



IOSCO Consultation Report on Financial Benchmarks

Background

As we have previously reported¹, a Task Force of the International Organization of Securities Commissions (“IOSCO”) published a consultation on financial benchmarks on 11 January 2013 in response, in part, to recent controversies in relation to the setting of financial benchmarks, including LIBOR. The January consultation discussed concerns regarding the potential for inaccuracy or manipulation of benchmarks and considered issues such as appropriate standards for benchmark calculation, related governance issues and transparency and openness in the benchmarking process. Subsequent to the publication of the consultation, the IOSCO Task Force held stakeholder meetings and received over 50 comment letters.

On 16 April 2013, the IOSCO Task Force published a follow-up Consultation Report which sets out draft Principles for those involved in the administration of benchmarks and providers of information in connection with their determination.² It also includes a feedback statement on the January consultation.

The IOSCO Task Force is co-chaired by Martin Wheatley, the chief executive of the new Financial Conduct Authority (the “FCA”) in the UK and Gary Gensler, the chairman of the Commodity Futures Trading Commission (the “CFTC”) in the US, both of whom have been active in their respective roles in considering the need for greater and more active regulation of the setting and use of financial benchmarks. In the UK, Martin Wheatley undertook a review of setting and usage of LIBOR and published a report on this issue in September 2012³. This report recommended that LIBOR should be comprehensively reformed (although not necessarily replaced), that transaction data should be explicitly used to support LIBOR submissions and that market participants should continue to play a significant role in the production and oversight of LIBOR. The recommendations included the introduction of a statutory regulation of administration of and submission to LIBOR and the transfer of the responsibility of LIBOR to a new administrator to be responsible for compiling and distributing the rate and providing internal governance and oversight. Many of these recommendations have been included in the UK’s Financial Services Act 2013.

The IOSCO Consultation Report reiterates the Task Force’s objective to create an overarching framework of principles for benchmarks used in financial markets. Specifically it expresses an intention to establish policy guidance and principles for activities related to the setting of benchmarks to address conflicts of interest in the benchmark setting process, transparency and possible transition away from certain benchmarks in appropriate circumstances. Following the establishment of final Principles, it is stated that IOSCO intends to undertake a review of the implementation of such Principles within 18 months.

¹ Structured Thoughts: Volume 4, Issue 3 February 6, 2013—<http://www.mofo.com/files/Uploads/Images/130206-Structured-Thoughts.pdf>.

² The Consultation Report may be found at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD409.pdf>.

³ The Wheatley Review of LIBOR, final report—<https://www.gov.uk/government/news/independent-review-into-libor-published>.

Key Definitions

The definition of “Benchmark” for the purpose of the Principles is wide and includes:

“prices, estimates, rates, indices or values that are:

- a) Made available to users, whether free of charge or for payment;
- b) Calculated periodically, entirely or partially, by the application of a formula or another method of calculation to, or an assessment of, the value of one or more underlying Interests;
- c) Used for reference for purposes that include one or more of the following:
 - determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments;
 - determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument; and/or
 - measuring the performance of a financial instrument.”

This definition is therefore significantly wider than interest rate benchmarks and, as currently proposed, its ambit will include other types of reference rates, including proprietary indices. Other key definitions include:

- **“Administrator”**, being the organization or legal person who controls the creation and operation of the benchmark process, whether or not it owns the intellectual property relating to the Benchmark. The Administrator is required to have responsibility for all stages of the Benchmark administration process including its calculation, the determination and application of the methodology and its dissemination.
- **“Benchmark Publisher”** is a legal entity that publishes the Benchmark values (whether on the internet or otherwise and whether or not free of charge).
- **“Interest”** which includes any physical commodity, currency, tangible goods or intangibles (including derivatives, interest rates or other indices) that are intended to be measured by a Benchmark.
- **“Stakeholder”** includes a subscriber purchasing Benchmark determination services from an Administrator and any other person who owns contracts or financial instruments that reference a Benchmark.
- **“Submitter”** is defined as any person who provides information to an Administrator or a Calculation Agent (a person having responsibility for determining a Benchmark) required in connection with the determination of a Benchmark.

The Principles

The Consultation Report sets out 18 Principles concerning the determination and quality of benchmarks, governance issues and accountability issues. The Task Force states it does not expect these to be implemented on a ‘one size fits all’ basis. Although the IOSCO Principles will not be directly binding on any Benchmark Administrator, Submitter or other market participant, the Task Force notes that there are a number of completed and ongoing regulatory work streams in connection with Benchmarks, including the Wheatley Review referred to

above. The Task Force states that the Principles are not intended to supersede existing laws or regulations but to provide guidance to Administrators, Submitters and regulators. It is stated that IOSCO members should give consideration as to whether regulatory action may be appropriate in individual jurisdictions to encourage implementation of the Principles.

