

29 November 2012

Ms. Maria Teresa Fabregas-Fernandez  
European Commission  
Directorate-General Internal Market and Services  
Securities Markets Unit  
Rue de spa 2  
1000 Brussels  
Belgium

Transparency Register Identification Number: 89854211497-57

**Re: Consultation Document on the Regulation of Indices**

Dear Ms. Fabregas-Fernandez,

CFA Institute appreciates the opportunity to respond to the public consultation on the regulation of the production and use of indices serving as benchmarks in financial and other contracts (the "Consultation").

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

To inform regulatory reform initiatives associated with the alleged manipulation of the London Interbank Offered Rate (LIBOR), CFA Institute surveyed its global membership.<sup>1</sup> The survey addressed issues such as the methodology for the setting of LIBOR, the governance and supervision of LIBOR, and possible alternatives to LIBOR. Amongst other findings, the survey results indicated that a majority of CFA Institute members favour a calculation methodology based on actual transaction rates, regulatory oversight of interest rate benchmarks, and powers for regulators to pursue criminal sanctions in cases of manipulation of such benchmarks.

CFA Institute believes that greater transparency over the calculation and production of benchmarks and indices in general, particularly where indices are based on subjective or judgmental inputs, is a key element to uphold integrity. Greater transparency underscores market discipline and helps mitigate conflicts of interest.

Other important measures to ensure the integrity of benchmarks include robust internal controls, policies, and procedures surrounding the assimilation and contribution of data for the calculation of benchmarks; adequate management reporting and supervision over the provision of inputs; conflicts management policies; and appropriate regulatory oversight.

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<sup>1</sup> The survey is available at [http://www.cfainstitute.org/Survey/libor\\_survey\\_report\\_final.pdf](http://www.cfainstitute.org/Survey/libor_survey_report_final.pdf).

Our specific comments in response to the Consultation's questions follow. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,



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### **Specific Comments**

CFA Institute is a not-for-profit professional association that represents the interests of investment professionals. We have responded only to those questions that are relevant to our organisation.

### **Chapter 1: Indices and Benchmarks**

#### **1. Which benchmarks does your organisation produce or contribute data to?**

Not applicable.

#### **2. Which benchmarks does your organisation use? What do you use each of these benchmarks for? Has your organisation adopted different benchmarks recently and if so why?**

CFA Institute does not use benchmarks itself, although CFA Institute members use benchmarks practicing as investment professionals.

#### **3. Have you recently launched a new benchmark or discontinued existing ones?**

Not applicable.

#### **4. How many contracts are referenced to benchmarks in your sector? Which persons or entities use these contracts? And for which purposes?**

We are not able to comment.

#### **5. To what extent are these benchmarks used to price financial instruments? Please provide a list of benchmarks which are used for pricing financial instruments and if possible estimates of the notional value of financial instruments referenced to them.**

There are numerous benchmarks used to price financial instruments such as futures, options, swaps, exchange-traded funds, and other financial instruments and contracts. These instruments derive their prices from certain indices, including, but not limited to:

- Stock market indices
- Bond market indices (including indices of corporate bonds, government bonds, asset-backed and mortgage-backed securities, among others. Such indices may be subcategorised by credit rating, sector, geography, or other factors)
- Commodity indices (the most common being oil, precious metals, and agricultural commodities)
- Foreign exchange indices (such as those calculated based on a basket of currencies on a trade-weighted basis)
- Interest rate indices (such as LIBOR, EURIBOR, and other similar interest rate benchmarks)
- Credit default swap (CDS) indices (including CDS indices based on single-name corporate CDSs and sovereign CDSs, indices based on a basket of names, sectors, geographies, or other factors).

We are not able to provide an estimate of the notional amount of financial instruments referenced to these indices.

- 6. How are benchmarks in your sector set? Are they based on real transactions, offered rates or quotes, tradable prices, panel submissions, samples? Please provide a description of the benchmark setting methodology.**

Not applicable, CFA Institute is not a direct user of benchmarks.

