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European Fund and Asset Management Association

EFAMA response to the ESMA Consultation Paper on Draft Technical Advice under the Benchmarks Regulation

A. GENERAL REMARKS

The European Fund and Asset Management Association[1], EFAMA, welcomes the opportunity to provide comments to the ESMA Consultation Paper on the technical advice to the European Commission on the Benchmarks Regulation. EFAMA also welcomes a number of clarifications and improved points that ESMA is providing in its Consultation and draft Technical Advice since its previous Discussion Paper.

The EU asset management industry considers that a robust legal framework for Benchmarks is an important step for restoring market credibility and confidence in benchmarks and allowing a level playing field for all market participants.

Asset managers represent an important group of benchmarks users, either in the case of passive managed funds and exchange traded funds (ETFs) - where benchmarks are used as a target for index linked funds - or in the case of the evaluation of an active manager's performance - where the fund performance is measured against a selected index or a set of indices. Asset managers as benchmarks users are generally not involved in the production, calculation, and contribution to data on which benchmarks are based. Therefore, their role being clearly limited to the use of a benchmark – for which they are called to pay high and multiple fees – does not make it possible for them to have direct access or control over the benchmark setting processes, as a benchmark administrator does.

Moreover, investment funds are highly regulated financial products (through the UCITS and AIFM Directives). In particular, in the case of UCITS, asset managers are already subject to extensive requirements and conditions under which UCITS may use financial indices as benchmarks. The ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937/EN)[2] foresee that only transparent indices are permitted for UCITS to use as a benchmark. These transparency requirements are very extensive covering calculation, re-balancing methodologies, as well as constituents and their respective weightings. In addition, indices used as performance evaluation tools need to be disclosed in advance in the UCITS KIID. This complements existing industry practice around robust index selection necessary to perform to the highest fiduciary standards.

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[1] EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members EUR 21 trillion in assets under management of which EUR 12.6 trillion managed by 56,000 investment funds at end 2015. Just over 30,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 25,900 funds composed of AIFs (Alternative Investment Funds). For more information about EFAMA, please visit www.efama.org

[2] https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf

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The text of the Benchmarks Regulation as finalized after the conclusion of the trilogues, ensures further legal clarity for users of benchmarks by foreseeing a definition of the "use of a benchmark" rather than a definition of concrete groups of users (as was the case in the initial legislative proposal). From the asset management industry's perspective, the main category of use into which investment funds fall, is the one referenced in article 3 para 1 point 7(e) related to the "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, of defining the asset allocation of a portfolio, or of computing the performance fees".

At the same time, the definition of what constitutes a benchmark, includes also a concrete and isolated only to investment funds reference, i.e. the benchmarks used by investment funds for measuring their performance (article 3 (1) point 3). While the definition of the benchmark refers in general to every type of financial instruments and contracts that use indices to measure their value or determine the payable amount, when it comes to cases of non-determining the value of the underlying financial product, but of using a benchmark only for performance assessment purposes, the only investment product targeted are the investment funds.

EFAMA is really surprised to see that benchmarks used for the purpose of assessing the performance of an investment fund, are the ones to be sorted out as the single case of performance benchmarks that should be included in the scope of this Regulation. In particular, as this Regulation aims at ensuring the proper functioning of the internal market and therefore eliminating risks of conflicts of interest and manipulation and therefore targeting benchmarks that are susceptible to those risks. As stated above, investment funds are highly regulated financial products. Non-index tracking funds do not use indices to price their net asset value and a physical index tracking fund's value is determined by the value of the assets held in the portfolio and not by the benchmark. These features make those benchmarks' susceptibility to manipulation by funds extremely narrow. Therefore, the single reference to those type of indices in the definition of a benchmark seems to be disproportionate and creating a non-level playing field for investment funds.

As a last general comment concerning the Benchmarks Regulation, EFAMA welcomes the fact that the requirements for users deriving mainly from article 19 are concrete and are stating that users and supervised entities, such as UCITS and AIFs, may use a benchmark or a combination of benchmarks if it is provided by an administrator included in the ESMA register. Therefore, it is EFAMA's understanding that by confirming a benchmark is made available by an administrator referenced in the public ESMA register, users can consider this benchmark as compatible with this Regulation with no additional controls required from their side.

