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EU benchmark regulation

What you need to know

Contents

EU Benchmark Regulation

What you need to know

The pricing of many financial instruments and financial contracts depends on the accuracy and integrity of benchmarks. Serious cases of manipulation of interest rate benchmarks such as the LIBOR and EURIBOR market-rigging scandals, as well as allegations that energy, oil and foreign exchange benchmarks have been manipulated, demonstrate that benchmarks can be subject to conflicts of interest.

The 10 largest fines levied by FCA against firms are all over £100 million, demonstrating the seriousness with which FCA places on this area. Benchmarks are often used as a reference price for other financial instruments and contracts such as mortgages, and so any manipulation of benchmarks has the potential to negatively impact upon a broad range of investors and consumers, across both institutional wholesale to retail. Failures in, or doubts about, the accuracy and integrity of indices used as benchmarks can undermine market confidence, cause losses to consumers and investors and distort the real economy.

The use of discretion, and weak governance controls, increase the vulnerability of benchmarks to manipulation. As a result, there has been an increase in the amount of pressure on the EU to restore confidence in the integrity and accuracy of benchmarks following these scandals. Multi-million pound fines have already been levied against several European banks and further investigations into manipulations of interest rate, energy and FX benchmarks are still on going.

FCA powers also include the ability to bring criminal prosecutions for certain types of misconduct in relation to regulated benchmarks, (per S91 Financial Services Act 2012), and includes two offences:

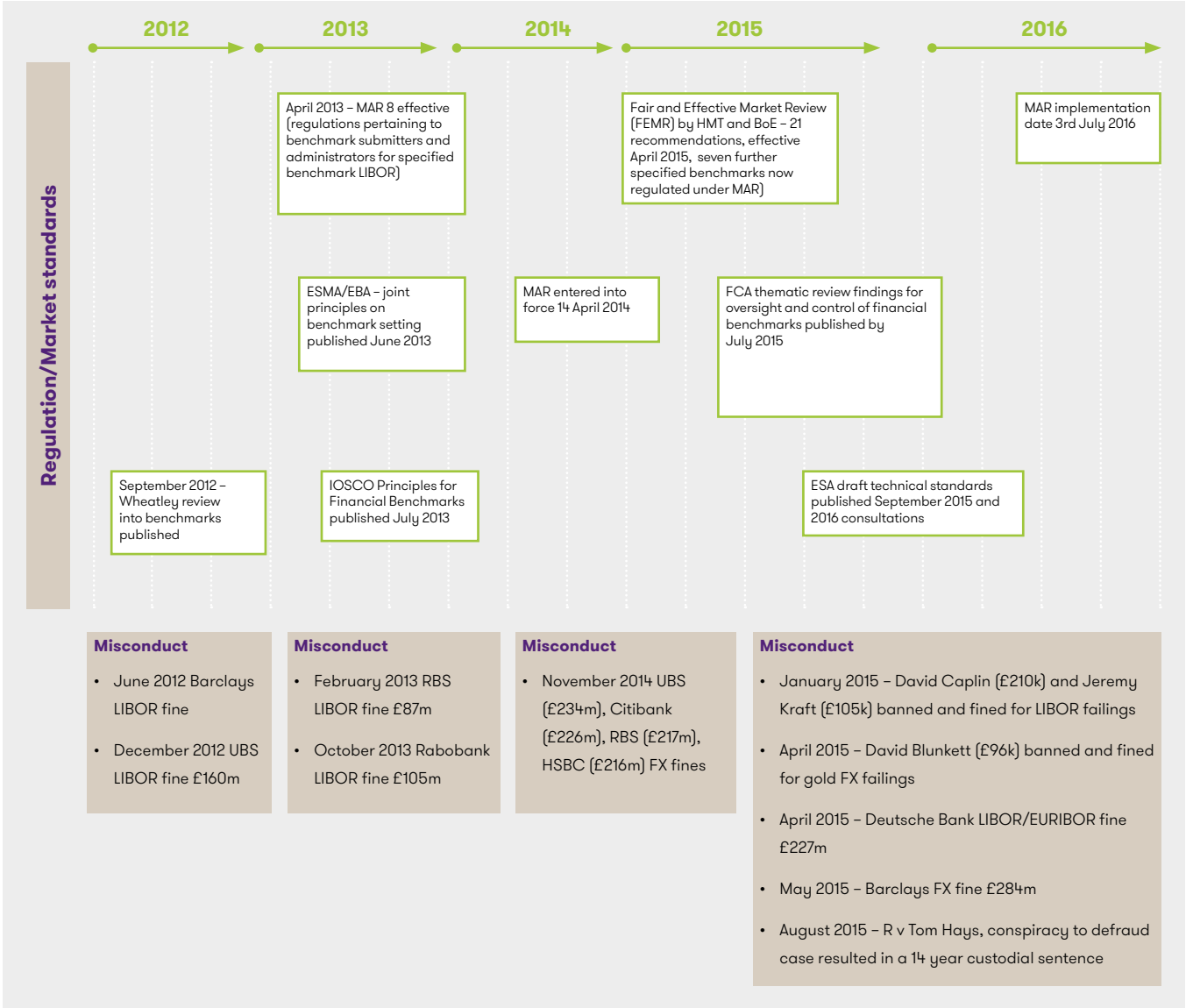
- Making false or misleading statements in the course of arrangements for setting a relevant benchmark, intending that the statement(s) will be used for the purpose of setting the benchmark.
- Creating a false or misleading impression as to the price or value of an investment (or as to the appropriate interest rate for a transaction), in the knowledge that the impression may affect the setting of a relevant benchmark.

