

FESE Response to IOSCO Consultation Report on 'Financial Benchmarks' – CR01/13

1. Introduction

The Federation of European Securities Exchanges (FESE) represents 46 exchanges active in equities, bonds, derivatives and commodities through 21 full members from 30 countries, as well as 7 observer members from European emerging markets. FESE is a keen defender of cross-border competition and many of its members have become multi-jurisdictional exchanges, providing market access across multiple investor communities. FESE members operate Regulated Markets (RMs), which provide both institutional and retail investors with transparent and neutral price-formation.

FESE members are pleased to have the opportunity to contribute to the IOSCO consultation report. FESE supports efficient, fair, orderly and transparent financial markets that meet the needs of well protected and informed investors and provide a source for companies to raise capital and for investors to hedge their portfolios. As such, exchanges can be regarded as neutral providers of data, and in certain cases also indices, but without any conflict of interest between trading activity leading to beneficial ownership and the provision of data and/or the provision of indices and benchmarks (as in the case of LIBOR).

Below you will find our response to certain questions included in the consultation report. Please also find included in this response general introductory comments in the context of financial benchmarks.

2. General Comments

We agree with IOSCO's objectives to create an overarching framework of principles for Benchmarks used in financial markets. In this regard, we also agree with the IOSCO assessment that Benchmarks are large and diverse and therefore the approach of the Task Force to develop a set of high level principles that would be applicable to Benchmarks generally, and a subset of more detailed principles that are intended to address Benchmarks having specific risks arising from their reliance on Submissions (principles 4, 10, 13 and 17) and/or ownership structures (Principles 2, 5 and 16), as described above.

This approach is in line with the FESE comments on the original consultation report¹. We believe that it is important to differentiate between the different categories of benchmarks and actors operating in this area in order to determine the potential shortcomings and introduce appropriate principles. This approach to changing the regulatory perimeters proposed would enable policy makers to retain their focus on addressing, as a matter of urgency, the issues which have occurred and the deficiencies which have been identified, in relation to benchmarks submission/pollled rates benchmarks. Moreover, they would not lose sight of the potential benefits of broader application of such policy action. The benefits of wider application, and any requisite calibration of regulations to other types of benchmarks could then be given due consideration over the medium term.

FESE believes that it is appropriate that all benchmarks should be brought within the scope of civil and criminal sanctions against manipulation, and that their governance, transparency and calculation methodology arrangements should be subject to a set of high level principles by IOSCO.

Should policy makers engage in future discussions on benchmarks and indices and the need to preserve market integrity, FESE believes that these discussions should be in line with the goals of the European

Commission's current work on MAD/R, and should focus on ensuring independence and transparency. Moreover, any regulatory intervention should aim at maintaining a level playing field and focus on those parts of the market where (mostly) unregulated price sources determine the value of an index.

i. Response to the Consultation Questions

1. Equity indices: Indices may be used to measure a wide range of underlying Interests, using a variety of calculation methodologies and inputs. In the specific case of equity indices, inputs are typically based on transactions concluded on Regulated Markets. In light of this: are there any principles or parts of the principles that cannot, or should not, be applied to equity indices? If so, please identify these principles and explain why their application is inappropriate.

Whilst equity indices are not immune from failure, their governance and operation have not been the subject of serious regulatory concern, nor have the regulatory authorities identified any demonstrable misconduct in relation to their compilation. As IOSCO recognises in this Consultation Report, a key differentiating factor between equity indices and many other types of financial benchmark is that typically equity indices are calculated on the basis of the price of shares traded on regulated markets. Those regulated markets are required to comply with stringent regulations concerning market integrity, orderly and transparent price formation, and the operation of proper markets. Moreover, their compliance with such regulations is subject to close and continuous oversight by the relevant regulatory authorities. Therefore, in principle, FESE supports the application of the Principles to equity indices.

However, FESE agrees that it is appropriate to further consider whether certain Principles cannot, or should not, be applied to such benchmarks. FESE supports the approach taken by IOSCO to create a core set of provisions within the Principles – which would apply to all benchmarks – and supplementing them with additional provisions which will apply only to benchmarks based on submissions. FESE urges IOSCO to further consider the current definition of “Submitter” is it could potentially cover equity indices, which FESE understands that this is not the intention of IOSCO. This is further explained in our response to Question 4.

Regarding the individual principles proposed by IOSCO, FESE has responded below to this question with regard to the following principles:

Principle 1(c)

Benchmark Administrators should take all reasonable commercial steps to provide for contingency measures. FESE asks IOSCO to consider how administrators would guarantee contingency measures in the event of absent or insufficient inputs. Clearly this concept should only apply to Benchmarks which are based on submissions and not based on actual transactions. FESE agrees that there should be established systems and processes put in place to explain to the market what the index provider would do if certain inputs are not available. However, these procedures must not place the obligation on index providers to supplement the missing data.

