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Ms Verena Ross
Executive Director
European Securities and Markets Authority (ESMA)
103 Rue de Grenelle
75007 Paris
France

Re: Principles for Benchmarks-Setting Processes in the EU

Dear Ms Ross,

CFA Institute appreciates the opportunity to respond to ESMA's consultation paper on principles for benchmarks-setting processes in the EU (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 financial market benchmarks, CFA Institute surveyed its global membership on issues associated with the alleged manipulation of the London Interbank Offered Rate (LIBOR).[1] 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 calculation methodologies 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.

Executive Summary

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. Actual transaction data should be used in the compilation of benchmarks (where relevant) to the fullest extent possible.

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; policies to manage and mitigate conflicts of interest; and appropriate regulatory oversight.

[1] The survey is available at http://www.cfainstitute.org/Survey/libor_survey_report_final.pdf

We believe that benchmark administrators and submitters should adhere to a code of conduct to ensure accountability. Codes of conduct should be supplemented by additional regulatory oversight of submitters or administrators or both, where relevant and as appropriate, along with strong enforcement powers. In general, benchmarks that are systemically relevant (i.e. are widely used or followed among a range of different stakeholders or across markets or countries), that are based on subjective inputs (i.e. non-transaction data), and that are not adequately covered under existing financial market regulations (such as trade reporting and market abuse regulations under existing securities and derivatives markets legislation), should be the main candidates for additional regulatory oversight.

In general, the appropriate combination of industry codes and formal regulatory oversight and enforcement powers would help mitigate the risks and vulnerabilities associated with benchmarks.

We believe that regulators should limit themselves to the regulation of index production (where appropriate as outlined above) and not step into invasive regulation of index choice or limit index use.

Our specific comments in response to the Consultation's questions follow. For further information on the use of benchmarks in investment management, regulators and other interested stakeholders may wish to refer to the book "Benchmarks and Investment Management" published by the Research Foundation of CFA Institute.[2]

Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,

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[2] Laurence B. Siegel, 2003, "Benchmarks and Investment Management", Research Foundation of CFA Institute, August 2003, Vol. 2003, No. 1, available at http://www.cfapubs.org/toc/rf/2003/2003/1

CFA Institute

Specific Comments

Definition of the activities of benchmark setting

1. Do you agree with the definitions provided in this section? Is this list of activities complete and accurate?

We broadly agree with the definitions provided.

With regard to "benchmark user", the definition stipulates "A financial market participant that uses a benchmark in one of the following manners:

– as a reference for financial transactions that it sells or places, or for financial instruments that it structures; or

– as a reference for financial transactions to be entered into by its clients (or by itself on behalf of its clients) in the context of its individual or collective portfolio management activities."

We suggest that the definition be clarified to explain that a "financial market participant" is, for the purposes of these principles, a professional market participant (acting in the capacity of a financial institution or on behalf of an investment firm or its clients) and not a retail investor. We elaborate on the appropriateness of the principles for benchmark users in our response to question 8.

Principles for benchmarks

2. **Would you consider a set of principles a useful framework for guiding benchmark setting activities until a possible formal regulatory and supervisory framework has been established in the EU?**

We consider the development of benchmark-setting principles by ESMA a useful interim step. However, we stress the need for coordination and alignment with international developments such as the IOSCO taskforce on financial benchmarks.[3] The principles developed should be sufficiently broad in order to be compatible with the outcome of the European Commission's work on a possible regulatory framework for indices used as benchmarks.[4]

3. Do you agree with the principles cited in this section? Would you add or change any of the principles?

The principles in section A of the Consultation provide a general framework for benchmark setting and include principles related to methodology, governance structure, supervision, transparency, and continuity of benchmarks. We broadly agree with these principles. Our comments in relation to each area are as follows:

- **A1: Methodology.** We agree that a benchmark should adequately represent the market to which it refers and measure the performance of a representative group of underlyings in a relevant and appropriate way.

[3] CFA Institute's response to the IOSCO consultation on financial benchmarks is available at http://www.cfainstitute.org/Comment%20Letters/20130211.pdf

[4] CFA Institute's response to the European Commission consultation on the regulation of indices used as benchmarks is available at http://www.cfainstitute.org/Comment%20Letters/20121129.pdf

For a benchmark to be credible and useful to investors, it must fairly and accurately represent the key attributes of the market segment or financial instrument in question. In particular, benchmarks should be 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).

We also firmly agree that actual market transactions should, as a matter of preference, be used as a basis for a benchmark, where appropriate.

In our view, indices that do not use actual transaction data are generally less robust. 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 are not available, can be advantageous. An analogous approach is prescribed under accounting standards 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 benchmark and to mitigate conflicts of interest.

- **A2: Governance structure**. We agree that the process of setting a benchmark needs to be governed by a clear and independent process. We also agree that the governance of a benchmark should be designed to mitigate conflicts of interest and limit its susceptibility to manipulation, discretionary decision making or price distortion.

