EU Benchmarks Regulation and Market Impact as of 1 January 2018

The new EU Benchmarks Regulation (BMR) was published in June 2016 and most rules will apply as of 1 January 2018. The BMR introduces new compliance requirements for benchmark administrators, contributors, a12345nd users, with regard to interest rate, foreign exchange, security, commodity, and other benchmarks used in financial transactions. The BMR was enacted in response to public pressure resulting from the aftermath of the LIBOR scandals and follows the recommendations of the IOSCO and ESMA EBA Principles.

Executive summary

Functioning benchmarks are key to ensuring the smooth functioning of financial markets. However, they lead to conflicts of interest and other integrity issues on the part of contributors of input data and administrators. The scope of the BMR covers all published benchmarks which are used in the European Union with regard to associating financial instruments, financial contracts and/or fund managers. The BMR defines obligations and conduct requirements for both administrators and contributors to ensure market integrity. The Regulation has an extraterritorial dimension in cases where third country administrators request market access. Market access can be granted on the basis of equivalence, recognition, and endorsement by an EU supervised entity. All the legal requirements of the BMR will phase-in on 1 January 2018 and take effect on 1 January 2020 – except for the EURIBOR, which is subject to the BMR today.

What is a benchmark?

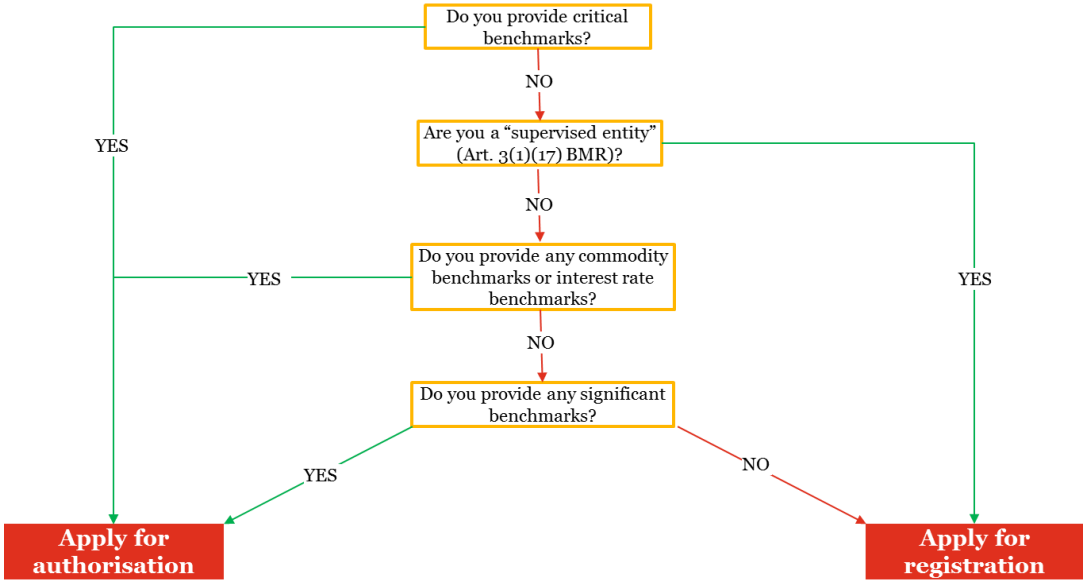
A benchmark is defined as "a reference index, to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument, is determined, or an index that is used to measure the performance of an investment fund with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees" (Article 3(1)(3) BMR). Such an index is a figure, fulfilling one of the following criteria:

i) Published or made publicly available;
ii) Determined at a regular interval by either
   a. partially or entirely applying a formula or any other method of calculation, or another means to assess it by; and
   b. on the basis of the value of one or more underlying assets or prices, including estimates of prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys.

Derivatives as defined in Section C, Annex I, Directive 2014/65/EU do not qualify as an index where there is only a single reference value. Such is the case where a single price or value is used as a reference for a financial instrument, e.g. the reference price for a future or option, without any calculation, input data or discretion. The exclusion does not cover e.g. a basket of securities or an index based on the price of more than one financial instrument. Equally, reference or settlement prices produced by central counterparties are not considered to be benchmarks, because such parties lack the ability to determine the amount payable under a financial instrument or value of a financial instrument. The setting and reviewing weights within a combination of benchmarks, which is generally also only based on a simple average or similar figure if any, does not involve discretion and is thus not considered to be the provision of a benchmark.