EFAMA acknowledges the important work that has been done so far and that still needs to be done at Level 2 by ESMA, as well as the adjustments that ESMA has applied to the text of its technical advice based on the feedback received by stakeholders on its previous discussion paper of February 2016. At the same time, we consider that there are still some important points to be taken into consideration, which we raise in our response to the questions of the consultation.

EFAMA will be responding to the sections of this Consultation Paper that are relevant for users of benchmarks and in particular on the definition of what is an index “made available to the public”, the definition of the “issuance of a financial instrument”, the measurement of the NAV of a fund, the criteria as to the definition of a critical benchmark and the transitional provisions.

B. RESPONSES TO THE QUESTIONS OF THE DISCUSSION PAPER

Section 2.1-2.2 – Draft Technical Advice: "making available to the public"

Q1: Do you agree with the conditions on the basis of which an index may be considered as made available to the public?

EFAMA would like to recall its position as presented in its response of March 2016 to the ESMA Discussion Paper. The scope of the Benchmarks Regulation covers clearly only those indices that are public or made available to the public and, thus, the scope is a precise one and not one that covers all future or existing indices offered and used in the financial markets. It is in that context that the term "made available to the public" should be defined.

Therefore, we did not agree in our previous response with the initial proposal of ESMA, i.e. that even the use by one supervised entity is enough to determine this benchmark as "made available to the public", neither did we agree that this rationale of defining the scope of the Regulation as broadly as possible is in line with the Level 1 text.

It is EFAMA's understanding that the current consultation paper takes into consideration some of the arguments raised on that point.

- ESMA considers it a pre-condition that the indices would have to be accessible to an indeterminate and open group of recipients in order for them to be considered "made available to the public" (point 14 in 2.1). Still, it is not fully clear what is meant as "at least potentially accessible", as any given index is either accessible to/by an open group of recipients or not.

- Moreover, we agree with the reference to the ECJ definition of accessible and in particular as regards the advent of new technologies. When it comes to investment funds, it is true that the financial indices used by them along with their values and prices, are covered in several cases by disclosure requirements under the MiFIR, as well as the UCITS Directive and the AIFMD. EFAMA wishes to recall its response to the ESMA Discussion Paper referring to those cases. *"Still, the indices received upon subscription or fee may be made available to the public via different channels for instance via the UCITS KID. It is indeed the UCITS KID on which Recital 11 makes a concrete reference mentioning UCITS funds as an example. Hence, it is shown that the provision of an index by subscription or fee and not for free is not necessarily an impediment for this index to be considered as made available to the public, as long as there is another way via which the index is made available to the public. But this only underlines, that the index has to be made available to the public via any possible channel in order to be covered by the Regulation."* EFAMA continues to support that the disclosure of the index and its values to the wider public (or as stated in the ESMA's technical advice to *an indeterminate number of people*) is a precondition for an index to be deemed as "made available to the public". Regulatory disclosure requirements are possible channels of dissemination to the wider public and UCITS KIDs is an example of that. In that way, there is no paradoxical situation as described by ESMA in point 22, i.e. an index referenced by an instrument (or a fund) traded on a trading

venue and accessible to/by a huge number of retail investors, which as long as it is not public will not be covered by the Regulation. But this only underlines once more that the concept of "made available to the public" applies for an index already accessible to/by the wider public and an undetermined number of users and when it is simply implied or envisaged that there is such a potential in the future.

- Finally, as also pointed out by ESMA in the consultation paper, there are cases that are not covered by specific transparency obligations and in which it is questionable whether the availability of an index to one or a few supervised entities for the sake of its use bilaterally might be regarded as sufficient to consider the index as being disclosed to a wider public (point 20, of 21). In that case ESMA is making reference only to financial contracts, but the same is valid also for investment funds with a restricted number of professional investors. In the case of investment funds, bespoke indices that are agreed between the asset manager and one or a small number of institutional investors are not made available to the wider public (please see our point on bespoke indices further on).

