

EU Benchmarks Regulation

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Overview 1

- LIBOR/EURIBOR/TIBOR, FX and gold benchmark manipulations
 - existing regulations did not adequately capture abuse
 - only one bank found to have manipulated HIBOR
- Wheatley Review in UK
- IOSCO Principles
- EU Benchmarks Regulation – Regulation (EU) 2016/2011
- Impact on third countries
 - Asian benchmarks sold into EU
 - EU benchmarks sold into Asia?
 - Impact on proprietary indices

Overview 2

- These slides cover
 - background (largely for future reference)
 - EU Benchmarks Regulation
 - third country administrators
 - proprietary indices
 - consequences of non-compliance

- See our [elexica](#) website for the latest position:
 - <http://www.elexica.com/en/resources/microsite/benchmarks-regulation>
 - Benchmarks Legislative Tracker at <http://www.elexica.com/-/media/files/microsites/benchmarks%20regulation/benchmark%20legislative%20tracker%20updated%2010%20october%202017%20376575091.pdf>

Background

Why was BMR introduced?

- Focus on financial benchmarks following regulatory investigation into manipulation of setting financial benchmarks including LIBOR and EURIBOR
 - 2008: US CFTC begins examining potential LIBOR manipulation
 - 2010: FSA enforcement investigation into potential LIBOR manipulation begins
 - 2011: European Commission begins LIBOR/EURIBOR anti-trust investigations, eventual fines of €1.49 billion on 8 banks for cartel

- Wheatley Review in UK
 - August 2012: initial discussion paper highlighted shortcomings in the existing system (e.g. not based on actual transaction data, conflicts of interest)
 - September 2012: final report set out recommendations for reform in the United Kingdom

Benchmark fines

Barclays FX failings <small>(May 2015)</small>	£284m
UBS FX failings <small>(Nov 2014)</small>	£234m
Deutsche Bank Libor and Euribor failings <small>(Apr 2015)</small>	£227m
Citibank FX failings <small>(Nov 2014)</small>	£226m
JPMorgan Chase Bank FX failings <small>(Nov 2014)</small>	£222m
RBS FX failings <small>(Nov 2014)</small>	£217m
HSBC FX failings <small>(Nov 2014)</small>	£216m
UBS Libor failings <small>(Dec 2012)</small>	£160m
Rabobank Libor failings <small>(Oct 2013)</small>	£105m
Lloyds Bank of Scotland Libor and BBA Repo failings <small>(Jul 2014)</small>	£105m
RBS Libor failings <small>(Feb 2013)</small>	£87m
Barclays Libor failings <small>(Jan 2012)</small>	£60m
Barclays gold failings <small>(May 2014)</small>	£26m
ICAP Libor failings <small>(Sep 2013)</small>	£14m
Martin Brokers Libor failings <small>(Mar 2014)</small>	£630,000



Benchmark fines in the United Kingdom

Causes of action focused on breaching FCA's Principles for Businesses:

- PRIN 3 on “management and control”
- PRIN 5 on “market conduct”
- PRIN 11 on “relations with regulators”

Source: <https://www.fca.org.uk/markets/benchmarks/enforcement>

United States Actions – LIBOR Manipulation

Include:

- **27 June 2012:** Barclays fined \$200 million by the CFTC and \$160 million by the U.S. Department of Justice
- **19 December 2012:** UBS agreed to pay \$1.2 billion to the CFTC and U.S. Department of Justice
- **23 April 2015:** Deutsche Bank agreed to a \$2.175 billion fine by U.S. regulators
- Class action against 16 major banks accused of collusion in the LIBOR scandal was given approval to proceed by New York federal appeals court in May 2016
 - ongoing: but reports that settlement has been reached with 2 banks

