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IOSCO – Financial benchmarks – Consultation report
ISDA response

Introduction

On behalf of our members, ISDA appreciates the opportunity to respond to this consultation, with the goal of contributing to a robust and stable financial market. In this response, we have limited ourselves to commenting on those issues that are directly relevant to ISDA and OTC Derivatives Markets. There are, of course, many important issues discussed in the consultation document that go beyond that scope, and we defer, in relation to those issues, to other financial market respondents with greater expertise and/or a more relevant focus. Equally, we will not address considerations of possible alternatives or successors to relevant indices (e.g. Libor or Euribor), either generically or specifically, in the case of those that we are aware will already be discontinued or those where a decision is yet to be made for the discontinuation of any indices/rates.

Our responses to selected questions where ISDA does have a comment can be found in full in the accompanying Annex 1. **Our submission addresses ISDA concerns around financial benchmarks (eg benchmarks in the interbank market, including LIBOR) unless our response explicitly states otherwise, for example where we comment on the treatment of oil price reporting agencies (PRAs).**

HIGHLIGHTS

- In relation to any **transition** to alternative benchmarks, there should be clear and long term arrangements in place. Failure to achieve a smooth and progressive transition will result in major market dislocation and significant “jump risk” if there is an abrupt move from old benchmarks to a successor. The rate of any transition will likely be chiefly determined by the speed of migration to an alternative in terms of liquidity, as well the extent to which market participants have amended their documentation (Q. 39).
- Regarding a **hybrid methodology** for calculation purposes, we generally support the use of actual trade data (where available) in benchmarks’ compilation. At the same time, we believe that it will still be necessary to deploy algorithms or expert judgment to fill the gaps where no trade data exists. In fact, we would argue that expert judgment still plays a part even where actual trade data exists, given that the decision to transact the trade(s) in practice depends upon the exercise of such expert judgment (Q. 33).
- ISDA developed **ISDAFIX** to facilitate the determination of exercise values for cash-settled swap options. The existence of such a benchmark provides a transparent, readily available value to which parties to a transaction can refer as a settlement rate. Without such a benchmark, it might be necessary to go through the process of calling a number of active

dealers for quotes in order to settle transactions. For more information on ISDAFIX and other benchmarks used by ISDA members please refer to Annex 2.

- ISDA encourages IOSCO to take account of the distinction between key **public benchmarks** that are primarily used for purposes of pricing a broad range of financial instruments or contracts and benchmarks in the broader sense (including **proprietary indices**). In short, not all indices should be regarded as “public goods” and this should be reflected in the design of regulation (Q. 1).
- In relation to future reforms, there should be alignment with **existing regulatory initiatives**. Particularly, if transactions are to be reported, then existing reporting databases, systems and reporting routes should be leveraged (Q. 39).
- Regarding commodity derivatives, many benchmarks are important for the functioning of the markets. Exchange-traded benchmarks including CME/ NYMEX, ICE and CRB as well as benchmarks of price reporting agencies are used to price physical markets and, indirectly, derivatives and hedging instruments. In this respect, ISDA would like to make some general points regarding commodities markets:
 - Physical indices have a degree of subjectivity for two primary reasons: (1) the absence of standardisation in physical qualities requires an assessment of value; and (2) the fact that certain physical oils may not trade continuously, requires an assessment of where value is likely to be;
 - The physical markets reflect the supply/demand fundamentals, and financial markets derive prices from there - not vice versa.
- Regarding more specifically PRAs, ISDA supports IOSCO’s work on self-governance and considers that PRAs, taking into account the role they play for physical, cash and derivatives contracts and given that they are used by any market participants, should be subject to:
 - Transparent methodologies that are subject to independent oversight consistent with existing IOSCO principles;
 - Transparent governance, including robust dispute resolution and complaints processes.

We have pleasure in submitting our responses, and look forward to staying very much engaged with IOSCO as regards future initiatives on this topic.

Yours faithfully,

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ANNEX 1: CONSULTATION QUESTIONS & RESPONSES

Chapter 1

Scope

1. *Do you agree with the scope of the report and intended audience? Are there other Benchmarks or stakeholders that have idiosyncrasies that should place them outside of the scope of the report? Please describe each Benchmark or stakeholder and the idiosyncrasies that you identify and the reasons why in your view the Benchmark or stakeholder should be placed outside of the scope of the report.*

Some ISDA members regularly produce customized indices that are used for pricing bespoke bilateral or similar transactions among a limited number of counterparties. We note in many cases that these customized indices should not fall under the scope of the report. Examples would include customized or privately-negotiated indices, reference portfolios or baskets, defined in connection with specific issuances of structured notes, with bespoke transactions to effect investment strategies, or with similar bilateral or limited arrangements. The indices or baskets come in many forms and are in many cases subject to product regulation as a result of the products with which they are used. In some cases the indices or baskets are more connected with the products they are used with and are not free-standing benchmarks which could be separately regulated.

In our view, a regulation should consider the function of a particular benchmark (governance, controls, management, conflict of interest, etc.). In respect of proprietary indices, we believe that adequate regulatory protections already exist, reflected in a number of pieces of European legislation:

- MiFID rules on suitability and appropriateness and on the management of conflicts of interest;
- Recently enhanced Prospectus Directive disclosure provisions relating to indices; and
- Recently enhanced UCITS provisions on the eligibility of a particular index.

Given that proprietary indices are today already subject to a number of governance mechanisms, the main consequence of additional rules in respect of proprietary indices (e.g. the mandatory use of third party calculation agents) beyond governance arrangements already in place would be to increase costs borne by the end investor or otherwise reduce investor choice, without advancing in a meaningful way the level of protection provided to the investor.

ISDA encourages IOSCO to take account of the differences between key public benchmarks and benchmarks in the broader sense (including proprietary indices). In short, not all indices should be regarded as “public goods” and this should be reflected in the design of regulation.

