



EU BENCHMARKS REGULATION

NOVEMBER 2017

LATHAM & WATKINS

CONTENTS

EU Benchmarks Regulation

INTRODUCTION	3
WHO IS AFFECTED?	4
WHICH BENCHMARKS?	7
THIRD COUNTRY BENCHMARKS	9
TIMEFRAME	10
KEY CHALLENGES	12
KEY TERMS	13
YOUR CONTACTS	14

INTRODUCTION

Background to the reform

The EU Benchmarks Regulation was created due to concerns about the accuracy and integrity of indices used as benchmarks in financial markets, following the LIBOR scandal. The Regulation implements and builds upon the global standards set out in the IOSCO Principles for Financial Benchmarks, which were published in July 2013. A legislative proposal emerged in September 2013, shortly after many of the large LIBOR fines had been imposed, and as further concerns were emerging about the integrity of foreign exchange and commodities benchmarks.

The final Regulation came into force on 30 June 2016. Some provisions relating to critical benchmarks came into effect immediately, but most of the provisions will come into effect on 1 January 2018 (subject to transitional measures).

The Regulation has implications for those who provide, contribute input data to, and reference, benchmarks within scope. In contrast to the targeted approach taken to benchmark regulation domestically in the UK, the Regulation (which will supersede the existing UK rules) uses a very broad definition of “benchmark”, capturing a wide range of indices used in financial markets.

The **IOSCO Principles** are designed to provide an overarching framework of principles for benchmarks used in financial markets. They cover:

- **Governance:** to protect the integrity of the benchmark determination and oversight processes and to address conflicts of interest.
- **Benchmark quality:** to promote the quality and integrity of benchmark determinations through the application of design factors and the collection, use and retention of input data.
- **Quality of the methodology:** to promote the quality and integrity of methodologies by setting out minimum information that should be addressed within a methodology. The Principles also call for credible change and transition policies where a benchmark may need to be amended or may cease to exist due to market structure change or disruption.
- **Accountability mechanisms:** to establish complaints processes, documentation requirements and audit reviews.
- **Submitter Codes of Conduct:** where a benchmark is based on submissions, the administrator must require submitters to adhere to its submitter code of conduct to promote the quality of inputs submitted.

In the UK, various measures were put in place to try to address the perceived failings relating to benchmarks, including:

- New criminal offences relating to making false or misleading statements and creating false or misleading impressions regarding benchmarks.
- New conduct and supervision requirements for benchmark administrators and submitters.

The UK regime only applies to certain specified benchmarks. It originally captured only LIBOR, and was expanded subsequently to include: the ICE Swap Rate; SONIA; RONIA; LBMA Gold Price; LBMA Silver Price; ICE Brent Index and WM/Reuters London 4 p.m. Closing Spot Rate.

WHO IS AFFECTED?

Impact for administrators, contributors and users

The Regulation affects (i) administrators of, (ii) contributors to, and (iii) users of benchmarks. The table below summarises who is captured in each role and the basic requirements under the Regulation relating to each role.

	Administrator	Contributor	User
Description	<p>Person who has control over the administration of the benchmark. Includes:</p> <ul style="list-style-type: none"> ▪ Administrating arrangements for determining a benchmark ▪ Collecting, analysing or processing input data for the purposes of determining a benchmark ▪ Determining a benchmark through the application of a formula or other method of calculation, or by an assessment of input data 	<p>Person contributing input data:</p> <ul style="list-style-type: none"> ▪ That is not readily available to the administrator ▪ That is required in connection with the determination of a benchmark and is provided for that purpose 	<p>Person who:</p> <ul style="list-style-type: none"> ▪ Issues financial instruments which reference a benchmark ▪ Determines the amount payable under a financial instrument or financial contract by referencing the benchmark ▪ Is party to a contract which references a benchmark ▪ Measures the performance of an investment fund through the use of an index
Requirements	<ul style="list-style-type: none"> ▪ Authorisation or registration ▪ Proportionate controls in light of classification of benchmark ▪ Governance and control ▪ Outsourcing / licensing arrangements ▪ Methodology and transparency 	<ul style="list-style-type: none"> ▪ Follow administrator's code of conduct ▪ Supervised contributors must <ul style="list-style-type: none"> > prevent conflicts of interest > co-operate in auditing and supervision of benchmarks > maintain records and make these available 	<ul style="list-style-type: none"> ▪ Only use authorised benchmarks ▪ Produce robust action plans if a benchmark materially changes or ceases to be produced (to be reflected in contractual documents)

Key initial questions to ask when thinking about implementation include:

1. What is the firm's role? Is it an administrator, contributor or user (or a combination)?
2. With which types of benchmark is the firm involved?
3. Which counterparties does the firm rely on in its role as an administrator/contributor/user?
4. Does the firm have any reliance on cross-border benchmarks?