Criminal Charges

- First person to be tried and convicted on **criminal charges** for manipulating LIBOR
- Convicted in August 2015 of eight counts of **fraud** for conspiring to fix LIBOR and sentenced to 14 years in prison
 - “[t]he fact that others were doing the same as you is no excuse, nor is the fact that your immediate managers saw the benefit of what you were doing and condoned it and embraced it, if not encouraged it.” Justice Cooke
- Sentence reduced to 11 years in December 2015 following an appeal
- Since Hayes was sentenced:
 - 4 Barclays traders imprisoned in the UK
 - 3 Rabobank traders imprisoned in the US
- “*The Fix: How Bankers Lied, Cheated and Colluded to Rig the World's Most Important Number*” by Liam Vaughan and Gavin Finch (2016)



“Just give the cash desk a Mars bar and they’ll set wherever you want” – Tom Hayes

Wheatley Review - developments

- Following Wheatley Review – Section 91 Financial Services Act 2012 introduced a new criminal offence of benchmark manipulation
- FSMA was amended so that administering a specified benchmark and providing information in respect of a specified benchmark became regulated activities on 1 April 2013
- Initially only LIBOR was specified but seven others have been added including SONIA and RONIA
- Proprietary indices not included
- Oversight of benchmarks moved
 - LIBOR: from BBA to ICE
 - EURIBOR: from EBF to EMMI
 - Number of currencies/maturities reduced



HIBOR

- “Report on the Review of Hong Kong Interbank Offered Rate” by the Treasury Markets Association (TMA) dated November 2012:
 - “Reference banks for HIBOR fixing do not have significant incentives to misreport. Unlike in the case of LIBOR fixing where the contributing banks are asked to estimate their own funding costs, reference banks for HIBOR are asked to **estimate the funding costs of prime banks in Hong Kong**. There is less concern about the stigma effect of their submissions in distressed market situations which may create a strong incentive to underreport the rates in such circumstances.”

- Code of Conduct for Benchmark Submitters
 - HIBOR (HKD and CNH)
 - In HKMA Supervisory Policy Manual as “statutory guideline”
 - Issued in 2013 by HKMA pursuant to Banking Ordinance (Cap. 155) s.7(3)
 - Covers Authorised Institutions only
 - HONIA (HKD)
 - Issued in 2016 by TMA, as a “supplementary guideline”
 - Applies to Approved Money Brokers

EU Benchmarks Regulation

IOSCO Principles

- **October 2012:** IOSCO Final Report on Principles for Oil Price Reporting Agencies
- **July 2013:** IOSCO Final Report on Principles for Financial Benchmarks (“**IOSCO Principles**”)
 - **Governance:** overall responsibility of administrator; oversight of third parties; conflicts of interest for administrators; control framework for administrators; internal oversight
 - **Quality of the Benchmark:** benchmark design; data sufficiency; hierarchy of data inputs; transparency of benchmark determinations; periodic review
 - **Quality of the Methodology:** content of the methodology; changes to the methodology; transition; submitter code of conduct; internal controls over data collection
 - **Accountability:** complaints procedure; audits; audit trail; cooperation with regulatory authorities
- **May 2016:** Second review by IOSCO of implementation of IOSCO Principles for EURIBOR, LIBOR and TIBOR
 - Majority of recommendations made in first review have been implemented by IBOR administrators
 - All administrators have developed and improved their policies and procedures

EU Benchmarks Regulation

- **September 2013:** EU Commission published draft Regulation seeking to regulate benchmark administrators, contributors and users
 - adopted by EU Parliament in April 2016 and by the EU Council on 17 May 2016
- The September 2013 proposal was issued in conjunction with:
 - the revision of MiFID which aims to strengthen the provision of benchmarks by increasing both market transparency and the availability of more robust data
 - amendments which bring benchmarks with the scope of the Market Abuse Regulation and the recast Market Abuse Directive (MAD II) introducing sanctions for the manipulation of benchmarks
- **June 2016:** Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (“BMR”)
 - amends Directives 2008/48/EC [Consumer Credit Directive], 2014/17/EU [Mortgage Credit Directive] and Regulation (EU) No 596/2014 [Market Abuse Regulation]
- Goes well beyond IOSCO Principles

When does it apply?