  To ensure the integrity of information, administrators should establish and enforce a code of conduct over data submissions that unambiguously and transparently specifies the basis and process for inputting data. Administrators should also ensure that the composition of the panel or set of inputs used to calculate the benchmark is a fair and accurate representation of the underlying interest being measured. 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 benchmark in question. Panel members should be sufficiently numerous, diverse and sufficiently active to accurately and fairly represent the market in question.

  Furthermore, administrators should perform adequate quality assurance procedures to verify or corroborate data submissions. For example, for survey-based (i.e. non-transaction) data, administrators should assess the reasonableness of submissions having regard to other gauges of relevant financial market activity (e.g. comparing purchasing managers indices with GDP data; comparing interest rate benchmarks such as LIBOR with overnight index swaps (OIS) and the spread between such measures having regard to historical norms or averages;

comparing benchmark expectations derived from models or formulas with actual outcomes). Administrators should seek clarification and understanding over data outliers. Periodic audits or third-party verification over the information produced by administrators would also help to strengthen the integrity of benchmark-setting.

In general, measures to address potential conflicts of interest should include: effective controls; Chinese walls; continuously evaluating and using effective methodologies for submissions or data inputs; management and supervision of relevant personnel along with a credible whistle-blowing policy and complaints procedure; appropriate reporting and cooperation with relevant authorities; monitoring, reviews and audits of submissions processes; 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, where appropriate (such as rate submissions to LIBOR).

The administrator's oversight committee should play an active role in scrutinising all issues related to integrity of the benchmark. However, in cases where the administrator is a trade body representing the interests of the contributors to the benchmark, and where the benchmark is systemically important and calculated based on non-transaction data, an oversight committee alone may be insufficient to protect the integrity of the benchmark. In such cases, an oversight committee of the administrator may not be a sufficiently credible deterrent to prevent abusive or manipulative practices on the part of contributors.

This scenario has been most notably evident in the case of the LIBOR scandal. Given the systemic importance of the LIBOR benchmark, its reliance on subjective inputs, and the manifest failures in its governance arrangements, public supervision by the relevant regulatory authority is a necessary component of the oversight framework, in addition to any private oversight committees established by the administrator.

With regard to the representation of an oversight committee, there should be an appropriate balance between sufficient oversight independence and sufficient knowledge of the business issues associated with production of the index concerned.

- **A3: Supervision**. We broadly agree that confidence in a benchmark is enhanced through regulation and oversight and an appropriate sanctioning regime that allows sanctions for improper conduct.

  However, a one-size-fits-all approach to the regulation of indices may not be appropriate, as indicated by IOSCO in its consultation report on financial benchmarks.

  Regulation of benchmark submissions can be advantageous by acting as a credible deterrent to abusive or manipulative practices on the part of submitters. The threat of enforcement and sanctions provides a stronger incentive to contribute accurate and fair submissions than industry oversight alone. For enforcement to be credible, it must be backed up by strong statutes. Authorities must be endowed with powers to impose fines in the case of fraudulent activity (such as deliberate mis-reporting of a benchmark submission for private economic gain) that are commensurate with the scale of the fraud committed. Regulators should also possess criminal sanctioning powers to punish manipulative or abusive practices for interest rate benchmarks such as LIBOR.

  The advantages of regulating benchmark administration include the threat of regulatory enforcement action acting as a mechanism to ensure sufficiently robust administrative

processes, controls and governance, and the mitigation of conflicts of interest which can arise when the administrator is a trade body or is owned by the market participants who submit data to the administrator.

However, additional regulatory oversight may create unnecessary cost if the benchmark is produced by a well-governed private entity not subject to the aforementioned conflicts of interest, and if the benchmark is based on transaction (i.e. objective) data. For benchmarks that are based purely on transaction-based data, additional regulation of benchmark submissions or administration might not yield marginal benefits if the market transactions concerned are already covered under existing securities or derivatives markets legislation, such as regulation that prescribes trade reporting practices and regulation that prohibits market abuse.

In general, benchmarks that are systemically relevant (i.e. are widely used or followed among different stakeholders or across markets or countries), that are based on subjective inputs (non-transaction data), and that are not adequately covered under existing financial market regulations, should be the main candidates for additional regulatory oversight.

- **A4. Transparency.** We agree that a benchmark should be transparent and accessible, with fair and open access, and that a high degree of transparency over the process for determining the benchmark enhances confidence.

  Producers of benchmarks should provide sufficient transparency for users to be able to clearly understand and evaluate the methodology used to compile the benchmark. We agree that the full methodology should be disclosed wherever possible. Such transparency enables investors to hold index producers to account and exercise market discipline.

  For benchmarks that require periodic rebalancing, users would benefit from advance information on the methodology used for rebalancing in order to assess the continued suitability of the benchmark**.** Administrators should consult with relevant stakeholders prior to any change in benchmark methodology.

- **A5: Continuity.** We broadly agree that benchmark administrators should put in place robust contingency provisions for a drying-up of market liquidity, a lack of transactions or quotes or the unavailability of a benchmark.