- 7. What factors do you consider to be the most important in choosing a reliable benchmark? Could you provide examples of benchmarks which incorporate these factors?**

In our view, there are three key factors that determine the reliability of a benchmark. These include whether the calculation methodology is robust and based on clear, unambiguous rules or guidelines that leave little room for discretion or interpretation; whether the inputs comprise actual, observable transaction data; and whether there are appropriate governance and oversight arrangements to ensure the integrity of the benchmark.

Other factors include whether these benchmarks are investable, measurable, (with some frequency for performance attribution), appropriate, reflective of current investment opinions, specified in advance (publicly known at the start of an evaluation period where possible), and owned (i.e. there is appropriate accountability).

Stock market indices, which are typically based on the prices of actual, current transactions and have transparent methodologies and governance arrangements, typically exemplify these characteristics.

## **Chapter 2: Calculation of Benchmarks – Governance and Transparency**

### ***2.2 Use of Actual Transaction Data***

- 8. What kinds of data are used for the construction of the main indices used in your sector? Which benchmarks use actual data and which use a mixture of actual and estimated data?**

Not applicable.

- 9. Do you consider that indices that do not use actual data have particular informational or other advantages over indices based on actual data?**

In our view, indices that do not use actual data are generally less robust. CFA Institute members believe that actual transaction rates are a better basis for calculation of interest rate benchmarks. 56% of CFA Institute members responding to a survey on LIBOR said that the most appropriate methodology for the setting of LIBOR would be an average rate based on actual inter-bank transactions only; a further 32% thought that a hybrid methodology using actual and estimated rates would be appropriate.

In summary, therefore, we believe that actual rates should be used wherever possible but in certain circumstances estimated rates could play a part in the setting of interest rate benchmarks.

- 10. What do you consider are the advantages and disadvantages of using a mixture of actual transaction data and other data in a tiered approach?**

The main disadvantage of using estimates or other types of data alongside or in place of actual transactions is that such data are subjective, allowing the provider scope to exercise discretion or

judgment when submitting inputs. Subjectivity can allow conflicts of interest to interfere with the provision of fair and honest inputs, which could undermine market integrity.

However, depending on the type of index or benchmark in question, use of transaction data alone can be disadvantageous if actual transaction data are not always current, timely, or readily available. In these cases, use of transaction data alone may result in the production of an index that is stale or not reflective of fair market value.

Therefore, a tiered approach that places emphasis in the first instance on actual transaction data, supported by estimated data where current transaction data is not available, can be advantageous.

An analogous approach is prescribed under accounting standards (both US GAAP and IFRS) for the determination of fair value of a financial instrument. Generally, fair value is taken to be the current market price of a security or financial instrument. However, where a current market price is not available, fair value may be determined by using a model, formula, or methodology that uses observable inputs. If neither approach is possible, fair value may be determined using a model, formula, or methodology using unobservable inputs. This three-tiered approach could be applied generally to various indices.

It is important to note, however, that the more reliance that is placed on models, formulas or judgment, the greater the transparency that is needed (of both the inputs into the models or formulas and of the models or formulas themselves) in order to protect the integrity of the index and to mitigate conflicts of interest. Another measure to improve transparency where actual transaction data is not used is to assign a flag or code to the data output. This would enable investors to be aware that the index or benchmark being used has been based partly or wholly on subjective data.

**11. What do you consider are the costs and benefits of using actual transactions data for benchmarks in your sector? Please provide examples and estimates.**

We are not able to provide specific estimates of costs and benefits, but note that where actual transactions are used, they are generally reported or collected by a data vendor, enabling the index to be quickly and efficiently calculated. In comparison, survey-based indices are more resource-intensive and time-consuming.

Another benefit of using actual transaction data that is widely collected and reported is that such data leave little room for human intervention. Transaction data is therefore much cleaner (it is not interfered with or manipulated by humans), allowing more efficient compilation and dissemination.

Overall, we consider these benefits to outweigh any costs.

**2.3 Governance and Transparency of Underlying Data**

**12. What specific transparency and governance arrangements are necessary to ensure the integrity of benchmarks?**

In general, to ensure the integrity of benchmarks, the following arrangements are necessary: high levels of transparency over the provision of inputs into the production of benchmarks; robust internal controls, policies, and procedures; adequate management reporting and supervision over the provision of inputs; conflicts management policies; and appropriate regulatory oversight.