FCA Enforcement

The FCA has been swift to take action where they have seen evidence of attempted benchmark manipulation and imposed fines on firms following attempted manipulation of LIBOR, gold and FX benchmarks. Such enforcement has been extended against individuals.

Firm	Benchmark	Amount (£ million)
Barclays	FX	£284m
UBS	FX	£234m
Deutsche Bank	LIBOR / EURIBOR	£227m
Citibank	FX	£226m
JP Morgan	FX	£222m
RBS	FX	£217m
HSBC	FX	£216m
UBS	LIBOR	£160m
Rabobank	LIBOR	£105m
Lloyds Bank of Scotland	LIBOR / BBA Repo	£105m

Benchmarks
A recent history



Key regulations and business standards

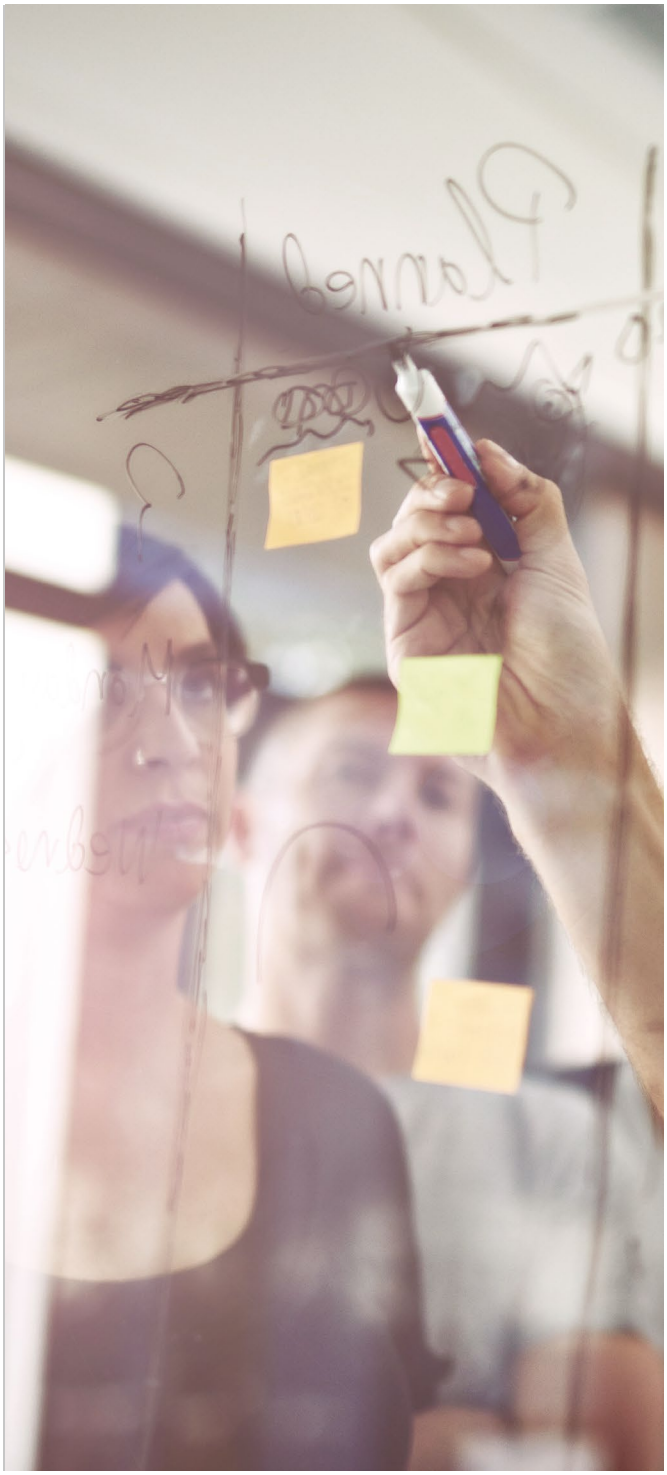
As a result of the additional regulations and scrutiny, there is an increased focus by firms to ensure that the controls in place are robust and sufficient to mitigate risks associated with benchmark activities.