- Most provisions will apply without further action from 1 January 2018
 - Uncertainty of application from 30 June 2016 to 1 January 2018 now clarified by ESMA Q&A A6.1 (i.e. BMR does not apply there)
 - Have until 1 January 2020 to apply for authorisation or registration
- Member States will need to ensure that appropriate measures are in place by 1 January 2018 such that:
 - competent authorities have all supervisory and investigatory powers necessary to perform their functions
 - competent authorities have power to impose other administrative measures
- By 1 January 2018 Member States shall notify the Commission of the relevant national law provisions



EU Benchmarks Regulation

ESMA Publications

- Level 2 measures behind schedule:
 - ITS 2017/1147 (amending ITS 2016/1368) specifies EURIBOR and EONIA as critical benchmarks
 - 4 adopted RTSs
 - draft RTSs published by ESMA in its final reports dated 30 March 2017 and 1 June 2017

- Level 3 measures:
 - ESMA Q&A Version 2 published on 29 September 2017
 - ESMA technical advice dated 10 November 2016 (some of this goes beyond what is in the adopted RTSs)
 - ESMA technical advice in the final reports dated 30 March 2017 and 1 June 2017 not in the draft RTSs

The primary restriction

- A **supervised entity** will only be permitted to **use** a benchmark in the EU if it is provided by an **administrator who is authorised or registered** in the EU under the BMR (BMR Art. 29, but note third-country provisions)
- The list of supervised entities is very broad, including credit institutions, investment firms, UCITS, AIFMs and creditors, and only covers EU supervision
- The “use” of a benchmark includes:
 - a) issuing a financial instrument which references the benchmark
 - b) determining the amount payable under a financial instrument or financial contract referencing the benchmark
 - c) being a party to a financial contract which references the benchmark
 - d) providing a borrowing rate calculated as a mark-up over the benchmark
 - e) determining the performance of an investment fund through an index or combination of indices for the purpose of tracking the return thereof or defining the asset allocation of a portfolio or computing performance fees
- Authorisation/registration requires compliance with BMR provisions (BMR Art. 34)

What is a benchmark?

- A benchmark is “*any index by reference to which the amount payable under a financial instrument or a 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*”

- An *index* is:
 - “any figure:
 - (a) that is *published or made available to the public*;
 - (b) that is *regularly determined*:
 - (i) *entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and*
 - (ii) *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.*”

Example benchmarks

- Interest rates: e.g. LIBOR, EURIBOR, HIBOR, TIBOR
- Equities: e.g. FTSE 100, Hang Seng Index
- Swap rates: e.g. ICE Swap Rate (formerly ISDAFIX)
- Commodities: e.g. MSCI/GSCI indices
- FX: e.g. WM/Reuters which cover multiple currency pairs
- Probably not benchmarks:
 - credit derivatives indices such as iTraxx/CDX as they are lists of names, though the names are selected semi-annually based on market submissions
 - ... and used for pricing (e.g. credit spreads/upfront amounts and tradeable credit fixings)
 - IHS Markit is determining in line with IOSCO Principles anyway
 - single price from index futures (BMR Art. 2(2)(d))

Who is affected by BMR?

Administrators

- Person having control over the provision of a benchmark

Contributors

- Person contributing input data to an administrator for the purposes of determining a benchmark

Users

- Person who (a) issues a financial instrument which references the benchmark; (b) determines the amount payable under a financial instrument or financial contract referencing the benchmark; (c) is a party to a financial contract which references the benchmark; (d) provides a borrowing rate calculated as a mark-up over the benchmark; or (e) determines the performance of an investment fund through a benchmark

Benchmark significance

- The extent to which administrators must comply with BMR varies according to the significance of the benchmark.

