

The EU Benchmarks Regulation – Third country non-critical benchmark rules and impact on EU users

Introduction

The EU Benchmarks Regulation (BMR) was agreed and published in the EU Official Journal in 2016 as Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds.

The BMR came into force on 30 June 2016, with a number of provisions relating to critical benchmarks coming into effect immediately, and the majority of the provisions coming into effect on 1 January 2018, subject to transitional measures.

The BMR has significant implications for those who provide, use and contribute to those indices caught by the BMR definition of “benchmark”¹, which is deliberately broadly drafted to capture a wide range of financial products and use cases, including the administration and use of equity, bond and FX indices.

Recent years have revealed the weaknesses in the formulation of some widely used benchmarks, which alongside structural changes in financial markets have served to undermine the viability of several widely used benchmarks. Alongside this, the far-reaching consequences of the BMR have already resulted in reduced contributions to benchmarks and increased compliance costs and regulatory burdens for benchmark administrators, presenting a real test to the viability of many benchmarks and investment strategies which rely on them.

The purpose of this note is to examine in detail a very specific part of the BMR, focusing on **the impact on EU investors** (caught as “users”) from the provisions on **third country non-critical benchmarks**². It is important to note that this paper will not address the issues involved in the use of critical benchmarks (for more information on ICMA’s work on critical benchmarks, please see our [website](#)).

Given international bonds will typically reference critical benchmarks (such as LIBOR or EURIBOR), it is expected that this note will primarily be relevant for EU investors that use benchmarks within the scope of the BMR (e.g. for measuring the performance of an investment fund), rather than sell-side market participants in the international bond market.

Provisions on third country non-critical benchmarks

If they want their benchmarks to be used in the EU, third country benchmark providers must take certain actions prior to 1 January 2020 to ensure their benchmarks *can* still be used in the EU. The BMR makes it illegal for any EU market participant to make BMR-defined “use” of a third country benchmark unless that benchmark is equivalent, recognised or endorsed and, crucially, included in a register maintained by the European Securities and Markets Authority (ESMA).

¹ A benchmark is defined in Article 3(3) of the BMR as “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 with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees.”

² The BMR empowers the European Commission to designate critical benchmarks in Article 20(1), which the Commission has done by a [Delegated Act](#) in October 2018, containing four benchmarks: EURIBOR, EONIA, LIBOR and STIBOR. All other benchmarks caught by the BMR will be considered “non-critical” benchmarks.

To put the legal requirement more broadly, any benchmark administrator based outside of the EU that provides benchmarks that are used in the EU by a supervised entity³ will be subject to the third country regime requirements of the BMR and thus defined as a third country administrator. Subject to the transitional requirements discussed further below, for benchmarks administered by a third country administrator to continue to be used in the EU after 1 January 2020, the third country administrator must comply with the requirements of the BMR.

While third-country benchmark administrators must consider the appropriate route for their benchmarks to be used in the EU, EU users, such as investment funds, insurance companies and pension funds have to map their current use of third country benchmarks in the eventuality that third country administrators do not want to or cannot achieve equivalence, authorisation or recognition in the EU. Performance measurement is one aspect of BMR impact, but an investment fund could be also captured by BMR through its strategy to replicate or track the performance of an index or indices, through either synthetic or physical replication of such indices.

It is important to note, however, that the BMR exempts central banks from its rules under Article 2(2)(a). Also, Article 2(2)(b) exempts “public authorities” where they “contribute data to, provide, or have control over the provision of, benchmarks for public policy purposes, including measures of employment, economic activity, and inflation”. Therefore, benchmarks or indices administered by central banks or public authorities (e.g. SROs or organisations with similar characteristics to public authorities) will not be caught by the rules and can continue to be used by EU users.

Using a benchmark

Article 29 of the BMR stipulates that an EU supervised entity may only use a benchmark (or combination of benchmarks) if the benchmark is provided by an EU benchmark administrator (on the official ESMA register) or a third country benchmark in the official ESMA third country benchmark register.

It is worth specifying what “use of a benchmark” entails, as the rules are specific while deliberately designed to be broad. Article 3(7) defines “use of a benchmark” to include:

- (1) issuance of a financial instrument which references an index or a combination of indices;
- (2) determination of the amount payable under a financial instrument or a financial contract by referencing an index or a combination of indices;
- (3) being a party to a financial contract which references an index or a combination of indices;
- (4) providing a borrowing rate as defined in in the consumer credit directive, calculated as a spread or mark-up over an index or a combination of indices and that is solely used as a reference in a financial contract; or
- (5) 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.