Key requirements for benchmark submitters	
Organisational requirements	Adequate and effective organisational and governance requirements for process of making benchmark submissions
Conflict managment	Sufficient conflict management processes established, to include approach, policy and control processes
Notification requirement	FCA notification requirement for suspicions of actual or attempted benchmark manipulation, including collusion
Record keeping	Record keeping of benchmark submissions (five years), including relevant and associated information used to create the benchmark submission
Audit	Appointment of an independent auditor to report annually on compliance

Key Requirements for Benchmark Administrators	
Systems and controls	Effective organisational requirements to carry out administration of benchmarks to ensure ongoing compliance, oversight and FCA notification requirements established for actual or attempted manipulation, including the following
Conflicts of interest	Identification and management of conflicts of interest
Confidentiality	Confidentiality requirements
Compliance	Arrangements for compliance oversight of benchmark administration
Monitoring	Monitoring and surveillance of benchmark submissions
Governance	Establishment of oversight committee, to ensure practice standards are maintained with respect to submitters, infrastructure providers and users of benchmarks
Review	Oversight committee to undertake periodic review of practice standards
Publication of statistics	Daily provision to FCA of all benchmark submissions and quarterly aggregated statistics in the relevant market underlying the benchmark
Record keeping	Record keeping of all benchmark submissions used to determine specific benchmarks
Financial resources	Requirement to meet all financial liabilities and maintain sufficient financial resources to cover operating costs
Notification	Notification to FCA as soon as benchmark administrator identifies reasonable possibility of not being able to hold resources to cover operating costs
Access	Fair access to benchmarks must be permitted on a non-disciminatory basis to users

The key regulations and business standards to note, include the following:

