The start of trilogue – what the Benchmark Regulation will mean for you

Speed Read

Ever since the scandals involving the alleged manipulation of the “-IBORs”, regulatory reform of benchmarks has been high up on the national and international regulatory reform agenda. One of the principal outputs of this regulatory reform agenda is the proposed EU Regulation on indices used as benchmarks in financial instruments and financial contracts (the “Benchmark Regulation”).

Trilogue negotiations on the Benchmark Regulation are expected to start at the beginning of June and agreement may well be reached before the end of 2015. In its current form the Benchmark Regulation has important implications for many types of index, far beyond the -IBORs. In some cases it is possible customised indices, baskets or portfolio levels may be caught. An important trigger for any level falling within the scope of the Benchmark Regulation is the nature of products that link to the index. There are very limited transitional provisions and regimes for third country benchmark administrators may well prove unworkable. Despite EU legislators acknowledging that “one size does not fit all”, the Benchmark Regulation is likely to have unintended consequences. Market participants should engage with the Benchmark Regulation and should review existing products and indices to see how these will be affected.

In this eAlert, we focus on the following aspects of the scope of the Benchmark Regulation:

Each of the EU Commission, EU Council and EU Parliament will be seeking to find common ground between their competing versions of the Benchmark Regulation text. Unless otherwise indicated, references are to the EU Parliament text settled on 19 May 2015.

What levels are in scope?

The Benchmark Regulation covers a very wide range of index levels and potentially many basket or portfolio levels that are regularly determined.

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1 We have already seen, for example, IOSCO’s Principles for Financial Market Benchmarks (July 2013), the ESMA-EBA Principles for Benchmark-Setting Processes in the EU (June 2013) and the GPMA Principles for Financial Benchmarks (updated in November 2012) as well as significant reform at a national and individual benchmark level.
The product scope of the Benchmark Regulation turns on whether or not you have a “benchmark” defined in the EU Parliament text as “any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument is determined”. (Our emphasis added)

The Council and Commission texts also bring into the definition of “benchmark” an index used for certain purposes by an investment fund (a UCITS or an AIF). The EU Parliament text does not but arguably its restriction on using an index for investment fund purposes achieves a similar effect (see “What activities are in scope? – (d)” below).

Therefore, what is an index?

The term “index” is defined broadly in the EU Parliament text as any figure:

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

The exact meaning of “published or made available to the public” will be key to the scope of the Benchmark Regulation. It is possible this and other key points are moved to the level 2 stage with the Commission being empowered to adopt delegated acts on technical elements of the definitions. While this may be politically expedient the outcome on this might be very important for which levels are in or out of scope, particularly for proprietary or customised indices.

And what is a financial instrument and financial contract?

“Financial instrument” is defined as any of the instruments listed in Section C of Annex 1 to MiFID II² for which a request for admission to trading on a trading venue (as defined in MiFID II i.e. a regulated market, MTF or OTF) has been made or which are traded on a trading venue. While the list of instruments in Section C is very wide, the scope of this definition is limited by the trading venue requirement. For example, it would not cover bonds not traded on a trading venue. On the other hand the obligation for certain classes of derivatives to be traded on a regulated market, MTF, OTF or equivalent third-country trading venue in MiFIR³ would mean that certain derivatives will be in scope.

In the EU Council text, the definition of “financial instrument” is extended to include financial instruments traded on a systematic internaliser. This is significant as it would widen the scope of the scope of the Benchmark Regulation by capturing many OTC trades concluded on a systematic internaliser.

The definition of “financial contract” is much narrower and essentially limited to consumer credit agreements.

Are any entities out of scope?

The Benchmark Regulation will only exclude a very limited number of entities.

The text of the EU Parliament states that that Benchmark Regulation will not apply (in summary) to the provision of benchmarks by central banks and public authorities (including non-EU central banks and public authorities) where they provide benchmarks for public policy purposes, central counterparties, administrators where they provide single prices or single value reference prices and the press where they publish/refer to a benchmark and credit unions (as defined in Directive 2013/36/EU).

The Benchmark Regulation will also not apply to an index provider that is unaware and could not reasonably have been aware that an index it provides is being used as a “benchmark”. This may be difficult to rely on given the objective test.

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² Directive 2014/65/EU
³ Regulation (EU) No 600/2014
What activities are in scope?

