

The Wheatley Report on Reforming LIBOR: A Step in the Right Direction?

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I. INTRODUCTION	883	R
II. WHAT IS LIBOR?	885	R
III. WHAT HAPPENED?	888	R
IV. PRIVATE SELF-REGULATION VS. GOVERNMENT INVOLVEMENT.....	892	R
V. THE WHEATLEY REPORT	895	R
VI. ANALYSIS OF THE WHEATLEY REPORT.....	899	R
A. <i>Reform vs. Replacing the Benchmark</i>	900	R
B. <i>Use of Actual Transaction Data</i>	904	R
C. <i>Market Participants</i>	906	R
VII. CONCLUSION	909	R

I. INTRODUCTION

Many professionals have called it the largest financial scandal of all time, “the banking industry’s tobacco moment.”¹ The ongoing investigations into the manipulation of the London Interbank Offered Rate (“LIBOR”),² used in a variety of financial instruments, ranging from retail loans to derivative swap agreements, have proven that substantial regulatory reform of financial markets is globally in order. Michel Barnier, European Commissioner responsible for internal markets and services, rightly noted in a speech to the European Parliament that “[w]e have to get rid of this ‘everything is allowed, everything is permitted’ attitude.”³ In particular, Barnier noted that self-regulation is no longer a viable option. Additionally, United States Chairman of the Commodity Futures Trading Commission Gary Gensler has stated that as a result of banks’ shift away from lending unsecured funds to each other, he “believe[s] that continuing to reference such rates diminishes market

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1. *The LIBOR Scandal: The Rotten Heart of Finance*, THE ECONOMIST, July 7, 2012, <http://www.economist.com/node/21558281> (“‘This is the banking industry’s tobacco moment,’ says the chief executive of a multinational bank, referring to the lawsuits that cost America’s tobacco industry more than \$200 billion in 1998. ‘It’s that big,’ he says.”).

2. See discussion *infra* Part. II.

3. Martin Banks, *EU Commissioner Michel Barnier Has Called for “Strong and Robust” Measures to Combat Market Manipulation Such as the Rigging of Benchmark Interest Rate Libor*, THE PARLIAMENT, Sept. 24, 2012, <http://www.theparliament.com/latestnews/article/newsarticle/barnier-calls-for-strong-and-robust-response-to-liborscandal/#.URgN8KWmDdk>.

integrity and is unsustainable in the long run.”⁴

The LIBOR benchmark was developed to represent the rate at which banks could realistically borrow funds in the interbank market prior to 11:00 a.m. on a given day.⁵ The setting of the LIBOR rate largely relied on the integrity and truthfulness of contributing bank submitters that the rate submitted was the true rate at which that bank could borrow on that particular day. However, as a result of greed and lack of oversight and controls, submitters and traders at various banks were able to manipulate rates in accordance with their individual goals. The LIBOR benchmark was no longer representative of actual borrowing costs: it was a fictional rate negotiated between banks’ traders for their benefit.

After the commencement of investigations concerning manipulation of the LIBOR benchmark, the Chancellor of the Exchequer asked Martin Wheatley, Managing Director of the Financial Services Authority (“FSA”) and Chief Executive of the UK’s Financial Conduct Authority, to consider whether the findings of manipulation and false submissions call for a wider policy response. Wheatley proposed a ten-point plan centered on three main conclusions for the reform of LIBOR and the restoration of its credibility.⁶

This Article discusses Wheatley’s suggested reforms and analyzes their viability. Part II provides a detailed background on LIBOR and how it was calculated before any reform to the benchmark. Part III details how the manipulation of LIBOR rates occurred and the various banks that have acknowledged involvement. Part IV provides a detailed analysis of what financial regulation is and why it is essential for a benchmark, such as LIBOR. Part V gives a detailed description of Wheatley’s recommendations and reasoning. Lastly, Part VI discusses the implications of Wheatley’s final report and challenges the viability of the proposed recommendations and regulatory system. In particular, Part VI challenges Wheatley’s (A) reluctance to explore the possibilities of replacing LIBOR with a different, more structured benchmark that elicits contributing banks’ commitment to their submitted rates; (B) factors allowing adjustment of actual transaction data in the calculation of LIBOR in various instances; and finally, (C) allowance of market par-

4. Kevin McCoy, *Gensler: Libor Isn’t Useful for Setting Rates*, USA TODAY, Feb. 28, 2013, <http://www.usatoday.com/story/money/business/2013/02/28/gensler-criticizes-libor-system/1953441.system/1953441/>.

5. *Historical Perspective*, BBALIBOR, <http://www.bbalibor.com/explained/historical-perspective> (last visited May 19, 2013).

6. For a detailed discussion on Martin Wheatley’s Report see *infra* Part V; see also MARTIN WHEATLEY, *THE WHEATLEY REVIEW OF LIBOR: FINAL REPORT* 40 (Sept. 2012), available at http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf.

ticipants' and submitters' use of discretion in the submitting and calculations of LIBOR. Although Wheatley's proposed changes to the structure and governance of LIBOR may be a step in the right direction, this Article explores the possibility of the necessity for stricter regulation or replacement.

II. WHAT IS LIBOR?

During the early 1980s, London, England, possessed a thriving financial market, which consisted of active trading of newly emerging financial instruments known as derivative contracts and syndicated loans.⁷ Each contract contained its own provisions with respect to calculating the underlying rate. Because of this lack of uniformity of procedure for establishing these rates, the British Banker's Association ("BBA")⁸ was asked to devise a benchmark that would act as a reference rate for derivatives and other financial transactions.⁹ Subsequently, the BBA, working with the Bank of England and other entities, invented the BBA standard for Interest Settlement Rates, which in turn eventually led to the publication of the first BBALIBOR (London Interbank Offered Rate) in January 1986.¹⁰ LIBOR rates were originally published solely for three currencies: U.S. Dollars, Japanese Yen, and British Pound.¹¹

The BBA defines LIBOR as "[t]he rate at which an individual contributor panel bank could borrow funds, were it to do so by asking for and then accepting interbank offers in reasonable market size, just prior to [11:00 a.m.] London time."¹² The BBA further specifies that "[t]he rate at which each bank submits must be formed from that bank's perception of its cost of unsecured funds in the London interbank market" and "must represent rates at which a bank would be offered funds in the

7. *Historical Perspective*, *supra* note 5.

8. *Disclaimer*, BBALIBOR, <http://www.bbalibor.com/disclaimer/bbalibor-explained/historical-perspective> (last visited May 19, 2013) ("The Government has recommended the regulation of activities related to LIBOR and a new set of institutions to administer and oversee LIBOR. The Hogg Committee has been set up to oversee a process to recommend these new institutions. For an interim period until a new administrator has been identified and a successful transition has been completed, the BBA has been asked to continue to support the ongoing collection, calculation and distribution of LIBOR rates. . . . Please note that all information contained within the previous website shall from 2 April 2013 be considered to be for historic reference purposes only.").

9. *See Historical Perspective*, *supra* note 5 ("Rather than negotiating the underlying rate or forming rates by taking averages of ad-hoc panels, banks could now use a standard rate.").

10. *See id.*

11. *See id.*

12. Up until 1998, the LIBOR rate was based on the rates at which banks thought that interbank deposits would be offered by one prime bank to another prime bank for a reasonable market size in that day at 11 a.m. *Definitions*, BBALIBOR, www.bbalibor.com/bbalibor-explained/definitions (last visited Feb. 09, 2013).

London interbank market.”¹³

Every working morning at approximately 11:00 a.m. London Time, the panel of banks informed Thomson Reuters of the rates at which they could borrow funds in the market for each specific currency and maturity.¹⁴ Subsequently, the highest one-fourth and lowest one-fourth rates were eliminated, and an average was calculated from the resulting rates, which in turn produced the official LIBOR rate for the day.¹⁵ Once the LIBOR rate was calculated, individual submissions of panel banks were made public. According to the BBA, the publication of individual submissions promoted transparency and reliability.¹⁶

It is important to note that the BBA has stated it would not be “feasible to create a full suite of LIBOR rates” if it were necessary that all reported rates be based on actual transactions because “not all banks will require funds in a marketable size each day in each of the currencies/maturities they quote.”¹⁷ Furthermore, the BBA has stated that “a bank will know what its credit and liquidity risk profile is from rates at which it has dealt and can construct a curve to predict accurately the correct rate for currencies or maturities in which it has not been active.”¹⁸ However, this may precisely be the practice that allowed for the escalation of LIBOR-rate manipulation.