WHO IS AFFECTED? continued

Impact for administrators, contributors and users

Administrators

Administrators will be required to become authorised or registered, and will need to put in place appropriate governance arrangements and controls to help ensure the integrity of the benchmarks they provide. Authorised and registered administrators will be subject to the same ongoing compliance requirements (the requirements are differentiated according to the type of benchmark provided), but the registration process is intended to be less onerous.

As such, the registration process applies in respect of administrators that are 'supervised entities', unless they provide a critical benchmark (in which case they must be authorised). The term 'supervised entity' is defined by reference to EU financial services legislation, and includes banks, investment firms, insurers, UCITS management companies, AIFMs and consumer credit providers. If an administrator is not a supervised entity, they must be authorised if they provide a critical or significant benchmark, but need only be registered if they provide a non-significant benchmark.

Certain providers are exempt from the rules. For example, the Regulation does not apply to central banks, public authorities providing benchmarks for public policy purposes, media personnel publishing benchmarks as part of their journalistic activities, or (in limited circumstances) persons unaware that an index they provide is in scope of the Regulation.

Key implementation steps for administrators

- Identify which employees are involved in benchmark administration and the legal entity by which they are employed.
- Identify universe of benchmarks.
- Identify which legal entity owns the IP for each benchmark.
- Decide which legal entity should hold the regulatory licence for administering each benchmark. This will require consideration of which entity is best suited to face the requisite capital requirements and liability exposure. For UK administrators, it will also be appropriate to consider whether it is best for an entity within the EEA (post-Brexit) to hold the licence.
- Scope out an appropriate governance framework. This will require consideration of the board's composition and experience, and the composition of the oversight committee. Firms will need to carry out a gap analysis against the requirements set out in the Regulation and build a suitable governance, compliance control and accountability frameworks (the latter with the Senior Managers Regime in mind for UK firms).
- Build a methodology design and approval framework, and determine how an ongoing review of methodologies will take place.
- Prepare a benchmark statement describing key features of the benchmark.

WHO IS AFFECTED? continued

Impact for administrators, contributors and users

Contributors

Contributors of input data (which may include, for example, the value of underlying assets, prices, quotes or other values) to a benchmark will need to comply with the relevant code of conduct set by the administrator of the benchmark in question. This is to raise standards and help ensure the accuracy and reliability of data being contributed to benchmarks. Additional organisational obligations apply if the contributor is a supervised entity.

Key implementation steps for contributors

- Perform a conflict gap analysis.
- Develop an internal code of conduct.
- Scope out an appropriate governance framework. This will require the firm to develop a framework for signing off on its role as a contributor to third party benchmarks, set up a code of conduct gap analysis framework, build a compliance control framework, and embed this within existing conflicts management processes.

Users

Users of benchmarks that are supervised entities will be restricted as to the benchmarks they may use in the EEA after 1 January 2018 (subject to transitional arrangements). Relevant entities may only use benchmarks that appear on the register to be maintained by ESMA. These will be benchmarks that are either provided by an authorised or registered EEA administrator, or that qualify for use in the EEA under the third country regime set out in the Regulation.

This means that the use of third country benchmarks by users within the EEA may become severely restricted in future. A key obligation for users is to produce and maintain an action plan in case a benchmark they use is discontinued or changes materially. This is particularly important at this stage when there is little certainty around which administrators and benchmarks will make it onto the register.

Key implementation steps for users

- Determine the location of the benchmarks they rely upon (in particular, third country benchmarks).
- Assess the impact of the transitional measures on third country benchmarks.
- Conduct lobbying, where appropriate, in relation to the retention of key third country benchmarks.
- Develop a framework for risk-rating benchmark administrators.
- Prepare written plans for dealing with changes to or cessation of a benchmark that the firm uses.
- Carry out ongoing due diligence on alternative benchmark providers.
- Implement procedures for confirming that benchmarks used are on the ESMA register.

