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SUPPLEMENTARY REPORT ON THE LEGAL ASPECTS OF BENCHMARK REFORM

Haut Comité Juridique
de la Place Financière de Paris

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INTRODUCTION

1- The Haut Comité Juridique de la Place Financière de Paris (the **"HCJP"**) has previously addressed the legal issues arising from the reform of the principal benchmarks, which are LIBOR, EURIBOR and EONIA, as part of Regulation (EU) No. 2016/1011 of June 8, 2016 (**"the Benchmark Regulation"**). On July 20, 2018, the HCJP published an initial report drafted by a working group composed of bank in-house counsel, law professors, lawyers, members of the HCJP and representatives of the authorities, which was established to study these issues.

2- This report took stock of the legal aspects of the transition and contained a number of recommendations for market participants and the authorities and administrators overseeing the aforementioned benchmarks. The previous report had identified a number of issues related to the transition from interbank rate benchmarks to new benchmarks, particularly with regard to the performance of legacy contracts in existence at the time of the transition.[1] The report mentioned that the discontinuation or substantial reform of a benchmark could make it impossible to calculate payments without modifying the contract, significantly affect the structure of the contract and its value, or create mismatches between the relevant contracts and the derivatives used to hedge interest rate risk for borrowers. Some of these risks have been addressed or have disappeared, but others still remain and will be discussed in this report.

3- The HCJP had recommended that market participants map and list the various fallback clauses in contracts, ensure that new contracts with floating interest rate terms include clauses to ensure the continuity of the parties' obligations when benchmarks are modified or replaced, and harmonize the various fallback provisions in contracts indexed to the same benchmark. In particular, it had called on the authorities to authorize the use of EURIBOR and EONIA calculated according to their current methodology until the end of the transitional period of the Benchmark Regulation for legacy contracts and to postpone the end of the transitional period provided for in the Benchmark Regulation. This recommendation on the postponement of the transitional period, which was consistent with similar recommendations by other organizations, has been implemented.

4- The HCJP had also recommended that administrators and authorities establish a precise methodology and a clear legal framework to better define the respective responsibilities of the contributors or providers of basic data and benchmark administrators, but also ensure that the

[1] *See to paragraph 5.1 of the HCJP report of July 20, 2018 (the "HCJP 2018 Report").*

panels of contributing institutions are representative of the market. It also recommended developing a precise methodology applicable to expert opinions by providing for alternative solutions to their use. This subject will not be covered in this report. Nevertheless, the recommendations made in the previous report are still relevant today.

5- The HCJP had also called for a political position on the adoption of a general act governing the legal consequences of benchmark reform. This recommendation also remains highly relevant.

6- Developments in the work of the various official working groups and the emergence of certain alternative benchmarks have justified a new review by the HCJP. Indeed, it has been observed that the developments have been different for each benchmark. For some, such as EURIBOR, only the methodology has been adjusted, while the benchmark has remained. For others, such as EONIA, a transitional phase was organized to facilitate the adoption of a new benchmark by the market.

7- These developments have brought to light new legal issues, which the HCJP felt it was necessary to discuss in a new report. After reviewing the conclusions of the previous report (I) and providing an overview of developments to date (II), the HCJP's working group presents new recommendations (III).

I- Overview of the main conclusions of the HCJP's previous report on the impact of the reform or discontinuation of benchmarks

The Working Group studied the legal risks of modifying or discontinuing benchmarks from the perspective of French law, New York law and English law, the three principal legal regimes governing contracts to which French and European market participants are exposed.

It concluded that the termination of a contract by a court or a decision to release a party from its obligations due to the discontinuation of a benchmark was unlikely. However, the risk of disruption from a legal standpoint cannot be excluded, particularly if a clear successor benchmark or the relevant spreads are not identified at the time a benchmark is discontinued.

The contracts with the lowest risks are those that contain written terms, or "fallback" clauses, which make it possible to determine a clear alternative interest rate benchmark when the benchmark designated in the contract is modified or discontinued. The courts will seek to give effect to the written terms of the parties to the greatest extent possible, where necessary by interpreting them in such a way that favors the continuation of the contract.

1.1 - The principle of contract continuity for legacy contracts containing a fallback clause

1.1.1 - The general principle of application of fallback clauses

A contract indexed on a floating rate benchmark may expressly provide for the replacement of one benchmark with another for various reasons in the context of a fallback clause.

In such cases, the contractual clause in question often grants one of the contracting parties or a third party the right to determine the alternative benchmark. While such clauses generally specify the criteria for determining the alternative benchmark, many important parameters (particularly with regard to the method of calculation) are left to the discretion of the party responsible for determining the alternative benchmark. It cannot be entirely excluded that the choice of the new benchmark or certain parameters linked to it may be challenged in court, particularly if a clear successor benchmark or the relevant adjustment criteria (spreads) are not identified at the time the relevant benchmark is discontinued.

If the contract is subject to French law, pursuant to Article 1164 of the French Civil Code,[2] framework

[2] *Article introduced by Order No. 2016-131 of February 10, 2016.*

agreements may establish that the rate will be unilaterally fixed by one of the parties, and it would be incumbent on that party to justify the rate in the event of a dispute.

The same applies to contracts subject to New York State law, where case law has consistently upheld clauses granting a party the power to determine the economic criteria to be taken into account when the contract is concluded between experienced parties. The previous report also stated that an English court would also have to accept such a clause if the criteria applicable to the determination of the new benchmark were faithfully respected by the party making that determination. It is nevertheless preferable, as a precautionary measure, to provide guarantees of transparency, autonomy and independence in the determination of the alternative benchmark.

1.1.2 - Old and new fallback clauses

First, it should be noted that the content of fallback clauses varies according to the type of contract and the product concerned. For example, clauses included in financing contracts may vary from one credit agreement to another and provide for different solutions from those contained, for example, in the documentation applicable to bond issues or hedging transactions.

At the time of publication of this report, some contracts still do not include fallback clauses or contain inadequate or potentially incomplete fallback clauses.

1.1.2.1 - Fallback clauses in credit agreements (LMA standard)

Credit agreements or, more broadly, financing agreements, are bilateral contracts between a borrower and a bank or a syndicate of lending institutions. Any change in such an essential aspect of a credit agreement such as the determination of the interest rate must normally be the subject of an agreement between the parties.

The Loan Market Association ("LMA") included standard fallback clauses in its model credit agreements in the event of the temporary unavailability of benchmarks. The French legal standard[3] essentially provided only for situations where the screen rate (EURIBOR, LIBOR or other benchmark) was unavailable.[4]

[3] *Multi-currency credit facility agreement comprising a term loan and a reusable credit facility.*

[4] *See section 4.2.2.1 of the HCJP 2018 Report.*

A joint Bank of England and LMA working group was set up to revise the LMA standard clauses and to provide solutions for the permanent and definitive discontinuation of benchmarks used for determining interest rate provisions in credit agreements. The LMA published its new model fallback clauses on May 25, 2018.[5]

In the LMA's standard contracts subject to French law, parties to credit agreements are mainly using two mechanisms to address the discontinuation of a benchmark:

– first, if an official successor benchmark exists and is officially recognized by a regulator or official authority in the euro zone or the European Union, then such successor benchmark may be applied to the contract, provided that this change is accepted by a majority (simple or super) of the lenders and by the borrower.

– Second, some mechanisms refer to a negotiation between the agreement's facility agent and the borrower in the event that the benchmark is discontinued. The objective of these negotiations is to agree on an alternative benchmark, which also requires the consent of a simple or super majority of the lenders and the borrower.

In certain financing agreements, one practice that is also used is to include a clause making the determination of the alternative benchmark subject to a separate agreement between the Facility Agent and the borrower.

<u>1.1.2.2 - Fallback clauses in the capital markets context (debt)</u>

In the case of bonds, the issue is quite different, especially for French-law governed bonds, since the bondholders have subscribed to financial securities (bonds) and are grouped together in a body (the *masse*) which acts as representative of the bondholders The modification or discontinuation of a benchmark used to determine the interest rate of the bonds would not easily be subject to a renegotiation of the terms of the bonds, particularly in view of the number of bondholders and the difficulty in obtaining the required majority or, where applicable, the unanimous consent of these holders.

Bonds subject to French law most often refer to two methods for determining the interest rate:

(i) a screen rate similar to that used in LMA contracts; or

[5] *Loan Market Association, "The Recommended Revised Form of Replacement Screen Rate Clause and Users Guide", May 25, 2018, amended December 21, 2018.*

(ii) a floating rate fixed by the calculation agent in a theoretical interest rate swap in accordance with the definitions developed by the Fédération Bancaire Française (**"FBF"**) and the International Swaps and Derivatives Association (**"ISDA"**).

In general, the terms and conditions of more recently issued bonds typically require the issuer or calculation agent to determine the rate applied on the basis of a successor benchmark on which there is market consensus.

In order to make this determination, the issuer appoints an agent (which could be the issuer or one of its subsidiaries) whose task is to determine the alternative benchmark, as well as the terms and conditions for the necessary calculations and adjustments (margins, etc.). As a general rule, it is up to this agent to choose the alternative benchmark recommended by the central bank (or any other monetary authority) of the country of the relevant currency or, failing that, a benchmark generally accepted by the market. If the agent is unable to determine an alternative benchmark, then the rate is generally set on the basis of the last published screen rate.

1.1.2.3 - Fallback clauses in derivatives

The market documentation for derivatives developed by ISDA and the FBF as part of their standard definitions provide for fallback mechanisms in the event of benchmark unavailability – generally a rate determined on the basis of an average of the quotes collected from several major banks in the relevant market. However, these fallbacks did not appear to be sufficient to address the discontinuation of a benchmark and the requirements of the Benchmark Regulation.