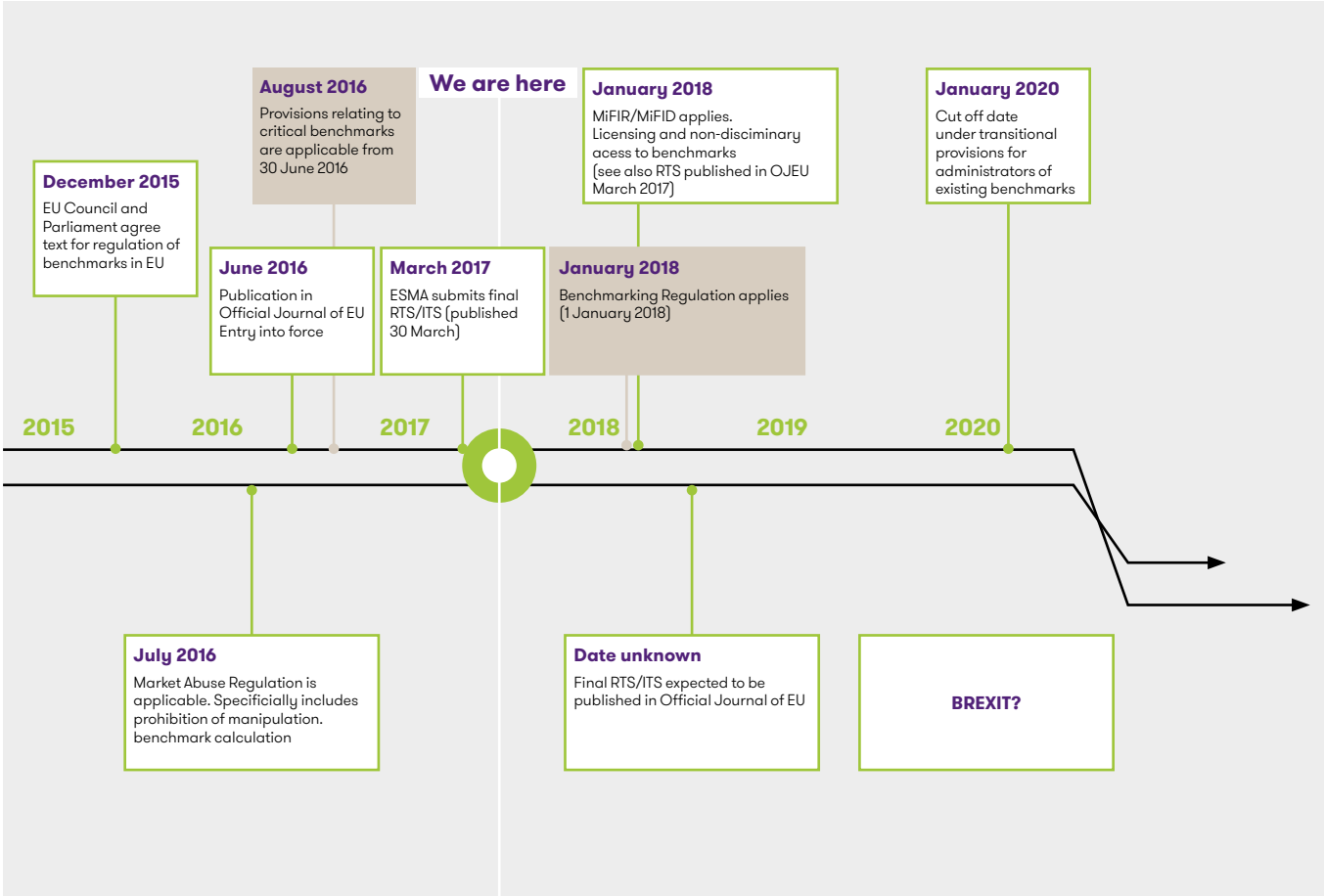
- **MAR 8** incorporated into the FCA handbook for regulations pertaining to benchmark submitters/administrators for specified benchmarks (currently only seven benchmarks are specified and fall into a regulated activity under the RAO). However, firms who do not submit/administer a specified benchmark should still consider the the following rules.
- **IOSCO Principles** for Financial Market Benchmarks published July 2013. A set of principles governing benchmark activities, which set out recommended practices for benchmark administrators and submitters.
- **Senior Management Regime and Certification Regime –** approval of individuals both as SMR but also as CF40/ CR50 function
- **FCA thematic review** of oversight and controls for financial benchmarks – published July 2015, providing guidance on what firms should consider. The 6 key messages being:
  - identification of all activities that constitute a benchmark activity
  - improve outstanding gaps
  - strengthen governance and oversight
  - continue to identify/manage conflict of interest
  - establish robust controls for in-house benchmarks, and
  - the impact of exiting benchmarks needs to be properly considered.
- **EU Market Abuse Regulation (MAR)** – effective July 2016. MAR was specifically amended to ensure wording relating to the prohibition of abuse or manipulation relating to benchmarks.
- **Reviews of regulatory cases as pertains to benchmarking** – There are several findings/conclusions contained within the cases - LIBOR, gold trading, spot- FX trading and the criminal case - R v Tom Hayes. Firms should note these and where necessary provide examples in training/guidance.
- **Continued EU regulatory developments** – There are continued discussions in EU to negotiate a mandate to have EU wide benchmark regulations. Firms should



The EU Benchmark Regulation (BMR)

BMR entered into force on 30 June 2016. The provisions relating to the mandatory administration of and mandatory contribution to critical benchmarks came into effect immediately. The early application of these provisions on critical benchmarks is intended to prevent critical benchmarks from being undermined by an exodus of contributors. The rest of the Regulation will apply from **1 January 2018**.

BMR aims to reduce the risk of manipulation of benchmarks by addressing conflicts of interest, governance controls and the use of discretion in the benchmark-setting process. It requires EU administrators of a broad class of benchmarks to be authorised or registered by a national regulator and to implement governance systems and other controls to ensure the integrity and reliability of their benchmarks.