We broadly agree with the framework set out on p.13 of the Consultation to manage conflicts of interest. The framework includes: effective controls; Chinese walls; continuously evaluating and using effective methodologies for submissions; management and supervision of relevant personnel along with a credible whistleblowing policy and complaints procedure; appropriate reporting and cooperation with relevant authorities; monitoring, reviews and audits of submissions process; appropriate documentation and record-keeping; appropriate transparency through reporting to the public, to the market, and to authorities; and possible regulation of the activity of submitting an input into the production of a benchmark.

Overall, these transparency and governance measures are comprehensive.

**13. What are the advantages and disadvantages of imposing governance and transparency requirements through regulation or self-regulation?**

A mixture of self-regulation and formal regulation is appropriate. Firms or industry bodies are best placed to design and establish internal controls and other organisational policies, procedures, and governance arrangements.

Regulatory oversight over the process of submitting inputs in the production of a benchmark is appropriate – in a recent survey, 70% of CFA Institute members globally and 77% in EMEA (Europe, Middle East and Africa) supported regulatory oversight of the LIBOR submission process. Such oversight would act as a credible deterrent to manipulation and would provide authorities with appropriate powers to pursue sanctions against perpetrators.

Regulatory requirements for transparency and reporting may also be appropriate where current levels of transparency are inadequate.

**14. What are the advantages and disadvantages of making contributing data or estimates to produce benchmarks a regulated activity? Please provide your arguments.**

We support regulatory oversight of the process of contributing data or submitting estimates to the production of benchmarks – see response to previous question.

**2.3 The Contributors of Data**

**15. Who in your sector submits data for inclusion in benchmarks? What are the current eligibility requirements for benchmarks' contributors?**

Not applicable.

**16. How should panels be chosen? Should safeguards be provided for the selection of panel members, and if so which safeguards?**

The selection of panels, index contributors, or constituents should be based on clear, objective, and robust criteria and governed by the relevant industry committee or body responsible for administering the index in question.

Panel members should be sufficiently numerous, diverse and sufficiently active to accurately and fairly represent the market in question. Appropriate safeguards should include requiring a minimum number of panel participants contributing data at all times, such that the number of contributions is sufficiently

high to mitigate the propensity for a few contributors to manipulate the index in a collusive fashion, as alleged in the case of LIBOR.

**17. How should surveys of data used in benchmarks be performed? What safeguards are necessary to ensure the representativeness and integrity of data gathered in this way?**

As suggested in our response to the previous question, surveys should include a sufficiently numerous, diverse, and active set of contributors so as to fairly represent the market in question. There should be clear and objective criteria over the selection of survey contributors and policies in place to overcome sample selection biases. For example, the sample of contributors, once established, should be reviewed regularly to ensure that the contributors are sufficiently active to fairly represent the market in question.

Periodic audits or third party verification over the accuracy and reliability of the information provided would also help to strengthen the integrity of survey-based data.

**18. What are the advantages and disadvantages of large panels? Even in the case of large panels could one panel member influence the benchmark?**

Large panels generally are more advantageous than smaller panels, because the weight attached to any single contribution ( $1/n$ ) in the panel is lower the higher the number of participants (the higher is  $n$ ). In other words, the potential for any single contribution to influence the outcome is lower in large panels, thereby minimising the scope for manipulation of the index.

Additionally, where contributions are voluntary, a large panel should help ensure that where one or a few panel members choose not to contribute data on any given date, the panel is still sufficiently large enough for the index to not be materially affected.

A possible disadvantage of large panels is the possible higher cost associated with compiling data from numerous contributors.

**19. What would be the main advantages and disadvantages of auditing of panels? Please provide examples.**

Please refer to our response to question 17. No further comments.

**20. Where indices rely on voluntary contributions, do you consider that there are factors which may discourage the making of these contributions and if so why?**

Where contributions are voluntary, firms may be discouraged from contributing data if market circumstances are volatile or uncertain; or if a contributor has a relatively large exposure to financial instruments that reference the index in question; or if, for other reasons, the firm wishes to preserve anonymity or not reveal information to the market. Under these circumstances, it may be relatively advantageous for firms not to contribute data.

