Client Alert

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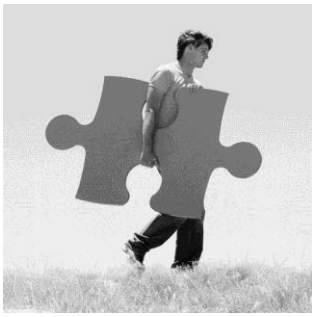

Setting the New Benchmark: EU Regulation on Financial Benchmarks

Background

The integrity of benchmarks used in financial transactions has been the subject of increasing focus from regulators since the investigations into manipulation of the setting of LIBOR, EURIBOR and other benchmarks. Action was taken in the UK following the Wheatley Review of LIBOR[1] to reform the setting and usage of LIBOR, and the UK Financial Conduct Authority (FCA) has subsequently taken action to regulate additional specific financial benchmarks[2].

At an international level, in July 2013, the International Organisation of Securities Commissions (IOSCO) published its Final Report on Principles for Financial Benchmarks[3]. Shortly thereafter, the EU Commission published a draft regulation seeking to establish a pan-European approach to the regulation of benchmark administrators, contributors and users. The subsequent legislative process has been lengthy and has involved significant amendments to the initial draft. However, on 17 May 2016, the European Council of Ministers formally adopted the final version of the Regulation on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "Benchmark Regulation") which had previously been adopted by the EU Parliament. It published what is expected to be the final version of the Benchmark Regulation on 10 June 2016.[4] The Benchmark Regulation will come into force the day after it is published in the Official Journal of the EU. This is expected to happen in June or early July 2016. Most of its provisions will not, however, be implemented until 18 months after such date (so December 2017 or January 2018) with the exception of some provisions that will apply immediately upon it coming into force and provisions amending the Market Abuse Regulation[5] (which will apply from 3 July 2016 to dovetail with the Market Abuse Regulation becoming effective).

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191762/wheatley_review_libor_finalreport_280912.pdf.
[2] SONIA (Sterling Overnight Index Average), RONIA (Repurchase Overnight Index Average), WM/Reuters London 4pm Closing Spot Rate, ISDAFIX, London Gold Fixing, the LMBA Silver Price and the ICE Brent Index.
[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf.
[4] http://data.consilium.europa.eu/doc/document/PE-72-2015-REV-1/en/pdf.
[5] Regulation 596/2014, 65 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0596&from=EN.

Scope of Regulation

The Benchmark Regulation will apply to a very wide range of indices, including proprietary indices, which are used as benchmarks in financial instruments. The key definitions in this context include the following:

Benchmark: There are two elements to this definition:

- in relation to financial instruments or financial contracts, any index by reference to which the amount payable under such instrument or contract is determined, or by which the value of a financial instrument is determined;
- in relation to investment funds, any index that is used to measure the performance of any such fund with the purpose of tracking the return of such index or of defining the asset allocation of a relevant portfolio or in computing performance fees.

Index: This is defined as any figure that is:

- published or made available to the public; and
- regularly determined (i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment, and (ii) on the basis of the value of one or more underlying assets or prices including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys.

In draft technical advice referred to further below, the European Securities and Markets Authority (ESMA) provides that an index should be deemed to be made available to the public if (i) it is accessible by a large or potentially indeterminate number of recipients, or (ii) it is provided or is accessible to one more supervised entities to allow use of the index in the EU.

Financial instrument: Any instrument listed in Annex I(C) to MiFID II[6] that is either traded on a trading venue (as defined in MiFID II) or is the subject of a request made for admission to trading on a trading venue or via a systematic internaliser[7]. The instruments listed in Annex I(C) of MiFID II are very wide and include transferable securities, money-market instruments, UCITS, a very wide range of derivative transactions and financial contracts for difference.

Financial contract: Any credit agreement within the ambit of the Consumer Credit Directive[8] or the Mortgage Credit Directive[9] (basically EU consumer credit agreements and residential mortgages).

