ISDA comments on the Greek Presidency note on benchmarks, dated 9 May 2014

26 May 2014

ISDA is pleased to have the opportunity to comment on the Greek Presidency note of 9 May 2014.

1 - Key issues

- The **scope** should be made proportionate by considering the diversity of benchmarks, in order to establish an effective benchmarks regime (See 2.1);
- With the goal of reflecting real market developments, the definition of **'critical benchmark'** should be cumulative, and based on qualitative and quantitative factors (See 2.2).
- When the input data contributing to a benchmark is **regulated data**, certain requirements for the front office should not be applicable, on grounds of proportionality (See 2.4);
- Important clarifications are required, in order to know to what extent an administrator can **disclose** details of index methodology, without infringing **intellectual property rights** or confidentiality agreements (See 2.6);
- Since in many non-EU jurisdictions, there is no equivalent regulatory framework on benchmarks (or no regulatory framework at all), **the equivalence regime (Art. 20)** could seriously undermine EU competiveness (See point 2.7).

2 - Comments

2.1 - Scope (Art. 2)

In order to strike a necessary balance between integrity and proportionality, we suggest a definition of '*de minimis* benchmark', under which the appropriate benchmarks are exempted from the Regulation, provided that any of certain specific circumstances (developed by ESMA), are met. These would refer to certain benchmark characteristics that would make the application of the Regulation duplicative or disproportionate.

We welcome extending the exemption in Art. 2.2 (*'The Regulation shall not apply ...'*), e.g., to public bodies which have control over the provision of benchmarks used for public policy purposes. Additionally, we understand that as written, this provision covers relevant EU public bodies, as well as non-EU public bodies, which could partially minimise the negative impacts caused by the current 'equivalence regime' (Art. 20).

Yet, Art. 2 does not address the issue of proportionate application of the proposal. The text is still applying the same set of rules to a great diversity of benchmarks, e.g., public and bespoke alike. Bespoke indices are sometimes designed for a limited number of sophisticated users. As such, they are not subject to the same systemic risks or regulatory concerns, as those for public benchmarks widely used in the markets.

In **order to strike a necessary balance between integrity and proportionality,** we suggest a definition of '*de minimis* benchmark', under which appropriate benchmarks are exempted from the Regulation, provided that any of certain specific circumstances (developed by ESMA), are met. These would refer to certain benchmark characteristics that would make the application of the Regulation duplicative or disproportionate.

Please refer to amendment 1 of the list.

2.2 - Critical benchmarks (Art. 3.1.21)

With the goal of reflecting real market developments, the definition of "critical benchmark" should be cumulative, and based on qualitative and quantitative factors.

The new definition of 'critical benchmark' is heading in the right direction. Replacing the previous singular criterion (viz., a fixed threshold related to a notional amount), with some qualitative factors (e.g., financial stability), would provide some positive effects, such as avoiding the cliff-effect and taking into account some market developments.

However, we are concerned that, since the limits of the definition are not sufficiently clear, the current proposal raises legal uncertainty issues. Art 3.1.21.1(a) does helpfully establish a few criteria, which somewhat determine benchmark criticality. However, in our view, more elaboration on these criteria and their application, as well as adding some additional criteria, would be helpful for providing necessary clarity. Consider the following cases:

- Art. 3.1.21.1(a): The 'aggregate notional value of financial instruments', needs to be framed within a specific timeline, in order to truly assess the impact of a benchmark from a notional value standpoint. Additionally, the calculation method to obtain this notional amount should be specified in Art. 3.2 (via Level II).

- Art. 3.1.1.21.1(d): The 'possibility of substitutions of the benchmarks with other available benchmarks' could be supplemented with other kinds of 'substitute' apart from 'available benchmarks'. In some cases, although there is no 'available benchmark' as substitute, there are solid and effective mechanisms, which can avoid 'significant impact on financials stability'.

- Art. 3.1.21.1(f) (New criterion): The data of the benchmark is compiled from Regulated data as defined in Art. 3.1.11.

