks as being in scope based upon their use or the potential impact of their failure on users in the EU using pre-defined qualitative criteria.

        - This would recalibrate the BMR to ensure only the benchmarks whose failure would pose a systemic threat to users in the EU are mandatorily subjected to the most burdensome aspects of the regime.

        - Administrators of systemically important benchmarks tend to be those most able to cope with the compliance burden.

        - This approach would mean Equivalence decisions would likely cover most in-scope benchmarks for jurisdictions in which benchmarks are regulated.

    - Voluntary compliance by election. Administrators of benchmarks that would otherwise be out-of-scope should be able to elect for their benchmarks to comply and be labelled as such.

        - This would promote higher standards of governance and compliance by incentivizing administrators that will then be able to use the labelling in their marketing.

        - It would provide investors with confidence that benchmarks they use meet those high standards.

        - It would provide recognition of the efforts and investment that EU and third-country administrators have already made to comply with the BMR.

The Australian and New Zealand benchmark regulations both contain an elective regime of this nature.

- **Exempt Benchmarks.**

    - 'Non-significant' EU and equivalent third country benchmarks should not be in scope for mandatory designation since these pose the least risk of systemic disruption. Administrators that only produce such benchmarks (rather than more sophisticated administrators that also produce critical benchmarks) are least equipped to qualify their benchmarks by means of the costly and burdensome Recognition or Endorsement routes and cannot benefit from Equivalence decisions.

    - Consideration should be given to removing significant EU and equivalent third-country benchmarks from scope of mandatory designation to ensure parity with benchmark regimes in other jurisdictions.

    - Regulated data benchmarks should not be in-scope of mandatory designation. Where the input data is regulated at its source, then it is appropriate to reduce the regulatory burdens applicable to these benchmarks under the BMR. The regulated data benchmark exemption should extend to include indices that rely on inputs from major global exchanges.

    - Public utility benchmarks – for example, FX rates used in NDFs and interest rates (including restricted or pegged rates) used in dollar-settled swaps (e.g., NIRDS) – should not be in scope of mandatory designation because they are pseudo-governmental and their prohibition would be disproportionately disadvantageous to end users.

- **Quantitative Thresholds.**

    - If significant benchmarks remain capable of being brought into scope, the quantitative threshold should be increased to €100 billion over six months.

    - Given the unreliability of the data, any quantitative thresholds should be used as indicators within the qualitative criteria rather than as hard thresholds.

- **Reforming the Third-country Benchmark Qualification Routes**

    - Third-country benchmark administrators should be able to apply for authorization or registration for their benchmarks from ESMA, following a similar process to that applicable for EU administered benchmarks. Consideration should also be given to allowing EU administrators to have their benchmarks qualify by means of Endorsement.

    - The role and responsibilities of the legal representative should be clarified, along with their potential liability (which should be proportionate to their role and responsibilities).

- **No New Flow.**

    - If the administrator of a designated in-scope benchmark fails to gain qualification within a fixed period of time, or to maintain qualification thereafter, it would become a 'non-qualifying benchmark'.

    - Supervised entities would only be permitted to continue using non-qualifying benchmarks in new and lifecycle transactions for 'permitted purposes' (i.e., to transition to new benchmarks or to service, hedge, reduce or close out existing exposures) and not, subject to the below, for the purpose of acquiring new exposures.

    - Client-facing supervised entities such as central counterparties and market makers would be permitted to acquire new exposures to non-qualifying benchmarks but solely to facilitate their clients' permitted purposes.

    - This provision should not be subject to any contingencies (such as the need to demonstrate frustration, force majeure or breach) or require any regulatory authority to exercise any power in order for users of the non-qualifying benchmark to benefit from it.

    - The provision should cover all circumstances in which a supervised entity that has been using a benchmark would otherwise be prohibited from using that benchmark. This should include:

        - Withdrawal or suspension of an administrator's registration or authorization under Article 35;

        - Withdrawal of an Equivalence decision, or a third-country administrator's Recognition or Endorsement;

        - Failure by an administrator or its benchmark to comply with the BMR before expiry of the relevant transition period;
        - Prohibition on use of a benchmark for any other reason.
    - This approach provides users of benchmarks that fail to become compliant or become non-compliant with the ability to manage or reduce their exposures in a safe and efficient way, avoiding the current risk of a cliff edge. This will become critically important in advance of any discontinuation of any systemically important benchmarks like LIBOR.

- **Improving End-user Visibility**

  In order to allow end users of benchmarks visibility over whether benchmarks have or are likely to qualify for use at the end of the transition period or have become non-qualifying third country benchmarks, ESMA should publish details of each application received, including the name and location of the administrator or the benchmark, the name and ISIN and other unique identifiers of the benchmark, the status of the application (received/approved/rejected/withdrawn/suspended), whether the benchmark has been designated for mandatory compliance as a critical or potentially significant benchmark or whether its administrator has elected for voluntary compliance, whether any relevant Equivalence, Recognition or Endorsement has been withdrawn, and provide contact information for the administrators . This will allow EU end users to reduce their exposures to third-country benchmarks ahead of a failure to qualify under the EU BMR.

Conclusion

There are many other technical improvements that can be made to the BMR to enable users, administrators, contributors and regulators to understand what is in and out of scope, and whether that status can change over the lifetime of a financial instrument. The proposals set out in this paper represent the most fundamental and critical reforms. Their implementation would result in a benchmark regulation that protects investors without stifling their bona fide use of more minor benchmarks.

About ISDA and the basis for this paper in relation to ISDA members' views
Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 900 member institutions from 74 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube. ISDA's membership is diverse and includes firms that use benchmarks but do not administer or contribute to them; firms that administer benchmarks but do not contribute to or use them; and firms that administer, use and contribute to benchmarks. The proposals set out in this paper were supported by a significant majority of the ISDA members who provided feedback as part of its response to the EC's consultation on the Benchmark Regulation Review and subsequently. For example, 92% of those responding supported the proposal that third-country equivalents of non-significant benchmarks be removed from scope of the BMR and 85% of those responding supported the proposal that non-significant EU benchmarks be removed from scope. However, divergent minority views were also put forward in respect to the above proposals. They are reflected in the feedback that ISDA submitted as its response to the EC's consultation here but have not been reflected in this paper.

About ASIFMA
The Asia Securities Industry and Financial Markets Association (ASIFMA) is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, professional service firms, law firms and market infrastructure service providers. It harnesses the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. It drives consensus, advocates solutions and effects change around key issues through the collective strength and clarity of one industry voice. ASIFMA is based in Hong Kong and is the Asia member of the GFMA.

About FIA
FIA is the leading global trade organization for the futures, options, and centrally cleared derivatives markets, with offices in London, Brussels, Singapore and Washington, DC. FIA's mission is to support open, transparent and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct. FIA's membership includes clearing firms, exchanges, clearing houses, trading firms and commodities specialists from about 50 countries, as well as technology vendors, law firms and other professional service providers..

About GFXD
The Global Foreign Exchange Division (GFXD) was formed in co-operation with the Association for Financial Markets in Europe, Securities Industry and Financial Markets Association and ASIFMA. Its members comprise 24 global foreign exchange (FX) market participants, collectively representing a significant portion of the FX inter-dealer market. Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.