

1 December 2016

European Securities and Markets Authority
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07
France

Dear Sirs,

DRAFT TECHNICAL STANDARDS UNDER THE BENCHMARKS REGULATION

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

On 18 September 2013, the European Commission adopted a proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts (COM (2013) 641 final, the "**Legislative Proposal**") in order to improve overall transparency and integrity in the way benchmarks are produced and used, with a view to increasing governance and controls over benchmarks, thereby strengthening the protection afforded to benchmark users. The FMLC commented extensively on the Legislative Proposal.¹

Regulation (EU) 2016/1011 (the "**BMR**")—reflecting the Legislative Proposal as amended by co-decision of the European Council and Parliament—was published in the Official Journal on 29 June 2016. It requires the European Securities Markets Authority ("**ESMA**") to develop a number of draft regulatory and implementing technical standards and provide technical advice to the Commission.

Before the BMR was published or entered into force, on 15 February 2016, ESMA published a Discussion Paper (the "**DP**") putting forward a proposed approach for both draft technical standards and technical advice.² The FMLC responded to the DP in March 2016 (the "**March Response**"), analysing certain key issues: (i) ESMA's definition of "available to the public" for the purposes of determining an "index"; (ii) the concept of "independence" as part of the oversight function requirements; (iii) inconsistencies between proposals on the "appropriateness" and "verifiability" of input data and the definition of "expert judgement" in the Draft Regulation; and (iv) transitional arrangements for the cessation of an existing benchmark, including analysis on contract frustration and force majeure.³

More recently, ESMA has published a follow-up to the DP, in the form of a Consultation Paper published on 29 September 2016 (the "**CP**") setting out draft technical standards ("**Draft RTS**") under a variety of mandates. Not all topics addressed in the DP, however, are included in the CP. Certain key questions concerning definitions and transitional arrangements, for example, have been addressed in an earlier consultation.⁴ The FMLC takes this opportunity to offer a short response to the CP.

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Characteristics and procedures of the oversight function

In the March Response, the FMLC discussed the oversight function requirements and the proposals put forward by ESMA on this subject in section 3 of the DP. In particular, the FMLC highlighted passages in the DP where ESMA contemplated the possibility that *independent* members of the oversight function might include independent non-executive directors (INEDs), appointed to the board of the administrator, where “independent members” are described by ESMA as persons who are not otherwise directly affiliated with the administrator. The FMLC suggested that careful thought should be given to the role and independence of INEDs who would, as a matter of law, owe common law duties of care, skill and diligence to the administrator.

In the CP (at paragraph 11), ESMA explains that it has, on reflection, removed any provision which would allow INEDs of the administrator of the benchmark to serve on an oversight function as independent members and the new approach is reflected in Article 1(2) of the accompanying Draft RTS on the oversight function. The FMLC welcomes the adjustment and the revised approach.

In relation to the positioning of the oversight function, the CP (at paragraphs 17 and 18) refers to the importance of ensuring effective challenge of the management body, which is, in essence, the board of the administrator.⁵ In certain circumstances, a board may delegate management to executive and operational staff. The FMLC recommends that this possibility is reflected in the Draft RTS on the oversight function. Thus, Article 2 might provide:

The oversight function shall ... challenge the decisions of the management body ... and of any staff of the administrator to whom the management body has delegated the responsibilities described in Article 3(1)(20) [BMR] with regards to benchmarks provision ...

The FMLC notes, further, that ESMA has given additional consideration to the structures which reflect the independence of the oversight function (at paragraphs 21 and 22 of the CP) and has introduced restrictions which ensure the internal separation of the oversight function from the business of the administrator to avoid conflicts of interest. The FMLC welcomes this.

Verifiability of input data and use of expert judgement

The FMLC supports the proposals to provide for contingency measures or fall-back arrangements to ensure the provision of input data during conditions of market stress (at paragraph 75 of the CP).⁶ There may, however, be occasions when an administrator is unable to guarantee the provision of input data because s/he believes that the available data does not meet the threshold standards for adequacy set by Article 11 of the BMR.⁷ It is important that the requirement to “ensure the provision of input data” in Article 6(2)(d) of the Draft RTS on input data does not conflict with these standards and consideration could usefully be given, therefore, to qualifying the requirement. For example, Article 6(2)(d) could require contingency arrangements:

to ensure, where possible and consistent with the requirements established by Article 11 [BMR], the provision of input data in the event of a disruption ...