Investment fund: An alternative investment fund (AIF) as defined in the Alternative Investment Fund Managers Directive (AIFMD)[10], or a UCITS fund as defined in the UCITS IV Directive[11].

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[6] The recast Markets in Financial Instruments Directive, Directive 2014/65/EU, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN.
[7] investment firms which, on an organised, frequent, systematic and substantial basis, deal on own account by executing client orders outside a regulated market, MTF or organised trading facility as defined in MiFID II.
[8] Directive 2008/48/EC, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:133:0066:0092:EN:PDF.
[9] Directive 2014/17/EC, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0017&from=EN.
[10] Directive 2011/61/EC, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF.
[11] Directive 2009/65/EC, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF.

The Benchmark Regulation therefore diverges from the existing approach to regulation of benchmarks by the FCA and other regulators which have to date focused on a small number of key benchmarks that are widely used in the financial markets and which are regarded as systemically important. In contrast, the Benchmark Regulation will, subject to limited exceptions, apply to all indices used in financial securities or derivatives traded on a regulated venue in the EU or traded outside such a venue, using an investment firm designated as a systematic internaliser under MiFID II. Although the definition of "index" limits the scope of the Benchmark Regulation to indices that are published or made available to the public, this is likely to be construed widely with the draft ESMA technical standards recommending that an index should be considered as being made available to the public even if only provided to supervised entities to allow use of the index in the EU.

To ameliorate the impact of the vastly increased number of benchmarks to become subject to regulation and supervision in the EU under the Benchmark Regulation, the Regulation distinguishes between "critical", "significant" and "non-significant" benchmarks as specified further below with differing standards of regulatory requirements applying to each category.

The Benchmark Regulation will not, however, apply to the following:

- central banks;
- public authorities, in respect of such an authority contributing data to or having control over the provision of benchmarks for public policy purposes (e.g., indices measuring employment, economic activity or inflation);
- central counterparties (CCPs) in their capacity of providing reference prices or settlement prices used for CCP risk-management purposes and settlement;
- the provision of a single reference price for any financial instrument;
- commodity benchmarks based on submissions from contributors, the majority of which are non-supervised entities, provided that the benchmark is referenced by financial instruments for which a request for admission to trading has been made on only one trading venue or which are traded on only one trading venue, and the total notional value of financial instruments referencing the benchmark does not exceed €100 million;
- an index provider, in respect of an index provided by it where such provider is unaware and could not reasonably have been aware that the index is used as benchmark within the scope of the Benchmark Regulation.

Regulation and Supervision of Benchmark Administrators

One of the key elements of the Benchmark Regulation is a new regulatory and supervisory regime that will apply to administrators of benchmarks that fall within the scope of the Benchmark Regulation. For these purposes, an administrator is any natural or legal person that has control over the provision of a benchmark. There is no guidance as to the meaning of "control" for this purpose, but the definition is likely to be construed fairly widely so any person or entity involved in producing a financial benchmark should consider whether it comes within the scope of the Benchmark Regulation as a benchmark administrator.

Title VI of the Benchmark Regulation requires any benchmark administrator that is located in the EU to apply to its relevant competent authority for authorisation to act in such capacity if it provides or intends to provide

indices for use as benchmarks within the scope of the Benchmark Regulation. There is a registration regime for entities supervised under other relevant EU regulation (including credit institutions, MiFID investment firms, insurance and reinsurance undertakings, UCITS funds and managers, AIFs regulated under the AIFMD and CCPs and trade repositories regulated under EMIR[12]). Benchmark administrators only need to be registered (rather than authorised) with their competent authority if they are only providing indices that are non-significant benchmarks (see further below).

There are also transitional provisions for benchmark administrators that are already providing benchmarks on the date the Benchmark Regulation comes into force. Such entities will have 42 months from such date to apply for authorisation or registration, as applicable. Until the end of that 42-month period (or, if earlier, until any application for authorisation or registration during that time is refused), such existing administrators may continue to provide such existing benchmark(s). If such administrator wants to provide a new benchmark after the Benchmark Regulation becomes effective, it will need to obtain appropriate authorisation or registration prior to doing so.