Critical	Significant	Non-significant
<ul style="list-style-type: none"> • used as a reference for financial instruments or financial contracts or for the determination of the performance of investment funds having a total value of at least EUR500bn; or • based on submissions by contributors, the majority of whom are located in one EU member state and is recognised as critical in that member state by the relevant competent authority; or • (i) same as first point above but with a value of EUR400bn; (ii) no or few market led substitutes; and (iii) cessation would have significant and adverse consequences. 	<p>Does not satisfy all the criteria to be a critical benchmark, but:</p> <ul style="list-style-type: none"> • is used as a reference for financial instruments or financial contracts or for the determination of the performance of investment funds having a total average value of at least EUR50bn over a period of six months; or • has no or very few market-led substitutes and its absence would have a significant and adverse consequences for amongst others consumers or the financing of households and corporations in one or more EU member state 	<p>Does not fulfil the necessary criteria to be a “critical” or “significant” benchmark</p>

Benchmark requirements

Critical	Significant	Non-significant
<ul style="list-style-type: none"> • Detailed requirements set out in BMR Title II (Arts 4 to 16), e.g.: <ul style="list-style-type: none"> • 4(1) : robust governance arrangements, identifying/managing conflicts of interest, discretion “independently and honestly exercised” • 11(1): input data “sufficient to represent accurately and reliably the market or economic reality” • 12(1): benchmark methodology “robust and reliable” with clear rules • 15: administrators to develop code of conduct • Plus: <ul style="list-style-type: none"> • Mandatory administration (Art. 21) • Mitigation of market power (Art. 22) • Mandatory contribution (Art. 23) 	<ul style="list-style-type: none"> • Administrator may choose not to apply certain provisions of BMR Title II if “the application of one or more of those provisions would be disproportionate taking into account the nature or impact of the benchmark or the size of the administrator” (BMR Art. 23(1)) • These provisions are BMR Arts: 4(2); 4(7) (c), (d) and (e); 11(3)(b); and 15(2), e.g.: <ul style="list-style-type: none"> • 4(2): “The provision of a benchmark shall be operationally separated from any part of an administrator’s business that may create an actual or potential conflict of interest.” • 11(3)(b): if input data from front office, those contributors to have “adequate internal oversight and verification procedures” 	<ul style="list-style-type: none"> • Administrator may choose not to apply even more, with no “disproportionality” requirement • These provisions are BMR Arts: 4(2); 4(7) (c), (d) and (e); 4(8); 5(2); 5(3); 5(4); 6(1); 6(3); 6(5); 7(2); 11(1)(b); 11(2)(b) and (c); 11(3); 13(2); 14(2); 15(2); 16(2); 16(3), e.g.: <ul style="list-style-type: none"> • 7(2): administrator to designate internal function to review and report on compliance with BMR • 11(3)(a): input data from front office to be corroborated against other sources • 16(2): supervised contributor to have “effective systems and controls to ensure the integrity and reliability of all contributions of input data” • 16(3): policies on use of judgment or exercise of discretion

Likely consequences

- Third country benchmark providers considering whether to withdraw their benchmarks to avoid time and expense of compliance
- LIBOR expected to go altogether in 2021
 - LMA/APLMA committees recently set up to address this
 - ISDA forming working groups
- Hang Seng Indices – smaller ones may not be viable
- Need to consider consequences on existing transactions referencing those benchmarks

Third Country Administrators

Non-EU administrators and benchmarks

“Its extraterritorial impact is vast. The use of benchmarks by EU financial firms is prohibited unless those benchmarks or their administrators are authorized in the EU, or if produced outside the EU, the third country benchmark administrator will need to apply for equivalence, recognition or endorsement. While many of the administrator and submitter proposals are in line with existing controls under IOSCO, we remain concerned about EU restrictions on users of benchmarks. We are concerned that this will have major extraterritorial impacts...”