**21. What do you consider to be the advantages and disadvantages of mandatory reporting of data? Please provide examples.**

The disadvantages of mandatory reporting of data are that, under certain market conditions, firms contributing data could be exposed to adverse market movements upon revelation of their contributions. However, this risk can be managed through a well-calibrated reporting framework for data contributions that provides for anonymity and deferred publication under limited conditions.

The advantages of mandatory reporting of data are that it provides transparency, credibility, and integrity of the data (for both inputs and outputs). Mandatory reporting also provides market discipline by allowing investors to exercise greater scrutiny over data. Moreover, mandatory reporting underpins confidence and trust, and enables investors to make more informed decisions.

The mandatory reporting of data in the equity market and the resulting reliability and integrity of equity market indices is an example of the advantages from mandatory reporting.

**22. For entities contributing to benchmarks which are regulated by financial regulation, what would be the advantages and disadvantages of bringing their benchmark submissions under the scope of this framework?**

Please see our response to questions 13 and 14. We have no further comments.

### **2.5 Index Calculations**

**23. Do you consider that responsibility for making adjustments if inadequate data is available should rest with the contributor of the data, the index provider or the user of the index?**

To ensure accountability and the provision of accurate, reliable information, the primary responsibility for making adjustments should rest primarily with the index provider. Accountability would ensure that the index provider undertook appropriate quality assurance procedures to ensure data quality. However, the contributor should also have responsibility for ensuring that it provides the index compiler with accurate information. To that end, data contributors should adhere to consistent standards over data submission.

**24. What is the formal process that you use to audit the submissions and calculations?**

Not applicable.

**25. If there are any weaknesses identified in the audit, who are they reported to and how are they addressed? Is there a follow up process in place?**

Not applicable.

**26. How often are submissions audited, internally or externally and by what means? Do you consider the current audit controls are sufficient? What additional validation procedures would you suggest?**

Not applicable.

**27. What are the advantages and disadvantages of a validation procedure? Please provide examples.**

Third party verification of index data strengthens the credibility and integrity of the index. One analogous example is the calculation and presentation of composite performance data by investment firms that adhere to the Global Investment Performance Standards (GIPS<sup>®</sup>).<sup>2</sup> The GIPS standards are produced and maintained by CFA Institute. Firms that present their composite performance

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<sup>2</sup> Visit <http://www.gipsstandards.org/Pages/index.aspx>



information in accordance with the GIPS standards are recommended to have their performance information verified by a third party and are required to include a statement indicating whether or not the firm was verified in their GIPS compliant presentations. The GIPS standards are globally accepted, widely used, and recognised as the gold standard in investment performance reporting.

**28. Who should have the responsibility for auditing contributed data, the index provider or an independent auditor or supervisor?**

The index provider should perform appropriate quality assurance procedures to verify the accuracy and reliability of contributed data. Periodic third-party audits, although not necessarily a requirement, should be considered best practice.

**29. What are the advantages and disadvantages of making benchmarks a regulated activity? Please provide your arguments.**

Regulators should have appropriate jurisdiction over benchmarks so that they are able to pursue sanctions in an effective manner in instances of abuse or malpractice. In our survey on LIBOR, 55% of CFA Institute members globally, and 59% in EMEA, thought that administration of LIBOR should remain with the industry but should be subject to regulatory oversight.

**Chapter 3: The Purpose and Use of Benchmarks**

**30. Is it possible and desirable to restrict the use of benchmarks? If so, how, and what are the associated costs and benefits? Please provide estimates.**

In general, we believe that regulators should limit themselves to the regulation of index production, and not step into invasive regulation of index choice.

**31. Should specific benchmarks be used for particular activities? By whom? Please provide examples.**

No comment.

**32. Should benchmarks developed for wholesale purposes be used in retail contracts such as mortgages? How should non-financial benchmarks used in financial contracts be controlled?**

No comment.

**33. Who should have the responsibility for ensuring that indices used as benchmarks are fit for purpose, the provider, the user (firms issuing contracts referenced to benchmarks), the trading venues or regulators?**

Please see our response to question 23. We have no further comments.

