



## ADVICE TO ESMA

### Benchmarks/Indices

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#### I. Executive summary

Indices are fundamental because they may underpin an investment strategy, serve as underlyings or even reflect the state of an economy. The competitive environment in which index providers operate means that indices have been refined over time to take advantage of improvements and offer better choice for users. Nevertheless, these should be underpinned by universally agreed principles of good governance, sound methodology and transparency, in order to provide investors with the adequate level of protection and to limit risks of conflicts of interests and manipulation.

To this end, the members of the Securities and Markets Stakeholder Group (hereafter referred to as “the Group”) welcome ESMA and EBA’s Principles, which will provide for the “interim” regulatory framework needed prior to the application of more binding requirements through, notably, the revised Market Abuse Directive and the forthcoming Benchmark Regulation. In addition, the Group members believe that the proper enforcement of existing product regulations, which indirectly provide a framework for indices and benchmarks used in certain financial instruments (such as the Prospectus Directive and UCITS) at national levels should be encouraged.

In terms of scope, the majority of the Group believes that, contrary to ESMA and EBA’s suggestions, the Principles should apply both to widely used benchmarks and indices and to strategy and proprietary indices. To this end, a “one-size-fits-all” approach should be avoided. The Principles should leave indices and benchmarks providers with the ability to choose between two main approaches: (i) a governance-based approach (where the processes in respect to the setting and calculating of indices and benchmarks should be supervised by independent third parties) or (ii) a transparency-based approach (where firms would have to disclose to regulators and their clients clear information about the methodology and data used to calculate the index or benchmark). Whichever approach is adopted, it should be made public.

In terms of information source, the Group members believe that the Principles should draw a clear hierarchy between the different sources of data (transaction prices, quotes, surveys), and should encourage particular care to be given to the liquidity of the markets on which indices and benchmarks are based, in order to limit distortions and manipulations.

The Group members consider that user information should be encouraged. In particular, access to indices’ and benchmarks’ past performance should be made easily and freely available to individual investors and borrowers. However, a proper balance should be maintained between, on the one hand, the need for a sufficient level of transparency, and, on the other hand, the need to protect intellectual property (IP) rights. In order to protect IP rights, which are crucial to the economic value of indices and benchmarks, and to ensure that these Principles do not put EU index provider at a competitive disadvantage in compar-

ison to other providers operating on a global level, ESMA and EBA should attempt at further coordinating with other national regulators, at the international level.

The Group members believe that in the near future direct supervision of indices and benchmarks by EU regulatory authorities should be encouraged, notably in respect to the governance arrangements in place at the level of the index provider, as well as in respect to the data and methodology used to calculate the indices.

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## **II. Summary of ESMA SMSG discussions on benchmarks**

1. The Group members decided that given the short deadlines, it would be preferable to concentrate on giving high-level advice rather than responding to ESMA/EBA consultation. The questions from ESMA focus on the following issues: scope, who should be captured, what activities should be subject to regulation and/or oversight, how would this impact the users and the continuity of indices.
2. Based on the discussions in the Group, the SMSG advice is structured as follows:

### **Scope and definition**

3. The original purpose of indices was to be a barometer of stock market performance. The compilation of information is useful for price information as it reduces the cost by allowing parties to share research. Indices are compiled from different sources including:
  - Censuses – e.g. GDP, retail price index
  - Traded prices on exchanges – e.g. FTSE 100, Euro STOXX 50, CAC40
  - Off-exchange real-time tradable prices – e.g. EuroMTS government Bond Index
  - Estimates and quotes – e.g. EURIBOR, LIBOR
4. Typically, an “index” is an aggregation of market data of financial instruments or acquirable assets which are used either as a basis for financial products (“underlying”) or to evaluate financial investments (“benchmark”). Although provision of information was the primary reason for establishing the first indices, today’s prominent and well-known indices usually fulfill three main purposes often simultaneously, namely:
  - (i) as a benchmark for the risk and performance assessment,
  - (ii) as an underlying for tradable investment products and
  - (iii) as aggregated information to the public and investors.
5. The Group members believe that ESMA and EBA, for the purpose of the proposed Principles, should ensure that the definition of indices and benchmarks used is consistent with other regulations. To this end, the Group members encourage ESMA and EBA to adopt the same definition as the one recommended by the European Commission in its September 2012 Consultation Paper, according to which

a “benchmark” means “*any commercial index or published figure calculated by the application of a formula to the value of one or more underlying assets or prices, including estimated prices, interest rates and other values, or surveys by reference to which the amount payable under a financial instrument is determined*”.

