IOSCO’s Principles: A Benchmark for Benchmarks

The regulatory drive to reform financial benchmarks took an important step forward in April when the International Organization of Securities Commissions released draft principles that will guide efforts to restore confidence in the industry.¹

The principles, which were drafted by IOSCO’s Task Force on Financial Market Benchmarks, stem from efforts by policymakers and regulators to respond to recent events that have called into question the integrity of the London Interbank Offered Rate and other financial benchmarks. The Financial Stability Board and the G-20 have signaled their support for the work of IOSCO and the task force, which is co-chaired by Martin Wheatley, CEO of the U.K. Financial Conduct Authority, and U.S. Commodity Futures Trading Commission Chairman Gary Gensler. Many regulators believe the final principles will be the basis for regulations and industry standards for financial-benchmark activity.

**KEY TAKEAWAYS**

- The IOSCO draft principles for financial benchmarks published in April are likely to become the gold standard for the financial benchmark industry.

- The principles are not binding but will influence the industry’s future regulation and will set the framework for enhanced governance, design, and control arrangements in it. The principles also neatly frame the transition arrangements for stakeholders to consider.

- IOSCO’s approach is pragmatic and rejects a one-size-fits-all approach to benchmark oversight; proportionality in application is an overarching theme of the principles.

- IOSCO recognized the vulnerabilities of survey-style benchmarks (and benchmarks with ownership structures prone to conflicts of interest) by proposing a subset of principles specifically for them.

- Administrators, data contributors, and product developers using benchmarks will need to consider the organizational, financial, and operational consequences of the principles, particularly as they pertain to governance and accountability.

Chairman Gensler has been particularly vocal in calling for the replacement of key benchmarks and warned last month at a conference that market participants should “not fall prey to accepting that Libor or any benchmark is ‘too big to replace.’” The financial services industry has closely followed the development of the principles, which will have profound consequences for financial markets, including the organization and cost structure of the financial-benchmark business.

The IOSCO draft principles build upon prior conclusions reached by the U.K. Financial Services Authority, the CFTC, the European Securities Markets Association, and the European Banking Authority, as well as upon some industry-led initiatives. The task force’s work followed more than 50 comment letters on its earlier consultation paper.

The principles will not be binding on any jurisdiction or benchmark administrator, but because of IOSCO’s prominent role as a global standard-setter, they will likely serve as policy guidance and as the basis for national regulations to oversee benchmark-related activity. They will also serve as the foundation for further controls by benchmark administrators and will have implications for benchmark design going forward.

IOSCO is expected to issue the final principles in June. Given the limited consultation questions, it is unlikely that these final principles will differ materially from the draft. IOSCO will review the extent to which the principles have been implemented within 18 months after the final release.

Pragmatic and Proportional Approach

Laying out the principles marks an important step toward restoring the integrity of the benchmark process, and reducing flawed calculation methods and perceived conflicts of interest. The themes of the principles are broad: governance of administrators and submitters; transparency; accountability; and benchmark design and quality. The high-level approach is pragmatic, and premised upon the limitations of a one-size-fits-all method of benchmark oversight. While the principles are not granular enough to apply to a specific benchmark, they contain a number of detailed provisions that address common survey-style benchmarks such as Libor.

The draft identifies three areas where benchmarks are especially prone to risk: submissions, policies and procedures governing methodology, and governance. The variety of data submission and collection forms, the diversity of data submitters, the lack of transparency surrounding the methodology, and potential conflicts of interest at the administrator and submitter are all potential vulnerabilities.

Proportionality is a key concept in the principles. The task force said the application of the principles should scale with “the size and risks posed by each benchmark administrator and benchmark-setting process.” The concept extends to flexibility in implementation and application of the principles, such as in developing policies for governance, addressing conflicts of interest, and making transition arrangements.

1. http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler140
Key Themes of the IOSCO Principles

The benchmark industry is likely to focus on several key themes in the draft principles.

