Clients&FriendsMemo

Proposed Amendments to the European Benchmark Regulation Address "Tough Legacy" IBOR Contracts

July 24, 2020

The European Commission has today published a draft regulation[1] to amend the Benchmark Regulation[2] ("**BMR**"), in respect of (i) the exemption of certain third country foreign exchange benchmarks and (ii) the designation of replacement benchmarks for certain benchmarks in cessation (the "**Draft Regulation**"). The latter portion of the regulation is modeled on legislation proposed by the ARRC for New York governed contracts.[3]

I. A statutory replacement rate

In the view of the European Commission, the BMR has to be amended to establish a statutory replacement rate to facilitate the mitigation of the adverse consequences for legal certainty and financial stability that might ensue if LIBOR was discontinued without a replacement rate being both available and integrated into legacy contracts that involve *supervised entities*[4] (such as banks, investment firms or asset managers) that are within the scope of the BMR.

Conditions for exercise of the power

The Draft Regulation empowers the European Commission to designate a replacement benchmark where (A) a benchmark will cease to be published, and (B) the cessation may result in significant disruption in the functioning of financial markets in the EU. The conditions to the exercise of the new powers will be that:

(a) the competent authority for the administrator of that benchmark has issued a public statement, or has published information, in which it is announced that the capability of that benchmark to

1 https://ec.europa.eu/finance/docs/law/200724-benchmarks-review-proposal_en.pdf.

2 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016R1011.

3 https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Proposed_Legislative_Solution.pdf. Cadwalader served as counsel to the ARRC in drafting the New York legislation.

4 For non-supervised entities, the laws of the Member States would need to be extended and harmonised. The European Commission intends to set up a working group with Member States to ensure the smooth transition of all LIBOR referencing contracts to the statutory replacement rate in a uniform way.

measure the underlying market or economic reality cannot be restored through the exercise of any of the remedial powers;

(b) the administrator of a benchmark has issued a public statement, or has published information, or such public statement has been made or such information has been published on behalf of that administrator, in which it is announced that that administrator has ceased or will cease to provide the benchmark, permanently or indefinitely, provided that, at the time of the issuance of the statement or the publication of the information, there is no successor administrator that will continue to provide the benchmark; or

(c) the competent authority for the administrator of a benchmark or any entity with insolvency or resolution authority over the administrator of that benchmark has issued a public statement or has published information in which it is stated that the administrator of that benchmark has ceased or will cease to provide that benchmark permanently or indefinitely, provided that, at the time of the issuance of the statement or the publication of the information, there is no successor administrator that will continue to provide that benchmark.

Recommendations of relevant working groups

When it designates a replacement benchmark, the European Commission will take into account, where available, the recommendation by an alternative reference rate working group operating under the auspices of the central bank responsible for the currency in which the interest rates of the replacement benchmark are denominated.[5]

Replacement by operation of law

A replacement benchmark so designated by the European Commission shall, *by operation of law*, replace all references to the benchmark that has ceased to be published in financial instruments, financial contracts and measurements of the performance of an investment fund where those contracts or instruments: (a) reference the benchmark that has ceased to be published on the date the implementing act designating the replacement benchmark enters into force, and (b) contain no suitable fall-back provisions.

II. A special case for currency spot rates; exemption of specific foreign exchange benchmarks

Almost no other jurisdiction regulates spot exchange rates

At the end of the current Brexit transitional period,[6] the reference to foreign exchange spot rates in EU-traded currency forwards or swaps will no longer be allowed. This means that, at the beginning of 2022, EU supervised entities are at risk of losing access to many public policy rates

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[5] For example, when designating the statutory replacement rate for USD LIBOR, the Commission should align with the recommendations for all USD LIBOR tenors that will be issued by the Alternative Reference Rate Committee in the US.

[6] Set out in Article 51 of the BMR.

administered outside the EU, including spot foreign exchange rates that they reference in derivative contracts that they offer corporate counterparts to help them manage their day-to-day hedging of currency risk.

Due to the absence of regulation, currency spot rates could not be the subject of an equivalence assessment under the BMR. The Draft Regulation, therefore, makes targeted modification of the scope of the BMR in order to ensure that European companies retain access to hedging tools against volatility of currencies that are not freely convertible into their base currency, ensuring seamless continuation of their business activities abroad after the expiry of the transitional period at the end of 2021.

Conditions to exemption

In order for the spot foreign exchange benchmark to qualify for exemption, it has to: (1) measure the spot exchange rate of a third-country currency that is not freely convertible and (2) be used by EU supervised entities, on a frequent, systematic and regular basis as settlement rate to calculate the pay-out under a currency forward or swap contract.

A public list will be maintained

The European Commission shall maintain a list of foreign exchange benchmarks that fulfill those criteria. The local regulators of supervised entities that use the designated third country foreign exchange benchmarks will have to report to the Commission and to ESMA on the number of derivative contracts at least every two years.

Next steps

The European Parliament and the Council will now have to review the proposal by the Commission, and may propose amendments. We understand that the expected publication and entry into force is by end of December 2020.

UK and Brexit

If the Draft Regulation is agreed and published in the Official Journal of the EU by the end of 2020, then it - being a regulation - will automatically become part of UK law, but the UK will be free to modify the UK BMR accordingly after the end of 2020.

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