markit™

4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

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European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

European Banking Authority
Tower 42 (Level 18)
25 Old Broad Street
London EC2N 1HQ
United Kingdom

Submitted via: www.esma.europa.eu

Re: **Consultation Paper: Principles for Benchmarks-Setting Processes in the EU**

Dear Sir/Madam:

Markit[1] is pleased to submit the following comments to the European Securities and Markets Authority ("***ESMA***") and the European Banking Authority ("***EBA***") (together "***ESMA and EBA***"), in response to their Consultation Paper on *Principles for Benchmarks-Setting Processes in the EU* (the "***Consultation Paper***" or the "***CP***").[2]

Introduction

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics, and related services across regions, asset classes and financial instruments. Our products and services are used by a large number of market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities. Markit is an index provider for various index families across regions and asset classes, including bonds, credit default swaps and loans. We administer and publish the composition of all Markit indices and also calculate the levels of the Markit iBoxx suite of bond indices and other third-party indices.

Markit has been actively and constructively engaged in the discussion regarding regulatory reform of financial markets. We regularly provide regulatory authorities with our insights on current market practice, for example in relation to valuation methodologies, the provision of scenario analysis, and the use of reliable and secure means to provide daily marks. We have also advised regulatory bodies on potential approaches to enable timely and cost-effective implementation of newly established requirements, for example through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying regulatory requirements. Over the last two years, we have submitted over 40 comment letters to regulatory authorities around the world, and participated in numerous roundtables. In the context of the discussion regarding the regulation of benchmarks and indices we have submitted responses to *The Wheatley Review*[3]*,* the FSA's *Consultation Paper on the regulation and supervision of benchmarks*,[4] the European

[1] Markit is a financial information services company with over 2,900 employees in Europe, North America, and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see www.markit.com for additional information.
[2] ESMA and EBA Consultation Paper: Principles for Benchmarks-Setting Processes in the EU. 11 January 2013.
[3] The Wheatley Review of LIBOR: initial discussion paper. Markit letter to HMT regarding the initial discussion paper (07 September 2012) *available* here.

Commission's *Consultation Document on the Regulation of Indices*[5] as well as to IOSCO's *Consultation Report on Financial Benchmarks.*[6]

Executive Summary

Benchmarks ("***BMs***") and indices are products that have built a long established history of providing transparency and liquidity to the financial markets, including for less liquid market segments. These benefits have been recognized by market participants and also by various regulatory authorities that have approached index providers over the years with a desire to increase the transparency, liquidity, and tradability of their local markets by creating indices for them. We encourage ESMA and EBA to recognize the benefits that indices and benchmarks provide to market participants as well as to the public, and their contribution to making financial markets more efficient and liquid, fostering a sound basis to provide financing that drives economic growth.

The recent Libor-related events have put "benchmarks" into the spotlight and caused the marketplace and regulatory authorities to re-examine the functioning of these instruments. We agree that the underlying facts of any manipulation of Libor and other benchmarks should be investigated and failings of the existing mechanisms identified and addressed. However, given the multitude of products that could potentially be regarded as benchmarks, ESMA and EBA should ensure that any regulatory approach is proportionate to enable a timely implementation for the most relevant and exposed benchmarks while avoiding unintended consequences for the broader range of index and benchmark products that are not exposed to the same challenges. To achieve this goal, ESMA and EBA should try to create a clear distinction between benchmarks and indices, as well as between Libor-type products and others given the significant differences that exist between them.

We commend the Joint EBA-ESMA Task Force on Principles for Reference Rates and other Benchmarks-Setting Processes in the EU (the "***Task Force***") for publishing its Consultation Document on the Benchmarks-Setting Process. We believe that many commercial providers of benchmarks and indices are engaged regarding most of the issues listed in the CP and, in many cases, already address them through use of appropriate means. We appreciate the opportunity to provide the Task Force with our comments at the public hearing, and with our written comments and responses below.