In particular, proprietary indices used by ISDA members are designed to help particular clients implement specific investment strategies or achieve particular investment objectives, rather than to capture or approximate a transaction (e.g. the cost of borrowing in the interbank market, in the case of Libor). Therefore, the policy measures that may be applied to public benchmarks are unlikely to be appropriate for private indices. For example, the level of transparency that might be expected of a public benchmark could not readily be extended to private indices, which essentially constitute intellectual property, without undermining the ability of firms to offer their clients products that offer specific exposures in a cost-effective manner. As noted above in many cases these indices are already subject to product regulation, including disclosure requirements in legislation such as the Prospectus Directive or UCITS legislation.

Chapter 2

Please note that this is a general remark on the matters of governance, transparency and integrity discussed in Chapter 2. We have also provided several additional remarks in response to certain particular questions.

We consider the following governance related criteria to be important:

- Appropriate seniority of and responsibility of staff (so less open to being influenced);
- Complaints process – need for somewhere to raise concerns (independent of benchmark contributors);
- Appropriate consultation with users on changes;
- Systems and controls which lead to reliable daily operations;
- Transparency of methodology, of operation and application of any judgment.

Here we address the specific question of PRAs

Regarding oil PRAs, we consider that the processes – i.e. the quality and integrity of methodologies – must be envisaged from three perspectives:

- the relationship between the PRAs and market participants,
- the relationship between the PRAs and trading venues/derivative contracts, and
- the relationship between the PRAs' methodologies and the market.

Relationship between PRAs and market participants

PRAs are extensively used by all market participants, including consumers and producers of physical oil. The PRAs' price assessments are used as a reference point to price purchases and sales with the intention of effectively buying and selling at the prevailing market prices during the pricing period so limiting risk to the premium/discount of the quality and delivery terms of the oil. This pricing mechanism is common from upstream oil production through the refining system to wholesale pricing of refined products across the globe.

Relationship between PRAs and trading venues/derivative contracts

PRAs produce prices which assess physical markets and these are often reflected in the prices derived by exchange traded futures, directly or indirectly, such as Nymex RB, HO, CL and ICE Brent, Gasoil. The following two examples illustrate the direct and indirect linkages between PRAs and trading venues:

a. **Direct linkage:** This is where the physical markets that are assessed by the PRAs customarily trade as an EFP (Exchange of Futures for Physical) against an exchange futures contract. An EFP occurs when a physical is traded as a fixed differential to a future which is floating until the process of 'posting' the EFP. Posting involves both fixing the price of the physical and exchanging the futures contract as a hedge with a counterpart resulting in no net change in price exposure for both parties. Platts assess EFP premia/discounts in their assessment mechanism. Moreover, because of this direct linkage and the underlying complexities, the different components of the physical and futures legs must efficiently relate to each other and, in that sense, be co-ordinated.

By way of example: Jet Fuel is purchased at April Gasoil + 65 usd/mt in the market and this trade is to be used to form the PRA's assessment. The assessment is formed by taking a price from the exchange of the April Gasoil contract at a specified time and adding the 65 usd/mt premium observed to form the PRA's price publication. This published assessment then forms the settlement mechanism for Jet Fuel physical contracts priced using the assessment on that day.

b. **Indirect Linkage:** In other markets, where OTC swaps markets rather than exchange traded futures function as a hedging mechanism for buyers and sellers, the relationship with exchanges is often through either that swap being customarily traded as an (Exchange of Futures for Swap) EFS to a futures contract (e.g. Singapore gasoil swaps and ICE Gasoil Futures customarily trade as a spread relationship in this way) or through the relationship between the product and crude (the crack spread). A futures contract is not explicitly referenced because the OTC swap replaces the future as a reference price and hedging instrument. However, the OTC swap is, itself, linked to the futures market as it customarily trades as a spread to ICE gasoil, so indirectly the PRA assessment for Singapore Gasoil reflects ICE gasoil prices.

The direct and indirect relationships result in PRA assessments having a very high correlation with futures prices for a large proportion of oil products. This allows the effective hedging of PRA indexed oil purchases and sales on exchanges and is part of the mechanism whereby physical oil consumption and production fundamentals translate to exchange prices. Regardless of whether the PRA establishes the market price, or where the exchange does so, using the PRA relative values, there is a strong and complex relationship between the two.

Relationship between PRAs' methodologies and the market

Following from the above discussion, the methodologies used by PRAs necessarily have an impact on the physical oil and oil derivative markets as traders must deal in a manner and time stipulated by the PRA methodology if they want their trades to be included in the price assessment.

PRAs have a substantial amount of discretion in applying their methodologies e.g. they can decide to exclude trades from their price assessments. Further, they do not have to account for the basis on which they exercised their discretion.

Therefore, concerning oil PRAs, ISDA sees the need for transparent methodologies especially in relation to the substantial discretion exercised in their implementation; there should be a formal complaints process and an adequate compliance function. However, today price assessments essentially operate under governance procedures may be somewhat opaque and which can result in a subjective approach, where there is no appeals process in respect of subscribers' price contributions).

There have been instances where mathematical errors in the published prices were clearly evident to subscribers who can see the trades on the screen and calculate that the prices published are outside the range. Where these discrepancies are noted, subscribers may not have open to them a formal, objective route at the respective PRA to lodge complaints or concerns over errors, PRAs in general lack a formal complaints process, and visible control processes which results in a largely subjective approach where there is no appeals process in respect of subscribers' price contributions.

The PRAs may listen to subscribers' proposals for amendments required to their methodologies however the evaluation of any proposed amendments is not always clear and transparent. Absent an equitable framework for agreeing amendments, the risk of apparent undue influence by either one class of producers or consumers can exist.

We therefore strongly advocate that PRAs must establish a clear and unambiguous framework, including methodology and formulas, all of which are transparent to the subscribers and objectively applied. Such a framework should extend to establishing principles and guidance where formulas are not appropriate and judgment needs to be used by the PRA e.g. in times of limited liquidity. PRA practices must be capable of being monitored internally or externally, including by market participants. Furthermore, there must be procedures in place which will govern any changes to the methodology. These procedures must allow for practitioner consultation and input.