6. Such definition would enable to exclude pure macroeconomic indicators describing the state of an economy, as these are not directly tied to any financial instrument, and are usually only used to achieve a clearer picture of the current economic environment. However, it would be comprehensive enough to include the two main existing types of indices and benchmarks:
  - (i) *Widely used “public” benchmarks and indices.* These include indices that are broadly recognised and used, such as the ones produced by exchanges, but also interbank interest rates such as LIBOR and EURIBOR.
  - (ii) *“Proprietary” and “strategy” indices.* Characteristically the purpose of these indices is to reflect individual trading strategies of the index provider. They therefore tend to be much more bespoke than widely used “public” benchmarks and indices.
7. In fact, whilst certain Group members consider that “proprietary” or “strategy” indices should not fall under the scope of these Principles, the majority of the Group members agrees that these indices, similarly to benchmarks, should be covered by high standards in terms of governance, transparency, and methodology for calculation, and therefore fall under the scope of the Principles. This is because even the most bespoke proprietary indices can be used in retail products such as mortgages for instance.

## **Two alternative approaches: governance-based approach and transparency-based approach**

8. In order to improve investor and user confidence, the Group members believe that the adoption of Principles in terms of governance and/ or transparency is key. In fact, the setting of benchmarks and indices, as demonstrated by the recent LIBOR and EURIBOR cases, may give rise to important risks of conflicts of interests. These conflicts may materialize when the same entity undertakes the calculation of indices / benchmarks while, simultaneously, creating products based on the benchmark and index and holding trading positions in these products, thereby rendering it directly interested in the evolution of the benchmark or index. Risks of conflicts of interests may also arise when entities combine different activities, such as exchanges. However, exchanges, as some of the Group members pointed out, appear to be more neutral entities in respect to index provision, as they do not take any position or enter into risk hedging activities in respect to the indices they create.
9. Therefore, the majority of the Group members agrees that all indices and benchmarks should be covered by the Principles. However these Principles should be flexible enough to meet the particular constraints faced by benchmarks and indices providers and avoid resulting in disproportionate costs. To this end, the majority of the Group members believes that indices and benchmarks providers should be given the ability to choose between two alternative regulatory approaches in the Principles.
  - (i) *Governance-based approach.* This approach would require indices and benchmarks providers to have in place sound governance mechanisms for the setting and calculation of

benchmarks and indices, notably via the monitoring of the related processes by independent third parties. This would be ensured by requiring an independent committee to oversee the production of indices and benchmarks. The composition of such committee should be set in such a way to avoid one constituency to be favoured over another, by, for instance, requiring representatives of issuers and investors to be included as members. Independent committees should ensure that rules and due processes are followed including dialogue with clients, stakeholders and regulators. They should be responsible for approving and vetting the rules governing the processes for benchmarks and indices setting, and oversee these processes on the basis of sound principles and subject to an audit trail. If these fundamental principles are not guaranteed, the index should not be allowed to be linked to contracts such as mortgages, ETFs, UCITS, etc. In addition, and notably in the case of indices created by exchange, third parties should ensure that decisions on the composition of the index are made in accordance with a process giving the companies part of the index or which could be expelled from the index the possibility to be heard. Ideally there should be regulatory oversight of these principles. In the case of indices based on quotes rather than trade information, the role of this independent committee would be particularly important to ensure that a framework is in place for the submitting entities.

- (ii) *Transparency-based approach.* Under this approach, indices and benchmarks providers would be required to disclose to regulators and the providers' clients the methodology used for the calculation of benchmarks and indices as well as the sources of data used, in order to enable the external monitoring of the setting of those indices and benchmarks. This approach would meet the constraints faced by some indices and benchmarks providers, who do not necessarily have the internal resources needed for the intervention of the third-parties mentioned in alternative (i), and avoid disproportionately increasing their cost-base (which would ultimately be passed on to end-users in the form of higher fees) while still ensuring that these providers are subject to external monitoring.
10. In order to ensure that regulators and users are made aware of the regulatory approach chosen by the index / benchmark provider, the Group members believe it is necessary for the Principles to encourage the indices and benchmarks providers to publicly disclose the approach chosen. This could be achieved by adding a flag to the indices and benchmarks corresponding to the approach retained. This would enable users and regulators to identify the indices and benchmarks for which no third-party is involved, and therefore encourage them to monitor with particular care the disclosure made by the related providers.

