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Hot topic

EU Benchmarks Regulation: Nearly final

Highlights

ESMA submitted its final draft technical standards to the European Commission.

While it has not yet clarified transitional provisions, ESMA's submission provides the industry with near-final rules for implementation.

The **EU Benchmarks Regulation (BMR)** came into effect on 30 June 2016. ESMA has now submitted final Level 2 advice to the European Commission (EC). This includes the **final technical advice** ESMA submitted to the EC in November 2016 and the **regulatory technical standards (RTS) and implementing technical standards (ITS)** it submitted in late March 2017. These technical standards together provide the near-final version of the requirements administrators and contributors have to implement by the time BMR goes live on 1 January 2018, subject to transitional provisions.

The final draft technical standards cover the following topics. This paper discusses the first ten.

1. Procedures and characteristics of the oversight function (Article 5 BMR)
2. Input data (Article 11 BMR)
3. Transparency of methodology (Article 13 BMR)
4. Code of conduct for contributors (Article 15 BMR)
5. Governance and control requirements for supervised contributors (Article 16 BMR)
6. Compliance statement for administrators of significant and non-significant benchmarks (Articles 25 and 26 BMR)
7. Criteria for significant benchmarks (Article 25 BMR)
8. Benchmark statement (Article 27 BMR)
9. Authorisation and registration of an administrator (Article 34 BMR) and Potential limitations of the transitional regime
10. Recognition of an administrator located in a third country (Article 32 BMR)
11. Procedures and forms for exchange of information (Article 47 BMR)

1. Open Item: Transitional provisions

Market participants grappling with BMR remain confused about the applicability of the transitional provisions. ESMA asks the EC to resolve the issue, rather than providing immediate clarity. We anticipate that the EC might do so in a consultation paper on proposed delegated acts to be published in May or early June. **We discuss ESMA's analysis below.**

2. Near-final technical standards

ESMA's final draft technical standards are near final. The EC has 3 months from 30 March to **accept or reject ESMA's proposed rules** and once adopted by the EC, the European Parliament and the Council have a further 3 months to accept or reject. After that hurdle, the binding technical standards will be published. We anticipate this should happen in mid to late summer 2017.

Proportionality

Policymakers embedded the proportionality principle in BMR by applying the standards below based on the nature, scale and complexity of the risks involved in producing the benchmark. Consequently, the technical standards apply differently according to benchmark type (i.e. critical, significant and non-significant benchmarks) and sector benchmarks (i.e. regulated data, interest rate and commodity benchmarks).

For example, while several Level 1 requirements apply to non-significant benchmarks, the associated Level 2 requirements do not. (See Table 1.) This ensures that the regulatory burden remains proportional to the risk of providing the benchmark.

Table 1.

| Applicability to non-significant benchmarks | Level 1 | Level 2 |
|---|---------|---------|
| Oversight function | | |
| Input data | ✓ | ⊘ |
| Transparency of methodology | | |
| Governance and controls for supervised contributors | | |

Oversight function (Article 5 BMR)

All benchmark administrators must have a permanent and effective oversight function embedded within the organisational structure of the administrator or its parent company. The RTS establishes requirements for procedures, characteristics, composition, and positioning within the organisational structure of the administrator. ESMA maintains its proposed non-exhaustive list of governance arrangements which vary by benchmark type and sector. This includes a minimum of two independent members for critical benchmarks. The oversight function must also be a committee for critical benchmarks, but it can be an individual for non-critical benchmarks and would be exempt from some provisions that apply to committees.

In order to assess and challenge the management body, the oversight function must remain separate, although board members may be invited to attend as needed, but only in a non-voting capacity. Members of the oversight committee must have appropriate skills, expertise and knowledge of the underlying market or economic reality the benchmark seeks to measure. Contributors, supervised users and staff may also have a role on the oversight function. The inclusion of staff means that legal and compliance can now participate as voting members. External members such as third party providers of outsourced activities can participate but not vote on matters directly related to their business. Administrators must establish conflicts procedures which restrict voting rights for staff, external members and non-member observers.

Input data (Article 11 BMR)

The administrator must ensure that input data is appropriate and verifiable. Input data is appropriate when it conforms to the benchmark methodology and represents the underlying market or economic reality. Input data is verifiable if it is accurate and comes from a reliable source. The administrator must monitor input data and may determine the frequency of checks based on the type of data contributed.

However, administrators of critical benchmarks must perform checks prior to publication. ESMA expanded the scope of the proposed RTS to include all kinds of input data, not just contributed data. Extensive checks are required for non-transaction data, whereas less extensive checks are permissible for regulated-data contributions.

