

THE VICE CHAIRMAN

6 October 2020

Mr. Tilman Lueder,
Head of Securities Markets
Directorate-General for Financial Stability
Financial Services and Capital Market Union
European Commission
1049 Bruxelles
Belgium

RE: EFMLG FEEDBACK TO THE EUROPEAN COMMISSION PROPOSAL TO AMEND THE BENCHMARK REGULATION.

Dear Mr. Lueder,

As you know well, the European Financial Market Lawyers Group (EFMLG) intends to foster the harmonization of laws and market practices in the European Union (EU) and to facilitate the progress in the Capital Markets Union.

By means of this letter, the EFMLG is very pleased to contribute to the feedback process opened by the European Commission (EC) on the EC proposal to amend the European Benchmark Regulation (BMR) by introducing, among other changes, the so-called replacement tool that would allow the EC to designate a statutory fallback provided that certain conditions are met. We apologize for not submitting our feedback through the ad hoc EC page.

The EFMLG welcomes the EC proposal. In our opinion, the proposal is a very positive step to facilitate a smooth and safe transition from current IBORs towards risk free rates. We also note that the EC proposal is, in fact, aligned with *legislative scenario 2* included in the EFMLG presentation that the EFMLG shared with you in its letter dated 20 March 2020.

In addition, we would like to contribute further to this very positive step of the EC by providing feedback on the following points:

1.- Scope.-

1.a) Scope of products.- Although, as we say, the statutory fallback is seen by the EFMLG as a very positive measure, obviously, the effects of the measure may be very reduced if its scope is limited

to the products currently covered by the BMR. In the context of and for the benefit of financial stability, which is a key motivating factor of the measure, it would be desirable that **the scope of this tool is extended** to, at least, business loans (both syndicated and bilateral), financial instruments not traded on a trading venue and bonds issued by non-supervised entities. In this regard, we support the idea of **widening the scope of the BMR** to any contract or product linked to the particular affected benchmark for the specific purpose of the replacement tool.

1.b) Governing law of the agreements.- There have been some discussions about whether the replacement tool would apply only to contracts governed by the law of an EU Member State or if it would also be applicable to other potential situations. This is of course a difficult matter but also a fundamental one. **A precise definition of the jurisdictional scope would avoid further discussions and potential disputes among parties which may result into a weakening of the financial stability effects sought by the measure.** In this regard:

(i) We understand that the statutory fallback identified through the replacement tool will apply to contracts subject to any law of any EU Member State;

(ii) However, if the replacement tool is limited to that scope, its effects would be radically limited, as all contracts subject to New York (NY) and English law would fall outside the scope of the measure. But these are indeed the laws which are usually chosen in their cross-border transactions by the parties to which the statutory fall back is ultimately addressed.

Potential solutions for this problem would be:

- **To assess whether the statutory fallback may also be applicable to contracts subject to a third country law (NY, English, other) provided that all parties to the contract are established in the EU:**
 - This alternative would be based on the consideration that leaving those contracts outside the effects of the replacement tool would be detrimental to the EU financial stability which is indeed a key motivating factor of the EC proposal. Thus, the extension of the statutory fallback to contracts among EU counterparties subject to third country laws would operate as a matter of public order. Under this alternative, in the EU, for EU counterparties, the solution based on the application of the EU replacement tool would supersede the solution provided for under the law of the contract.
 - However, when not all the parties to the contract subject to a third country law would be based in the EU but only one or several of them would, the application of the statutory fallback to that contract, based as well on public order considerations, would be far more disputable. Nevertheless, the EU legislator might want to assess this alternative as well.

- **To coordinate similar actions with NY and UK legislators** in order to ensure that this tool is also available under those applicable laws and that an identical statutory fallback would be triggered for contracts subject to these laws.

In this regard, the US Alternative Reference Rate Committee suggested to the FED a similar legislative action and UK authorities have recently announced that they intend to provide the FCA with additional powers in order to reduce the negative impact that LIBOR cessation may have for some legacy contracts. A coordinated action by the EU, US and UK would provide certainty to the transition and to market participants.

The advantages of a coordinated approach are obvious but the EFMLG is also aware of the relative practical and timing difficulties that the materialization of such coordinated approach might face. In the meantime, the EFMLG supports the materialization of the EC proposal in the manner most conducive to financial stability in the euro area.

