EU Benchmark Regulation: Is your transaction up to the mark?

Key points

- the EU Benchmark Regulation is, as of January 1 2018, now in effect, applying to administrators, users and contributors to benchmarks;
- the Benchmark Regulation defines these terms widely, so a broad range of transaction parties may be affected by the changes;
- transaction parties must ensure that their transaction documents are compliant, specifically by creating contingency plans and implementing wording in relation to any benchmarks connected to a finance transaction;
- grandfathering provisions are limited in both scope and length, meaning that affected parties must now ensure that they are compliant with the Benchmark Regulation in their transactional work as soon as possible, especially as penalties for non-compliance can be severe.

Introduction

On 30 June 2016, the EU Benchmark Regulation[1] came into force, imposing new requirements on administrators, users and contributors to a wide range of interest rate, currency and securities commodity indices and reference prices in securitizations and structured finance transactions. The scope of the Benchmark Regulation is much broader than any existing EU framework and will affect activities and firms that use benchmarks, as well as those administering or contributing to benchmarks. Most of the provisions took effect from 1 January 2018 and are directly applicable to EU firms that are benchmark users, administrators or contributors, without the need for national implementing legislation.

Benchmarks are used to price transactions in a variety of financial instruments and services, both domestic and cross-border, and are relied upon as a standard to measure the performance of an investment or security. The accuracy and integrity of a benchmark's underlying data and methodology are therefore highly relevant to the stability of the financial markets.

The impetus behind the Benchmark Regulation is to ensure the reliability of benchmarks in the wake of manipulation of the Euro Interbank Offered Rate and other critical benchmarks. There was much lobbying as the Benchmark Regulation was developed, partly due to the significant effect that a more stringent regulatory regime would have on the financial industry.

Grandfathering provisions in the Benchmark Regulation are limited and existing documents may need to be updated, so it is essential that market participants who are affected ensure their compliance as soon as possible not only on future transactions, but existing ones as well.

Am I or my transaction subject to the Benchmark Regulation?

The scope of the Benchmark Regulation is deliberately broad in order to establish a preventative regulatory framework.

A 'benchmark' is widely defined as:

> *"any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument is determined or an index that is used to measure the performance of an investment fund with the purposes to track the return of such index or to define the asset allocation of a portfolio or to compute the performance fees."*

1 EU Regulation 2016/1011

An 'index' is further defined as any figure that is:

– published or made available to the public

– regularly determined (either wholly or partially) by the application of a formula or any other method of calculation, or an assessment where determination is based on the value of one or more underlying assets or prices (including estimated prices, actual or estimated interest rates, quotes and committed quotes or other values or surveys)

Under the Technical Advice published by the European Securities and Markets Authority (**ESMA**) in November 2016, an index is "made available to the public" if it is accessible to an "indeterminate number" of recipients. The key is that there will be an open group of recipients that could change in size and composition, regardless of whether this is a limited number of people or access is restricted by payment of a fee. Accordingly, even figures made available to investors in a specific instrument are caught, given that investors typically trade their financial instrument and the group of holders changes over time. An indeterminate group in this context could obtain access to the index.

In addition, where an investor can derive an index value from published differentials, values of financial instruments and investment funds, strike prices or coupons, that value should be considered available to the public – a position that caused controversy during consultation. In this respect, the Benchmark Regulation goes further than what is typically considered to be an index under existing domestic regulation.

ESMA has published a register of administrators and third country benchmarks for market users' reference[2].

If I am subject to the new rules, why should I act now?

Transitional provisions will apply to existing benchmarks. ESMA has clarified that this will include all benchmarks in financial contracts or instruments that are in place on 1 January 2018, but has made no suggestion that this will extend to benchmarks pending authorisation. Accordingly, no benchmark can be created after 1 January 2018 until it has been authorized.

A supervised entity user (see below) may continue to use an unauthorized benchmark until January 2020 or, if an application for authorization is made and refused, until the date of such refusal. In addition, where the relevant national authority agrees that altering or ceasing a specific benchmark to fulfill the requirements of the Benchmark Regulation will result in a *force majeure* event or frustrate the terms of any financial instrument or contract, the benchmark may continue to be used under such instrument or contract until such time as is agreed by that authority.

However, prospectuses approved prior to 1 January 2018 must be updated by 1 January 2019. As such, for market users who are not 'supervised entities' and cannot benefit from the grandfathering provisions it is even more crucial to be compliant as soon as possible.

Regulators are continuing to work on transition issues from existing benchmarks with market participants through entities such as the Financial Conduct Authority (**FCA**)'s market-led working group on Sterling Risk-Free Rates and the European Central Bank (**ECB**)'s Working Group on Euro Risk-Free Rates. The FCA has also published a policy statement (PS17/28) setting out near-final rules to accompany the application of the Benchmark Regulation.

No time limit has been imposed for these grandfathering provisions, which is welcome.

2 https://www.esma.europa.eu/benchmarks-register

What does this specifically mean for structured finance and securitization transactions?

