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***Stand out for the right reasons***  
Financial Services Risk and Regulation

# ***Hot topic***

## ***EU Benchmarks Regulation: Time to Act***

### ***Highlights***

*ESMA published draft technical standards and final technical advice.*

*Administrators and contributors have sufficient clarity to develop implementation plans that cover benchmark inventories, oversight functions and governance frameworks.*

Since the **EU Benchmarks Regulation (BMR)** came into effect on 29 June 2016, ESMA has clarified detail on the level 2 measures. ESMA released **draft technical standards** on 29 September 2016 and **final technical advice** on 10 November 2016, and held a public hearing. Though still evolving, these documents collectively provide substantive direction of travel for all level 2 measures. Firms awaiting further regulatory detail before developing their implementation plans now have it – in abundance.

ESMA's level 2 measures cover the following topics:

- definitions
- reference values
- impact on Member States (MS)
- endorsement
- transitional arrangements
- oversight and governance
- input data and front office contributions
- methodology
- contributor codes of conduct
- compliance statements and optional requirements
- benchmark statements
- authorisation, registration and recognition.

We explore these in more detail below.

## 1. False equivalence with MAR 8 and IOSCO

Some firms are incorrectly relying on compliance with MAR 8 or IOSCO to demonstrate equivalent compliance with BMR. There are several reasons why this is incorrect: BMR is broader in scope, regulates benchmark users and is legally binding.

BMR imposes a much broader definition of benchmarks which are then further categorised by type (critical, significant, non-significant) and sector (regulated data, interest rate, commodity). Bespoke indices can also be benchmarks if made available to the public or an indeterminate number of recipients. Regulators may provide specific guidance whether equity baskets and consensus pricing services are in scope. Nevertheless, administrators, contributors and users must develop comprehensive inventories to ensure that they capture all benchmarks in scope. Many users have already identified this as a significant task.

Unlike MAR 8 and IOSCO, BMR regulates the behaviour of benchmark users. EU-supervised entities cannot use a benchmark unless its administrator is authorised or registered by a national competent authority (NCA) and listed in the ESMA Register of administrators and foreign benchmarks.

Most importantly, BMR is legally binding and enforceable without transposition into national law. BMR supersedes national law within the EU, including IOSCO and MAR 8. Moreover, administrators, contributors and users are potentially subject to substantial civil and criminal penalties.

BMR also imposes mandatory administration and contribution requirements and establishes rigorous standards for input data. While compliance with MAR 8 and IOSCO can provide a foundation for compliance with BMR, firms should not underestimate the level of effort required. The following level 2 measures should thus form the basis of a robust BMR implementation plan.

## 2. Technical advice

BMR mandates that ESMA advises the EC on technical aspects of the regulation. ESMA's final report covers the following points.

### *Definitions*

*Making an index available to the public* means the index is available to a potentially indeterminate number of people outside the provider's legal entity. This includes dissemination to the public by making indices available to supervised entities for reference in financial instruments or investment funds.

*Administering arrangements for determining a benchmark* means setting the benchmark methodology and managing the infrastructure and personnel involved in determining the benchmark. This definition is important to determine who is the administrator providing benchmarks.

*Use of a benchmark based on issuance of financial instrument* means initial offerings of transferrable securities, money-market instruments, and units in collective investment undertakings.

### *Reference values*

Measuring the reference values needed to determine the quantitative thresholds for critical and significant benchmarks are to be governed by the regulations applicable to the instrument in question:

- MiFIR governs the nominal value of financial instruments other than derivatives
- EMIR governs the notional value of derivatives
- UCITS IV and AIFMD govern the net asset value of investment funds subject to these directives.

### *Impact of critical benchmarks on Member States (MS)*

Critical benchmarks must meet a quantitative threshold between €400bn and €500bn and have little to no market-led alternatives. Critical benchmarks must also have a significant and adverse impact on a MS. ESMA's mandated technical advice to the EC includes a non-exhaustive list of criteria for assessing the impact on market integrity, financial stability, consumers, the real economy and financing of households and businesses. This concept is repeated in both the level 1 and level 2 texts.

*Market integrity* – The value of financial instruments, financial contracts or investment funds referencing the benchmarks in the MS or traded on venues in the MS is a significant share of total outstanding in that MS. This assessment should also take into account the benchmark's use (or designation) as a successor to a critical benchmark, as an accounting standard or for regulatory purposes, e.g. under prudential regulations or tax purposes.

*Financial stability* – The value of financial instruments, financial contracts or investment funds referencing the benchmark is a significant share of the total assets of the financial or banking sectors in the MS.