Who will be affected?

While the IOSCO Principles are the basis of the BMR, the Principles included the concept of "comply or explain"; this exemption with respect to proportionality and the nature of the benchmark is only included to a limited extent in the BMR. In order to comply with the new Regulation, administrators of a benchmark will either have to apply for registration or for authorisation, depending on the type of benchmark they provide. The provision of critical and significant benchmarks, as well as commodity and interest rate benchmarks, requires an application, while in all other cases registration with the designated authority will suffice.



Administrators: An administrator can be either a natural person or a legal entity with control over the provision of a benchmark, in particular by administering the arrangements determining the benchmark, by collecting and analysing the input data, as well as by determining the rate of the benchmark, and by publishing it. While specific functions of the administrator can be outsourced to a third party, the sole act of publishing or referring to an existing benchmark is insufficient for an individual or an entity to be considered as the benchmark administrator. Control of provision of the benchmark is a necessary regulatory requirement for the provider to become subject to the BMR.

(Supervised) Contributors: The two types of contributors are differentiated in that any natural person or legal entity can contribute input data as a "contributor", but only a "supervised contributor" can contribute input data to an administrator located in the EU as a supervised entity and the contributor has to comply with more stringent requirements, in accordance with Article 16 BMR. The quality and reliability of any benchmark is based on the integrity and accuracy of the input data, which is provided by the contributor. To prevent manipulation at data contribution level, contributors are subject to stringent rules under the BMR. The administrator has to ensure contributors adhere to the code of conduct and that input data is of the required integrity and can be validated, even if the contributor is located in a third country. Any omission by a contributor providing input data to a critical benchmark can undermine the credibility and representativeness of such a benchmark, with severe impact on the underlying market and economic reality. As such, national authorities are given the power to demand mandatory contributions from supervised contributors to critical benchmarks.

Mandatory contributions: Supervised entities may be required to contribute to a critical benchmark by the competent authority. The selection of contributors is based on the size of the entity's actual and potential participation in the market which is measured by the benchmark. Where a critical benchmark is based on contributions mainly provided by supervised entities, the national authorities can demand mandatory contributions for a maximum of 24 months in total for supervised entities, to ensure ongoing representativeness of the benchmark. To qualify the significance of the benchmark to the market, competent national authorities can base their calculations on the volume of transactions the supervised entity conducts in the market which the benchmark intends to measure. Various transaction characteristic may be considered to determine mandatory contributions, such as:

i) Currency of transaction;
ii) Maturity of transactions;
iii) Type of transaction;
iv) Counterparty to the transaction; or
v) Geographical location of the transaction.

The competent authority may also take the potential participation in the market into consideration; when determining whether mandatory participation in a benchmark is required, priority should be given to actual market participation. Any mandatory contribution must increase the representativeness of the benchmark in question.

User of a benchmark: A supervised entity may use a benchmark or a combination of benchmarks in the EU if the benchmark is provided by an administrator located in the Union and included in the register or is a benchmark which is included in the register. Where the object of a prospectus is transferable securities or other investment products that reference a benchmark, the issuer, offeror, or person asking for admission to trade on a regulated market shall ensure that the prospectus also includes clear and prominent information stating whether the benchmark is provided by an administrator included in the register.

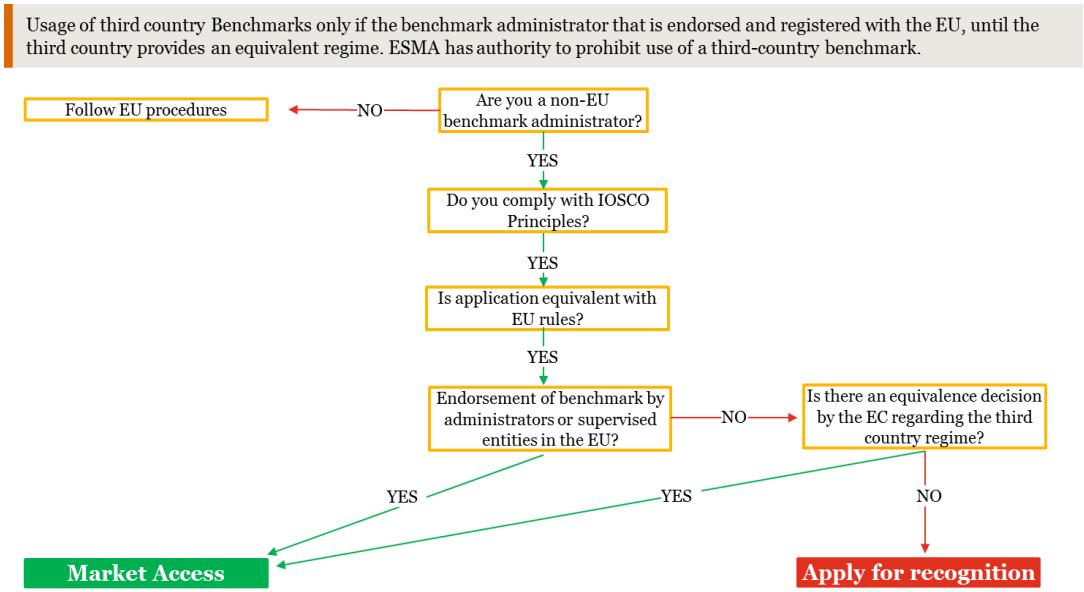
Which benchmarks will be affected?