ISDA participates as an observer in certain working groups organized by central banks since July 2016. The FSB has invited ISDA to work on improving the robustness of derivative contracts based on interest rate benchmarks.

As a result of the work carried out by ISDA, a public consultation was launched on July 12, 2018 on proposed definitions for replacing IBOR rates with RFR rates for transactions that refer to the ISDA definitions, the results of which were published in November 2019. At that time, ISDA proposed that the new rates automatically apply to any transaction put in place after the adoption of the final version of this supplement to the ISDA definitions. In addition, ISDA's work has led to a consensus on the methodology to be applied under the new fallback and "spread" clauses.

[6] *ISDA, "Summary of Responses to the ISDA Consultation on Final Parameters for the Spread and Term Adjustments", November 15, 2019; the last consultation, which concerned EURIBOR and EUR-LIBOR, was completed just before the publication of this report. ISDA, "December 2019 Benchmark Fallbacks Supplemental Consultation," December 18, 2019.*

ISDA also plans to provide market participants with a protocol enabling them to apply the new provisions to their ongoing transactions at the time of the transition. However, there is a risk that the take-up rate for this type of mechanism by buy-side market participants, such as corporate issuers, may be low.

In addition, the Fédération Bancaire Française (**"FBF"**) has published two sets of documents to enable users of the FBF Master Agreement for Transactions in Financial Futures Instruments to comply with the requirements of the Benchmark Regulation.

Concerning transactions documented by reference to Technical Schedules, the FBF has just published the "Benchmarks Events Technical Schedule". This new Technical Schedule provides for alternative mechanisms in the case of events affecting interest rate benchmarks, foreign exchange benchmarks and equity benchmarks. The FBF has also published a model amendment to the Master Agreement in order to implement this new Technical Schedule.

With regard to transactions documented by reference to the definitions published by ISDA, the FBF has just published a model clause, known as a "bridge clause", allowing the use of the ISDA 2018 Benchmarks Supplement for transactions governed by an FBF master agreement. This clause is also accompanied by a model amendment.

1.2 - Legal risks for contracts lacking fallback clauses

For contracts that are ongoing when a benchmark is discontinued, the risk of non-continuity of the contract is low from a legal standpoint since, in the legal systems studied, the role of the court is generally to safeguard the contract. In such a case, it is likely that a French, English or New York court would seek to apply a benchmark similar to the one that was discontinued, unless otherwise indicated by the parties.

As a practical matter, the risk of non-continuity of the contract nevertheless remains (particularly for contracts not containing an effective fallback clause), insofar as a court may not be able to identify an alternative benchmark on its own. Indeed, the power of a court to impose an alternative benchmark largely depends on the existence of a successor benchmark that has earned market consensus or has been officially chosen by a competent authority. It should be noted that even if courts in some countries agree to modify contracts to replace a benchmark, conflicting or divergent decisions could also be issued by courts within the same country or under different legal systems or in different countries.

The consequences of a court decision to terminate contractual obligations when a benchmark is modified or discontinued could be dramatic. Such a decision would have a major impact on the confidence of market participants and would give rise to a situation of great uncertainty. This could lead to a sharp change in the value of financial instruments, and certain market participants could experience significant losses (or gains).

The decision of a court to terminate contractual obligations would also give rise to ancillary issues that could have significant consequences. In particular, the court would have to determine the consequences of its decision:

– does the termination apply to the entire contract or only to the part affected by the discontinuation or modification of the benchmark? For example, for a credit agreement, does the borrower have an obligation to repay the debt before maturity? What does the borrower do if it is unable to refinance the debt? Can the borrower wait until the maturity date to make the repayment, without paying interest? If so, is the lender entitled to be compensated for its loss or at least the cost of refinancing?

– According to applicable law, is the contract rendered null and void, effective only prospectively? Or is it declared null and void *ab initio* (with reciprocal obligations to reimburse amounts already paid)?

– If the termination of the contract causes damages to one of the parties, can the court order the other party to compensate for the damages, at least in proportion with the gains it has obtained?

– If a party believes it has overpaid after a change of benchmark, is it entitled to reimbursement?

These questions do not have clear answers in the three legal systems studied.

It is therefore advisable for market participants and authorities to take measures to avoid the occurrence of such risks.

The following paragraphs restate the highlights of the analysis provided in the previous report on the legal aspects of benchmark reform in the three legal systems studied (French law, New York State law and English law). The reader is invited to refer to the previous report of the HCJP for a more detailed analysis.

1.2.1 - Benchmark modification in contracts subject to French law

In the absence of a law linking the discontinued benchmark to the "successor" benchmark and of an express clause setting out the terms of the substitution of the benchmark, three solutions are possible, in principle:

– applying the last rate determined on the basis of the discontinued benchmark for the remaining duration of the contract;

– declaring the contract null and void, because one of its essential elements has disappeared;

– applying another benchmark to replace the discontinued benchmark.

Taking into account the intention of the parties would suggest against the first solution. The analysis of the parties' intentions should make it possible to direct the court towards one of the other remaining solutions.

Established case law holds that:

– the court may apply another benchmark to replace the discontinued benchmark, provided that it deems this substitution to be in accordance with the parties' intentions.[7]

– However, the court must declare the contract null and void where it considers that the parties intention is to condition its continuation on the continued use of the chosen benchmark[8] or where there is no alternative benchmark capable of conforming to their intentions.

Moreover, the French Supreme Court has ruled that, when the parties have agreed to use a benchmark rate, the court must replace the discontinued benchmark with another benchmark, unless the parties express a contrary intention.[9] It thus appears that, under the guise of interpreting the intention of the parties, the court in fact gave itself the power to "safeguard" the contract in the event that the benchmark chosen by the parties is discontinued.

This has become even more apparent since the case law set out above was enshrined in Article 1167 of the French Civil Code, as amended by Order No. 2016-131 of February 10, 2016: "When the price or any other element of the contract must be determined by reference to a benchmark that does not exist or has ceased to exist or to be accessible, it shall be replaced by the benchmark that comes closest to it."

The closeness between the discontinued benchmark and the closest substitute benchmark ("closest substitute") is likely assessed by comparing their administrators, calculation methods, use by the market and respective currencies. The rule preempts the parties' will: the parties must be able to disregard the "safeguard" power attributed to the court by Article 1167 of the French Civil Code, by agreeing that the contract will only be maintained if the chosen benchmark survives.

Consequently, the risk of the contract lapsing in the event of the discontinuation of a benchmark appears to be limited under French law, particularly if a "successor" benchmark is clearly identified.

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[7] French Supreme Court, First Civil Chamber, November 9, 1981, Civil Bull. I, no. 332; French Supreme Court, Third Civil Chamber, January 12, 2005, Civil Bull. III, no. 4.

[8] French Supreme Court, Commercial Chamber, November 16, 2004, no. 02-15202, in which the parties had already, in the past, provided for two alternative benchmarks; French Supreme Court, Commercial Chamber, June 30, 1980, Civil Bull. IV, no. 281.

[9] French Supreme Court, Third Civil Chamber, July 22, 1987, Civil Bull. III, no. 151.

However, it should not be excluded that a party may invoke the discontinuation of a chosen benchmark to claim to be released from its obligations under a contract, particularly if there is no successor benchmark that has earned market consensus or has been officially chosen by a competent authority.

Moreover, the previous report mentioned that the discontinuation of a benchmark should not fall under the unforeseen hardship mechanism enshrined in Article 1195 of the French Civil Code.[10]

In applying such mechanism, the aim is to identify cases where the new calculation methodology applied to the benchmark by its administrator would result in a sudden and excessive increase in the rates published by the relevant benchmark. Such an unforeseen increase by the parties would be tantamount to making the performance of the contract excessively onerous for one of them without the party ever having assumed the risk.

Its application in the case of the intrinsic modification of a benchmark nevertheless remains to be distinguished.

The parties to the contract necessarily foresaw and accepted that the benchmark may vary. It is therefore a contractual possibility – and not an extra-contractual contingency - which does not give rise to a right to revision for unforeseen circumstances.

1.2.2 - Benchmark modification in contracts subject to New York State law

In the United States, contract law falls under the jurisdiction of each state, based mainly on case law (common law). Financial contracts are most often subject to New York State law.

If a benchmark used in a contract under New York law ceased to exist, the parties could seek to release themselves from their contractual obligations or terminate the contract on the basis of two legal theories:

– the theory of "impracticability" (or "impossibility");

– the theory of "frustration of purpose".

These theories have only very rarely been applied in the context of financial contracts. Indeed, American courts favor negotiated solutions and are very reluctant to rewrite the terms of a contract. Unlike in French and English law, it is rare for an American court to designate a substitute clause in place of a contractual clause that has ceased to function.[11]

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[10] *Article introduced by order no. 2016-131 of February 10, 2016 and amended by ratification act no. 2018-287 of April 20, 2018.*

[11] *In Aluminum Co. of America v. Essex Group, 499 F. Supp. 53 (W.D. PA., 1980) a court agreed to reformulate a benchmark-linked clause in a contract, but this decision is an exception to the general trend.*

Under these two theories, the court hearing the case must determine whether the parties have considered the risk of occurrence of the concerned event in their contractual terms or whether the event can be implicitly attributed to one of the parties. Courts are more likely to accept an implicit allocation of risk between the parties where the parties are sophisticated market participants. Thus, there are many obstacles to the termination of a contract subject to New York law under these two theories, particularly with respect to contracts between sophisticated parties.[12]

1.2.3 - Benchmark modification in contracts subject to English law

In the event that a benchmark is discontinued, an English court can decide to terminate a contract in application of the frustration theory, which has a wider scope of application than the New York principle of the same name. This doctrine of English law encompasses the principles of impossibility and frustration of purpose, as recognized under New York law.