All these points raised in the Consultation Paper are shared by EFAMA to the extent that they underline the need for an index to be accessible to the wider public in order for it to be deemed as "made available to the public".

However, the following reference in ESMA's paper is not consistent with this rationale: "the availability of index determinations to one or more supervised entity users can imply its availability to an indeterminate number of recipients, rendering the index to be a benchmark fully in scope" (point 21). Moreover, there is also the reference that "the index would have to be (at least potentially) accessible to an indeterminate and open group of recipients" (point 14).

The accessibility of the index to a indeterminate/ wide group of recipients is either the case via various channels of dissemination as presented above or it isn't. The mere fact of the availability of the index to one or more supervised entity users cannot a priori imply its availability to the wider public neither can it deem the index as potentially accessible to an open group of recipients.

EFAMA would therefore urge ESMA to clarify that, despite of these references in points 14 and 21, the determination on whether an index is made available to the public is not to be presumed simply on the fact that an index is provided to one or more supervised entity users, but on the fact that it is accessible to the wider public.

Apart from those less clear statements in points 14 and 21, EFAMA agrees with the two criteria set in ESMA's draft technical advice as to which index shall be deemed as made available to the public.

EFAMA would also like to underline the distinction between public commercial benchmarks created for a large number of users and the bespoke/customized indices. Bespoke indices are individually agreed between fund managers and a very limited number of investors according to the specific needs of the latter. A bespoke benchmark is often imposed on the asset manager by its client, or more specifically by the asset manager selection consultant employed by the pension fund or the insurance

company. The main purpose is to reflect that the actual product (investment universe and risk) sold to the client matches the client's investment expectations, as this is expressed in the choice of the index.

Therefore, customized/bespoke indices are targeting the personalized objectives and strategies of a particular investor and implement only the specific risk/return profile of that investor. In many cases, those indices are referenced only by one investment fund/sponsor or a restricted number of investment funds and are related to their restricted group of investors. The composition of the benchmark being fully transparent by the asset manager to the investor (but only to him/her) along with the fact that the benchmark is based on an existing regulated benchmark minimize any risk of manipulation or conflicts of interest.

These indices are not made available by the investment fund to the public. However, some more widely used variations of originally "bespoke" indices which have been used over time by many institutional investors are usually broadcasted by the benchmark providers themselves, e.g. a broad stock index expressed in another currency than its home market currency, in which case they are made available to the public.

EFAMA, considers that bespoke/customised indices that are not broadcasted to the wider public do not fall in the scope of the Regulation as they do not fulfil either of the two conditions set by the definition of "made available to the public" as proposed in this consultation paper by ESMA – they are not automatically accessible by a large or potentially indeterminate number of recipients and their use by one or more supervised entities does not make them accessible to an indeterminate number of people - such indices are usually not distributed by supervised entities to their end-clients.

We believe that this allows for the continuation of the use of bespoke/customised indices as agreed privately between asset managers and their supervised entity clients (such as insurance companies and pension funds) with no additional fees and administrative burden (which would bring no added value). Thus, asset managers and their investors will be able to continue targeting personalised objectives and therefore applying strategies that best fit the end-investors.

Section 2.5-2.6 – Draft Technical Advice: "issuance of a financial instrument"

Q3: Do you agree that the 'use of a benchmark' in derivatives that are traded on trading venues and/or systematic internalisers is linked to the determination of the amount payable under the said derivatives for any relevant purpose (trading, clearing, margining, …)?

EFAMA agrees largely with the definition of the "issuance of a financial instrument" and with the decision to include activities related to trading or clearing of derivatives, under the second point of the provision on the "use of a benchmark" (Article 3 (1) point 7 b).

Q4: Do you have any comments on the proposed specification of issuance of a financial instrument?

EFAMA would like to comment on one of the financial instrument types that are to be included in the case of an issuance of a financial instrument for the purposes of determining the use of an index

(foreseen in Article 3(1) 7 b). In its draft technical advice ESMA makes reference to paragraphs (1) to (3) within the list of Annex I, Section C of MiFID. The financial instruments mentioned in paragraph (3) are “units in collective investment undertakings”.