Joint letter of ASIFMA, FIA and ISDA to the EU Commission, 15 January 2016

Non-EU benchmarks

Grandfathering

- To the extent that a benchmark provided by a non-EU administrator is “used” in the EU, such use will be permitted only for financial instruments, financial contracts or investment funds that reference the benchmark in the EU on, or which add a reference to such benchmark prior to 1 January 2020.
- If a non-EU administrator wants new financial instruments, financial contracts or investment funds in the EU to reference its benchmark after 1 January 2020 then an equivalence decision will need to be adopted, or the third country administrator will need to obtain recognition or endorsement.

Non-EU benchmarks

Using a third-country benchmark in the EU

Where grandfathering is not available - three methods to facilitate “use” in the EU:

1. Equivalence
2. Recognition
3. Endorsement



Non-EU benchmarks

Equivalence

- ESMA may register a third country administrator and the benchmark if:
 - an equivalence decision is adopted by the EU commission for the jurisdiction where the administrator is located
 - the administrator is authorised or registered and subject to supervision in the jurisdiction where it is located
 - the administrator notifies ESMA of its consent to the benchmark being used by supervised entities in the EU
 - **cooperation arrangements** are in place between ESMA and the relevant authority in the administrator's own jurisdiction (including exchange of information and procedures concerning co-ordination of supervisory activities) – draft RTS for this published in ESMA Final Report dated 1 June 2017
 - EU Commission must be satisfied that administrators are subject to effective supervision and enforcement on an ongoing basis

- At present it is considered that few administrators/jurisdictions would meet the equivalence criteria, but a lot of work being done on it

Non-EU benchmarks

Recognition

- Until an equivalence determination is made, a third country administrator may have its benchmark used in the EU if the administrator is “recognised” by its “**Member State of reference**” in the EU
- “Member State of reference” is determined by a number of factors including:
 - the location of affiliated supervised entities
 - location of relevant trading venues for financial instruments referencing the benchmarks
 - location of supervised entities using the benchmarks
- To be recognised, the third country administrator will need to comply with the requirements applicable to EU administrators under the BMR – this may be demonstrated by compliance with the IOSCO Principles provided that the application of such principles is equivalent to compliance with the BMR

Non-EU benchmarks

Recognition (cont'd)

- The third country administrator must have a legal representative in the applicable Member State
 - legal representative can be a natural person domiciled in the EU or a legal person domiciled in the EU
 - legal representative has to perform an oversight function and acts on behalf of the administrator vis-à-vis the EU authorities and is accountable to the Member state of reference

- ESMA Final Report dated 30 March 2017 in section 11 sets out detailed guidance on the information that must be submitted in relation to (i) the third country administrator, (ii) the legal representative and (iii) the benchmark(s) as part of the recognition process

Non-EU benchmarks

Recognition (cont'd)

- Once a third country administrator is granted recognition in one Member State, it is entitled to passport for the provided benchmarks in the whole of the EU
- Challenges to “recognition”
 - only applies pending an equivalency decision (i.e. it is temporary)
 - identifying the Member State of reference
 - obtaining certification of compliance with the IOSCO Principles
 - appointment of a legal representative

Non-EU benchmarks

Endorsement

- EU administrators can endorse third country benchmarks where the EU administrator:
 - has a clear and well defined role in the accountability framework of the third country administrator
 - can monitor the provision of the benchmark
 - there is an objective reason to provide the benchmark and endorse it for use in the EU

- The EU endorsing administrator must remain fully responsible for the third country benchmark and for its use in the EU
 - effectively limits the endorsement regime only to EU affiliates of non-EU administrators

Proprietary Indices

Are proprietary indices covered by BMR?

- Meaning of “*published or made available to the public*” is key to the scope of the BMR and is broad
- Adopted RTS Art. 1(1):

*“A figure shall be considered to be made available to the public ... where the figure is made *accessible to a potentially indeterminate number* of legal or natural persons other than the index provider or other than a determined number of recipients connected or related to the index provider”*
- ESMA Final Report 10 November 2016 section 2.1.3:
 - Accessible to an “*indeterminate number*” means accessible by an open group of recipients (i.e. the group could potentially change in size and composition)
 - ESMA disagrees with the proposal that this should carve out figures that are only made available to investors in a specific financial instrument

Are proprietary indices covered by BMR? (cont'd)

- Adopted RTS Art. 1(2):

“A figure is made available to the public where it may be accessed by such persons either directly or indirectly as a result, inter alia, of its use by one or more supervised entities ...