LIBOR, since its inception in 1986, has been the most widely used benchmark in financial markets around the world.¹⁹ LIBOR has been used as a reference rate in mortgages, student loans, and credit cards.²⁰ Additionally, it is the primary benchmark used in most derivative financial instruments, such as options and swap agreements.²¹ In particular, contracts with an outstanding value of \$300 trillion reference the LIBOR benchmark. Furthermore, it is used as an indicator of strain in money

13. *Id.*

14. See *The Basics*, BBALIBOR, <http://www.bbalibor.com/explained/the-basics> (last visited Mar. 23, 2014).

15. Yovonne Diaz, *Thomson Reuters Role in the Calculation and Distribution of Libor*, THOMSON REUTERS, Oct. 5 2012, thomsonreuters.com/content/news_ideas/articles/financial/our-role-in-the-calculation-and-distribution-of-libor (“Thomson Reuters is the official calculation and distribution agent for LIBOR. This role has been performed under the auspices of the British Bankers Association since 2005, when Thomson Reuters acquired Telerate, the original calculation agent since the benchmark’s inception in 1986.”).

16. Justin Wong, *LIBOR Left in Limbo; A Call for More Reform*, 13 N.C. BANKING INST. 365, 369 (2009).

17. See *The Basics*, *supra* note 14.

18. *Id.*

19. See John Kiff, *What is LIBOR?*, FINANCE & DEVELOPMENT INTERNATIONAL MONETARY FUND, Dec. 2012, <https://www.imf.org/external/pubs/ft/fandd/2012/12/basics.htm>; see also Mike Segar, *Libor Lies: 13 Giant Lenders Sued over the Benchmark Rate Riggin*, RT, Sept. 24, 2013, <http://rt.com/business/jpmorgan-libor-banks-sued-268/>.

20. *Id.*

21. *Id.*

markets and future central bank interest rates.²² LIBOR produced 150 rates per day using ten currencies with fifteen maturities quoted for each.²³ Contributor banks were selected based on their scale of market activity, credit rating, and perceived expertise in the currency concerned.²⁴ However, the market of contributing banks is significantly small, which could either be beneficial or detrimental to such a market. For example, a small market should mean that one bank knows the practices and procedures of the other bank; however, it is this exact tight community that may allow for collusion and agreement between traders to manipulate rates for the benefit of themselves and other banks.

There is very little data on the volume of actual interbank transactions that serve as the basis of panel banks' contributing rates.²⁵ There is no mechanism through which contributing banks are required to report the transactions or data on which they base their rate submissions. As a former trader stated, "[N]o one really knows what's going on in the market . . . [y]ou have this vast overhang of financial instruments that hang their own fixes of a rate that doesn't actually exist."²⁶

Although a benchmark-lending rate, such as LIBOR, is necessary, a manipulated and loosely governed interbank lending rate may be detrimental to financial markets rather than provide stability. In normal market conditions, where there is relatively high liquidity in financial markets, the LIBOR benchmark is directly correlated with Treasury bill rates, which are low risk and highly liquid.²⁷ However, when financial markets experience stress, the correlation disintegrates, and there is no other market-based benchmark that reflects the actual costs of interbank short-term lending.²⁸ It is during times of financial stress that manipulation is most likely to occur due to the submitting banks' fear of developing a reputation as unstable or having low liquidity in the event that a high borrowing rate is submitted for calculation into LIBOR.²⁹ How-

22. *Id.*

23. *Id.*

24. *Id.*

25. WHEATLEY, *supra* note 6.

26. *The LIBOR Scandal*, *supra* note 1.

27. Rosa M. Abrantes-Metz & David S. Evans, *Replacing the LIBOR with a Transparent and Reliable Index of Interbank Borrowing: Comments on the Wheatley Review of LIBOR Initial Discussion Paper*, at 4 (Sept. 6, 2012), available at <http://ssrn.com/abstract=2142878>.

28. *Id.* ("During a crisis, a flight to quality may drive down the yields on 'risk-free' instruments like Treasury-bills at precisely the same time that the liquidity and credit premium demanded by interbank lenders are likely to rise. Additionally during those times the market segmentation between short term borrowing and lending to which the LIBOR pertains, and longer tenor borrowing and lending as typically represented in corporate bonds and credit default swaps, is likely to increase.")

29. "As far back as March 2008, the Bank for International Settlements concluded that during period of severe market volatility, LIBOR fixings are less representative of banks' cost of

ever, the problem may be bigger than possible manipulation solely during times of financial stress. Traders in the interbank loan industry have suggested that LIBOR rates were being manipulated as far back as fifteen years ago.³⁰ Additionally, Barclays' traders and submitters manipulated the bank's LIBOR submission as far back as 2005, when financial markets were not experiencing stress.³¹ Therefore, it is questionable whether the added elements of regulation proposed by the Wheatley Report will indeed combat and identify any such attempts at manipulation of the LIBOR rate.

III. WHAT HAPPENED?

In 2008, criticisms arose regarding the manipulation and possible fixing of LIBOR. In particular, it was evident that the interbank lending market was not functioning properly, as banks were "wary of lending to each other," and their risk exposure was increasing, but the LIBOR rate was not increasing to reflect these market changes.³² Additionally, suspicions surfaced concerning bank managers ordering submittal of lower rates out of fear that a higher rate would act as a symbol of illiquidity and financial weakness.³³ In response to these suspicions, the BBA undertook a review of actual data and the reliability of the LIBOR rate.³⁴ The review elicited concerns that the publication of individual contributing bank submissions could lead to herd behavior—"where banks are reluctant to report rates higher than their peers for fear of appearing in financial distress."³⁵ Despite such concerns, the BBA failed to take any action in implementing a system where the identities of submitting panel banks remained undisclosed. In April 2008, the BBA announced that it would block any panel bank that had manipulated data, but it failed to recognize that manipulation was a reality, which was indeed occurring in the submissions of panel banks.³⁶

Specifically, the BBA considered opinions regarding unverified

borrowing. Moreover, they found that there can be a significant dispersion in submitted rates due to heightened uncertainty about credit quality and greater incentives to engage in 'strategic behavior' or manipulation." Jun Anthony Garcia, *Fixing the benchmark*; *Wheatley Considers LIBOR Overhaul*, FINANCIAL REGULATION INT'L (Sept. 2012), <http://ssrn.com/abstract=2143137>.

30. *The LIBOR Scandal*, *supra* note 1.

31. Agreement Appendix A, U.S. Dep't of Justice, Criminal Division, Fraud Section & Barclays, at 4, available at <http://www.justice.gov/iso/opa/resources/9312012710173426365941.pdf>.

32. Gavin Finch & Ben Livesey, *Libor Cracks Widen as Bankers Struggle with Reforms (Update 2)*, BLOOMBERG (May 27, 2008, 6:53 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&refer=home&sid=amURZMCR_wkI.

33. Wong, *supra* note 16, at 366.

34. *Id.*

35. *Id.* at 373.

36. *See id.* at 372.

transparency, creation of an additional U.S. Dollar Benchmark, expansion of the LIBOR panels, tightening the definition of “reasonable market size,” and enhancement of governance and scrutiny.³⁷ Despite these considerations, the BBA only agreed to the possible expansion of LIBOR panels and a mechanism of enhanced governance and scrutiny.³⁸ The BBA contended that the LIBOR panels already included the largest banks in London but agreed to consider adding more contributing panel banks.³⁹ The enhanced governance and scrutiny mechanism provided that the Foreign Exchange and Money Markets Committee (“FX & MM Committee”), which was responsible for the functioning and development of BBALIBOR, would include two subcommittees comprised of practitioners from both contributing and non-contributing banks.⁴⁰ In particular, this mechanism established a process by which the BBA monitored submissions and analyzed discrepancies between the fluctuation of submitted rates and actual market activity and flagged those discrepancies for future investigation.⁴¹ Nonetheless, the scrutiny mechanism was majorly flawed: banks were manipulating data in order to fit into the spread of submissions by other banks, so there would not be a discrepancy as compared to market activity or any fluctuation in rates. Because this was an industry-wide practice, the submissions by panel banks did not contain any major outliers, and thus the scrutiny mechanism in place was unable to detect the manipulation.⁴²

In late June 2012, Barclays Bank PLC⁴³ admitted to misconduct related to misrepresented submissions of the rate at which it could borrow in the interbank lending market.⁴⁴ From 2005 through 2009, Barclays’ swap traders proposed rates to Barclays’ LIBOR submitters that would benefit their particular positions.⁴⁵ Subsequently, Barclays’ submitters tendered inaccurate rates in accordance with swap traders’ requests to Thomson Reuters for the calculation of the LIBOR rate. In

37. *See id.* at 373–79.