Under BMR Article 11(3), the administrator must ensure that the contributor has internal oversight and verification procedures in place where input data is contributed from the front office. **Front office includes any ‘department or personnel of the contributor that performs pricing, trading, sales, marketing, advertising, solicitation, structuring or brokerage activities’.** Internal oversight procedures must be implemented along three lines of defence with a governance structure that requires defined roles **and reporting to contributor’s management and to the administrator. The contributor’s first line** will be responsible for compliance with the code of conduct, including *pre*-contribution checks of input data. Its second line will focus on **surveillance of submitters’ communication and post**-contribution checks of input data. The **contributor’s compliance function must also have** a staff member embedded in the front office. Although the second line must maintain a conflicts management policy, administrators of significant benchmarks can limit the **contributor’s second line responsibility for a conflicts management policy to ‘actual or potential material conflicts’.** The front office rule does not apply to administrators of regulated-data benchmarks because the data is not contributed.

It is worth noting that in its analysis of this **article ESMA declined to define ‘readily available input data’** on the grounds that doing so would be beyond the scope of its mandate to provide technical standards.

Transparency of methodology (Article 13 BMR)

Administrators must publish key elements of the methodology, details of its internal review and approval process, and procedures for consulting

on proposed material changes to the methodology. Transparency of methodology will assist stakeholders to understand how the benchmark is produced in order to determine whether it is appropriate for the intended use. This RTS provides details on the information to be published.

The transparency disclosure will be more detailed than the benchmark statement. The RTS lists 22 items that the administrator must publish including a definition and description of the benchmark, the market it intends to measure, the criteria used by the administrator to select sources of input data, minimum quality and quantity of input data required to calculate the benchmark in line with the methodology, and when discretion can be used. ESMA didn’t align the methodology with UCITS guidelines as some respondents requested, as the scope of BMR is broader than UCITS.

Administrators must also publish information regarding the internal review and approval of the methodology. These include any policies and procedures, circumstances that might trigger an internal review and the function responsible for reviewing and approving the methodology.

Administrators must publish procedures for consulting on material changes to the methodology. A rationale for material change is that the benchmark would no longer represents the underlying market or economic reality. Although an administrator must consult on all material changes, the revised RTS provides flexibility on the length of consultation period for sudden market events. The administrator must publish consultation responses unless the respondent requests confidentiality.

Code of conduct for contributors (Article 15 BMR)

BMR requires administrators to establish a code of conduct and to ensure contributor adherence at least annually. The RTS details the content of the code with rules for the description of input data, submitter qualifications, policies on input data and record keeping, systems and controls (including pre- and post-contribution checks),

reporting suspicious input and conflicts management.

The RTS includes a new article on the use of discretion which was not in ESMA's proposed draft. The code of conduct must state when and how the exercise of contributor discretion is permitted, authorised persons and internal controls.

ESMA reiterates that codes of conduct are only required for 'benchmarks based on contributions from contributors.' For example, administrators of regulated-data benchmarks are not subject to Article 15 or this RTS because the input data is taken from a regulated trading venue or data service provider, not from a contributor.

Administrators of significant and non-significant benchmarks may opt out of Article 15(2) which sets forth the specific requirements of codes of conduct. These administrators may determine for themselves what should be in their contributors' codes.

Governance and control requirements for supervised contributors (Article 16 BMR)

Supervised contributors must establish a controls framework governing input data. This RTS applies directly to supervised contributors and is similar to administrator input **requirements in Article 11 and contributors' code of conduct requirements in Article 15.**

The final draft RTS changes very little from the original proposal. Supervised entities must establish a control framework with effective oversight, systems and controls for designating, monitoring and training submitters, conflicts management and recordkeeping. Contribution sign-off is needed where required by the code of conduct or when appropriate depending on the use of discretion, the nature, scale and complexity of business or the potential for conflicts. Supervised contributors must also have policies governing contributions based on expert judgment and discretion.

As with Article 15, administrators of regulated-data benchmarks are not subject to Article 16 or

this RTS because the input data is taken from a regulated trading venue, not from a contributor.

Compliance statement for administrators of significant and non-significant benchmarks (Articles 25 and 26 BMR)

Where administrators of significant and non-significant benchmarks decide not to apply the optional requirements of BMR Title II, they must publish a compliance statement explaining their rationale. The ITS provides templates for the compliance statement.

