

ESMA's and EBA's consultation paper on Principles for Benchmarks-Setting Processes in the EU

BVI¹ welcomes the opportunity to comment on the Consultation for Principles for Benchmarks-Setting Processes in the EU.

We support the initiatives by IOSCO, ESMA/EBA, and the EU Commission to regulate the production, calculation, use and dissemination of benchmarks. A new regulatory framework for all involved market participants (e.g. contributing firms, benchmark administrators, calculation agents, benchmark publisher and users) is essential in order to restore investor confidence in the market and improve financial stability. A new regulatory framework for benchmarks and the involved market participants should be coordinated worldwide in order to avoid regulatory arbitrage.

German investment funds are highly regulated financial products (e.g. through UCITS and AIFM directive) which did not contribute to any manipulation of the Libor or Euribor. The German investment fund management companies usually do not produce or contribute data used in the calculation of benchmarks. Investment fund management companies acting on behalf of the investment funds are users of financial, commodity and real estate indices.

General comments

We welcome the initiative to introduce principles for reference rates and other benchmarks-setting processes to bridge the interim period until a formal regulatory and supervisory framework for benchmarks has been created in the EU.

In this context, we would like to draw your attention to the ESMA Guidelines on ETFs and other UCITS issues (ESMA/2012/832EL). These guidelines set the conditions under which UCITS may use financial indices as benchmarks. They demand that only transparent indices can be used. Asset managers have to impose extensive transparency requirements on benchmark administrators in terms of calculation methodologies, calculation process, re-balancing methodologies, constituents and their respective weightings for all indices in which UCITS invest. In our view, however, it is not appropriate to indirectly impose requirements on indices while regulating only a small group of benchmark users. It is more efficient to regulate the benchmarks-setting processes and the involved market participants. This will create a level playing field between all benchmark users.

The proposed principles by ESMA/EBA will have no binding effects. Thus, we fear that UCITS fund management companies will be put at a disadvantage as they have to follow extensive transparency requirements for financial indices in comparison to other benchmark users.

¹ BVI represents the interests of the German investment fund and asset management industry. Its 78 members currently handle assets of EUR 2 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI's investor education programmes support students and citizens to improve their financial knowledge. BVI's members directly and indirectly manage the capital of 50 million private clients in 21 million households. BVI's ID number in the EU register of interest representatives is 96816064173-47. For more information, please visit www.bvi.de.



Therefore, we propose that the ESMA Guidelines on ETFs and other UCITS issues on financial indices (chapter IX) shall come into force until a formal regulatory and supervisory framework for benchmarks and their providers has been created in the EU and not before.

We believe that so called customized/bespoke indices that are individually agreed between the asset manager and its clients should be considered out of scope of ESMA's/EBA's principles and any regulatory discussion as they implement only a specific risk/return profile of a specific institutional investor (e.g. insurance company hedging interest rate risk on the based portfolio). The same reasoning applies to indices produced and used within one company only.

Only market or strategy indices which are created for a large number of users should be in the focus of the ESMA's/EBA's principles and for any potential regulation of benchmarks-setting processes.

Specific Comments

Question 1: Definition of the activities of benchmark setting

Do you agree with the definitions provided in this section? Is this list of activities complete and accurate?

BVI agrees in general with the definitions. Regarding the definition of “benchmarks” and “benchmark users” we would like to make the following additional comments:

- **Definition “benchmark”**

We agree with the definition of “benchmark” (page 4) which is similar to that of the EU Commission in the amended proposals for a Regulation and Directive on market abuse and with the different types of benchmarks (page 6). In terms of application we recommend to construe the definition narrowly: We would like to highlight the difference between indices and benchmarks. Most indices are produced and published on a commercial basis and may be used by third parties as benchmarks against which to measure their own performance. The fact that somebody uses information produced by somebody else without the knowledge, permission, or involvement of the producer of the information to price a financial instrument should not result in the information being automatically treated as being a “benchmark” in the regulatory sense with all the resulting obligations.

Additionally, we believe that the definition should reflect the fact that asset management applications of indices are fundamentally different from the reliance on a benchmark to price financial indices. Asset managers use indices mainly for evaluating an active manager's performance or as a target for passive managers to track in managing an index fund. Asset managers have usually no access to the rate benchmark or public indices production processes and are not able to manipulate their outcome. We note that the proposed benchmark definition by referring to the “amount payable under a financial instrument” in its part b) would appear to exclude the use of benchmarks or indices by asset managers, as such use does not determine the pricing of an instrument. We would also not consider the use of an index as benchmark for the determination of a performance fee of a active manager as a major factor in the determination of the pricing of an instrument, i.e. the fund. We urge ESMA to explicitly state this exemption in its definition of benchmark.