38. *See id.*

39. *See id.* at 375.

40. FX & MM COMM. SECRETARIAT, LIBOR GOVERNANCE AND SCRUTINY (2008), available at <http://www.bbalibor.com/download/4025>.

41. Wong, *supra* note 16, at 377.

42. *Id.* at 378–79 (“This new Scrutiny Mechanism, thus, may be able to detect a rogue bank reporting inaccurate data, but it is unlikely to detect multiple banks acting as a herd to report false data together.”).

43. Barclays is a financial services company headquartered in London, England. *See* Agreement Appendix A, *supra* note 31, at 4.

44. Press Release, U.S. Dep’t of Justice, Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay \$160 Million Penalty (June 27, 2012), available at <http://www.justice.gov/opa/pr/2012/June/12-crm-815.html>.

45. Agreement Appendix A, *supra* note 31, at 5.

particular, the traders “either proposed a particular LIBOR . . . contribution for a particular . . . currency, or proposed that the rate submitter contribute a rate higher, lower, or unchanged for a particular . . . currency” for the benefit of their positions.⁴⁶ The manipulation was not contained solely within Barclays. Barclays’ traders engaged in rate-fixing negotiations with traders at other contributing panel banks and requested that those traders communicate rates that would be favorable to both the Barclays’ traders and traders at other banks.⁴⁷ These types of rate-fixing negotiations resulted in “scratch my back, and I will scratch yours” situations, where traders outside of Barclays would also make requests to Barclays’ traders for certain interest rates to benefit their positions.

Barclays’ management did not stand far behind the traders. While rate manipulations were occurring between traders, Barclays also “under-reported its perception of its borrowing costs.”⁴⁸ On various occasions during the crisis period, submitters were instructed by management to submit false rates, ones that were closer to expected rates of other contributing panel banks, rather than actual rates at which Barclays would borrow.⁴⁹ In most instances, the intention behind the managers’ orders was not to alter the fixed LIBOR rate, but rather just the submission, which in turn would be excluded as being in the upper quartile and not affect the actual LIBOR rate.⁵⁰ Nevertheless, these “concerns apparently were outweighed by [the managers’] priority for Barclays’ submissions to be ‘within the pack.’”⁵¹ The central motive behind these actions was avoiding negative press coverage and concern over Barclays’ liquidity.⁵² Although during the crisis the interbank loan market was not properly functional as a result of low liquidity, which may justify Barclays’ perception that other banks were also misquoting their rate submissions, what is more troublesome is that even prior to the occurrence of any crisis, individual traders attempted to influence rates for their own benefit.⁵³ It is questionable whether the proposed regulation by Wheatley will prevent similar motives in the future.

Despite the fact that Barclays’ misconduct was the first to be publi-

46. *Id.*

47. Press Release, FSA, Barclays Fined £59.5 Million for Significant Failings in Relation to LIBOR and Euribor, (June 27, 2012), *available at* <http://www.fsa.gov.uk/library/communication/pr/2012/070.shtml> [hereinafter FSA Press Release, June 27, 2012]; *see also Timeline: Libor-Fixing Scandal*, BBC NEWS, Feb. 6, 2013, <http://www.bbc.com/news/business-18671255>.

48. *Id.*

49. *See id.*

50. *See* Agreement Appendix A, *supra* note 31, at 16.

51. *Id.*

52. *See Timeline: Libor-Fixing Scandal*, *supra* note 47.

53. *See The Libor Scandal*, *supra* note 1.

cized, it is not the only financial institution that engaged in manipulation. For example, UBS has agreed⁵⁴ to pay a \$1.5 billion fine to regulators in the United Kingdom, United States, and Switzerland in order to settle LIBOR manipulation charges.⁵⁵ Similarly, traders at UBS contacted traders at other banks and attempted to coordinate submissions that would benefit their trading positions.⁵⁶ Additionally, in February 2013, the Royal Bank of Scotland Plc (“RBS”) was fined £87.5 million for breaches of the FSA’s requirements relating to LIBOR.⁵⁷ In particular, the FSA found that at least 219 document requests and an unquantifiable number of oral requests for inappropriate submissions were made, and “RBS failed to identify and manage the risks of inappropriate submissions.”⁵⁸ It is important to note that Barclays, UBS, and RBS did not have any LIBOR-related systems and controls in place until December 2009, September 2009, and March 2011, respectively.⁵⁹ “U.S.-based Citigroup, JPMorgan, and Bank of America have said they are cooperating with investigators’ requests for Libor-related records.”⁶⁰

Although underreported or manipulated rates may be beneficial for those invested in similar positions as the traders at the time of the submissions, the lower LIBOR rate has resulted in high losses. For example, when the LIBOR rate is artificially low, borrowing costs for many corporate and retail borrowers are low. However, lenders or those having investments with returns contingent upon the LIBOR rate are at a loss. It is this disparity that causes problems in determining whether parties are on the losing or winning side and the extent of their damages. Moreover, because the rate was widely manipulated, it is difficult to estimate what the proper rate should have been. Likewise, it is questionable how settlements from panel banks involved in the manipulation will be allocated because for each transaction where one person gained due

54. Press Release, Assistant Attorney General Lanny A. Breuer Speaks at the UBS Press Conference (Dec. 19, 2012), *available at* <http://www.justice.gov/criminal/pr/speeches/2012/crm-speech-121219.html> [hereinafter Press Release, Dec. 19, 2012] (UBS Japan and its parent company UBS AG have entered into non-prosecution agreements with the Justice Department regarding manipulation of their submissions to the British Bankers Association for calculation of LIBOR, agreeing to pay a total of \$1.5 billion.).

55. Lindsay Fortado & Greg Farrell, *UBS Said to Face \$1.6 Billion Libor Penalty This Week*, BLOOMBERG BUSINESSWEEK, Dec. 16, 2012, <http://www.businessweek.com/news/2012-12-16/ubs-said-to-face-1-dot-6-billion-libor-penalty-this-week>; *see also* *UBS to Pay \$1.5 Billion to Settle Libor Charges*, WALL ST. J., Dec. 19, 2012.

56. Press Release, Dec. 19, 2012, *supra* note 54.

57. Press Release, FSA, RBS Fined £87.5 for Significant Failings in Relation to LIBOR (Feb. 6, 2013), *available at* <http://www.fsa.gov.uk/library/communication/pr/2013/011.shtml>.

58. *Id.*

59. *See id.*; Press FSA Press Release, June 27, 2012, *supra* note 47; FSA, Final Notice UBS AG (Dec. 19, 2012), *available at* <http://www.fsa.gov.uk/static/pubs/final/ubs.pdf>.

60. McCoy, *supra* note 4.

to a lower or higher rate, the other suffered losses due to the manipulation. Although banks will be liable for their actions in cases where causation is proven, the proceeds gained from the manipulation by various persons involved in the day-to-day manipulation will not be recoverable.

IV. PRIVATE SELF-REGULATION VS. GOVERNMENT INVOLVEMENT

Financial regulation has been defined as “governmental standards or commands, backed by coercive sanctions, requiring private persons to undertake or refrain from specified conduct.”⁶¹ Regulation of the operation and management of financial institutions focuses on oversight of business operations, risk management, and corporate governance.⁶²

Milton Friedman,⁶³ an economist who believed in free market economics, proposed in his laissez-faire economics theory, that economies—including financial markets—possess the ability to correct themselves, provided there is no regulation. The principle underlying this theory is that man makes rational calculations in striving to maximize the utility of goods.⁶⁴ Friedman argued for a free market in which there is little or no government involvement or regulation, stating that the world runs on individuals pursuing their separate interests and that the world’s greatest achievements have not come from government bureaucracies.⁶⁵ When questioned on whether the capitalist free market system rewards system manipulation more than it does virtue, Friedman responded by stating that no man acts solely on virtue.⁶⁶

However, it is important to note that prior to formal regulatory frameworks, the viability of financial systems was heavily dependent on relationships of trust.⁶⁷ “[A] primary function of financial institutions is to improve allocation of funds within the economy.”⁶⁸ Faith in markets

61. Richard Stewart, *Regulation and the Crisis of Legalisation in the United States*, in *LAW AS AN INSTRUMENT OF ECONOMIC POLICY: COMPARATIVE AND CRITICAL APPROACHES* 97, 100 (Terence Daintith ed., 1998).