If a court were to find that a LIBOR-indexed contract had been "frustrated", it would result in the termination of the entire contract. The consequence of such a conclusion could be severe. Under a 1943 Act,[13] a contracting party has, *inter alia*, the right to recover amounts paid prior to the event that caused the frustration.

This solution would be particularly onerous for a borrower if it were unable to obtain the funds necessary to repay the principal that has become payable or if previous payments were used to cover other obligations that could not be settled retroactively.

This is why English courts seek, wherever possible, to avoid applying the principle of frustration, in particular by interpreting the implied terms of the contract or by applying the Sudbrook principle (a case law principle according to which an English court would impose a new clause in place of a clause that cannot be implemented, provided that this clause is not an essential element of the contract and that the application of the substitution clause is not contrary to the intentions of the parties).

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[12] See no. 5.2.2 of the HCJP 2018 Report.

[13] Law Reform (Frustrated Contracts) Act 1943. It is possible for the contracting parties to exclude the application of the 1943 Act. In such a case, payments made prior to the event giving rise to the frustration are not reimbursed, which constitutes an even more severe consequence than that resulting from the application of the 1943 Act.
It is unlikely that financial contracts would exclude the application of this law.

II- Overview of the changes linked to benchmark reform

2.1 - Proposed amendments to the Benchmark Regulation

2.1.1 - Amendments to the Benchmark Regulation

In its previous report of July 20, 2018, the HCJP had recommended that the authorities postpone the end date of the transitional period set out in Article 51 of the Benchmark Regulation.

This idea was also put forward in the Fall of 2018 by the working group on euro risk-free rates, whose secretariat is managed by the European Central Bank (**"ECB"**), which asked co-legislators of the European Union to extend this transition period for critical benchmarks for a minimum of two years. Market associations such as ISDA, AFME and FIA have also requested that this exemption be extended to non-critical benchmarks.

These recommendations have been partially granted by the authorities and the co-legislators. On November 27, 2019, the European Parliament and the Council adopted an amendment to the Benchmark Regulation as part of the regulation on benchmarks related to the EU's "Climate Transition" and "Paris Accord".[14] The amendment to the Benchmark Regulation extended (i) the transitional period for third country benchmarks and critical benchmarks to December 31, 2021, and (ii) the period during which the competent authority may impose mandatory contributions from two to five years for critical benchmarks.

i) Extension of the transitional period for third country benchmarks and critical benchmarks.

<u>Third countries</u> – Due to ongoing discussions regarding equivalence decisions and the lack of effective recognition in this area, supervised entities will be granted an extension to the transition period for the use of benchmarks that have not yet been declared compliant and are managed by third country administrators. Article 51 of the Benchmark Regulation has been amended to extend the period during which supervised entities may continue to use non-compliant third country benchmarks from January 1, 2020 to December 31, 2021. The use of these non-compliant benchmarks for ongoing operations will not be restricted until 2022.

[14] *"Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks", no. 2018/0180, October 23, 2019.*

<u>Critical benchmarks</u> – The work carried out by the administrators to make the benchmarks robust and compliant with the requirements of the Benchmark Regulation has taken longer than expected and not all of them have been finalized. The supervised entities will therefore be granted an extension of the transition period from January 1, 2020 to December 31, 2021. By that date, the administrators of these benchmarks will have to comply with the Benchmark Regulation in order for supervised entities to be allowed to continue to use these benchmarks. It should be noted that the transition period has not been extended for non-critical benchmarks whose administrators are not located in a third country.

ii) The extension of the mandatory contribution period for critical benchmarks.

The period during which the competent authorities are authorized to require mandatory administration of a benchmark and/or mandatory contribution to a critical benchmark will be extended from 2 to 5 years.

2.1.2 - General consultation in view of revising the Benchmark Regulation

On October 11, 2019, the European Commission launched a consultation, open until December 31, 2019, for the revision of the Benchmark Regulation. This revision of the Benchmark Regulation could become a vehicle for introducing measures to accompany and facilitate the transition of the benchmarks (see Recommendation 1 of this report, which calls for legislative intervention at the European level, as a first step).

This consultation stems from Article 54 of the text, which provides that the European Commission must submit a report to the European Parliament and the Council concerning, in particular:

– the functioning and effectiveness of the critical benchmarks, mandatory administration and mandatory contribution regime; and

– he effectiveness of the regime for the approval, registration and supervision of administrators and boards and the proper supervision of certain benchmarks by a body of the European Union.

In addition, by April 1, 2020, the European Commission must also present a report on the implementation of the provisions of the Benchmark Regulation concerning the third country regime.

The questions posed as part of the above-mentioned consultation cover many aspects:

– the powers of the authorities relating to the methodology of critical benchmarks,

– management of the discontinuation of a benchmark and the corresponding remediation plans,

– the supervision of benchmarks by boards,

– the suspension of the authorization of a benchmark administrator,

– the method for determining the significance or criticality of a benchmark,

– the register of administrators,

– the statement issued by the benchmark administrator,

– supervision of climate-related benchmarks,

– rules specific to commodity benchmarks,

– the problems raised by third country benchmarks of the FX forwards type,

– NDFs (non-delivery forward) managed by private entities (KRW, INR, etc.).

The regulation on supervision and the role of the supervisory authorities, which is in the process of being adopted, is also likely to have an impact on the implementation of the Benchmark Regulation. Starting on January 1, 2022, it will modify the role of ESMA in the supervision of critical benchmarks and administrators and in its role in recognizing third country benchmark administrators.

2.2 - The emergence of alternative benchmarks

2.2.1 - EONIA, transition to €STR

2.2.1.1 - EONIA in its original form no longer met the criteria set out in the Benchmark Regulation

This index had been deteriorating for several years, as evidenced by:

– a steady decline in the volumes used as a basis for its calculation (from €48bn per day in 2007 to €2bn in 2019),

– a deterioration in the panel with a sharp drop in the number of contributors, which now stands at only 28,

– a strong concentration of volume on a few contributors, and

– a sharp increase in its volatility.

In September 2017, the European Central Bank announced the production of an overnight unsecured rate, €STR, as well as the establishment of a working group on risk-free rates in euros. Within the euro zone, this working group on risk-free rates in euros and the European Central Bank were the architects of this reform.[15]

The working group on risk-free rates in euro (RFR working group) is a market group, chaired by ING, in which the European institutions (European Commission, ESMA, FSMA, ECB) participate, and which includes 21 European banks as members. It also includes five market associations, the administrator of the relevant benchmarks (the European Money Markets Institute, or **"EMMI"**), as well as two invited guests and four observers, each without voting rights. Its secretariat is operated by the ECB.

It is mandated to:

– identify a risk-free rate in euros to replace non-compliant benchmarks,

– identify best practices to ensure the robustness of contracts,

– develop a legal transition plan for contracts referencing existing benchmarks, and

– develop a risk-free interest rate term structure that can be used as a fallback solution for EURIBOR.

2.2.1.2 - The recalibrated EONIA and the publication of €STR

€STR is the natural successor to the EONIA benchmark and features a more regulated calculation methodology. As of October 2, 2019, €STR is published by the European Central Bank on D+1 at 8:00 am.

Since October 2, 2019, the EONIA methodology has been recalibrated and determined on the basis of €STR. In this context, the methodology for calculating €STR is evolving to ensure consistency between the two benchmarks. After conducting an analysis, the European Central Bank has determined a margin of 8.5 bps to guarantee the equivalence between the two rates; EONIA has thus become the "recalibrated" EONIA, but its ISIN code remains the same.

From October 2, 2019 to January 3, 2022, the "recalibrated" EONIA and €STR will coexist. From January 4, 2022 onward, only €STR will be published (at 8.00 a.m.), and the "recalibrated" EONIA will no longer be published.

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[15] *"Working group on euro-risk-free rates", BCE (www.ecb.europa.eu).*

Until January 3, 2022, the application of the new EONIA methodology will not raise any legal risks with regard to the continuity of contracts referencing this benchmark.

At the end of this period, the disappearance of EONIA in favor of €STR is likely to raise legal difficulties for contracts that reference EONIA and do not contain an adequate fallback clause.

2.2.1.3 - The principal recommendations of the RFR Working Group

The efforts of the RFR working group have resulted in:

– A recalibration of the EONIA methodology, which is now determined on the basis of €STR + a fixed spread of 8.5bps until its disappearance on January 3, 2022 following the announcement of its administrator (EMMI).

– A legal action plan for contracts referencing EONIA. It is recommended that EONIA should no longer be referenced in contracts concluded after October 2, 2019 and that robust fallback clauses should be introduced in existing contracts maturing after January 3, 2022.[16]

– The publication of a report on the operational impacts of the transition for derivatives and cash. The aim is to alert and prepare participants for the consequences of the change in methodology and publication schedule, as well as the changes required by clearing houses in their updating regime.[17]

– The publication of a report on the financial accounting implications of the transition from EONIA to the €STR rate and the introduction of fallback solutions based on the €STR rate for EURIBOR. The report highlights the accounting implications of the transition in both IFRS and IAS.[18]

2.2.2 - EURIBOR

2.2.2.1 - The situation of EURIBOR is different from that of EONIA

EURIBOR is the main reference rate for the euro and is managed by EMMI. It measures the cost of unsecured financing for credit institutions on the euro money market. It was created in January 1999 to replace the national benchmarks in the euro zone.