WHICH BENCHMARKS?

Wide range of indices within scope

The definition of “benchmark” for the purposes of the Regulation is extremely broad. It includes any index by reference to which the amount payable under a financial instrument, a consumer credit agreement or residential mortgage agreement is determined, or by reference to which the value of a financial instrument is determined. In this context, ‘financial instrument’ means those set out in MiFID II, in relation to which a request for admission to trading has been made, or which is traded on a trading venue or systematic internaliser.

The definition of benchmark under the Regulation also includes an index that is used to measure the performance of an AIF or UCITS, with the purpose of tracking the return, defining the asset allocation of a portfolio or computing performance fees.

An index is any figure that is regularly determined on the basis of a calculation or assessment on the basis of the value of one or more underlying assets or prices, and that is published or made available to the public.

There are several exemptions, including for benchmarks that provide a single reference price for any financial instrument, and for proprietary standard fixed or variable rates used by credit providers. However, there is no de minimis threshold or consideration of how widely any benchmark is used.

Instead, the regime distinguishes between different types of benchmarks, classifying them as critical, significant or non-significant. Administrators of critical benchmarks are subject to the most stringent requirements, while those providing significant and non-significant benchmarks can benefit from more proportionate requirements.

Critical	Significant	Non-significant
€500bn or more	€50bn–€500bn	Less than €50bn
(regulator's discretion)	(few substitutes and significant impact)	
<ul style="list-style-type: none"> ▪ Mandatory contribution ▪ Procedure for cessation of benchmark ▪ Mitigation of market power 	<ul style="list-style-type: none"> ▪ Limited exemptions for requirements relating to: <ul style="list-style-type: none"> > governance and conflicts > oversight of input data > shorter-form code of conduct ▪ Administrator must deem these requirements disproportionate and notify regulator of its decision (comply or explain) ▪ Regulator may overturn administrator's decision 	<ul style="list-style-type: none"> ▪ Extensive exemptions for requirements relating to: <ul style="list-style-type: none"> > governance and conflicts > oversight > control framework > accountability framework > input data > transparency of methodology > reporting infringements > code of conduct > controls for contributors ▪ Explanation as to why each requirement is inappropriate to be included in compliance statement ▪ Useful for proprietary indices (N.B. not available for interest or commodity indices)

WHICH BENCHMARKS? continued

Wide range of indices within scope

The Regulation also includes special requirements for interest rate benchmarks and certain commodity benchmarks, and lighter-touch provisions for regulated-data benchmarks.

Interest rate	Commodity	Regulated-data
<p>Determined on the basis of the rate at which banks may lend to, or borrow from, other banks</p>	<p>Underlying asset includes any goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity</p>	<p>Input data is contributed entirely and directly from trading venues, approved publication arrangements, approved reporting mechanisms and specified commodity exchanges</p>
<ul style="list-style-type: none"> ■ Cannot make use of concessions for significant or non-significant benchmarks, but extra obligations for critical benchmarks may apply ■ Specific additional obligations set out in Annex I to the Regulation (which either build upon or replace the requirements in Title II), including: <ul style="list-style-type: none"> > rules on priority of use of input data > rules on adjustment of input data > requirement to set up an independent oversight committee > requirement to appoint independent external auditors to report on compliance > additional systems and controls requirements for contributors 	<ul style="list-style-type: none"> ■ Cannot make use of concessions for significant or non-significant benchmarks, but extra obligations for critical benchmarks may apply ■ Specific additional obligations set out in Annex II to the Regulation, including in relation to: <ul style="list-style-type: none"> > methodologies used for benchmark calculations and the process for making changes > the quality and integrity of benchmark calculations > contributors and assessors > audit trails > conflicts of interest > complaints handling > appointment of independent external auditors to report on adherence to methodology criteria ■ Annex II replaces the Title II requirements, unless: <ul style="list-style-type: none"> > the benchmark is a regulated-data benchmark > the majority of contributors are supervised entities > it is a critical benchmark and the underlying asset is gold, silver or platinum 	<ul style="list-style-type: none"> ■ Can make use of concessions for significant or non-significant benchmarks ■ Certain requirements in relation to input data and reporting of infringements do not apply ■ Code of conduct and other requirements for contributors not applicable ■ Not required to keep records of all input data

THIRD COUNTRY BENCHMARKS

Restricted future use in the EEA¹

Subject to transitional arrangements, third country benchmarks (that is, benchmarks provided by administrators located outside of the EEA) can only be used in the EEA if they qualify under the third country regime set out in the Regulation. There are three ways in which a third country benchmark may qualify for use in the EEA, all of which require compliance with equivalent standards to those in the Regulation.