**SCOPE**

The draft principles are structured broadly to enhance benchmark reliability, integrity, and oversight by addressing the quality, governance, and accountability of benchmark activity. Though they apply across all asset classes and determination methods, they contain special provisions for survey-style benchmarks and for benchmarks whose ownership structures potentially create conflicts of interest.

The principles may apply less stringently to administrators of some equity indices derived from regulated stock markets, including the Dow Jones Industrial Average and the S&P 500, but the increasing regulatory focus on the customized equity indices underlying exchange-traded funds, unit trusts, and mutual funds makes it unlikely that these indices will be completely outside their scope.

**REGULATION**

Benchmark activities — both administration and data submission — are likely to be brought within the regulatory perimeter in many jurisdictions that currently do not regulate benchmarks. The principles establish criteria in designing and applying regulation, including the systemic significance of a benchmark and the extent of its use by investors and retail clients.

The pragmatic approach recognizes that many jurisdictions do not have the basic legislative and regulatory infrastructure to regulate benchmarks, and prioritizes benchmarks that pose the greatest systemic challenges. The principles promote extensive disclosure of benchmark-related matters to appropriate local regulators, even in jurisdictions that do not formally regulate benchmarks.

**GOVERNANCE AND ACCOUNTABILITY**

The principles affirm the importance of the role of the benchmark administrator, as other reviews have. The administrator has ultimate responsibility for benchmark design and operation, as well as all aspects of the determination process — including credible and transparent governance, sound methodologies and compilation, integrity of the submissions process, and accountability procedures.

The principles address conflicts of interest within the administrator and between the various participants in a benchmark process, and specifically note that independent representation in the governance mechanism is advisable where the administrator’s ownership structure gives rise to potential conflicts. Accommodating formal representation will be a new element for many benchmark administrators. The principles also call on administrators to implement and enforce documented policies and procedures that mitigate potential conflicts, and to disclose them to benchmark users and regulators. IOSCO again emphasizes proportionality, stressing that any control framework should be appropriately tailored to the level of the existing or potential conflicts of interest.

The principles include two other governance elements that may well require enhancements at a number of benchmark providers. One is the need for clear contractual arrangements between
administrators and third parties, such as calculation agents, that providing benchmark services. The second is a periodic control review of benchmark activities by independent internal-audit functions or third parties.

**METHODOLOGY AND USE OF TRANSACTION DATA**

The principles most highly anticipated by stakeholders were those relating to the use of transaction data in determining benchmarks, and the approach adopted could bring meaningful changes to interbank offered rates. While Gensler is widely perceived to support benchmarks based almost wholly on price data from actual transactions, the draft principles assert the primacy of transaction data but leave open the option of a hybrid approach that uses a hierarchy of inputs and expert judgment. Benchmark administrators and users will look for greater clarity in the final principles on acceptable methodologies.

IOSCO also said benchmark design should adapt to secular market trends, particularly to changes in liquidity. Administrators will clearly need to pay closer attention the problems that became apparent in the global financial crisis — when interbank liquidity progressively decreased — by monitoring market quality and incorporating long-term contingency arrangements for benchmark redesign and transition.

**CODE OF CONDUCT**

Submitters now have detailed guidance on a code of conduct for survey-style benchmarks that is consistent with recent regulatory reviews, the investigations of the Ibors, and principles put forth by the Global Financial Markets Association. Core elements cover internal governance, organization, and control arrangements to prevent submitters from exercising inappropriate influence over the data contributed, combined with extensive record-keeping and independent review. The code would also prevent the rapid withdrawal of members from submission panels, which clearly addresses regulators’ concerns about how the withdrawal of panel banks affects systemically important benchmarks.