[16] *"Private sector working group recommends legal action plan for transition from EONIA to €STR", BCE, July 16, 2019.*

[17] *"Report by the working group on euro risk-free rates, On the impact of the transition from EONIA to €STR on cash and derivatives products", BCE, August 2019.*

[18] *"Report by the working group on euro risk-free rates, On the financial accounting implications of the transition from EONIA to €STR and the introduction of €STR-based fallbacks for EURIBOR", BCE, November 5, 2019.*

To date, EURIBOR will continue to be published. Consequently, there is no current need to migrate contracts and financial instruments referencing EURIBOR to a new benchmark. However, its methodology has had to evolve, in particular due to:

– developments in the financing market,

– a significant decrease in the number of contributing banks,

– a concentration of the volume on a limited number of contributors, and

– the need to anchor the benchmark to actual transactions as required by the International Organization of Securities Commissions ("IOSCO") and the Benchmark Regulation.

The new methodology for calculating EURIBOR, resulting from the reforms described below, has been recognized as complying with the requirements of the Benchmark Regulation. The methodology is partly based on rate contributions proposed by a panel of banks active in the euro zone. Therefore, its sustainability is only ensured if banks agree to maintain their contributions.

The increase of the period, from 2 to 5 years, during which the competent authorities are authorized to require mandatory administration of a benchmark and/or a forced contribution to a critical benchmark, as set out in the amended Benchmark Regulation,[19] is likely to reassure the markets with regard to the sustainability of EURIBOR.

However, it cannot be ruled out that other benchmarks will be developed at a later stage. If a new forward rate index based on €STR were to emerge, this new index could possibly affect the liquidity and representativeness of EURIBOR. However, to date, there is no evidence to support this risk.

Although EURIBOR remains, in order to comply with the provisions of Article 28(2) of the Benchmark Regulation, contracts concluded after January 1, 2018[20] referencing this index must contain fallback clauses that, to the extent possible, must designate one or more other benchmarks that may serve as a reference in substitution for the benchmarks that are no longer provided.

[19] *"Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks", no. 2018/0180, October 23, 2019.*

[20] *"Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks", no. 2018/0180, October 23, 2019.*

The RFR Working Group, set up under the aegis of the ECB, is currently working on the identification of EURIBOR substitution rates, in particular with a view to enabling users, where appropriate, to be able to include such substitution rates in their fallback clauses. However, no clear EURIBOR-substitute benchmark has been identified to date, which may lead to difficulties with regard to the provisions of Article 28(2) of the Benchmark Regulation.

In addition, it should be noted that market participants have encountered difficulties in modifying legacy contracts, which can only be carried out, subject to exceptions, by means of an amendment, particularly in the case of buy-side contracts. This issue should be examined with particular attention in the case of retail banking.

2.2.2.2 - Reforms carried out by EMMI, the EURIBOR administrator

In 2018 and 2019, EMMI carried out extensive reforms to meet the requirements of the Benchmark Regulation, strengthen its governance framework and develop a hybrid methodology for EURIBOR.

The governance framework of EURIBOR was strengthened and adopted on January 31, 2019, replacing the former code of conduct put in place in 2013 and revised in 2016. It includes:

– the governance code of conduct, which defines the governance, control and accountability frameworks established by EMMI to provide EURIBOR,

– the code of obligations of the banks in the panel, concerning the data transmitted to EMMI,

– the Code of Conduct of EURIBOR Calculation Agents,

– the methodology for determining EURIBOR, which contains its specifications and defines the determination methodology for calculating EURIBOR in normal or unforeseen circumstances.

EURIBOR's governance framework is based on a set of policies and procedures covering all aspects of the provision of the benchmark index.[21]

The main objective of the EURIBOR reform is to provide the market with a more transparent, robust and representative index, while minimizing the risk of market manipulation.

With this in mind, EMMI has just completed the transition of the EURIBOR methodology from a quote-based determination method to a methodology based on, as much as possible, actual

[21] *"EURIBOR Reform", EMMI, (www.emmi-benchmarks.eu).*

transactions provided by a panel of contributing banks. However, this methodology is not exclusively based on actual transactions, as this would result in its not being sufficiently robust. If such were the case that only actual transactions were used, the daily determination of EURIBOR would be based, for most tenors, on a limited number of transactions executed by a limited number of contributors.

In order to ensure the robustness of the calculation in the absence of underlying transactions, the methodology for determining EURIBOR follows a three-tiered approach, to be applied progressively by the panel banks in the following order:

– level 1 includes contributions based solely on transactions for the tenor concerned on the previous day,

– level 2 corresponds to contributions based on transactions on the relevant underlying , across all money market maturities and over a few prior days,

– level 3 consists of contributions based on transactions on the relevant underlying and/or other data from several markets closely related to the euro money market (unsecured), using a combination of modelling techniques and/or the judgement of the contributor. The panel banks each had to develop their own methodologies in order to be able to contribute in accordance with level 3.

The highest and lowest 15% of the final contribution rates of all banks in the panel are eliminated from the benchmark calculation. The remaining rates are calculated as an arithmetic average and rounded to three decimal places.

Following two public consultations from May to the end of July 2018, EMMI tested the hybrid methodology with sixteen participating banks.

The test phase was considered satisfactory with regard to the requirements of robustness and representativeness.

Following the results of the test phase, EMMI applied for and received approval from the Belgian Financial Services and Markets Authority (FSMA) under Article 34 of the Benchmark Regulation for the administration of EURIBOR in July 2019.[22]

[22] *"The FSMA authorises EMMI as administrator of the EURIBOR Benchmark", FSMA, Press release, July 3, 2019.*

EMMI has begun a transition to the new hybrid methodology of the group of contributing banks according to the defined specifications. The complete transition to the new hybrid EURIBOR methodology, spread over time, has just been completed.

Following the expression of some concerns as to contractual continuity due to the change in method (from an interbank offered rate to a rate at which banks could obtain funds on an unsecured wholesale money market and the fact that trades no longer correspond to an 11 a.m. rate but to the previous day's rate), EMMI noted that the change in EURIBOR methodology does not alter the underlying purpose of this benchmark, which has always sought to measure the cost of banks' borrowing on unsecured money markets. EMMI also points out that this reform is merely a clarification of the existing underlying data of EURIBOR, combined with the adaptation of a robust methodology that complies with the Benchmark Regulation.

2.2.2.3 - Work conducted by the RFR Working Group

In addition to the work already carried out in connection with EONIA and the transition to €STR, the RFR Working Group set up under the aegis of the ECB addressed certain issues more directly related to EURIBOR, resulting in the publication of "high-level recommendations on fallback provisions in contracts for cash products and derivatives transactions referencing the EURIBOR rate" on November 6, 2019.[23]

The RFR Working Group recommends that market participants include fallback clauses in all new contracts referencing EURIBOR. Existing contracts referencing EURIBOR concluded after January 1, 2018, and falling under the EU Benchmark Regulation, should also be covered by "robust written plans". Provisions should be introduced or existing provisions improved when they are next amended or updated. In the absence of a recommended fallback provision and pending further recommendations by the RFR Working Group or the authorities, market participants could consider the inclusion of generic clauses as a fallback provision. To this end, the working group recommends a generic standard text that has been published. Again, it should be noted that market participants have encountered major difficulties in modifying legacy contracts.

The RFR working group will also work on drafting model fallback clauses covering the main asset classes, which should be submitted for consultation and published in early 2020.

[23] *"Working group on euro risk-free rates issues high level recommendations for fallback provisions in contracts referencing EURIBOR", BCE, November 6, 2019.*

2.2.3 - LIBOR

LIBOR is the average interest rate at which banks can borrow on the market without collateral (unsecured). It is calculated on the basis of data provided by each bank in the contribution panel (from 11 to 16 major banks). LIBOR is published daily in five currencies (GBP, USD, EUR, CHF and JPY) and for seven maturities (day-to-day, weekly, monthly, two-month, three-month, six-month and one-year).

Following in the footsteps of the British Bankers Association, ICE Benchmark Administration Limited (**"IBA"**) became the administrator of LIBOR on February 1, 2014, following the recommendation of the Wheatley Report of September 2012 that LIBOR should be the responsibility of a private organization rather than a public body.

The Financial Conduct Authority (**"FCA"**) authorized the IBA as the administrator of ICE LIBOR in accordance with Article 34 of the Benchmark Regulation in April 2018.

It is important to note that this approval was only given after the implementation of a new governance system and the launch of a reform of LIBOR similar to the one that has just been carried out for EURIBOR. The Wheatley report of September 2012 recommended a reform, rather than the replacement of LIBOR, in order to make this benchmark more robust and compliant with the requirements set by the IOSCO recommendations and, subsequently, by the Benchmark Regulation. The new methodology known as "waterfall" (or "mixed"), prepared in 2016, has since come into force. However, like EURIBOR, the sustainability of LIBOR depends on the continuity of contributions by the panel of banks.

Despite bringing LIBOR into compliance with the requirements of the Benchmark Regulation, the Chief Executive of the Financial Conduct Authority, Andrew Bailey, recommended in July 2017 that LIBOR be phased out by 2021 and then indicated that the FCA would no longer be able to wield its powers of persuasion or compulsion to require panel banks to contribute beyond that date. Since that announcement, the UK and US authorities have repeatedly reiterated the need for market participants to stop using LIBOR for their new transactions. Despite these communications, the use of LIBOR remains substantial.