1.c) In-scope benchmarks.-

We **support the application of the replacement tool to benchmarks other than critical benchmarks** if their cessation, lack of representativeness or lack of authorization/registration of the administrator may result in significant disruption in the functioning of financial markets in the EU.

In this regard, for the sake of legal certainty, we would like to share the following comments:

(i) According to the EC proposal, the replacement tool would be triggered *“where the cessation of that publication may result in significant disruption in the functioning of financial markets in the Union”*. However, **trigger events are not only linked to the cessation of publication but also to the lack of representativeness of the benchmark**. Also, as explained below, the lack of authorization or registration of the administrator should also trigger the replacement tool. Therefore, the reference to the cessation of the publication does not seem sufficient. It should be completed with the reference to the other trigger events.

(ii) The replacement tool is included in the EC proposal as a new article 23a, within a **chapter which is dedicated to critical benchmarks** (chapter 4). This may create doubts about the possibility to apply the replacement tool to non-critical benchmarks. Article 23a may be included in a different chapter to avoid this potential confusion.

(iii) Some **benchmarks might mainly be used in a particular EU Member State** but their cessation, lack of representativeness or lack of authorization/registration of the administrator may result as well in significant disruption in the functioning of financial markets as a whole in the EU. This circumstance may be addressed by any of the following means:

- **Considering these national benchmarks within the scope** of the replacement tool in order for the EC to identify a statutory fallback for them as for any other benchmark which may impact financial stability in the Union.
- **Imposing on Member States the need to trigger the replacement tool** through the enactment of national legislation if any of the national benchmarks is at risk and may result in a significant disruption in the functioning of financial markets in the EU.

2.- Trigger events.-

2.a) New trigger event.- We support the trigger events included in the EC proposal and, as already indicated, would also recommend the **inclusion of a new trigger event: that the competent authority withdraws or suspends the authorization or registration of the benchmark administrator**, provided that, at the time of the withdrawal or suspension, there is no successor administrator that will continue to provide that benchmark.

Although art. 35.3 of BMR provides an option to continue using the benchmark in legacy contracts in these situations, the use of a non BMR compliant benchmark would pose high litigation risks (similar to the risks linked to using a non-representative benchmark) that would be solved by the application of the replacement tool.

2.b) Implementing act.- In terms of procedure, it would be of the utmost importance **that the replacement tool is triggered, and that the statutory fallbacks are applied, before the benchmark is effectively affected by the relevant trigger event.** This is, the statutory fallback should be applying to the contract before the former benchmark has ceased to be published or has become non representative of the underlying interest.

In the first case, for obvious reasons; in the second scenario (non-representativeness), because the use of a non-representative benchmark in a contract until the statutory fallback is actually triggered may imply high litigation risk.

2.c) Trigger event dates.- In order to avoid disputes between the parties of the contract, the relevant **implementing act must specify the dates in which the replacement benchmark(s) are effective.** Considering that the replacement tool may be activated by a specific event (i.e.: a statement made by the relevant competent authority) which may or may not match with the date of effects of such event (i.e.: it is announced that the benchmark administrator will cease to provide the benchmark in 3 weeks) legal certainty would be needed to avoid different effective dates within the market or discrepancies between the parties of the contract.

3.- Suitable fallbacks.-

One of the most complex discussions in connection with the EC proposal is certainly the one around the concept of “*no suitable fallback*”. In this regard, the EFMLG would like to contribute to the debate with the following comments:

(i) We would **avoid the reference to no suitable fallbacks itself**. Many of the fallbacks included in legacy contracts may not be operationally workable or could lead to unintended consequences from an economic perspective. Also, the *non-suitable tag* is an undefined legal term which would yet become the trigger of consequences which are strictly legal in nature. In addition this *tag* may have other implications or meanings within European legislation that would be preferable to avoid.

(ii) Instead of the undefined reference to “no suitable fallback” our proposal would be rather to **directly identify a list of cases/fallbacks in which the statutory fallback would apply**, leaving the door open for additional specification by way of the relevant implementing act. Within that list of cases/fallbacks that would be overridden by the statutory fallback, the BMR text could include, without being exhaustive:

- Contracts with no fallback;
- Contracts in which the application of the fallback requires further consent from the parties in case of a permanent cessation of the relevant benchmark;
- Fallback rates involving a poll, survey or inquiries for quotes from third parties;
- Fallback rates calculated by fixing the last publication of the affected benchmark until maturity;
- Fallback rates based on a particular interest rate without an adjustment spread that would re-balance the position of the parties in the relevant product or contract.