A wide range of activities in relation to a benchmark and benchmark linked products will be restricted.

The Benchmark Regulation applies to the “provision of benchmarks”, the “contribution of input data” to a benchmark and the “use of a benchmark” within the Union.

Subject to the application of the transitional provisions, a supervised entity is not able to use a benchmark or a combination of benchmarks as a reference in a financial instrument or financial contract unless it is provided by an administrator that is authorised or registered under the Benchmark Regulation or an acceptable third country administrator (see below). The definition of “use of a benchmark” is significant as this extends the scope of the Benchmark Regulation to the following activities:

(a) issuance of a financial instrument which references an index or a combination of indices;
(b) determination of the amount payable under a financial instrument or financial contract by referencing an index or combination of indices;
(c) being party to a financial contract which references an index or combination of indices; and
(d) determination of the performance of an investment fund through an index or combination of indices for the purpose of tracking the return of such index or combination of indices, of defining the asset allocation of a portfolio or of computing the performance fees (Article 3(5) of the EU Parliament text).

The EU Commission’s proposal that “use of a benchmark” should also extend to owning a financial instrument that references a benchmark will hopefully not appear in the final agreed text - arguably this would be a disproportionate extension of the scope of the Benchmark Regulation and could potentially trigger large-scale disposals of index-linked assets by supervised entities.

Does one size fit all?

The Benchmark Regulation only makes limited concessions to different types of benchmark.

In July 2013 IOSCO published its Principles for Financial Market Benchmarks (the IOSCO Principles)\(^4\) to create an overarching framework of Principles for Benchmarks used in financial markets. The IOSCO Principles seek to articulate policy guidance and principles for benchmark-related activities and can be understood as a set of recommended practices that should be implemented by benchmark administrators and submitters and a form of roadmap for regional and national regulation. IOSCO recognized that “although the Principles set out uniform expectations, IOSCO does not expect a one-size-fits-all method of implementation to achieve the objectives of the Principles.”

The EU Parliament text in particular introduces important proportionality into the Benchmark Regulation. For example:

(a) a less onerous regime can apply to non-critical benchmarks but only for certain provisions;
(b) benchmarks determined by the application of a formula to “regulated data” are not required to comply with certain provisions in the Benchmark Regulation;
(c) a less onerous regime applies to commodity benchmarks based on submissions from contributors the majority of which are not supervised entities whose main business is the provision of investment services;
(d) Parliament’s text does not contain the Annexes with specific obligations for interest rate benchmarks and commodity benchmarks contained in the EU Commission’s original proposal;

the principle of proportionality must be taken into account by the administrator in developing the control framework for a particular benchmark;

ESMA must take into account the principle of proportionality in preparing various regulatory technical standards; and

proportionality is a factor that Member States must take into account when determining administrative sanctions.

It remains to be seen whether the proportionality introduced in the EU Parliament text will be carried through into the final agreed version of the Benchmark Regulation or indeed whether this proportionality is enough to prevent smaller benchmarks being overwhelmed by disproportionate regulation. The –IBORs may be too-big-to-fail but many benchmarks are arguably too-small-to-comply.

**What about third country administrators?**

At the moment there are a range of overlapping and potentially unworkable solutions for non-EU administrators. This may mean that going forward non-EU benchmarks will be far less liquid in EU markets.

The Benchmark Regulation is stated to apply to “the provision of benchmarks, the contribution of input data to a benchmark and the use of a benchmark within the Union.” But what is the exact extraterritorial scope of the Benchmark Regulation?

For example, how is the Benchmark Regulation intended to apply where one user of a benchmark is located in the Eu and the other is not? Similarly, what if all benchmark related activities are conducted outside the EU, but financial instruments referencing the benchmark are purchased by end investors in the EU?

**Regime applicable to administrators located outside of the EU**

In order for a third country administrator to be acceptable for Benchmark Regulation purposes it must comply with either Article 20 (Equivalence), Article 21a (Recognition of an administrator in a third country) or 21b (Endorsement).