Benchmark design

2. *Do you agree that the design of a Benchmark should clearly reflect the key characteristics of the underlying interest it seeks to measure?*

Yes. Benchmarks should reflect the key characteristics of the underlying interest, since they play a critical role in setting the price of transactions and contracts. As a result, ISDA considers important that entities responsible of such Benchmarks are subject to:

- Transparent methodologies that are subject to independent oversight
- Transparent governance, including robust dispute resolution and complaints processes.

In relation to derivatives, some of the most important factors to take into account would be liquidity of the underlying; as well as high transparency of benchmark development and changes; good governance (i.e., a single, identified authority with specific accountability for the sound operation of the benchmark); and a methodology which suits the underlying. For physical market benchmarks, confidence is more likely to develop where underlying infrastructure is not controlled by any one or a small number of market participants. Also, political stability and transparency of government in the relevant jurisdiction can be key to fostering development of effective benchmarks in some cases.

Quality and integrity of Methodologies

3. *What measures should Administrators take to ensure the integrity of information used in Benchmarking-setting and that the data is bona fide? Please highlight any additional measures required where Benchmarks are survey based. Please also comment on each of the factors identified in the discussion on the 'vulnerability of data inputs' such as voluntary submission, discretion exercised by Administrators. Are these measures adequately reflected in the discussion of roles and responsibilities of the Administrator discussed in section E?*

We acknowledge that there is a tension where indices rely on voluntary contributions, though we believe that if powers to compel participants in financial markets to make submissions to benchmarks exist, they should only be used as a last resort, and where there is a significant risk of widespread disruption. Thought should be given to which body would have power to compel an entity to make a submission to a specific index.

If powers to compel participants in financial markets to make submissions to benchmarks are exercised, it is important that such participants can benefit from "safe harbors" for so long as they act within the scope of the rules of the relevant index.

4. *What measures should Submitters implement to ensure the integrity of information provided to Administrators? Are these measures adequately reflected in the discussion of a code of conduct for Submitters discussed in section E? In particular, should Submitters submit all input data and not a selection of such data so as to maximise the representation of the underlying market? Please comment on any practical issues that compliance with such an approach may give rise to.*

We strongly support transparent methodology for sourcing rates in the case of a rate derived via a panel of contributor firms. Rate definitions should be tightly worded as to how and where contributed rates should be sourced, and alternative rate generation processes should be provided when the preferred method is unavailable/unreliable at any point. Where possible, and provided it is deemed appropriate for a specific rate, we would support the use of live/executable prices, based on a standard contract size. A standard contract size would be determined based on the specifics of each market and the nature of the benchmark to be published.

Regarding specific questions of PRAs please refer to the above general remarks on Chapter 2.

Transparency of Benchmark methodologies

5. *What level of granularity with regard to the transparency of Methodologies would enable users to assess the credibility, representativeness, relevance and suitability of a Benchmark on an on-going basis and its limitations with respect to their intended use? Relevant factors could include; criteria and procedures used to develop the Methodology, type of data used, how data is collected, relative weighting of data used, how and when judgement is used, contingency measures (e.g., methods when transaction data is unavailable etc), publication of information supporting each Benchmark determination, etc. Please provide examples where you consider there are currently significant gaps in the provision of this information.*

Please refer to the above general remarks on Chapter 2.

Transparency of contingency provisions for episodes of market disruption, illiquidity or other issues

6. *What steps should an Administrator take to disclose to Market Participants and other stakeholders the contingency measures it intends to use in conditions of market disruption, illiquidity or other stresses?*

All benchmark rates should have specific, transparent and published processes detailing how the final published rate is calculated. If deemed appropriate, specific measures could be set out detailing if any sort of contingency plan could be invoked in the case of, for instance, severe local circumstances which would prevent a rate from publishing per the standard fixing methodology. An example of this would be in the case of a benchmark which is fixed via a calculation based on a number of panel bank submissions, but fixes only when a minimum level of contributions are received within a certain timeframe. A contingency plan could involve extending the usual window for submissions, lowering the minimum level of contributions required, etc. We consider it essential that any sort of contingency plan is transparent and should only be invoked per the stated definition.

Here we address the specific question of PRAs

Concerning oil PRAs, where there is limited liquidity in the underlying physical markets to form assessments, eg. (Liquid Petroleum Gas) LPG's such as Butane and Propane, there is the possibility that the assessment process can lead to unrepresentative price formation, especially given the substantial commitment required to engage in window mechanisms such as Platts' MOC process for smaller participants.

Where there is low liquidity, PRAs will use:

- the differential between the OTC physical and OTC swaps markets, or
- 'survey the market.'

We are supportive of the differential method used, providing the methodology is subject to the balance and checks noted above. Where possible, our preference would always be to use quotes from a liquid market and apply basis differentials.

Transparency over changes to the Methodology

7. *What steps should an Administrator take to notify Market Participants of material changes to a Benchmark Methodology (including to Benchmark components) and to take their feedback into account?*

We do not consider that there is a solution that would work for every benchmark. Each benchmark should be assessed on its own merit and suitable notification procedures put in place.

Here we address the specific question of PRAs

See question 5: there must be procedures in place which will govern any changes to the methodology. These procedures must allow for practitioner consultation and input.

8. *How often should the Administrator review the design and definition of the Benchmark to ensure that it remains representative?*

As per our response to question 7, we think individual benchmarks should be assessed on their own merit, and a review schedule agreed to by all involved parties, including users of the benchmark.