Issuers, originators and service providers of securitization and structured finance transactions must carefully consider their obligations as benchmark users under the Benchmark Regulation. The following issues are of note:

- under Article 29(2) of the Benchmark Regulation, issuers will need to include in prospectuses published under the Prospectus Directive or the Undertakings for Collective Investment in Transferable Securities Directive a "clear and prominent" statement (for which the International Capital Markets Association (**ICMA**) has provided a model wording example for prospectuses), on whether the benchmark being used for the issued financial instrument is provided by an administrator included on the ESMA register of benchmarks and administrators mentioned above;
- consideration may be required as to whether provisions should be included in transaction documentation to ensure that calculation agents, cash managers and other service providers (e.g. derivatives counterparties) comply with their obligations as benchmark users;
- when originating consumer credit and mortgage loans, appropriate due diligence and consideration may be required as to whether it is necessary to include representations in related transaction documentation to ensure that only eligible benchmarks are being used to determine the amounts owed by borrowers and to ensure that the underlying loan or mortgage agreement identifies the benchmark, its administrator and the potential implications for the borrower;

- consideration should also be given as to whether it is necessary to include disclosure (such as risk factors) in the related securitization prospectus, as well as representations and warranties in transaction documentation, to the effect that amounts owing under the underlying loans or mortgages are all determined using an eligible benchmark;
- under Article 28(2), where any of the transaction parties are supervised entity users, they must produce and maintain "robust written contingency plans" setting out the actions that they will take if a benchmark that they use materially changes or ceases to be produced. These contingency plans must be reflected in client-facing documents (including contracts entered into before 1 January 2018, where practicable and on a best-effort basis) and provided to the firm's regulator on request;
- these plans should, where feasible and appropriate, nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. In a securitization context, this could mean a supervised entity issuer including the 'robust written contingency plans' in the terms and conditions of the instrument, or a calculation agent in the agreement which appoints them;
- the International Organization of Securities Commissions (**IOSCO**) published a statement on 4 January 2018 setting out matters to consider in contingency planning and selecting an appropriate benchmark. Users should select benchmarks for their own current and future needs, and those of their clients, and consider how well a particular

benchmark meets those needs. In any case, users should periodically assess the appropriateness of a given benchmark. For contingency planning, sufficiently robust fallback provisions should be included involving, at least, one alternative or fallback rate as a substitute should the benchmark initially referenced become unavailable. Such fallback provisions should be put in place in new and, where possible, existing arrangements.

Am I a benchmark user? If so, what does that mean?

The obligations now placed on benchmark administrators, contributors and users will create a regime with much more stringent controls than those existing under national law.

Under the Benchmark Regulation, the concept of a benchmark user is widely drawn and encompasses anyone that:

- issues a financial instrument[3] that references a benchmark;
- determines the amount payable under a financial instrument or financial contracts, including certain consumer credit agreements and mortgages[4], by referencing a benchmark;
- is a party to a financial contract which references a benchmark;
- provides a borrowing rate calculated as a mark-up of a benchmark;
- measures the performance of an investment fund through an index.

While the Benchmark Regulation will affect all benchmark users, its obligations and restrictions apply only to users that are "supervised" entities, including:

- credit institutions;
- investment firms;
- insurers or reinsurers;
- pension funds;
- undertakings for collective investment in transferable securities;
- central counterparties;
- trade repositories.

Merely holding a financial instrument that references a benchmark does not constitute use of a benchmark. In the derivatives market, those affected may include supervised entities who issue or are party to financial instruments which reference an index.

Supervised entities may apply a benchmark only if it or its administrator appears on a register of eligible benchmarks maintained by ESMA. This register can include benchmarks provided by non-EU administrators which have satisfied the requirements for equivalence under the Benchmark Regulation.

These changes will have an impact on future issuances. The prohibition on using unauthorized benchmarks may limit both buy and sell-side activities by restricting the types of security that EU-supervised entities can respectively hold and issue. This may have a particular business impact on bank issuers of structured products.

3 For example, transferable securities which are traded or for which a request for admission has been made to trade on a regulated market or multilateral trading facility, or an organized trading facility. As the same definition as in MiFID II is used, it includes structured products, listed and exchange traded derivatives and over-the-counter derivative trades.

4 Credit agreements under Article 3(c) of Directive 2008/48/EC and Article 4(3) of Directive 2017/17/EU.

Why is it so important to comply?

National competent authorities now have the power to impose a range of penalties, including fines and non-financial penalties, for infringement of the Benchmark Regulation or failure to cooperate with an investigation. For instance, the authorities may:

- make cease and desist orders;
- order the disgorgement of gains arising through a breach;
- issue public warnings;
- the financial penalties for a breach of the requirements applicable to benchmark users are:
  - at least €500,000 for individuals;
  - the higher of either €1M or 10% of the total annual turnover for companies and other legal entities.

Member states may grant their competent authorities power to impose higher levels of penalties, or elect to impose no administrative penalties where an infringement is subject to criminal penalties under national law.

What is the goal of these reforms?

