

European Union Proposal for Regulation of Benchmarks

GFMA Comments on proposed EU benchmark Regulation

November 2013

The Global Financial Markets Association (“GFMA”)¹ is pleased to provide comment on the European Union’s legislative proposal for the regulation of Benchmarks (the “Regulation”)².

GFMA supports the work of the European authorities, including the European Parliament, the European Commission, the European Securities and Markets Authority, and the European Banking Authority, in developing frameworks of principles and regulation for benchmarks used extensively in financial markets. GFMA has also endorsed the international Principles for Financial Benchmarks³ published by the International Organization of Securities Commissions (“IOSCO”) in July 2013 and was encouraged by the alignment of the IOSCO Principles with GFMA’s own earlier published Best Practices Standards⁴. We note that the Regulation is intended to reflect closely the IOSCO Principles.

While GFMA considers that benchmark innovation, production and distribution should remain industry-driven activities, we believe that internationally-agreed best practice standards, supported by appropriate regional or local regulation, are critical to promoting both investor confidence and the integrity of global financial markets.

GFMA wishes initially to offer two general observations, which underpin our more detailed comments below. Firstly, we are concerned that the proposed Regulation could better embody the concept of proportionality imbedded in the IOSCO Principles. We believe that the provisions of the Regulation should apply commensurately with the risks posed by a benchmark to the financial system and with the importance of a benchmark to market participants, investors and consumers.

¹ The Global Financial Markets Association (GFMA) brings together three of the world’s leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit <http://www.gfma.org>.

² Commission proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts – 18.09.2013; Benchmarks - European Commission

³ IOSCO’s Principles for Financial Benchmarks July 2013;
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf>

⁴ GFMA’s Principles for Financial Benchmarks, November 2012; <http://www.gfma.org/Initiatives/Market-Practices/GFMA-Provides-its-Updated-Principles-for-Financial-Benchmarks-to-the-Global-Regulatory-Community>

Benchmarks vary widely, and the specific emphasis of the regulation should be tailored to the characteristics of the benchmark, the administrator, and the benchmark process, along dimensions such as the significance of a benchmark for the market it represents, the extent of the benchmark's use in investor or retail contracts, and the susceptibility of the benchmark to manipulation. Secondly, we are concerned that the equivalence regime approach for non-EU benchmarks, limited proposed exemptions, and demanding timelines, may need to be modified to reflect market practicalities and risks. A pragmatic approach to implementation is necessary in order to avoid confusion, uncertainty and volatility in markets, which would adversely impact EU institutions and consumers.

Accordingly, we offer our comments below with the intent to ensure that the Regulation achieves its goals of underpinning the integrity of benchmarks used in the EU financial markets for the benefit of investors and consumers, while avoiding adverse economic consequences and unwelcome market disruptions.

1. Proportionality in Regulatory Approach

The Regulation specifies that all published benchmarks used in the EU would be subject to a significant degree of regulation, either by a national competent authority or a college of supervisors, with only a very limited set of exemptions.

GFMA considers that this approach is overly broad and does not reflect an appropriate application of the principle of proportionality to which both the Regulation and the IOSCO Principles refer. Under this principle, the intensity of regulation should be calibrated by factors including the systemic nature and economic importance of a benchmark. The Regulation identifies certain categories of benchmark for specific and more intense regulatory treatment – “Critical” benchmarks that have a systemic importance and benchmarks in Interest Rate and Commodity asset classes. Conversely, benchmarks based on data from regulated venues are exempt from certain provisions. However, all benchmarks within scope are subject to a significant threshold level of regulation, with prescriptive approaches to governance, oversight, methodology and controls. GFMA believes that this approach does not reflect an adequate weighing of the cost of compliance in relation to the significance of a benchmark in the marketplace or to the risks that a benchmark may pose.

GFMA suggests the Regulation be revised to reflect greater tiering in the intensity of regulation, with a calibration of regulation to the materiality of risk posed by a benchmark. Under such an approach, the most extensive regulatory provisions would apply only to the systemically significant

benchmarks. Benchmarks where the administrator is already a regulated entity would receive exemptions from provisions of the Regulation which are largely reflected in existing regulation of these entities. Finally, a minimum risk-based threshold would be established, below which a benchmark may only be subject to a registration requirement.

In establishing such tiering, clear and transparent criteria should be specified to allow benchmark administrators to determine to which regulatory provisions they are subject.