We welcome the work that the Task Force has performed aiming to restore the credibility of financial benchmarks. While we recognize that the proposed provisions are technically without binding effect we note the Task Force's view that they will provide benchmarks users, benchmark administrators, calculation agents and publishers and contributing firms with "a common framework to work together and provide a glide path to future obligations that are likely to be binding."[7] On this basis, our comments focus on what we believe should be the final outcome of any regulatory framework for benchmarks, and we apply this view to the regime that the Task Force has proposed to establish for an interim period. We take this approach as we believe that it will be important for the Task Force to get the framework of the regime right even if it might only apply during an the initial period. This is because we believe it will set an important precedent and the major decisions that the Task Force will take over the coming months will be difficult to reverse in any following stages.

Responses to the Task Force's specific questions

<u>Definitions</u>

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[4] FSA Consultation Paper: The regulation and supervision of benchmarks. Markit letter to the FSA regarding consultation paper (16 January 2013) *available* here

[5] Consultation Document on the Regulation of Indices: A Possible Framework for the Regulation of the Production and use of Indices serving as Benchmarks in Financial and other Contracts. Markit letter to the European Commission regarding the consultation document (29 November 2012) *available* here.

[6] IOSCO Consultation Report: Financial Benchmarks. January 2013.

[7] ESMA and EBA Consultation Paper: Legal basis.

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

1. Definition of Benchmark

The CP defines "benchmark" as

> *Any commercial index or published figure, including those accessible on the internet whether free of charge or not,*
> *(a) calculated entirely or partially by the application of a formula to or an assessment of the value of one or more underlying assets, prices or certain other data, including estimated prices, interest rates or other values, or surveys;*
> *(b) by reference to which the amount payable under a financial instrument or the value of the financial instrument is determined.*[8]

We believe that, in relation to this proposed definition of BM, the Task Force should a) provide further clarification on some aspects of the definition, b) assess the consistency of its proposed definition with the ones that have been brought forward by other regulatory bodies, and c) carefully consider the appropriateness of the scope that its proposed definition would set.

a) Clarification

We believe that the Task Force's definition of benchmark should be clear and concise but also easily applicable to all of the parties that are involved in the process of benchmark setting today. In this respect, we believe that the Task Force should clarify the following aspects of its proposed definition:

- The second prong of the definition contains a reference to "the value of the financial instrument". We are concerned that, on that basis, potentially any number that, in some respect, is used by market participants as input into the valuation of a financial contract[9] would be captured, resulting in a scope that is excessively broad. We believe that the Task Force should therefore either remove this clause from the definition or clarify that it would only apply if such reference was *embedded in the contractual agreement* of the product.

- The definition refers to "any commercial index or published figure". It is unclear whether, in this context, "published" means publicly available, available to a number of users (including potentially just one), or something else. As explained in more detail below,[10] we believe that only those BMs that are "widely referenced" should be in scope of any future regime.

- It is not clear how prongs (a) and (b) of the BM definition relate to each other. Based on our understanding, we believe the Task Force should add "and" between them.

b) Consistency with definitions proposed by other regulatory bodies

We welcome the Task Force's stated goal of achieving a high degree of consistency between its principles for the regulation of benchmarks and those of other regulatory authorities.[11] We believe that achieving this objective would provide significant benefits to all stakeholders.

However, the Task Force should note that its definition of benchmark is not fully aligned with those that have been proposed by others. For example, while IOSCO included "performance benchmarks" in its

[8] ESMA and EBA Consultation Paper: Definitions.
[9] For example, many market participants will use the average temperature in specific regions as input into their valuation/pricing of some soft commodity contracts and derivatives on them.
[10] See our comments on "widely referenced" in FN 21.
[11] Open Hearing on ESMA/EBA consultation paper on Principles for Benchmarks-Setting Processes in the EU.

definition[12] the European Commission made no reference to "value" or "performance benchmark" in its CP.[13] We believe that such divergent definitions could result in significant differences between the scope of the respective regimes. We therefore strongly encourage the Task Force to work with IOSCO and the EC to align their respective definitions of benchmark.

c) General appropriateness of the definition of benchmark

We are concerned that the scope that the Task Force's proposed definition would set is not only very wide but also fairly vague, and might capture many instruments that are not benchmarks and/or carry Libor-type characteristics, for example any numbers that serve as input into valuations or bespoke indices that are only used by a small number of market participants. Using such scope would make any implementation much more difficult and time consuming. We recommend that the Task Force pursue a proportionate, two pronged approach that establishes explicit regulatory oversight for Libor-type "benchmarks", similar to what is being put in place in the UK,[14] while other relevant benchmark and/or index products that the Task Force believe should be exposed to more scrutiny would be expected to conform with an industry code of conduct.