Governance

9. *The Consultation Report discusses a number of potential conflicts of interest that may arise at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties. Are there other types of conflicts of interest that have not been mentioned that you consider may arise? If so, how best should these conflicts of interest be addressed? Are the measures discussed in the Consultation Report sufficient to address potential conflicts of interests at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties?*

Here we address the specific question of PRAs

In the specific context of PRAs, there is potential for conflicts of interest to arise where PRAs provide both price reporting and news services on oil markets. Where PRAs offer both these services, they should be required to manage conflicts managed through information barriers or Chinese walls to minimise contamination risk of information which could be considered inside or privileged.

10. *Do you agree that the Administrator should establish an oversight committee or other body to provide independent scrutiny of all relevant activities and management of conflicts of interest? Please comment if and why any different approaches might be appropriate for different kinds of Benchmarks. What is the minimum level of independent representation this committee or body should include?*

Here we address the specific question of PRAs

In the specific context of oil PRAs, ISDA believes that the PRAs need to develop transparent procedures around disputes and complaints. These processes should be part of a robust corporate governance regime and independently overseen. In our view, both these steps will enhance confidence around the price discovery processes of these agencies.

ISDA believes that PRAs should be subject to standards of corporate governance in relation to services, in particular when they provide trading services: members of the management body should be of sufficiently good repute and have sufficient experience to ensure prudent management etc.

With respect to corporate governance standards, we believe PRAs should be able to apply corporate governance principles in a way which takes into account the size, structure and requirements of individual firms. Transparency measure on PRAs corporate governance standards and their oversight by an independent body is also important.

Accountability

11. *Should the Submitters establish accountability procedures to assess their compliance with operational standards and scrutiny of Benchmark submissions?*

Here we address the specific question of PRAs

Concerning oil PRAs, as noted above, they provide an essential price discovery function for global oil markets. It is therefore crucial that they have a robust dispute resolution and transparent complaints

processes. It is not always the case and sometimes it is unclear how decisions are made and this leaves the PRAs open to the charge of favouritism. We consider that addressing these concerns would be the most practical step that should be taken.

12. *Are the measures discussed in the Consultation Report (e.g. Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure the accountability of Submitters? Should additional mechanisms be considered?*
13. *How frequently should Submitters be subject to audits? Should these be internal or external audits?*

Accountability of the Administrator

14. *Are the measures discussed in the Consultation Report (e.g., complaints process, Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure accountability of the Administrator? Should additional mechanisms be considered?*
15. *If recommended, how frequently should Administrators be subject to audits? Should these be internal or external audits?*
16. *Is public self-certification of compliance with industry standards or an industry code another useful measure to support accountability? This approach might also contemplate explanation of why compliance may not have occurred. If so, what self-certification requirements would make this approach most reliable and useful to support market integrity?*

Code of conduct for Submitters

17. *The Consultation Report discusses elements of a code of conduct for Submitters. Are the measures discussed (e.g., adequate policies to verify submissions, record management policies that allow the Submitter to evidence how a particular submission was given, etc.) sufficient to address potential conflicts of interest identified or do you believe that other control framework principles should be added?*

Here we address the specific question of PRAs

ISDA believes that self regulation may carry some risks: Specifically it is hard for third parties via a committee to have sufficient power to meaningfully modify behaviour inside PRAs without becoming shadow directors for the purposes of company law. The committees should be structured in a way that ensures that they are not dominated by those with the most significant commercial interests.

The trend over recent years has been a move away from self regulation to more formal regulation, recognizing the benefits of independence providing the regulation is appropriately tailored to the market and supervision is conducted by knowledgeable staff.

As stated above, the nature of this regulatory framework would vary from those applicable to financial markets since PRAs, when they operate like trading venues, are physical trading venues.

ISDA believes that such a code of conduct should be binding, reflect standards set by the authorities and be subject to regulatory scrutiny (financial regulators for financial benchmarks or energy regulators for PRAs for instance).

18. *What would be the key differences in the code of conduct for Benchmarks based on different input types, for example transactions, committed quotes and/or expert judgement?*

Chapter 3

Approaches to enhanced oversight

In response to questions 19-29, we would like to highlight that governance and the application of regulation should always be considered on a careful assessment of the associated costs against the expected resulting benefits. Market impact of the index or benchmark is a further important factor and it is clear that many index/ benchmark prices are important for the functioning of the markets. IOSCO has considered this balance in its review of oil price reporting agencies, in which it recommended that appropriate protections and governance are put in place through self-regulatory principles for PRA benchmark governance. PRAs are thus encouraged to comply subject to independent audit. If satisfactory compliance is not achieved, then other policy instruments, including applying a form of regulation of PRAs should be applied.

Index providers fulfil a high impact and critical role in many markets and as an association of market users, we support any measures designed to ensure that appropriate standards are achieved, provided these can be justified on a cost benefit basis.

We consider regulatory burdens relating to index/benchmark production should primarily fall on the provider of the benchmark, as it has primary control over and responsibility for the final price publication. Many participants who submit to indices/ benchmarks are regulated firms themselves, so extension of regulation to further activity represents additional incremental cost. Again, we consider that any such extension should be considered on a cost-benefit basis. Benchmarks/ indices provide essential transparency to markets and it is important not to impose regulatory burdens which may deter legitimate participation in these processes.

Regulatory reporting of benchmark submissions should leverage existing trade capture and reporting routes already used by many market participants for their existing trading and/ or regulatory reporting activities.

Here we address the specific question of PRAs relevant to Chapter 3

Considering the importance PRAs as benchmarks for physical markets, transparency of methodologies and independent oversight of these methodologies is needed to ensure confidence in the markets.

For the purpose of such needed confidence, ISDA believes that oversight of PRAs activity is necessary, on a basis consistent with other companies engaged in analogous activities. We consider key areas that need addressing are:

- Management controls and oversight,
- Conflict management processes,
- Record-keeping procedures,
- Risk management processes,
- Compliance,
- Business resilience,
- Inducements,
- Complaints and dispute resolution.