2. Proportionality in Application

The IOSCO Principles allow for flexibility in governance and control frameworks, commensurate with the scale of use and risks specific to a given benchmark.

While the Regulation envisages certain broad categories of control regimes, based on distinctions, for example, between Critical and other benchmarks, nonetheless GFMA believes that the main provisions reflect a prescriptive, “one size fits all” approach. This is a character that the IOSCO Principles specifically seek to avoid. Such a prescriptive approach may impose a compliance cost burden on benchmark stakeholders out of proportion to the risks posed by a benchmark. It may also reduce innovation in the benchmark field that would be of benefit to investors and consumers. Finally, it may place EU-based financial institutions and benchmark administrators at a disadvantage relative to counterparts in other jurisdictions where a more proportionate approach to implementation of regulation, still reflecting the IOSCO Principles, is adopted.

GFMA therefore believes that consideration should be given to reviewing provisions of the Regulation relating to benchmark governance and controls, with a view to tempering requirements in line with the risks posed by a benchmark. Particular attention should be paid in this regard to regulated, but non-Critical, benchmarks. Secondly, greater discretion should be given to competent authorities in evaluating the compliance of benchmark control frameworks with the principles embodied in the Regulation, with due allowance being made for both alternative but equivalent controls, and the risks posed by a particular benchmark. The standards under which sanctions are evaluated should also be clarified, specifically to ensure that potential penalties are commensurate with the significance and risks of a benchmark and the severity of the breach.

Finally, while GFMA supports the IOSCO principles on transparency, a proportionate approach should be taken in considering disclosure requirements for benchmark methodologies and data inputs. Competent authorities should have discretion to balance the extent of disclosure required

against both the associated costs, and the need to offer protections to benchmark administrators and data contributors for intellectual property rights and commercially sensitive information.

3. Clarity in Scope and Explicit Exemptions

The definition of index in the Regulation contains certain undefined terms such as “published” and “made available to the public”. This could lead to confusion as to whether, for example, proprietary benchmarks and customized indexes used by a limited number of professional counterparties are covered by the Regulation. The Regulation would benefit by more explicit definition of the terms used. Moreover, non-financial indices produced by public agencies, other than central banks, appear to be within the scope of the Regulation.

GFMA suggests that the Regulation be amended to provide greater clarity on the scope of coverage. GFMA also recommends that the scope definitions and exemptions be consistent with those used in the IOSCO Principles. Non-alignment on definitions creates additional complexity for implementation as well as challenges in harmonizing approaches with non-EU jurisdictions.

Finally, GFMA suggests that immediate exemptions be granted for major benchmarks produced by non-EU central banks and public sector agencies. Any lack of clarity on the status of such benchmarks under the Regulation has the potential to lead to significant market volatility, and may disadvantage EU-based users of such benchmarks.

4. Criteria for Designation of Critical Benchmarks

In designating a benchmark to be a “Critical Benchmark”, the Regulation specifies as a main criterion that it reference financial instruments of notional value of at least Euro 500 billion. Benchmarks so designated are subject to additional governance and control provisions.

GFMA strongly supports the principle of proportionality and so recognizes that criteria need to be set to identify benchmarks that are systemically significant. GFMA also recognizes the scale of use of a benchmark should be considered in making such a designation. However, GFMA believes that reliance on a numerical threshold poses risks arising from the practical uncertainty of calculating the scale of use of a benchmark across many markets and instrument types and from market disruption effects should a benchmark transition from or to the systemic designation. Accordingly, GFMA asks that consideration be given to using risk-based criteria, which may include consideration of both qualitative and quantitative factors, in the designation of Critical

Benchmarks. Such designation should made initially by regulators with the opportunity for consultation with and response from the relevant administrator. The criteria and the rationale for any critical designation should be clearly articulated and transparent, with adequate notice periods established for any designation or subsequent removal of such designation. GFMA believes regulations should require that both the criteria and the designation of particular benchmarks as Critical Benchmarks be reviewed periodically by the European Commission.

5. Equivalence Regime for non-EU Benchmarks

For benchmarks produced in non-EU jurisdictions, the Regulation envisages the establishment of an equivalent regime designation, whereby such benchmarks would be authorized for use in the EU. Equivalency status may be granted by the European Commission if administrators in the third country are subject to binding requirements equivalent to those arising from the Regulation, including reflection of the IOSCO Principles, and if effective supervision and enforcement mechanisms are in place.