The Benchmark Regulation aims to establish a consistent and effective regime to address vulnerabilities and restore market confidence in indices used as financial benchmarks by:

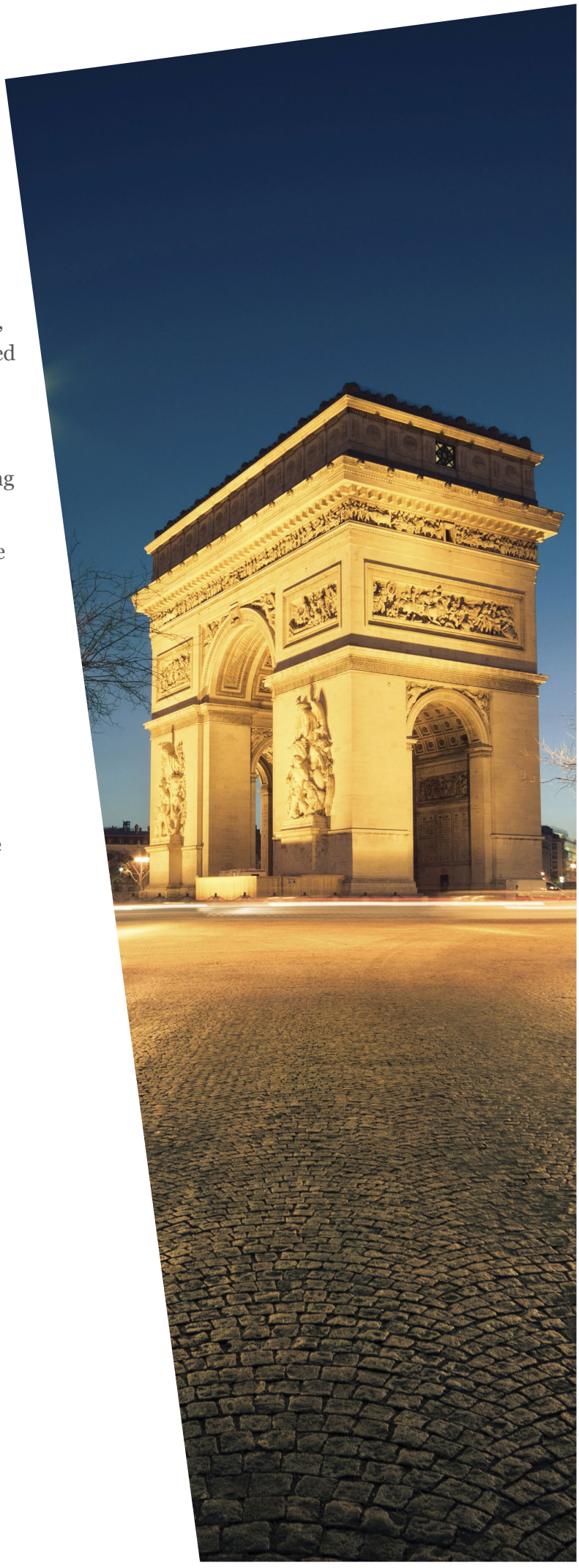
- improving the governance and controls over the benchmark process;
- improving the quality of input data and methodologies;
- subjecting contributors to adequate governance controls;
- ensuring adequate protection for consumers and investors through greater transparency and rights of redress.

In effect, the Benchmark Regulation limits administrators' ability to set benchmarks using their own discretion, and prohibits the use in the European Union of unauthorized benchmarks, including those prepared by unregistered administrators outside the European Union. The aim is to ensure the robustness and reliability of benchmarks and benchmark determination, thereby strengthening trust in the financial markets. The framework also aims to give stakeholders transparency on how a benchmark is derived, enabling them to assess its representativeness, relevance and appropriateness for its intended use, and consequently to ensure a harmonized regime across the European Union, with no risk of divergence in scope and application

Non-EU benchmarks

Non-EU benchmarks can be authorized for use in the European Union by way of equivalence, recognition or endorsement, but in practice these methods will present challenges. For example, an equivalence decision is likely to be relevant only for a limited number of jurisdictions, which would not include the United States, and the ability to apply for recognition will exist only where such an equivalence determination is pending. The endorsement regime requires an endorsing EU administrator to take on direct responsibility for – and oversight of – the benchmark, meaning that it may be only non-EU affiliates that look to use this.

Non-EU administrators will also have little incentive to seek such authorization, particularly if they derive low licence revenues from the European Union.



Comment

Now that the Benchmark Regulation has taken effect, supervised entities in the securitization and structured finance market should start to identify which of their business lines are engaged in activities that may constitute the use of a benchmark and consider how this may affect operations – for example, when issuing securities or entering into derivatives contracts.

Market participants should aim to ensure compliance and determine whether administrators will continue to provide benchmarks, particularly where these are outside the European Union. ISDA has worked on this issue in cooperation with regulators and intends to publish an ISDA Benchmark Supplement this year detailing amendments to standard terms for certain products required to demonstrate compliance with Article 28(2).

As such, market users should continue to keep an eye on regulators and industry bodies who will provide more guidance as to best practices for maintaining Benchmark Regulation compliance over the next two years.

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