*Consumers* – The value of financial instruments and investment funds referencing a benchmark and offered to retail investors is a significant share of the total value of all financial instruments and investment funds sold to retail investors in the MS, and the estimated number of retail investors who bought those products is a significant share of the MS's total population. The technical advice sets out similar rules for benchmarks used by pension funds and in consumer credit agreements

*Real economy* – The value of financial instruments, financial contracts and investment funds referencing the benchmark is a significant share of the gross national product of the MS.

*Financing households and businesses* – The value of loans to households and non-financial corporates referencing the benchmark is a significant share of total loans to households and non-financial corporates in the MS. The estimated number of households or non-financial corporates with loans referencing the benchmark in the MS is a significant share of the total number of households and non-financial corporates in those MS.

The regulation does not define significance when used in this context.

### *Endorsement*

Endorsement permits the use of foreign benchmarks in the EU. An EU administrator or supervised entity may endorse a foreign benchmark if there's an objective reason why the benchmark must be provided in a third country and why it should be endorsed for use in the EU.

The NCA assessing an endorsement application must consider whether the benchmark has to be provided in the third country due to geographic proximity, specific skills, and legal restraints. Geographic proximity means the market which the benchmark measures is geographically limited such as when contributors or the infrastructure or systems necessary to administer the benchmark are only located in the foreign country. The benchmark requires specific skills if, for example, it relies on the expertise of local firms or individuals, including employees of the foreign administrator or contributor. Local law may prevent the administrator or contributor from providing their expertise to an EU administrator or supervised entity. Similarly, legal restraints on input data may prevent the foreign administrator from submitting certain data to an EU administrator.

The NCA must further assess objective reasons for using the third country benchmark in the EU. The failure to endorse or the cessation of a foreign benchmark would adversely and materially affect financial stability, market integrity, consumers, real economy or financing of households and businesses.

### *Transitional arrangements*

Administrators of pre-existing benchmarks in use on 30 June 2016 must apply for authorisation or registration by 1 January 2020. But existing benchmarks can still be used in the administrator's MS after this date if changes or cessation resulting from BMR would trigger force majeure provisions or breach of financial contracts. The NCA will determine how to use benchmarks on a case-by-case basis if, for example, there are material changes to input data or methodology that undermine the representativeness of the benchmark.

### **3. Technical standards**

While ESMA's technical advice currently sits with the EC for adoption, the evolution of technical standards is comparatively early on in its process. ESMA recently issued the consultation paper with **draft regulatory and implementing technical standards (RTS and ITS)**, containing proposals for the overwhelming majority of the substantive requirements applicable to administrators and contributors.

#### *Oversight function*

Benchmark administrators have eagerly awaited ESMA instructions on the characteristics of the permanent oversight function. ESMA purposely gives administrators flexibility to determine the structure most appropriate to their business as a concession to firms with oversight functions based on IOSCO principles. Critical benchmarks must have two independent members not directly affiliated with the administrator and who have no vested interest in the benchmark. The oversight function must be separate from the management body and other governance functions which it is required to assess and challenge. This emphasis on independence ensures the function's ability and willingness to report infringements to NCAs. ESMA also proposes a list of governance procedures for the oversight function such as terms of reference, member selection criteria, and disclosure of conflicts procedures.

In keeping with the proportionality principle embedded in BMR, these RTS do not apply to the oversight functions of interest rate and non-significant benchmarks. For interest rate benchmarks, BMR replaces some requirements in Article 5 with specific oversight requirements in Annex I. Administrators of non-significant benchmarks can waive certain Article 5 requirements.

#### *Input data*

Under BMR Article 11, input data must be appropriate and verifiable. Data is *appropriate* for the methodology if it accurately reflects the underlying market and economic reality. *Verifiable data* can be checked to be accurate, is 'materially plausible' or stems from a reliable source. Administrators may request additional information for non-transaction data based on judgment and discretion. Verifiability requires *evaluation* and *validation* in the form of formal checks of contributed input data before and after publication. The frequency of this ongoing monitoring will depend on the characteristics of the benchmark in question.

These RTS on input data apply only to critical and significant benchmarks.

#### *Corroboration of front office contributions*

Article 11 also requires administrators to corroborate input data contributed from a front office function. This level 1 provision does not indicate whether it is the administrator's or the contributor's front office. But where the contributor sources input data from its own front office, the administrator must ensure that the contributor has oversight and verification procedures in place. The administrator must ensure that the contributor has a transparent internal oversight framework across its three lines of defence. Front office staff involved with benchmarks must have tailored training and submission procedures, while the second line of defence must have an appropriate conflicts policy for the front office.

While administrator corroboration and contributor verification procedures are required for critical benchmarks, it is optional for significant benchmarks. Administrators can also waive the segregation requirement for contributors to significant benchmarks. Corroboration is not required at all for non-significant benchmarks.

