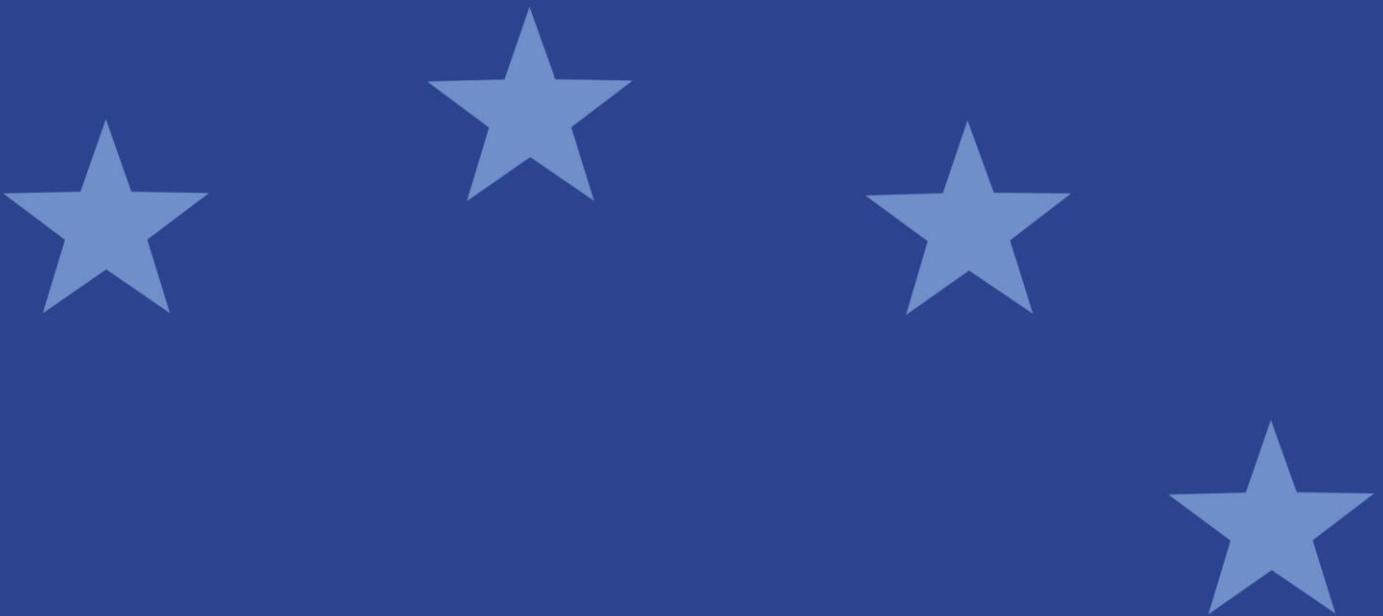


Consultation Paper

Principles for Benchmarks-Setting Processes in the EU



Responding to this paper

ESMA and EBA invite comments on all matters in this paper and in particular on the specific questions identified in the text. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA/EBA should consider.

ESMA and EBA will consider all comments received by **15 February 2013**.

All contributions should be submitted online at www.esma.europa.eu under the heading “Your input-Consultations”.

Publication of responses

All contributions received will be published following the closing of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA/EBA rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the ESA Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading “Legal Notice”.

Who should read this paper?

This document will be of interest to market participants such as, but not limited to, parties to financial contracts based on benchmarks, benchmark-setting bodies, data providers involved in the calculation or publication of benchmarks, legal advisers involved concerned with contracts involving the use of benchmarks.