Distinguishing between "benchmark" and "index"

We believe that the Task Force is planning to cast the net too wide, resulting in its principles being imposed on many instruments for which there is little justification to be covered by regulation. For example, we noted that the Task Force proposed for its principles to cover "all types of benchmarks".[15] Also, while the CP provides a definition of "benchmark" the terms "benchmark" and "index" are used interchangeably throughout the document.[16] However, this interchangeable use combines two distinct products and use cases. We therefore believe that the Task Force should clearly distinguish between benchmarks and indices. Specifically, we believe that a more appropriate definition of benchmark would be:

> *A commercial or published composite price assessment, distributed regularly to the public and widely used as a reference price in determining the amount payable pursuant to financial instruments or contracts that are material in size and scope.*[17]

In contrast, the term "index" refers to a basket of instruments or constituents that is maintained by a set of rules. Of course, if such index serves as the basis for the calculation of a reference number that is a widely referenced benchmark, that calculation process may also be the subject of benchmark regulation. On that basis, we believe that the Task Force should distinguish between the following categories of instruments:

- Category A: a composite price that is calculated based on a set methodology or formula, the purpose of which is to serve as a reference to determine the cash flows of financial contracts;[18]
- Category B: a defined set of instruments that is maintained by a set of rules, the purpose of which is to track the performance of an asset class or a market segment;[19] and
- Category C: a defined set of instruments that is maintained by a set of rules, the purpose of which is to serve as reference to determine the cash flows of financial contracts.

Category A describes Libor-type instruments where the price for a *single*[20] instrument is determined based on contributions or inputs. Category B describes indices that consist of multiple, often hundreds, of

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[12] IOSCO Consultation Report: Financial Benchmarks. January 2013.
[13] European Commission Consultation Document on the Regulation of Indices: A Possible Framework for the Regulation of the Production and use of Indices serving as Benchmarks in Financial and other Contracts.
[14] See FSA: The regulation and supervision of benchmarks. December 2012.; HM Treasury Initial Discussion Paper: The Wheatley Review of LIBOR. August 2012.; HM Treasury The Wheatley Review of LIBOR Final Report. September 2012.
[15] ESMA and EBA Consultation Paper: Principles of good conduct for benchmark setting.
[16] ESMA and EBA Consultation Paper: paragraph 22.
[17] Derived from the definition of benchmark that is provided in the GFMA Principles for Financial Benchmarks. 20 November 2012.
[18] An example of Category A would be the LIBOR fixings.
[19] Examples include most well-known equity indices, commodity indices, or fixed income indices.
[20] Or a small number.

instruments where the pricing of its components might be determined based on contributions or in a variety of other ways, and Category C describes those indices whose levels are used as a reference in financial contracts. The Task Force should note that we will refer back to these three categories throughout this document and respond to the Task Force's questions with these definitions in mind.

In order to ensure that a regulatory regime for benchmarks is proportionate and effective in achieving the regulatory objectives we believe that, across the various asset classes, products in Category A and, to the extent the calculated index value is widely referenced as a benchmark in financial products, in Category C could be regarded as areas where direct regulatory oversight might be appropriate.[21]

Drawing regulatory distinctions

Notwithstanding this advice, we recognize the challenge that the Task Force faces in creating a definition of benchmark that captures exactly the products that should be in scope while not including any others. We therefore recommend that the Task Force aims to differentiate between categories of benchmark and index products beyond the overall definition.

Specifically, we believe that the Task Force, in addition to using a general definition of BM to set the scope of its regime, should consider embracing IOSCO's concept of "drawing regulatory distinctions", i.e. identifying the relevant factors that will allow it to separate the various benchmark products into categories. The creation of such categories will be useful to either define whether a product should be in or out of scope of the regime, or, for the ones that the Task Force believes should be in scope, to determine the extent to which certain requirements should actually apply to them.[22] We recommend that, for this purpose, the Task Force consider making use of the following factors:[23]

- The extent to which a benchmark is widely referenced in financial instruments and/or it has a significant economic impact;
- Whether and to what extent the benchmark is referenced in exchange-traded products;
- Whether and to what extent the benchmark and the parties that are involved in the process of benchmark setting are already subject to regulatory oversight;[24]
- Whether the benchmark and the parties that are involved in the process of benchmark setting already comply with a Code of Conduct based on market forces;
- The susceptibility of the BM to manipulation[25] or conflicts of interest; and
- The availability of products that serve as close substitutes and the ability of users to switch to those alternative benchmarks if they so desire.

