The Benchmarks Regulation

Introduction

The Regulation on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (Benchmarks Regulation) was published in the Official Journal of the EU on 29 June 2016.

The Regulation builds upon the work of the Organization of International Securities Commissions' (IOSCO) agreed principles on financial benchmarks (2013), so as to ensure a consistent approach to scope and implementation of a system to ensure the accuracy and integrity of benchmarks at EU level.

Scope

Geographical

The text of the Regulation is one with EEA relevance and hence will be applicable to non-EU, EEA countries once incorporated into the EEA Agreement. Whether the Regulation will continue to apply in the UK, if the UK were to invoke Article 50 of the Lisbon Treaty and consequently leave the EU (Brexit), depends upon the future relationship of the UK and the EU. If the UK were to remain a member of the EEA following a Brexit, the Regulation would continue to apply once incorporated into the EEA Agreement; but in other scenarios, the UK would become a third country for the purposes of the Regulation, unless special terms were negotiated between the UK and EU.

Definition of a benchmark

The Regulation defines a benchmark as 'any index by reference to which the amount payable under a financial instrument or financial contract, or the value of a financial instrument, is determined, or an index that is used to measure the performance of an investment fund with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees'.

Financial instrument is defined by reference to the revised Markets in Financial Instruments Directive and associated Regulation (MiFID 2) definition for which a request for admission to trading on a MiFID 2 trading venue has been made or which is traded on a MiFID 2 trading venue or via a systematic internaliser. Financial contract is defined by reference to a credit agreement under the Consumer Credit Directive or the Mortgage Credit Directive.

An index is a figure that is (i) published or made available to the public and (ii) that is regularly determined (a) entirely or partially by the application of a formula or other method of calculation and (b) on the basis of the value of one or more underlying assets or prices, interest rates, other values or surveys (whether actual or estimated).

'made available to the public'

The European Commission is empowered to adopt Delegated Acts under the Regulation 'in order to specify further technical elements of the definitions' and has requested the European Securities and Markets Authority (ESMA) to provide technical advice on how to specify what

constitutes 'making available to the public' for the purposes of the definition of an index. In its request for technical advice the Commission notes that 'making available to the public' is 'a concept stemming from the EU *acquis* on copyright. Although of a different nature and not providing a legal definition of the concept, the discussion in that context may provide useful guidance for the preparation of the technical advice.' ESMA is invited to provide the technical advice taking into account recital 8 of the Regulation and any other existing Union legislation on this matter.

In its discussion paper ESMA noted that recital 8 states that 'The scope of this Regulation should be as broad as necessary to create a preventive regulatory framework' in support of its view that this requirement should be defined in an open manner so as not to restrict the number of benchmarks in scope unduly.

In its consultation paper on draft technical advice under the Regulation (27 May 2016), ESMA examines whether publication to a restricted group of recipients might be considered to be made available to the public. Considering the Directive on Copyright (2001/29/EC) and its interpretation by the European Court of Justice (ECJ), ESMA comes to the view that the publication would have to be (at least potentially) accessible to an indeterminate and wide group of recipients. However, ESMA notes that under EU copyright law, the ECJ gives consideration, given the advent of new technologies, both to initial recipients and those to whom the original communication is re-transmitted. Applying this to financial indices, ESMA's view is that where a supervised entity to which an index is communicated determines the amount payable under a financial instrument by referencing the index (or when it determines the performance of an investment fund through the index) this might be analogous to the onward transmission of a communication to a wider public under EU copyright law. ESMA notes that the transparency regime imposed by the Markets in Financial Instruments Regulation requires disclosure of prices and values for financial instruments which reference an index; similarly the Undertakings for Collective Investment in Transferable Securities Directive and the Alternative Investment Fund Managers Directive require disclosure of net asset values for funds which reference an index. ESMA notes that whilst financial contracts are not subject to transparency obligations, the large majority of outstanding financial contracts are normally referenced to the most widely used indices. Therefore, ESMA considers that the availability of index determinations to a single or small group of supervised entities might imply its availability to an indeterminate number of recipients if the index is used by that entity or entities as a reference as set out above, thus bringing it within scope of the Regulation.

ESMA is not of the view that access to all recipients or users needs to be equal for the index to be made available, since the type of access might depend upon the specific needs of the types of users. Therefore, access might be in a variety of media or modalities, including by open access or subscription and through its use in financial instruments, contracts or investment funds referencing it.