Furthermore, “financial instrument” is defined as one that is traded on a trading venue (TOTV) or by a Systematic Internaliser (SI), as set out in the Markets in Financial Instruments Directive (MiFID II).⁴

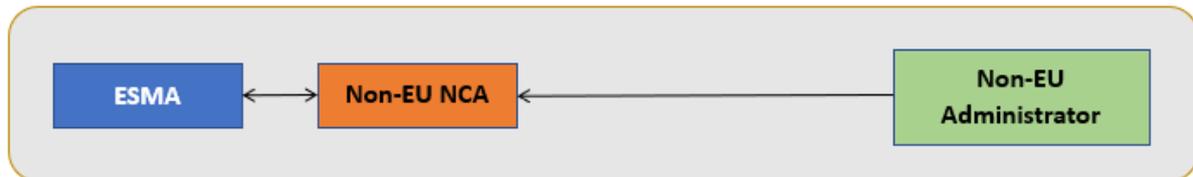
³ An EU supervised entity is defined in Article 3(17) of the BMR as EU authorised: (1) banks, (2) investment firms, (3) insurers and re-insurers, (4) UCITS and AIF investment funds, (5) pension funds, (6) creditors as defined in the consumer credit directive, (7) non-banks for the purposes of credit agreements, (8) market operators as defined in MiFID II, (9) central counterparties, (10) trade repositories and (11) benchmark administrators.

⁴ Article 3(16) of the BMR, referring to MiFID II (Directive 2014/65/EU)

The ESMA register

Article 36 of the BMR empowers ESMA to set up a list of eligible third country benchmarks. EU users of benchmarks can only use third country benchmarks registered on this list. ESMA's third country benchmark [website](#) is live but does not yet at the time of writing (December 2018) have a single entry.

Equivalence



The BMR establishes equivalence between a third country and the EU as the base line for the use of third country benchmarks in the EU.

Accordingly, in order for a third country benchmark to be included in the ESMA register, it must comply with the following:

- 1) An equivalence decision has to be adopted by the European Commission (on advice from ESMA) for the country of the administrator;
- 2) The administrator has to be authorised or registered and supervised in that country;
- 3) ESMA has to be notified by the administrator of its consent for the benchmark to be included in the register; and
- 4) There must be cooperation arrangements between ESMA and the third country regulator.

The equivalence decision under (1) above can be a general one finding that the legal framework and supervisory practices of a third country are equivalent to the BMR, taking into account whether the third country's rules and practices at a minimum conform to the IOSCO principles for financial benchmarks or the IOSCO principles for Price Reporting Agencies (PRAs). The decision can also be a more specific one finding that binding requirements on specific benchmark administrators are equivalent to the BMR.

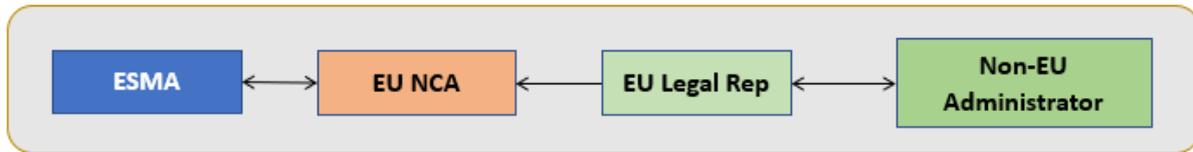
The BMR also recognises that it will take some time before equivalence decisions are adopted (or even undertaken at all), so there are two other ways for third country benchmarks to be included on the ESMA register: (1) recognition and (2) endorsement, detailed below.

It is important also to establish that there are cooperation arrangements in place under (4) above before equivalence can be effective.

For those jurisdictions considering equivalence, it is important to note that ESMA issued guidelines for non-critical benchmarks on 20 December 2018, proposing certain changes to the requirements for non-critical benchmark administrators in (1) the oversight function, (2) input data, (3) transparency of methodology and (4) governance of contributors.⁵

⁵ ESMA [Guidelines on Non-Significant Benchmarks](#) 20 December 2018

Recognition



A benchmark provided by a third country administrator can still be used by EU supervised entities without the aforementioned equivalence procedure by being recognised by a competent authority of an EU Member State, who effectively becomes accountable for the provision of the third country benchmark in the EU.

The third country administrator seeking recognition may demonstrate compliance with the BMR by proving it applies the IOSCO principles for financial benchmarks or IOSCO principles for PRAs.