A number of the Principles contain additional requirements where the Benchmark determination relies upon submissions from a Submitter, as is the case with LIBOR. This includes the requirement for a Submitter Code of Conduct as set out in more detail below.

The Principles come under four headings:

- **Governance:** These are intended to ensure that Administrators have appropriate governance arrangements in place to protect the integrity of the Benchmark determination process and to address conflicts of interest.
- **Quality of Benchmark:** Aimed at promoting the quality and integrity of Benchmark determinations so that the Benchmark reflects a credible market for the relevant Interest.
- **Quality of Methodology:** Principles aimed at promoting the quality and integrity of methodologies including minimum information that should be included in a methodology and the need for procedures when material changes to the methodology are planned. These Principles also require Administrators to have credible policies in case a Benchmark ceases to exist or Stakeholders need to transition to another Benchmark.
- **Accountability:** Requirements that there are appropriate complaints processes, documentation requirements and audit reviews to provide evidence of compliance by the Administrator with appropriate quality standards.

The detailed Principles include:

Governance

- **Overall Responsibility of the Administrator:** Each Benchmark, regardless of its structure and administration, should have an Administrator that retains primary responsibility for all aspects of the Benchmark determination process including development, compilation of the Benchmark and establishing credible and transparent governance, oversight and accountability procedures.
- **Oversight of Third Parties:** The Administrator must adopt clearly defined arrangements in writing, setting out the roles and obligations of all parties involved in the Benchmark determination process and the monitoring of any third party's compliance with such arrangements. The Administrator must maintain appropriate oversight of such third parties. There should be transparency to Stakeholders and regulatory authorities as to any third parties who participate in the Benchmark determination process.
- **Conflicts of Interest for Administrators:** Administrators should document, implement and enforce policies and procedures for identification, disclosure, management, mitigation or avoidance of conflicts of interest. Such policies and procedures should be reviewed and updated as appropriate and Administrators should disclose material conflicts of interest to the relevant regulatory authorities. Amongst potential conflicts identified as needing to be included in the conflicts management framework are personal and business interests and connections and remuneration policies – it should be ensured that staff participating in the Benchmark determination are not directly or indirectly rewarded or incentivised by the levels of the Benchmark.

- **Internal Oversight:** The Administrator should establish an oversight function to review and provide challenge on all aspects of the Benchmark determination process. The oversight should include consideration of the intended or expected usage of the Benchmark and existing or potential conflicts of interest, and should be carried out by a separate committee or other appropriate governance arrangements. Additional requirements apply where a Benchmark is based on submissions, including a requirement that the oversight function provides suitable oversight and challenge of submissions.

Quality of Benchmark

- **Benchmark Design:** The design of the Benchmark should seek to ensure an accurate and reliable representation of the economic realities of the relevant underlying Interest, and eliminate distorting factors.
- **Data Sufficiency:** The data used to construct the Benchmark should be based on prices, rates, indices or values primarily under observable transactions entered into between parties at arm's length. Non-transactional data such as bids and offers or the Administrator using its discretion to adjust the factors that may impact the quality of the data may be relied on only as an adjunct or supplement to transactional data. It is also noted that the nature of certain indices, including volatility indices, requires non-transactional data to reflect what the index is designed to measure.
- **Hierarchy of Data Inputs:** The Administrator is required to publish clear guidelines as to the hierarchy of data inputs and the exercise of expert judgment in relation to the determination of the Benchmark. In general, this should include reported or observed arms-length transactions in the underlying Interest or related markets, executable bids and offers and other market information or expert judgments. Where a Benchmark is dependent upon submissions, the Submitter's own concluded arms-length transactions in the underlying Interest or related markets should have the primary hierarchy. Some flexibility is permitted, provided it is consistent with the Benchmark methodology, *e.g.* it is acknowledged that an Administrator may need to rely on expert judgment in an illiquid market.