In addition to this list, as the various benchmarks potentially subject to the replacement tool may be used in different types of agreements which, in turn, may contain very different (and unworkable) fallbacks, **our proposal would be that the level 1 legislation to be adopted on the basis of the EC proposal allows the EC to make further specification in the relevant implementing acts of:**

- (a) **any other fallback which should be overridden by the statutory fallback**. With this tool, the EC would be able to provide ad hoc solutions to particular problems linked to a given benchmark;
- (b) **any particular fallback that should not be overridden by the statutory fallback**. With this tool, the EC would be able to maintain industry initiatives that have been

able to implement workable fallbacks in the agreement and that should not be overridden (i.e.: ISDA protocols, new LMA templates, etc.)

In general terms, it could be said that legacy contracts do not include workable or economically equivalent fallbacks as the IBORs' risk of disappearance has not been a reality until 2017 and fallback rates based on new risk free rates have been identified only recently or are even pending to be recommended. In this regard, **a wide list of situations in which the statutory fallback applies would likely solve an historical problem with a fair/balanced solution.**

At the same time, this list of situations of application of the statutory fallback would not really override contractual freedom of parties as most of these parties would have probably agreed on the fallback rate without considering the IBOR cessation or without having the possibility to consider a different and workable fallback provision.

(iii) In any case, it is of the utmost importance to **avoid open concepts** as "suitable fallbacks" or references to "fallbacks which do not cover the permanent cessation of a reference benchmark".

This last reference **would also create huge legal uncertainty**, as the party who may benefit from the application of the original fallback may argue that its intention when entering into the contract was that such a fallback provision would cover a permanent cessation. **That discussion will probably end up in the courts, increasing legal uncertainty, associated costs and creating an additional burden for the judiciary system.**

For the sake of clarity, we may use an example with a contract in which the fallback implies the fixing of the last publication of the benchmark. It may be clear that neither party was considering a permanent cessation of the benchmark when that fallback was agreed, but the party who may benefit from that benchmark (the client in some long term loans; the issuer in long term bonds...) could bring before the courts that, in fact, that was its original intention and, consequently, the statutory fallback should not apply.

At the end of the day, it is a financial decision that many entities may take. **That may dramatically increase litigation along Europe, multiply litigation cost and would not ensure a final and unique result, as courts across Europe and even within a particular EU Member State may provide different resolutions (as the discussion would also be a matter of facts).**

In our opinion, it would be preferable to have a close list (long or short) of situations in which the statutory fallback would apply rather than having an open concept which leaves the interpretation to contractual parties and thus opens the floor for litigation and financial risks.

4.- Statutory fallback.

4.a) Not one but several replacement rates for different products.- We welcome the initiative from the EC to base the identification of the statutory fallback on specific work published by the relevant nearly risk free rate working groups (RFR WGs). In this context:

(i) considering that the RFR WGs are recommending different fallbacks for the different products, the statutory fallback shall also reflect that situation. For that purpose, the **reference should be made to one or more replacement rates instead of just one;**

(ii) consequently, also **adjustment spreads** for the different tenors should be provided together with the relevant benchmarks.

4.b) Conforming changes: embedding new rates into an existing contract may create some operational mismatches that should be re-adjusted. In this regard, new fallback clauses normally include “conforming changes” wording that provides one party with the possibility of making those adjustments. In the absence of that contractual agreement, a **description of the conforming changes in the relevant implementing act would avoid disputes between parties to the contract.**

4.c) Opt out: the explanatory memorandum envisages on page 12 the ability for all the parties to a contract to opt-out of the statutory fallback. We agree with this possibility and consider that an **explicit reference** to the opt-out in the legislative text would clarify that freedom of the parties may override the application of the statutory fallback once it has been triggered.

5.- Conversion powers.

