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STRATEGY GROUP

IRSG briefing paper on EU Benchmarks Regulation

The International Regulatory Strategy Group (IRSG)[1] broadly welcomes the aim of the European Commission to ensure benchmarks are robust and reliable in order to restore confidence in benchmarks and ensuring a level playing field for all market participants and end-users. A number of recent events have highlighted the shortcomings in the benchmark process, in particular the potential for conflicts of interests to arise, and we support moves to address these weaknesses in the system. We agree that index providers should uphold standards of effective governance, clear methodology and transparency.

However, the role of benchmarks in helping to enable investment and growth should be recognised. Restoring market confidence is not an end in itself but a means to help investors make informed and transparent choices leading to more efficient capital allocation. That means supporting a competitive and innovative benchmark sector. Regulation should enable innovation in benchmark design to increase choice and meet evolving user demands (for example environmental, social or SME investment).

The regulation must also recognise that benchmarks are global and therefore the Regulation must be fully compliant with IOSCO principles to ensure a level playing field globally.

In this regard, we do have some specific concerns regarding the scope of the proposals, the use of proportionality and the treatment of third countries.

Scope

The proposed scope of the regulation is very broad and would encompass thousands (if not millions) of benchmarks and indices. However, there is no evidence of widespread manipulation across the diverse range of indices. The inclusion of such diverse types of benchmarks and indices regardless of the risk they carry for manipulation or their susceptibility to conflict of interest, i.e. a one-size-fits-all approach, will not enhance market efficiency or enhance consumer protection.

We, therefore, believe that the regulation should focus on where there is evident risk of manipulation and conflict of interest.

For example, end-users of benchmarks, such as asset managers, should not be subject to the onerous requirements in the regulation as they do not input into and are in no position to influence the benchmark setting process; but rather asset managers use benchmarks to measure the performance of funds, track the development of benchmarks, or create internal, bespoke performance measuring tools using one or more benchmarks. Furthermore, the use of indices as reference points is already regulated in the UCITS rules and guidelines from ESMA.[2]

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[1] The International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based representatives from the financial and professional services industry. It is an advisory body both to the City of London Corporation and to TheCityUK.

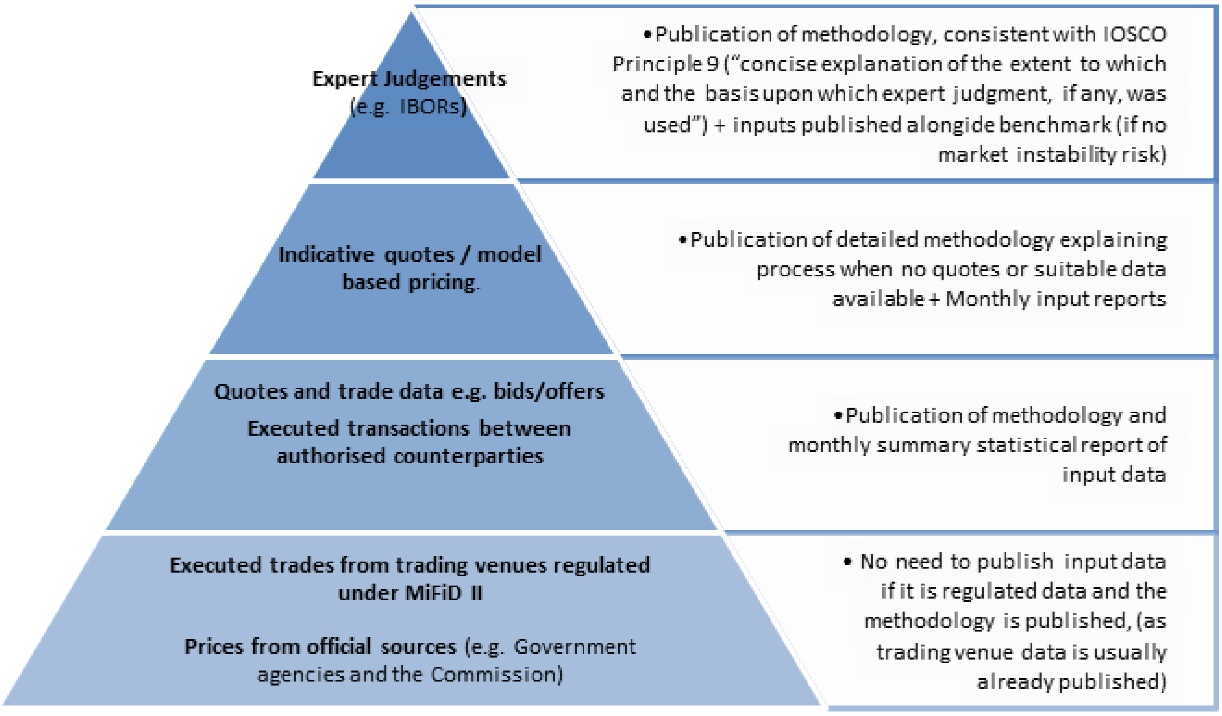
[2] If entities are authorised under MiFID II/MiFIR, AIFMD or UCITS, relevant conduct of business and other rules will apply. Benchmarks that are used as performance evaluation tools must be disclosed in advance in the UCITS KIID. ESMA has also issues guidelines relating to benchmarks, UCITS and ETFs, please see:

Proportionality

We believe that the regulation should be applied in a proportionate way, taking into account the risks posed by a benchmark to the financial system and the importance of a benchmark to market participants, investors, and consumers. This will ensure that we avoid investors facing additional costs, higher barriers to entry for newcomers or reduced competition.