Further, as noted above, over time some PRAs have evolved from being price reporters to becoming a trading forum where buyers and sellers interact under rules determined by the PRA (eg. the Platts eWindow) and these prices form a settlement mechanism for physical and financial contracts that reference the index. As such, these PRAs provide services that have the characteristics of regulated execution facilities, however the PRAs have their own self-determined mechanisms and rules and lack independent oversight. PRAs providing such services are not captured under the current regulatory structure.

We therefore consider that when PRAs are providing a material transaction execution function in a market, it is logical to require relevant aspects of their activity to be subject to a regime analogous to that applying to regulated execution facilities. We recognize that there may be physical contracts involved in such execution function; however, we do not believe that this aspect precludes the function from being regulated.

Recognizing the unique nature of the PRA market, it is likely that no one current scheme of regulation would fit it exactly: rather, the appropriate elements of conduct controls applying to regulated firms, together with relevant elements of price formation controls applying to regulated execution facilities should be applied.

Such a scheme of regulation need not and should not require the duplication of regulation across different jurisdictions. Under criteria set by IOSCO, a PRA meeting the regulatory requirements in one state should be recognized for those purposes in other states in which it offers services.

19. What are the advantages and disadvantages of making Benchmark submissions a regulated activity?

20. What are the advantages and disadvantages of making Benchmark Administration a regulated activity?

Regarding questions 19 and 20, we see the following advantages and disadvantages:

Disadvantages:

- Associated cost for both administrators and submitters,
- Firms may consider the risks and costs associated with contributing to be too onerous,

Advantages:

- Controls would be tighter.

21. Do you agree with the factors identified for drawing regulatory distinctions? What other factors should be considered in determining the appropriate degree of oversight of Benchmark activities (discussed in Chapter 3)? Please provide specific recommendations as to how the distinctions discussed in Chapter 3 should inform oversight mechanisms.

22. What distinctions, if any, should be made with regard to Benchmarks created by third parties and those created by regulated exchanges?

There is not a one size fits all approach. Considerations need to be taken into account as to who is contributing to a rate and who is ultimately using the rate, and an informed assessment needs to be made as to what is appropriate.

Here we address the specific question of PRAs

In the specific context of oil PRAs, ISDA supports the idea that when the entity operates like trading venues, it should be subject to regulatory oversight as trading venues.

23. Assuming that some form of enhanced regulatory oversight will be applied to an asset class Benchmark, should such enhanced oversight be applied to the Submitters of data as well as the Administrator?

24. What are the considerations that should be taken into account if the Submitters to a Benchmark operate in an otherwise unregulated market (e.g., physical oil, gold or agricultural commodity markets) and are not otherwise under any obligation to submit data to an Administrator?

25. Do you believe that a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks

that have been identified in Chapter 2? What measures should be established in conjunction with a code of conduct? For which Benchmarks is this approach suitable?

- 26. What other measures outlined in the report, if any, should apply in addition to a code of conduct? If you believe a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2, what type of code of conduct should apply (e.g., a voluntary code of conduct, an industry code of conduct submitted to and approved by the relevant Regulatory Authority, a code of conduct developed by IOSCO, etc.)?*
- 27. Do you believe that the creation of a Self-Regulatory Organisation (.e.g., one that exercises delegated governmental powers) and itself subject to governmental oversight, whether or not in conjunction with industry codes is a viable alternative for sufficient oversight and enforcement to mitigate the risks that have been identified in Chapter 2? For which Benchmarks is this approach suitable? What if any complementary arrangements might be necessary, such as new statutory obligations or offences for Administrators and/or Submitters?*
- 28. Do you believe that, for some Benchmarks, reliance upon the power of securities and derivatives regulators to evaluate products that reference a Benchmark or exercise their market abuse or false reporting powers creates sufficient incentives for the Administrator to ensure sure that Submitters comply with a code of conduct?*
- 29. Do you believe that users of a Benchmark, specifically, the users who are regulated or under the supervision of a national competent authority should have a role in enhancing the quality of Benchmarks? Which form should this role take: on a voluntary basis (e.g. the user being issued a statement that will only use Benchmarks that follow IOSCO principles), or on a compulsory basis (e.g., the competent authority could request that users who are registered under their jurisdiction should only use Benchmarks that fulfil IOSCO principles)?*

Chapter 4

Data sufficiency

30. *Do you agree that a Benchmark should be anchored by observable transactions entered into at arm's length between buyers and sellers in order for it to function as a credible indicator of prices, rates or index values? How should Benchmarks that are otherwise anchored by bona-fide transactions deal with periods of illiquidity due to market stress or long-term disruption?*
31. *Are there specific Benchmarks for which you consider that observable transactional data is not an appropriate criterion or the sole criterion? If so, please provide a description of such Benchmarks and what value you think such Benchmarks provide?*
32. *What do you consider the limitations or value in Benchmarks referencing asset classes and underlying interests where there is limited liquidity? Please describe the uses and value of such Benchmarks in the financial markets.*
33. *Do you agree that the greatest weight should be given to transactions in the construction of a Benchmark and that non-transactional information should be used as an adjunct (e.r., as a supplement) to transactions?*

At a high level with regard to methodology, we generally support the use of actual trade data (where available) in benchmarks' compilation. At the same time, we acknowledge that it will likely still be necessary to deploy algorithms or expert judgment subject to appropriate governance and systems and controls safeguards still plays a part even where actual trade data exists, given that the decision to transact the trade(s) depends upon the exercise of such expert judgment.

As noted earlier, ISDA maintains ISDAFIX, a benchmark based on a mid-day and, in some markets, end-of-day polling of mid-market rates. ISDA members also make use of other benchmarks, although ISDA is not responsible for the maintenance of those benchmarks, or the methodology that underlies them.

