Benchmarks: ISDA comments on the agenda of the 24 July Council Working Group meeting (Italian Presidency)

31 June 2014

We are pleased to have the opportunity to comment on the Italian annotated agenda for the 24 July working group meeting.

1 - Key issues

- The definition of '**critical benchmark**' should be cumulative, and based on qualitative and quantitative factors, in order to allow market participants to clearly identify which benchmarks fall within this definition (See 2.1);
- Calibration should be introduced into the obligations pertaining to the code of conduct; and contributors should be closely involved in the drafting of this code, which establishes control requirements for non-supervised contributors (See 2.2);
- To avoid unfit contributors and inaccurate data harming the benchmarks process, those subject to mandatory contribution in Art. 14 should be able to challenge it (See 2.3);
- Important clarifications are needed, in order to know when an administrator can **disclose** details of index methodology, without infringing **intellectual property rights** or confidentiality agreements (See 2.4).
- Unless the problems posed by the 'transitional provisions' (Art. 39) are addressed - problems including penalising those who use non-EU benchmarks, and an unhelpful one-size-fits-all approach - there is risk of major EU market dislocation, and significant 'jump risk', given the resulting abrupt move from old benchmarks to successors (See 2.5);

2 - Comments

2.1 - Critical benchmarks (Art. 3.1.21)

With the goal of reflecting actual developments in the marketplace, the definition of 'critical benchmark' should be cumulative, and based on qualitative and quantitative factors. This is a definition where legal clarity and certainty are vital, since 'critical benchmark' is the cornerstone for applying the two-tier approach involving administrator obligations.

The newer definition of 'critical benchmark' heads in the right direction, as it introduces some qualitative (e.g., financial stability) and somewhat quantitative factors. These modifications are partly positive, helping to avoid the cliff-effect, and taking into account some market developments.

"critical benchmark' means *a benchmark which, if it were to cease being provided or whose integrity were to be put in doubt, would have significant adverse impact on market integrity and financial stability. The following quantitative and qualitative criteria shall be used to determine a critical benchmark:*

(a) The majority of contributors to the benchmarks are supervised entities;

(b) The aggregate notional value of financial instruments being referenced by the benchmark exceeds 500 billion euro;

(c) The benchmark is reasonably deemed by the national competent authority to pose a potential threat

(i) To the liquidity and stability of domestic financial markets;
(ii)For manipulation given the historical pattern of rate submissions and taking into consideration the credit quality and liquidity position of the contributors.

(d) The benchmark comprises a complex structure of contributed information."

However, since there is no further guidance, and the definition is not based on cumulative criteria, the current proposal raises legal certainty concerns - Market participants would not be able to know in advance which benchmarks fall within the definition. In our view, Art 3.1.21, as proposed in the agenda, implies that competent authority would enjoy significant discretion in establishing whether or not a benchmark is regarded as 'critical'. This discretion stems from the fact that *"adverse impact on market integrity and financial stability"* - an inherently ambiguous concept - would be determined by the following criteria, giving additional discretion to the authority:

(a) "*The majority of contributors to the benchmarks are supervised entities."* It is not precisely clear what number or percentage of supervised entities is required to fulfil this criterion - merely 51% or 'higher' figure?

(b) *"The aggregate notional value of financial instruments being referenced by the benchmarks exceeds 500 billion euro."* We consider that this aggregate value needs to be framed within a specific timeline, in order to truly assess a benchmark from a notional value standpoint. Moreover, the calculation method to obtain this figure, is not specified in the text.

(c) *"The benchmark is reasonably deemed by the national competent authority to pose a potential threat:*

(i) To the liquidity and stability of domestic financial markets;
(ii) For manipulation given the historical pattern of rate submissions and taking into consideration the credit quality and liquidity position of the contributors."

This criterion assigns a great deal of discretion to competent authority, and implies that the authority's judgment would itself be the standard for regarding a benchmark as critical, since the definition is not cumulative.

(d) "*The benchmark comprises a complex structure of contributed information."* The definition does not provide any guidance as to what is the meaning of "a complex structure of contributed information", or how this phrase should be understood by the relevant authority.

In light of the above, we consider that the criteria should be cumulative, in order to clearly and certainly establish the scope of application for the definition. Otherwise, Art. 3.1.21 as drafted, could be thought to mean that any benchmark might become a 'critical' benchmark whenever competent authority considers that "*significant adverse impact on market integrity and financial stability*" is involved, merely because any one of the above ambiguous criteria are met.

Moreover, we believe that the criteria themselves, should be detailed via Level II measures (ESMA RTS, or Commission delegated acts), in order to provide needed guidance for market participants, so that they can clearly know in advance how the conditions would be applied (e.g., timeline for calculating the notional amount).

