EVENT REPORT

EUROPEAN CAPITAL MARKETS INSTITUTE

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Following the recent alleged manipulation of financial indices like LIBOR, EURIBOR and TIBOR financial markets regulators are now discussing the appropriate way to regulate the production of financial indices and benchmarks; this sector of the financial industry, which so far has remained substantially unregulated, has shown to be extremely vulnerable to fraudulent manipulations whose consequences have been suffered by the broadest set of financial markets participants.
Given the topical nature of the debate and the forthcoming Commission proposal for a regulation on benchmarks the European Capital Markets Institute have organized a two-session meeting gathering together regulators and market participants to discuss recent developments and future prospects for financial indices and benchmark settings regulation.

Session 1, speakers:

- **Giles Ward**, Policy Officer, Securities Markets, European Commission
- **Alex Claringbull**, Managing Director, Blackrock
- **Jeremy Penn**, Chief Executive, Baltic Exchange
- **Richard Stevens**, Executive Director for International Research and Product Development, CME Group
- **Kay Swinburne**, Member of the European Parliament
- **James Smethurst**, Partner, Freshfields [moderator]

Session 2, speakers:

- **Steffen Kern**, Head of Economics and Financial Stability, ESMA
- **Sophia Dancygier**, Managing Director, Markit
- **Elizabeth Murphy**, Regulatory Counsel, Platts
- **Chris Woods**, Head of Governance and Policy, FTSE
- **John Ewan**, Head of Fixings Business Development, Thomson Reuters
- **Diego Valiante**, ECMI Head of Research and Research Fellow, CEPS [moderator]

The first session of the event has been introduced by **Giles Ward** (EC) who, without going into the details of the forthcoming Commission proposal for a regulation on benchmarks, presented the reasons why the present legislative framework has not been able to prevent benchmarks manipulations and the key objectives that the Commission proposal is assumed to achieve. Despite the absence of specific regulatory discipline the manipulation of benchmarks is already considered a crime under EU law by different pieces of legislation most notably under the Market Abuse Directive (MAD); anyway the focus of MAD is mostly on individual felonies and does not provide comprehensive rules and procedures regulating benchmarks production. The objective of the Commission proposal is the one of designing a legislative framework that covers vertically the whole benchmarks supply chain (administrators, contributors, calculating agencies and final users) endorsing the high degree of consensus emerged from public consultations regarding the benefits of higher *transparency* and *governance standards* across all the supply chain. Ward underlined how, recognizing the cross-border nature of the benchmark industry, the proposal will be in line with the principles set by the International Organization of Securities Commissions (IOSCO) regarding the importance of methodological transparency and the necessity of different set of rules for transaction-based indices and for all the others being the latter more prone to be manipulated.

The Commission expects positive developments in terms of creating a true competitive market for benchmarks production and in terms of improving the reliability of existing benchmark from the more effective application of the *open access* principle supported in the new text of the Market for Financial Instruments Directive and Regulation (MiFID/MiFIR). On this aspect MEP **Kay Swinburne** expressed a less optimistic view regarding the real novelties that will be derived by open access implementation claiming that if better alternatives were available on the market those would have been already adopted. Swinburne raised further concerns regarding the possibility that any legislation at EU level would eventually be effective considering the global playing field in which benchmarks are daily involved.

The prospective of firms involved in the production of benchmarks has been brought by **Jeremy Penn** from Baltic Exchange, a firm involved in the production of a benchmark price for shipping and freight costs. The concerns of benchmarks producers with respect to the incoming wave of legislation are grounded on multiple aspects.

In first place, the excessive stress that is put on auspicating more transaction-based indices can be misleading and ultimately harming for the quality of benchmarks. According to Penn transactions data say very few things about the reality of the market in the shipping business (and surely this is the case also in other commodity markets), that is why transaction based formula need to be complemented by the *judgement* of a panel of experts. From here the necessity of legislation resilient enough to take in consideration markets characteristics, a solution ‘one size fits all’ is definitely to be avoided. Penn stressed that benchmarks production is hardly a profitable business (low margin and often cross-subsidised) and excessive transparency on market data and data availability can harm the quality of

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existing benchmarks in terms of driving producers out of the market because of the further lowering of margins. Two more issues are warring the benchmark industry: first, an excessive regulatory burden imposed on contributors, who are participating on *exclusively voluntary basis*, will eventually prevent them to be willing to be engaged in this activity in the future causing the loss of necessary information to produce high quality benchmarks; second, benchmark administrators find definitely unacceptable the possibility of being considered liable for the purposes to which their data are used for as most of the time they do not have the means to know who is using their products and for what scope. Some of those concerns have been shared also by **Richard Stevens** (CME group) especially far what concerns the necessity of having a legislative body able to cope with different classes of indices each of them characterised by specific features; moreover, the possibility of seeing a drop in voluntary contributors is seen as likely in case the legislative burden would excessive on those key players.