About this consultation

1. The Boards of Supervisors of EBA and ESMA have established a Joint EBA-ESMA Task Force on Principles for Reference Rates and other Benchmarks-Setting Processes in the EU.
2. The objective of the Task Force is to establish Principles focussed on reference rates and other benchmarks setting processes in the EU. The Principles will address the activities of reference-rate and other benchmark administrators, publishers and market participants submitting data to the administrators and/or publishers. The Principles may also address National Competent Authorities, users of reference rates and other benchmarks and other persons or entities involved in the setting process of reference rates and other benchmarks.
3. In doing so, the Task Force
 - i. determines the scope of applicability of the Principles in light of the susceptibility of benchmark categories to conflicts of interests or manipulation as well as their importance to financial market activity, the real economy and investor protection;
 - ii. coordinates closely with the joint EBA-ESMA workstream on the Review of the Euribor Rate-Setting Process as well as EBA work on supervisory cooperation in this area;
 - iii. considers the work on principles for financial benchmarks as undertaken by international bodies, in particular by IOSCO; and
 - iv. closely liaises with the EU Commission in order to align the Principles with possible future legislative proposals.
4. The Principles are being developed by the Task Force, aiming to become applicable by April 2013, after having been approved by the Boards of Supervisors of EBA and ESMA.
5. The Principles are designed to bridge the interim period until a potential formal regulatory and supervisory framework for benchmarks has been devised in the EU. They take existing legal provisions as given.
6. The Principles are not intended in any way to prejudge the outcome of any Commission legislative initiative in respect of benchmarks or indices.

Legal basis

7. The principles to be developed by this Task Force are designed to address the problems in the area of benchmarks in the period until a potential formal regulatory and supervisory framework for benchmarks has been devised in the EU.
8. Although the provisions will be without binding effect they can have significant positive impact since they will be aligned with the principles that IOSCO will develop. As such they provide benchmark users, benchmark administrators, calculation agents and publishers and contributing firms with a common framework to work together and provide a glide path to future obligations that are likely to be binding.
9. As regulation advances through legislative developments it may be desirable in the future to propose provisions with firmer regulatory consequences for non-compliance and that address in more detail specific sectors. In the meantime the Task Force sees a clear importance of principles being available

and used as part of the supervisory process of financial market participants who are within regulatory scope.

10. Accordingly, in this paper the Task Force proposes Principles for Benchmarks-Setting Processes in the EU.

Definitions

11. For the purpose of this Consultation Paper, the following definitions apply:

- i. **Benchmark:** Any commercial index or published figure, including those accessible on the internet whether free of charge or not,
 - a) calculated entirely or partially by the application of a formula to or an assessment of the value of one or more underlying assets, prices or certain other data, including estimated prices, interest rates or other values, or surveys;
 - b) by reference to which the amount payable under a financial instrument or the value of the financial instrument is determined.¹
- ii. **Contributing firm:** A legal person contributing to benchmark data submissions which are used for the calculation of the benchmark.
- iii. **Benchmark administration:** Includes all the stages and processes involved in the production and dissemination of a benchmark from the gathering of the input data and the calculation of the benchmark based on the input data to the dissemination of the benchmark to users including any review, adjustment and modifications to this process.
- iv. **Benchmark administrator:** Refers to the person that controls the creation and operation of the benchmark process, and in particular has responsibility for the calculation of the benchmark, determining the benchmark methodology and disseminating the benchmark regardless of whether it delegates or outsources any of these activities to a third person such as a benchmark calculation agent.
- v. **Benchmark calculation:** The activity of performing the calculation of the benchmark based on the data collected by the entity performing the calculation or submitted by contributing firms.
- vi. **Benchmark calculation agent:** A legal entity performing benchmark calculation activities.
- vii. **Benchmark publication:** The activity of publishing the benchmark values, which includes making available such values on the internet, whether free of charge or not.
- viii. **Benchmark publisher:** A legal entity performing benchmark publication activities.
- ix. **Methodology:** The written rules and procedures according to which the data are collected and the benchmark is calculated.

¹ This definition is broadly in line with the definition of benchmarks proposed by the European Commission in the amended proposals for a Regulation and Directive on market abuse. These proposals provide that “*Benchmark*’ means any commercial index or published figure calculated by the application of a formula to the value of one or more underlying assets or prices, including estimated prices, interest rates or other values, or surveys by reference to which the amount payable under a financial instrument is determined”.