### *Transparency of methodology*

Administrators must publish their benchmark methodology. Although this does not include the 'black box' formula or algorithm used to calculate the benchmark, it should include sufficient information for the user to determine whether the benchmark is accurate and reliable in representing the underlying economic reality. In the RTS, ESMA proposes the elements administrators must disclose, including procedures for internal review and consultation on material changes.

Significant benchmark administrators can opt out of certain disclosure requirements. The transparency requirement does not apply to non-significant benchmarks.

### *Contributor code of conduct*

The administrator must satisfy itself at least annually that contributors adhere to its contributor code of conduct. Contributors must implement internal controls to confirm their own compliance with the code. In addition to reporting breaches to the administrator and regulators, contributors can require an administrator to revise a code of conduct that does not meet BMR standards. The code must reflect the methodology and list the types of permissible input data, contribution process and the frequency of review. The code must also require the contributor to designate an authorised submitter (the contributor's employee) with the necessary skill, knowledge, training and experience.

These RTS provide rules specific to the kind of benchmark. Codes of conduct only apply to

contributions from contributors. Consequently, it does not apply to:

- regulated-data benchmarks defined as benchmarks with input data from trading venues or a data reporting service
- commodity benchmarks if the majority of contributors are non-supervised entities.

Furthermore, the specific content of the code of conduct set out in the level 1 text is optional for significant and non-significant benchmarks.

### *Governance and controls for supervised contributors*

Supervised contributors (e.g., MiFID II firms, credit institutions, and UCITS or AIFs) must have effective systems and controls to govern their data contribution process. Policies and procedures should cover authorised submitters and alternates, submission sign-off, periodic review and oversight, conflict management including physical separation, use of expert judgment, breaches, submitter training on BMR and the code of conduct. These RTS should be read in conjunction with those on codes of conduct and input data.

These proposed technical standards apply to critical and significant benchmarks. BMR Annex 1 contains the level 1 requirements for supervised contributors to interest rate benchmarks.

### *Optional requirements for significant benchmarks*

BMR Article 25 lists the optional requirements for significant benchmarks. An NCA may nevertheless decide to apply certain requirements to significant benchmarks due to the nature or impact of the benchmark, or the size of the administrator. Administrators of significant benchmarks can waive provisions on governance, conflicts management, input data and codes of conduct. When making the assessment, NCAs should consider the extent to which the benchmark is vulnerable to manipulation, the nature of the input data, the level of potential conflicts, use of discretion, size

of the administrator and the qualitative and quantitative aspects of the benchmark itself.

### *Compliance statements for significant and non-significant benchmarks*

Administrators of significant and non-significant benchmarks must publish a compliance statement explaining their decisions not to implement optional requirements. In this draft ITS, ESMA's proposed template requires a list of the exact provisions the administrator chose not to apply and an explanation of why implementation would be disproportionate. Both types of administrators must publish their compliance statements for each family of benchmarks. But non-significant benchmark administrators must also submit a copy to their NCA.

### *Benchmark statement*

Administrators must publish a benchmark statement within two weeks of their inclusion in the ESMA register. The statement provides prescribed information on transparency, appropriateness, use of discretion and risks to help users determine whether the benchmark is fit for purpose. The RTS set forth the general disclosure requirements as well as specific content for benchmark types and sector benchmarks. The statement must disclose the input data for regulated data benchmarks, and the increased oversight measures and delays in publication due to exceptional circumstance of interest rate benchmarks. Critical benchmark administrators must note the impact of manipulation or cessation. Commodity benchmarks administrators must indicate whether Title II or Annex II applies.

### *Authorisation, registration and recognition*

Finally, these RTS contain ESMA's proposals for the content of applications for authorisation and registration of EU administrators and for recognition of third country administrators.

## **4. Next steps**

Comments to the consultation paper on the regulatory and implementing technical standards were due by 2 December 2016. ESMA must submit its final technical standards to the EC by 1 April 2017.

Once the EC adopts ESMA's technical advice, the EP and Council have a renewable three-month period to object.

All level 2 measures, both delegated acts, which are final technical advice, and the technical standards must be published and apply along with the BMR level 1 measures on **1 January 2018**.

### ***What do I need to do?***

ESMA has given most firms more than enough regulatory detail to proceed with implementation plans. Administrators should develop a comprehensive inventory of their benchmarks, establish their governance structures, update contributor codes of conduct and revise methodologies to reflect new standards for input data. Contributors should likewise develop a comprehensive inventory and establish controls that ensure compliance with codes of conduct. Both should implement procedures where a front office contributes input data. Unfortunately, despite offering some direction on endorsement and transitional provisions, these level 2 measures do not provide much detail for benchmark users. Establishing a user inventory alone may prove challenging. ESMA has not made it clear what, if any, organisational measures or due diligence is required.

**If you would like to discuss any of the issues outlined in this paper, please speak to your usual PwC representative or one of contacts below.**

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