Linklaters

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FAQs on the ISDA Benchmarks Supplement

The ISDA Benchmarks Supplement was published on 19 September 2018. Linklaters is delighted to have acted as drafting counsel on the project. Set out below in an FAQ format is a brief overview of the key aspects of the Benchmarks Supplement. If you have any questions, please contact your usual Linklaters contact.

Question 1: What is the Benchmarks Supplement?

It is a document published by ISDA to help firms address the requirements in Article 28(2) of the EU Benchmark Regulation ("**BMR**"). It also seeks to address certain aspects of the International Organization of Securities Commissions' ("**IOSCO**") Statement on Matters to Consider in the Use of Financial Benchmarks.

Although it was primarily drafted to address Article 28(2) of the BMR, the Benchmarks Supplement is drafted generically and may therefore be used by market participants who are not subject to the BMR.

It is an elective supplement and so parties need to actively incorporate it into their relationship in order for it to apply. Given that the effect is to enhance the contractual robustness of benchmarks within a number of ISDA definitions booklets, it is expected that take up will be by more than those affected by the BMR.

Question 2: What does the BMR require of users of benchmarks?

Article 28(2) of the BMR requires "**supervised entities**" that use a benchmark to produce and maintain robust written plans setting out the actions they would take in the event that a benchmark materially changes or ceases to be provided. Where feasible and appropriate, those plans must nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided. These plans must be reflected in the contractual relationship with clients.

The BMR also provides that a supervised entity is only permitted to use a benchmark or a combination of benchmarks in the EU if the benchmark or the administrator, as required, is included in the European Securities and Markets Authority's register of authorised/registered/equivalent/recognised/endorsed administrators and benchmarks.

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Finally, Article 35 of the BMR provides that, if a competent authority withdraws the authorisation or registration of an administrator of a benchmark, then Article 28(2) shall apply.

Question 3: What does IOSCO's Statement say?

IOSCO's Statement on Matters to Consider in the Use of Financial Benchmarks provides that users of benchmarks should consider the appropriateness of a benchmark before use. It also provides that users should consider their contingency plans if a benchmark is no longer available or materially changes in order to mitigate the risks involved.

This is similar to the requirements of Article 28(2) of the BMR and provides that, where feasible and appropriate, contingency plans for the cessation of a benchmark should include sufficiently robust fallback provisions in financial contracts and instruments which should ideally involve at least one alternative fallback rate and/or figure as a substitute for the original benchmark.

Question 4: How does the Benchmarks Supplement address these requirements?

The Benchmarks Supplement includes a number of trigger events relating to benchmarks and fallbacks which apply upon the occurrence of one of those triggers. It is relevant for transactions which incorporate one or more of the following ISDA definitions booklets:

> the 2006 ISDA Definitions;

> the 2002 ISDA Equity Derivatives Definitions (Equity Definitions);

> the 1998 FX and Currency Option Definitions (FX Definitions); and

> the 2005 ISDA Commodity Definitions (Commodity Definitions).

The approach taken in relation to each relevant ISDA definitions booklet varies, depending on the provisions already included in those booklets. See questions 5 to 8 below for further information in relation to each relevant booklet.

Question 5: How does the Benchmarks Supplement affect transactions which incorporate the 2006 ISDA Definitions?

Existing provisions

In relation to a number of benchmarks within the 2006 ISDA Definitions, fallbacks are already included which apply if the rate does not appear on the screen. The problem is that these fallbacks were not generally drafted with permanent cessation in mind. For example, they can rely on quotations from "reference banks" or "major banks" in the relevant market. The consensus is that these are not robust because banks may not (and the expectation is that they will not) provide quotations on an ongoing basis. The definitions do not currently cater for this. Material change to a benchmark is also not contemplated in the 2006 ISDA Definitions.

Supervised entities

"**Supervised entities**" under the BMR include credit institutions, investment firms, insurance undertakings, reinsurance undertakings, UCITS, alternative investment fund managers, institutions for occupational retirement provision, creditors and non-credit institutions for the purposes of credit agreements, market operators, CCPs and trade repositories.