Quality of Methodology

- **Content of Methodology:** The Administrator should document and publish the methodology used to make determinations of the Benchmark. This should provide sufficient detail to enable Stakeholders to understand how the Benchmark is derived and to assess its representativeness, relevance to particular Stakeholders and appropriateness as a reference for financial instruments. The Principles set out minimum elements to be contained in the methodology. Where a Benchmark is based on submissions, the Administrator is required to establish criteria for including and excluding submissions.
- **Changes to Methodology:** The Administrator should publish the rationale for any proposed material change in the methodology and procedures for making such change, which should set out clearly what constitutes a material change and the method and timing for consulting or notifying subscribers and other Stakeholders, where appropriate, of changes.
- **Transition:** Administrators should have clear written policies and procedures to address the need for possible cessation of a Benchmark, due to changes in market structure or product definition or any other condition that means the Benchmark is no longer representative of the underlying Interest. Such policies and procedures should be made available to all Stakeholders and should be proportionate to the estimated breadth and depth of contracts and financial instruments that reference the Benchmark and the economic and financial stability impact that might result from its cessation. The Administrator should take into account the views of Stakeholders and regulatory authorities in determining such policies and procedures

and should encourage subscribers and Stakeholders to have robust fall-back provisions in contracts or financial instruments that reference a Benchmark.

- **Submitter Code of Conduct:** Where a Benchmark is based on submissions from Submitters, a Code of Conduct should be developed by the Administrator setting out guidelines for relevant factors, such as the selection of inputs, who may submit data and information to the Administrator and quality control procedures. This should be made available to Stakeholders and relevant regulatory authorities and the Administrator should only use inputs or submissions from Submitters who adhere to the Code of Conduct.

Accountability

- **Complaints Procedures:** The Administrator should establish and publish a written complaints procedures policy enabling Stakeholders to make complaints, including as to whether a particular Benchmark determination is representative of the underlying Interest.
- **Audits:** The Administrator should appoint an independent internal or external auditor with appropriate experience and capability to periodically review and report on the Administrator's adherence to its stated criteria and the Principles. The frequency of such audits should be proportionate to the size and complexity of the Administrator's operations. Where appropriate, *e.g.* having regard to existing or potential conflicts of interest, an Administrator should also appoint an independent external auditor to periodically review and report on the Administrator's adherence to its stated methodology criteria.

Feedback Statement on Previous Consultation

The Consultation Report contains a feedback statement in respect of responses to the 11 January consultation. 54 written responses were received—many respondents were concerned at the potential for principles being too wide and the need for some differentiation between different types of Benchmarks in the Principles. Some respondents thought there should be exclusions of some Benchmarks from any Principles, including equity indices, smaller or private Benchmarks (particularly where they are more akin to private contracts between buyers and sellers) and Benchmarks used for performance evaluation.

The feedback statement also includes detailed responses on requirements in relation to the methodology related to Benchmarks, roles and responsibilities of the Administrator and other parties, transparency, governances, conflicts of interest, regulation, data sufficiency and transition to new Benchmarks.

Next Steps and Conclusion

The comment period is open until 16 May 2013, following which IOSCO will publish final Principles.

The Consultation Report contains a number of specific questions which respondents are invited to address, including:

- whether the Principles should apply to equity indices;
- the need for additional Principles to address specific risks arising from a reliance on submissions;
- the need for further explanation relating to transparency requirements where expert judgment has been used in the Benchmark determination;
- any proposed changes or additions to the Principles.

The Consultation Report continues the work by the international regulatory community to address concerns in respect of financial benchmarks, particularly in relation to the calculation of LIBOR. The Principles are consistent with the concerns raised in IOSCO's January 2013 consultation and it would be surprising if any significant changes are made to the Principles as set out in the Consultation Report. In particular, it seems clear that the scope of the Principles will remain wide and will cover many benchmarks measuring financial information, including proprietary indices. As expected, a key focus of a number of the Principles is a requirement that Benchmarks designed to represent transactions should be based on observable data from arm's length transactions. The additional governance and oversight requirements, including the requirements for internal or external auditors and audit record retention requirements are likely to raise costs, particularly for providers of proprietary indices⁴. It remains to be seen if regulators in individual jurisdictions will formally adopt the Principles or impose additional requirements. It is clear, however, that this remains an area of key focus for regulators, with Gary Gensler and others continuing to raise concerns as to existing market practice in relation to benchmarks, for market participants to transition to new benchmarks.

Authors

Peter Green
London
+44 20 7920 4013
pgreen@mofocom

Jeremy Jennings-Mares
London
+44 20 7920 4072
jjenningsmares@mofocom

Contacts

Bradley Berman
New York
+1 212 336-4177
bberman@mofocom

Lloyd Harmetz
New York
+1 212 468-8061
lharmetz@mofocom

Anna Pinedo
New York
+1 212 468-8179
apinedo@mofocom

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer's* A-List for nine straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofocom. © 2013 Morrison & Foerster LLP. All rights reserved.

For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/thinkingcapmkts.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

⁴ Administrators of proprietary indices may be likely to opt for internal audits, where feasible, in lieu of compensating a third party for the service.