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Industry Waking To Enormity Of EU Benchmarks Regulation

By **Mark Taylor**

Law360, London (May 9, 2017, 10:24 PM BST) -- Of the flurry of legislation swamping Europe's financial services sector in January, lawyers say one of the broadest and most problematic stems from attempts to stop manipulation of the benchmarks in financial instruments, a complex and demanding raft of changes that have flown under the radar as banks juggle with competing demands.

The second phase of the European Union Benchmark Regulation, which goes into effect at the beginning of 2018, reaches beyond traditional benchmarks such as commodities or the Libor money-market rate to include exchange-traded funds, performance of invest investment funds and credit contracts. It may also include major stock indices.

The EU's go-it-alone approach without equivalent legislation in other global markets like the U.S. can open huge implementation issues for regulators and compliance problems for European firms trading in international financial indices like the Standard & Poor's 500 or the Dow Jones Industrial Average. Information required by regulators might not be available in non-EU benchmarks and indices, lawyers fear, raising questions of how to deal with those outside jurisdictions.

"Right now, every bank is going through wholesale implementation programs of EU Benchmark Regulation," said Nicola Higgs, global financial institutions partner at Latham & Watkins LLP. "It is incredibly broad in scope, probably more than any regulator recognized when originally drafting the rules. The direction of travel is for there to be no aspect of regulated business that is not subject to regulation."

The EU Benchmark Regulation doesn't just regulate certain specific benchmarks; it defines what a benchmark is and regulates activities that fit the definition.

"It is so wide it doesn't just cover the usual suspects like Libor; it covers essentially any index made available to the public that is used to price or value a financial instrument or contract," said Mark Compton, financial services partner at Mayer Brown International LLP. "That takes it to an enormously broad level. It will cover indices used to value and price funds, those uses to price contracts, indices used as a bespoke measure for a specific structured derivatives contract."

It will be challenging to even identify each benchmark, let alone authorize and regulate the estimated 1 million-plus indices and benchmarks that are used in Europe, lawyers say.

"It will catch potentially all of the energy benchmarks, along with anything from Libor down to a very

bespoke calculation, which takes a basket of factors and then uses them to price a single derivative, in principle," Compton said. "It is very broad indeed. This is why it surprised people when it was first proposed and why it so different to what the U.K. has been doing to date."

Moving from no laws to a rapid and heavy regulation of benchmarks was the direct result of attempts to stamp out the lawless environment that allowed rogue traders in some of the world's biggest banks to rig markets for personal gain. Benchmarks such as Libor and its Brussels equivalent Euribor became the center of controversy in Europe and the U.S., saddling banks with fines and landing brokers in hot water with regulators.

In June 2012, Barclays PLC was fined $450 million by U.S. and U.K. regulators over alleged Libor and Euribor violations. Months later, UBS AG paid $1.5 billion to settle a similar case, followed by The Royal Bank of Scotland PLC, which agreed a $612 million settlement in February 2013. And in November 2015, the U.K. charged 10 former Deutsche Bank AG and Barclays employees in connection with Euribor manipulation.

The regulation comes amid litigation trials into the matter. In April, former Barclays derivatives trader Stylianos Contogoulas was found not guilty by a London jury of rigging Libor to boost his profits, dealing a blow to the Serious Fraud Office, which pursued the case. Another former Barclays derivatives trader, Ryan Reich, was found not guilty of the same offense at Southwark Crown Court. Both men had denied one charge of conspiracy to defraud.

The SFO won its first criminal trial over Libor in August 2015, ultimately securing an 11-year sentence for former UBS AG and Citigroup Inc. trader Tom Hayes. But the agency then failed in January 2016 to persuade a second jury to convict six brokers who it claimed had conspired with Hayes to manipulate the Japanese yen-denominated version of the benchmark.

Until 2014, calculation of Libor was overseen by the British Bankers' Association, based on submissions by a panel of banks, but following the controversy it is now handled by the Intercontinental Exchange, with greater emphasis on transaction data. Given what is at stake, the benchmark-setting process has been meticulously picked apart as officials attempt a move to a data-based methodology to ensure greater transparency after the rigging scandals.

However, last week, plans to reform the calculation of Euribor by using transactional data instead of bank submissions were abandoned due to the effects of regulation and low interest rates on the market, the administrator of the benchmark said. The Brussels-based European Money Markets Institute said it will not be going ahead with a proposed transaction-based methodology to calculate the rate.

"On Euribor, it seems an echoing of what we see in the U.K.; the methodology gets scrutinized heavily, [and] banks are concerned about contributing to something that throws up the wrong results only to then being held accountable for it," Higgs said. "When reform is suggested, banks rightly drill down on the proposals. This seems to be what has happened here. The industry has said the proposals don't work and need to be revisited."

Further complications arise when non-EU parties, be they benchmarks or indices, are involved.

"The new rules present a significant implementation challenge, particularly where EU firms reference non-EU benchmarks in securities or derivatives or use them in the management of investment funds," said Christopher Bates of Clifford Chance LLP.

One of the main areas of contention is the third-country aspect, according to Azad Ali, financial services regulatory partner at Fieldfisher LLP.

“For example, some of the largest traded indices are stock indices administered outside the EU, which from January 2018 cannot be used within the EU without regulatory approval,” Ali said.

There are several ways in which administrators outside the EU can get their index or benchmark used inside the EU, but there are lingering questions over how this will happen.

“One relies on the non-EU jurisdiction being deemed to have an equivalent regime to the regulation, which will be a difficult route simply because outside the EU, there is no regime as extensive as the regulation,” Ali said.

Another interim measure, he said, is recognition in a particular EU state of the non-EU administrator, which depends on whether the administrator is conforming to the global nonbinding guidelines set by the International Organization of Securities Commissions, the global standards setter.

He noted the particular problems some U.S. firms will face in overcoming the third-country aspect and how an avalanche of regulation had conspired to hide a particularly tricky compliance burden placed for firms dealing with a multitude of other issues.

Brexit aside, rules on packaged retail and insurance-based investment products, EU payment reforms, open banking, ring fencing and the inescapable second Markets in Financial Instruments Directive all go live in the first week of January. The MiFID II regulates firms that provide services to clients linked to shares, bonds, units in collective investment schemes and derivatives and is casting a long shadow over the sector.

“For many banks, MiFID is like performing open heart surgery: it touches every single business line of the bank, and quite significantly,” Higgs said. “The benchmark regulation is not as big a beast, and as a result, it is fair to say, may have been ignored or banks haven't had capacity to turn attention to it.”

The middle-to-small end of the market is where it may cause most ructions, Compton said, where a firm is possibly more likely to be defined as a user of a benchmark or a submitter of benchmark data, both having obligations.

“It is challenging for banks to find time and resource to implement a number of regulatory reform projects side by side whilst also asking their internal project teams to carry on with their day jobs,” Higgs said.

--Additional reporting by Alex Davis, Melissa Lipman, Paige Long and Stewart Bishop. Editing by Christine Chun and Brian Baresch.

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