However, in this context we would like to draw ESMA's/EBA's attention to the definition and classification on different types/categories of benchmarks made by the EU Commission, ESMA/EBA and IOSCO. As all mentioned institutions try to classify essentially the same types of benchmarks with different categorizations (categorization by types of benchmarks made by ESMA/EBA vs. categories of benchmarks according to markets made by IOSCO) we think it is more appropriate and efficient to develop and establish a global definition and classification of benchmarks. A global definition and classification of benchmark products could enhance legal certainty and integrity of the benchmark formation process for all market participants who use indices and benchmarks in their daily business. The scope of the classification of benchmarks should be made in close consultation with the industry.

An index is usually a reflection of a specific market created and calculated by private and public bodies for a large number of users. Many financial indices are based on market capitalization but increasingly, strategy indices which are based on economic fundamentals or on a risk/return profile are used by market participants.

These need to be distinguished from so called customized/bespoke indices that are created and customized either by the provider of the basic market index or by a third party (e.g. asset manager) on the request of one or a very limited number of market participants and according to the specification of such market participants. Such individually agreed indices should be considered out of scope of the debate at hand and any regulatory discussion as they implement only a specific risk/return profile of an institutional investor (e.g. insurance company hedging interest rate risk on the based portfolio).

Only market or strategy indices which are created for a large number of users should be in the focus of the potential regulation of index providers.

- **Definition “benchmark users”**

We agree that benchmarks are used in the investment fund industry in the context of individual or collective portfolio management activities.

The German investment fund management companies usually do not produce or contribute to data used in the calculation of benchmarks. Investment fund management companies acting on behalf of the investment funds are in principle users of financial, commodity and real estate indices.

Asset management applications of indices are fundamentally different from the reliance on a benchmark to price financial indices. Asset managers use indices mainly for evaluating an active manager's performance or as a target for passive managers to track in managing an index fund. In more detail:

- There are index replicating and index linked funds which aim to achieve a performance in line with the index. These include, but are not limited to, exchange traded funds (ETFs). These products are usually based on public indices. They are often based on well-known equity indices (e.g. DAX, FTSE, MSCI), bond indices (e.g. ITRAXX) and money market indices such as EONIA, EURIBOR, or LIBOR (plus a spread). Sometimes several indices are used in combination, e.g. 50% equity and 50% money market indices, to reflect e.g. an absolute return strategy objective aiming at preserving the invested capital while participating in the return potential of the equity markets.
- Indices are also widely used within actively managed investment funds. They are used as management tools to control achieving return and performance targets, e.g. a fund's aim to achieve a



performance in excess of a specified index or combination of indices (index as performance benchmark). Money market funds may use financial instruments in their investment portfolio which have to adhere to indices based on maturities (LIBOR maturities, medium term notes, some certificates of deposit).

- German investment fund managers use indices in two ways as benchmark for the performance of actively managed portfolios. Firstly, they use indices without modification. Secondly, asset managers more often use so called customized/ bespoke indices. These are usually a combination and modification of existing public indices which are individually agreed between the asset managers and the institutional investors in order to reflect the specific investment objective and strategy of the particular investor. The calculation of the customized index is often performed by the provider of the base index, e.g. S&P calculates 50,000 and MSCI 5,000 customized indices on behalf of their clients (please see Investment Europe, 12 July 2012, p. 20). Customized indices agreed between the asset managers and one or few investors do not cause regulatory concerns, especially when the underlying indices are well regulated and transparent.
- Deutsche Performancemessungs-Gesellschaft für Wertpapierportfolios mbH reports in its client database German (institutional) funds with 770 Billion Euros AuM which use indices in their investment strategy. This represents close to 40 per cent of the total German fund market measured by assets under management. These funds use more than 7,000 benchmarks. 15 per cent have more than one benchmark per fund. And 75 per cent of the benchmarks in use are based on two components, usually indices.
- In the actively managed so-called absolute or total return fund performance, targets are often set as hurdle rates, e.g. minimum performance needs to exceed EONIA, EURIBOR, or LIBOR plus a defined basis point spread. Such performance benchmarks and hurdle rates are usually reported to investors and often need to be disclosed in advance, e.g. in the UCITS KIID. In order to be able to use bond and equity indices for replication purposes or as a management tool in actively managed investment fund products, it is necessary to know the methodology applied as well as the index value, the index components and their individual weightings, the index calculation (including effect of leverage within the index), re-balancing methodologies and index changes on a daily basis. Only on the basis of this information the investment fund management companies are able to either replicate the index via passive management or to determine the effects of under- or overweighting index components in active management. This level of transparency is also necessary in order to effectively prevent market manipulation through indices and benchmarks.
- In many cases indices determine the fees to be paid by investors (performance fees) and the remuneration of the investment fund management companies as well as the remuneration of the individual fund manager.