In the letter that the EFMLG addressed to you on 20 March 2020, we identified a third *scenario* called “the tracker solution” which is also known in the market as the “synthetic benchmark” or “conversion powers”. As we stated in our letter, both the *second* (statutory fallback) and the third *scenarios* found strong support across the EFLMG. In that regard, the EFMLG still believes that a combination of both scenarios is compatible and consistent with the aim of ensuring the availability of sufficient legal tools to address the various potential situations that might arise in the short, medium or long term.

Therefore, as much as we support the statutory fallback solution, we would like to recall the benefits of having conversion powers as an additional tool to the statutory fallback. In addition to the arguments provided in the presentation attached to our former letter, please note that:

(i) We understand that **conversion powers would not solve the LIBOR problem**. In that case, and notwithstanding the solutions that UK authorities may provide, we agree that the EU solution should be the statutory fallback. In that regard, the conversion powers should not be included in the BMR as an obligation for the authorities, but as an additional tool that might be used or not depending on the circumstances. Our **support to the conversion powers to be added as a tool to the statutory fallback solution is mainly triggered by the**

thought of a potential EURIBOR cessation in the future. According to the Minutes provided by the UK Working Group, UK authorities are still thinking of conversion powers for LIBOR. Having a similar tool in the BMR which might be used for EURIBOR in the future seems to be a useful alternative for the EU even if finally it is never used.

(ii) If the conversion power is executed through an implementing act, the risk would be as limited as for the statutory fallback. Maybe even less than for the statutory fallback, as there would be neither discussion nor litigation around the concept of suitable fallback. (See our remarks above on the convenience to avoid this latter concept, nevertheless).

(iii) Current article 23.6.d) already provides a very favorable framework for the conversion powers. In fact, it could be understood that the conversion powers are already granted to the relevant competent authorities and that the only provisions that should be added would relate to the procedural aspects of its exercise.

6.- Article 23.6.d) and material change.-

Irrespective of whether conversion powers are reinforced or not by way of amending article 23.6.d) it would be positive to introduce a reference either in such article or in article 28.2 stating that any changes resulting from the application of article 23.6.d) should not be considered as a material change of the benchmark as per article 28.2.

The introduction of such a reference would provide legal certainty to market participants and prevent fallback provisions from being triggered due to a change in the benchmark methodology which, if done through the application of article 23.6.d), is intended to ensure the benchmark continuity rather than its cessation or lack of application.

7.- EONIA transition to €STR + 8,5 bp.-

The first possible use case of the new replacement tool could be EONIA, which cessation is scheduled for 3 January 2022:

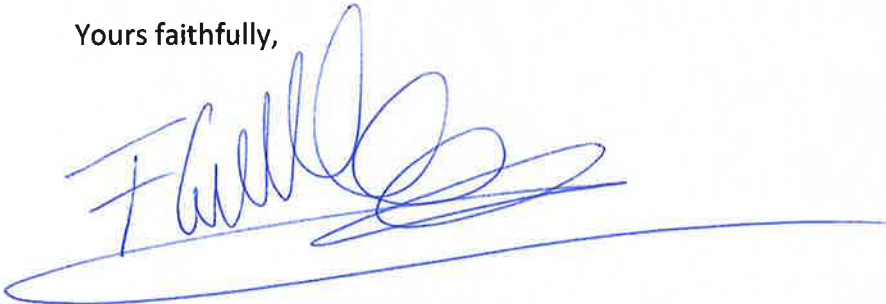
(i) It will provide legal certainty to the transition from EONIA to €STR. There are many collateral agreements subject to EU Member States' laws that would benefit from this measure with no downside for any of the parties. The private sector is currently negotiating the transition from EONIA to €STR plus a compensation payment, but those negotiations may end unsuccessfully. The statutory fallback would provide a safety net and prevent unfair negotiations.

(ii) The equivalence between EONIA and €STR+8,5bp is widely accepted in the market so there will be little room for controversy in this regard. We do not see any downside with regard to the application of the replacement rate in this context.

(iii) It could be a **good test for this new tool**: the EC and market participants may benefit from the experience obtained in EONIA/€STR+8,5bp for more complex applications that will come in the future (i.e.: LIBOR).

We appreciate your consideration for the EFMLG feedback in this legislative project of utmost importance. The EFMLG stays at your disposal and that of the EC for further discussion including by means of a teleconference to discuss and explain further our feedback and proposals.

Yours faithfully,



Fernando Conlledo Lantero

EFMLG Vice Chairman