The BMR subdivides the benchmarks into various subcategories, based on the type of market they reproduce. The Regulation contains specific additional requirements for both commodity and interest rate benchmarks. The following provides an overview of the various subcategories of benchmarks:

Type of Benchmark	Description
Regulated Data Benchmark	Data input for the benchmark is provided directly from regulated venues. Certain provisions of the BMR do not apply to regulated data benchmarks, and they cannot be classified as critical.
Interest Rate Benchmark	An IR Benchmark is determined on the basis of the rate at which banks may lend or borrow from other banks or agents in the money markets. They are subject to the requirements set out in Annex I BMR. Provisions of the BMR relating to significant and non-significant benchmarks do not apply.
Commodities Benchmark	The basis for the benchmark is a commodity as defined by MiFID II. Commodity Benchmarks are subject to the requirements of Annex II BMR, unless the benchmark also qualifies a regulated data benchmark, or is based on submissions from mainly supervised entities. Provisions of the BMR relating to significant and non-significant benchmarks do not apply.
Critical Benchmark	To qualify as a critical benchmark, the value of the underlying contracts needs to be at least EUR 500 bn, or it has to have been recognised as critical in a member state. Critical benchmarks are subject to more stringent and specific requirements than other types of benchmarks. A framework has been developed by ESMA to determine Interbank Offered Rates benchmarks (IBORs) and the Euro OverNight Index Average (EONIA) as critical benchmarks. To date, only EURIBOR has been qualified as such by the EC.
Significant Benchmark	Requires the value of underlying contracts to be at least EUR 50 bn, or there to be none or very few market-led substitutes, leading to significant impact on financial stability, if the benchmark ceases to be produced.
Non-Significant Benchmark	All other benchmarks where the benchmark is neither a commodity nor an interest rate benchmark and the value of underlying contracts of the benchmark is less than EUR 50 bn.

How will a Switzerland-based benchmark provider be affected?

Non-EU administrators are subject to BMR rules where they intend to obtain EU market access; non-compliance will likely lead to these non-EU benchmarks being denied EU market access. There are three ways for third country administrators to become compliant: equivalence, recognition, and endorsement. Firstly, an equivalence decision with regard to foreign jurisdictions can be made by the European Commission if the requirements of Article 30(1) BMR are met and this results in benchmarks from relevant third country jurisdictions being eligible for use by supervised entities in the EU. Secondly, where an administrator located in a third country provides proof of compliance with the IOSCO Principles and said compliance is equivalent to the BMR, the administrator should be recognised as an administrator within the EU. An administrator located in a third country, such as Switzerland, must have a legal representative in the reference member state, if the entity intends to obtain recognition. The legal representative must oversee the provision of benchmarks as performed by the administrator and is accountable to the competent EU member state authority. Finally, market access as a third country administrator can be gained through an endorsement by an administrator of a supervised entity located in the EU. Endorsement will permit market access where the third country administrator adheres to the IOSCO Principles and such adherence results in equivalent compliance with the BMR.



Obligations for administrators and contributors

The BMR directly imposes a variety of obligations on persons involved in the provision, contribution, and use of benchmarks throughout the EU to prevent conflicts of interest and manipulation of benchmarks as well as to ensure maximum harmonisation in cross-border applications. If tasks are outsourced to an external service provider the provider also has to adhere to the BMR. In particular, the administrator is required to provide a code of conduct specifying the requirements and responsibilities regarding input data and to supervise adherence to the code, even if the contributor is located in a third country.