62. Eric J. Pan, *Understanding Financial Regulation* 12 (Cardozo Legal Studies Research, Paper No. 329, 2011), available at <http://ssrn.com/abstract=1805018>.

63. *Milton Friedman A Heavyweight Champ*, at *Five Foot Two*, *THE ECONOMIST*, Nov. 23, 2006, http://www.economist.com/node/8313925?story_id=8313925 (stating that Milton Friedman was “the most influential economist of the second half of the 20th century . . . possibly of all of it.”).

64. Paul Krugman, *Who Was Milton Friedman?*, Feb. 15, 2007, <http://www.nybooks.com/articles/archives/2007/feb/15/who-was-milton-friedman/> (“[W]hether consumers are deciding between corn flakes or shredded wheat, or investors are deciding between stocks and bonds, those decisions are assumed to be based on comparisons of the ‘marginal utility,’ or the added benefit the buyer would get from acquiring a small amount of the alternatives available.”).

65. Milton Friedman—Greed, *YOUTUBE* (July 14, 2007), http://youtu.be/RWsx1X8PV_A.

66. *Id.*

67. See Colin Mayer, *Trust in Financial Markets*, 14 *EUR. FIN. MGMT.* 617 (2008).

68. *Id.* at 618.

facilitates the growth of those markets. “[P]rotection of investors is a crucial determinant of the development of financial systems.”⁶⁹ Trust in markets results where individuals are willing to look out not only for their own interests, but also for the interests of others.⁷⁰ In fact, through dedicating behavior to the interests of others, individuals again essentially act in self-interest—the conventional description of self-interest having no application—because they anticipate other benefits from acting this way.⁷¹ Thus, it is hard to say that Friedman was operating on a definition of self-interest that completely excluded the interests of others.

Absent such trust, Friedman’s idea of self-correcting markets and free economies where individuals act in their own self-interest becomes flawed. It is questionable whether Friedman or any other economist who has theorized that the best economic system is that of a free market with very little or no government regulation would continue to preach these theories after the 2007–2008 crisis, which has had worldwide instances of manipulation, such as the LIBOR scandal. The very self-interest—absent integrity and trust—of those individuals involved in the submission and setting of the LIBOR rate, which is used in over \$300 trillion worth of investments and contracts, incentivized them to manipulate the banks’ rates and submit rates that were not representative of actual transactions. It is this self-interest that led to unethical practices—practices that led to gains for submitters and to major losses for those who would have gained had LIBOR not been manipulated. Free markets with little or no government involvement should correct themselves and should not lead to gains for those who have chosen to act without the slightest bit of ethical and moral motivations. Instead, the lack of regulation over the market-generated LIBOR and the market actors’ ability to control such an important benchmark have led to nothing but scandalous cheating.

Regulatory bodies are often faced with the decision whether to enact strategies that require their direct oversight and expenditure or to delegate the regulatory responsibility to the private sector and allow for self-regulation.⁷² Generally, extensive financial regulation is enacted only in response to a crisis, a shift in markets, or any other change that may lead to financial instability.⁷³ In normal market conditions, where

69. *Id.*

70. *Id.* at 630.

71. *Id.*

72. Pan, *supra* note 62, at 5.

73. Charles K. Whitehead, *Regulating for the Next Financial Crisis*, 37 CORNELL L.F. 20 (2011) (“The decisions in the 1930’s to separate commercial and investment banking followed the onset of the Great Depressions, which result from, among other things, a restrictive monetary policy and a precipitous decline in stock values after transformative growth in equity markets.”).

there is no indication of instability or crisis, governments and regulators tend to delegate a majority of their regulatory responsibility to private market participants. It is not until a major financial crisis occurs that government involvement in financial regulation becomes a focus. For example, it was not until the start of the 2007–2008 financial crisis that governments and regulators began to focus on regulating financial markets. As a result, the private-public divide in regulation narrowed. However, it is not certain whether there will be a retraction in regulation once markets return to normal, thus causing the private-public divide to again widen.

Even with the increase in cross-border trade and financial transactions, self-regulation was still the most widespread form of regulation.⁷⁴ Prior to World War I and the Great Depression, government regulation of financial markets was virtually non-existent. A move towards more regulation can be seen in the fifteen years prior to the 2007–2008 crisis, such as the development of codes of conduct, and, following Enron, the passage of Sarbanes-Oxley. Similarly, if those actions by regulators were insufficient to prevent crisis and scandal, then the proposals made by the Wheatley Report will be insufficient to combat future manipulation or scandal associated with the setting of the LIBOR rate or any other benchmark.

It is during times of financial crisis that the use of benchmarks is most important, as that is when benchmarks diverge from the rate reflected by treasury notes. However, if the regulations proposed by Wheatley are weak and allow for self-regulation—particularly in times of crisis—then they are and will be ineffective in preventing the misconduct that called for more regulation. Thus, the following question arises: does the lack of regulation or delegation to private actors lead to market instability or weaker markets in the long term?

Market instability breeds more competition between financial institutions and market participants. It is at this point that manipulation and misconduct essentially become a survival mechanism, allowing participants to inch up or at least not fall off of the totem pole of competition and lose prominence in the global financial industry. In particular, in a time of crisis, market regulators are motivated to display control over market conditions, and therefore, enact various measures to encourage a

74. See Stefano Pagliari, *Who Governs Finance? The Shifting Public–Private Divide in the Regulation of Derivatives, Rating Agencies and Hedge Funds*, 18 EUR. L.J. 44, 45 (“The predominance of private rule-making in the regulation of finance endured and reached its height during the ‘first wave of globalisation. . . . At this time, both the most important financial centre in the world (London) and its emerging challenger (New York) maintained powerful self-governing corporatist institutions, such as the London Stock Exchange, the Corporation of Lloyd’s, and the New York Stock Exchange.”).

restored public confidence in the markets; however, this motivation seems to dissipate once markets return to normal conditions and the public's confidence is restored.⁷⁵ Intervention of financial regulatory authorities is necessary in areas that were previously left solely to private market participants. Accordingly, there are two issues that must be analyzed. First, is more government regulation a feasible solution to the ongoing LIBOR crisis? And second, how effective will the currently proposed regulation be in preventing future financial market demise and misconduct by private entities?

Effective financial public regulation depends on the formulation of effective rules and adequate supervision over the actual compliance of institutions. Rules must be precise, transparent, and intelligible, and should inform the regulated persons of the ramifications of noncompliance.⁷⁶ Supervision consists of application of existing rules to oversee the manner in which a regulated entity attempts to comply with the rules.⁷⁷ Regulatory supervision is closely related to enforcement, which involves prosecution for lack of compliance to the rules set out by the regulatory body.

V. THE WHEATLEY REPORT

Subsequent to the confirmation of Barclays' involvement in manipulations and misconduct in fixing of the LIBOR rate, the British government asked Martin Wheatley, Managing Director of the Financial Services Authority ("FSA") and Chief Executive-designate of the UK's Financial Conduct Authority to conduct a review of the LIBOR rate-setting process and its use.⁷⁸ In particular, Wheatley was asked to make recommendations on how the benchmark could be reformed and its credibility restored.⁷⁹

In a speech, Wheatley stated, "The system is broken and needs a complete overhaul . . . [i]t has been torn from the very fabric that our financial system was built on."⁸⁰ He emphasized the importance of proper-functioning financial markets that foster the confidence and

75. Pan, *supra* note 62, at 6 ("In the aftermath of any such financial crisis or scandal, regulators face intense pressure to demonstrate they are in control of the financial markets and, therefore rely more on public strategies—strategies that give the regulator greater visibility and command. . . . Eventually, however, resource constraints force regulators to seek more cost effective regulatory strategies, driving them to rely more on private strategies.")

76. *See id.* at 14.

