An overview of the Benchmark Regulation

Prevention of manipulation is the most important goal

By Dr. Simon G. Grieser and Jael Karck

The BMR affects “benchmark administrators,” — defined under Article 3(1)(6) of the BMR as “a natural or legal person that has control over the provision of a benchmark.”

Historical background

Interest rate benchmarks have a huge impact on decisions in the financial markets. They can therefore play a role in conflicts of interest, especially in situations where a person who controls an index used in establishing a benchmark is a direct or indirect beneficiary of the performance of that benchmark, as there is a risk that such a person may be tempted to manipulate the index. Benchmarks are vulnerable to manipulation because it is possible to take advantage of granted discretion and weak governance systems. Over the past several years, there were numerous instances of benchmark manipulation — a series of which became known as the Libor scandal.

The EU responded by adopting Regulation (EU) 2016/2011 (the Benchmark Regulation, or BMR). The BMR regulates indices used as benchmarks in financial instruments and financial contracts, as well as indices measuring the performance of investment funds. It also revises Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No. 596/2014.

The BMR came into force on June 30, 2016, and was applicable as of January 1, 2018. Since the latter date, an administrator has been responsible for managing new benchmarks. Article 51 of the BMR contains transitional provisions to cover the two-year period leading up to January 1, 2020, after which all requirements in the BMR become effective. In contrast to the Market Abuse Regulation and the Directive on Criminal Sanctions for Market Abuse, the BMR is viewed as a regulation aimed at prevention.

Objective

It was inevitable that the European Commission would introduce far-reaching legislation to deal with the market abuse of benchmarks, as the threat of criminal sanctions had proved ineffective at improving the way benchmarks were defined and used. By introducing the BMR, the Commission was primarily aiming to prevent conflicts of interest through the improvement, monitoring and regulation of benchmark processes and by ensuring data contributors are supervised in an appropriate manner.

The further purpose of the BMR is to restore trust in the accuracy and integrity of benchmarks. The regulation ensures that benchmarks established and used in the European Union are robust, reliable, representative and fit for purpose. In addition, it aims to improve both the procedure for inputting data as well as the quality of data. Eventually, the BMR is intended to protect consumers and investors by providing more transparency and compensation rights to those affected by the benchmarks, as well as a suitability assessment in certain situations. Regarding the term "benchmark," it is broadly defined, allowing the BMR to have wide application.

Content of the BMR

Article 1 of the BMR sets out a common framework to ensure the accuracy and integrity of indices used as benchmarks in financial instruments and financial contracts, as well as to measure the performance of investment funds in the EU. It applies to the provision of benchmarks, the contribution of input data to a benchmark and the use of a benchmark within the EU. Article 3 of the BMR defines all relevant terminology.

The BMR affects "benchmark administrators" — defined under Article 3(1)(6) of the BMR as "a natural or legal person that has control over the provision of a benchmark." Administrators located in the EU are now obliged to apply for approval from and register with a competent authority, in accordance with Article 34 of the BMR.

The requirements related to the recognition of an administrator located in a third country are stipulated in Article 32 of the BMR. Until January 1, 2020, regardless of whether administrators are in the EU or from a third country, they are covered by the transitional provisions in Article 51 of the BMR.

Furthermore, benchmarks affect "contributors" — a term that includes "any natural or legal person contributing input data" (Article 3[1][9] of the BMR), where "input data" is defined as "the data in respect of the value of one or more underlying assets, or prices, including estimated prices, quotes, committed quotes or other values, used by an administrator to determine a benchmark" (Article 3[1][14] of the BMR). Pursuant to Article 3(1)(8) of the BMR, the "contribution of input data" means providing to an administrator, or to any other person for the purpose of passing to an administrator, any input data that is not readily available but is required in connection with the determination of a benchmark and is provided for that purpose. Articles 15 and 16 of the BMR apply to contributors.

Article 3(1)(7) of the BMR specifies the circumstances under which a benchmark is used and provides examples. Articles 28 and 29 of the BMR apply to the "supervised entities" (as defined in Article 17 of the BMR) that may use benchmarks. Under these provisions, supervised entities are obliged to draw up and maintain robust written plans in which they set out the measures they would take in the calculation process should a malfunction result in the relevant benchmark changing significantly or ceasing to be provided.

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Where possible and appropriate, contingency plans must be in place to identify one or more alternative benchmarks that could be used in the event that the principal benchmark can no longer be provided. The supervised entity must also indicate why these benchmarks would be appropriate alternatives.

The BMR also sets out the organizational obligations of supervised entities as users of benchmarks.

Details of contingency plans are outlined in the European Securities and Markets Authority (ESMA)'s Questions and Answers on the Benchmarks Regulation. Contingency plans are robust to the extent that they constitute operational procedures in writing, provide detailed procedures, indicate appropriate communication channels and include precautionary measures for a variety of scenarios and possible outcomes. Users must administer the contingency plans in a diligent and appropriate manner, taking into account the nature and relative importance of the specific benchmark as well as how widely it is used. They must also continuously monitor all factors that could impact the effective maintenance of the contingency plans and update the plans when necessary. In addition, upon request, users are required to provide the competent authority with a copy of the contingency plans and any potential updates. Article 28 of the BMR contains additional stipulations relating to customers of supervised entities.

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Types of benchmarks under the BMR

In order to have a broad scope of application, to achieve proportionality and to ensure that its provisions have the intended effect on benchmarks, the BMR makes use of three different approaches focusing on the types of assets, their significance and data quality.

Regarding the types of assets, the BMR differentiates between interest rate benchmarks and benchmarks whose underlying assets are raw materials.

The details of the provisions vary depending on the scope of the benchmark. The BMR categorizes interest rate benchmarks as critical, significant or non-significant. Critical benchmarks (for example, Libor and Euribor) impact financial instruments and contracts with an average value of no less than €500 billion and could thus affect the stability of the financial markets in Europe. A benchmark can also qualify as critical if there are no or very few appropriate replacements and if there would be a considerable effect on market stability were it to cease to be provided. Significant benchmarks are used as a reference for financial instruments or financial contracts with a total value of at least €50 billion. Non significant benchmarks do not meet the criteria outlined for the major (critical and significant) benchmarks. Benchmarks can, if necessary, be switched from one category to another.

The third approach, which involves data quality, refers to benchmarks derived from "regulated data." These benchmarks result from the application of a formula calculated from input data respecting the EU marketplace, particularly EU electricity stock exchanges, auction platforms for EU greenhouse gas emission allowances, or independent providers, respectively.

Impact on domestic law

Since January 1, 2018, a supervised entity may only make use of a benchmark within the EU if the reference value or the administrator of that specific benchmark is entered in an ESMA register pursuant to Article 36 of the BMR. In Germany, the BMR was implemented by the Second Financial Market Amendments Act and the Financial Supervision Amendment Act. Moreover, the BMR grants BaFin (the Federal Financial Supervisory Authority) the right to intervene and impose sanctions. Since July 1, 2018, pursuant to Article 247, Section 4(3) of the Introductory Act to the German Civil Code, it is necessary to comply with a new pre contractual duty to provide information for general consumer loan agreements within the meaning of Section 491(2) of the German Civil Code (insofar as reference is made therein to a "reference value" within the meaning of the BMR). Since January 1, 2019, existing benchmarks may be used. <–

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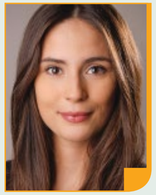

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