A similar point arises in the context of expert judgement. Although the proposals in paragraph 142 of the CP on the procedures for applying expert judgement are welcome, the FMLC suggests that it would be helpful if the Draft RTS were also to indicate the limits of contributors' discretion in relation to benchmark inputs.⁸ Failing such clarification, there may be a risk that the use of expert judgement expands to fill the methodological vacuum caused by a lack of reliable transaction data.⁹ At this point, contributors will be concerned about their potential civil or criminal liability for the provision of false or misleading inputs. This issue was discussed in considerable detail by the FMLC in section 4 of the March Response, where the Committee pointed out that the BMR defines expert judgement exclusively in terms of adjustments to input data such as transactions, bids and offers and other value data.¹⁰ In order better to track the definition in the BMR, Article 3 of the Draft RTS on governance and control requirements for supervised contributors could be introduced with the words "Where input data is adjusted by expert judgement ..."

A final, short point on the Draft RTS on input data is that references to monitoring communications—at Article 6(3)(e) and (f)—will, in the view of the FMLC, be interpreted in accordance with the usual practice of recording communications and performing random spot checks. The Draft RTS should stipulate for a different standard if one is intended.

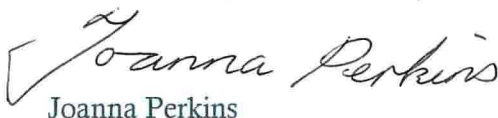
Third country benchmarks and compliance with IOSCO Principles

In a paper on the Legislative Proposal published in March 2014, the FMLC sought clarification from the European Commission as to the extent to which compliance with the *Principles for Financial Benchmarks* (the "*Principles*"), adopted by the International Organisation of Securities Commissions ("*IOSCO*") on 17 July 2013, would assist the administrator of a third country benchmark in obtaining recognition for that benchmark under the proposed regulation.¹¹

In this regard, the FMLC welcomes ESMA's decision to include specific points on a benchmark's compliance with the *Principles* as information required to be provided in an application for recognition as a third country provider.¹² The FMLC also welcomes the provision at Article 1(4) of the Draft RTS on recognition, which permits an applicant to dispense with providing this information where it is contained, instead, in an assessment by an independent auditor of the benchmark's compliance with the *Principles*. These provisions go some considerable way towards clarifying the extent to, and means by, which compliance with the *Principles* will support an application for recognition.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,



Joanna Perkins

FMLC Chief Executive¹³

¹ The FMLC papers on the Legislative Proposal are as follows:

- (i) letter to the European Commission on non-deliverable forward rate sources under the Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts, dated 16 October 2015, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_letter_to_commission_on_benchmark_reform.pdf;
- (ii) letter to the European Commission on a Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts, dated 3 March 2015, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_letter_to_european_commission_on_benchmark_reform.pdf
- (iii) paper on "Discussion of Legal Uncertainty Arising from the Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts", dated 18 March 2014, available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_issue_177_benchmark_reform_paper_2014_12.pdf

All FMLC publications are available at: <http://www.fmlc.org/fmlc-papers.html>

² The Discussion Paper is available at: https://www.esma.europa.eu/sites/default/files/library/2016-288_discussion_paper_benchmarks_regulation.pdf

³ The FMLC March Response is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_up_11680394_v_1_fmlc_response_to_esma_discussion_paper_on_the_benchmarks_regulation.pdf

⁴ ESMA, Draft technical advice under the Benchmarks Regulation published 27 May 2016, available at: <https://www.esma.europa.eu/file/18642/download?token=1IGy8wgR>

⁵ See Article 3(1)(20) of the BMR.

⁶ See also the Draft RTS on input data, Article 6(2)(d).

⁷ The administrator is required to disclose contingency measures which will be taken when the thresholds for minimum quantity and quality of input data are not met under Article 1(1)(15) of the Draft RTS on transparency of methodology.

⁸ See the Draft RTS on governance and control requirements for supervised contributors, Article 3.

⁹ Responsibility for contingency measures to be taken when the thresholds for minimum quantity and quality of input data are not met rests firmly with the administrator, see *supra* n.7.

¹⁰ See Article 3(1)(13) of the BMR.

¹¹ FMLC, "Discussion of Legal Uncertainty Arising from the Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts", dated 18 March 2014, *supra* n.1, at p.11-12.

¹² Annex 1 to the Draft RTS on recognition lists the information to be provided in this context.

¹³ The FMLC is grateful to David Bunting (Deutsche Bank AG) for his comments on this letter and contributions thereto.