77. *See id.*

78. Wheatley, *supra* note 6, at 3.

79. *Id.*

80. Martin Wheatley, Managing Director, FSA, and CEO Designate, FCA, Speech at Wheatley Review of LIBOR: Pushing the Reset Button on LIBOR (Sept. 28, 2012), available at <http://www.fsa.gov.uk/library/communication/speeches/2012/0928-mw.shtml>.

trust of consumers.⁸¹ Although Wheatley suggested a “complete overhaul,” he stated that “the current system . . . is not beyond repair,” and a complete replacement⁸² of the LIBOR benchmark is not necessary.⁸³ Rather, Wheatley focused on restoring LIBOR to what it was supposed to be—restoring its integrity and ensuring a situation in which individuals act with integrity through the help of both market participants and market regulators.⁸⁴ Wheatley further emphasized that “LIBOR is a creation of the market, invented by the market for the market,” and therefore, “banks and market participants must play their part” in the restoration of the LIBOR benchmark the way that it was initially supposed to be.

Wheatley identified various problems and flaws with the current system.⁸⁵ Wheatley first identified weaknesses in the LIBOR mechanism.⁸⁶ Second, he pointed to limitations in the current governance framework.⁸⁷ Third, he identified a lack of external accountability.⁸⁸ Accordingly, Wheatley’s report sets out a ten-point plan for reforming the framework of LIBOR and restoring its credibility. Specifically, Wheatley’s report focuses on three broad areas: (1) a regulatory structure that would include criminal liability; (2) a transfer of governance from the BBA; and (3) technical changes to LIBOR itself.⁸⁹

In particular, Wheatley’s plan for a new regulatory structure⁹⁰ requires that governmental authorities amend the Financial Services and Markets Act of 2000 (“Act of 2000”) to make submitting and administering LIBOR a regulated activity.⁹¹ In response to Wheatley’s plan, the UK’s Financial Services Act of 2012, which amends the Act of 2000,

81. *Id.*

82. Wheatley, *supra* note 6, at 7 (“A move to replace LIBOR could only be justified by clear evidence that the benchmark is severely damaged, and that a transition to a new, suitable benchmark or benchmarks could be quickly managed to ensure limited disruption to financial markets. . . . [A] transition to a new benchmark or benchmarks would pose an unacceptably high risk of significant instability, and risk large-scale litigation between parties holding contracts that reference LIBOR. Furthermore, through the course of consultation, it has become clear that, despite the loss of credibility that LIBOR suffered recently, there has been no noticeable decline in the use of LIBOR by market participants. Indeed, a clear majority market participants responding to the Review’s consultation argued for the continuation of a form of LIBOR, rather than its wholesale replacement.”).

83. Wheatley, *supra* note 80.

84. *Id.*

85. Wheatley, *supra* note 6, at 82.

86. *See id.*

87. *See id.* at 82–83.

88. *See id.* at 83.

89. Wheatley, *supra* note 6, at 8–9.

90. *Id.* at 12 (“The majority of responses to the discussion paper have been in favour of making both [the administering and submission of LIBOR] regulated activities.”).

91. *Id.* at 11.

provides that the setting of benchmarks is a regulated activity and specifically includes provisions on misleading statements in relation to benchmarks.⁹² This allows the Financial Conduct Authority⁹³ (“FCA”) to regulate, through a set of rules, the submission, calculation, and publication of the LIBOR benchmark. The FCA is responsible for taking actions against and prosecuting any wrongdoing, including supervising submitting banks’ conduct (both identifying and investigating any suspicious submissions), invoking monetary sanctions, and criminally prosecuting for manipulation of LIBOR. Wheatley further suggests that those individuals involved in “controlled functions”⁹⁴ related to the rate submission and administration processes should first be approved by the FCA, thus ensuring that these individuals are fully aware of their responsibilities in regards to LIBOR submissions or administration.⁹⁵ Additionally, Wheatley invites the UK to support the EU in developing a civil market abuse system and accessible and transparent access to benchmarks.⁹⁶ Wheatley acknowledges that this regulatory system would be more costly for firms and would place a higher burden on regulatory authorities; however, he believes that any such burdens are outweighed by the benefits resulting from a more structured regulatory system.

A lack of or weak institutional governance allowed for the creation of an obvious opportunity for manipulation. Therefore, Wheatley suggests that a well-structured regulatory scheme and proper governance and oversight are essential. He suggests that the first step that must be taken is to replace the BBA as administrator of LIBOR and name a new administrator,⁹⁷ which is to be a private organization, rather than a pub-

92. Financial Services Act, 2012, c. 21, §§ 7, 91 (U.K.), available at <http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted>.

93. *Id.* at § 1A(1) (“The body corporate previously known as the Financial Services Authority is renamed as the Financial Conduct Authority.”).

94. Wheatley identifies senior management—the manager responsible for the submission process—or the individual submitters as possible options for the controlled function. Wheatley, *supra* note 6, at 14.

95. *Id.* at 13 (Wheatley suggests that the “approved persons regime” will allow the FSA to ensure that individuals are “fit and proper” to perform the controlled function and ensure that these individuals comply with the regulations put into place, while holding the power to strip the individual from his or her role or impose a public censure or monetary penalty.).

96. *Id.* at 11.

97. On February 26, 2013, the Hogg Tendering Advisory Committee chaired by Baroness Hogg opened the tendering process to recommend the appointment of a new LIBOR administrator. See Hogg Tendering Committee for LIBOR, <https://www.gov.uk/government/policy-advisory-groups/hogg-tendering-committee-for-libor>. Starting on February 1, 2014, the Intercontinental Exchange Benchmark Administration took over as the new administrator of LIBOR, replacing the BBA. See *ICE Benchmark Administration to Become New Administrator of LIBOR on February 1, 2014*, WALL ST. J., Jan. 17, 2014, <http://online.wsj.com/article/PR-CO-20140117-904457.html>.

lic body.⁹⁸ This new private administrator will be tasked with the responsibility of overseeing the compilation and distribution of LIBOR, as well as providing credible internal governance and oversight.⁹⁹ The new administrator will be tasked with setting up various checkpoints in the submission and administration of the LIBOR rate, and most importantly, providing a system that is transparent. Wheatley notes that one of the most important responsibilities of the administrator will be “scrutiny of submissions.”¹⁰⁰ The system put in place to ensure scrutiny should include both pre- and post-publication verification against verifiable statistics, other deposit transactions and financial data.¹⁰¹ The administrator would also be responsible for defining submission guidelines that must be met by panel banks participating in the setting of LIBOR. Furthermore, Wheatley suggests that an independent external oversight committee should make many of the decisions.¹⁰²

Lastly, contributing panel banks’ submissions of interbank borrowing rates should be subject to a tougher system and more controls. Wheatley recommends that more transparency is needed. In particular, actual transactions need to be recorded, firms regularly audited, and transparency provided as to whether the submitted rate is based on an actual transaction.¹⁰³ Wheatley suggests several procedures that should be put in place: (1) publicizing individual bank LIBOR submissions after three months to reduce the incentive to manipulate due to a possible negative stigma; (2) reducing the number of currencies and maturities for which LIBOR is calculated; and (3) ensuring that a large number of panel banks participate in the submittal of rates used in the calculation of LIBOR.¹⁰⁴ Furthermore, Wheatley invites users of LIBOR to consider the appropriateness of LIBOR for their specific contract and to consider

98. Wheatley explains that LIBOR should remain a “market-led benchmark” and therefore remain under the governance of a private administrator:

A private organization is likely to have a greater incentive to ensure that the benchmark is fit for purpose and evolves to meet the changing needs and nature of the market. In contrast, public ownership would; change the relationship between the market that created and developed LIBOR, and the future evolution of the benchmark; reduce the incentive and ability for LIBOR to adapt to the needs of market participants; and potentially affect the choice of benchmarks by these participants.

Wheatley, *supra* note 6, at 22.

99. *Id.* at 8.

100. *Id.* at 24.

101. *Id.*

102. This oversight committee should include market participants that use the benchmark, with all members of the committee having equal standing, and their meeting minutes and details of their membership should be made available to the public. *See id.* at 25.