Otherwise, as an alternative to these additional clarifications, we suggest a cumulative definition based on qualitative and quantitative factors, which would include that of significant impact on financial stability.

Please refer to amendments 2 and 3 of the list.

2.3 - Code of conduct (Art. 9)

Contributors should be closely involved in the drafting of the code of conduct (which establishes control requirements for non-supervised contributors).

We understand that the earlier proposed obligations for administrators and contributors, as well as the legally binding nature of the code of conduct, have been deleted from the current proposal. Instead, the administrator is responsible for compliance with the 'code of conduct' *('shall make sure'*), and the competent authority needs to be informed as to the relevant processes and methodologies for achieving this.

But additionally, obligations of the code of conduct should not deter participants from contributing to a benchmark. Hence, contributors should be involved in the definition and drafting of the code of conduct, and should be consulted prior to the adoption of Commission delegated acts regarding terms of the code.

Thus, we recommend that Art. 9.2 explicitly mention that the administrator shall consult relevant contributors before adoption of the code of conduct.

Please refer to amendment 4 of the list.

2.4 - Regulated data (Art. 10)

With the goal of reconciling calibration with adequate internal oversight**,** certain obligations, particularly related to the front office, should not be applied when the input is regulated data.

We welcome the extension of dis-applicability to some governance requirements, on proportionality grounds. We believe that some requirements of the Regulation should not be applied to benchmarks produced using regulated data (Art. 10), given that the risk of manipulation is extremely limited. We also think that further adjustments are needed, to ensure that high standards of governance and internal controls are met, in a way that is feasible and appropriate considering the wide variety of benchmark producers in the EU.

In particular, Annex I Section A I points 6-8, appear to not be always necessary (where a benchmark is produced entirely using regulated data) - or proportionate (for benchmarks which are not widely referenced in products by market participants) - or sometimes not even achievable (e.g., in the case of pre-submission controls for same-day automated indices). In order to address all of this, an amendment is needed, restricting applicability to only benchmarks not produced using regulated data, and allowing post-submission verification where necessary.

For example, Annex I A Section 1.8, states that administrators shall not accept input data from office functions, unless there are adequate oversight and verification procedures, including *"physical separation of employees in front office function and reporting lines"*. This could dis-incentivise some firms from contributing, since, in some cases, individual contributors need to have front office knowledge and expertise in order to make sensible contributions. Additionally, such pre-submission controls could lead to the discontinuance of many indices due to prohibitive costs.

Please refer to amendment 5 and 12 of the list.

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2.5 - Required contribution (Art. 14)

In order to avoid harmful consequences for the benchmarks process (i.e., unfit contributors and inaccurate data), required contributors should be able to challenge the mandatory contribution detailed in Art. 14.

We note that required contribution is not automatically triggered as mentioned in the original proposal (e.g., at a 20% threshold). Instead, there is to be a helpful assessment of the implications when one or more contributors intending to cease contributing.

Although the Presidency note helpfully recognises some circumstances, where the required contribution can be challenged ('it is materially impossible to contribute', Art. 14.a), we believe that such an objection framework should be detailed for legal clarity and certainty. In fact, we consider that supervised entities should be aware of the steps to take regarding objections, as well as have some transitional time to implement a new set of requirements.

Please refer to amendment 6 of the list.

2.6 - Transparency of input data (Art. 16)

Important clarifications are required, to know to what extent an administrator can disclose details of index methodology, without infringing intellectual property rights and confidentiality agreements.

In respect to transparency obligations, the Presidency note introduces some exceptions to the disclose requirements, which in some cases can provide some comfort ('except where publication would have serious adverse consequences for the contributors'). However, we would like to have more clarity on to what extent the administrator can disclose details of index methodology, without infringing intellectual property rights and confidentiality agreements. A suggestion addressing this would be administrators shall ensuring that confidential agreements and intellectual property rights are nor infringed when publishing the input data.