Benchmark administrators are subject to a number of requirements under the Benchmark Regulation aimed at maintaining the integrity and reliability of relevant benchmarks, including:

- ***Governance and conflicts of interest***: benchmark administrators are required to have in place robust governance arrangements including a clear organisational structure with well-defined transparent and consistent roles and responsibilities for all persons involved in the provision of a benchmark. Administrators will also be required to take adequate steps to identify and prevent or manage conflicts of interest and to ensure that where any judgment or discretion is required in the benchmark determination process, it is exercised independently and honestly. The provision of the benchmark must be operationally separated from any part of the administrator's business that may create an actual or potential conflict of interest.

- ***Oversight function requirements***: benchmark administrators will be required to establish and maintain a permanent and effective oversight function to ensure oversight of all aspects of the provision of their benchmarks. They will be required to develop and maintain robust procedures regarding their oversight function and make this available to the relevant competent authorities.

- ***Control framework requirements***: it will be necessary for benchmark administrators to have in place a control framework that ensures benchmarks are provided and published or made available in accordance with the Benchmark Regulation. The framework must be reviewed and updated as appropriate and made available to the relevant competent authority and, upon request, users of the benchmark.

- ***Accountability framework requirements***: benchmark administrators will be required to have in place an accountability framework covering record-keeping, auditing and review and a complaints process.

- ***Record-keeping***: record-keeping requirements provide that benchmark administrators must keep various records, including records of all data, the methodology used for the determination of a benchmark, exercises of judgment or discretion by the benchmark administrator and changes in or deviations from standard procedures and methodologies, including those made during periods of market stress or disruption. Records should be kept for a period of at least five years.

[12] European Market Infrastructure Regulation ("EMIR"), Regulation 648/2012, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN.

- ***Outsourcing***: benchmark administrators must not outsource functions in the provision of a benchmark in such a way as to impair materially the administrator's control over the provision of the benchmark or the ability of the relevant competent authority to supervise the benchmark. The administrator must comply with certain specified conditions when outsourcing any functions, including ensuring that the service provider has the ability, capacity and any applicable authorisations to perform the outsourced functions, services or activities reliably and professionally.

- ***Input Data***: various requirements apply to input data, including that it should be sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure. The input data must be transaction data if available and appropriate. If transaction data is not sufficient or is not appropriate to represent accurately and reliably the market or economic reality that the benchmark is intended to measure, input data which is not transaction data may be used, including estimated prices, quotes and committed quotes or other values. ESMA is required to develop draft regulatory technical standards to specify further how to ensure that input data is appropriate and verifiable.

- ***Methodology***: benchmark administrators are required to use a methodology for determining a benchmark that is robust and reliable, has clear rules identifying how and when discretion may be exercised in the determination of that benchmark and is rigorous, continuous and capable of validation including, where appropriate, back-testing against available transaction data. The methodology must also be resilient in a wide set of possible circumstances and be traceable and verifiable. The benchmark administrator must also develop, operate and administer the benchmark and methodology transparently.

- ***Reporting of infringements***: benchmark administrators will be required to report to the relevant competent authority any conduct that may involve manipulation or attempted manipulation of a benchmark under the Market Abuse Regulation and in this regard must monitor input data and contributors in order to be able to make any such notifications.

- ***Code of conduct for contributors***: where a benchmark is based on input data from contributors, the benchmark administrator must develop a code of conduct for each benchmark clearly specifying contributors' responsibilities with respect to the contribution of input data. This code of conduct shall contain the elements specified in the Benchmark Regulation. ESMA is required to develop draft regulatory technical standards to specify further the elements of the code of conduct.