## **Information sources**

11. Regarding information sources, the Group members expressed divergent views on the use of quotes versus trade data. However, generally the Group members were of the opinion that it is preferable to base an index on real prices and real liquidity as otherwise, the index was more prone to manipulation. However, although anchoring a benchmark by observable transactions is ideal, it is not always possible. There was also a problem for submitting entities to quote prices when there was no information available on transactions.
12. The proposed MiFID review, which is currently being discussed at EU level, may improve the trade data available for non-equities, in particular for fixed income products. However, certain indices and benchmarks may require the use of other data. In fact, three different types of data sources are usual-

ly differentiated (as it is the case in IOSCO January 2013 Consultation Report). The Group members generally believed that these data should be classified in accordance with the following hierarchy:

- (i) *Publicly available transaction and trade data.* Traded prices or firm quotes sourced from a liquid and regulated market. Traded prices from a regulated market do not require explicit explanations. A relevant example would be equity indices like the EURO STOXX 50, CAC 40 or the DAX being calculated with the traded prices from the leading locally regulated exchanges in Europe. Firm quotes from regulated markets are defined as being executable at all times. An example of the usage of firm quotes is the process for including new components in the eb.rexx fixed income indices, where binding ask prices from the regulated Eurex Bonds platform are used.
- (ii) *Any other indicative pricing which could be non-firm quotes or estimates obtained systematically or randomly.* An example would be the LIBOR. However, indices for market segments currently dominated by off-exchange trading resulting in non-transparent pricings also fall into this category. One prominent example would be many fixed income indices (if they are not based on traded prices).
- (iii) *Any other data may also be used as a basis for the other informational instruments.* Those figures might be obtained by surveys, statistical census or individual measurements. Examples here are unemployment rates, inflation rates or consumer sentiment data. In principle, there is no limitation for any such figures.

13. Where surveys are used, such as in the case of interbank interest rates, the Group believes that ESMA and EBA Principles should be consistent with CFTC's guidelines<sup>1</sup> which set the following hierarchy:

- (i) Bank's borrowing or lending transactions observed by the submitter
  - Transactions in the market;
  - Transactions in other markets (unsecured funds);
  - Transactions in related markets (foreign current forwards, repo, etc.).
- (ii) 3<sup>rd</sup> party transactions observed by bank's submitter
  - Transactions in the market;
  - Transactions in other markets (unsecured funds);
  - Transactions in related markets (foreign current forwards, repo, etc.).
- (iii) 3<sup>rd</sup> party offers observed by bank's submitter
  - Transactions in the market;
  - Transactions in other markets (unsecured funds);
  - Transactions in related markets (foreign current forwards, repo, etc.).

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<sup>1</sup><http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfrbsoorder020613.pdf>

14. In addition, the Group members encourage ESMA and EBA's Principles to highlight that not only the source of the data should be considered as important but also the quality of those data. As a general rule indices and benchmarks should, as much as possible, be based on liquid products, in order to limit the scope for distortions or manipulations. Providers should therefore be required to give due consideration to the liquidity of the underlying when creating indices / benchmarks.
15. Furthermore, whilst data originating from electronic transactions duly published raise little risks in terms of conflicts of interests, on the contrary data originating from surveys or OTC transactions, not necessarily subject to a strict regulatory framework in respect to disclosures and publications, may be more prone to risks of conflicts of interests and manipulation, as demonstrated by the recent LIBOR and EURIBOR cases. As such, the Group members believe that the Principles should include appropriate rules requiring entities to manage the risks of conflicts of interests that may arise when calculating indices or benchmarks on the basis of data collected through surveys or OTC transactions.

### **Users and access to past performance**

16. The Group members understand that the "Users" section of the Consultation Paper does not target end investors and borrowers but only financial professionals. The Group members believe that ESMA and EBA should spell out the definition they use of "users of benchmarks", and enlarge its scope, as end investors and borrowers are indeed users of benchmarks and indices, and their needs and protection must be taken into account when designing rules, guidelines and principles on benchmarks-design.
17. In fact, indices are used across many applications both by the buy side and the sell side for investment and trading purposes. Consumers are directly and indirectly impacted by benchmarks as retail investors and as borrowers. For instance over 90% of mortgages in several EU Member-states are referenced on LIBOR or EURIBOR. In that context, the Group members pointed to the fact that the further development and improvement of LIBOR was a politically sensitive issue. It was also pointed out that it is important to take into account the fact that LIBOR in particular is widely used outside of Europe. 50% of assets are quoted and monitored out of the USA primarily by asset managers. The Group members pointed out that there was an increasing 'retailisation' of the use of indices.
18. Consumer representatives Group members stated that it is necessary for investors to have the ability to access the information on the past performance of the index. Whilst in general the Group members believe that all types of users should be given the means to understand indices and benchmarks, some Group members believe it is necessary to highlight that there is very little access of retail investors to retail products benchmark's past performance. Retail investor associations found examples of indexed UCITS - reported to the national supervisor and to the European Commission<sup>2</sup> – where the index's past performance is either missing or wrong. The issue is compounded by the fact that it is often impossible for the retail client to verify the accuracy of many major index/benchmark's past performances as they are not published and freely accessible to retail clients, especially by the index providers themselves (including world leading equity and fixed income index providers). Besides, there is no mention or ineffective mention of where to find such data in the KIID.

