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**The EU Benchmarks Regulation
and its ramifications for asset managers**

Co-authored by ASIFMA and Herbert Smith Freehills

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DEVELOPING ASIAN CAPITAL MARKETS

ASIA SECURITIES INDUSTRY &
FINANCIAL MARKETS ASSOCIATION

Unit 3603, Tower 2
Lippo Centre

89 Queensway
Admiralty, Hong Kong

Tel: +852 2531 6500
www.asifma.org

The [EU Benchmarks Regulation](#) (the **BMR**) came into effect on 1 January 2018, and will prohibit EU supervised entities from “using” an unregulated third country (i.e. non-European) benchmark in the EU from 1 January 2020.

However, the BMR's broad definition of the term "use in the EU", and expansive definition of EU "supervised entity", means that the BMR is likely to have a significant impact on asset managers in the APAC region and beyond in relation to their use of benchmarks. This is on the basis that the definition of "use in the EU" of a benchmark may capture activity which extends outside the EU, as discussed further below. Further, the definition of EU "supervised entity" for the purposes of the BMR includes Undertakings for Collective Investment in Transferable Securities (**UCITS**), UCITS management companies and Alternative Investment Fund Managers (**AIFMs**).

The BMR is likely to also affect those asset managers located in the APAC region who operate under a sub-delegation agreement with an EU asset manager which requires the APAC firm to comply with all applicable legislation applicable to the EU firm. Further, if regulated entities in the EU (e.g. banks, asset managers, funds, intermediaries and insurance providers) are unable to use unregulated benchmarks, EU end-users will also cease to have effective access, via EU market participants, to these benchmarks. This may hinder inward investment into the Asia-Pacific (**APAC**) region (as such investment cannot be hedged or benchmarked).

This paper sets out:

- (1) an overview of the BMR; and
- (2) the consequences of the BMR for asset managers specifically, as well as markets generally, if non-EU benchmark administrators do not successfully register their benchmarks.

The severity of the impact of the BMR outside the EU will depend significantly on whether non-EU benchmark administrators choose to register their benchmarks in the EU. However, a July 2017 survey conducted by ASIFMA and Herbert Smith Freehills of APAC benchmark administrators indicated that many benchmark administrators are unclear whether they will seek registration.

Ultimately, this means that there is a risk that many firms will be denied access to financial instruments and contracts that reference non-EU benchmarks, including derivatives, loans, bonds and mortgages. In the short-term, this is likely to give rise to liquidity, market access and contractual issues. Longer term, there is a risk that EU market participants will switch to alternative benchmarks if administrators in the APAC region are unable or unwilling to register their benchmarks.

The BMR introduces a harmonised set of rules on benchmarks across the EU. It outlines authorisation options for EU benchmark administrators, sets out rules applicable to those who contribute or provide submissions to a benchmark, and prohibits use in the EU of a benchmark that is not authorised or registered. Additional rules apply to benchmarks deemed to be significant or critical.

What is a benchmark according to the BMR?

The BMR generally defines a **benchmark** as any *index* that is referenced in a financial instrument (e.g. an option, forward, future or other derivative, note or equity product traded on a trading venue) or a financial contract (i.e. a regulated mortgage or credit agreement) in order to determine the amount payable under that contract or determine the value of a financial instrument. For investment funds, a benchmark is any index referenced in a financial instrument to measure the performance of an investment fund (i.e. a UCITS or an Alternative Investment Fund) with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees.

An **index** is then defined to mean any figure that is published or *made available to the public*, that is regularly determined: (i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and (ii) on the basis of 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 and surveys. Interest rate, fixed income, foreign exchange and equity indices may be covered by this definition.

An index is **made available to the public** if it is made accessible to a potentially indeterminate number of people either directly or indirectly. Where a recipient of a benchmark provides this onwards to one or more of their own clients, and these clients may provide the benchmark to other third parties, the benchmark may be deemed to be made available to the public. This may raise issues in relation to the sharing of benchmarks with private wealth clients, depending on the number of clients the benchmark is shared with and the degree to which these clients might themselves disseminate it more broadly.