Requirements for Specific Types of Benchmark

Commodity benchmarks: administrators of commodity benchmarks will be subject to additional requirements set out in Annex II of the Benchmark Regulation. These require the benchmark administrator to formalise, document and make public any methodology that the administrator uses for the benchmark calculation. It must also specify the criteria that define the physical commodity that is the subject of a particular methodology and give priority to concluded and reported transactions in respect of its input data. A commodity benchmark also cannot benefit from any of the exclusions relating to significant or non-significant benchmarks specified below. However, if a commodity benchmark which has gold, silver or platinum as the underlying asset is a critical benchmark, it will be able to comply with the rules generally relevant to financial benchmarks rather than the specific commodity rules.

Interest rate benchmarks: specific requirements set out in Annex I of the Benchmark Regulation will apply to interest rate benchmarks. These provide that the general priority of use of input data for such benchmarks will be:

- a contributor's transactions in the underlying market that the benchmark is intended to measure or, if not sufficient, in related markets;
- a contributor's observations of third-party transactions in such markets;
- committed quotes;
- indicative quotes or expert judgments.

The administrator of an interest rate benchmark must also have in place an independent oversight committee and ensure that a contributor's systems and controls include specific matters set out in Annex I. Additional record keeping requirements also apply, including in relation to input data and names and responsibilities of submitters (defined as a natural person employed by a contributor for the purpose of contributing input data).

Regulated data benchmarks: a regulated data benchmark is one that is determined by the application of a formula from input data contributed entirely and directly from certain regulated venues as specified in the Benchmark Regulation. Such benchmarks will be exempt from certain of the governance and control requirements that would otherwise apply under the Benchmark Regulation, including in relation to input data and the need to develop a code of conduct for contributors. Regulated data benchmarks may benefit from the provisions relating to significant and non-significant benchmarks if used as a reference for financial instruments or financial contracts or for measuring the performance of investment funds, having a total value of up to €500 billion on the basis of all the range of maturities or tenors of the benchmark, where applicable.

Critical Benchmarks

The EU Commission is required to adopt implementing legislation to establish and review, at least every two years, a list of critical benchmarks provided by benchmark administrators located in the EU. To be categorised as a critical benchmark, one of the following requirements must apply:

- the benchmark is used directly or indirectly within a combination of benchmarks as a reference for financial instruments or financial contracts or for measuring the performance of investment funds having a total value of at least €500 billion on the basis of all the range of maturities or tenors of the benchmark; or
- the benchmark is based on submissions by contributors, the majority of which are located in one member state and is recognised as being critical by the relevant competent authority in accordance with criteria specified in the Benchmark Regulation; or
- the benchmark fulfils all of the following: (i) it meets all the criteria specified in relation to the first bullet point above but with a total value of at least €400 billion, (ii) the benchmark has no, or very few, appropriate market-led substitutes and (iii) in the event that the benchmark ceases to be provided or is provided on the basis of input data no longer fully representative of the underlying market or economic reality or on the basis of unreliable input data, there would be a significant and adverse impact on market integrity, financial

stability, consumers, the real economy or the financing of households and businesses in one or more member states.

Critical benchmarks will be subject to additional requirements:

- the relevant competent authority shall establish a supervisory college in respect of each critical benchmark comprising the competent authority of the administrator, ESMA and the competent authorities of all supervised contributors to the benchmark;

- if the administrator of a critical benchmark intends to cease providing such benchmark, it must immediately notify its competent authority and within four weeks submit an assessment of how such benchmark is to be transitioned to a new administrator or is to cease to be provided. The administrator shall not cease to provide the benchmark during this four-week period. During this time the relevant competent authority shall liaise with the relevant supervisory college and make its own assessment of how the benchmark should be transferred to a new administrator or cease to be provided. At the end of this period, the competent authority has the power to compel the administrator to continue providing the benchmark until the benchmark has been transitioned to a new administrator or has ceased to be provided in an orderly manner or is no longer critical. The period in respect of which the competent authority may compel the administrator to continue to provide the benchmark cannot exceed 12 months (which period can be extended by a further 12 months);