- x. **Benchmark user:** A financial market participant that uses a benchmark in one of the following manners:
- as a reference for financial transactions that it sells or places, or for financial instruments that it structures; or
 - as a reference for financial transactions to be entered into by its clients (or by itself on behalf of its clients) in the context of its individual or collective portfolio management activities.

12. The benchmark administration, calculation and publication activities may be performed by distinct legal entities, or may be grouped together such that one entity performs more than one.

Question 1: Definition of the activities of benchmark setting

Do you agree with the definitions provided in this section? Is this list of activities complete and accurate?

Benchmarks-setting processes

I. Background

I.I. Concerns by ESMA and EBA

13. Financial market reference rates and their calculation procedures have come under close public scrutiny in recent years. Starting in 2009, authorities in jurisdictions such as the EU, the US, Japan, and others have investigated cases of alleged misconduct around the rate-setting of LIBOR, Euribor, and other reference rates. More recently, the first outcomes of the investigations at national levels, legal settlements between charged institutions and their supervisory authorities, as well as a mounting number of cases of private litigation have highlighted the scope and scale of potential manipulations of reference rate-setting mechanisms. A number of initiatives to reform reference rate-setting mechanisms have been launched across wide parts of the regulatory and supervisory communities as well as the financial markets.
14. ESMA and EBA are concerned by and take an immediate interest in this issue. First, the on-going investigations may point at serious flaws in the way inter-bank interest rate benchmarks are being set in the EU. Second, the use of these benchmarks is widespread in securities and other financial markets, and any abuse can have serious implications for market integrity and the credibility of reference rates in the future, with significant negative consequences for financial flows and activities in the EU and globally. Finally, and as a result, the elements arising from the on-going investigations may provide additional evidence supporting the need for legislative reforms regarding reference rate setting in the EU, and in their regulatory and supervisory capacities ESMA and EBA are ready to contribute to these reforms. A consistent and coordinated response is clearly desirable, and ESMA and EBA have worked closely with IOSCO and the European Commission to ensure that any principles arising from this consultation are closely aligned.
15. In that context, in order to fully understand the Euribor-EBF rate-setting process and its susceptibility to the risk of manipulation, EBA and ESMA also agreed to undertake a review of the Euribor-EBF process. The findings of the review are set out in the EBA-ESMA report (ESMA/2013/BS/2) which includes recommendations to the EBF related to the administration and management of Euribor. This review has contributed to the development of the draft principles proposed in this consultation paper.

I.II. Other relevant workstreams

16. The following workstreams are aimed at analysing and addressing the issues related to financial benchmarks. ESMA and EBA have coordinated and aligned their work with the other work streams on financial benchmarks as undertaken at the European and international level. This consultation is not aimed at prejudging the outcomes of either of these work- streams.
17. At the international level, ESMA and EBA are closely following the work undertaken by the Board Level Task Force on Financial Market Benchmarks constituted in September 2012 within IOSCO to identify relevant benchmark-related policy issues and develop global policy guidance and principles for benchmark-related activities of particular relevance to market regulators.² ESMA and EBA are also aware of the Bank for International Settlements Governors having agreed to set up a group of senior officials to take forward examination of these issues and to consult with the market in order to provide input into the wider official debate coordinated by the Financial Stability Board.³
18. At EU level, in July 2012 the European Commission already put forward proposals to amend its proposals for a Regulation on market abuse⁴ and for a Directive on criminal sanctions for market abuse⁵ to ensure that any manipulation of benchmarks is clearly and unequivocally illegal.
19. On 5 September 2012 the European Commission published a Consultation Document on the Regulation of Indices (A Possible Framework for the Regulation of the Production and Use of Indices serving as Benchmarks in Financial and other Contracts)⁶ aimed at assessing how to improve the production and governance of benchmarks and verifying the need for any necessary changes to the legal framework in relation to benchmarks.
20. Finally, the European legislation on UCITS⁷ contains provisions on the use of a subset of benchmarks, i.e. financial indices to which UCITS funds take an exposure. These rules have been complemented by the guidelines on Exchange-Traded Funds (ETFs) and other UCITS issues recently published by ESMA⁸ which, among others, provide guidance on financial indices.