Separately, many ISDA members maintain proprietary indices to help track the performance of a particular asset class or sector, and potentially to determine the pay-off on structured products, including exchange-traded funds (ETFs), notes, certificates and warrants. A proprietary index might reference a basket of securities relating to a particular sector or market (a basket of emerging market securities, government debt, corporate debt), or physical assets, such as commodities (precious metals, energy resources, for example), or a combination of asset classes and sectors. Typically the value of such indices is derived from market data on its constituent assets, collected and weighted according to the documented, rules-based methodology of the index. The internal governance structures designed around the development of these proprietary indices may require the calculation, or at least the verification, of the levels of such indices by independent third parties. The existence of such indices allows an investor to gain exposure to a given sector or class of assets (i.e., making it easier to gain exposure to multiple reference assets), whilst avoiding many of the difficulties and costs associated with arranging a direct investment in the underlying reference assets.

Finally, in relation to wholesale energy markets, indices and benchmarks produced by PRAs are based on actual transaction data, on bids and offers and on opinion obtained from a panel, in that order of preference.

34. *What factors and how often should Administrators (or others) consider in determining whether the market for a current Benchmark's underlying interest is no longer sufficiently robust? What effective methods of review could aid in determining the insufficiency of trading activity within the market for a Benchmark's underlying interest?*

Transition

35. *What precautions by Benchmark Administrators, Submitters, and users can aid Benchmark resiliency during periods of market stress, mitigating the potential need for market transition?*
36. *What elements of a Benchmark “living will,” drafted by a Benchmark Administrator, should be prioritised?*
37. *By what process, and in consultation with what bodies, should alternatives be determined for Benchmark replacement?*

We think individual benchmarks should be assessed on their own merit, and a review schedule agreed to by all involved parties, including users of the benchmark.

We encourage policymakers to ensure international coordination and alignment of regulatory changes which relate to international markets.

38. *What characteristics should be considered when determining an appropriate alternate Benchmark? (Examples below) Should any of these factors be prioritised?*

- *Level and Type of Market Activity*
- *Diversity/Number of Benchmark Submitters*
- *Length of historical price series for the Benchmark alternative*
- *Benchmark Methodology*
- *Existing regulatory oversight*
- *Existing enforcement authority*
- *Volume, tenors and contract structure of the legacy trades*

39. *What conditions are necessary to ensure a smooth transition between market Benchmarks?*

In this response, we have limited ourselves to providing mainly comments regarding the challenges created by a transition from contracts relying on **Libor** to future contracts.

As the trade association for OTC derivative products, our comments below relate solely to those products, whilst recognising that changes to Libor or a transition away from it will also impact other products in other markets which often underlie **OTC derivatives transactions**. Within the OTC derivatives markets, interest rate derivatives are the most heavily impacted asset class. We offer some detailed analysis of how trades might be affected by changes to or a move from Libor, according to the terms of their ISDA documentation and in the wider context of incident legal risk.

The majority of OTC interest derivatives transactions use Libor rates as the reference rate for floating legs of transactions. These transactions are typically **documented** under an **ISDA Master Agreement and a trade Confirmation**, which will reference the relevant published **ISDA Definitions**. The Definitions give formal and detailed descriptions for all of a transaction’s variables that will be referenced in the trade Confirmation. In other words, the Definitions remove the need to restate the often lengthy descriptions of commonly-used trade attributes in Confirmations. This has an important risk reducing effect in that it enables rapid (often electronic) turnaround times, given that the Confirmations can be brief in that they refer to, rather than restate the Definitions. The main operative booklet of definitions with respect to Libor is the “2006 ISDA Definitions”.

In essence the definitions of Libor rates are very much **page-driven**, by which we mean that the rate for (say) GBP Libor is defined as being the rate that appears on Reuters screen LIBOR01 (or an equivalent page in the case of the Bloomberg definition). Defining the rates in this way means that

the Definition should be able to accommodate a certain amount of change to the rate in terms of methodology of compilation, for instance, so long as the rate still appears on the given page.

Clearly, however, there are limits to this and as **changes** become more economically significant, and to the extent that Libor is fundamentally changed into something else (even if its description does not change and even if it continues to fall within the strict wording of the definition), so the risk increases that parties may claim, under doctrines of frustration or otherwise, that the contract is not what they bargained for (see below). The definition provides that where the rate is not published at all, parties will revert to the polling of specified numbers of so-called "Reference Banks" to arrive at a rate themselves.

ISDA member firms support the final proposals the BBA has made in terms of the currencies and maturities of LIBOR that will be discontinued.

Of the 5 currencies to be discontinued, ISDA only publishes definitions for the AUD and CAD rates. Parties using any of the other 3 rates will presumably have had to define these rates in their own bespoke documentation and would need to act in accordance with its terms in the event of discontinuation. That said, we suspect that trade volumes here to be very low. With respect to AUD and CAD, data from the DTCC Global Trade Repository indicates there is only a handful of extant trades, meaning that the Reference Banks fallback should work effectively i.e. that firms should be able to conduct polls, albeit manually, in order to calculate a rate, or else firms can bilaterally agree an alternative, suitable local rate to use.

The discontinuation of the specific maturities presents more of a problem, as we believe the outstanding number of trades to be such that the market would not be able to support a trade by trade solution. In addition, the "Reference Banks" mechanism for determining rates for discontinued maturities faces the same issue that the Wheatley Review is looking to resolve, i.e. no transaction data to corroborate submissions. This essentially means that the industry needs to seek a solution to deal with this effectively.

The problem that exists is that the majority of confirmation documents are unlikely to specify the use of interpolation for trades with discontinued maturities. The only way to legally change a confirmation retrospectively is for the parties to agree to that amendment. Agreeing and affecting such amendments bilaterally would be cumbersome, but ISDA could facilitate this process by publishing a protocol, which firms would need to adhere to in order to amend their contracts with the other parties. This would be a voluntary process and both parties would need to adhere to the protocol for it to be useful. ISDA continues to assess the market impact of the maturities and currencies to be discontinued, and is working with the industry to agree a solution to minimise market disruption.