The IBA has indicated its intention to continue to develop new rules allowing the continuous publication of a representative LIBOR, at least for certain tenors, and to facilitate the continuity of current contracts that would be particularly difficult to modify. The continued publication of LIBOR after 2021 will, however, depend on the voluntary support of the panel's contributing banks.

The previous report of the HCJP focused on GBP and USD LIBOR, the two main currencies used by French market participants. Recent developments in these currencies are presented below.

2.2.3.1 - Transition from GBP LIBOR to SONIA

A working group on sterling (GBP) risk-free reference rates was set up in 2015 to implement the recommendation of the Financial Stability Board and determine the preferred risk free rate for GBP markets.

In April 2017, this working group recommended the use of the Sterling Overnight Indexed Average (**"SONIA"**) as the risk-free rate. SONIA has been administered and published since April 2018 by the Bank of England.

SONIA was created in 1997 but has been extensively redesigned to apply a more reliable and robust calculation method based on actual transaction volumes. It also features improved governance and transparency.

In January 2018, the reconstituted working group focused on the transition from LIBOR and the use of SONIA in GBP markets.

SONIA is considered a more robust benchmark within the meaning of the Benchmark Regulation because it is based on an active and liquid underlying market. The average value of transactions underlying SONIA since April 2018 is approximately £50 billion per day.

It follows the Bank of England base rate very closely.

In the first six months of 2019, SONIA accounted for just over 45% of notional swaps traded in sterling.

However, SONIA is still rarely used as a reference for financing contracts; to date, only a few transactions have referred to SONIA. Indeed, the financing market has not displayed a willingness to switch from a forward rate (GBP LIBOR) to an overnight rate (SONIA).

As a result, it is unlikely that stakeholders will seek to modify their contracts until there is industry consensus on the benchmark that will replace LIBOR GBP for futures trading.

Work is underway regarding the possibility of producing a forward "SONIA +" rate, which would be published on a prospective basis for specific tenors, as is the case for LIBOR today. However, no timetable exists at present.

Mr. Andrew Bailey warned lenders that "delaying the transition until forward rates are in place" was a mistake. In the absence of a forward rate based on SONIA, market participants should therefore look for other solutions.

In particular, on January 16, 2020, the FCA and the Bank of England invited the market to stop using LIBOR for derivatives as of March 2020, and for financing products as of September 2020, and to use SONIA instead.[24]

2.2.3.2 - Transition from USD LIBOR to SOFR

In 2014, the Federal Reserve Bank of New York created a working group, the Alternative Reference Rates Committee (**"ARRC"**), to discuss the risks associated with USD LIBOR with market participants and determine a risk-free replacementindex.

In June 2017, the ARRC designated the Secured Overnight Financing Rate (**"SOFR"**) as an alternative benchmark for USD LIBOR. SOFR, first published by the Federal Reserve Bank of New York on April 3, 2018, measures the overnight cost of borrowing through repurchase agreements backed by US Treasury securities.

It is a volume-weighted median of three types of repurchase transactions: (1) tri-party general repurchase transactions; (2) general repurchase transactions with a basket of collateral; and (3) bilateral repurchase transactions cleared by the FICC (with certain transactions weighed to reduce the impact of exceptions or abnormal trading activity on the SOFR rate).

The ARRC's decision to opt for SOFR was motivated by the rate's compliance with IOSCO's reference principles, but above all by its liquidity and its resistance to possible manipulation and market uncertainties.

The possibility of publishing a rate with a term longer than overnight maturity was considered in order to facilitate the transition from USD LIBOR to the new index. However, the rates initially studied did not meet the necessary criteria (compliance with the IOSCO Principles, deep and active market, etc.). The development of a futures market for SOFR is underway and could enable the construction of a rate curve before the end of 2021.

In November 2019, the ARRC published standard clauses allowing the use of a SOFR rate for a period longer than one day, based on an average of the SOFR rates observed each day during the period (either a simple average or a compounding of interest each day). The proposed methodology is

[24] *"FCA and Bank of England encourage switch from LIBOR to SONIA for sterling interest rate swaps from Spring 2020", FCA, January 16, 2020.*

complex and gives market participants several options for dealing with technical issues (e.g. how to determine the rate for compounding purposes on non-business days).

One of the difficulties with these methodologies is that the rates are determined ex post, at the end of the interest calculation period. For this reason, it is impossible to know the amount of interest to be paid before the last days of the calculation period.

In the absence of an alternative methodology, market participants are considering the use of this methodology in their contract documentation. The question of whether clauses will actually be included in the documentation in the year 2020 remains open.

Between April and November 2019, the ARRC also published model fallback clauses for floating-rate issues, bilateral and syndicated financings, securitizations and mortgage real estate financings.[25]

These clauses generally provide for procedures to replace LIBOR following triggering events. These triggers include, for example, a formal statement that LIBOR has ceased or will cease to be published, or that it is "no longer representative". Two approaches have been proposed: one that incorporates a waterfall of specified alternative options (the "hardwired" approach), and another that provides for the new rate to be determined at the appropriate time (the "amendment" approach).

Furthermore, the ARRC has just launched a consultation on the methodology for calculating spreads that would bring the SOFR closer to the current LIBOR.[26]

Because the financing markets have not yet adopted SOFR as a benchmark and as a substitute for USD LIBOR, and because the volumes traded and the liquidity of this index have not yet developed sufficiently, it is difficult for lenders and borrowers to use the ARRC's "hardwired fallback" clauses or their variants in credit contracts. As a result, these hardwired fallback clauses have not been widely adopted by the market to date.

The ARRC has also proposed a similar fallback clause for SOFR-based financings in the event that this new benchmark disappears. This fallback clause will ensure compliance with Article 28(2) of the Benchmark Regulation by European supervised entities using SOFR.

The ARRC "fallback amendment" clause for syndicated financing (which is a more comprehensive version of the clauses often used in LSTA model credit agreements since 2018) is, however, becoming

[25] *"Summary of ARRC's a LIBOR Fallback Language, Alternative Reference Rates Committee", November 2019.*

[26] *"ARRC Releases Consultation on Potential Spread Adjustment Methodologies", Fed, January 21, 2020.*

more frequent in syndicated loans. This clause allows the borrower and the facility agent to agree on a new benchmark and price adjustment ("adjustment spread"), which will be applied in the absence of objections from the majority of lenders within five business days. Variants of this clause prohibit the lenders from objecting to a new benchmark based on SOFR, while reserving the right to object to the adjustment spread.

In addition, some credit agreements still contain other standard clauses which could be incompatible with the provisions of the ARRC and should therefore be removed.

Examples include contractual provisions that generally suspend a lender's obligation to "enter into or maintain" LIBOR-indexed loans when the lender (or the majority of lenders or the agent) determines that LIBOR is no longer "adequate and fair" and no longer represents its cost of financing. Such a suspension then deprives the borrower of the ability to borrow LIBOR-indexed funds by substituting a potentially more expensive alternative rate. In addition, in certain cases, these contractual provisions could result in the borrower having to repay the loan or index it to a new benchmark or agree on an applicable interest rate. If the provisions recommended by the ARRC were to be inserted in the credit agreements, the above-mentioned contractual terms would have to be deleted.

A large number of issues of securities indexed to USD LIBOR are subject to New York State law and do not systematically provide for fallback clauses in the event of the discontinuation of LIBOR, or if such clauses are provided for, the fallback solution is generally a switch to a fixed rate.

Generally, the agreement of all holders is required to amend interest rate and payment provisions. Identifying the holders and then obtaining their unanimous agreement is a major challenge.

ARRC is studying a possible legislative solution under New York State law that would allow the transition of existing products to SOFR. Such an initiative, if implemented, would allow the transition to be organized for products within its scope and governed by New York State law.

At the time of publication of the report, the fate of LIBOR remains highly uncertain, and no clear successor benchmarks have been identified, in particular by the markets.

2.2.3.3 - LIBOR with respect to derivatives

ISDA has demonstrated its commitment to these issues since 2016 by conducting multiple consultations and is currently continuing its work with the expected publication of fallback provisions in the event of the permanent disappearance of IBORs. Implementation of these provisions is expected

in the first half of 2020, following the introduction of its Benchmarks Supplement in September 2018.[27]

An ISDA "protocol" is also under consideration in order to facilitate the inclusion of definitions and fallback clauses in contractual documentation, for those market participants who would accept the principle. However, in practice, its use is more common among financial players than among companies in other sectors.

It is essential that these provisions be harmonized with those of other products developed by other market associations concerning other instruments and products so as not to create possible distortions between the cash market and its hedging.

In November 2019, ISDA also published the results of a third industry consultation on methodologies for adjusting the fallback benchmarks in the event of a permanent discontinuation of LIBOR. These methodologies were the subject of a consensus accepted by a majority of participants.

It is expected that the publication of indicative fallback benchmarks based on these adjustments will begin in early 2020.

An ISDA protocol allowing the modification of current contracts will be published as soon as a question regarding the definition of the events triggering the replacement of benchmarks is resolved.

The FSB would like the derivatives industry to include a mandatory fallback clause that would apply a benchmark other than LIBOR that would be designated by an authority in the event that it no longer considers LIBOR to be representative, in addition to a clause envisaging the definitive discontinuation of the LIBOR benchmark.

Such a fallback provision would thus allow a mandatory switchover from LIBOR depending on the decision of the authorities, even in the event that this benchmark continues to exist beyond 2021.

