MEMO# 32824

October 9, 2020

LIBOR Update: ICI Global Revised Position Paper on the European Union Benchmark Regulation; Your Feedback Requested

[32824]

October 9, 2020 TO: ICI Global Regulated Funds Committee
LIBOR Transition Working Group
SEC Rules Committee RE: LIBOR Update: ICI Global Revised Position Paper on the European Union Benchmark Regulation; Your Feedback Requested

Last month, ICI Global submitted a position paper on the European Commission's proposal to amend the EU Benchmark Regulation (BMR) to allow a replacement benchmark rate to substitute for LIBOR in "tough legacy" contracts that still reference LIBOR after it is discontinued.[1] Since our submission, the European Council has finalized its general approach to the BMR proposal[2] and the European Parliament has initiated its consideration of the proposal.[3] Given these developments, ICI Global is considering a submission of a revised position paper to make specific recommendations to the European Parliament based on the most recent drafts of the BMR, as described below.

Please let us know your feedback on the attached ICI Global draft position paper by emailing bridget.farrell@ici.org with any questions or comments by Wednesday, October 14.

Updates in the European Parliament Draft Report and European Council General Approach

While the both drafts are broadly consistent with the European Commission BMR proposal from earlier this year, the European Parliament Report and European Council General Approach make some notable changes that merit attention.

European Parliament Draft Report

- *"Suitable" fallback language*: The European Commission proposal would have applied the BMR replacement rate to financial instruments and contracts that referenced a discontinued benchmark and did not have "suitable" fallback language. The European Parliament Draft Report removes the term "suitable." Under the Draft Report, the BMR replacement rate will apply to financial instruments and contracts that reference a discontinued contract and contain no fallback provisions.

- *OTC Derivatives*: The European Parliament Draft Report adds a clarification that derivatives contacts should continue to be considered legacy trades that do not trigger clearing and margining requirements when those contracts are updated for a benchmark replacement.

European Council General Approach

- *Contracts governed by the law of an EU Member State*: In an expansion of the scope of the BMR, the European Council General Approach would apply the BMR not only to EU-regulated financial instruments and contracts[4] but also to financial instruments and contracts that are subject to the law of an EU Member State. This expansion is consistent with the recommendations ICI made in its earlier position paper.
- *Contracts governed by third-country law*: In a further expansion, the European Council General Approach would apply the BMR replacement rate to contracts governed by the laws of non-EU jurisdictions that have been entered into by EU parties if the non-EU jurisdiction does not provide for an orderly wind down of a benchmark.
- *Fallback language that does not contemplate permanent cessation of a benchmark*: In contrast to the European Parliament draft, the recital of the European Council General Approach states that the BMR replacement rates would apply to financial instruments and contracts containing a fallback provision "which [does not] addresses the permanent cessation of a benchmark." For those fallbacks that contractual counterparties have determined are not "intend[ed] to cover the permanent cessation of a chosen benchmark," the recital provides a safe harbor for use of the BMR replacement rate.
- *Fallback language that does not reflect economic reality*: The European Council General Approach states that the replacement benchmark "under certain preconditions" should apply to instances where relevant EU authorities[5] have established that an originally agreed-upon fallback provision "no longer reflect[s] the economic reality that the ceasing benchmark was intended to measure or could pose a threat to financial stability."

  The legislative text describes the preconditions for applying the benchmark rate to contracts under these circumstances. First, a relevant authority would establish that a certain fallback provision does not reflect the underlying market or economic reality and could have an adverse impact on financial stability. Following that assessment, the second precondition requires one of the parties to the contract to object to the fallback language at least three months before the permanent cessation of the benchmark. Finally, the contractual counterparties must be unable to come to an agreement on an alternative replacement rate before the permanent cessation of the benchmark.

Draft Revised ICI Global Position Paper

Consistent with the position paper we previously submitted on the European Commission proposal, ICI Global'srevised position paper supports the BMR proposal overall. We urge EU authorities to align their approach with the tough legacy solutions proposed in other jurisdictions to promote legal certainty and support funds' operational transition.

Regarding the application of the BMR to contracts that are governed by the laws of non-EU countries, we recommend that the European Parliament clarify, consistent with the European Council approach, that the BMR would only apply if all parties to the contract were EU entities and the third-country jurisdiction otherwise did not address LIBOR discontinuation. We would urge the EU, to the extent possible, to promote alignment of tough legacy solutions across the globe to minimize differences between approaches to reduce litigation risk even in cases where there may be uncertainty about which jurisdiction laws govern a contract.

We also recommend that the European Parliament follow the European Council's approach in expanding the application of the BMR to not only EU-regulated contracts and financial instruments but also to contracts and financial instruments subject to the laws of an EU Member State.

As for the application of the BMR, ICI Global supports a narrowly-tailored approach contracts in which there is no fallback language or fallback language that references LIBOR or another benchmark being permanently discontinued. Additional requirements that the fallback to be "suitable" or "intended to cover the permanent cessation of chosen benchmark" would not be advisable as they would increase legal uncertainty. Similarly, providing for EU authorities to make a determination that particular fallback language "no longer reflect[s] the economic reality or could pose a threat to financial stability" would be likely to increase the risk of litigation over already agreed-upon contractual language.

We further support requirements that the EU consider industry rate conventions in setting replacement rates for LIBOR in applicable currencies. Standardized rate conventions for tough legacy contracts across the globe will minimize the risk of litigation or regulatory arbitrage.

Finally, ICI Global also welcomes the European Parliament's approach to considering OTC derivatives that are updated for benchmarks to be legacy trades for purposes of clearing and margin requirements.

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Attachment

endnotes

[1] *See* ICI Memorandum No. 32777, *available at* https://www.ici.org/my_ici/memorandum/memo32777. *See also* European Commission's proposal to amend EU rules on financial benchmarks (Jul. 24, 2020), *available at* https://ec.europa.eu/info/publications/200722-proposal-benchmarks_en.

[2] *See* Council of the European Union Presidency Compromise Text ("European Council General Approach") (Oct. 6, 2020), *available at* https://data.consilium.europa.eu/doc/document/ST-11049-2020-ADD-1-REV-1/en/pdf.

[3] *See* European Parliament Draft Report (Oct. 6, 2020), *available at*

https://www.europarl.europa.eu/doceo/document/ECON-PR-658859_EN.pdf.

[4] *See* Regulation (EU) 2016/1011.

[5] The European Council General Approach legislative text would require that EU Member States to designate relevant authorities. Any statement by a relevant authority that contractually agreed-upon fallback language does not reflect economic reality would eb reported to ESMA and the European Commission.