... as a reference for a financial instrument it issues or to determine the amount payable under a financial instrument or a financial contract, or to measure the performance of an investment fund, or to provide a borrowing rate calculated as a spread or mark-up over such figure.”

- Mode of access is irrelevant
- Access may be free of charge or by payment

Exceptions

- BMR will not apply if an administrator produces an index that is a benchmark which is used in financial instrument or contract but they are unaware (and could not have reasonably been aware) of its use
- Where ESMA notifies an administrator that their index has or may become a benchmark, the administrator can withhold consent in which case the index may not be used as a benchmark and the BMR will not apply to the administrator
 - if the administrator does consent it will become subject to BMR in respect of that benchmark

Classification of proprietary indices

- Most proprietary indices will not meet the criteria to be “critical” or “significant” and will therefore be subject to less onerous requirements
- There is an exception for indices (including proprietary indices) which reference **interest rates** or **commodities** – these must comply with more stringent regimes applicable for such assets and each have their own bespoke annexes to the BMR

Impact on administrators of proprietary indices

- Administrators of proprietary indices will likely have to comply with the requirements for “non-significant” benchmarks
- Administrators of non-significant benchmarks are only obliged to comply with a limited set of the “Title II” requirements which apply to other benchmarks. The administrator will be required to:
 - a) have a clear organisational structure with well defined, transparent and consistent roles and responsibilities for all persons involved in the provision of a benchmark
 - b) take limited steps to prevent conflicts of interest and ensure discretion is independently and honestly exercised
 - c) establish a limited permanent oversight function
 - d) use sufficient input data, robust and reliable methodologies and provide appropriate transparent
 - e) develop a limited code of conduct for each family of benchmarks specifying the contributors obligations

Impact on administrators of proprietary indices (cont'd)

- f) publish a procedure covering actions to be taken in the event of changes to a benchmark or its cessation
 - g) report any manipulation of the benchmark under the EU Market Abuse Regulation
 - h) apply for authorisation and/or registration in the same way as for other types of benchmark (if all benchmarks provided by the administrator are non-significant then only registration is required)
 - i) publish a benchmark statement for each family of benchmarks containing certain prescribed information, including details relating to the exercise of any discretion
- To the extent that an administrator chooses not to comply with the full set of Title II requirements, it must publish and file with the competent authority a compliance statement explaining why it is appropriate for it not to comply with such requirements. The form of compliance statement was published by ESMA in its draft technical advice under the Benchmarks Regulation (29 September 2016)

Non-compliance

Sanctions and Enforcement

- Competent authorities can:
 - request documents and information
 - carry-out onsite inspections and investigations
 - suspend trading of any financial instrument that references a benchmark

- Sanctions can be imposed on entities or individuals:
 - public warning
 - fines
 - disgorgement of profits gains (or losses avoided where determinable)
 - withdrawal or suspension of administrator's authorisation
 - temporary ban prohibiting any individual who is held responsible for the breach from exercising management functions in benchmark administrators or contributors

What next?

What next for benchmark providers?

- Consider requirements that apply
 - Critical v significant v non-significant
 - Benchmark statements (BMR Art. 27)
- Expect questions from EU “users” of your benchmarks:
 - they may seek assurances that third-country administrators have plans to comply with the BMR
 - they may ask about intended “mode of access” to the EU (i.e. equivalence, recognition or endorsement)
 - users may consider EU alternatives to third-country benchmarks
 - contingency plans in documentation – e.g. contractual fallback clauses in case a benchmark can no longer be used



What next for benchmark users?

- See what is happening to your benchmarks
 - Many being withdrawn (e.g. LIBOR from 2021)
- Check fallbacks/alternatives



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