II. General considerations on benchmarks

21. The existence of a large number and spectrum of different benchmarks is broadly recognised. Benchmarks are used not only as a reference for financial instruments and transactions, but also to price a variety of non-financial transactions such as commercial contracts.

II.I. Different types of benchmarks

22. The range of benchmarks that are based on different asset classes is very broad and includes:

- interbank lending and borrowing rates,
- overnight index rate and borrowing indices,
- swap indices,
- credit benchmarks,
- commodity indices,

² See the press release available at: <http://www.iosco.org/news/pdf/IOSCONEWS250.pdf>.

³ See the press release available at: <http://www.bis.org/press/p120910.htm>.

⁴ Available at: http://ec.europa.eu/internal_market/securities/docs/abuse/20120725_regulation_proposal_en.pdf.

⁵ Available at: http://ec.europa.eu/internal_market/securities/docs/abuse/20120725_directive_proposal_en.pdf.

⁶ Available at: http://ec.europa.eu/internal_market/consultations/docs/2012/benchmarks/consultation-document_en.pdf.

⁷ Directive 2009/65/EC.

⁸ ESMA/2012/474, available at: <http://www.esma.europa.eu/system/files/2012-474.pdf>.

- currency benchmarks,
- bond and equity indices,
- strategy and investment indices, and
- others, including but not limited to hedge fund strategies, or financial parameters such as volatility or correlation.

II.II. Types of data used to calculate benchmarks

23. The range of inputs used to calculate the different benchmarks is diverse. The types of data used includes actual prices or transaction values, bids and offers, surveys, auction price systems, quotes, market reports, judgements. Some of these methods may naturally give wider discretion in the calculation of the benchmark to either the contributor of the data or the calculators. Whenever transaction data are used, such data may be considered to be more objective and easily verifiable. Rate-setting mechanisms using estimated rather than transaction-based data may require more discretion and the estimate may be more susceptible to conflicts of interest and manipulation. The range of submissions is likely to have an impact on the level of representativeness of the benchmark.
24. The number of contributing firms submitting data to survey-based or panel-based benchmarks may vary considerably. This phenomenon is also common for transaction-based benchmarks, which may receive submissions from a limited number of market participants or from a broad number of submitters. Moreover, market liquidity itself (i.e. the number of executed transactions) may vary over time.

II.III. Use in financial markets

25. Benchmarks include a variety of interest-rate benchmarks, but also market indices such as stock, bond, derivatives market indices, or commodity market benchmarks, including raw material and oil markets. Especially in the case of market indices and commodity market benchmarks, methods of data collection and calculation are highly heterogeneous and vary widely. In addition, for a large number of these benchmarks the underlying data is obtained or the benchmark is calculated outside the EU, even if their use by market participants in the EU may be widespread.

Principles of good conduct for benchmark setting

26. In light of these considerations, ESMA and EBA are considering establishing principles for benchmark-setting processes. ESMA and EBA consider important that these principles are enforced not only by market participants, but also by competent authorities in their supervisory practices, where relevant and possible.

Question 2: Principles for benchmarks

Would you consider a set of principles a useful framework for guiding benchmark setting activities until a possible formal regulatory and supervisory framework has been established in the EU?

27. Such principles would cover all types of benchmarks.
28. Such principles would cover:
 - benchmark data submissions,
 - benchmark administration,

- benchmark calculation,
- benchmark publication, and
- the use of benchmarks.