Should discontinuation be considered for **other benchmarks in the interbank market** a few general issues need to be taken into account. An initial obstacle here in the interbank market will be that the parties will need to agree upon which **Reference Banks** to approach, if this is the defined or agreed fallback, should a benchmark no longer be available. Once agreed, polling can take place, however it is possible that strictly speaking thousands of polls may need to be conducted on a trade by trade basis and it is highly unlikely the market could support this burden of activity. Even if all the polls were conducted in a timely and orderly manner, each would yield a different result. This would mean that a party with (say) 2 resetting trades with 2 banks would see those trades reset at different levels.

Changes would be required to the standard ISDA **documentation** to give effect to changes, once their details were known, or to address the consequences of the outright discontinuation of an interbank rate, both in respect of the "back book" of legacy trades and to cover new trades on a going forward basis. The market would need to migrate to a successor rate or rates (pre-existing or

otherwise) in respect of each rate that was discontinued, be that a more minor rate such as AUD or a major one such as GBP. ISDA could publish Supplements to its Definitions to facilitate changes to contracts necessary to reference any newly-published successor rates.

To facilitate the use of successors in legacy trades, ISDA would likely publish a **Protocol** which would have the effect of amending OTC derivatives contracts between adhering parties so as to convert their back book trades to reference the agreed successors. It would be absolutely vital to have clear and long term transition arrangements in place, given that the market will take time to migrate liquidity to new rates. It is important to note that adherence to an ISDA Protocol is entirely voluntary, and market participants will only adhere if they perceive that it is in their interest to do so. For the Protocol to be as effective as possible a significant period of time is required so that as many market participants as possible can participate, and can have the opportunity to do so as they see liquidity migrating to the new rate sources. Without such transition arrangements, the ensuing market disruption could be potentially unmanageable.

We have mentioned the **risk of claims of contractual frustration** a number of times, and now turn to cover this in more detail in the context of OTC derivatives portfolios covered by English law-governed ISDA Master Agreements. As suggested above, there is likely to be something of a continuum from minor changes that could most likely still be regarded as falling within the existing definitions of the floating rates, through to more significant changes that could lead some market participants to claim under doctrines of contractual frustration or otherwise, that the nature of their contract had changed fundamentally from what they had originally intended. It is certainly unclear at which point one becomes the other, and we hope that changes could be managed in such a way that it is not tested.

Under the English law doctrine of frustration a contract may be discharged if broadly speaking, after its formation supervening events occur which have the effect of either (i) frustrating the contract's commercial object or purpose or (ii) making its performance impossible. It is unclear whether major changes to a rate, or its discontinuation, would be grounds for a valid claim of frustration or under some other doctrine but it will be clear those changes to or discontinuation of a rate potentially brings us into this territory and indeed some of the decided cases touch on these very points. As mentioned above, the 2006 ISDA Definitions provide a fallback to Reference Bank polling in the event that a given rate disappears from a page, so to a degree direct contractual provision has been made for the eventuality of a rate's discontinuation. On the other hand, as noted above, that fallback might not prove workable in practice. We believe that there is a risk that discontinuation of a rate or changes other than those that are clearly economically immaterial to its calculation, could give grounds for claims of contractual frustration. We urge the authorities to bear this in mind as they contemplate the future of a benchmark, both in its current form or some other, in order to avoid the major market disruption that the uncertainty of any such claims would cause.

Additional analysis would be required to assess the risk of claims under doctrines such as contractual frustration (or any local equivalent) in respect of ISDA Master Agreements governed by anything **other than English law**. We understand that concerns similar to those noted above could arise under New York law. New York or English law is the governing law for most OTC derivatives contracts.

Moreover, there should be **alignment with existing regulatory initiatives**. Particularly, if transactions are to be reported, then existing reporting databases, systems and reporting routes should be leveraged. It would be highly disadvantageous to require another regulatory reporting system from market participants when in most cases they already submit to more than one. Appropriate time should be allowed for introduction of changes. Finally, we encourage policymakers to ensure international coordination and alignment of regulatory changes which relate to international markets.

40. What considerations should be made for legacy contracts which reference a Benchmark in transition? To what extent does a substantive legacy book preclude transition away from a

Benchmark? What provisions can be included in [new and existing] contract specifications which would mitigate concerns if and when a Benchmark transitions occurs?

Please see response to question 39.

41. How should a timeframe be determined for market movement between a Benchmark and its replacement? What considerations should be made for:

- *Altered regulatory oversight?*
- *Infrastructure development/modification?*
- *Revisions to currently established contracts referencing the previous Benchmark?*
- *Revisions to the Benchmark Administrator?*
- *Risk to contract frustration*

ISDA believes that there should be clear and long term arrangements in place to manage any transition to alternative benchmarks. Failure to achieve a smooth and progressive transition will result in major market dislocation and significant “jump risk” if there is an abrupt move from old benchmarks to a successor. The rate of any transition will likely be chiefly determined by the speed of migration to an alternative in terms of liquidity as well the extent to which market participants have amended their documentation.

Regarding revisions to currently established contracts referencing the previous benchmark and risk to contract frustration please see response to question 39.

ANNEX 2: ISDAFIX and other benchmarks used by ISDA members

ISDA FIX

ISDAFIX is the leading benchmark for annual swap rates for swap transactions worldwide. This screen service provides average mid-market swap rates for six major currencies at selected maturities on a daily basis. ISDAFIX rates are based on a midday polling and, in some markets, an additional end-of-day polling of mid-market rates. ISDA established ISDAFIX in 1998 in co-operation with Reuters (now Thomson Reuters) and Intercapital Brokers (now ICAP plc.).

ISDA developed ISDAFIX to facilitate the determination of exercise values for cash-settled swap options. The existence of such a benchmark provides a transparent, readily available value to which parties to a transaction can refer as a settlement rate. Without such a benchmark, it might be necessary to go through the process of calling a number of active dealers for quotes in order to settle transactions. The 2006 ISDA Definitions refer specifically to ISDAFIX rates as a means of settlement of over-the-counter derivatives transactions. In the sample Swaption Confirmation in the 2006 ISDA Definitions (Exhibit II-E), for example, the parties can include 'ISDA Source' - that is, ISDAFIX - as the reference settlement rate under Settlement Terms.