- the administrator is required to take adequate steps to ensure that the licenses of, and information relating to, the benchmark are provided to all users on a fair, reasonable, transparent and non-discriminatory basis;

- administrators of a critical benchmark are required to submit to their competent authorities every two years an assessment of the capability of such benchmark to measure the underlying market or economic reality;

- if a supervised contributor to a critical benchmark intends to cease contributing input data in respect of the benchmark, it shall notify the administrator who shall also notify the relevant competent authority. The administrator must, within 14 days, submit to such competent authority an assessment of the implications of the benchmark to continue to measure the underlying market or economic reality. During this time, the competent authority has the power to require contributors to continue contributing input data (provided that this shall not impose an obligation on supervised entities to trade or commit to trade). The competent authority shall liaise with the relevant supervisory college and make its own assessment as to the capability of the benchmark to continue to measure the underlying market or economic reality. On the basis of such assessment, the authority can require supervised entities to continue to provide input data for a period not exceeding 12 months (which period can be extended by a further 12-month period).

The above rules in relation to mandatory administration and contribution to critical benchmarks will take effect on the date that the Benchmark Regulation comes into force.

Significant and non-significant benchmarks

A benchmark that is not a critical benchmark will be regarded as significant if either:

- it is used directly or indirectly within a combination of benchmarks as a reference for financial instruments or financial contracts or for measuring the performance of investment funds having a total average value of at

least €50billion on the basis of all of the range of maturities or tenors of the benchmark over a period of six months; or

- it has no or very few appropriate market-led substitutes and, in the event that the benchmark would cease to be provided or would be provided on the basis of input data no longer fully representative of the underlying market or economic reality or unreliable data, there would be a significant and adverse impact on market integrity, financial stability, consumers, the real economy or the financing of households or businesses in one or more member states.

Any benchmark that is not a critical or significant benchmark is regarded as a non-significant benchmark.

The administrator of a significant benchmark may choose not to apply certain provisions of the Benchmark Regulation that would otherwise apply, including the need to operationally separate the provision of a benchmark from parts of its business for conflict of interest reasons, certain of the provisions relating to diligence of employees and personnel and contributors on a "comply or explain" basis if it considers that complying with such provisions would be disproportionate, having regard to the nature or impact of the benchmark or the size of the administrator. The competent authority may, however, decide that one or more of such provisions should apply to the administrator on the basis of certain specified criteria set out in the Benchmark Regulation.

Administrators of non-significant benchmarks may choose not to apply a wider list of provisions from the Benchmark Regulation, including many of the specific requirements relating to the oversight function and control function. Again, this is on a "comply or explain" basis and requires the preparation of a compliance statement by the administrator explaining why it considers it appropriate not to comply with the relevant provisions. The relevant competent authority may request additional information and may require changes to the compliance statement to ensure compliance with the Benchmark Regulation.

Use of Benchmarks in the EU

Subject to the provisions relating to non-EU benchmarks below, a supervised entity will only be permitted to use a benchmark in the EU if the benchmark is provided by an administrator authorised or registered under the Benchmark Regulation.

The Benchmark Regulation provides that "use of a benchmark" means:

- issuance of a financial instrument which references an index or a combination of indices;
- determination of the amount payable under a financial instrument or a financial contract by referencing an index or a combination of indices;
- being a party to a financial contract which references an index or a combination of indices;
- providing a borrowing rate calculated as a spread or mark-up over an index or a combination of indices that is solely used as a reference in a financial contract to which the creditor is a party; or
- measuring the performance of an investment fund through an index or a combination of indices for the purpose of tracking the return of such index or combination of indices, or defining the asset allocation of a portfolio or of computing the performance fees.

The definition does not therefore prevent a supervised entity from acquiring, holding or trading a financial instrument that references an index within the ambit of the Benchmark Regulation. However, parties to an OTC derivative referencing a benchmark would appear to be regarded as issuing a financial instrument so where a supervised entity enters to such a derivative that is traded on a trading venue or where the counterparty is a systematic internaliser, entry into such derivative will be regarded as the use of a benchmark for the purpose of the Regulation.