We believe that the use of such factor-based approach will allow the Task Force to more easily make regulatory distinctions between different product sets and identify their need to be subject to oversight or not.

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[21] We believe that the notion of "widely referenced" is consistent with the concept of "economic impact" as proposed by IOSCO. One possible approach to determine whether a benchmark is "widely referenced" would be to define a number of relevant factors and assign the task of applying them to existing benchmarks to the relevant regulatory authority. This approach would be similar to the process established for the Clearing determination for OTC derivatives. CFTC Clearing Requirement Determination Under Section 2(h) of the CEA. 77 Fed. Reg. 74284. (December 13, 2012).

[22] IOSCO Consultation Report: Financial Benchmarks.

[23] While some of those factors were proposed by IOSCO, we added several others.

[24] While we believe that the Task Force should consider this factor to some extent, e.g. in terms of setting priorities, we generally believe that the Task Force should ultimately aim for treating all relevant entities equally, regardless of whether they are regulated entities or not. This would be based on the Task Forces view that "in the EU, a formal regulatory regime for benchmarks does not exist so far." This view was also reflected by IOSCO, when it stated that "Although the submission and/or compilation of some of the Benchmarks considered by the Task Force is performed by regulated firms, the specific acts of submission and Benchmark compilation do not appear to be directly covered by the relevant regulatory framework." and "IOSCO member jurisdictions generally have enforcement authority in relation to Benchmark setting where the misconduct is related to financial firms, products, and the provision of financial services or the trading of securities and derivatives, although Benchmark setting is not of itself a regulated activity." IOSCO Consultation Report: Discussion of options for enhanced oversight of Benchmark activities.

[25] For example, given the large number of components that most indices are based upon, Category C products are only to a much more limited degree exposed to the challenges that exist for Category A products, e.g. the potential for manipulation.

Specific considerations

Finally, we believe that the Task Force should take the following aspects into account when designing an appropriate scope for any regulatory regime:

- **Application across asset classes** - The principles of any regulatory regime for benchmarks and/or indices should apply equally across all asset classes. However, the regime should be sufficiently flexible to reflect the relevant differences between asset classes and products.

- **Bespoke indices** - Indices that are created to be referenced in bilateral transactions should be out of scope as they only have relevance to a small number of parties, i.e. they are not "widely referenced" and will have only limited economic impact.

- **Level playing field** - In case a determination is made that a benchmark product provided by a specific sponsor is widely referenced,[26] this categorization should apply also to all competing products in this category, even if they might not be as widely referenced at that point in time. We believe that such approach, where the entire product category would be in or out of scope based on its economic impact, will be required to secure a level and consistent playing field between competing benchmark sponsors and to avoid creating opportunities for regulatory arbitrage.

- **Benchmark administration by public bodies -** IOSCO did not consider BM Administration by public bodies to be in scope. However, it also stated that benchmarks "where a public body acts as mechanical Calculation Agent … are within scope." We believe that it would be useful if the Task Force clarified whether it believes that BM Administration by public bodies would be in scope for regulatory scrutiny or oversight. It is our view that publicly administered benchmarks, the importance of which can be significant, are exposed to the same issues as other benchmarks,[27] while the incentives to address them will often be low.[28] As a general principle, we strongly believe that the creation and administration of indices and BMs is best performed as a private sector activity as to ensure that innovations continue to occur, it remains competitive and high quality products are made available to the market.[29]

2. Definition of benchmarking activities

To secure the proper operation of a benchmark or index, several distinct functions will need to be performed. While these functions can be, and often are, performed by a single entity, in practice they are often split between several specialized entities. We therefore commend the Task Force for acknowledging that the "benchmark administration, calculation and publication activities may be performed by distinct legal entities"[30] and for providing definitions for the Benchmark Administrator ("***BMA***") who is responsible for the

[26] Please see footnote 21 for details of how this determination could be made.