Trigger events

The Benchmarks Supplement introduces a new permanent cessation trigger (called an "**Index Cessation Event**") for transactions subject to the 2006 ISDA Definitions. It also introduces a new trigger event (called an "**Administrator/Benchmark Event**") that applies if a benchmark or an administrator is not approved such that the benchmark cannot be used by the parties to the transaction or the Calculation Agent in accordance with applicable law or regulation (including where any such approval is suspended or withdrawn).

The Benchmarks Supplement does not introduce a trigger for material change to a benchmark but it does contain an acknowledgement that, if a benchmark is changed, references to the benchmark shall be to the benchmark as changed.

Fallbacks

Except for a few benchmarks which are dealt with separately (on which, see question 9 below), the Benchmarks Supplement requires parties to consider a number of fallbacks (called "**Alternative Continuation Fallbacks**") upon the occurrence of an Index Cessation Event or an Administrator/Benchmark Event. The parties must act in good faith and use commercially reasonable efforts to try and apply these fallbacks during a specified period of time. If more than one of these fallbacks can be utilised to allow the transaction to continue, there is a hierarchy in place. If none of these fallbacks can be utilised within the period of time, no fault termination rights arise.

The Alternative Continuation Fallbacks are:

> Agreement between the parties.

> Use of a replacement benchmark nominated by the parties at the time of trading plus an Adjustment Payment/Adjustment Spread.

> Use of a substantially equivalent replacement benchmark nominated by the administrator or use of a benchmark nominated by a Relevant Nominating Body (the "**Alternative Post-nominated Index**") plus an Adjustment Payment/Adjustment Spread. A "**Relevant Nominating Body**" is a relevant supervisor, central bank or any working group or committee officially endorsed or convened by a relevant supervisor, central bank, group of supervisors/central banks, the Financial Stability Board or part thereof.

> Use of a replacement benchmark nominated by the Calculation Agent plus an Adjustment Payment/Adjustment Spread.

Additional provisions are also included which deal with (i) what should happen if the benchmark is required under the contract before the fallback process is completed, (ii) disputes in relation to calculation agent determinations and (iii) fallbacks that do not otherwise comply with applicable law or regulation.

Adjustment Payment/ Adjustment Spread

The Adjustment Payment/Adjustment Spread is a payment or spread which is paid by one party to the other, or applied to the replacement benchmark, in order to reduce or eliminate any transfer of economic value from one party to the other as a result of replacing the original benchmark with the new benchmark. The Adjustment Payment must be agreed between the parties or the Adjustment Spread will apply. The Adjustment Spread is determined by the parties or, failing this, the Calculation Agent. However, if a Relevant Nominating Body recommends a spread or a methodology for determining a spread in relation to the Alternative Post-nominated Index, this will be applied.

Question 6: How does the Benchmarks Supplement affect transactions which incorporate the Equity Definitions?

The Equity Definitions already include trigger events for the permanent cancellation of, or modification to, an index. Currently, the fallbacks are specified in the confirmation and typically include one of Calculation Agent Adjustment, Negotiated Close-out and Cancellation and Payment. The Benchmarks Supplement introduces an Administrator/Benchmark Event as a new trigger event (see question 5 above) and related fallbacks.

Given that one of the requirements of Article 28(2) of the BMR is to, where feasible and appropriate, nominate one or several alternative benchmarks that can be used to substitute the original benchmark, the Benchmarks Supplement also introduces a mechanism by which parties can make this nomination. However, parties are not required to do so. If an alternative benchmark is specified in the confirmation, it will apply following the permanent cancellation of the index or an Administrator/Benchmark Event.