GFMA notes the adoption of an equivalent-regime approach to allow the use of benchmarks produced outside the EU, and supports the basing of such an approach on conformity with the IOSCO Principles. However, GFMA believes that the proposed equivalence criteria place too heavy an emphasis on third country regimes conforming with the provisions of the Regulation itself, rather than the broader requirements of the IOSCO Principles. We recommend that the criteria be re-specified to make adherence to the IOSCO Principles the main determinant of equivalency.

Additionally, GFMA believes that the Regulation should give greater consideration to the practical aspects of implementing the equivalence regime. Many non-EU jurisdictions, while striving to comply with IOSCO Principles, may yet lack the primary legislative and regulatory mechanisms to achieve full compliance in the timescales envisaged in the Regulation, or may opt to implement alternative standards that would require detailed evaluation to determine general conformity to the IOSCO Principles. Delays in designation may disadvantage EU financial institutions that seek to use otherwise robust benchmarks produced in third countries. This may lead to unwelcome market volatility and disruption, impacting EU investors and consumers. The choice of investments open to EU investors might be limited and the ability to manage business risk exposures constrained, with significant adverse real economy consequences.

GFMA recommends that the Regulation permit a more flexible designation process, including the alignment of designation timescales with those envisaged by IOSCO, as well as conditional designation or grandfathering arrangements.

6. Mandatory Contribution of Data for Critical Benchmarks

The Regulation provides for mandatory contribution to Critical Benchmarks in the event of a significant reduction in the number of voluntary contributors. Institutions subject to mandatory contributions may or may not have been voluntary contributors. Mandatory contribution requirements would be re-evaluated one year after they are imposed.

GFMA recognizes that continuity of systemic benchmarks is critical to financial stability and, consequently, that it may be necessary for regulators to have powers to compel data contributions to a systemically important benchmark, in order to prevent market disruption. GFMA notes as important the provision in the Regulation that the use of mandatory compulsion powers would be reviewed after a defined period. GFMA believes that mandatory compulsion powers should only be exercised on a temporary basis until market order is restored or alternative benchmark arrangements are put in place. Moreover, GFMA asks that legal or regulatory protections be offered to institutions when they are subject to mandatory contribution in order to safeguard against third party suits while the institutions are attempting to assist regulators in maintaining market stability. Such protections could be offered provided that the institutions adhere to basic standards of professional diligence and control during the mandatory contribution period.

7. Timeframes for Transition Measures

The Regulation specifies a number of timeframes for such processes as registration, equivalency designations and transitional arrangements.

GFMA believes that, in order to prevent market disruptions, consideration should be given, firstly, to better alignment of the timescales for the various processes, and secondly to ensuring that the individual timescales are adequate in view of the multiple stakeholders and jurisdictions concerned. In particular, the Regulation should provide for appropriate notice periods for those institutions that may not be in full compliance, as well as reasonable periods for remediation and reassessment. Timescales should also be aligned to the level of regulatory resources dedicated for undertaking the review and authorization processes. Finally, the Regulation should provide explicit timescales for the authorization processes in respect of non-EU benchmarks, including grandfathering provisions for existing benchmarks. The provisions in the Regulation to allow continued production of a benchmark while awaiting authorization should be explicitly extended to cover non-EU benchmarks also.

8. Limiting Adverse Impact on End-User Investors and Consumers

The Regulation contains a number of provisions prohibiting the use of existing benchmarks under certain circumstances, including failure to adhere to operating standards or when referencing contracts falling below a threshold level. End-users of a benchmark – investors or consumers – may have no ability to influence the factors leading to the prohibition of use and may be constrained in their on-going ability to manage exposures referencing the benchmark.

GFMA believes that clear protocols for making such determinations, including adequate notice periods, should be established to protect end-users from potential economic harm arising from the de-authorization of a benchmark. Competent authorities should be granted adequate powers of discretion to protect end-users in these circumstances. The Regulation should also make provision for the establishment of an adequate timeframe and continuity arrangements during transition away from a benchmark that is planned for termination, to ensure that contracts referencing the benchmark can be adjusted or settled in an orderly manner. Such transition may necessitate the parallel existence of the old and new benchmark for a sufficient period of time.

Conclusion

GFMA welcomes this opportunity to share our perspectives on the proposed Regulation. We encourage public officials and all market participants to minimize departure from the internationally agreed IOSCO framework. Adhering to this framework will ensure that uniform standards are observed, while streamlining compliance costs for the industry.

GFMA looks forward to continuing to work with the EU public authorities to strengthen benchmarking practices and to improve investor and consumer confidence in markets.