In summary, the BMR is very broad in its approach to identifying benchmarks and the definitions would include proprietary indices, which are often used in the private wealth context. There is some uncertainty as to whether baskets, portfolios or strategies that are used to determine the value of a financial instrument are "benchmarks" within the meaning of the BMR.

To whom does the BMR apply?

The BMR applies to EU "supervised entities" in relation to their "use" of a benchmark. These entities include EU banks, investment firms (broadly equivalent to entities regulated by the Securities and Futures Commission in Hong Kong or that hold a capital markets services licence in Singapore), Undertakings for Collective Investment in Transferable Securities (**UCITS**), UCITS management companies, Alternative Investment Fund Managers (**AIFMs**), insurance providers and exchanges and markets. End-users of benchmarks, such as investors or consumers, will be affected by extension.

It does not appear that unregulated funds formed within the EU fall within the definition of this definition of EU "supervised entities". Accordingly, these funds will not be directly caught by the BMR, but are likely to be indirectly affected by the broader impact of the BMR, as discussed below at 3.2.

What does "use of a benchmark" mean?

Use of a benchmark means:

- issuance of a financial instrument that references an index or a combination of indices;
- determination of the amount payable under a financial instrument or a financial contract by referencing an index or a combination of indices;
- being party to a regulated credit agreement or mortgage that references an index or a combination of indices;
- providing a borrowing rate in a regulated credit agreement or mortgage calculated as a spread or mark-up over an index or a combination of indices and that is solely used as a reference in a financial contract to which the creditor is a party; or
- measuring the performance of an investment fund through an index or combination of indices for the purpose of tracking the return of such index or combination of indices, or defining the asset allocation of a portfolio, or of computing the performance fees.

Notably, this definition of "use" does not appear to prohibit EU supervised entities from recommending that their clients invest in funds which use unregistered benchmarks, providing that those clients are not themselves EU supervised entities.

What does use "in the EU" mean?

The "use" of such benchmarks must occur "in the EU" to be captured by the BMR. However, the meaning of "in the EU" is unclear, and as a result the APAC operations of EU supervised entities may be caught. For instance the issuance of a note within the EU by an EU bank that is then sold into the APAC region could be caught, as even if the secondary market in the notes is in APAC, the initial issuance takes place in the EU. Similarly, derivatives contracts entered into by APAC counterparties with EU counterparties – or even APAC branches of EU counterparties – could also be in scope.

ESMA has recently updated its Q&A to indicate that the BMR does not apply to the provision of benchmarks that are used exclusively outside the Union. However, the meaning of "exclusively used outside the Union" is unclear and remains problematic. There is hope that ESMA will issue more guidance to clarify what constitutes "use in the EU" and "exclusively used outside the Union", but it is not yet clear whether such guidance will be forthcoming.

Based on ASIFMA's benchmarks survey conducted in August 2016, there are at least 55 important benchmarks used in the APAC region that stand to be affected by the BMR, including several in Asia's largest markets – Japan, Hong Kong and South Korea. We understand that many non-EU administrators within the APAC region currently administer benchmarks that are currently "used" in financial instruments in the EU, as well as by EU supervised entities outside the EU. We therefore expect that the BMR will have an impact on the markets for those products in the EU (and, ultimately, the end-users of benchmarks such as investors or consumers), if measures are not taken to permit the use of these non-EU benchmarks under the BMR.

Do any exceptions apply?

The BMR does not apply to EU and non-EU central banks, and certain other limited persons, including public authorities such as national statistics agencies, as well as persons or entities performing public administrative functions or providing public services (such as measures of employment and economic activity) under the control of a government entity.