  Benchmark producers should clearly disclose their policies and circumstances for using alternative inputs when current transaction-based data are unavailable. The information should include specific criteria for when alternative inputs would be used and ideally the length of time for which it would be permissible to produce the benchmark based on these alternative inputs. These policies and circumstances should be specified in advance of index production and updated as necessary.

  It is important, however, that the exercise of discretion in these circumstances is kept to a minimum and only used when current transaction data are unavailable, such as during episodes of market stress or illiquidity. During such times, investors should be provided with even greater transparency in order to uphold confidence and to enable liquidity to return. In periods of market stress, opacity regarding the production of benchmarks and financial instruments in general merely breeds uncertainty and exacerbates stress.

  The design of a benchmark should be reviewed any time there is a material change to the market or underlying interest that the benchmark seeks to represent (such as a prolonged

discontinuity in benchmark participants or index contributors, or a prolonged period of illiquidity that would prevent transaction-based data from being used where transaction data are otherwise the norm, etc.)

Principles for firms involved in benchmark data submissions

4. Do you agree with the principles cited in this section? Would you add or change any of the principles?

The general principles include:

"B1: A contributing firm should have in place internal policies covering the submission process, governance, systems, training, record keeping, compliance, internal controls, audit and disciplinary procedures, including complaints management and escalation processes.

B.2: A contributing firm should maintain and operate effective organisational and administrative arrangements with a view to avoid conflicts of interests from affecting the benchmark data submitted."

We agree with these general principles, and broadly agree with the supporting principles. With regard to supporting principle B.8, where it states "controls performed on the data submitted should include comparisons with actual, transaction-based, verifiable data", we suggest amending the language to include "wherever possible" at the end of the sentence to provide adequate suitability for indices based purely on non-transaction data.

Principles for benchmark administrators

5. Do you agree with the principles cited in this section? Would you add or change any of the principles?

The general principles include:

"C1: A benchmark administrator should ensure the existence of robust methodologies for the calculation of the benchmark and appropriately oversee its operations and ensure that the appropriate level of transparency to the market regarding the rules of the benchmark is made."

We agree. The supporting principles (C2 – C14) are broadly reasonable; we have no specific comments beyond those set out in our response to question 3.

Principles for benchmark calculation agents

6. Do you agree with the principles cited in this section? Would you add or change any of the principles?

The general principles include:

"D1: A benchmark calculation agent should ensure a robust calculation of the benchmark and ensure the existence of appropriate internal controls of the benchmark calculations it makes."

We agree. We have no specific comments on the supporting principles (D2 – D6).

Principles for benchmark publishers

7. **Do you agree with the principles cited in this section? Would you add or change any of the principles?**

   The general principles include:

   "E1: A benchmark publisher should ensure the well-controlled publication of the benchmark it has agreed to publish."

   We agree. We have no specific comments on the supporting principles (E2 – E3).

Principles for users of benchmarks

8. **Do you agree with the principles cited in this section? Would you add or change any of the principles?**

   The general principles include:

   "F1: Benchmark users should regularly assess the benchmarks they use in financial products or transactions, and verify that the benchmark used is appropriate, suitable and relevant for the targeted market. Any potential irregularities observed in a benchmark should be notified to the benchmark administrator or the relevant competent authorities if appropriate."

   We broadly agree with the general principle; it should be incumbent upon professional investors to undertake adequate due diligence to ensure the suitability and appropriateness of the benchmark for their client's needs, and for their needs where professional investors are not acting on behalf of clients.

   We disagree with supporting principle F2, which states "A benchmark user should ensure that the relevant benchmark administrator and benchmark calculation agent comply with the principles applying to benchmark administrators and benchmark calculation agents. In order to comply with this requirement the benchmark user may consult, among other sources, the confirmation of compliance publicly disclosed by the benchmark administrator and the benchmark calculation agent, and should apply reasonable judgement."

   This principle might imply an outsourcing of a third-party audit or verification function to users; it is therefore inappropriate and unnecessary. Compliance should already be performed at the respective entities contributing to the production of the index (as outlined in the respective principles) and subject to external audit as appropriate. Placing an additional requirement on users to check compliance is therefore unnecessary and would do little to further strengthen the integrity of the benchmark. The user contribution to benchmark integrity is sufficiently achieved

through general principle F1. Furthermore, unless the definition of "user" is clarified to exclude end-users such as retail investors, supporting principle F2 is also unrealistic.

Finally, supporting principle F4 ("A benchmark user should regularly assess the appropriateness, suitability, and relevance of the use of a benchmark.") is redundant; it does not add detail to, or elaborate on, the general principle. F4 could therefore be removed.

Practical application of the principles

9. Are there any areas of benchmarks for which the above principles would be inadequate? If so, please provide details on the relevant benchmarks and the reasons of inadequacy.

No further comments.

Continuity of benchmarks

10. Which principles/criteria would you consider necessary to be established for the continuity of benchmarks in case of a change to the framework?

Please see our comments under question 3, section A5. We have no further comments.