The Benchmarks Supplement also provides that, if either party thinks that an Adjustment Payment should be made, the replacement of the original benchmark with the nominated benchmark will only apply if the parties agree on the Adjustment Payment within a specified period of time. Failing such agreement, or if the parties have not nominated an alternative index, the fallbacks specified in the confirmation will apply (e.g. Calculation Agent Adjustment, Negotiated Close-out or Cancellation and Payment). If no consequences are specified for an Administrator/Benchmark Event, the consequences specified for an Index Cancellation under the Equity Definitions apply.

Question 7: How does the Benchmarks Supplement affect transactions which incorporate the FX Definitions?

The FX Definitions currently include a trigger event if it is impossible to obtain the “Settlement Rate” (for example, if it has been permanently discontinued). However, unless otherwise specified, this trigger event (“**Price Source Disruption**”) is only deemed to apply to non-deliverable transactions. This is because deliverable transactions do not typically use a benchmark.

However, there are circumstances in which a deliverable transaction may use a benchmark (for example if “Non-Deliverable Substitute” applies). The Benchmarks Supplement therefore applies Price Source Disruption and related fallbacks to deliverable transactions that use a benchmark.

The Benchmarks Supplement also introduces an Administrator/Benchmark Event into transactions incorporating the FX Definitions. The fallbacks that apply will be those specified in the confirmation for either an Administrator/Benchmark Event or, failing this, a Price Source Disruption. If no fallbacks are specified, the deemed fallbacks for Price Source Disruption under the FX Definitions apply.

The FX Definitions do not include a disruption event which directly anticipates material change to a benchmark. However, there are certain disruption events which may be triggered if a benchmark materially changes (for example, Price Materiality under the FX Definitions or Exchange Rate Divergence which is included in certain EMTA template terms, which are typically used in FX transactions). The Benchmarks Supplement therefore includes an acknowledgement that, if a benchmark changes and unless otherwise agreed, references to a benchmark will be to that benchmark as changed.

Question 8: How does the Benchmarks Supplement affect transactions which incorporate the Commodity Definitions?

The Commodity Definitions already include triggers for the permanent discontinuance or unavailability of a commodity reference price ("**Disappearance of Commodity Reference Price**") and material change in the formula for or method of calculating the commodity reference price ("**Material Change in Formula**"). The Benchmarks Supplement therefore only introduces an Administrator/Benchmark Event trigger into transactions which incorporate the Commodity Definitions.

Upon the occurrence of an Administrator/Benchmark Event, the fallbacks for it specified in the confirmation will apply or, if none, those specified for Disappearance of Commodity Reference Price. Failing this, the deemed fallbacks in the Commodity Definitions apply which include the "fallback reference price" specified by the parties, if any, "delayed publication or announcement", "postponement" and "negotiated fallback" and, failing this, "fallback reference dealers" and "no fault termination".

Question 9: How does this interact with the new triggers and fallbacks for certain interbank offered rates (IBORs) which ISDA is developing?

ISDA is in the process of developing new fallbacks which will apply upon the permanent discontinuation of certain IBORs. ISDA will update the definitions of the relevant IBORs in the 2006 ISDA Definitions to include these new fallback, likely during 2019. ISDA will also publish a protocol to facilitate incorporation of the new fallbacks in existing transactions.

This raises the question as to how these new IBOR fallbacks will interact with the Benchmarks Supplement.

The 2006 ISDA Definitions Benchmarks Annex to the Benchmarks Supplement provides that, if the definition of a benchmark (for example, the definition of the benchmark in the 2006 ISDA Definitions) includes a concept defined or otherwise described as an "index cessation event", then any fallback specified to apply upon the occurrence of such an event will be a "Priority Fallback". These Priority Fallbacks will apply in the first instance following an "index cessation event" in relation to that benchmark. The Alternative Continuation Fallbacks (and, failing these, no fault termination rights) included in the Benchmarks Supplement will only apply if any such Priority Fallbacks fail.

This means that the IBOR fallbacks which ISDA is developing will, once incorporated, take precedence over the Benchmarks Supplement if an "index cessation event" occurs. However, before the IBOR fallbacks are implemented, the fallbacks in the Benchmarks Supplement will apply to an IBOR which is referenced in a transaction that incorporates the Benchmarks Supplement and the 2006 ISDA Definitions.