**Equivalence** requires (among other things) either: (i) a Commission equivalence decision that the legal and supervisory framework of the third country ensures compliance with binding requirements equivalent to those resulting from the Benchmark Regulation (taking into account if the legal and supervisory framework ensure compliance with the IOSCO Principles and the IOSCO Principles for Oil Price Reporting Agencies of 5 October 2012 (the IOSCO Principles for Oil Price Reporting)); or (ii) a Commission decision that specific rules/requirements of a third country with respect to individual and specific benchmarks/administrators are equivalent to those in the Benchmark Regulation; and cooperation arrangements with the relevant third party competent authorities. These may be difficult for the Commission to determine given the EU is the front runner by a long stretch in benchmark regulation.

**Recognition** is intended as a temporary measure (until such time as an equivalence decision is adopted) where a third country administrator may apply for prior recognition by ESMA if (in summary) it complies with all key requirements of the Benchmark Regulation (subject to a few limited exemptions\(^5\)) or complies in full with the IOSCO Principles or (if applicable) the IOSCO Principles for Oil Price Reporting and has an EU representative. Where the third country administrator is supervised by a third country authority, there is again a requirement for an appropriate co-operation agreement with a third country supervisor and the effective exercise by the competent authority or ESMA of its supervisory functions under the Benchmark Regulation must not be prevented by the laws of the relevant third country.

**Endorsement** requires the EU administrator (the endorsing administrator) to apply to its competent authority to endorse a benchmark or family of benchmarks provided in a third country for their use in the Union. The EU administrator is required to assume considerable responsibility for the third country administrator, for example, verifying and

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\(^5\) A third country administrator intending to obtain prior recognition by ESMA may also apply to ESMA for a temporary exemption from one or more of the applicable requirements of the Benchmark Regulation or of the relevant IOSCO principles in certain limited circumstances (Article 21a(7) of the EU Parliament text).
monitoring compliance with requirements at least as stringent as those in the Benchmark Regulation or full compliance with the IOSCO Principles or (if applicable) IOSCO Principles for Oil Price Reporting Agencies.

What are other countries doing in relation to benchmark regulation?

When finalizing the extraterritorial scope of the Benchmark Regulation it will be of crucial importance for legislators to ensure those performing benchmark-related activities in the EU are not at a competitive disadvantage and that the final regime is workable for third country administrators, avoiding conflicts of law and market disruption. We have seen the difficulties in achieving a workable third-country and equivalence regime in derivatives regulation. This will be a difficult task in the context of the Benchmark Regulation given the different approaches other jurisdictions are taking to benchmark reform. Many jurisdictions do not intend to implement the IOSCO Principles into local legislation at all, whilst others only intend to implement the IOSCO Principles for systemically important benchmarks. U.S. government/regulatory officials have recently publicly affirmed their commitment to the IOSCO Principles but openly criticised the Benchmark Regulation: they consider that direct government involvement in the administration of benchmarks will have adverse market consequences and that the third countries regime in the Benchmark Regulation “goes well beyond” the scope of new oversight of benchmarks envisaged by IOSCO⁶.

Are there effective transitional provisions?

Currently the transitional provisions are very limited and there is no meaningful form of grandfathering. This may cause particular problems for entities with a large number of outstanding products over existing indices.

In particular, the EU Parliament text states, for example, that existing products may temporarily be permitted by the relevant competent authority to continue to use a non-compliant benchmark if changing the benchmark would cause a force majeure event or frustrate otherwise breach the product terms. Given normal index adjustment provisions at the product level it is not clear how likely it is a force majeure event or frustration breach would occur.

On the other hand the EU Parliament text permits new financial instruments to reference an existing benchmark that does not meet the requirements of the Benchmark Regulation for a period of one year after the date it applies, provided that the financial instrument is necessary for certain hedging purposes. It also provides a transitional provision for benchmarks provided by third country administrators used as a reference in existing products at the time of entry into force of the Benchmark Regulation and also in new products for a period of 3 years from the date of application of the Benchmark Regulation.

What should I do next?

Market participants should engage with the Benchmark Regulation to determine if it will be suitable for their business and meaningful for their investors and clients. Market participants may also need to review all existing arrangements where products are linked to any type of index, basket or portfolio to determine how these will be affected by the Benchmark Regulation.

The scope issues highlighted in this eAlert will be key topics in the trilogue. In many respects the EU Parliament text is more workable than that of the EU Council or the EU Commission but significant issues remain.

Allen & Overy LLP is closely following the evolution of the Benchmark Regulation and is advising a wide range of financial institutions, index providers and index users. Please do not hesitate to contact us should you wish to discuss this further.


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