

New Draft Regulatory Technical Standards Under the EU Benchmarks Regulation

The draft RTS introduce new, potentially more onerous obligations on the administrators of all categories of benchmarks.

Key Points:

- The draft RTS contain new guidance that makes clear who is responsible for which decisions in relation to benchmark administration, including extending these responsibilities to general management.
- The draft RTS also include further explanation on the requirement for back-testing, to ensure that benchmarks are traceable and verifiable.
- Additional direction is provided on the continuous monitoring and surveillance obligations which have to date been subject to market divergence.
- The draft RTS reiterate that less onerous obligations apply for administrators of non-significant benchmarks; however, they do not appear to provide any further guidance on how this applies.

On 9 March 2020, ESMA published a [consultation paper](#) (CP) on draft Regulatory Technical Standards (RTS) under the EU Benchmarks Regulation (BMR). The CP covers governance arrangements, methodology, reporting of infringements, mandatory administration of critical benchmarks, and non-significant benchmarks, each being provisions of the BMR for which ESMA was not originally required to deliver RTS. ESMA initially requested comments on the CP by 9 May 2020, but in light of recent events, the timeline has been extended until 8 June 2020.

This *Client Alert* highlights key provisions contained in the latest draft RTS that were not covered in previous technical standards, and which are likely to represent compliance uplifts for benchmark administrators.

The roles of employees

In line with the requirement to maintain well-defined roles and responsibilities, the specific roles of certain employees engaged in the determination of benchmarks should be clearly set out, in order to comply with Article 4(1) of the BMR. As such, ESMA proposes to include the following obligations:

- Administrators' organisational structures must be clear and must specify the decision-making procedures and reporting lines that unambiguously allocate the functions and responsibilities regarding the provision of benchmarks.
 - This will, in turn, ensure accountability for decisions taken regarding the provision of benchmarks.
 - These should include written procedures and should focus primarily on the roles and responsibilities of the persons involved in the provision of the benchmark (this now comprises members of the management body as well as those involved in internal and oversight functions) and must include at least the following key components:
 - The composition, roles, and responsibilities of the management body and related committees, if any
 - The structure of the management body
 - An organisational chart of the different functions, including the reporting lines
 - The procedures for the appointment of the management body and its members
- Consideration should be given to whether employees involved in the provision of a benchmark can commit sufficient time to that provision, especially when they are involved in other roles and committees. Key to complying with this will be documenting the analysis carried out and reviewing it periodically.
- Persons involved in the provision of benchmarks should be aware of the responsibilities allocated to them and of the procedures they must follow to properly discharge them. Administrators may wish to consider obtaining employee attestations to evidence compliance.
- Administrators should establish a remuneration framework to ensure that the remuneration of persons involved in the provision of the benchmark is appropriately set out and not subject to conflicts. Many firms include their benchmark administration businesses within their overall remuneration framework. However, this obligation appears to go further and require an administration specific framework which ensures that there are no conflicts caused by the remuneration structure. This may mean that employees engaged in the administration of benchmarks cannot be remunerated based on the level of income received from the use of benchmarks.
- Governance arrangements should clearly state the persons responsible for the publication or disclosure of potential conflicts and for the establishment of specific internal control procedures to ensure the integrity and reliability of the employee or person determining the benchmark. This may give rise to individual, personal responsibility and firms will wish to carefully consider who is named for this role.
- Specific procedures are required for preventing and managing conflicts of interest that may arise from the group structure. Many firms already reference such conflicts; however, this obligation appears to go further by requiring procedures that are specific to the management of this named conflict.

Methodology, policies, and procedures

The draft RTS attempt to introduce some uniformity to the differing approaches used by benchmark administrators to developing benchmarks, by aiming to harmonise the disclosures required in methodologies:

- The BMR recognises that the construction of a benchmark methodology necessarily contains elements of discretion, for example in constructing the formula, performing calculations, and determining input data.
- Where discretion is used to determine a benchmark, the methodology should state at what step of the calculation this occurs, and whether discretion is based on an algorithm or some other form of pre-defined methodology.
- Where transaction data is used, it should be clearly stated when this would not be considered sufficient and what alternative, related markets would be considered appropriate.
- A risk assessment should be carried out in relation to data integrity, in order to help determine:
 - The appropriate technical measures to reduce the risk of manipulation or attempted manipulation
 - The controls that need to be carried out on the sources of risk identified
- Procedures should allow for the immediate notification to the oversight function of attempted or actual manipulation or failure to comply with data control procedures.
- There should be dedicated training for those involved in data integrity.
- There should be a data integrity policy that includes a list of minimum content provided.

Benchmark administrators have previously focused on the exercise of discretion in the production of the benchmark level, rather than discretion during the benchmark construction. Firms will need to consider whether additional controls at this level are required.

Back-testing

The back-testing requirements represent new rules (although many firms carry out back-testing as a matter of course) and are designed to ensure that the methodologies in question are rigorous, continuous, and capable of validation. The methodologies must be resilient and able to be calculated in the widest set of possible circumstances without compromising their integrity. They must also be traceable and verifiable. The RTS acknowledge that back-testing is only applicable to particular methodologies and firms will need to assess whether and when it is appropriate.