[27] We believe it would be wrong to assume that challenges in relation to governance or conflicts of interest do only exist to a lesser degree for a benchmark that is provided by a public body. In contrast, we believe that they are likely to be exposed to the same issues, while these bodies generally have more limited incentives to ensure the application and effectiveness of the BMs they create, including the continuous updating of their design to safeguard the accuracy of the BM data. It is worth noting that some of the Libor-related problems might have arisen precisely because these benchmarks were not administered by commercial entities. This is because commercial benchmark providers will only ever succeed in creating viable products if they manage to establish credible governance structures, produce accurate and reliable data, and provide sufficient transparency around their methodologies and data inputs.

[28] This can result, for example, in a lack of innovation or an inability to make timely changes to the index if market conditions change. This issue is evidenced by examples where commercial entities have successfully designed and launched indices with improved design that now serve as alternatives to the indices that are provided by public entities. In the case of CPIs, for example, indices that are provided by commercial index sponsors adjust for new goods and changes in consumption habits based on price movements in a more timely manner than the "official" CPIs.

[29] For example, the development of Category B type instruments that measure the performance of an asset class or its sub-sectors needs to be able to move at the speed of the marketplace in order to best fulfil market participants' needs. These types of indices require greater innovation and must evolve quickly in order to stay competitive.

[30] ESMA and EBA Consultation Paper: Definitions.

application of the index rules, the Benchmark Calculation Agent ("***BMCA***") who determines the value of the index, and the Benchmark Publisher.[31]

However, we believe that the Task Force should add the definition of "Benchmark Sponsor", which is the entity that designs the index and sets the index rules, owns the intellectual property ("***IP***") of the benchmark, and is ultimately responsible for the accuracy and reliability of the BM. Similar to the other functions, the benchmark Sponsor can often be an entity that is separate from the other defined entities.

While we believe that the separation between the various functions is needed, it is not clear whether the proposed principles appropriately differentiate between the requirements that should apply to the various parties. Also, we encourage the Task Force to clarify how the principles that are defined for the separate functions would apply if the functions are exercised by the same entity, and whether, in this case, each function would need to satisfy them separately.

<u>Principles of good conduct for benchmark setting</u>

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

In the wake of the Libor events, rapid and determined action needs to be taken by all stakeholders to restore confidence in the benchmarks that are widely used as reference in the financial markets. However, as part of this process it will be important to identify where the real issues lie, which products are most prone to such types of issues, and address the relevant issues in a targeted manner. In contrast, one should avoid indiscriminately classifying various products as Libor-type benchmarks.

We are generally supportive of approaches to the oversight of the benchmarking process that are principles-based and/or rely on an industry code of conduct. We believe that these approaches might represent the appropriate long term solution for many products that are in scope of this consultation. We believe that the Task Force's approach groups too many product types and activities together and may impose a high implementation burden on all participants involved in benchmarking process, particularly given that these principles might only apply for a limited period of time.[32] From the CP, it seems as if the Task Force requires each individual party that is involved in the benchmarking process to control and/or audit almost all other parties it deals with, in addition to the self-certification requirements for certain parties, e.g. benchmark Submitters and BMAs.[33] We believe that this level of requirements is excessive, particularly given that in numerous instances direct regulatory oversight of the relevant entities already exists, or is less warranted anyway as commercial BMAs will enforce sound practices in order to stay competitive in the marketplace. This would also cause any implementation to take more time and require significant resources which, we believe, is particularly problematic given that another regime is likely to be introduced in the not too distant future in any case.