Administrators of non-significant benchmarks must make a statement for each benchmark (not family of benchmarks). Administrators of non-significant benchmarks must merely provide a copy to their compliance statement to the National Competent Authority (NCA) which may also request changes to it. There will be no assessment.

Criteria for significant benchmarks (Article 25 BMR)

The NCA will assess the appropriateness of the optional exemptions selected by the administrators of significant benchmarks and may require the administrator to implement the requirement. This RTS sets detailed criteria for NCAs assessing the exemptions selected by administrators of significant benchmarks. The criteria includes vulnerability of the benchmark to manipulation, nature of input data, level of conflicts of interest, degree of administrator discretion, and impact of benchmark on markets, among others. Again ESMA declined to distinguish transaction data from 'readily available' data in this RTS.

Benchmark statement (Article 27 BMR)

Within two weeks of being listed on the ESMA register, administrators must publish a benchmark statement for each benchmark or family of benchmarks. The benchmark statement provides clear information on what the benchmark is intended to measure and the risk of manipulation. It must be reviewed and updated every two years. The RTS provides

requirements for general disclosures and updates, as well as requirements by benchmark type or sector.

ESMA uses this section to note that where a benchmark type and sector benchmark overlap, then all requirements apply. For example, a commodity/regulated-data benchmark is possible, but Title II would apply instead of Article II because the contributors are not non-supervised. There are exceptions for commodity/interest rate and critical/regulated-data benchmarks which cannot be combined because their definitions preclude it.

Authorisation and registration of an administrator (Article 34 BMR) and Potential limitations of the transitional regime

Administrators must be authorised or registered with the NCA where they are located. The extensive 4-month authorisation application is required for sector, critical or significant benchmarks. The streamlined 45-day registration application is available for supervised entities providing non-critical benchmarks or administrators of non-significant benchmarks. The RTS sets out the requirements for each type of application.

Transitional provisions allow supervised entities to continue using existing benchmarks until 1 January 2020. ESMA does not provide much-needed clarity on the definition of pre-existing benchmarks. In a statement requesting further **direction from the EC, ESMA's analysis takes the** focus off the pre-existence of the *benchmark* and places it on the *administrator*. An administrator providing benchmarks on 30 June 2016 can continue to provide any benchmarks, even new ones, until 1 January 2020. Any other **interpretation in its words may “lead to** significant market disruption and may put supervised entities at a considerable **disadvantage.”**

Recognition of an administrator located in a third country (Article 32 BMR)

Recognition permits third country administrators to provide benchmarks in the EU

until the EC renders an equivalence decision. EU-supervised entities will be able to use these foreign benchmarks pending the equivalence decision. The foreign administrator must comply with IOSCO principles or certain BMR provisions. Their compliance can be based on the determination of independent external auditor. The foreign administrator must have legal representative in EU to perform oversight. The **foreign administrator's** Member State of reference is where that foreign administrator has the most supervised entities or where financial contracts containing foreign benchmarks are admitted to trading. Foreign benchmarks not yet used in the EU are considered non-significant.

The application must be completed in the official language of the Member State of reference, but attachments may be in English. The applicant must include where available an assessment by the independent external auditor, and where the applicant is subject to supervision, a certification from its home NCA attesting to compliance with IOSCO.

3. Next steps

All firms should be well on their way into developing inventories. Inventories should identify the **firm's** role as administrator, contributor and supervised users, jurisdiction of the benchmark administrator, benchmark type (i.e. critical, significant and non-significant benchmarks) and sector benchmarks (i.e. regulated-data, interest rate and commodity benchmarks). Because transitional provisions are still in flux, firms should note the publication data of all benchmarks to isolate those in use on 30 June 2016.

Administrators should determine which benchmarks may require applications as of 1 January 2018. Even though ESMA has provided a view on transitional provisions, there is no guarantee that the co-legislators will agree. Some third country administrators have decided to apply for recognition while the EU makes a decision on the interpretation of the transitional

provisions applicable to third country benchmarks.

Administrators should also ensure that their controls, processes and governance structures are in line with the requirements of BMR.

Supervised contributors must implement Article 16 internal controls in their own right. This is not contingent on the administrator providing a contributor code of conduct.

Supervised users would do well to indicate the availability of substitutes when compiling inventories to ensure that this information is available in writing as required by BMR Article 28, one of only two provisions in BMR directly applicable supervised users.

4. Timeline

The EC is expected to publish a consultation paper in the coming weeks seeking industry comment on its proposed delegated acts which are based on the technical advice ESMA provided in November.

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 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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