The obligations include the following provisions for administrators:

i) Robust governance arrangements, including a clearly organisational structure with well-defined, transparent and consistent roles and responsibilities for all involved, preventing conflicts of interest (Article 4 BMR).

ii) Develop and maintain robust procedures to ensure oversight of all aspects of the provision of a benchmark and communication with the relevant competent authorities (Article 5 BMR).

iii) Ongoing control of benchmarks to ensure they are provided, published and/or made available in accordance with the Regulation, and maintained through an accountability framework, record-keeping, auditing, and review and complaints handling process (Article 6 to Article 9 BMR). These frameworks must include any third party to which a task has been outsourced (Article 10 BMR).

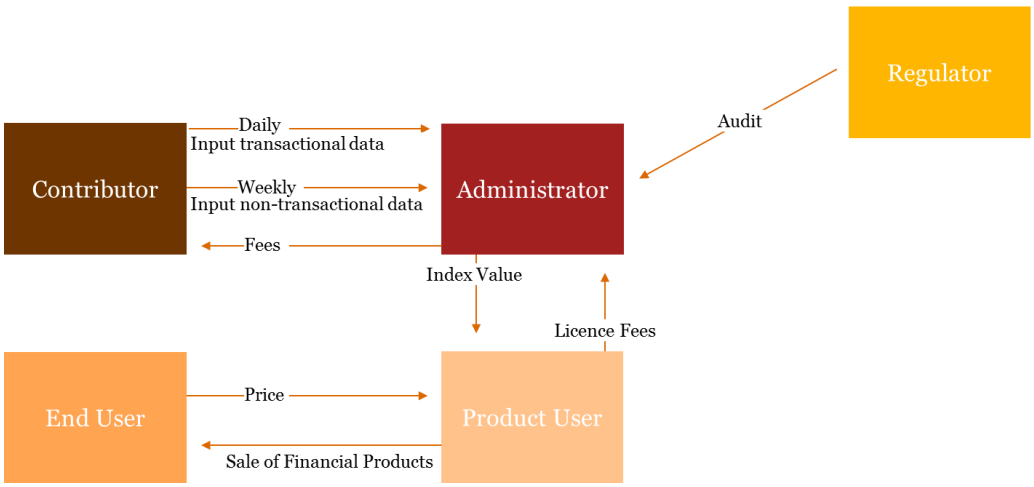
iv) The administrator is also responsible for overseeing the quality of input data and reporting any infringements without delay to the competent authority (Article 11 to Article 15 BMR).

The obligations include the following provisions for contributors:

i) The contributor must adhere to the code of conduct provided by the administrator and the specific requirements prescribed with respect to the contribution of input data (Article 15 BMR).

ii) Supervised contributors must also ensure input data is not affected by any existing or potential conflicts of interest and that all discretion is exercised in an independent and honest way (Article 16 BMR).

The following provides an overview of the interaction between the parties subject to the BMR:



Typical products in scope

Financial instruments referencing an index	• Structured Products • IRS • CDS • Other derivatives • KID (PRIIPS)
Credit Products referencing an index	• All credit products • Lombard credit • Mortgages • Structured credit agreements
Funds	• KIID
All placements requiring a prospectus	• e.g.: Admission to trading processes or public placements • Prospectus according to Prospectus Directive

Entry into force

The BMR will enter into force on 1 January 2018. There is a transition period for certain new and existing benchmarks until 1 January 2020. In accordance with the transitional provisions of Article 51(3) BMR, ESMA considers *existing benchmarks* as including benchmarks "*existing on or before 1 January 2018*", including those provided for the first time on or before 1 January 2018. Thus, an EU index provider may provide a benchmark created between 30 June 2016 and 1 January 2018, including updates and modifications, to supervised entities in the EU until 1 January 2020, even if authorisation or registration has not yet been granted, unless authorisation or registration has been refused.

The BMR has applied to the EURIBOR since 12 August 2016, following qualification as a *critical benchmark*.

Impact

The BMR is a highly complex regulation with implications for all market participants. It requires considerable time to plan, structure, and implement the requirements set forth in accordance with the IOSCO Principles and EU regulations. The requirements have a direct impact on the usage of benchmarks, provision of input data, and cross-border market access.

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