Another sector who is likely to be affected by the regulation of benchmarks is the one of service providers for *index investing*. Index investing is a very popular investment strategy whose attractiveness for many investors is mostly based on its low costs and simplicity. Being a highly commoditised business both investment managers and index providers are subjected to fierce competition. In order not to be harming for this industry, according to **Alex Claringbull** (Blackrock), legislation should be careful in treating in the same way all the indices; in this regard particularly helpful would at least to recognize formally two broad families of indices: the one formed by *rate benchmarks* (LIBOR, EURIBOR, etc) which are largely used to price financial contracts and the one of *market benchmarks* (SP500, Dow Jones, etc) which represent the value of a basket of securities and whose manipulation has not been an issue.

The second session of the event was opened with some key remarks by **Steffen Kern** (ESMA) presenting the ongoing activity of ESMA concerning benchmarks regulation. ESMA's effort is targeted to provide a general non-binding framework which sets guidelines for every agents of the supply chain (administrators, submitters, calculating agencies and benchmarks users) in terms of clear methodologies of calculation, governance (oversight and control) and overall transparency. On the issue of providing the market with higher transparency on data and calculation methodologies **Elizabeth Murphy** (Platts) assured that in the case of price reporting agencies those firms are already providing such information to market participants as this is highly valued by their customers and increase the agencies trustworthiness. Nonetheless they also envisage the risk of seeing contributors retreating due to excessive regulatory obligations; the fear of losing contributors, indeed a major concern for all the panellists from the industry, has been mentioned also by **John Ewan** (Thomson Reuters) who reported how anyway this has not been the case for the LIBOR panel since the contributors to that benchmark have been subjected to tighter controls. Interventions from the audience anyway highlighted how, despite any legislative burden, contributors will still have vested interests in the having benchmarks properly calculated therefore a massive retreatment of those players should not be a major concern; moreover, retreatment of contributors could became a real issue whether lack of transparency in index calculation and lack of governance standards would shift considerable amount of risk over those players.

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Central to the debate has been again the issue on how much future regulation will need to rely on transaction data. Representatives from the industry showed to be very sceptical on this issue explaining how in their view this could be counterproductive in terms of producing meaningful information for their clients. Murphy reported that in order to meet at best the necessities of their clients the approach of Platts has been to apply *experts' judgement* even when dealing with the most liquid markets. Ewan noted that relying on transactions in liquid markets doesn't provide long term guarantee as market liquidity can be subjected to sharp volatility; moreover, none can guarantee that market transactions are not manipulated in first place.
Steffan Kern assured that the position that ESMA will adopt will not be of the type '*one size fits all*', the authority is well aware of the heterogeneous nature of benchmarks and its approach will take in consideration such differences. He also agreed on the dangers prospected by the panel regarding a possible overreliance on transaction data; to this regard he explained how different solutions are being explored: an option considered has been the introduction of a 'shadow' benchmark completely based on transaction data to complement indices partially based on judgement. This kind of approach seems anyway deemed to generate more uncertainty than good, which benchmarks should have to be trusted in case of consistent discrepancies among the two? Would that automatically signals a market manipulation of the judgement-based index?

The two sessions managed to draw a clear picture on where debate is standing and on which are going to be the future challenges for regulators. Everyone agree that after the recent scandals is necessary a regulatory answer to restore trust and credibility in the benchmark industry and that this can be beneficial both to producers of indices and to consumers.
Regulation anyway does not have to come at any costs, it is necessary that regulatory obligations will not induce contributors to step back from their voluntary commitment to data submission, regulators will therefore have to find a balance between the need for standard methodology, transparency and higher governance and the necessity to maintain the sources of such valuable market information.
The other key point on which regulators will have to be particularly careful is the introduction of excessive reliance on transactions data. Transactions data are no panacea to restore credibility in benchmarks, in order to produce marketable and meaningful information many classes of indices will still have to rely of experts' judgement, to the regulators then expect the difficult task to understand to which extent a full reliance on market transactions is resulting in worse outcome then the exercise of subjective judgment in benchmark calculation.

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