29. A framework for any benchmark-setting process should include the following principles in order to instil confidence in financial markets and market participants, and guarantee the necessary accuracy and integrity of the benchmark formation process:

A. General framework for benchmarks setting

A.1 Methodology: The methodologies for the calculation of a benchmark, including information on the way in which contributions are determined and corroborated, should be documented and be subject to regular scrutiny and controls to verify its reliability. The definition of a specific benchmark should be precise in order to avoid subjective interpretation of key concepts. A benchmark should represent adequately the market to which it refers, and measure the performance of a representative group of underlyings in a relevant and appropriate way. The underlyings should be sufficiently liquid. As relevant, a benchmark should reflect market conditions, including relevant prices and volumes. Actual market transactions should, as a matter of preference, be used as a basis for a benchmark, where appropriate.

A.2 Governance structure: The process of setting a benchmark needs to be governed by a clear and independent process in order to avoid conflicts of interest and limit its susceptibility to manipulation, discretionary decision making or price distortion. Governing processes should include clear rules on the allocation of responsibilities for calculation and oversight activities. Benchmark structures should be managed in a way so as to reduce conflicts of interest as much as possible. Conflicts of interest may arise where contributing firms have discretion regarding the submitted data, while at the same time they or their clients have an exposure against the benchmark.

A.3 Supervision: Confidence in a benchmark is enhanced through regulation and oversight and an appropriate sanctioning regime that allows sanctions for improper conduct. In the EU, a formal regulatory regime for benchmarks does not exist so far. For any existing applicable regimes and rules, contributing firms, benchmark administrators and users of benchmarks should co-operate closely with the relevant supervisory authorities.

A.4 Transparency: A benchmark should be transparent and accessible, with fair and open access to it. A high degree of transparency on the process determining a benchmark and/or any modification thereof will enhance confidence in its integrity, which would also help foster understanding of the benchmark in the market place. However, transparency needs to be carefully balanced with protecting confidentiality, as the release of institution-specific information could also create countervailing incentives. The full methodology should be disclosed wherever possible. Where this is not possible, the relevant information such as weightings and prices of components should be disclosed prior to any rebalancing.

A.5 Continuity: Benchmark administrators and users should put in place robust contingency provisions for a drying-up of market liquidity, a lack of transactions or quotes or the unavailability of the benchmark, respectively.

Question 3: General principles for benchmarks

Do you agree with the principles cited in this section? Would you add or change any of the principles?

B. Principles for firms involved in benchmark data submissions (where relevant for a benchmark)

General principles

- B.1 A contributing firm should have in place internal policies covering the submission process, governance, systems, training, record keeping, compliance, internal controls, audit and disciplinary procedures, including complaints management and escalation processes.
- B.2 A contributing firm should maintain and operate effective organisational and administrative arrangements with a view to avoid conflicts of interests from affecting the benchmark data submitted.

Supporting principles

- B.3 A contributing firm should establish, implement and maintain an effective conflicts of interest policy to enable it to identify, with reference to the activities related to benchmark data submissions, conflicts of interest that may arise, along with the procedures to be followed, and measures to be adopted, in order to manage such conflicts.
- B.4 The conflicts of interest policy should include:
- effective procedures to prevent or control the exchange of information between staff engaged in activities involving a risk of a conflict of interest where the exchange of that information may affect the benchmark data submitted;
 - rules to avoid collusion between contributing firms and between contributing firms and benchmark administrators;
 - measures to prevent any person from exercising inappropriate influence over the way in which staff involved in benchmark data submission carries out activities;
 - the removal of any direct link between the remuneration of staff involved in benchmark data submissions and the remuneration of, or revenues generated by, different staff principally engaged in another activity, where a conflict of interest may arise in relation to those activities.
- B.5 Record keeping should mean for a contributing firm to arrange for records of all relevant aspects of the submission process to be kept in line with the normal requirements on record keeping. Records should be retained in a medium that allows the storage of information in a way accessible for future reference, and in such a form and manner that it must not be possible for the records to be manipulated or altered.
- B.6 A contributing firm's governance policy should ensure that:
- clearly accountable, named individuals, at the appropriate level of seniority within the

firm, are responsible for benchmark data submissions;

- staff involved in benchmark data submissions are aware of the procedures which must be followed for the proper discharge of their responsibilities.