On December 4, 2019, ISDA reiterated that it would again seek to find consensus to help regulators push for the discontinuation of LIBOR, while emphasizing that there is reluctance to implement the clause proposed by the FSB. Indeed, during the consultations conducted by ISDA on benchmark reform, the majority of responses opposed the introduction of a pre-cessation triggering event prior to the actual discontinuation of a benchmark.[28]

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[27] *"ISDA Publishes Benchmarks Supplement", ISDA, September 19, 2018.*

[28] *"ISDA Letter to FSB OSSG on Pre-Cessation Issues", ISDA, December 4, 2019.*

The introduction of such clauses also poses a problem of market homogeneity. Whether or not to include such a provision is a matter of the parties' contractual freedom, and there is currently no consensus on the subject.

ISDA also reiterated the need for clearing houses to "definitively confirm" that if the benchmark is no longer representative, they will change all cleared derivative portfolios to refer to a more "robust" benchmark. ISDA has stressed the importance of coordination between the derivatives market and the financial products market.

On January 24, 2020, ISDA published two letters received from the CFA and IBA in response to its request for clarification.[29] These letters contain important clarifications regarding the manner and duration of how and for how long a non-representative LIBOR could be issued and the direction that could be taken in the event that LIBOR is declared non-representative by the CFA.

The CFA and IBA have clearly expressed their intention to reduce, to the greatest possible extent, the length of time a non-representative LIBOR would be published.

The FCA also acknowledged in its letter the existence of contracts that are not technically possible to modify and announced the creation of a specific working group dedicated to the theme of "tough legacy" within the Sterling Risk Free Rate Working Group meeting under the aegis of the Bank of England.

III- Recommendations of the Working Group

3.1 - Summary of remaining risks

The first part of this report restates the conclusions of the HCJP's report of July 20, 2018 on the legal aspects of benchmark reform.

The working group had studied the risks related to the continuity of contracts from the point of view of French, New York and English law, the three main legal regimes governing contracts to which participants in the French and European markets are exposed. It concluded that the likelihood of a court deciding to terminate a contract or to release a party from its obligations was low, but could not

[29] *"New Letters on Pre-cessation Issues Welcome", ISDA, January 24, 2020.*

be totally excluded, particularly if, at the time of the benchmark's discontinuation, its successor benchmark or the necessary spreads had not been clearly identified, or if adequate and robust fallback clauses were not included in the contractual documentation.

The second part of this report mentioned the positive developments that have taken place since the first report, in particular the fact that EURIBOR now complies with the Benchmark Regulation and that a successor index has been designated for EONIA, which also complies with the Benchmark Regulation.

Nevertheless, market participants still face the following main challenges:

– while the application of Article 28(2) of the Benchmark Regulation should, in principle, ensure that contracts contain fallback clauses in the event that a benchmark is discontinued, it should be noted that this provision only applies to contracts concluded after January 1, 2018. Consequently, there is uncertainty regarding the treatment of legacy contracts concluded prior to that date that do not have a fallback clause in the event that the benchmarks to which these contracts refer to is discontinued. It should also be noted that uncertainty remains regarding contracts concluded after that date that cannot be modified or do not contain an adequate fallback clause. As previously stated, modifying legacy contracts raises difficulties insofar as the modification can only be carried out, barring exceptions, by means of an amendment, particularly in the case of buy-side contracts. Particular attention must be paid to retail banking in this regard.

– EURIBOR now complies with the Benchmark Regulation and no discontinuation is expected as of the date of this report. Furthermore, the Benchmark Regulation gives the authorities the power to require contributions to continue for a period of up to 5 years. However, a fully satisfactory substitution rate, in the event that it becomes necessary, has not yet been established.[30]

– As EONIA will cease to exist on January 2, 2022, banks must provide for the substitution of the €STR + 8.5 bp for EONIA for contracts with a maturity date after January 2, 2022.

– LIBOR could disappear at the end of 2021 without a successor for which there is an unquestionable market consensus. The situation regarding this benchmark is therefore very alarming.

– The theoretical risk of non-continuity of contracts in the event that a benchmark is discontinued seems low, but there is no visibility on future judicial decisions as courts have little guidance on how to deal with the consequences of benchmark discontinuations. In such cases, without a European legislative solution, courts could issue divergent decisions in the various Member States of the European Union, which would be highly unsatisfactory.

[30] *The work of the Euro RFR Working Group under the aegis of the ECB has not yet been concluded on this issue.*

In order to alleviate these difficulties, and in particular to facilitate the major operational task of renegotiation, the HCJP makes the following recommendations:

3.2 - Recommendations to authorities and index administrators

The HCJP makes the following recommendations to French and European institutions and authorities: legislative intervention at the European level, public statements by European authorities and educational communications addressing the public and investors. The first two initiatives would have a positive impact on the competitiveness of European Union law.

3.2.1 - Legislative intervention at the European level

3.2.1.1 - The objectives of legislative intervention in European law

The HCJP recommends that the institutions of the European Union adopt a level 1 legislative act that would facilitate, for all contracting parties, the renegotiation of current contracts, or even avoid it, thus reducing the operational risks generated by large-scale renegotiation ("repapering"), the success of which is highly uncertain.[31] This legislative proposal would supplement the European legislative framework allowing a smooth transition of (current and future) benchmarks in order to avoid repeating the pitfalls currently identified and would be consistent with other similar proposals, in the United States, for example.[32]

The HCJP proposes drafting of legislation based on the following considerations:

– focusing the draft text on cases where a benchmark has been discontinued, regulations prohibit its use, or an administrator has withdrawn its approval of the benchmark in question;

– providing generic wording intended to cover the discontinuation of current benchmarks (e.g. EONIA on January 3, 2022) but also of any future benchmark whose administrator is European or from a third country. The general wording will also set out the procedures for designating successor benchmarks without specifying them by name;

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[31] To date, the volume of the contracts concerned by this repapering process has yet to be determined. It should also be noted that the legislative intervention recommended in this report would apply to contracts subject to the law of a European Union country.

[32] The ARRC has made a proposal of this type in the United States. At this stage, the position of the legislature is not known.

– proposing a general provision, valid for all types of contracts and instruments governed by the law of a country within the European Union, that refers to a benchmark used as a reference in Europe (LIBOR, EURIBOR, TIBOR, EONIA, etc.);

– supporting a "waterfall" approach: in descending order of priority, referring to a rate chosen or recommended by a competent authority (central bank, market authority or monetary authority) or, failing that, an industry-accepted successor benchmark; alternatively, relying on a provision similar to the one found in French law (Article 1167 of the French Civil Code, the wording of which is derived from the recent reform of the law of contracts and obligations), emphasizing the notion of the "closest" benchmark or rate;

– considering that the level 1 legislative act would preempt the contracting parties' will;

– ensuring that the text is applied to both new and existing contracts;

– supporting such a legislative intervention by the European legislator with reference to figures concerning the contracts potentially concerned, i.e. contracts subject to European Union law that refer to a benchmark that is likely to disappear and that do not already have an adequate fallback clause.

3.2.1.2 - The proposed drafting

The proposed drafting would be the following:

"Except as otherwise agreed by the parties to a relevant agreement, when a benchmark (as defined in Regulation EU 2016/1011) has ceased to exist, or has been discontinued or is no longer available (except on a temporary basis), or its use is prohibited under applicable laws, the relevant amount, value or performance measure shall instead be determined by reference to (in the following order of priority):

a) the alternative benchmark that is selected or recommended by the Relevant Governmental Body, plus any Benchmark Replacement Adjustment;

b) the alternative benchmark that is an industry-accepted successor benchmark plus any Benchmark Replacement Adjustment; or

c) the alternative benchmark that is closest to the benchmark that is being replaced, plus the Benchmark Replacement Adjustment.

An alternative benchmark may be selected only if it is authorised for use by supervised entities in accordance with Article 29 of Regulation EU 2016/1011 to the extent such authorisation is required. The source of publication and method of calculation of an alternative benchmark shall be in accordance with industry-accepted practices.

For these purposes:

"Benchmark Replacement Adjustment" *means the spread adjustment, or method for calculating such spread adjustment, which may be positive, negative or zero, selected or recommended by the Relevant Governmental Body for the applicable benchmark, or if no such adjustment or method is so selected or recommended, an industry-accepted adjustment or method, or if there is no such industry-accepted adjustment or method, an adjustment or method determined so as to minimise the transfer of value between the parties arising solely as a result of the replacement of the benchmark. and to preserve the economic characteristics of the agreement.*

"Relevant Governmental Body" *means the central bank, reserve bank, monetary authority or any similar institution in the jurisdiction of the relevant currency, or that is otherwise competent to make a selection or recommendation with respect to the replacement of the relevant benchmark."*

3.2.1.3 - Jurisdiction of the European Union and the nature of the legislative act

In view of the delays inherent in the adoption of a level 1 European legislative text (proposal of the European Commission, common position of the Council and amendments of the European Parliament, potential for a three-way dialogue between the three institutions), we feel it is imperative to start this process quickly, so that it can be adopted, from a technical standpoint before the disappearance of EONIA at the beginning of 2022.

There is little doubt that the European Union has jurisdiction to adopt a legal act to ensure the continuity of contracts. The appropriate legal basis for this is Article 114 of the Treaty on the Functioning of the European Union (the "TFEU"). Like the Benchmark Regulation, which it is intended to amend, the purpose of the proposed legislative act would be to establish and ensure the functioning of the internal market within the meaning of Article 114 of the TFEU. On the other hand, it is necessary to establish the nature of the legal act that the European Union may adopt.