The third country administrator must have a legal representative in the relevant EU Member State, acting on behalf of the third country administrator and who will be accountable to the relevant competent authority.

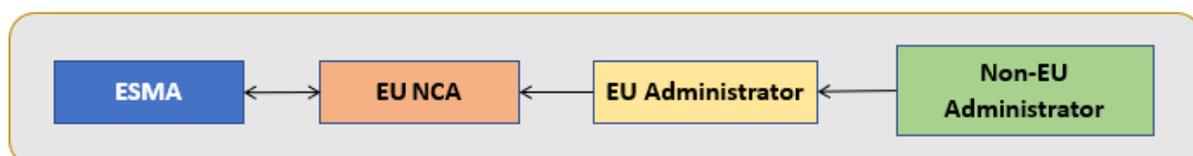
Determining what is the relevant Member State (“Member State of reference”) is stipulated in Article 32(4) based on a waterfall of options, depending on the presence and activity of the third country administrator in the EU.

Upon successful recognition, ESMA would include a third country benchmark administrator in its register.

It is worth noting that the on-going legislative process on the [proposal to review the powers of the European Supervisory Authorities \(ESAs\)](#) will likely change the way the recognition process works.

If the current proposals are agreed, the third country benchmark administrator together with their legal EU representative would apply to ESMA directly instead of a national competent authority for recognition. However, the ESAs review is not yet agreed, and once it is agreed and published in the Official Journal, it will take 18 months to implement and apply. Furthermore, under current proposals, ESMA would not take up its supervisory powers until 36 months after the entry into force of the ESAs Review.

Endorsement



The final route for EU supervised entities to use third country benchmarks is endorsement. Under this route, an authorised EU based benchmark administrator can apply to an EU competent authority to endorse a third country benchmark administrator’s benchmarks for use by EU supervised entities. This can also be done by any EU supervised entity with a “clear and well-defined role within the control or accountability framework” of the third country benchmark administrator.

The EU administrator (or supervised entity) has to:

- (1) prove that the third country administrator provides the benchmark in accordance with rules at least as strict as the BMR;
- (2) have the necessary expertise to monitor effectively the provision of the third country benchmark; and
- (3) ensure there is an “objective reason” to provide the benchmark in a third country and to be endorsed in the EU.

The endorsed benchmark will be considered the benchmark of the EU authorised benchmark administrator (or supervised entity), responsible for compliance with the BMR. The “objective reason” test is subject to a future delegated act from the European Commission, so any entity starting to pursue this route must bear this in mind.

IOSCO principles

All three options (equivalence, recognition and endorsement) indicate that as a minimum, third country benchmark administrators should comply with the [IOSCO principles for financial benchmarks](#) and/or the [IOSCO principles for PRAs](#).

Hence, it is essential if third country administrators want to continue to allow their benchmarks to be used in the EU after January 2020 within the scope of the BMR that they appropriately align their governance, risk and control framework for their benchmarks’ administration operations to the IOSCO principles. European authorities or third country competent authorities will be using the IOSCO principles as the starting point for compliance with the BMR rules.

Timeline and transitional arrangements

As mentioned, the BMR was applied from 1 January 2018 but there are transitional arrangements in place until 1 January 2020, including for third country benchmarks.

On 8 November 2017 ESMA updated its Q&A with more details on how the transitional arrangements will work for third country benchmarks. ESMA specified that third country benchmarks are able to be used in the EU throughout the duration of the transitional period, to 31 December 2019.

Additionally, third country benchmarks that existed prior to 1 January 2020 can continue to be used in existing contracts (unless re-papered) post 1 January 2020 until maturity, without the need for an equivalence decision, recognition or endorsement.

After 1 January 2020, however, the use of existing non-compliant third country benchmarks is not allowed in respect of new financial instruments, contracts or measurements of the performance of an investment fund within the scope of the BMR.

At the time of writing, there is discussion in the EU to extend the transition period for critical benchmarks by a further two years. Although there have been requests for a similar extension regarding non-critical benchmarks, this is unlikely to be granted and so the critical benchmark extension would not impact the 2020 deadline for non-critical benchmarks.

Issues with the third country benchmark equivalence, recognition and endorsement

With only one year to go before the 31 December 2019 cut-off date, it remains unclear how third country benchmarks will be able to be used by supervised entities in the EU after 1 January 2020. All three methods: equivalence, recognition and endorsement, are problematic for third country benchmark administrators to comply with by the deadline (or at all), as evidenced by the lack of a single third country benchmark on ESMA's register.