- B.7 A contributing firm should ensure that staff involved in benchmark data submissions have the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. Staff involved in benchmark data submissions should undergo appropriate training and development programmes.
- B.8 A contributing firm should establish, implement and maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the firm. Internal procedures should stipulate, for example, periodic internal and external audit of submissions and procedures. Controls performed on the data submitted should include comparisons with actual, transaction-based, verifiable data. Any reverse transaction subsequent to a submission should be recorded. Compliance reports containing explanations of the compliance function's findings should be submitted to senior management on a regular basis.
- B.9 A contributing firm should implement and maintain systems that are adequate to ensure consistent and timely delivery of submissions.
- B.10 A contributing firm should have clear internal sanctions, establishing a zero-tolerance policy for non-compliance with internal policies, with a credible whistle-blowing policy.
- B.11 A contributing firm should publicly disclose a confirmation by the management of the relevant entity of compliance with the above principles.

Question 4: Principles for firms involved in benchmark data submissions

Do you agree with the principles cited in this section? Would you add or change any of the principles?

C. Principles for benchmark administrators

General principles

- C.1 A benchmark administrator should ensure the existence of robust methodologies for the calculation of the benchmark and appropriately oversee its operations and ensure that the appropriate level of transparency to the market regarding the rules of the benchmark is made.

Supporting principles

- C.2 A benchmark administrator should have governance or compliance functions to enable it to operate effectively and ensure the quality of the benchmark. A benchmark administrator should provide well-defined criteria and procedures to select members of the governance/compliance functions that participate in the determination of the methodologies

for the calculation of the benchmark. Members of the governance/compliance functions should have ‘independent’ (i.e. non-contributing) members who are present and fully involved in ensuring that the work respects internal rules and procedures. Details of the membership of the relevant governance/compliance functions should be made public, along with any declarations of conflicts of interests and the processes for election or nomination to the governance/compliance functions.

- C.3 A benchmark administrator should establish methodologies with well-defined criteria for the calculation of the benchmark, so that judgement and qualitative assessments or other opportunities for discretionary decision making are limited as much as possible. Such criteria should address *inter alia* the composition of the panel, the algorithm for the calculation of the benchmark, provisions regarding operational continuity.
- C.4 The methodologies established by the benchmark administrator should be rigorous, systematic and continuous. Any amendment to an established methodology should be made according to a transparent and determined process.
- C.5 A benchmark administrator should regularly review the range of benchmarks that it provides (such as for example asset classes, currencies and tenors). It should ensure that the range of benchmarks reflects market conditions.
- C.6 A benchmark administrator should fully disclose the methodology. Where this is not possible, the relevant information such as weightings and prices of the components should be disclosed particularly in advance prior to any rebalancing.
- C.7 A benchmark administrator should have procedures to enable its oversight functions to report to their respective competent authorities, if any, any misconduct by the contributing firms of which they become aware.
- C.8 A benchmark administrator should record and post minutes of relevant meetings along with details of the interactions between its oversight function on the one hand and contributing firms and benchmark calculation agents on the other.
- C.9 The governance/compliance function of a benchmark administrator should ensure that principles applying to contributing firms in order to prevent any misconduct are implemented.
- C.10 A benchmark administrator should establish, implement and maintain adequate internal control mechanisms on the data contributed that should include consistency checks on the basis of transaction-based or other verifiable data where available. Controls should also ensure that the benchmark computation process works properly at the level of the benchmark calculation agent.
- C.11 A benchmark administrator should retain adequate access and control on the activities of the benchmark calculation agent and the ability to check its compliance with the methodology of the benchmark.
- C.12 A benchmark administrator, when outsourcing benchmark calculations to a third party, should retain adequate access and control on the activities of the third party. A benchmark administrator should periodically audit the benchmark calculation agent.
- C.13 A benchmark administrator should establish an effective whistleblowing mechanism in order to ensure early awareness of any misconduct or other irregularities that may arise.
- C.14 A benchmark administrator should publicly disclose a confirmation by the management of the

relevant entity of compliance with the above principles.