According to established case law, the provisions of EU law are immediately applicable to current contracts as soon as they enter into force, but only as regards their future effects.[33] However, the immediate applicability of the new standards must be subject to legal certainty, which implies a legitimate expectation,[34] which the European Court of Justice has narrowly defined.

The European Court of Justice has stated that "the scope [of the principle of the protection of legitimate expectations] cannot ... be extended so far as to prevent, generally speaking, new rules from

[33] *ECJ, January 29, 2002, Pokrzeptowicz-Meyer, C-162/00, ECLI:EU:C:2002:57, points 51-52.*

[34] *ECJ, July 4, 1973, Westzucker GmbH, 1/73, ECLI:EU:C:1973:78.*

applying to the future effects of situations arising under previous rules".[35] According to the European Court of Justice, the existence of a contract is not sufficient to give rise to a legitimate expectation that the rules in force at the time of its conclusion will be maintained.[36] The European Court of Justice is particularly severe with regard to well-informed operators, which are not recognized as having a legitimate expectation.[37]

The choice of a legislative act is therefore necessary because the transitional provisions provided for in Article 51 of the Benchmark Regulation[38] are not sufficient to address the potential contractual risks inherent in the termination or modification of benchmarks. Although Article 51(6) of the Benchmark Regulation provides for delegation to the European Commission, this does not mean that the continuity of contracts could be provided for by a delegated act adopted by that institution. Indeed, the scope of the delegation provided for in Article 51(6) is strictly defined.

From a materiality point of view, the measures relate to cases where the termination or modification of a benchmark "would reasonably be expected to result in an event of *force majeure*, or would jeopardize or otherwise breach the terms of a financial contract or financial instrument or the rules of an investment fund". From a timing standpoint, the reference period ends on January 1, 2020.[39] Thus, Article 51(6) is not the appropriate legal basis for adopting an act aimed at ensuring the continuity of contracts.

In any event, a delegated act cannot include the essential elements of a subject, which are reserved for legislative acts. The European Court of Justice shall thus exclude from delegation authority provisions whose adoption requires political choices that fall within the EU legislature's specific responsibilities.[40] The question of which elements of a subject matter are to be regarded as essential is not a question for the EU legislature alone to determine, but must be based on objective factors which may be subject to judicial review.[41] It is therefore on a case-by-case basis that the European Court of Justice identifies the essential elements of a legislative act, depending on the field of action, the specific features or the objectives of the legislation in question.

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[35] *ECJ, May 16, 1979, Tomadini, 84/78, ECLI:EU:C:1979:129, point 21.*

[36] *ECJ, Westzucker GmbH, 1/73, cited above, points 6 et seq. (see also: ECJ, January 29, 2002, Pokrzeptowicz-Meyer, C-162/00, points 54 et seq.).*

[37] *See for example ECJ, December 10, 1975, Agricultural grain cooperatives v. Commission and Council, 95 to 98/74, 15 and 100/75 (calculation of compensatory amounts), ECLI:EU:C:1975:172.*

[38] *See also delegated Commission Regulation (EU) 2018/67 of October 3, 2017 supplementing Regulation (EU) 2016/1011 of the European Parliament and of the Council concerning the establishment of conditions for determining the impact of the discontinuation or modification of existing benchmarks, OJEU L 12, January 17, 2018, p. 14.*

[39] *Admittedly, paragraphs 4 and 6 of the Regulation do not expressly refer to this period. However, they are part of a provision that sets the end of this transitional period at January 1, 2020, and the second subparagraph of Article 290(1) of the TFEU provides that the legislative act must explicitly delimit the duration of the delegation of power.*

[40] *ECJ, Gde ch., September 5, 2012, Parliament v. Council, C-355/10, ECLI:EU:C:2012:516, point 65.*

[41] *Ibid., point 67.*

On the other hand, according to the European Court of Justice, the provisions relating to the protection of fundamental rights are "of such importance that intervention by the EU legislature is necessary".[42] Where they restrict the exercise of fundamental rights, provisions of EU law must always be treated as essential elements of the legislation in question. The issue at stake here is freedom of contract as derived from Article 16 of the Charter of Fundamental Rights of the European Union.[43]

According to section 52(1) of the Charter, any limitation on the exercise of the rights and freedoms recognized by the Charter must be prescribed by law and respect the essential content of those rights and freedoms. In accordance with the principle of proportionality, limitations may be made only if they are necessary and genuinely meet objectives of general interest recognized by the EU or the need to protect the rights and freedoms of others. If it is considered that the principle of continuity of contracts constitutes a limitation on the exercise of freedom of contract, such a limitation may nevertheless comply with the Charter provided that it is laid down by law (adoption of a regulation), that it is necessary and that it actually meets an objective of general interest. Following Ledra and Dowling, financial stability can be considered a public policy objective.[44]

For this reason, the adoption of a legislative act under the ordinary legislative procedure is necessary. A regulation is preferable to a directive, which, apart from the difficulty of the transposition deadline, does not provide a uniform solution for the internal market.

3.2.2 - Public statements by European authorities

The HCJP recommends a public statement by ESMA (or even the European Commission) to strengthen the legitimacy of alternative benchmarks and to facilitate the renegotiation of contracts (and possibly even avoid their renegotiation). The aim is to ask the authorities, which co-led the transition to euro-denominated interest rate benchmarks, to support the regulatory and operational implementation of this transition.

The letter (September 3, 2019) from the Vice-President of the European Commission and the speech (September 25, 2019) given by the President of ESMA do not call into question the importance of such public statements.

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[42] ECJ, Parliament v. Council, C-355/10, cited above, point 77.

[43] Article 16 enshrines freedom of enterprise. However, the European Court of Justice considers that freedom of enterprise, which includes freedom of contract, is enshrined in Article 16. The Explanation on Article 16 relating to the Charter confirms that freedom of contract is part of freedom of enterprise and may be subject to the limitations laid down in Article 52(1) of the Charter. ECJ, October 17, 2013, Herbert Schaible v. Land Baden-Württemberg, C-101/12, ECLI:EU:C:2013:661, point 25.

[44] ECJ, Gde ch., September 20, 2016, Ledra Advertising Ltd, C-8/15 P to C-10/15 P, ECLI:EU:C:2016:701, point 74; ECJ, G de ch., November 8, 2016, Gerard Dowling e.a., C-41/15, ECLI:EU:C:2016:836, points 45-51.

3.2.2.1 - Concerning €STR

This is the most eagerly awaited recommendation, since EONIA (succeeded by the €STR) will disappear on January 2, 2022 and some contracts referencing EONIA have a maturity date after January 2, 2022. There are two possible approaches here:

o A recommendation explicitly designating an "alternative" benchmark.

This approach would be the most direct, comprehensive and efficient for all parties to transactions referencing these benchmarks. It would consist in designating €STR as the official and natural successor to EONIA, which will disappear on January 2, 2022. For existing contracts, including those maturing after 2021, a reference to EONIA should be interpreted as a reference to €STR + 0.085%.[45]

To this end, this recommendation could, on the basis of the elements set out for the educational outreach referred to below:

- underline the compliance with regulatory requirements and the successful operational completion of the transition between the two benchmarks (methodology, calculation and publication of the alternative benchmark; operational implementation, etc.),

- emphasize that the new benchmark reflects the same economic reality as the original benchmark,

- note that the purpose of the 0.085% spread[46] is to cancel any transfer of value between the parties on the day of the transition (and that the transition is therefore economically neutral for the counterparties),

- endorse the sustainability of the €STR benchmarks and the continuity of the contracts referencing it.

o A recommendation that does not explicitly designate an "alternative" benchmark.

This approach would be somewhat less binding for the European authorities, while still protecting the interests of all users of the benchmark.

On the basis of the elements set out for the educational outreach referred to below, it would be advisable, in the event of the disappearance of a benchmark (EONIA in January 2022), to choose an alternative benchmark and a "spread" that meet the following criteria:

[45] *N.B. The recommendation of the ECB Working Group provides that clearing houses (CCPs) and credit support annexes (CSAs) may switch the remuneration of collateral to €STR without a spread, provided that the collateral covers both liabilities arising before the changeover date and liabilities arising after the changeover date. This report does not oppose this recommendation.*

[46] *"ECB provides a one-off spread between €STR and EONIA", BCE, May 31, 2019.*

- a benchmark that reflects the same economic reality as the initial benchmark (or an economic reality that is as close as possible),

- a benchmark whose methodology, calculation and publication are reliable and comply with the requirements laid down by European legislation, or which has been recommended by European institutions and authorities, whose operational implementation is satisfactory, and whose sustainability appears certain,

- a "spread" that makes it possible to minimize or cancel any undue transfer of value between the parties on the day of transition.

3.2.2.2 - Concerning EURIBOR

The approach to EURIBOR is different from that of EONIA, as its transition is only intended to bring it into compliance with European regulations, as indicated above.

To this end, the recommendation could, on the basis of the elements set out for the educational outreach referred to below:

- underline the compliance with regulatory requirements and the successful operational completion of the transition between the two benchmarks (methodology, calculation and publication of the alternative benchmark; operational implementation, etc.),

- emphasize that the benchmark, whose methodology has been adjusted, reflects the same economic reality as the original benchmark,

- endorse the sustainability of the EURIBOR benchmarks and the continuity of the contracts referencing it.