Principle 2(c)

FESE agrees with this principle and we think it is acceptable to make public the details of the Benchmark Administrator who should be the party owning the intellectual property of the indices. However, we would argue that there is no need to make public who the subcontractors for the Benchmark Administrator are, e.g. for calculation or dissemination. We would be concerned that any publication of this level of information may impact the competitive environment.

We would therefore propose to delete in section c) the expression “to Stakeholders and” and to limit the transparency requirement to regulatory authorities only.

Principle 2(d)

FESE asks IOSCO to consider how administrators would guarantee these contingency measures in the event of absent or insufficient inputs. Clearly this concept should only apply to Benchmarks which are based on panel submissions or submissions not based on actual transactions. FESE agrees that there should be established systems and processes to be put in place to explain to the market what the index provider would do if certain inputs are not available. However, these procedures must not place the obligation on index providers to supplement the missing data.

Principles 3(c) & 3(d)

In instances where there are small teams that are working on providing the index, the index personnel may be limited to one or two people. Therefore, reporting lines and sign off in these cases may be less relevant; however, this will nonetheless still be subject to an appropriate management structure.

However, we regard the guidelines as insufficient to avoid conflicts of interest and too one-sided. Therefore, we would like to suggest adjustments for conflicts of interest between the Benchmark Administrator and users of Benchmarks. This conflict of interest was the principle reason for the LIBOR scandal. We would like to suggest critically reviewing a potential restriction of Benchmark Administration in case the same organization is also active in issuing, marketing and selling products related to the same benchmarks under administration.

For completeness, we would like to point out that any such restriction should of course not apply to organizations only providing an appropriate infrastructure for the trading of such products and who do not take an economic interest in the products traded or benchmarks used.

Principle 4(d)

Neutral index providers already have high standards of risk management, transparency and publication. Equity index providers, who collate data from global regulated markets and who are also highly regulated, would not necessarily be able to perform due diligence on input sources. Given that most equity indices are real-time automated services, therefore pre-publication or pre-compilation reviews are not always possible. We suggest therefore that these Principles should only apply to panel based indices.

Principle 5

Neutral index providers have range of oversight functions in place to collect feedback from the markets and enhance scrutiny of the process. However, we suggest that accountability is not diminished by the creation of oversight committees which may lead to a lack of clear accountability between the Benchmark Administrator and the Committee. An independent oversight committee will undoubtedly require market actors to participate who may themselves be a user of the indices and therefore present a conflict. Whilst such committees may be appropriate in certain circumstances and would provide useful insights into the requirements of the market accountability should remain the responsibility of the Administrator.

In instances where there are small teams that are working on providing the index, the index personnel may be limited to a small number of individuals with appropriate expertise. Therefore, there may be an issue of resources for other personnel within the exchange to provide the required oversight. However, FESE agrees that this should be subject to an appropriate management structure and controls.

We suggest that the oversight function as drafted should only be applicable to submission or panel based indices. In addition we suggest that an advisory committee should be made mandatory for all index providers.

Principles 13(g), (v) and (ix)

The response to this principle is based on whether IOSCO will clarify the definition of submitter to exclude 'equity benchmarks' (as outlined in our response to Question 4). This is because given that most

equity indices are real-time automated services, pre-publication or pre-compilation reviews are not always possible.

Principle 16

Equity index providers have implemented a broad range of governance and operational structures. Effective global competition enforces high scrutiny for superior standards in product related governance and operations. Therefore external audits for equity indices are not necessary and paragraph 16 should be re-restricted to submission based indices.

Principles 17(d) and 17(e)

The response to this principle is based on whether IOSCO will clarify the definition of submitter to exclude 'equity benchmarks' (as outlined in our response to Question 4). This is because given that equity indices are usually real-time and automated, therefore, personnel may not be actively involved on a day to day basis in the creation of data or determination of the index

2. Additional measures to address risks resulting from Submission-based Benchmarks or ownership or control structures: Additional measures have been specified within certain principles to address specific risks arising from a reliance on Submissions (principles 4, 10, 13 and 17) and/or from ownership or control structures (Principles 2, 5 and 16).

- a. Should these additional requirements apply to Submitters and Administrators of all submission-based Benchmarks or Benchmarks with the specified ownership/control structures?
- b. If not, please explain why all or some submission-based Benchmarks or Benchmarks with the specified ownership/control structures should be exempt.