**Chapter 4: Provision of Benchmarks by Private or Public Bodies**

**34. Do you consider some or all indices to be public goods? Please state your reasons.**

Most indices or benchmarks exhibit the characteristic of non-rivalry, whereby consumption or use of the index by one individual does not subtract from the ability of other individuals to use the index. However, not all indices or benchmarks are non-excludable, meaning that it may be possible to exclude access to an index or benchmark from certain individuals or firms. Some indices are only made available to subscribers of the organisation who compiles the index, or to subscribers of data vendors who may distribute data on the index. In other words, because it is possible to charge fees to provide data, some indices may not exhibit the characteristic of non-excludability which is also a prerequisite for a public good. Although many benchmarks or indices are widely available to the public, it is possible for index providers to differentiate the level of information provided among different consumer groups. Given this possibility for discrimination or excludability, indices or benchmarks may not be considered pure public goods.

**35. Which role do you think public institutions should play in governance and provision of benchmarks?**

Public institutions, namely regulatory authorities, have a role to play in the supervision and oversight of benchmarks. Whilst we acknowledge that some public institutions, such as central banks and national statistical agencies, produce benchmarks, generally we believe the compilation and production of benchmarks is best left to the private sector.

For comparison, only 26% of CFA Institute members globally, and 29% in EMEA, thought that LIBOR should be administered as well as overseen by regulators.

**36. What do you consider to be the advantages and disadvantages of the provision of indices by public bodies?**

Public bodies, although generally less subject to conflicts of interest, are not free from such conflicts. For example, the objective of a central bank to provide a benchmark or index may conflict with the central bank's objective to ensure financial stability, particularly if financial market conditions are stressed. Under such conditions, a central bank, or national statistical agency, may be incentivized to publish an index or rate that does not fully reveal the level of market stress.

Moreover, industry providers are better placed to have the means and resources necessary to design, construct, and produce benchmarks or indices that meet users' specific needs.

**37. Which indices, if any, would be best provided by public bodies?**

No comment.

**38. What conflicts of interest would arise in the provision of indices by public bodies? What would be the best way of avoiding these conflicts of interest?**

Please refer to our response to question 36. We have no further comments.

**Chapter 5: Impact of Potential Regulation – Transition, Continuity, and International Issues**

**39. What are the likely transition challenges, costs and timelines for relevant benchmarks? Please provide examples.**

Benchmarks that play a dominant role and are widely referenced by a range of financial instruments and contracts, such as LIBOR, could be substituted by other benchmarks but the transition should be

carefully managed and phased-in. LIBOR underpins the pricing of at least \$350 trillion of financial contracts so a transition away from LIBOR could have systemic consequences if implemented too abruptly. Nevertheless, we believe it would be possible to transition towards other market-based interest rate benchmarks in place of LIBOR.

We are not able to comment on costs and timelines for other benchmarks.

**40. How do you consider that the adoption of new benchmarks could be ensured? Is this best framed in terms of encouraging or mandating the use of particular benchmarks?**

It should be left to market participants, in collaboration with industry bodies and regulatory authorities, to determine how and when new benchmarks could be adopted. A collaborative approach as opposed to a regulatory mandate would be most desirable.

**41. How can reforms of the regulation of benchmarks be most easily implemented?**

Reforms could be implemented through the establishment of common standards by international regulators, working in consultation with the industry. 89 per cent of CFA Institute members responding to the survey on LIBOR agreed that a global framework of key principles or best practices should be developed for internationally used benchmarks. To that end, we support initiatives by IOSCO to develop international standards for benchmarks.

**42. What positive or negative impacts, if any, do you see on small and medium-sized enterprises of the possible regulation of indices, and how could any negative impacts be mitigated?**

No comment.

**43. Are there other impacts which should be considered? If so please specify the nature of these impacts and provide evidence.**

No comment.

**44. In which countries are benchmarks used in your sector produced? From which countries are data used for the production of benchmarks in your sector? In which countries are benchmarks used in your sector?**

Not applicable.

**45. Are there non-EU benchmarks which could serve as substitutes? Are there non-EU benchmark providers which could produce similar benchmarks?**

No comment.

**46. Are there international benchmarks which could serve as substitutes for national benchmarks?**

No comment.