Supervised entities that use a benchmark must produce robust written plans setting out the actions they would take if the benchmark should materially change or cease to be provided. Such plans must be provided to their relevant competent authority upon request.

Benchmark Contributors

The Benchmark Regulation defines a "contributor" as a natural or legal person contributing input data in respect of a benchmark. For this purpose, input data must be data not readily available to a benchmark administrator required in connection for the determination of the relevant benchmark. A "supervised contributor" is any supervised entity that contributes input data to a benchmark administrator located in the EU.

Article 15 of the Benchmark Regulation provides that where a benchmark is based on input data from contributors, the benchmark administrator is required to develop a code of conduct for each benchmark clearly specifying the contributors' responsibilities with respect to the contribution of input data and shall ensure that such code of conduct complies with the Benchmark Regulation. Administrators must be satisfied that contributors adhere to the code of conduct on a continuous basis.

The code of conduct is required to contain certain elements including:

- a clear description of the input data to be provided and the requirements necessary to ensure it is provided in accordance with the requirements of the Benchmark Regulation relating to input data;
- identification of the persons that may contribute input data to the administrator and procedures to verify the identity of a contributor;
- policies to ensure that a contributor provides all relevant input data; and
- the systems and controls that a contributor is required to provide.

Supervised contributors are also subject to certain requirements including:

- a requirement to ensure that the provision of input data is not affected by any existing or potential conflict of interest;
- the contributor has in place a control framework that ensures the integrity, accuracy and reliability of input data;
- it has in place effective systems and controls to ensure the integrity and reliability of all contributions of input data to the administrator including controls as to who may submit input data to an administrator, appropriate training for submitters, measures for the management of conflicts of interest and appropriate record keeping.

Non-EU Benchmarks

The ability for benchmarks administered outside the EU to continue to be used within the EU has been one of the most difficult and controversial issues during the drafting and negotiation of the Benchmark Regulation. As the EU is significantly ahead of other jurisdictions, including the US, in developing benchmark regulation, and having regard to the very wide scope of the Benchmark Regulation compared to the approach in other jurisdictions, there is a concern that any regime based on allowing non-EU benchmarks to be used in the EU only if subject to equivalent regulation in a non-EU jurisdiction would exclude a vast number of non-EU benchmarks from use in the EU.

To deal with some of these concerns, where a non-EU administered benchmark is already used in the EU on the date the Benchmark Regulation comes into force, the Benchmark Regulation provides for the "grandfathering" of existing financial instruments, financial contracts or investment funds referencing the benchmark for a period of 42 months after such date. In relation to new benchmarks, the Benchmark Regulation provides three alternative routes through which a benchmark administrator located outside the EU can seek to facilitate the use of their benchmarks in the EU as set out below:

- ***Equivalence***: ESMA may register a non-EU benchmark administrator and the benchmark if (a) an equivalence decision is adopted by the EU Commission in respect of the jurisdiction in which the administrator is located, (b) the administrator is authorised or registered and subject to supervision in such jurisdiction, (c) the administrator notifies ESMA of its consent that the benchmark(s) may be used by supervised entities in the EU and (d) cooperation arrangements between ESMA and the relevant authority in the administrator's jurisdiction are operational. Such cooperation agreements must cover at least the mechanism for exchange of information between ESMA and the competent authorities in the non-EU jurisdiction, mechanisms for notification to ESMA where the administrator is in breach of its conditions of authorisation in its home jurisdiction and the procedures concerning the coordination of supervisory activities.

The EU Commission may make an equivalence determination if either (i) administrators authorised or registered in the non-EU jurisdiction comply with binding requirements equivalent to the requirements under the Benchmark Regulation and such requirements are subject to effective supervision and enforcement on an ongoing basis in such jurisdiction or (ii) it is satisfied that binding requirements in the relevant jurisdiction with respect to specific administrators or specific benchmarks or families of benchmarks are equivalent to the requirements under the Benchmark Regulation (taking into account whether the legal framework and supervisory practice in such jurisdiction complies with the IOSCO principles) and such specific administrators or specific benchmarks or families of benchmarks are subject to effective supervision and enforcement on an ongoing basis.