In order to ensure market integrity, and in line with the goals of the European Commission's current work on both MiFID/R and MAD/R, any future discussion by policy makers on benchmarks should focus on ensuring independence and transparency.

However, there are strong potential conflicts of interest for "self-indexers", who acts as Benchmark Administrators and issuers of financial products at the same time. They predominantly provide indices for the use of organizationally related units or in-house issuers of products. The potential areas of conflict are amongst others:

- They benefit economically from the level of the indices.
- It is practically impossible to detect whether or not the design of the benchmark favors their interests so their Benchmark setting is prone to one-sided methodologies.
- We would therefore strongly argue to consider a much stronger restriction of Benchmark Administrators to be issuers of financial products or traders in such products.

We suggest that in such circumstances IOSCO should consider what appropriate controls or restrictions on the providers are necessary.

3. Notice Concerning Use of Expert Judgment: Should Administrators be required to briefly describe and publish with each benchmark assessment:

- a. a concise explanation, sufficient to facilitate a User's or Market Authority's ability to understand how the assessment was developed, terms referring to the pricing methodology should be included (e.g., *spread-based*, *interpolated/extrapolated* or *estimate-based*); and
- b. a concise explanation of the extent to which and the basis upon which judgment (i.e. exclusions of data which otherwise conformed to the requirements of the relevant methodology for that assessment, basing assessments on spreads, interpolation/extrapolation or estimates, or weighting bids or offers higher than concluded transactions etc.), if any, was used in establishing an assessment.

In order to ensure market integrity, and in line with the goals of the European Commission's current work on both MiFID/R and MAD/R, any future discussion by policy makers on benchmarks should focus on ensuring independence, and transparency.

4. Revisions to the principles: Please provide any suggested changes to specific principles or definitions of key terms set out in Annex A, including drafting proposals and rationale.

▪ **Definition of 'Submitter'**

FESE is concerned that as currently defined, the definition of "Submitter" would include the exchanges from which the administrator of an equity index takes price inputs. Therefore, we suggest that the definition be amended as follows: "Submitter: A legal person providing information (excluding information from a Regulated Market or Exchange concerning prices established in such venue) to an Administrator or Calculation Agent required in connection with the determination of a Benchmark.

▪ **Definition of 'Benchmark':**

FESE is concerned that this definition as currently drafted would imply that the price of an individual financial instrument would be classified as a "Benchmark". The corollary of this is that each Regulated Market and Exchange would be classified by the Principles as a "Benchmark Administrator" simply by virtue of its operation of a trading system through which the price of such financial instrument is determined. FESE recommends that the Principles be amended to make it clear that this is not the intention. This could be achieved either by stating that the price of an individual financial instrument is not to be regarded as a Benchmark, or by stating explicitly that Regulated Markets and Exchanges acting in their capacity as such will not be treated as if they were Benchmark Administrators".

▪ **Ownership or control structures (Principles 2, 5 and 16)**

When an exchange is the sole owner of an index, there could be conflicts of interests that need to be managed. There is for instance the distinct danger that the exchange could use the inclusion into the index (and the subsequent investment by local asset managers) as an argument when competing against other listing venues. Inclusion criteria in an index controlled by an Exchange should not limit the underlying constituent company from listing on additional exchanges.

5. Are any other principles needed: Should principles to address any additional issues, risks or conflicts of interest be developed? Please provide a summary of the issue and drafting for the proposed principle.

FESE wishes to raise one additional point under this consultation question:

1. Reference prices used for clearing purposes

Some regulated exchanges submit prices to CCPs in order to help the latter to value the CCP's positions with its participants. Such prices are of course essential for the proper risk management of the CCP, and accordingly are mandated within the CPSS-IOSCO Principles for FMIs² (the "PFMIs"). These end of day prices are calculated by exchanges using a standard process based on actual trade activity which they already have in place and does not represent a separate process for CCPs.

FESE is concerned that such prices could potentially be categorized as benchmarks under the definition set out in Annex A of the proposed IOSCO principles. We do not believe this is the intention and we would urge IOSCO to clarify this. Such reference prices are central to a CCP's risk management activities, and as such are governed directly by CCPs' existing regulatory arrangements. CCPs have no directional exposure, since they maintain a fully matched position, and are highly incentivized to ensure the reference prices to mark exposures to market are the most accurate available. Principles relating to such reference prices, and which take these considerations into account, are set out in CPSS-IOSCO's PFMIs, under paragraphs 3.6.4 to 3.6.5. We therefore propose that reference prices for use within CCPs be excluded, with reference instead made to the existing PFMIs.

² <http://www.bis.org/publ/cpss101a.pdf>