Based on the ASIFMA/Herbert Smith Freehills survey, there are concerns that a number of non-EU administrators will not register their benchmarks before 1 January 2020, if at all. This is due to a number of factors. For example, 18% of participants did not believe their business models would be adversely impacted if their benchmarks were no longer used in the EU, while another 36% said that the impact was "not possible to determine." One participant took the view that its activities were not within the scope of the BMR, while 36% of participants consider the process for seeking registration unclear or too complex. One participant was disappointed with the lack of engagement by EU regulators on the impact of the BMR on non-EU administrators.

Unless action is taken, there will likely be fewer non-EU benchmarks available for reference purposes in the EU once the transitional period has expired. Indeed, it is likely that the move away from non-registered benchmarks will begin before 1 January 2020 as EU supervised entities pre-empt the consequences of the BMR and switch to alternative benchmarks. This gives rise to several significant issues set out below, some of which were highlighted by the survey participants. Some of these are of specific relevance to asset managers, while others will have a broader impact on markets and market participants generally.

3.1 IMPACT ON ASSET MANAGERS

EU asset managers will not be able to use non-registered benchmarks

From 1 January 2020, EU asset managers will not be able to use non-registered benchmarks, which may reduce their reliance on non-EU benchmarks.

Sub-delegation agreements may prohibit APAC asset managers from using non-registered benchmarks

However, the BMR may also affect those asset managers located in the APAC region who operate under a sub-delegation agreement from an EU asset manager. Where that sub-delegation agreement provides that the APAC-based asset manager must comply with "all applicable legislation" and/or regulations applicable to the EU-based asset manager, the APAC firm may also be contractually prohibited from using un-registered benchmarks. In order for the APAC firm to continue using un-registered benchmarks, it may be necessary to revisit the contractual boundaries of the sub-delegation agreement.

Impact on hedging / investment choices

An EU investment fund (such as UCITS funds or AIFs) investing in Asian stock markets may traditionally buy a put option on an Asian stock index to hedge against the risk of the index falling. If the put option is classified under the BMR as a financial instrument and the Asian stock index is not registered as a benchmark for use in the EU under the BMR, that fund's manager may not be able to buy the put option. Deprived of that hedging opportunity, the fund may have to reconsider how much it invests in Asian stock markets.

Impact on funds

Where an EU fund uses a benchmark to measure its performance for the purpose of: (i) tracking the return of the benchmark; (ii) defining the asset allocation of the portfolio; or (iii) computing performance fees payable by it, such use will fall within the provisions of the BMR.

Where the prospectus of a UCITS fund references a benchmark, the prospectus must include information on whether the index provider complies with the BMR. This disclosure must be included in the prospectus

of all new UCITS funds authorised on or after 1 January 2018. Existing UCITS funds must incorporate such disclosure the next time they are updating their prospectuses after that date and in any event no later than 1 January 2019.

As supervised entities within the scope of the BMR, both UCITS funds and AIFMs must also prepare robust written contingency plans setting out the steps to be followed should a benchmark materially change or cease to be produced, and where feasible and appropriate, identifying one or several benchmarks that could be referenced to substitute for the benchmarks presently being used. While not expressly stated, it seems likely that the failure of a non-EU administrator to seek recognition of its benchmarks within the EU will amount to "material change" in its benchmarks. Accordingly, supervised entities, particularly where they understand from the administrators of such benchmarks that registration will not be sought or is likely to be difficult to obtain, should begin identifying the steps they will follow in the lead up to 1 January 2020 to replace those non-EU benchmarks (such as pre-positioning), and identifying suitable alternatives to the non-EU benchmarks currently used. This should include considering whether these alternatives will meet regulatory and market expectations.

ESMA has recently issued guidance indicating that supervised entities are required to reflect such contingency plans in all contracts with clients entered after 1 January 2018. In relation to contracts entered into prior to 1 January 2018 and which remain in force post-1 January 2018, ESMA has indicated that it expects supervised entities to amend them where practicable and on a best-efforts basis.

Extra-territorial impact on asset managers in APAC

Asset managers in APAC, including those that are subsidiaries of EU entities and are not themselves regulated in the EU, do not fall within the scope of "users" of a benchmark (even if they are servicing EU clients and/or investors) and therefore do not fall within the scope of the BMR.