Otherwise, as an alternative to the above measures, we suggest, at the very least, a cumulative definition based on qualitative and quantitative factors, which would exclude benchmarks fed by regulated data (since strict controls are already in place for them).

Please refer to amendments 1 and 2 of the list.

2.2 - Code of conduct (Art. 9)

Calibration should be introduced into the obligations pertaining to the code of conduct; and contributors should be closely involved in the drafting of this code, which establishes control requirements for non-supervised contributors.

We welcome the provisions of Article 9 of the Commission proposal, allowing benchmarks produced on the basis of regulated data to be exempted from the code of conduct requirement. However, we ask whether Art. 9 should not also apply, to benchmarks which are limited to a number of sophisticated users, and benchmarks produced only by using internal data - This is reasonable, given that internal controls should ensure that conflicts of interest are sufficiently well-managed for these types of benchmarks.

We are also concerned about the potential for multiple, duplicative codes of conduct, and also the provision that all of them be 'legally binding' - words which formally confirm that this is a significant administrative burden, a burden that may not be commensurate with the benefit of participating as a contributor. In light of this, we consider that the two-tier approach heads in the right direction, since it provides some relief from the administrator standpoint.

But in general, 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 3 of the list.

2.3 - Mandatory contribution (Art. 14)

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

We recommend that required contributors be able to object, with reasonable arguments, the determination of the competent authority. This would help avoid very negative consequences, not only for those entities contributing currently, or who may be obliged to contribute in the future, but also for all market operators. In this regard, we would like to point out the following:

- Every supervised entity will be subject to mandatory contribution, not only actual contributors, so this obligation affects any and every market operator regarded as a supervised entity.

- If a supervised entity does not have the infrastructure, capacity or knowledge to contribute, and is nonetheless obliged to participate, this may affect the correct formation of the benchmark, with the result that the market is mis-represented because of the compelled contribution.

- It is reasonable to assume that if the level of contribution falls by 20%, there would most likely be a significant reason behind the decline, e.g., problems with the market or financial systems. Therefore, in such a circumstance, mandatory contribution would most likely be inappropriate for the market and its full universe of participants.

Please refer to amendments 4 mentioned in the list.

2.4 - Transparency of input data (Art. 16)

Important clarifications are needed, in order to know when an administrator can disclose details of index methodology, without infringing intellectual property rights or confidentiality agreements.

Regarding transparency obligations, we would like to have more clarity as to what extent the administrator can disclose details of index methodology, without infringing intellectual property rights and confidentiality agreements. For instance, Bank 'X' pays an index provider for a licence to use its index (either to replicate some or all weighting, or to measure performance, alone or blended). Would Bank 'X' be obliged to disclose the methodology in full?

To address this, we suggest introducing in Art. 15, an obligation to protect intellectual property rights and confidentiality agreements, when details of methodology are required to be disclosed by the administrator. Additionally, the code of conduct (Art. 9) as well as the benchmark statement (Art. 15), should introduce a clause in this regard as well.

Our concern is that uncontrolled disclosure of such information, can adversely and unfairly affect relevant contributors, as well as all market participants. Particular individual data may be mis-understood by the market, as a potential problem or weakness of a contributor with respect to the specific market the data concerns (e.g., due to temporary treasury difficulties, or many other reasons). The risk is that quickly-assumed market interpretation, and further acts based on such un-considered views, can escalate a merely particular or transitory situation into a real crisis, not only for the relevant entity (e.g., diminished funding access), but also perhaps for that entire financial market or system.

Additionally, excessive disclosure of individual data provided by contributors, may negatively affect the quality of the benchmarks, by reducing incentives for market participants to contribute. If a number of contributors decide not to contribute anymore, because they are concerned about the confidentiality of their submissions, this will result either in a less-representative index, or in mandatory contribution for critical benchmarks, with the consequences mentioned in point 3.3 for contributors, non-contributors and the market as a whole.

Please refer to amendments 5, 6 and 10 of the list.

2.5 - Transitional provisions (Art. 39)

The transitional framework in Art. 39 poses several significant problems, including penalising those who use non-EU benchmarks; uncertain conditions to be met; and an unhelpful one-size-fits-all approach, which need to be addressed. Otherwise, there is risk of major EU market dislocation, and significant 'jump risk', given the resulting abrupt move from old benchmarks to successors.

The transitional framework in Art. 39 poses several significant problems such as penalisation of users of non-EU benchmarks; uncertain conditions to be met; and a one-size-fits-all approach, which need to be

addressed. Otherwise, there is risk of major EU market dislocation, and significant 'jump risk', given the resulting abrupt move from old benchmarks to successors.