As already stated in our general remarks, it is rather clear that all investment funds fall in the last case when it comes to “use”, i.e. the case of article 3 (1) point 7(e). This category covers all investment funds that use an index to determine their performance for all different purposes listed therein with no concrete exemptions, which means also funds admitted to trade or traded on a trading venue.

We, therefore, consider it appropriate to delete the reference to units of investment funds from the category of issuance of a financial instrument in order to avoid any duplications that could impede legal clarity, but also as for reasons of legal consistence it is better to have the use by investment funds under the same category of the “use of a benchmark”.

EFAMA suggestion on the draft technical advice would therefore be the following (in strikethrough bold italic):

> The issuance of a financial instrument that references an index or a combination of indices is to be intended as the initial offering of the financial instrument types specified in paragraphs (1) to ***(2)*** ~~***(3)***~~ within the list of Annex I, Section C, of Directive 2014/65/EU to third parties through negotiation on trading venues and/or systematic internalisers.

Section 3.4 & 3.7 – Draft Technical Advice on the measurement of the reference value of a benchmark – investment funds

Q5: What are your views on the transitional regime proposed to assess the nominal amount of financial instruments other than derivatives, the notional amount of derivatives and the net asset value of investment funds when regulatory data is not available or sufficient?

EFMA agrees with ESMA’s proposal on the transitional regime and on taking as alternative the NAVs of funds or proxies of these values into account. In addition, the data already held by national competent authorities (NCAs) should also be used as proxies during that period.

However, EFAMA would like to stress, that no additional burden and costs should result for the users related to the collection of the information on NAVs or the frequent update. In particular, there should be no explicit or implicit requirements to disclose notional or net asset values to the index provider as the Level 1 text does not foresee the requirements for investment funds as supervised entities and users to proactively report such data to index providers. EFAMA, therefore, urges ESMA to clarify that in such a case the administrators or the NCAs will not require the disclosure of data by supervised entity users, where such a provision is not foreseen by a regulatory requirement.

EFAMA suggestion on the draft technical advice would therefore be the following (in bold italic):

d) Transitional regime

Whenever data as set out above in paragraphs a), b) and c) is not available or not sufficient, when assessing benchmarks under the thresholds in Article 20(1) and Article 24(1)(a), the nominal amount of financial instruments other than derivatives, the notional amount of derivatives and the net asset value of investment funds, or proxies for these values, such as open interest data, as reported by alternative private providers or ***national competent authorities*** of information ***already*** available to administrators and competent authorities may be taken into account. In such cases, the competent authority or the administrator shall ***not require the disclosure of data by supervised entity users where such a provision is not foreseen by a regulatory requirement and*** provide written justification of this use, in particular in relation to the non-availability of the regulatory data.

Q6: Do you agree with the measurement performed at a specific point in time for assessing whether a benchmark hits the thresholds specified in Article 20(1) to be considered as critical?

EFAMA agrees with using the latest available NAV per unit as the reference for the NAV of investment funds.

As to the assessment of the threshold related to the critical benchmarks, we believe this is an exercise where precision is not the most important factor and amounts established at different dates can be added for the estimate. The main aim should be to establish on the basis of hard data that a given index is clearly above or below the thresholds set by the Benchmarks Regulation. Therefore, the availability in the market place of "hard" demonstrable data on the use of an index is the most paramount element when assessing the underlying value of a benchmark.

Consequently, EFAMA suggests to take into account the last NAV made public in a legal reporting. Moreover, given the volatility of particular values such as the NAVs of the funds, an index should be considered to go above the 500 billion euro threshold, only if it exceeds the threshold for a minimum period of time.

Q7: What are your views on the use of licensing agreements to identify financial instruments referencing benchmarks? Would this approach be useful in particular in the case of investment funds?

EFAMA considers that the publicly available data is the main and feasible way for a benchmark administrator to have access to data concerning the NAV of a fund. The licensing agreements are not the optimal means of access to such data as they will not necessarily lead to accurate results. The relevant data are not necessarily part of these agreements.

Moreover, considering licensing agreements as the optimal way to identify the value of investment funds referencing a benchmark, gives a regulatory priority over other means of identification, such as the latest publicly available NAV and for that reason might have undesirable effects on the pricing of these licensing agreements to the detriment of the users.