- In order to ensure that the methodology is capable of back-testing against available transaction data (as appropriate), the methodology should include at least:
 - An assessment of the adequacy and appropriateness of the historical values of the benchmark produced by means of that methodology
 - Reliable inputs, including appropriate size of the data samples, if any

- There is more detail around the back-testing requirements, including that they should be at least identical to the frequency of the calculation of the benchmark. Administrators should also consider the appropriate historical time horizon for the back-testing programme. They may need to carry out a 'test' back-test in order to establish the appropriate frequency and historical time horizon and should keep records of why the metrics chosen are appropriate, including relevant oversight body review and sign off.
- The administrator should consider clear statistical tests to assess the back-testing results and should have a documented process regarding the action it would take depending on the results of the back-testing on a case-by-case basis. In particular, the administrator should have in place a process to ensure that systemic anomalies highlighted by back-testing are identified and are appropriately addressed.
- An administrator should assess the resilience of the benchmark's methodology to various market conditions using historical data from realised stressed market conditions and hypothetical data for unrealised stressed market condition, and then document the action it will be taking depending on the results. Administrators may also wish to consider updating their procedures around changes to methodologies to make specific reference to the outcomes identified.

Monitoring and surveillance

The proposed new monitoring and surveillance rules are designed to create systems and controls that are robust and reliable, and unambiguous regarding the use of discretion in the determination of benchmarks so as to comply with the requirements of Article 12(1) of the BMR. This is an area of compliance which administrators have been grappling with given the lack of guidance to date and, while some of the rules may be viewed as onerous, the draft RTS will assist administrators in meeting regulatory expectations. The draft RTS also provide further clarity on the reporting requirements detailed in Article 14 of the BMR that are designed to further ensure data integrity and the avoidance of manipulation or attempted manipulation of a benchmark.

- Members of the management body should be subject to effective monitoring and controls, and there should be procedures in place to promote compliance with their decisions. While there are already similar requirements in place for the benchmark oversight committee, this extension to management is new.
- To ensure a robust and reliable methodology, the relationship between the assumptions underpinning the methodology and the sensitivity of the benchmark produced by the methodology should be consistent over time. As such, the underlying assumptions that create the benchmark should regularly be tested to ensure they are still valid.
- The requirements around reporting of anomalous or suspicious input data are separate, and require distinct policies and procedures from those for whistleblowing. As such, ESMA interprets:
 - The “*adequate systems*” and “*efficient controls*” described under Article 14 of the BMR to be the arrangements (comprising hardware, programmes, and procedures) that the administrator is required to have in place to ensure data integrity and manipulation detection
 - The “*integrity of input data*” to be the protection of data from unauthorised and unlawful changes, which is essential to ensure accuracy and consistency of data

- In relation to using (or not using) automated surveillance systems, administrators should also be able to explain why the levels of automation chosen are appropriate.
- The CP notes that the most effective form of surveillance will likely be a combination of automated and human controls. Human controls, in particular, may be deployed to discern whether suspect input data may be linked to manipulation behaviours.
- Where the oversight function requires more information in relation to suspicions, it may involve meeting with those involved in monitoring. Where this is done, the meeting should be recorded or minuted and signed by the reporting person.

Proportionality

While the draft RTS acknowledge the existing BMR provisions that the administrators of different types of benchmarks (*i.e.*, critical, significant, and non-significant) may choose not to comply with, and state that the new RTS around governance should “*not jeopardise the operation of smaller administrators with limited resources*”, there is little additional guidance around how proportionality may work in practice. The draft RTS set out the matters that administrators of non-significant benchmarks choosing not to apply certain BMR provisions should include in their compliance statements when explaining why it is appropriate not to comply with the chosen provisions. The draft RTS also give powers to the relevant national competent authority to require administrators to make changes to their compliance statement if the national competent authority considers that the statement does not clearly state why it is appropriate for an administrator of non-significant benchmarks not to comply with one or more of the requirements.

Conclusion

The draft RTS may represent another implementation uplift for many benchmark administrators and at a time when many have just got to grips with BMR compliance on a business as usual basis after going through an authorisation or registration process with their national competent authority.

The draft RTS provide new obligations in relation to designation of duties of employees, and in an era of senior manager responsibility, designating the right employee for the right obligation may prove challenging for some administrators, particularly in institutions with large, complicated governance arrangements. Benchmark administrators may wish to revisit the transparency of their internal structures, in order to set out the employees engaged in the relevant areas of benchmark creation and administration. Similarly, the draft rules regarding back-testing may represent a further compliance uplift. Administrators may also wish to assess the adequacy of their policies and procedures to ensure that these new requirements are captured and that the policies and procedures obtain sign-off at a sufficiently senior level. The monitoring and surveillance obligations do provide useful colour on these BMR requirements; however, many administrators may take the view that the draft rules are too proscriptive. Firms may, therefore, wish to carefully consider whether to respond to the CP on areas which in their view are too burdensome or go further than is necessary to achieve BMR compliance.

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