BMR benchmark definitions
A broad approach

What is a benchmark?

The EU Benchmarks Regulation defines an index as a figure that is publicly available and is regularly determined, either by applying a formula to, or making an assessment of, a representative set of underlying data.

Key examples

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
- defining the asset allocation of a portfolio, or
- computing the performance fees.

Any figure:

- that is published or made available to the public
- that is regularly determined, entirely or partially, by the application of a formula or any other method of calculation, or by an assessment; and on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes or other values or surveys.

The aim is to cover indices used in securities or derivatives traded on a regulated trading venue under MiFID II/MiFIR, including securities and derivatives traded outside a venue via an investment firm that is a "systematic internaliser" under MiFID II/MiFIR.

BMR scope and coverage

BMR also covers indices used to set interest rates under certain consumer loans and consumer mortgages as well as the indices used in index tracking and some other funds.

The concept of "financial instrument" has been borrowed from MiFID. However, only financial instruments which are admitted to trading (or for which a request for admission to trading has been made) are included for the purposes of the Regulation.

Benchmarks provided by central banks, public authorities, central counterparties, the press and credit unions, and priced/value reference priced benchmarks are exempt. In addition, only certain provisions of the Regulation apply to commodity benchmarks.

BMR transitional arrangements

EU benchmark administrators providing benchmarks on 30 June 2016 will have until 1 January 2020 to apply for authorisation or registration. Transitional provisions will allow these administrators to continue to provide those existing benchmarks (and for supervised entities to continue to use those benchmarks) until 1 January 2020.

After 1 January, 2020 national regulators will be able to permit the continued use of an existing benchmark provided by an EU administrator that does not comply with the Regulation if cessation or change to the benchmark would cause a force majeure event, frustrate or breach the terms of a financial instrument, financial contract or rules of an investment fund that references that benchmark.

No financial instruments, financial contracts or measurements of the performance of an investment fund will be able to add a reference to the existing EU benchmark after 1 January 2020 but no specific provisions allow for the continued production of the benchmark after that date.

Where a benchmark provided by a non-EU administrator is already used in the EU on 30 June 2016 and has not yet been qualified for use in the EU under the Regulation's third country regime, then its use in the EU will only be permitted in a financial instrument or financial contract, or for measuring the performance of an investment fund, that already references the benchmark or adds a reference to the benchmark before 1 January 2020.

Who needs to comply with the Benchmark Regulation?

Every person located in the EU that has control over the provision of a benchmark will be required to be authorised or registered by a national regulator, unless an exemption applies.

The Benchmark Regulation applies to benchmark administrators, contributors (including submitters) and users. BMR will introduce new regulatory requirements for index providers located in the EU that provide benchmarks used within the EU. Once their benchmarks are used, these providers will become benchmark administrators. They will be expected to apply to their competent authority for authorisation or registration. Index providers (persons who control the provision of an index) who are not aware that benchmarks provided to them fall outside the scope of the Regulation.

EU benchmark administrators

The obligations that apply to EU benchmark administrators mainly depend on the type and category of their benchmarks. There are four broad types of benchmark, depending on their underlying asset or factor: interest rate benchmarks, commodity benchmarks, regulated-data benchmarks and other (non-commodity) benchmarks. In addition, there are three different categories of benchmark: critical, significant and non-significant.

EU administrators that are supervised entities must be registered under the Regulation, unless they provide a critical benchmark, when they must be authorised. EU administrators that are not supervised entities must be authorised under the Regulation, unless they provide a non-significant benchmark, when they must be registered (note, there is a transitional period).

Administrators

The Benchmark Regulation overhauls and substantially increases administrators' regulatory burden by requiring strict control standards and oversight requirements on benchmark computation.

Administrators of critical benchmarks are required to be authorised, but administrators of non-critical benchmarks are only subject to a registration requirement. All administrators are required to:

a. Put in place controls (if not already in place) in respect of input data

b. Put in place procedures for reporting of infringements

c. Conduct their work in a transparent manner, including publishing the methodology used for each benchmark it administers. As administrators are also required to put in place a complaint handling framework

d. Ensure any outsourcing of functions comply with outsourcing rules (e.g. controls over the service provider and inability to outsource its regulatory responsibility). Any outsourcing agreements will need to be reviewed for compliance and may need to be re-papered

Code of Conduct

Administrators of critical benchmarks are required to draw up a code of conduct for each of their benchmarks. The Code needs to set out the respective responsibilities and obligations of the administrator and contributor. In particular, the Code needs to cover certain prescribed elements relating to the description of the input data, policies to ensure contributors provide all relevant input data, systems and controls that contributors are required to establish (including record-keeping, reporting of suspicious input data reporting and conflict management).