103. *See id.*

104. *Id.* at 38 (“[O]nly a small group of banks contribute to the benchmark, and there are some notable large banks that do not participate in the LIBOR panels.”).

contingency provisions in the event that a LIBOR rate is unavailable.¹⁰⁵

The British Government has fully accepted Wheatley's recommendations.¹⁰⁶ In particular, the Government has amended the Financial Services Act of 2000 in accordance with Wheatley's recommendations to make LIBOR a regulated activity, to create a new criminal offense for any misrepresentations in connection with the submissions or administration of benchmarks, and to give the FCA to be headed by Wheatley the power to develop rules and codes of conduct to be followed by submitting banks.¹⁰⁷ The British Government has reiterated the importance of a reliable LIBOR benchmark and its view that such manipulations are intolerable and that those involved should be punished.¹⁰⁸ Furthermore, Baroness Hogg led the panel that identified the new administrator to replace the BBA. Moreover, in accordance with Wheatley's report, the British Government stated that banks and market participants' role is essential in the success of the reform proposed by Wheatley and enacted by the British Government.¹⁰⁹

Additionally, the European Commission has conducted an analysis detailing the possible framework for regulation of the production and use of indices serving as benchmarks in financial markets and other contracts.¹¹⁰ "The Commission has already moved to amend the proposals for abuse [r]egulation and the criminal sanctions for market abuse [d]irective to clarify that any manipulation of benchmarks is clearly and unequivocally illegal and can be subject to administrative or criminal sanctions."¹¹¹ However, the European Commission goes a step further in recognizing that "[s]anctioning does not remove the risks of manipulation arising from the inherent conflicts of interest linked to the production and governance of benchmarks" and is "seek[ing] to assess how to improve the production and governance of benchmarks."¹¹²

VI. ANALYSIS OF THE WHEATLEY REPORT

Wheatley reached the following key conclusions that underline his

105. *Id.* at 7.

106. HM Treasury, *Government Accepts Recommendations from the Wheatley Review of LIBOR in Full*, Oct. 17, 2012, http://www.hm-treasury.gov.uk/press_94_12.htm.

107. Financial Services Act, 2012, c. 21 (U.K.), available at <http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted>.

108. HM Treasury, *supra* note 106.

109. *Id.*

110. European Commission, *Consultation Document on the Regulation of Indices* (Sept. 5, 2012), available at http://ec.europa.eu/internal_market/consultations/docs/2012/benchmarks/consultation-document_en.pdf (The report focuses on the improvement of governance structures for benchmarks generally, rather than solely focusing on LIBOR.).

111. *Id.* at 2.

112. *Id.*

recommendations: (1) LIBOR should be reformed rather than replaced; (2) transaction data should be used to support LIBOR submissions; and (3) market participants should continue to play a significant role in the setting and oversight of LIBOR.¹¹³ This section discusses whether the conclusions and changes proposed by Wheatley will prevent the occurrence of future manipulation and misconduct by reporting banks and their submitters and traders. The discussion points out that Wheatley's recommendations are an initial step in the right direction, but they may not be sufficient to effectively restore the benchmark and prevent manipulation in the future.

“For a benchmark to be robust and credible it should be based on actual data collected from diverse sources based on transactions executed in a well-regulated and transparent market, supported by appropriate governance and compliance procedures and monitoring.”¹¹⁴ In particular, a mechanism of procedures and controls that serve to verify the accuracy of underlying transaction data of submitted rates must exist. Additionally, expanding the number of contributing panel banks and market participants actually participating in the setting and governance of LIBOR rates will lead to less opportunity for collusion and manipulation. When a large pool of submitting rates exists even in the case of collusion between few contributing panel banks, the result on the LIBOR rate will not be significant. However, this proposition contains a very important caveat: if, as has occurred in the past, collusion between banks and manipulation of submissions for profit becomes an industry-wide phenomenon, it may spread to all contributing panel banks regardless of the large pool of participating banks. Establishing a perfect system is likely impossible; however, it is the responsibility of authorities and regulators to cabin all opportunities and incentives for manipulation of a once credible benchmark that not only the financial market relies on, but also retail consumers who are unfamiliar with the workings of financial markets, such as homebuyers and students.

A. *Reform vs. Replacing the Benchmark*

Wheatley advocates for a comprehensive reform of LIBOR rather than replacing it. Importantly, Wheatley's report concludes that “[a] move to replace LIBOR could only be justified by clear evidence that the benchmark is severely damaged, and that a transition to a new, suitable benchmark or benchmarks could be quickly managed to ensure lim-

113. Wheatley, *supra* note 6, at 7.

114. Vincent O'Sullivan, *Regulating to Save LIBOR*, HARV. CORP. GOVERNANCE F. at 5 (Oct. 10, 2012), http://blogs.law.harvard.edu/corpgov/files/2012/10/HF_Regulating-to-save-LIBOR_10-October-2012-1.pdf.

ited disruption to financial markets.”¹¹⁵ Despite the decline in LIBOR’s credibility, there has not been a decline in its use.¹¹⁶ Most market participants opine that they are reluctant to experience a transition into a whole new benchmark.¹¹⁷ However, Wheatley provides a slight caveat that his recommendations do not serve as an attempt to “conduct a detailed evaluation of alternatives that might, over time, come to be used by market participants.”¹¹⁸

Despite Wheatley’s reluctance to discuss or consider an alternative to LIBOR as part of his recommendations, he devotes a whole section in his report to the consideration of alternative benchmarks should there be a desire to move away from LIBOR to a new benchmark.¹¹⁹ Specifically, “there are a number of criteria that can be used to determine the suitability of a particular interest rate as a direct alternative to LIBOR.”¹²⁰ The criteria include the following requirements: (1) maturity curves for all given maturities; (2) resilience through times of stress and liquidity; (3) a liquid underlying market; and (4) transparency and historical data.¹²¹ However, many of the currently existing alternative benchmarks, such as overnight index rates, may be susceptible to the same problems experienced by the LIBOR rate.¹²² Additionally, Wheatley identifies weaknesses in the alternative benchmarks, such as lack of maturity curves and liquidity.¹²³

Wheatley’s recommendations focus largely on amending the governing structure of LIBOR, but they do not devote much analysis to amending the components of the calculation of the rate. Although a completely new alternative benchmark may not be a plausible solution at the moment, consideration should be given into a possible combination of already existing rates or a variation in the calculation of panel banks’ submissions. Wheatley fails to consider such alternatives and solely ana-

115. Wheatley, *supra* note 6, at 7.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.* at 46–50.

120. *Id.* at 46.

121. *Id.* at 46–47.

122. *Id.*

123. *Id.* at 47–50 (Wheatley considers the central bank policy rate (not a rate at which actual transactions are undertaken other than with the central bank and is based on a relatively short maturity), overnight index rates and overnight index swaps (by definition do not have a maturity curve and the market has a lack of liquidity), short-term government debt (involves complex analysis between moving maturities), certificates of deposits and commercial paper (suffer similar weakness to those of LIBOR), secured lending rates (do not fully reflect bank credit risk and very sensitive to credit and liquidity risk of underlying collateral), and a synthetic rate (only as strong as the components that it consists of and a risk of including unrelated elements exists), but concludes that no single currently existing rate is likely to be able to serve as a viable replacement of LIBOR.).

lyzes already existing rates without any inquiry into a new benchmark with a low transition risk.

Although Wheatley considers that the LIBOR scandal has not reached such magnitude to warrant replacement, there are others in favor of complete replacement. Gary Gensler, Chairman of the Commodity Futures Trading Commission, has stated that “[LIBOR] remains vulnerable to bank misconduct and should be replaced.”¹²⁴ Additionally, in the initial brink of the LIBOR scandal, many policymakers opined that a new benchmark was necessary in order to restore faith in global financial markets.¹²⁵

Scholars Abrantes-Metz and Evans¹²⁶ have proposed that CLIBOR, “committed” LIBOR, may serve as an alternative to the current LIBOR benchmark.¹²⁷ CLIBOR is premised on three important procedures. First, panel banks involved in the submission of rates for the calculation of LIBOR will be required to commit to conduct actual transactions within a submitted bid or ask-quote range.¹²⁸ Second, a data-clearing house will verify the panel banks’ commitment to transact at the given rates and also compile and report aggregate transaction data that will be made public with a lag on actual identities. Third, a governing body composed of participating banks, users of the benchmark, and other independent parties will serve as the administrator of CLIBOR, as well as be in charge of operating the data-clearing house.

Abrantes-Metz and Evans argue for such a “committed” system because they maintain that a benchmark based solely on actual transactions is insufficient. During times of financial crisis, the number of actual transactions carried out by panel banks may change drastically from one day to the next, market liquidity is likely to be low, and a few large banks entering or leaving the interbank lending market result in a highly volatile benchmark based on actual transactions.¹²⁹ Therefore, they suggest that the best alternative is to use a benchmark that is not based on previous actual transactions, but on an index of quotes pro-

124. *Gensler Calls for Libor Replacement*, WALL ST. J., Sept. 24, 2012, <http://online.wsj.com/article/SB10000872396390444358804578016483824832360.html>.