Equivalence

- Only applicable when the Commission has made a positive equivalence decision in respect of the relevant third country (taking into account whether the legal framework ensures compliance with the IOSCO principles)
- The administrator must be authorised or registered, and subject to supervision, in the third country
- The administrator must have notified ESMA of the identify of its regulator and the administrator's consent to the use of its benchmarks in the EEA
- A cooperation agreement between ESMA and the relevant third country regulator must be operational

Recognition

- To be used pending a positive equivalence decision
- Recognition provided by the regulator in the administrator's Member State of reference
- Regulator must confirm the administrator's compliance with standards equivalent to the Regulation, taking into account compliance with the IOSCO principles (may rely on an assessment by an independent external auditor or certification provided by the local regulator)
- The administrator must have a legal representative in its Member State of reference

Endorsement

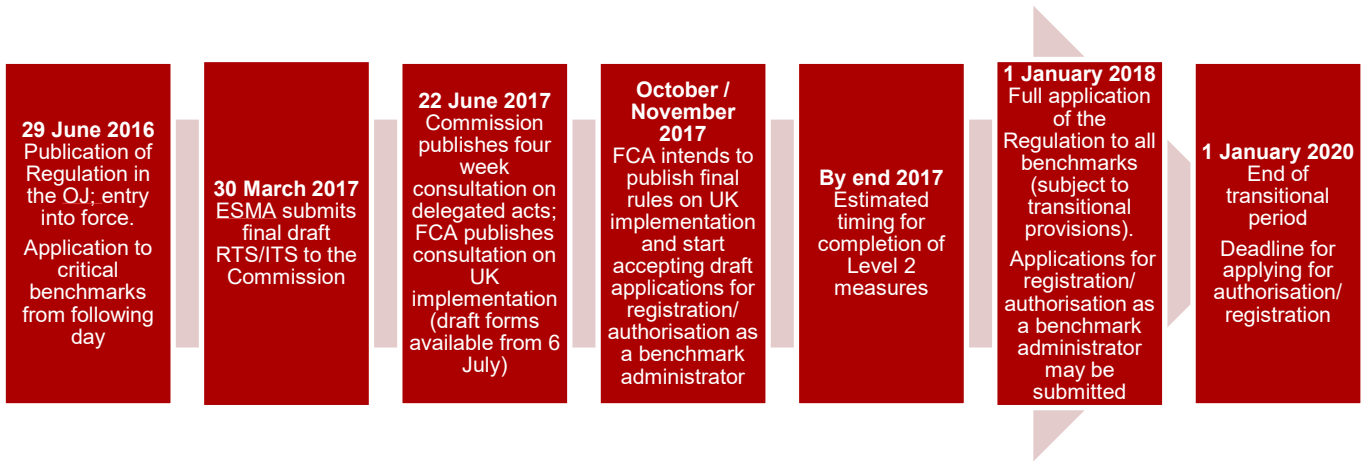
- A third country benchmark can be endorsed by an EEA regulator at the request of an EEA administrator who is authorised or registered under the Regulation
- Endorsing administrator must have verified compliance with standards equivalent to the Regulation (taking into account compliance with the IOSCO principles), have the necessary expertise to monitor the benchmark effectively and manage the associated risks
- There must be an objective reason for the provision of the benchmark in a third country, and for its use in the EEA
- Benchmark will be treated as belonging to the endorsing administrator who will be fully responsible for the benchmark and compliance with the Regulation

¹ Note that, for the purposes of this guide, we have assumed that the EU Benchmarks Regulation will be incorporated into the EEA Agreement.