The IOSCO principles include proportionality. IOSCO Principle 8 on the "hierarchy of data inputs" should be the key guide for ESMA and the European Commission to calibrate the application of the regulation for each type of benchmark (i.e. in relation to the level of transparency of data and methodology), alongside other factors such as the potential risks to market integrity. This approach would also take account of the source, risks and the type of data used in the determination of the benchmark, so that benchmarks based on submissions would have the strongest regulation, as this is where there is evidence of failure.

The diagram below illustrates how the principles underlying the hierarchy of data inputs could be used to determine proportionate transparency requirements.



In particular, the regulation should focus on benchmarks that are critical to market participants, investors and consumers and that are at most risk of manipulation and conflict of interest (i.e. those based on survey submissions as opposed to those based on traded prices).

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www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues

In determining what should be considered a critical benchmark, we believe that a purely quantitative approach could be misleading and unhelpful. Therefore, we would like to see powers given to regulators to calibrate what should be deemed critical using a mix of both qualitative and quantitative measures to determine the level of risk. We believe that key factors for consideration should include:

- Substitutability and competition in the market;
- Interconnectedness, including potential for conflict of interest and the size of the pool of submitters; and
- Complexity, in particular with regards to the methodology and input data.

Secondary factors could also include:
- Size
- Global reach (although this is rarely relevant)

Further details on our proposed matrix for determining critical benchmarks can be found in Annex 1.

Third country provisions

We are concerned that the inclusion of a strict equivalence regime will lead to European market participants and investors being denied access to benchmarks administered in third countries. While many jurisdictions have reformed regulation of critical benchmarks, we are not aware of any jurisdiction having proposed regulation with the same breadth of scope at the proposed EU regulation (see Annex 2). This, therefore, makes it unlikely that other jurisdictions will be found equivalent to EU legislation, potentially depriving EU market participants and investors access to products referencing non-EU benchmarks.

The consequences of this are that:

- Market participants and investors could be forced to sell off assets referencing these benchmarks or modify contracts, which would not only have cost implications for EU entities but would also prevent market participants and investors from effectively managing and diversifying their risks globally, making them less competitive vis-à-vis third country competitors.
- A number of products referring these benchmarks would have to be withdrawn, with potential impact on financial stability and market integrity.

We would, therefore, like to see an appropriately calibrated transition period to prevent market distortions, allowing EU entities to continue to use third country benchmarks until such time as the European Commission is able to make a positive equivalence decision (as we saw in MiFID2/MiFIR). We also believe that any equivalence test should be outcomes-based and based on compliance with the IOSCO Principles for Financial Benchmarks.

Annex 1- Achieving Meaningful Proportionality in EU Benchmarks Regulation

On 30 October 2013 IOSCO stated that: "[it] does not expect a one-size-fits-all method of implementation to achieve the objectives of the Principles [for Financial Benchmarks]. Given the large universe of Benchmarks in scope of the report, IOSCO believes the implementation of the Principles will not be identical for each Benchmark. Rather, the Principles provide a framework of standards, which might be met in different ways depending on the specificities of each Benchmark. In particular, the application and implementation of the Principles should be proportional to the size and risks posed by each Benchmark and/or Administrator and the Benchmark-setting process."

In that spirit, and to enshrine meaningful proportionality within the Regulation, it is possible to analyse each category of financial benchmark against the five high level criteria the Financial Stability Board (FSB) used to identify risk in banking and non-banking institutions – size, interconnectedness, substitutability, complexity and global reach.

Since the FSB criteria used to designate globally systemically important financial institutions (G-SIFIs) do not map neatly to non-banks or benchmarks, a degree of tailoring and adaptation is necessary. One possible proposal is set out below.

Primary considerations

Substitutability: Credible and competitive substitutes for a given index are important systemic and market risk mitigants.

Interconnectedness: Interconnectedness could be defined in two ways a) the link between the submitter and administrator, which creates different levels of conflict of interests / incentives to manipulate the benchmark and, b) the size of the pool of submitters.

Complexity: Benchmarks relying on submissions made by estimate and survey are relatively more complex, and arguably more susceptible to manipulation, than those that use observable price and transaction data. Furthermore, specific consideration should be given to the underlying nature of some sectors, such as fixed income or commodities, where submissions are done on a purely voluntary basis. In the case of commodities the submitters are not supervised entities hence mandatory submission cannot be imposed.

Secondary considerations

Size: Although size should not be an initial screen to determine systemic risk arising from failures in the benchmark setting process, the number of instruments referencing the benchmark could, in theory, be measured.

Global reach: The least relevant metric. We don't believe that analysing the location of the sovereigns or companies which benefit from funding through index investing, or where those entities that reference a particular benchmark are located, adds value to this exercise.

Annex 2- Implementation of IOSCO Principles in Key Jurisdictions

Criteria/ Jurisdiction	EU	US	Japan	Singapore	Hong-Kong	Australia	India
Legally binding	Yes	No	Yes	No[20]	Yes	No	No[21]
Scope	Wide	No	Narrow	Narrow	Narrow	No	Narrow
Administrator obligations	Yes	No	Yes	Yes	No	No	Yes
Contributor obligations	Yes	No	Yes	Yes	Yes	No	Yes
Required contribution	Yes	No	No	Yes[22]	No	No	Yes
Third-country regime	Yes	No	Yes	No	No	No	No
Transitional framework	Yes	No	No	No	No	No	Yes

Source: ISDA

Note: correct as at November 2014.