A Code of Conduct for a critical benchmark must be submitted to the relevant national regulatory authority for verification that it complies with the Benchmark Regulation.

Contributors are required to confirm their compliance with the Code and reconfirm compliance when changes are made to the Code.

What is a critical benchmark?

The Benchmark Regulation distinguishes between critical and non-critical benchmarks. A "critical benchmark" is:

i. a benchmark which is not based on regulated data (e.g. data from trading venues) with reference value of more than EUR 500 billon; or

ii. a benchmark, which, if ceased, would have a significant adverse impact on financial stability, the orderly functioning of a market, or the real economy of a Member State.

Administrators and contributors of non-critical benchmarks, and non-supervised contributors are subject to a lighter-touch regime under the Regulation. Further detail is set out below.

Critical benchmarks are subject to additional requirements, including the following:

- a mandatory annual external audit of compliance
- regulators' powers to delay the discontinuance of the benchmark by requiring the administrator temporarily to continue the provision of the benchmark
- a requirement for the administrator to provide licences of, and information on, the benchmark to all users on a fair, reasonable, transparent and non-discriminatory basis
- regulators may require supervised entities temporarily to contribute input data to the benchmark (although they cannot be required to enter into transactions for this purpose)
- the administrator's home state regulator must establish a college of supervisors to oversee the benchmark, including regulators from other Member States where the benchmark is significant.

The rules on mandatory administration and contribution to benchmarks took effect on 30 June 2016.

Significant and non-significant benchmarks

Non-critical financial benchmarks will be treated as significant benchmarks if:

- the benchmark underpins business valued at €50bn or more; or
- the benchmark has no, or very few, appropriate market-led substitutes and cessation of, or data failures relating to the benchmark would result in significant and adverse impacts on market integrity, financial stability, consumers, the real economy or the financing of households or corporations in one or more Member States.

Other benchmarks are treated as non-significant. However, it may be difficult for the administrator of a benchmark to establish whether the benchmark should be treated as non-significant, particularly where the administrator has no direct information on the volume of business underpinned by the benchmark.

The administrator of a significant benchmark has the option to "comply or explain" in relation to some compliance obligations, in particular as regards the operational separation of benchmark activities from other business activities.

However, national regulators have the discretion to override this option taking into account the nature or impact of the benchmark or the size of the administrator.

The administrator of a non-significant benchmark can make greater use of "comply or explain" (without a regulatory override). Such administrators are also exempt from some of the detailed technical standards made under the new Regulation, although ESMA may issue guidelines for these administrators.

Contributors and submitters

Contributors to benchmarks do not require authorisation or registration under the Regulation. Firms that are already authorised under other EU rules will be subject to additional requirements. Where a benchmark is based on input data from contributors, the administrator must develop a code of conduct for contributors and ensure that contributors adhere to the code. The administrator must also monitor input data and contributors so as to be able to report suspected market abuse to its national regulator.

BMR imposes obligations on supervised entities that contribute input data to benchmarks provided by EU administrators data not affected by conflicts of interest, that discretion is independently and honestly exercised and to a control framework/effective systems and controls to ensure the integrity, accuracy and reliability of input data and compliance with the code of conduct.

The Benchmark Regulation draws a distinction between supervised contributors and non-supervised contributors, recognising the fact that contributing to a benchmark is a voluntary activity and should not be discouraged.

This means that contributors who are already subject to regulation and supervision are within scope of the Regulation and need to comply with requirements relating to governance and control "to ensure the integrity and reliability of all contributions of input data to the administrator" which includes:

i. controls regarding who may submit input data to an administrator
ii. training for submitters
iii. conflict management; and
iv. record keeping.

Benchmark Users

Users who are regulated entities, will no longer be allowed to use a benchmark unless it is an authorised or registered administrator in the EU or, in the case of third countries, the third country administrator has been recognised or the benchmark has been endorsed. This will be of concern to those who use third country benchmarks.