At present, it is not clear that there will be any jurisdictions with equivalent provisions to the Benchmark Regulation at the time it becomes effective in respect of the same wide range of benchmarks within the scope of the Regulation. The ability for the EU Commission to determine equivalence where the relevant jurisdiction only regulates a limited category of administrators or benchmarks provides more scope for an equivalence determination. However, even with such increased flexibility, it seems likely that at the time when the Benchmark Regulation becomes effective, there will be relatively little scope for equivalence determinations to be made.

- ***Recognition***: Until such time as an equivalence determination is made in relation to any non-EU jurisdiction, a benchmark provided by an administrator located in such jurisdiction may be used by

supervised entities in the EU, provided that the non-EU administrator obtains prior recognition by the competent authority of its "member state of reference" in the EU. The member state of reference is to be determined by various criteria, including the location of affiliated supervised entities, the location of relevant trading venues for financial instruments referencing their benchmarks and the location of supervised entities using their benchmarks. For a non-EU administrator to obtain such recognition it will need to comply with the vast majority of the obligations that apply to EU administrators under the Benchmark Regulation. Such compliance may be fulfilled by compliance with the IOSCO Principles, provided that the relevant national competent authority determines that the application of such principles is equivalent to compliance with the requirements under the Benchmark Regulation (it may rely on an assessment by an independent external auditor or a certification by the competent authority in the relevant non-EU jurisdiction for such purpose). The non-EU administrator must also have a legal representative to perform an oversight function in relation to the provision of benchmarks by the administrator within the scope of the Benchmark Regulation which representative shall be accountable to the competent authority of the member state of reference.

Although the recognition process does provide greater scope for non-EU administrators to provide benchmarks for use in the EU, it is not a straightforward process. In particular, it may not be easy to identify the member state of reference and to obtain certification of compliance with the IOSCO principles. In addition, obtaining a legal representative to provide the functions required under the Benchmark Regulation may not be straightforward and is likely to involve considerable cost.

- ***Endorsement***: A non-EU administrator will be able to register benchmarks for use in the EU under the Benchmark Regulation if a benchmark administrator supervised in the EU or another supervised entity located in the EU with a clear and well-defined role within the control or accountability framework of the non-EU administrator and which is able to monitor effectively the provision of a benchmark, applies to its relevant competent authority to endorse a benchmark or a family of benchmarks provided in the relevant non-EU jurisdiction for use in the EU. Such application is dependent upon the satisfaction of specified conditions including:

    - the endorsing administrator or other supervised entity has verified and is able to demonstrate, on an on-going basis, to its competent authority that the provision of the benchmark or family of benchmarks to be endorsed fulfils (on a mandatory or voluntary basis) requirements at least as stringent as those under the Benchmark Regulation;

    - the endorsing administrator or other supervised entity has the necessary expertise to monitor the provision of the benchmark and to manage the associated risks; and

    - there is an objective reason to provide the benchmark or family of benchmarks in the non-EU jurisdiction and for them to be endorsed for use in the EU.

In determining whether the provision of the benchmark(s) fulfils requirements at least as stringent as under the Benchmark Regulation, the competent authority may take into account whether the provision of the benchmark(s) complies with the IOSCO principles.

The endorsement process was introduced as an alternative to the equivalence and recognition procedures above due to some of the challenges related to those regimes as outlined above. However, the endorsement route also presents challenges, not least the need to ensure that there is an appropriate supervised benchmark administrator or other supervised entity willing and able to perform the endorsing role. In particular, the requirement for such

entity to have a clear and well-defined role within the control or accountability framework of the non-EU administrator may give rise to practical challenges.