Question 2: Principles for benchmarks

Would you consider a set of principles a useful framework for guiding benchmark setting activities until a possible formal regulatory and supervisory framework has been established in the EU?

We support the initiative to introduce principles for reference rates and other benchmarks-setting processes with the involved market participants in order to bridge the interim period until a formal regulatory and supervisory framework for benchmarks has been created in the EU. A regulation of the bench-



marks-setting processes should also incorporate provisions of the licensing and pricing of different types/categories of benchmarks. The regulation of credit rating agencies could provide a good starting point for such a regime.

However, in this context, we would like to draw your attention to the ESMA Guidelines on ETFs and other UCITS issues (ESMA/2012/832EL). These guidelines set the conditions under which UCITS may use financial indices as benchmarks. They demand that only transparent indices can be used. Asset managers have to impose extensive transparency requirements on benchmark administrators in terms of calculation methodologies, calculation process, re-balancing methodologies, constituents and their respective weightings for all indices in which UCITS invest. In our view, however, it is not appropriate to indirectly impose requirements on indices while regulating only a small group of benchmark users. It is more efficient to regulate the benchmarks-setting processes and all involved market participants. This will create a level playing field between all benchmark users.

Although the proposed principles by ESMA/EBA will have no binding effects, we fear that the investment fund management companies will be put at a disadvantage as they have to follow extensive transparency requirements for financial indices in comparison to other benchmark users.

Therefore, we propose that the ESMA Guidelines on financial indices (chapter IX) shall come into force once a formal regulatory and supervisory framework for benchmarks has been established in the EU and not before.

Question 3: General principles for benchmarks

Do you agree with the principles cited in this section? Would you add or change any of the principles?

We agree with the principles. However, as mentioned above, the general framework for benchmarks-setting principles should also consider provisions of the licensing and pricing of different types/categories of benchmarks. We know that the costs of establishing (customized) index and benchmark products for the specific purposes for the investment fund industry have dramatically increased during the last years because index providers can have a quasi-monopolistic advantage over the users of their indices. In the institutional arena a market index or a blend of indices is selected for a new fund by the asset owner (e.g. a pension fund) with or without the help of a consultant. The index selected as a benchmark becomes part of the legal documentation of the fund (e.g. is mentioned in the prospectus). All firms involved in the investment process are then obliged to source the index data from the provider as part of their standard investment, fund accounting and fund performance processes thereafter. They thereby all become captive consumers of index data that are usually supplied by third party vendors. The index providers can then introduce high data prices over which the users have no choice than to pay, especially as investors tend to prefer to invest in benchmarks that have good brand and track record. Although there is competition between the major index providers in practice changing a benchmark on an existing fund is difficult.

We know that the fees of establishing (customized) index and benchmark products for the specific purposes for the investment fund industry have dramatically increased during the last years. Vendors charge fees in different ways, e.g. for internal use, reporting to clients, reporting on the internet and "manipulation" of index data, all of which require systemic licenses and lead to a doubling, in some cases quadrupling of license fees. Also the cost and effort for creating customized indices is in no relation to the charged fees. For example, the simple conversion of an index into another currency is consid-



ered a customized index. Even if customizing a market index is the client's obligation it may be subject to fees payable to the index provider.

It is not acceptable that benchmark administrators require licenses to use the index name as benchmark and/or to calculate the index performance as a benchmark of the fund performance if the indication of the benchmarks and its performance is required by law as it is currently the case for the UCITS Key Investor Information Document (KIID). The KIID requires disclosure of the fund benchmark (e.g. index name) and its historic performance over ten years if available. Regulation should not provide the benchmark administrators with the opportunities to create business opportunities which are costly to benchmark users.

This issue should be fully addressed by any future set of principles or regulation by taking a reasonable commercial cost approach as presented in the EU Commission consultation paper. Therefore the non-discriminatory access to and obligation to license use of indices as benchmarks to market should be an integral part of the new regulatory framework for indices.