The report of the working group on euro risk-free rates published on November 6, 2019 is explicit on this point:

"The situation for EURIBOR is different from EONIA, as EURIBOR is not scheduled to be discontinued. As a consequence, contracts and financial instruments referencing EURIBOR do not need to transition to a new rate, but need to incorporate new or improved fallback provisions. This would reduce potential uncertainties in the event of the potential disruption to EURIBOR and would be in line with the recommendations of the International Organization of Securities Commissions (IOSCO). For supervised entities and financial instruments and contracts that fall within the scope of the BMR, introducing robust fallbacks would also contribute to meeting the requirements laid down in the BMR. Market participants may also assess whether €STR could be used as an alternative benchmark for new financial instruments and contracts for certain asset classes."

3.2.3 - Educational outreach aimed at the public, businesses and investors

The HCJP also recommends that the European authorities (the European Commission or ESMA, or even the ECB) and the French authorities (the AMF,[47] and/or the Banque de France) carry out awareness-raising and educational campaigns aimed at the general public, and more specifically at benchmark users, particularly businesses.

This outreach would have several purposes:

<u>• Issue a reminder of the transition schedule for the EURIBOR and EONIA benchmarks</u>

- The transition timetable provided for in the European Regulation on Market Indices, with an extended transition period of 2 years (until January 1, 2022).

- For EURIBOR, EMMI's alignment of the benchmark calculation methodology with the Benchmark Regulation, completed in November 2019.

- For EONIA, the transition to a new successor index, €STR, through a "recalibration" of EONIA, whereby, as of October 2, 2019, EONIA is equal to €STR + a spread of 0.085% (8.5bp).

<u>• Indicate that the framework for the transition of the EURIBOR and EONIA benchmarks complies with the requirements of the Benchmark Regulation</u>

- For EURIBOR, the index now complies with the European Regulation's requirement of calculating the index primarily on the basis of transactional data, but without excluding non-transactional data in case no transactional data are available.

- For EONIA, its recalibration (in the form of a spread against €STR) was carried out on the basis of the recommendations of the European Risk-free-rate working group (in which the European Commission, ESMA, the ECB and the FSMA participated).

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[47] The AMF responded positively and concretely to this recommendation by publishing a press release on its website on December 9, 2019. The press release outlines regulatory changes and the dates on which certain critical benchmarks such as EONIA and LIBOR will disappear, and encourages French benchmark users to prepare for the transition to new risk-free rates and to keep abreast of the work of the RFR working group. The press release states that "the EONIA replacement benchmark, in the light of ECB publications and the work of the RFR WG, seems likely to be €STR + 8.5 basis points". The press release also refers to the HCJP report of July 2018, in particular the reference to Article 1167 of the French Civil Code, which provides that when a benchmark has ceased to exist, "it shall be replaced by the benchmark that comes closest to it", and to the conclusion of the HCJP report, according to which "the risk of lapse of contracts appears limited under French law".
Furthermore, regarding ESMA's request for a public statement on the fact that €STR + 8.5 basis points is the natural successor to EONIA, the AMF believes that the ECB already publicly supports the legitimacy of €STR by publishing the work of the RFR working group and insofar as it calculated the 8.5 basis point spread itself.
Regarding our request for Level 1 European legislative support, the AMF notes that this request should be supported by figures on the number of contracts concerned and their outstanding value.

- For EURIBOR and EONIA, the accreditation of EMMI by the FSMA as an administrator constitutes recognition of the regulatory compliance of the transition.

- It should also be noted that it is important for the users of these benchmarks to agree on a fallback clause for the contracts concerned, in order to fully comply with the provisions of the European legislation.

• Indicate that regulatory compliance ensures the sustainability of the EURIBOR and EONIA benchmarks and its successor benchmark

This sustainability justifies and guarantees the continuity of contracts referencing these benchmarks.

3.2.4 - A communication to the attention of the American and British authorities

The disappearance of LIBOR at the end of 2021[48] and the lack of any satisfactory alternative rate are a major source of concern for French and European market participants. Although the British and American authorities have set up working groups to prepare for the transition, we recommend that the French and European authorities draw the attention of their British and American counterparts to the fact that the disappearance of LIBOR is a subject of major importance in the European Union, since a very large number of contracts governed by European Union law use the various LIBOR tenors (in several currencies) as benchmarks.

3.3 - Recommendations for market participants

This report of the HCJP Working Group invites all benchmark users, bearing in mind that this invitation is not limited to financial institutions but is addressed to the entire market and particularly to borrowers, to continue to make the necessary preparations for replacing the benchmarks to be discontinued with alternative benchmarks.

In this regard, the recommendations set out in paragraph 6.1 of the previous HCJP report on the impacts of the modification or discontinuation of benchmarks remain relevant.[49] Their

[48] *Cf. supra II, B, 3) LIBOR.*

[49] *Namely: “ **1) Map and identify** (i) the various fallback clauses and (ii) the various contracts that contain fallback clauses (and those that do not) so that each market participant can measure the scope and extent of the risk generated by possible changes in the benchmarks. This identification (or mapping) should be carried out by each market participant for its own contracts. Making an inventory of its “personal” risks would enable it to identify (a) contracts that do not have a fallback clause and (b) contracts that contain insufficient fallback clauses in order to insert or modify, as appropriate, contractual provisions that comply with Art. 28(2) of the Benchmark Regulation.*

***2) Keep abreast of proposals from market associations regarding fallback clauses relating to specific sectors of activity** (International Swaps and Derivatives Association and French Banking Federation for derivatives; Loan Market Association for*

implementation, if it has not already started, should now be a priority for benchmark users.

More specifically, this report also recommends that contracts referencing benchmarks that are due to disappear (in particular EONIA and LIBOR, whose discontinuation has already been announced) should be amended as soon as possible (and in any event without waiting for possible legislative intervention as recommended by this report) in order to provide for their substitution with an alternative benchmark. It is also important to stop using old benchmarks that are likely to disappear in new contracts.

Lastly, it is recommended that banks relay to their non-bank counterparties the recommendations made by the HCJP and the various market and European studies on the transition to alternative benchmarks, such as those of the working group on euro risk-free rates.

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financing contracts). In this regard, the Working Group emphasizes that the use of technical schedules (or "supplements") and "modular" (option-based) protocols for derivatives will facilitate the spread of fallback clauses tailored to one or more sectors of activity.

3) Include clauses in new contracts with floating rate interest terms to ensure the continuity of the parties' obligations when modifying or replacing benchmarks. *This entails, for example, providing for contract renegotiation procedures that limit the risks of blockages during renegotiation, for example by reducing the need for unanimity and lowering quorums and majority thresholds. The clauses published by market organizations should be monitored by the various market participants.*

4) Harmonize, as much as possible, the triggering events of the fallback mechanisms in contracts indexed on the same benchmark and concluded as part of a transaction. *For example, in the ISDA proposals, the replacement of the benchmark is triggered by the actual discontinuation of the benchmark, whereas the "triggers" in the new fallback clause recommended by the LMA provide for the simple public announcement of the discontinuation of a benchmark. There is therefore a risk of a "mismatch" or "conflict" between the different contracts indexed on a floating rate within the same economic transaction if the triggers are not identical (as in the case of a financing contract and a hedging contract)."*

TABLE OF CONTENTS

Introduction...2

I- Overview of the main conclusions of the HCJP's previous report on the impact of the reform or discontinuation of benchmarks...4

1.1- The principle of contract continuity for legacy contracts containing a fallback clause 4

1.1.1- The general principle of application of fallback clauses 4

1.1.2- Old and new fallback clauses 5

1.1.2.1- Fallback clauses in credit agreements (LMA standard) 5

1.1.2.2- Fallback clauses in the capital markets context (debt) 6

1.1.2.3- Fallback clauses in derivatives 7

1.2- Legal risks for contracts lacking fallback clauses 8

1.2.1- Benchmark modification in contracts subject to French law 9

1.2.2- Benchmark modification in contracts subject to New York State law 11

1.2.3- Benchmark modification in contracts subject to English law 12

II- Overview of the changes linked to benchmark reform 13

2.1- Proposed amendments to the Benchmark Regulation 13

2.1.1- Amendments to the Benchmark Regulation 13

2.1.2- General consultation in view of revising the Benchmark Regulation 14

2.2- The emergence of alternative benchmark 15

2.2.1- EONIA, transition to €STR 15

2.2.1.1- EONIA in its original form no longer met the criteria set out in the Benchmark Regulation...15

2.2.1.2- The recalibrated EONIA and the publication of €STR 16

2.2.1.3- The principal recommendations of the RFR Working Group...17

2.2.2- EURIBOR...17

2.2.2.1- The situation of EURIBOR is different from that of EONIA 17

2.2.2.2- Reforms carried out by EMMI, the EURIBOR administrator 19

2.2.2.3- Work conducted by the RFR Working Group 21

2.2.3- LIBOR 22

2.2.3.1- Transition from GBP LIBOR to SONIA 23

2.2.3.2- Transition from USD LIBOR to SOFR 24

2.2.3.3- LIBOR with respect to derivatives 26

III- Recommendations of the Working Group 28

3.1- Summary of remaining risks 28

3.2 - Recommendations to authorities and index administrators 30
3.2.1- Legislative intervention at the European level 30
3.2.1.1- The objectives of legislative intervention in European law 30
3.2.1.2- The proposed drafting 31
3.2.1.3- Jurisdiction of the European Union and the nature of the legislative act ...32
3.2.2- Public statements by European authorities 34
3.2.2.1- Concerning €STR 35
3.2.2.2- Concerning EURIBOR 36
3.2.3- Educational outreach aimed at the public, businesses and investors 37
3.2.4- A communication to the attention of the American and British authorities 38

3.3- Recommendations for market participants 38

Table of contents 40

Members of the Working Group 42

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