However, APAC asset managers may be affected by a reduction in the number of non-EU benchmarks. This may occur where non-EU benchmark administrators either choose not to seek registration of their benchmarks, or are unsuccessful in their efforts to seek registration. If the administrators of these unregistered benchmarks then find that their lack of registration makes the continued provision of their benchmarks commercially unviable (i.e. because their benchmarks had previously been primarily used within the EU), these administrators may cease providing their benchmarks altogether – thus impacting those APAC asset managers who do rely on their benchmarks.

What can asset managers do to prepare for the changes pursuant to the BMR?

To understand the firm's risk exposure, asset managers should:

- 1 assess whether they themselves are "users;"
- 2 review their funds sold in the EU and their investment management agreements (**IMAs**) with EU clients to assess the likely impact of the BMR on their operations;
- 3 review their funds to assess whether they are "using" any benchmarks (in particular non-EU benchmarks) within the meaning of the BMR;
- 4 if so, begin engaging with the administrators of the non-EU benchmarks to understand whether these administrators are likely to seek registration; and
- 5 begin to prepare contingency plans to shift to an EU-registered benchmark in case the non-EU benchmarks relied upon by the asset manager do not obtain registration by 1 January 2020.

3.2 BROADER IMPACT OF THE BMR

Market liquidity and fragmentation

If certain non-EU benchmarks can no longer be used by affected EU entities, this may adversely affect the liquidity of APAC products which reference these benchmarks as a substantial portion of the relevant market for such products will disappear. This will further exacerbate market fragmentation issues currently arising from other regulatory developments such as MiFID II. It is anticipated that even a small decrease in the number of available benchmarks will have a significant impact on liquidity.

Market power and access issues

A reduction in the number of non-EU benchmarks in an EU jurisdiction may increase the market power of those "surviving" benchmark administrators. However, this will be less problematic in jurisdictions where benchmarks are provided by industry associations free of charge.

It is likely that users of benchmarks, and in particular, EU users of benchmarks, will end up switching to alternative benchmarks, further exacerbating market fragmentation issues. However, in many instances there may not be a suitable alternative benchmark and the EU users may therefore withdraw from the market.

Hedging risk

The ability of EU banks, corporates and investment institutions to hedge interest rate and other risks may be severely impacted as important products currently used for hedging purposes will no longer be available. If EU registered administrators respond to the BMR by launching new benchmarks to replace those benchmarks which are currently administered by non-EU Administrators, then this decreased ability to hedge may cause problems in the short term.

However, during this period of uncertainty, while banks may be able to bear this risk (potentially at a capital cost), many end-users may choose not to take on such risks and may pass the underlying and associated costs onto their commercial contractual counterparties who presumably have an APAC nexus. The building of liquidity in new EU-compliant benchmarks may lead to either whole market shifts or market fragmentation.

Contractual issues

The BMR raises complex questions in relation to existing bespoke contracts involving EU supervised entities that "use" non-EU benchmarks. The transitional provisions may mitigate this issue by providing a grace period for existing benchmarks until 1 January 2020, by which point many of these existing contracts may have expired.

However, this does not address the issue of new contracts that extend beyond the end of the transitional period. If non-EU benchmarks are no longer permitted to be used beyond the end of this period, then this may, depending on the relevant contractual documentation, constitute a termination event. Additionally, where benchmark administrators respond to the BMR by simply ceasing to supply specific benchmarks (on the basis, for example, that seeking registration is not cost-effective), this may potentially also constitute a termination event. We note that renegotiating contracts to mitigate the impact of a change in benchmark is likely to be complex and time-consuming.

Given the potential impact on contractual arrangements, users of benchmarks are now required to put in place certain written plans (as discussed above) setting out the actions that they would take in the event that the benchmark materially changes or ceases to exist; these plans must also be reflected in contracts with clients, as discussed further above.