ISDAFIX is also used as a reference rate for cash settlement in connection with early terminations of swap transactions. In addition, dealers often use ISDAFIX as an input when marking their swap portfolios to market.

Beyond their use in settling over-the-counter-traded transactions, ISDAFIX rates are also used as a rate or curve source in various exchange products. LIFFE, for example, uses ISDAFIX as the source of the swap curve in calculating the settlement price of its Swapnote futures contract. In addition, both the Chicago Mercantile Exchange and the Chicago Board of Trade use ISDAFIX as the settlement price in their swap futures contracts. In the United States, the Federal Reserve uses ISDAFIX as the source for USD swap rates in its H.15 Statistical Release.

At present, ISDAFIX provides rates for euro (EUR), Hong Kong dollar (HKD), Japanese yen (JPY), British pound (GBP), Swiss franc (CHF) and U.S. dollar (USD). In addition, ISDAFIX provides USD swap spreads. Contributed rates are collected by Thomson Reuters or ICAP, tabulated and then posted alongside the calculated ISDAFIX rate on the applicable Thomson Reuters screen at various times throughout the day.

In relation to ISDAFIX, contributor member firms are selected by ISDA in consultation with ICAP and Thomson Reuters on the basis of reputation among dealers, credit standing, scale of activity in the relevant market, and expertise in the currency concerned. Dealers that consistently fail to provide rates or provide rates that are off the market will be replaced at ISDA's discretion.

Rate Definition

The contributor is asked to provide a rate which is the mean of where that dealer would itself offer and bid a swap in the relevant maturity for a notional equivalent amount of US \$50 million or whatever amount is deemed market size in that currency for that tenor to an acknowledged dealer of good credit in the swap market. The rate should not be where the dealer sees mid-market away from itself, but should be a function of its own bid/offer spread.

Polling and Computation

The USD contributions are collected by ICAP and the rate is calculated by Thomson Reuters, all other contributions are collected and the rate calculated by Thomson Reuters.

Contributions collected and calculated by Thomson Reuters (CHF, EUR Euribor, EUR LIBOR, GBP, HKD, JPY)

Contributors contribute rates to Thomson Reuters in line with the rate definition above by electronic interface. Contributors are asked to provide rates for the full set of designated maturities of the given ISDAFIX currency within a polling window. Quotes may be submitted to five decimal places. The published rate will be to three decimal places. In the event of technical difficulties, the Contributor can provide their rate to Thomson Reuters via email or phone. The rates are observed and recorded at the end of the polling window following which Thomson Reuters will calculate the ISDAFIX rates and publish them.

Thomson Reuters will calculate the ISDAFIX rate by eliminating a given number (“topping and tailing”) of the highest and lowest rates submitted, and then by calculating a simple average of the remaining rates. A rate will be posted as long as a certain number of contributions (“Minimum Number of Contributions”) are received.

In the event a contributor does not provide a contribution for the full set of maturities within a given currency, none of their contributed rates will be included in the ISDAFIX rates for that currency that day.

During the polling window, panel members may update or amend a rate that they have contributed. Following the window, contributed rates can not be amended or withdrawn and are considered final.

Contributions collected by ICAP and the rate calculated by Thomson Reuters (USD, USD Spread):

ICAP collects spread information from contributors via a secure website that contributors log into every morning. Contributors are asked to indicate the USD swap spread as of 11:00 am, in accordance with the criteria set by ISDA as detailed above. At 10:58 am, ICAP will send an email reminder to each contributor reminding them to contribute. At 11:02 am, ICAP will indicate on the secure website a USD swap spread and USD swap rate to serve as a reference point for contributors. This reference point is generated from two sources of information:

- (1) Information contained on Reuters page 19901 at 11:00 am, which reflects the most recent swap spreads from completed trades and executable bids and offers in market size done/posted at ICAP.
- (2) Information reflecting executed trades and executable bids and offers at 11 a.m. for US Treasury securities from ICAP’s BrokerTec US Treasury electronic trading platform.

By their nature, because both sources of information reflect completed transactions and/or at-risk trading interest, ICAP considers them to be a useful and meaningful reference point for where the market may be at that point in time.

From 11:00 am to 11:15 am, contributors are able to submit their swap spread information and rate to the secure website. In terms of process, contributors may accept the reference swap spread and/or rate indicated on the website, or submit different values. During this time the ICAP swaps desk monitors dealer participation to ensure that the 10-bank minimum is met. As contributors submit spread and rate information, the values are sent to Thomson Reuters on a streaming basis.

At 11:26 am, Thomson Reuters will calculate the USD ISDA FIX rate by eliminating a given number of the highest and lowest rates submitted, and then by calculating a simple average of the remaining rates. A rate will be posted as long as the Minimum Number of Contributions is received.

For more information: <http://www2.isda.org/asset-classes/interest-rates-derivatives/isdafix/>

Other benchmarks used by ISDA members

ISDA has more than 800 members from 50 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearing houses and other service providers. As a result, our members are using a wide range of benchmarks for different purposes. Among them, the following may be noted:

- EURIBOR and LIBOR are used to price notional interbank loans as a reference for interest rate swaps, as well as to price commercial loans or be the reference interest rate in a retail mortgage or consumer credit contracts;
- EONIA, which indexes actual overnight transaction rates (in euros – just as SONIA does for sterling);
- Overnight Index Swaps ('OIS') are based on such an index of overnight rates;
- ISDAFIX, to facilitate the determination of exercise values for cash-settled swap options (Please refer to question 1);

In the commodities markets, exchange-traded benchmarks including CME/ NYMEX and ICE (Oil complex, Natural Gas, soft commodities, metals), CRB (commodities) as well as benchmarks of price reporting agencies (Platts, Argus, ICIS, McCloskey, Point Carbon), are used to price derivatives and hedging instruments.