125. *Saying Goodbye to Libor Won't Be Easy, but It's Necessary*, BLOOMBERG, July 23, 2012, <http://www.bloomberg.com/news/2012-07-23/saying-goodbye-to-libor-won-t-be-easy-but-it-s-necessary.html>.

126. Abrantes-Metz & Evans, *supra* note 27, at 1 (Rosa Abrantes-Metz is an Adjunct Professor at the Stern School of Business, New York University and a Principal of Global Economics Group. David S. Evans is Executive Director of the Jevons Institute for Competition Law and Economics and Visiting Professor at the University College London, Lecturer at the University of Chicago Law School and Chairman of Global Economics Group.).

127. *Id.*

128. *Id.* at 1.

129. *Id.* at 5.

vided by banks that are ready and will borrow or lend at a rate within the bid or ask spread. Panel banks that submit artificially low bid or ask quotes will be locked out of lending or borrowing for that day, unless they pay a penalty.¹³⁰ Abrantes-Metz and Evans do not discount the importance of actual transaction data, as they point out that the bid or ask quotes submitted by panel banks will then in turn be verified and analyzed in accordance with existing actual transactions. However, it is unclear whether a committed LIBOR system would be enough to combat an industry-wide practice of manipulation. For example, if all or many contributing banks collude with one another in the setting of their rates to be submitted for calculation, it would be difficult to single out the banks that are not reporting the manipulated rate. Banks will be incentivized to submit those rates that will be beneficial to their positions, as long as such rates do not exceed or underestimate the rate at which the panel bank is willing to borrow or lend.

In response to Wheatley's concern over a fluid transition from LIBOR to an alternative benchmark without a major disruption in markets, Abrantes-Metz and Evans draw a comparison to the transition to the use of the Euro and state that a transition to CLIBOR can similarly be achieved.¹³¹ Abrantes-Metz and Evans concede that the processes of setting and administering CLIBOR will be more costly than those associated with the current LIBOR benchmark but will effectively restore credibility in the interbank borrowing benchmark and reduce the possibility of future manipulation.¹³² It is also important to note that Wheatley's proposed recommendations of more regulation and a better-equipped and focused administrative body will cost more than the current process of LIBOR setting. A comparison of actual costs has not been made available. Furthermore, there may be concern that panel banks will be hesitant to accept a committed LIBOR rate.¹³³ However, Wheatley similarly notes that contributing banks may be hesitant to participate in the newly proposed process for LIBOR and may need to be compelled by stricter regulations.

Overall, it is questionable whether reform of the current administration of the LIBOR rate, together with the introduction of more sanctions, rather than an introduction of a new interbank lending benchmark, will prove to be sufficient in preventing future manipulation or misrepresentations by contributing banks. The fact that Wheatley concedes that a new benchmark may be needed in the future should be a red flag to

130. *Id.* at 10.

131. *Id.* at 13.

132. *Id.*

133. Rosa M. Abrantes-Metz & David S. Evans, *Will the Wheatley Recommendations Fix LIBOR?*, CPI ANTITRUST CHRON., at 7 (Nov. 2012).

regulators and market participants that a more radical change of LIBOR, such as a new or completely transformed benchmark, is necessary.

B. *Use of Actual Transaction Data*

Wheatley's second major conclusion is the necessity of actual transaction data, which would explicitly and transparently corroborate panel banks' submissions.¹³⁴ This does not entail a change in the definition of LIBOR, but instead calls for the use of other transactions to ensure correct submittal by contributing panel banks, particularly in times of limited activity in the interbank exchange market. It is important to note that Wheatley recommends that the new administrator develop a detailed code of conduct that would set out specific guidelines that all submitting banks must follow.¹³⁵

Until specific guidelines are developed, submitters should look to the submission guidelines proposed in Wheatley's Report.¹³⁶ These guidelines include a hierarchy of specific transactions to be used in determining the LIBOR rate to be submitted by each individual contributing bank, with the greatest emphasis placed on transactions by the contributing bank.¹³⁷ Submissions may be adjusted based on various factors, such as relationship in time between submission and impact of market events, techniques for interpolation and extrapolation from available data, changes in credit standing of market participants and the contributing bank, and non-representative transactions.¹³⁸

Wheatley has concluded that actual information that is capable of scrutiny should be used by banks upon calculating their rate to be submitted for inclusion in the calculation of the actual LIBOR rate.¹³⁹ However, Wheatley recognizes that in certain situations, due to a lack of data, panel banks may either have to take into account third-party transactions or rely on their own expert judgment.¹⁴⁰ This proposition seems counterintuitive because motivation for manipulation of rate submissions arose at a time when liquidity was low and actual transactions

134. Wheatley, *supra* note 6, at 27.

135. *Id.* at 28 (Wheatley proposes the following hierarchy: "(1) contributing banks' transactions in: the unsecured inter-bank deposit market . . . other unsecured deposit market . . . and other relations markets . . . (2) contributing banks' observations of third party transactions in the same markets; (3) quotes by third parties offered to contributing banks in the same markets; and (4) in the absence of transaction data relating to a specific LIBOR benchmark, expert judgment should be used to determine a submission.").

136. *Id.* at 8.

137. *Id.* at 28.

138. *Id.*

139. *Id.*

140. *Id.*

were scarce. Therefore, the requirement that actual data be used will be useful only during regular economic times.

It is during times of financial stress that the LIBOR rate is the most useful. During normal economic times where liquidity is high and risk is normal or low, LIBOR movement is positively correlated with the Treasury Bill rate because banks are able to lend and borrow to and from one another at normal rates, due to a lack of volatility and high risk.¹⁴¹ During a time of financial crisis, interest rates on Treasury bills are likely to decrease. However, in times of financial stress in the markets, where liquidity is low and risk is on the rise, banks in the interbank borrowing market are likely to tighten their criteria for lending and charge a higher rate, leaving LIBOR as the only benchmark representative of the interbank borrowing market. Therefore, the difference between LIBOR and the Treasury Bill rate gets wider as markets' liquidity decreases and risk increases, signifying the emergence of an economic crisis.¹⁴² The importance of an accurate, manipulation-free benchmark increases in times of financial stress or economic crisis.

However, according to Wheatley's suggestions, it is exactly during this time—when actual transactions are not prevalent—that contributing banks will be allowed to base their submissions on a variety of other transactions and factors, again providing an opportunity for manipulation. Upon analyzing the publicized facts of the LIBOR scandal, it is clear that it is during economic downturns that banks and traders are most incentivized to manipulate the LIBOR rate. In particular, it is during economic downturns that bank managers have an incentive to appear as being one of the stronger, more financially stable financial institutions in the market, thus also being incentivized to misrepresent the rate at which they are able to borrow in the interbank market so as not to appear weak or on the brink of destruction.

Additionally, Wheatley suggests that individual contributing bank submissions not be made available to the public for three months.¹⁴³ The reasoning behind this suggestion is that a delay in publication will essentially rid the submitting banks of a motivation to understate their rate resulting from the possible risk that if a bank's submitted rate is higher than others then a stigma that the bank is in trouble will be formed by the public.¹⁴⁴ However, this proposition seems counterintuitive to the proposition that the LIBOR processes are to be more transparent. Fur-

141. Abrantes-Metz & Evans, *supra* note 133, at 3.

142. *Understanding the TED Spread*, ECONOBROWSER, Sept. 28, 2008, http://www.econbrowser.com/archives/2008/09/understanding_t.html ("The LIBOR term spread must therefore be interpreted as some sort of a liquidity or risk premium.")

143. Wheatley, *supra* note 6, at 38.

144. *See id.* at 37–38.

thermore, it will become harder for market participants to evaluate the LIBOR rate's credibility and reliability in real-time markets. This assessment will have to be based on three-month old data, which may not at all be representative of the current market environment. A better solution to such a delay may be that proposed by Abrantes-Metz and Evans: publishing the submitted rates daily, but not including the identity of the bank that has submitted the rate. This may prove to be effective in combating the problem that has resulted from the transparency of daily publication and identification of the contributing banks' submitted rate.