Question 4: Principles for firms involved in benchmark data submissions

Do you agree with the principles cited in this section? Would you add or change any of the principles?

BVI agrees with the principles. The rights and obligations of the contributing firms should be regulated by a future EU wide regulatory framework for benchmarks. Submissions for data for inclusion of indices and benchmarks should be made only by contributing firms regulated for these purposes. The mandatory submissions of data to benchmark administrators by financial institutions as part of a panel should avoid a possible conflict of interest if the contributor of the data has a financial or other interest in the use of the data. Benchmark data provider also should provide information on liquidity of the contributed underlying trades.

Question 5: Principles for benchmark administrators

Do you agree with the principles cited in this section? Would you add or change any of the principles?

BVI agrees with the principles. One of the important pillars of the regulation of the benchmark administrators is a coherent transparency regime. Transparency should form an integral part of the process of establishing and computing indices and benchmarks. Regulators should work in close cooperation with the financial market in order to specify the efficient level of transparency to be made available by the benchmark administrators.

We think that transparency on the setting of indices and benchmarks, including daily license and fee free publication (including download/data feed capacity) of public index and benchmark prices/values/rates, their constituent or their structure parts (e.g. in case of the German bond index REX) their weightings, and – if applicable – contributors, on a central official EU website will promote investor confidence as daily publication on a central official EU website would limit the interest for and the possibility of market and other financial abuses by the providers of such products. Distribution by the provider of index and benchmark prices/values/rates without corresponding daily publication of their constituent parts and their weightings on a central EU website should be discouraged.

Question 6: Principles for benchmark calculation agents

Do you agree with the principles cited in this section? Would you add or change any of the principles?



Question 7: Principles for benchmark publishers

Do you agree with the principles cited in this section? Would you add or change any of the principles?

We agree with the principles.

Question 8: Principles for users of benchmarks

Do you agree with the principles cited in this section? Would you add or change any of the principles?

We agree with the “General principles” (F.1). However, in our view, it is not appropriate that benchmark users (e.g. investment fund management companies) have to ensure that the relevant benchmark administrator and benchmark calculation agent comply with the principles applying to benchmark administrators and benchmark calculation agents. We think that the national competent authorities should have the responsibilities to monitor whether the benchmark administrator and the benchmark calculation agent are compliant with the ESMA/EBA principles.

In this context we would like to reiterate our position that the UCITS have to comply with the ESMA Guidelines on ETFs and other UCITS issues. We think that it is not appropriate to require that the investment fund industry follows ESMA Guidelines on the one hand and on the other hand demand that all benchmark users (e.g. investment fund companies) ensure that the relevant benchmark administrator and benchmark calculation agent comply with the principles applying to benchmark administrators and benchmark calculation agents. Investment funds have no legal and economic means to enforce compliance by benchmark providers.

Therefore, we propose the following amendment to the Supporting principle F.2:

F.2 ~~A benchmark user~~ The competent authority should ensure that the relevant benchmark administrator and benchmark calculation agent comply with the principles applying to benchmark administrators and benchmark calculation agents. In order to comply with this requirement ~~the benchmark user~~ the competent authority may consult, among other sources, the confirmation of compliance publicly disclosed by the benchmark administrator and the benchmark calculation agent, and should apply reasonable judgment.

Question 9: Practical application of the principles

Are there any areas of benchmarks for which the above principles would be inadequate? If so, please provide details on the relevant benchmarks and the reasons of inadequacy.

We think that so called customized/bespoke indices that are individually agreed on should be considered out of scope of ESMA's/EBA's principles and any regulatory discussion as they implement only a specific risk/return profile of an institutional investor (e.g. insurance company hedging interest rate risk on the based portfolio).

Only market or strategy indices which are created for a large number of users should be in the focus of the ESMA/EBA principles and for any potential regulation of benchmarks-setting processes.



Question 10: Continuity of benchmarks

Which principles/criteria would you consider necessary to be established for the continuity of benchmarks in case of a change to the framework?

One important principle for the continuity of benchmarks is an appropriate transition period from existing to new indices and benchmarks. All market participants (e.g. investment fund management companies) should be given sufficient time in order to prepare and implement new regulatory requirements for indices and benchmarks in their procedures and arrangements, in the institution as well as in their contracts using index-based financial products.

We believe that any ad hoc and mandatory change to new indices and benchmarks in a very short time frame by cutting out contracts which are referenced to existing index-based financial products should be avoided in order to have legal certainty for market participants using index based products.