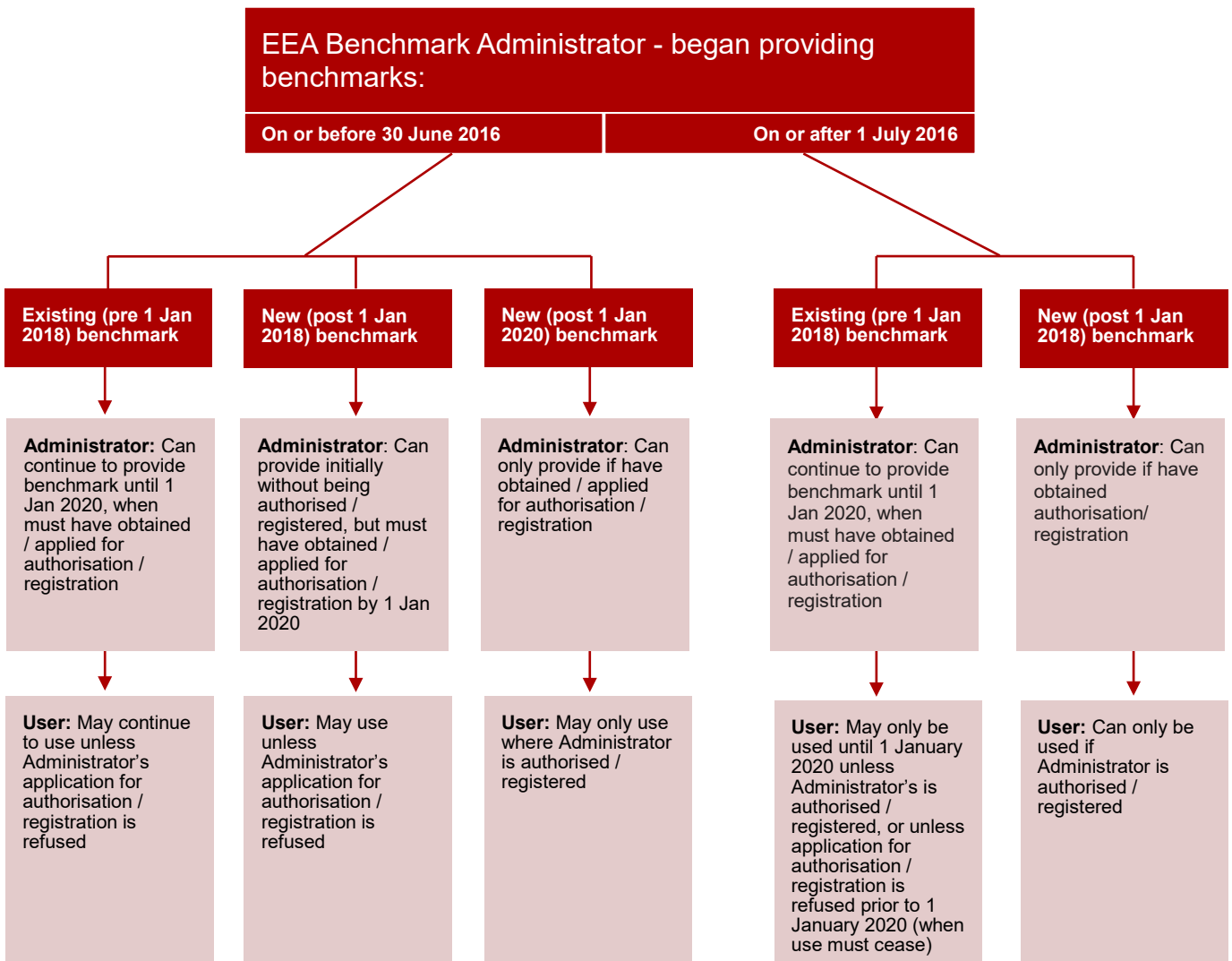
TIMEFRAME

Timing and transitional measures

Implementation timeline

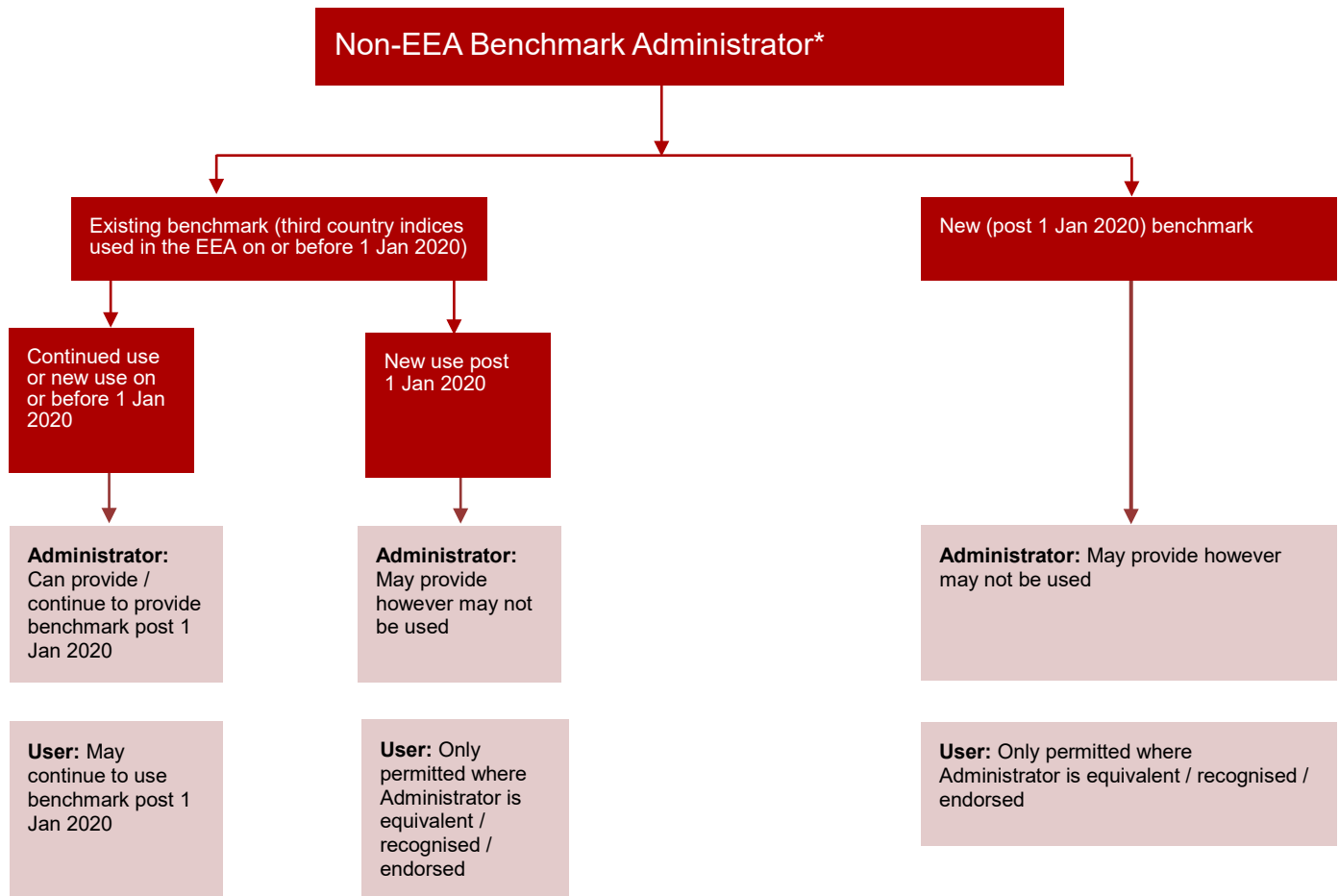


Transitional measures



TIMEFRAME

Timing and transitional measures (cont)



***Note:**

- Non-EEA Benchmark Administrators are not caught by the BMR, the use of their indices in the EEA is. Therefore, they may provide indices into the EEA but they may not be used by regulated users.
- Irrelevant whether a non-EEA administrator provided benchmarks on or before 30 June 2016.