Application of the Regulation

The Regulation applies to the:

Provision of benchmarks: carried out by an administrator who controls the administration of the arrangements for determining a benchmark and the collection, analysis and processing of input data for the process of determining a benchmark either through the application of a formula or other method of calculation (or assessment of the input data);

Contribution of input data to a benchmark: contributors are persons (natural or legal) who provide input data i.e. data not readily available to an administrator (or to another person for the purposes of passing the data to an administrator) that is required in connection with the determination of a benchmark, and which is provided for that purpose. This is a relatively wide definition given that the contributor does not have to provide the data directly to an administrator, but merely has to know what the information will be used for; and

Use of benchmarks in the EU by supervised entities: use is defined as referencing an index or a combination of indices (i) when issuing a financial instrument; (ii) when determining the amount payable under a financial instrument or financial contract; (iii) in a financial contract to which you are a party; (iv) when providing a borrowing rate (expressed as a spread or mark-up over the index or indices) and that is used solely as a reference in a financial contract to which the creditor is a party; or (v) to measure the performance of an investment fund through tracking the return of such an index or indices, of defining the asset allocation of a portfolio or of computing the performance fees.

Categories of benchmarks

The Regulation identifies three types of benchmarks:

Critical benchmarks: the Commission will adopt implementing acts establishing a list of critical benchmarks provided by EU administrators. To be included a benchmark must be used as a reference (directly or indirectly) for financial instruments or financial contracts or for measuring the performance of investment funds, having a total value of at least €500 billion or be recognised as critical in a Member State where the majority of its contributors are located. In addition, where the total value (as set out above) is at least €400 billion, a benchmark might be recognised by competent authorities as critical if it has no, or few, market-led substitutes and its existence and accuracy are relevant for market integrity, financial stability or consumer protection;

Significant benchmarks: benchmarks which are not critical benchmarks but which are used as a reference (directly or indirectly) for financial instruments or financial contracts or for measuring the performance of investment funds, having a total value of at least €50 billion (measured over a period of six months) or that have no, or very few, appropriate market-led substitutes and, in the event that the benchmark ceases to be provided (or is provided on the basis of non-fully representative input data), there would be a significant and adverse impact on market integrity, financial stability or consumers, the real economy or the financing of households or businesses within any EU Member State; and

Non-significant benchmarks: all other benchmarks.

The Regulation applies a proportionate approach.

Stricter rules govern more critical benchmarks than the other benchmarks including (i) rules application to an administrator that wishes to stop providing a critical benchmark including compelling the administrator to continue to provide the benchmark until it can cease to be provided or transferred to another administrator in an orderly fashion; (ii) administrators must take adequate steps to ensure that licences of, and information relating to, critical benchmarks are provided to all users on a fair, reasonable, transparent and non-discriminatory basis (FRAND); and (iii) rules permitting competent authorities to require contributors to continue to submit input data for up to four weeks and to require other supervised entities to contribute input data for up to 12 months, if there is a risk that the critical benchmark will stop being representative.

Administrators of significant benchmarks may choose whether to apply certain provisions of the Regulation in relation to managing conflicts, ensuring contributors have adequate oversight and verification procedures and implementing a code of conduct, where these are considered disproportionate taking into account the nature or impact of the benchmark or the size of the administrator. This decision is subject to scrutiny by the relevant competent authority.

Administrators of non-significant benchmarks may take such a proportionate approach to a greater number of provisions of the Regulation with respect to such benchmarks and must notify the relevant competent authority of this decision.

Administrators

The Regulation requires administrators to have (i) governance arrangements and control over the benchmark provision process and (ii) requirements in respect of input data, methodology and the reporting of infringements.

Administrators of critical and significant benchmarks are required to be authorised or, if already a supervised entity (being a credit institution, investment firm, insurance or reinsurance undertaking all as defined in the appropriate EU legislation), registered to act as an administrator by the competent authority of the Member State in which they are located. Administrators of non-significant benchmarks are required to be registered with the competent authority of the relevant Member State.

Governance arrangements

The arrangements must include a clear organisational structure with clear, well-defined roles and responsibilities for all those involved in the provision of a benchmark. The administrator

must identify and prevent or manage conflicts of interest arising and ensure that all judgements or discretions exercised are done independently and honestly.

An administrator is required to establish a permanent and effective oversight function (either a separate committee or other appropriate governance structure) over all aspects of the benchmark provision process. ESMA is tasked with developing draft regulatory technical standards (RTS) to specify the procedures regarding the oversight function, including a non-exhaustive list of appropriate governance arrangements. These RTS will not apply to non-significant benchmarks, although ESMA may produce guidelines for such benchmarks.

Further the administrator must provide:

- an appropriate and proportionate 'control framework' including the management of operational risk, adequate and effective business continuity and disaster recovery plans and the putting in place of contingency procedures in the event of a disruption to the process; and
- an 'accountability framework' covering record-keeping, audit and review and a complaints process.

For critical benchmarks, the administrator is required to appoint an independent external auditor to review and report annually on the administrator's compliance with the benchmark methodology and the Regulation.

Outsourcing is permitted only where there is no material impairment of the administrator's control over the provision of the benchmark or the ability of the relevant competent authority to supervise the benchmark.

Input data, methodology and reporting of infringements

Input data must be 'sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure' and either based upon transaction data, or if this is not available, upon estimates of prices, quotes and committed quotes or other values.