The proposal introduces a transitional framework for 24 months after the date of application of the Regulation, thus permitting, for a time, the use of existing benchmarks at the time of entry into force of the Regulation, but only if the administrator has applied for authorisation. Also, Art. 39.3 lists several cases (i.e., force majeure, frustration, and breach of contract), where existing benchmarks which do not comply with the proposal requirements, are allowed to use this transitional framework. In this regard, Art. 39.4 proposes an arrangement (although undefined in time), as to when Art. 39.3 is triggered: "*The use of a benchmark shall be permitted by the relevant competent authority of the Member State where the administrator is located, **until such time** as the benchmark references financial instruments and financial contracts worth no more than 5% by value of the financial instruments and financial contracts that reference this benchmark at the time of entry into force of this Regulation."*

There are several issues here worth addressing, for the sake of a progressive and smooth transition, issues which, if not resolved, will very likely lead to **major EU market disruption** and significant '**jump risk**', given the resulting abrupt move from old benchmarks to successors:

- Firstly, Art. 39 only applies to benchmarks produced by EU administrators (*'authorisation under Article 23'*). Our concern is that the proposed framework would penalise users of non-EU benchmarks, given that no transitional provisions are foreseen for administrators established in a third country (not even where relevant benchmarks comply with cases listed in Art. 39.3). As a result, use of non-EU benchmarks would be **abruptly suspended, with no prospect of progressive transition from old benchmarks to successors**. This seems inconsistent with the general approach of the text, which explicitly recognises the international nature of benchmarks (e.g., Recital 34[1] and 40[2]; extraterritorial scope in Art. 2; and equivalence process in Art. 20).

- Secondly, more granularity is needed for the transitional process mentioned in Art. 39.3 and 39.4. Further guidance and clarity is highly recommended, in order to know what steps should be followed by administrators, so that they can benefit from this transitional process (e.g., how to prove that frustration has occurred); and also for users, so that they can cease to issue new instruments but continue to hold existing instruments during the two year authorisation window, regardless of whether the administrator has already applied for authorisation or not. Moreover, it is uncertain how relevant competent authority is expected to assess whether the 5% threshold (in Art. 39.4) has been crossed; or whether an event of *force-majeure*, frustration or breach of contract terms has occurred; since neither Art. 39 nor Art. 23 provide any details about this. Additionally, the text uses the term 'would' instead of 'could', thus seeming to require 100% certainty, quite challenging to demonstrate. It is not clear how market participants could be sure that a force majeure event 'will' in fact occur, whereas wording such as 'could', or 'could

[1] "This Regulation should take into account the Principles for financial benchmarks issued by **the International Organization of Securities Commissions (IOSCO) (hereinafter referred to as 'IOSCO Principles'),** on 17 July 2013, which serve as a global standard for regulatory requirements for benchmarks. Following the publication of the Principles, IOSCO intends to review within 18-month period the extent to which the Principles has been implemented."

[2] "Some of the provisions of this Regulation apply to natural or legal **persons in third countries,** who may use benchmarks or be contributors to benchmarks, or may be otherwise involved in the benchmark process. Competent authorities should therefore enter into arrangements with supervisory authorities in third countries. ESMA should coordinate the development of such cooperation arrangements, and the exchange between competent authorities of information received from third countries."

reasonably be expected to' (i.e., possibility), is a more suitable solution. In light of all this, our fear is that any smooth transition would be hindered by such an unclear and uncertain framework.

- Thirdly, there is a one-size-fits-all approach when applying the transitional framework. We note that Art. 39 does not take into account different calibration factors, which otherwise underpin the proposal (e.g., 'critical benchmark', or sectoral requirements in Art. 12). These factors helpfully calibrate regulation requirements, to the risks and specifics of different types of benchmarks. We would welcome introducing such a proportional approach in applying the transitional framework to specific benchmarks (e.g., a critical benchmark). Additionally, IOSCO Principles recognise such an approach in Principle 13 (Transition): *"These policies and procedures should be* ***proportionate*** *to the estimated breadth and depth of contracts and financial instruments that reference a Benchmark, and the economic and financial stability impact that might result from the cessation of Benchmark.*"

- Fourthly, there remains risk of frustration or breaches of contract terms, despite the current framework. It is of concern that, due to the 5% trigger, issuers face the risks mentioned in Art. 39.3 (e.g., frustration) when complying with the Regulation. In order to address this, we recommend allowing the indices referred to in this article, to be used until the termination of the financial agreement, or the maturity of the financial instrument.

- Lastly, similar transitional arrangements will also be needed whenever an index becomes a benchmark, or a benchmark becomes a critical benchmark.

Considering all the above, we propose extending the transitional framework to administrators established outside the EU. Also, we suggest providing more clarity and certainty regarding the transitional framework (e.g., steps to take and conditions to meet); introducing a calibrated approach vis-à-vis certain benchmarks (e.g., critical ones) via ESMA; and allowing indices covered by Art. 39 to be used until the termination of the financial agreement, or the maturity of the financial instrument.

Please refer to amendments 7, 8 and 9 mentioned in the list.

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