The application of Priority Fallbacks following an “index cessation event” is not restricted to the IBORs and will be relevant for any benchmark which includes a concept defined or described as an “index cessation event”. For example, the definition of USD-SOFR-COMPOUND in the 2006 ISDA Definitions includes an “index cessation event” trigger and related fallbacks so these will be “Priority Fallbacks”.

Question 10: How can parties incorporate the Benchmarks Supplement?

The Benchmarks Supplement can be incorporated bilaterally, either on a trade-by-trade basis or at relationship level. ISDA also plans to publish a protocol to facilitate incorporation of the Benchmarks Supplement. Even if the protocol is used to implement the Benchmarks Supplement, market participants will need to incorporate it into new ISDA Master Agreements entered into after adherence to the protocol.

When incorporating the Benchmarks Supplement, parties will need to think about how any provisions dealing with, for example, index cessation in any instrument for which the derivative serves as a hedge will behave.

Question 11: Where can I find the Benchmarks Supplement and more information?

The Benchmarks Supplement can be found here:

https://www.isda.org/book/isda-benchmarks-supplement/

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Contacts

For further information please contact:

Pauline Ashall
Partner, London
(+44) 20 7456 4036
pauline.ashall@linklaters.com

Mark Brown
Partner, London
(+44) 20 7456 5229
mark.brown@linklaters.com

Mark Drury
Partner, London
(+44) 20 7456 4595
mark.drury@linklaters.com

Simon Firth
Partner, London
(+44) 20 7456 3764
simon.firth@linklaters.com

Toby Gray
Partner, London
(+44) 20 7456 5615
toby.gray@linklaters.com

Paul Lewis
Partner, London
(+44) 20 7456 4658
paul.lewis@linklaters.com

Matthew Monahan
Partner, London
(+44) 20 7456 4629
matthew.monahan@linklaters.com

David Phillips
Partner, London
(+44) 20 7456 5215
david.phillips@linklaters.com

Vinay Samani
Partner, London
(+44) 20 7456 4604
vinay.samani@linklaters.com

Deepak Sitlani
Partner, London
(+44) 20 7456 2612
deepak.sitlani@linklaters.com

Michael Voisin
Partner, London
(+44) 20 7456 4606
michael.voisin@linklaters.com

Rhian Roberts
Counsel, London
(+44) 20 7456 4815
rhian.roberts@linklaters.com

Doug Shaw
Counsel, London
(+44) 20 7456 5081
doug.shaw@linklaters.com

Ursula Williamson
Counsel, London
(+44) 20 7456 3757
ursula.williamson@linklaters.com

Phoebe Coutts
Associate, London
(+44) 20 7456 5886
phoebe.coutts@linklaters.com

Madeleine Wanner
Senior PSL, London
(+44) 20 7456 4950
madeleine.wanner@linklaters.com

Doug Donahue
Partner, New York
(+1) 212 903 9222
douglas.donahue@linklaters.com

Chong Liew
Partner, Hong Kong
(+852) 2842 4857
chin-chong.liew@linklaters.com

Stephen Song
Partner, Hong Kong
(+852) 2901 5440
stephen.song@linklaters.com

I-Ping Soong
Counsel, Hong Kong
(+852) 2901 5181
i-ping.soong@linklaters.com

Motoyasu Fujita
Partner, Tokyo
(+813) 6212 1213
motoyasu.fujita@linklaters.com

Sonia Lim
Counsel, Singapore
(65) 6692 5734
sonia.lim@linklaters.com

Christian Storck
Partner, Frankfurt
(+49) 69 71003 531
christian.storck@linklaters.com

Jörg Fried
Counsel, Berlin
(+49) 30 21496 331
joerg.fried@linklaters.com

Authors: Phoebe Coutts, Deepak Sitlani (19 September 2018)