The input data must be appropriate and verifiable. Where input data is from contributors, a reliable and representative panel of contributors who are required to adhere to a code of conduct shall be used. Where input data is used from within an organisation, the administrator is required to obtain data from other sources to corroborate that data.

ESMA is tasked with developing RTS to assist in ensuring input data is reliable and verifiable as well as the internal oversight and verification procedures that an administrator must have in place in respect of contributors to ensure the integrity and accuracy of the data input.

Methodologies used must be robust, reliable, traceable, verifiable, resilient and rigorous. The methodology must have clear rules identifying how and when discretion may be exercised and must be capable of validation, including by back-testing against available transaction data, if appropriate. The administrator must publish key elements of the methodology for each benchmark, details of the internal review and the approval of a given methodology (including the frequency of review and the procedures for consulting any proposed material change to the methodology and rationale for any such change).

Administrators are required to have systems and controls in place to be able to notify the competent authority of any conduct that may involve manipulation or attempted manipulation of a benchmark in contravention of the Market Abuse Regulation (when the Benchmarks Regulation becomes applicable).

Contributors

Where contributors provide input data, the administrator is required to develop a code of conduct for each benchmark including at least a clear description of the input data to be provided and how such data is to be provided to ensure compliance with the Regulation; identification of the persons that may contribute input data and procedures to verify the identity of a contributor and any submitters (including procedures to verify authorisation as a submitter); policies to ensure that a contributor provides all the relevant input data; and the systems and controls that a contributor is required to establish.

ESMA will develop draft RTS to specify further elements of the code of conduct.

Where a contributor is a supervised entity, further governance and control requirements apply. The supervised contributor is required to have in place a control framework that ensures the integrity, accuracy and reliability of the input data and the contributor must ensure that provision of input data is not affected by any conflict of interest, actual or potential. Systems and controls are required in respect of who may submit data, training for submitters, measures to manage conflicts of interest and record-keeping. ESMA will develop RTS specifying further requirements in this area.

Third country benchmarks

Supervised entities may only use a benchmark if (i) the administrator of the benchmark is located in the EEA and included in the register or (ii) the benchmark is included in the register.

Generally to be included in the register, non-EEA administrators and benchmarks will be required to be from a third country subject to an equivalence decision and administrators must be authorised or supervised in that third country. However, given the time periods experienced under other EU legislation for equivalence decisions to be made in respect of third countries, there is a welcome provision permitting the Commission to adopt implementing decisions in respect to specific administrators or specific benchmarks which are compliant with the IOSCO principles for financial benchmarks and which are subject to effective supervision and enforcement in their home jurisdiction. This system is likely to be used for major indices that are used widely in the financial markets.

In addition, an EEA administrator or any other supervised entity, with a clear and well-defined role within the control or accountability framework of a third country administrator, which is able to monitor the provision of a benchmark effectively, may apply to its competent authority to endorse a benchmark provided in a third country for their use in the EEA provided certain conditions are met. These conditions include that the firm endorsing the benchmark can verify and demonstrate to its competent authority that the provision of the benchmark fulfils requirements (either on a mandatory or on a voluntary basis) as stringent as those applicable under this Regulation. For the purposes of this assessment, the competent authority may take into account whether the provision of the benchmark is made in compliance with the IOSCO principles for financial benchmarks and whether this provides equivalent compliance with the requirements of the Regulation. In practice this is likely to be the most frequently used method used for the use of non-EEA benchmarks within the EU.

Whether the UK will be a third country regime following a Brexit remains to be decided depending upon the future relationship of the UK and the EU. However, in the event of the UK being a third country, it is highly likely to be deemed equivalent since the Benchmarks Regulation will have been directly applicable in the UK as an EU Member State at the date of application (1 January 2018 at the latest). The timing of when such an equivalence decision might be made is, however, uncertain and might form part of exit negotiations.

Specialist regimes

The Regulation contains three specialist regimes for regulated-data, interest rate and commodity benchmarks based on the IOSCO principles. For regulated-data benchmarks, only certain of the requirements apply. For interest rate benchmarks, Annex I of the Regulation contains further requirements that apply in addition, or as a substitute to, the Regulation. Whilst for commodity benchmarks which are in scope, a separate regime is set out in Annex II (based largely on the IOSCO principles for oil price reporting agencies) with only the rules on outsourcing for administrators being applicable in addition to this regime.

Transitional provisions

The Regulation contains a transitional provision which permits national competent authorities (NCAs) to permit the continued use of a benchmark which does not meet the requirements of the Regulation where financial instruments or financial contracts are in place that reference that benchmark on the date of application of the Regulation. NCAs must ensure that ceasing or changing the benchmark to conform with the Regulation would constitute a force majeure event, frustrate or otherwise breach the terms of the referencing contract. ESMA is consulting on draft technical advice on how to assess when these conditions arise. The assessment is proposed to be made on a case-by-case basis, defined by duration and published on the appropriate NCA website.

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