Question 5: Principles for benchmark administrators

Do you agree with the principles cited in this section? Would you add or change any of the principles?

D. Principles for benchmark calculation agents

General principles

- D.1 A benchmark calculation agent should ensure a robust calculation of the benchmark and ensure the existence of appropriate internal controls of the benchmark calculations it makes.

Supporting principles

- D.2 A benchmark calculation agent should have clearly accountable, named individuals, at the appropriate level of seniority within the entity, responsible for benchmark computation.
- D.3 A benchmark calculation agent should implement and maintain systems for pre- and post-submission control that are adequate to ensure consistent and timely benchmark computation.
- D.4 A benchmark calculation agent should establish an effective whistleblowing mechanism in order to ensure early awareness of any misconduct or other irregularities that may arise.
- D.5 A benchmark calculation agent should keep records of controls made and contacts with the benchmark administrator (when benchmark administration and benchmark calculation activities are not exercised by the same entity/person).
- D.6 A benchmark calculation agent should publicly disclose a confirmation by the management of the relevant entity of compliance with the above principles.

Question 6: Principles for benchmark calculation agents

Do you agree with the principles cited in this section? Would you add or change any of the principles?

E. Principles for benchmark publishers

General principles

E.1 A benchmark publisher should ensure the well-controlled publication of the benchmark it has agreed to publish.

Supporting principles

E.2 A benchmark publisher should have clearly accountable, named individuals, at the appropriate level of seniority within the entity, responsible for benchmark publication.

E.3 A benchmark publisher should implement and maintain systems that are adequate to ensure consistent and timely benchmark publication. Before publishing any benchmark data, the benchmark publisher should obtain a confirmation from the benchmark administrator that the procedures for the validation of the submissions and calculations have been followed.

Question 7: Principles for benchmark publishers

Do you agree with the principles cited in this section? Would you add or change any of the principles?

F. Principles for users of benchmarks

General principles

F.1 Benchmark users should regularly assess the benchmarks they use in financial products or transactions, and verify that the benchmark used is appropriate, suitable and relevant for the targeted market. Any potential irregularities observed in a benchmark should be notified to the benchmark administrator or the relevant competent authorities if appropriate.

Supporting principles

F.2 A benchmark user should ensure that the relevant benchmark administrator and benchmark calculation agent comply with the principles applying to benchmark administrators and benchmark calculation agents. In order to comply with this requirement the benchmark user may consult, among other sources, the confirmation of compliance publicly disclosed by the benchmark administrator and the benchmark calculation agent, and should apply reasonable judgement.

F.3 A benchmark user should develop robust contingencies for the unavailability of a benchmark within contracts referenced to it. The contingency provisions should be used in the event of occasional operational problems, or other market disruptive events, which lead to the benchmark not being reliable, calculated or published in the usual manner.

F.4 A benchmark user should regularly assess the appropriateness, suitability, and relevance of the

use of a benchmark.

Question 8: Principles for users of benchmarks

Do you agree with the principles cited in this section? Would you add or change any of the principles?

Adequacy of the principles to any benchmark-setting process

Question 9: Practical application of the principles

Are there any areas of benchmarks for which the above principles would be inadequate? If so, please provide details on the relevant benchmarks and the reasons of inadequacy.

Legal continuity

30. Without prejudice of the above principles, ESMA and EBA are conscious that any change to a benchmark's framework (calculation methodologies and procedures) should be managed so as to ensure that any disruption to existing benchmark-referenced contracts are proportionate and minimised.

Question 10: Continuity of benchmarks

Which principles/criteria would you consider necessary to be established for the continuity of benchmarks in case of a change to the framework?