It should, therefore, be sufficient for the purposes of establishing the regulatory thresholds of the different index categories that in the case of investment funds the administrators use the data on their NAVs as included in the most recent publicly available reports.

Section 4.3 - Draft Technical Advice on the criteria referred to in Article 20(1)(c) subpara. (iii)

Q8: Do you agree with the criteria proposed? Do you consider that additional criteria should be included in the technical advice?

EFAMA agrees with the criteria proposed and would like to highlight that as stated in ESMA's draft technical advice the list of criteria should not be exhaustive, they should be considered jointly, so that the final assessment is done in a holistic manner and that not all of them will always be relevant for each benchmark that will be assessed.

Moreover, EFAMA would like to make an addition in order to enhance legal consistency. The scope of the Regulation extends not only to financial instruments and contracts, but also to investment funds. This is not reflected in the point (e) on the market integrity.

For that reason, point (e) should be made as following (in strikethrough, bold italics):

e. The diversity of financial instruments, financial contracts ***and investment funds*** referencing the benchmark, and in particular:

Section 6.4 - Draft Technical Advice on transitional provisions

Q11: Do you agree with the criteria, included in the draft technical advice that NCAs should use when assessing whether the transitional provisions could apply to a non-compliant benchmark? Could you suggest additional criteria?

EFAMA agrees with the criteria identified in the draft technical advice and with the case-by case application of them by the NCAs.

Moreover, EFAMA believes that there are also cases where there is the possibility to substitute an index in the fund rules or by law, still the result will be very detrimental for the counterparties. This is mainly due to the fact that a decision of an investor related to a product is in many cases linked to a

particular benchmark and any other substitute would make the continuation of investing in the product not possible from the investor's perspective. In those cases, investors may desire to maintain an exposure from a particular index provider and might not consider that this exposure is sufficiently catered for by a different benchmark or a different benchmark provider.

A possible outcome of the non-continuation of the benchmark in those cases could be investors in an investment fund or holders of other financial instruments voting against a proposal to substitute the existing benchmark (which does not conform with this Regulation) to another benchmark (which conforms with this Regulation) and forcibly close an investment fund or wind up financial instruments.

In that sense, this frustration of the investment fund's portfolio could be treated as an event of similar value to a "force majeure" and we would therefore suggest an additional criterion related to the case of negative consequences for the end investors when no existing substitute benchmark is in line with their investment strategy.

Related to investment funds such a case will be mostly related to non-EU benchmark administrators who will decide not to apply for authorization/registration leaving thus the investment funds referencing them to a limited scope of alternatives, with the risk that none of them will be as representative of the market the non-complying Benchmark was. For example, a single emerging market fund may not be able to replace a national index provided by the Asian, African or American local stock exchange.

Finally, for reasons of legal consistency, we would also stress that a reference to investment funds should be included in the first part of the draft technical advice (which for the time being references only financial instruments and financial contracts, although investment funds are directly referenced in the scope of the Regulation along with financial products and financial instruments).

The EFAMA suggested changes/additions are the following (in underlying bold italics):

Conditions on which the relevant competent authority may assess whether the cessation or the changing of an existing benchmark to conform with the requirements of the benchmarks Regulation could reasonably result in a force majeure event, frustrate or otherwise breach the terms of any financial contract ~~or~~ financial instrument *or investment fund* which references such benchmark

(…)

o Whether the existing financial contracts, financial instruments and investment funds (or their accompanying documents) referencing the non-compliant benchmark already include reference to a possible substitute benchmark and, if yes, how such substitute benchmark has to be determined.

o Whether a benchmark administrator decides not to apply for authorization/registration leaving the financial contract, financial instrument or investment fund with alternatives not as appropriate as the one previously used.

o Whether the existence of possible substitute benchmark does not preempt it can reflect the investment strategy of the investors in a financial contract, a financial instrument or an investment fund and the absence of such link might cause negative consequences for them.

o Whether the transitioning of the benchmark to another administrator would lead to a substantial change in the benchmark.

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