Submitters may push back on a provision of the code that would put strict limitations on front-office functions participating in data submission. Though the provision is designed to prevent improper influence, including that of unrelated trading desks, benchmark quality and timeliness depend upon those with the greatest knowledge of the underlying market — typically the market makers themselves. Parties that object to the limitation on front-office participation are likely to point out that the code already addresses segregation of duties, information barriers, and supervisory oversight. It is possible that IOSCO will clarify this provision in the final principles.

**TRANSITION**

One of the major challenges in seeking possible replacements for Libor and other benchmarks is market resistance to adopting a replacement. The draft principles put the onus on the administrator to come up with an alternative and to drive the transition for industry stakeholders and regulatory authorities. Many administrators, however, may struggle to fulfill these roles, particularly for existing benchmarks. They may focus their efforts on periodic reviews of underlying markets to spot liquidity issues as early as possible; licensing arrangements and fall-back arrangements that support practical alternatives; and devising substitute benchmarks or determination methods.
Conclusion

IOSCO’s draft principles mark an important milestone in the ongoing reform efforts aimed at financial benchmarks. Though IOSCO cannot by itself compel action by benchmark administrators and data submitters, its draft principles constitute a blueprint for supervisory authorities who can. The final principles in June will likely clarify some of the draft’s ambiguities, but the draft nonetheless establishes the future framework for the design, governance, and control of financial benchmarks.

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<tr>
<th>WHAT THE HIGH-LEVEL PRINCIPLES MEAN FOR ADMINISTRATORS AND DATA SUBMITTERS</th>
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<tbody>
<tr>
<td>GOVERNANCE</td>
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<tr>
<td>1. <strong>Responsibility</strong>. Primary responsibility for all aspects of the benchmark determination.</td>
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<td>2. <strong>Third Parties</strong>. Oversight of third parties that undertake aspects of the benchmark-determination process.</td>
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<td>3. <strong>Conflicts</strong>. Document — and enforce — policies and procedures to identify, disclose, manage, mitigate, and avoid conflicts of interest.</td>
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<td>4. <strong>Control Framework</strong>. Use an appropriate control framework for determining and distributing the benchmark.</td>
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<td>5. <strong>Oversight</strong>. Establish an internal oversight function to review and challenge the determination process.</td>
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<tr>
<td>QUALITY OF THE BENCHMARK</td>
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<td>6. <strong>Design</strong>. Benchmark design should capture the economic realities of the interest it seeks to measure.</td>
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<td>7. <strong>Data Sufficiency</strong>. Data used to construct benchmark determination should be sufficient to measure the interest accurately.</td>
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<td>8. <strong>Input Hierarchy</strong>. Disclose clear guidelines on the hierarchy of data inputs and exercise expert judgment in benchmark determination.</td>
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<td>9. <strong>Review</strong>. Periodically review the conditions in the underlying interest that the benchmark measures.</td>
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<td>QUALITY OF THE METHODOLOGY</td>
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<td>10. <strong>Content</strong>. Disclose the benchmark-determination methodology.</td>
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<td>11. <strong>Changes</strong>. Disclose the rationale driving material changes to methodology, and the procedures for making changes.</td>
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<td>12. <strong>Transition</strong>. Have clear, written policies and procedures to handle benchmark cessation, whether due to market or product changes — or any other condition that makes the benchmark no longer representative of its intended interest.</td>
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<td>14. <strong>Data Collection</strong>. Ensure appropriate internal controls over the collection of data from external sources.</td>
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<td>ACCOUNTABILITY</td>
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<td>15. <strong>Complaints</strong>. Establish and publish a written policy for handling complaints.</td>
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<td>16. <strong>Audits</strong>. Appoint an independent internal or external auditor to review and report periodically on adherence to principles and their requirements.</td>
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<td>17. <strong>Audit Trail</strong>. Retain written records for five years.</td>
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<td>18. <strong>Regulatory Cooperation</strong>. Promptly deliver relevant documents, audit trails, and other information requested by authorities carrying out regulatory or supervisory duties.</td>
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Source: IOSCO Task Force on Financial Market Benchmarks
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