KEY CHALLENGES

Practical implementation issues

- The very wide definition of “benchmark”. In particular, firms need to consider proprietary indices, private custom indices and indicators.
- Identifying which indices are (i) administered by, (ii) contributed to, and/or (iii) used by the firm (it may be doing all three roles in relation to different benchmarks). Firms need to consider carefully the overlap between contribution and administration, particularly if as a contributor they have a role in collating data.
- Administrators need to:
 - > Work out what is new, compared to the IOSCO Principles framework and FCA rules for benchmark administrators (if applicable).
 - > Work out which categories the benchmarks they administer fall into, and which rules apply to them.
 - > Consider terminating some benchmarks or outsourcing administration due to the increased compliance obligations.
 - > Consider how to communicate appropriately with users of their benchmarks.
 - > Prepare appropriate communications to and agreements with contributors to their benchmarks.
 - > Consider the arrangements with their non-EEA affiliates in relation to their benchmarks.
- Contributors need to:
 - > Consider whether current systems and controls over data contributed to benchmarks are adequate.
 - > Think about whether they should require input into any contributor code of conduct supplied by an administrator before agreeing to comply.
 - > Consider no longer contributing to certain benchmarks, depending on the requirements.
- Users need to:
 - > Make sure that they communicate with administrators of benchmarks they currently use, and find out whether they intend to apply for authorisation or registration (as waiting to see who appears on the ESMA register will mean leaving things too late).
 - > Consider whether any third country benchmarks are used and find out whether there is any intention to ensure these qualify for use in the EEA.
 - > Put in place written plans in the event that current benchmarks can no longer be used, including designating alternative fall-back rates.
 - > Communicate appropriately with clients/investors about use of benchmarks. Users also need to consider necessary changes to contractual documentation and how these might be rolled out.

KEY TERMS

Summary of definitions under the EU Benchmarks Regulation

Benchmark	Any index by reference to which the amount payable under a financial instrument or a financial contract , or the value of a financial instrument, is determined, or an index that is used to measure the performance of an investment fund
Index	Any figure: <ul style="list-style-type: none"> ▪ That is published or made available to the public ▪ That is regularly determined, entirely or partially, by the application of a formula, other method of calculation, or assessment ▪ Where this determination is made on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys
Financial instrument	Any instrument listed in Annex I(C) to MiFID II that is: <ul style="list-style-type: none"> ▪ The subject of a request made for admission to trading on a trading venue (regulated markets, MTFs, OTFs); ▪ Traded on a trading venue; or ▪ Traded on a systematic internaliser
Financial contract	<ul style="list-style-type: none"> ▪ Consumer credit agreements; and ▪ Residential mortgage agreements
Investment fund	<ul style="list-style-type: none"> ▪ AIFs; and ▪ UCITS
Administrator	A person who has control over the administration of the benchmark. Includes: <ul style="list-style-type: none"> ▪ Administrating arrangements for determining a benchmark ▪ Collecting, analysing or processing input data for the purposes of determining a benchmark ▪ Determining a benchmark through the application of a formula or other method of calculation, or by an assessment of input data
Contributor	A person: <ul style="list-style-type: none"> ▪ Providing any input data not readily available to the administrator; ▪ That is required in connection with the determination of a benchmark; and ▪ Is provided for that purpose
User	A person who: <ul style="list-style-type: none"> ▪ Issues financial instruments which reference a benchmark ▪ Determines the amount payable under a financial instrument or financial contract by referencing the benchmark ▪ Is party to a contract which references a benchmark ▪ Measures the performance of an investment fund through an index

YOUR CONTACTS



Nicola Higgs

Partner, London

T +44.20.7710.1154
E nicola.higgs@lw.com



Rob Moulton

Partner, London

T +44.20.7710.4523
E rob.moulton@lw.com



Courtenay Myers Lima

Partner, New York

T +1.212.906.1691
E courtenay.myerslima@lw.com



Axel Schiemann

Partner, Frankfurt

T +49.69.6062.6509
E axel.schiemann@lw.com



Manuel Deó

Partner, Madrid

T +34.91.791.5013
E manuel.deo@lw.com



Thomas Vogel

Partner, Paris, London

T +33.1.40.62.20.47
+44.20.7710.1053
E thomas.vogel@lw.com



Becky Critchley

Associate, London

T +44.20.7710.4519
E becky.critchley@lw.com



Jonathan Ritson-Candler

Associate, London

T +44.20.7710.1815
E jonathan.ritson-candler@lw.com

London

99 Bishopsgate

London EC2M 3XF

United Kingdom

t: +44(0)20.7710.1000

f: +44(0)20.7374.4460