Benchmark users will be subject to additional requirements if they are an:

- Authorised person; and
- issue a financial instrument that references an index
- determine the amount payable under a financial instrument, mortgage or consumer credit contract referencing an index
- party to a mortgage or consumer credit contract that references an index
- provide borrowing rates calculated as a spread/mark-up over an index or combination of indices and that is solely used as a reference in a consumer credit contract to which the creditor is a party
- measure the performance of an investment fund through an index either to track the return of the fund or to define its asset allocation.

Non-EU benchmarks

The new rules present a significant implementation challenge, particularly where EU firms reference non-EU benchmarks in securities or derivatives or use them in the management of investment funds. There are three routes through which non-EU administrators can qualify their benchmarks for use in the EU under the Regulation:

Equivalence	ESMA is able to register benchmarks provided by a non-EU administrator as qualified for EU use if:
	i. the Commission has adopted an equivalence decision
	ii. the administrator is authorised or registered, and is supervised, in the non-EU state
	iii. the administrator has notified ESMA of its consent to the use of its benchmarks in the EU by supervised entities (and of a list of the benchmarks and of the relevant non-EU regulator); and cooperation arrangements between ESMA and the non-EU authority are operational.
Recognition	ESMA will be able to register a benchmark provided by a non-EU administrator as qualified for use in the EU, if the administrator has been recognised by the national regulator in its EU Member State of reference and maintains a legal representative in that Member State. The non-EU administrator will be allowed to fulfil that compliance obligation by applying the IOSCO Principles but only if the national regulator determines that their application is equivalent to compliance with the requirements established in the Regulation. Non-EU administrators will also have to identify their Member State of reference applying rules that take into account the location of affiliated supervised entities, the location of trading venues for financial instruments referencing their benchmarks and the location of supervised entities using their benchmarks.
Endorsement	ESMA will also be able to register a benchmark provided by a non-EU administrator as qualified for use in the EU if an administrator or other supervised entity in the EU has been authorised by its national regulator to endorse the benchmark. The endorsing entity will have to have a "clear and well defined role within the control or accountability framework of the third country administrator" that allows it "to effectively monitor the provision of the benchmark". The endorsing entity is responsible for compliance with the Regulation and will have to satisfy its national regulator that the provision of the third country benchmark fulfils mandatory or voluntary requirements in the non-EU country that are "at least as stringent" as those under the Regulation.

Consequences

The new Regulation imposes broad-ranging and exacting requirements on a wide range of market participants. It may reinforce the trend to discontinue benchmarks and reference prices and may result in some non-EU benchmarks becoming unavailable for use in the EU, restricting the range of hedging and investment products available in the EU.

Market participants will need to create implementation plans to prepare for full compliance with the Regulation's requirements by 1 January 2018.

To ensure compliance, the Regulation gives national regulatory authorities wide powers of supervision and investigation and creates sanctions for breach. The maximum fine that can be imposed is:

i. at least three times the amount of the profits gained or losses avoided; or

ii. €500,000 on an individual and EUR 1 million or 10% of total annual turnover on a firm.

BMR 2018

Are you ready?

In addition to reviewing internal processes to ensure compliance with existing IOSCO principals MAR and MiFID II, firms should also consider the following:

- Conducting a review of what constitutes a 'benchmark'?
- Completing a comprehensive review on identifying if they are an administrator, contributor or user;
- Evaluation of monitoring and surveillance?
- Performance of a conflictsreview to identify all perceived conflicts regarding their benchmark activity and how this is monitored?
- What are a firm's review/consideration processes if they wish to exist benchmark activities?
- Consideration of other regulations
- Engagement in industry debate – particularly around workability of third country regimes

Our compliance and risk experts can support your firm to implement the EU benchmark regulation. We offer best in class regulatory specialists who will leverage their sector expertise to deliver pragmatic, best practice advice for BMR implementation.

Our dedicated subject matter experts have an average of 25 years post qualified experience, from both an industry and assurance perspective. We understand regulatory expectation and what it means in real terms. We can support you through:

- Impact assessments and a gap analysis on how the regulation will affect your business and identification of high, risk and low impact areas
- Scoping and planning how to address any gaps in governance, monitoring and controls, including implementation planning and training
- Assurance over your BMR related processes, deliverables and controls

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