Regarding equivalence, many third countries will not have equivalent legislation and regulation in place to the BMR in place and may have no intention of enacting such legislation. In other countries, regulation of critical benchmarks may be in place, but not for the BMR-defined non-critical benchmarks addressed in this paper (which may be "critical" in third countries). Even where equivalent legislation and regulation may be in place, there may not be sufficient time for the European Commission to issue an equivalence decision.

One of the problems with the recognition route is the waterfall of criteria to identify the "reference Member State". In the absence of data on volumes on where the benchmark is used, the third country benchmark provider may be unable to determine the right reference Member State. Another issue is that the legal liabilities and role of the EU legal representative the third country benchmark provider has to establish are unclear. Consequently, many third country administrators are likely to be deterred from going down this route. Also, the uncertainty over whether to apply now to a national competent authority or to wait to apply potentially to ESMA (as outlined above) clouds the use of this method for third country administrators.

Much remains unclear regarding endorsement as well. Allowing an EU administrator or entity to endorse a benchmark could imply a degree of interference in the benchmark. The cost and terms (including any legal liability) of allowing EU administrators or entities this role are also unclear. For recognition, the IOSCO Principles are used as a barometer, but for endorsement it may be difficult to "prove" that the rules being used are at least as strict as the BMR.

Perhaps the case where endorsement is best used is in the case of affiliate entities, where non-EU benchmarks are endorsed by the EU benchmark administrator in the same commercial group. This already exists in credit rating agency (CRA) regulation where non-EU ratings are endorsed by the EU CRA in the same CRA group. However, benchmark provision is not as concentrated in a few large global commercial groups, making this option available only to a few global benchmark providers.

Given the serious consequences of infringement of the BMR (up to 10% of global annual turnover), it is not clear whether third country benchmark providers would judge the commercial benefit to outweigh the administrative burden of complying with one of the above-mentioned routes.

UK benchmarks after Brexit

Absent any transitional or other arrangements for the period from 29 March 2019, the UK will become a third country after Brexit. Upon the UK becoming a third country, all benchmark administrators in the UK would have to seek registration under the BMR in accordance with the BMR third country rules.

Provided the Commission issues a positive equivalence assessment for the UK, UK based administrators could be included in the ESMA register. However, such an assessment may be politically fraught in the current environment and subject to withdrawal, but at least the starting point will be that the UK has a look alike regulation enacted.

Impact on EU users

There is a significant risk that third country non-critical benchmark administrators will not achieve equivalence, recognition or endorsement for their benchmarks by January 2020. The impact could be significant, but it is currently unknown as little data is available on the extent to which EU users, particularly investors, make use of third country non-critical benchmarks. However, all EU supervised entities would do well to prepare for the disruptive possibility that the current benchmarks they use from outside the EU will not be available to them after January 2020.

For instance, commonly used spot FX benchmarks could become unavailable for use by EU investors. This would mean EU investors, including asset managers, insurers and pension funds, would be unable to hedge their exposures to non-EU currencies and products denominated in such currencies. Commonly used equity and bond indices from outside the EU may also very well become unusable by EU supervised entities. Firms must establish the potential impact and prepare accordingly. The recently published [briefing](#) by ISDA, GFMA, FIA and EMTA goes into greater detail about the potential impact on EU users and explores some of the third country benchmarks impacted.

Also, many investment funds, seeking globally diversified returns, seek to replicate or track the performance of a third country indices. Should such indices not be usable, the impact could be quite significant.

The impact of the UK exit from the EU will also be significant, as many widely used indices are currently administered out of London. At the time of writing it seems the index industry is waiting to see what happens with Brexit before deciding on their jurisdiction of choice. Providers have in many cases chosen dual registration in the UK and an EU jurisdiction, e.g. the Netherlands on the assumption that EU markets cannot be accessed from London due to Brexit.

Investors who have mapped their use of major third country indices are monitoring the authorisation and preparedness of the index providers. It is expected that the situation will be clearer after Q1 2019.

Conclusion

The BMR represents a significant new regulatory regime for critical and non-critical benchmarks. Although much public attention has been on the provisions applicable to critical benchmarks such as LIBOR and EURIBOR, this paper clearly illustrates that market participants must also pay attention to the impact in relation to non-critical benchmarks, particularly regarding third countries.

ENDS
20 December 2018