Supervision and Enforcement by Competent Authorities

National competent authorities will have wide-ranging powers to ensure compliance with the provisions of the Benchmark Regulation, including the ability to request relevant information, documents and data and to carry out onsite inspections and investigations. They will also have the ability to require corrective statements to be published about past contributions to a benchmark or the published level of a benchmark. Competent authorities will also have the ability to suspend trading of any financial instrument that references a regulated benchmark.

Competent authorities will also have the power to impose various sanctions upon entities or individuals breaching the Benchmark Regulation, including disgorgement of profits, imposition of fines or withdrawal or suspension of a regulated entity's authorisation.

Amendments to the Market Abuse Regulation and Other Legislation

The Benchmark Regulation makes amendments to the Market Abuse Regulation, including exempting persons discharging managerial responsibilities in relation to an issuer of securities from the requirement to disclose transactions in financial instruments linked to securities of the issuer where those securities provide an exposure not exceeding 20% of the issuer's shares or debt instruments. Amendments are also made to certain other financial services legislation, including amending the Mortgage Credit Directive to require that lenders making loans regulated under such Directive disclose to consumers the name of any benchmarks referenced in such loans, the name of the relevant benchmark administrator and the potential implications to the consumer from the use of the benchmark.

Next Steps and Impact of Benchmark Regulation

The Benchmark Regulation requires ESMA to produce drafts of a significant number of implementing and regulatory technical standards (some of which are highlighted above) – the EU Commission will then consider whether to adopt such technical standards. In addition, the EU Commission has requested that ESMA provide technical advice on certain aspects of the Benchmark Regulation.

Whilst the draft Benchmark Regulation was still going through the EU legislative process, ESMA published a Discussion Paper in February 2016[13]. Following responses in relation to the Discussion Paper, ESMA published a Consultation Paper on 27 May 2016[14] setting out its proposals in relation to the relevant technical advice (but not the draft technical standards). The technical advice covers the following issues:

- certain elements of the definitions, including when a benchmark is made available to the public and what constitutes the issuance of a financial instrument for the purpose of defining the "use" of a benchmark in the EU;
- the measurement of the reference value of a benchmark;
- the criteria for identification of critical benchmarks;

[13] https://www.esma.europa.eu/sites/default/files/library/2016-288_discussion_paper_benchmarks_regulation.pdf.
[14] https://www.esma.europa.eu/sites/default/files/library/2016-723_cp_benchmarks_regulation.pdf.

- framework for the endorsement of benchmarks provided by a non-EU benchmark administrator; and
- transitional provisions.

Responses to the Consultation Paper should be made by 30 June 2016. ESMA must provide its technical advice to the EU Commission within four months after the Benchmark Regulation comes into force. It is expected that ESMA will publish a further Consultation Paper in relation to its draft technical standards later in 2016.

Although the bulk of the provisions of the Benchmark Regulation will not come into effect until late 2017 or early 2018 (depending upon when it is published in the Official Journal), it will have a profound effect upon financial instruments and contracts referencing benchmarks in the EU. Firms administering, contributing to or using financial benchmarks should already be considering the effect of the Regulation on their businesses and, in the case of administrators, making preparations for obtaining authorisation or registration under the Benchmark Regulation.

Among the biggest concerns for market participants is the effect on benchmarks administered outside the EU. Although the final version of the Benchmark Regulation sought to address some of the concerns raised in this regard in previous drafts of the Regulation, there is a concern that many benchmarks administered outside the EU will cease to be used in the EU. The transitional provisions for benchmarks already in use when the Benchmark Regulation comes into force and the provisions for equivalence, recognition and endorsement of non-EU benchmarks outlined above are designed to facilitate the use of non-EU benchmarks within the EU. There are, however, challenges involved in all of these options, and it may be that certain non-EU administrators decide not to go down any of these routes.

As a result of these challenges, there is a likelihood that many benchmarks, both those administered in and outside of the EU, will be discontinued in due course and many non-EU benchmarks may cease to be available for use in the EU, reducing investor choice.

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