Although the recommendation to base all submissions on actual transactions is a step in the right direction, it is questionable how effective it will be and for how long it will be effective. It is important to note here that this was not simply one bank manipulating rates; in fact, it was an industry-wide practice—it was the norm. Therefore, it is doubtful that placing guidelines and reforming the regulatory structure of the LIBOR processes will rid the processes of all unethical practices and restore the benchmark to its original integrity-based system. Further, it is also questionable whether the LIBOR benchmark was ever rooted in a market based on integrity and fair practices. If not, the problem may be larger than anyone anticipated, and a call for stricter financial regulation or complete reform of all financial markets in the world may be in order. Therefore, for purposes of the immediate future, Wheatley's recommendations may be extended and refined to provide a better system for the management of submission of rates to be used in the calculation of the LIBOR rate.

C. *Market Participants*

Wheatley states that it would be inappropriate for regulatory authorities to take over the whole process of producing a benchmark that is used by and for the benefit of market participants.¹⁴⁵ In particular, it would be unacceptable for authorities to force users of the benchmark to accept or adopt a particular benchmark that will be used by them.¹⁴⁶ Wheatley argues that the role of the authorities is solely to ensure the integrity of the process of setting and administering the benchmark. Here, Wheatley's reasoning mirrors Milton Friedman's free market theory. He proposes that market participants will gravitate towards the most reliable and verifiable benchmark for any given transaction.¹⁴⁷ Market participants' continued support for reform rather than replacement of

145. Wheatley, *supra* note 6, at 7.

146. *Id.*

147. *Id.*

LIBOR evidences their willingness to assume the risk that incentives for manipulation may still exist.

Furthermore, Wheatley states, “[s]ubmitters should use their experience of the inter-bank deposit market and its relationship with other markets to develop their LIBOR submission.”¹⁴⁸ Is this not what submitters did when they decided to manipulate their bank’s submissions for calculation into the LIBOR rate? Leaving submitters with a spectrum of discretion may lead to future manipulation. Allowing the rates to be based on transactions other than the contributing bank’s transactions will allow submitters great leeway into reasoning why they used a specific transaction. Incentives for choosing the data that is most favorable to the particular bank will result in the possibility of collusion. If submissions are based on the contributing bank’s observation of third-party transactions in the market or quotes by third parties offered to the contributing bank, then what is to prevent collusion between panel banks by agreeing to quote lower than actual rates, knowing that these quotes will solely be used for the determination of the LIBOR rate? This gap in reasoning will result in a gap incentivizing strategies for manipulation in practice.

Market participants’ control over LIBOR led to the widespread practice of misrepresentation and manipulation of submissions. As the investigation of the LIBOR scandal deepens, it becomes evident that manipulation of rate submissions was an industry-wide practice by none other than market participants. Thus, market participants should have less discretion in the setting of LIBOR and regulating authorities must have more active involvement in the procedures involved in such setting.

It is important to note, as Wheatley suggests, that there are issues that may be best achieved by agreement between both the administrator and market participants.¹⁴⁹ It is not disputed that market participants should have some discretion and ability to recommend various goals or processes by which the benchmark should be administered; those suggestions should be scrutinized and approved by an active administrator. It is also important that the oversight committee set up by the new administrator consist of a diverse group of individuals, including scholars and users of the actual benchmark, so that the committee will have a range of experience on which to rely. Furthermore, it is important that such committee members are held to a high ethical standard of conduct to avoid any future collusions between persons heavily invested in contracts reliant on the LIBOR benchmark or a different benchmark should a transition be made.

148. *Id.* at 28.

149. *Id.* at 30.

A better alternative to granting market participants discretion may be a requirement that contributing banks commit to actually use the rates they submit for the calculation of the LIBOR rate, as suggested by Abrantes-Metz and Evans.¹⁵⁰ Allowing panel banks and market participants in general to have an active role in the governance of the LIBOR-setting process in combination with requiring contributing banks to commit to transact in accordance with their submitted rates will force all market participants to take on the processes associated with LIBOR in a more serious fashion.

Wheatley suggests that market participants who are currently using the LIBOR benchmark consider and evaluate their use of the LIBOR benchmark and further analyze the contingencies in place, in case the LIBOR rate referenced in their contracts becomes unavailable for a long period of time. Most current contracts contain alternative provisions in the event that LIBOR is unavailable.¹⁵¹ In particular, this process involves acquiring quotes from a set of reference banks that provide deposit rates for the required currency and maturity.¹⁵² Wheatley points out that the current system is flawed in that the magnitude of contracts that rely on the LIBOR benchmark is great, and the banks referenced in contracts usually consist of contributing banks. Therefore, in the event that a LIBOR rate is unavailable, it is quite unlikely that reference banks will be fully prepared and equipped to provide the rates. The variety of contingencies in each contract may lead to a calculation of different interest rates that are to replace the LIBOR benchmark, thus providing users with a spectrum of interest rates in order to replace one. Wheatley suggests that industry specialists that provide standardized legal documents for contracts referencing LIBOR also provide uniform contingencies that may take effect should there be a long-term disruption of LIBOR.

This is significant in that it represents a safety feature in the event that the LIBOR rate is again manipulated, unreliable, or becomes unavailable. It may mean that regulators are seriously considering a possible replacement of the LIBOR benchmark but are yet unaware of how the process would take place. On the other hand, this safety contingency recommendation may simply be representative of a slight fear that manipulation may again arise in the future and users need to be better equipped with a detailed procedure in the event that the LIBOR rate is no longer representative of interbank lending rates.

This question of LIBOR-rate contingencies applicable to existing

150. Abrantes-Metz & Evans, *supra* note 27.

151. Wheatley, *supra* note 6, at 39.

152. *Id.*

contracts leads to other questions: why has the LIBOR rate become a globally used rate? Why is it at the center of such a wide variety of financial contracts? Why is it so widely used in the United States for mortgages, student loans, and derivative contracts? It may be time for a benchmark that will be governed in the United States, based on submissions by panel banks that are active in United States' financial markets, and regulated by United States' officials and regulatory bodies.

VII. CONCLUSION

While Wheatley's recommendations may be a step in the right direction towards a more credible benchmark, there is still plenty of work to be done. Although Wheatley suggests that the LIBOR benchmark is not broken beyond repair, the better alternative to attempting to reform a broken LIBOR benchmark is to revolutionize the benchmark and provide a new one. Financial markets have changed drastically since LIBOR was first introduced in the 1980s. Accordingly, LIBOR should be reformed to account for the emergence of global markets in which greed is a prime motivator.

Providing a better regulatory system will help combat incentives for manipulation, but the question is for how long. Will market participants, traders, and banks alike discover a new way to beat the system and allow greed to take over, and in turn find new ways to manipulate rates to their advantage? Much of what has already begun to occur and is to come in the regulation and oversight of the LIBOR setting processes depends on the selection of an adequate administrator who will develop codes of conduct and an oversight committee that will effectively monitor discrepancies in submissions.

The introduction of monetary sanctions and criminal prosecutions may deter individuals from taking unethical actions on a large scale. However, it is questionable whether this is sufficient to deter an entire industry from acting together and colluding to evade existing regulations. It is evident that stronger and stricter regulations that possess an enforcement mechanism are necessary for the financial market. Although doubtful, if the LIBOR benchmark is to regain its credibility and usefulness, the only answer is a regulatory structure so tight that manipulation cannot take place without being noticed and punished appropriately.

Moreover, requiring banks to base their individual submissions on actual transaction data, which can then be analyzed by auditing and oversight committees, may provide a mechanism that makes it tougher for submitters, traders, and managers to manipulate submissions. However, allowing adjustments to actual transaction data in preparation for

rate submission—without requiring per se any underlying data—may result in a gap in this reform structure, which will allow for manipulation.

Furthermore, it is questionable how much discretion should be left to market participants. It is evident that this is a benchmark that was developed specifically to allow market participants participating in derivative and swap agreements to rely on a uniform benchmark, rather than determining an underlying rate for each individual contract. However, it has been established that those individuals involved in the market are not capable of governing themselves without allowing their dark motivations to take over. Therefore, although market participants should be a part of any committee formed, they should not be left with a large amount of discretion.

It is important to find balance: there may be a point where market participants and contributing panel banks decide that there is too much regulation and participating in the LIBOR market provides too much exposure to risks of sanctioning and possible prosecution if the banks' practices do not strictly comply with the rules and regulations. A system in which the contributing panel banks are held tightly to their submissions and incentivized to borrow and lend at their submitted rates, together with more oversight and a structure for verification of submissions, may prove to be a better system, if not a flawless one.