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<sup>2</sup> see for example [EuroFinUse reply to the EC consultation on the regulation of indices](#)

19. The Group members agreed that the Principles should require benchmark provider's clients to be granted access to data on past performance as well as to the methodology used to calculate these indices and benchmarks.

### **Intellectual property rights**

20. The publication of an index is a complex process which implies the collection and selection of data, the calculation, the checking of information and the distribution of data. In fact, indices are the result of significant investments in the making and maintenance of the underlying database. Index providers continuously invest significant financial and operational resources and know-how in the creation and maintenance of their indices, obtaining and cleansing the raw financial data, periodic reviews according to the applicable criteria, provision of real-time calculation IT infrastructure and monitoring.
21. Intellectual property rights allow the producers of indices to extract economic value from putting indices together. Indeed, indices are subject to multiple intellectual property rights, including, but not limited to copyrights, data base protection rights, trademark rights, trade secrets etc.. Such rights are, inter alia, enshrined in Article 17(2) of the Charter of Fundamental Rights of the European Union. The intellectual property rights guarantee that index providers can autonomously decide which data will be published and which is restricted or only available under licenses.
22. The majority of the Group members believes that the transparency requirements as currently described in the Consultation Paper could be too far reaching. Such requirements should avoid depriving independent index providers of their IP rights and their investments by requiring them to disclose virtually all information in connection with the constitution of their indices. From a political perspective such clauses would contravene longstanding ambitions of the EU to provide for an efficient protection of IP rights as a source of innovation, growth and economic dynamics in Europe. There is, in addition, a significant risk for ill-defined transparency requirements to result in an un-level playing field between, on the one hand, EU entities falling under the scope of such requirements and, on the other hand, other entities not covered by the same transparency rules which would have the ability to use the information disclosed by the former to replicate their indices and benchmarks.
23. Therefore, whilst the Group members acknowledge that transparency is a crucial policy goal and that protection of IP should not in any circumstances serve as an excuse to prevent users from getting crucial information, a balanced solution between the need for increased disclosures in respect to indices and benchmarks and the protection of IP rights is required.
24. Such a solution could be achieved through greater coordination between ESMA and EBA and other regulators, at the international level, in order to ensure that all index and benchmark providers are covered by similar transparency requirements across the world.
25. The recognition of those rights should not prohibit investigations by regulators regarding the implementation and enforcement of the Principles.

### **Continuity of indices**

26. Once an index is created and is embedded in existing contracts, there is a long-term interest in the continuation of the index from a user perspective. The Group members agree that there is therefore a

strong interest in the continuation of the current indices, both for borrowers and investors, both at the index level but also at the benchmarked product level (e.g. when the fund managers switches from one index to another).

## **Regulation**

27. Some Group members consider that indices and benchmarks are already indirectly regulated through product regulation such as the Prospectus Directive, UCITS Directive and ESMA's Principles for UCITS. However, other members pointed at the fact that indices regulation through product regulation greatly varies in the EU. Certain countries, such as France, monitor closely the indices used as underlying for certain financial instruments, but this practice is not necessarily widespread across member states. The Group members agree that proper enforcement of existing product regulation should be encouraged in the EU. Notably, correlation between product stocks and indices disclosed as underlying or as serving as a benchmark for performance should be ascertained and controlled by regulators.
28. However, relying only on product regulation does not appear as sufficient to ensure that indices and benchmarks are subject to an appropriate framework. The majority of the Group members believe that the adoption of additional Principles addressing indices and benchmarks specifically should be encouraged. In fact, today, many players in the industry are not regulated. Whilst the revised Market Abuse Directive and the potential Benchmark Regulation may put an end to this situation in the near future, a proper framework should be adopted and implemented in the meantime. However, the Group members acknowledge that the binding character of such "interim" regulation may be problematic. In order to encourage the broad acceptance and application of these principles, ESMA and EBA should put a particular emphasis on self-regulation and coordinate with industry representatives, such as Global Financial Markets Association, as well as with other standard setting bodies such as IOSCO. It was suggested that for instance producers could declare publicly that they were in compliance with the Principles.
29. Furthermore, whilst the Group acknowledges that such an approach may not be applicable in the absence of any binding regulation, the Group members believe that in the near future direct supervision of indices and benchmarks by EU regulatory authorities should be encouraged, notably in respect to the governance arrangements in place at the level of the index provider, as well as in respect to the data and methodology used to calculate the indices. Some Group members pointed at the need for those indices used in retail products to be supervised by ESMA (in terms of design, production and use) when:
  - no national supervisor is in charge;
  - the index is widely used by end investors and/or borrowers; and
  - the index is not based on publicly available trade prices based on real liquidity, or other objective data
30. Some Group members believe that indices such as LIBOR and EURIBOR should also be supervised at the European level.



This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

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