Please refer to amendment 7 and 8 of the list

2.7 - Equivalence (Art. 20)

Unless we have a realistic and effective equivalence regime (based on the administrator compliance with IOSCO principles) , the EU economy will suffer several major harmful consequences (e.g., sudden withdrawal of liquidity in products referenced to a non-EU benchmark; serious undermining of European banks in hedging their FX risks vis-à-vis non-EU currencies, and comparative disadvantage for non-EU banks).

Although we welcome the introduction of a transitional period from three years, this still does not address the following problems posed by Art. 20:

A - Non-EU jurisdictions as equivalent

We would like to outline **how difficult** it will be to regard any non-EU jurisdictions as **equivalen**t, since most of them have not yet put in place any of the regulations needed to enable this (as specified by

IOSCO[1] in its Principles report). In fact, in that document, IOSCO recommends members to consider, whether they should take regulatory action to encourage implementation of the Principles.[2] Moreover, the text mandates a review process starting 18 months after report publication, to assess how far the Principles have been implemented.

As a result, it is likely that many IOSCO members will be considering whether, or to what extent, any regulatory action on benchmarks should be taken (since the G20 Saint-Petersburg declaration is ambiguous[3]). On top of this, such regulatory action may not take the form of legislation; and even if it does, it may not contain all provisions equivalent to those in the proposed Regulation.

B - Negative effects

We believe that, the proposed equivalence procedure is likely to seriously limit the availability of non-EU benchmarks within the EU. This would result in a significant reduction of benchmarks at the disposal of EU banks, investment firms, insurers, and corporates (via banks). For instance, use of common indices provided by non-EU exchanges, non-EU central banks (e.g., the US) or monetary authorities, as well as the TIBOR (Tokyo Inter-Bank Offered Rate), would be restricted, unless an equivalence decision is taken by the Commission (a very uncertain outcome, as noted above).

Our over-arching concern is that, unless the equivalence procedure is more realistic, i.e., focused on IOSCO Principles, the competiveness of EU companies, financial markets, and market choice in general, will be seriously undermined. In order to illustrate this, the following possibilities may be noted:

- A sudden withdrawal of liquidity in products referencing a non-EU benchmark;
- Supervised entities (currently using benchmarks provided by non-EU administrators) forced to sell existing holdings or to modify existing contracts - it is worth noting that the proposal does not include any indication as to how and within what timeframe such entities should liquidate their positions, **as there is no transitional framework for non-EU benchmarks in Art. 39**;
- European banks' capacity to hedge FX risks vis-à-vis Asian economies, would be extremely limited;
- Non-EU users operating in third-country jurisdictions would enjoy significant comparative advantage, since non-EU entities would be able to choose between benchmarks provided by administrators either in EU or in third countries; thus creating a non-level playing field to the disadvantage of EU market participants

With this background,, we suggest as alternatives to the current equivalence approach in Art. 20: A two-pillar approach founded on the IOCO principles.

[1] In the July 2013 IOSCO final report on Principles for Financial benchmarks, p. 7 - "The majority of IOSCO members do not currently regulate benchmark administrators or submitters."
[2] "Following the publication of the IOSCO Principles on benchmarks, IOSCO intends to review, within an 18-month period, the extent to which the Principles have been implemented."
[3] Point 72-"We endorse IOSCO's Principles for Financial Benchmarks and look forward to reform as necessary of the benchmarks used internationally in the banking industry and financial markets, consistent with the IOSCO Principles".

1- A regime, which is based on adequate implementation of the IOSCO Principles by the non-EU administrator. In this regard, the supervised entity or the non-EU administrator must demonstrate to ESMA that such compliance is effective (e.g. legal framework, supervisory and rules of administrators). If this is the case, ESMA shall introduce the relevant administrator into a special register that would allow it to be used in the EU. Additionally, ESMA will issue RTS clarifying the details of the register and how to demonstrate compliance with IOSCO principles.

2- Non-EU benchmarks can be provided in the EU, provided that IOSCO and ESMA have positively assessed the implementation of the IOSCO principles in their respective non-EU jurisdictions (via the corresponding review conducted 18 months after the Principles report publication).

Please refer to amendment 9, 10 and 11 of the list

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