We believe that, instead, the Task Force should pursue a proportionate, two-tiered approach resulting in a careful calibration of any regulatory regime. This can be achieved by exposing only Category A Libor-type benchmarks to direct regulatory oversight, which should be coupled with the ability of regulatory authorities to persuade firms to contribute to these BMs if needed.[34] We believe that for products in Categories B and

[31] ESMA and EBA Consultation Paper: Definitions.
[32] "As such they provide benchmarks users, benchmark administrators, calculation agents and publishers and contributing firms with a common framework to work together and provide a glide path to future obligations that are likely to be binding. ESMA and EBA Consultation Paper: Legal basis.
[33] "A contributing firm should publicly disclose a confirmation by the management of the relevant entity of compliance with the above principles." ESMA and EBA Consultation Paper: Principles for firms involved in the benchmark data submissions, paragraph B.11. "A benchmark administrator should publicly disclose a confirmation by the management of the relevant entity of compliance with the above principles." ESMA and EBA Consultation Paper: Principles for benchmark administrators, paragraph C.14.
[34] "We reserve the right to consider requiring firms to submit to LIBOR if we begin to have concerns that the continuity of LIBOR, or a particular currency panel, is at risk or the size of the a particular currency panel is not sufficiently representative." FSA

C direct regulatory oversight is less warranted, and the Task Force should therefore rely on market forces driving Code of Conduct and transparency requirements for these instruments as they will need to stay competitive in the marketplace. It is worth noting that some specific industry principles have recently been proposed and provide a good starting point for further discussions.[35]

General considerations (Par. 21 – 25)

- **Types of data used to calculate benchmarks**

We welcome the Task Force's acknowledgement that many different data sources can be used as basis for a benchmark. We agree that transaction data may be considered to be "more objective and easily verifiable,"[36] and that comparatively more effort is required in this respect when other types of data are used.[37] The Task Force further stated[38] that those benchmarking mechanisms that use "estimated rather than transaction-based data" may require more discretion and the estimate "may be more susceptible to conflicts of interest and manipulation."[39]

However, in this context the Task Force should note that cases of manipulation of transaction prices are not isolated events. Further, we believe that any rules-based benchmark calculation methodology that is purely mechanical and excludes the use of expert judgment would be prone to manipulation.[40] Additionally, the checks imposed on such procedures are likely to be less stringent than for benchmarks that are based on more subjective inputs. We are therefore supportive of the Task Force's proposal[41] for the use of carefully designed hierarchies of a wide range of data sources, which could include non-transactional data and allow for the use of expert judgment where appropriate. We believe that such approach would be beneficial as it could be flexibly applied to a broad range of benchmarks and indices across asset classes as well as over time in varying market conditions.[42]

- **Panel size**

We support the Task Force's view[43] that variations in the number of relevant inputs or contributions are common not only for "survey-based" and "panel-based"[44] but also for transaction-based benchmarks.[45] Our experience in operating contribution-based pricing services for a variety of indices and financial instruments

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Consultation Paper, Section 4.24. "Banks, including those not currently submitting to LIBOR, should be encouraged to participate as widely as possible in the LIBOR compilation process, including if necessary, through new regulatory compulsion." Wheatley Review of LIBOR, Section 5.19 and 5.28.

[35] GFMA Principles for Financial Benchmarks. 30 November 2012.

[36] ESMA and EBA Consultation Paper: Types of data used to calculate benchmarks.

[37] ESMA and EBA Consultation Paper: Types of data used to calculate benchmarks, paragraph 23.

[38] ESMA and EBA Consultation Paper: Types of data used to calculate benchmarks, paragraph 23.

[39] ESMA and EBA Consultation Paper: Types of data used to calculate benchmarks.

[40] This is because any potential manipulator will find it easier to analyze the impact that certain submissions will have and decide how to skew its submission in order to achieve the desired BM level as a result.

[41] ESMA and EBA Consultation Paper: Types of data used to calculate benchmarks, paragraph 23.

[42] For example in the asset classes of fixed income and derivatives indices individual instruments do not trade on a regular basis and many not even trade every day. The use of transactional data for the pricing of the components of many of Markit's indices will therefore, in many instances, not be feasible and/or the reliability of this data as a sole input will not be sufficient. As a result, index construction in these asset classes needs to largely rely on additional pricing inputs many of which are not directly observable in the market. For bond indices, for example, it is through the use of evaluated bond prices and/or contribution-based prices that the consistent, objective, and timely calculation of indices can be achieved, despite the fact that transactions do not take place on a regular basis for many bonds. In practice, we calculate daily levels for the Markit iBoxx bond indices based on multi-contributor pricing from market makers for the underlying bonds. We verify these contributed bond prices against transaction data and other pricing sources, where available, to ensure accuracy based on best practices that have been established within each region.

[43] ESMA and EBA Consultation Paper, paragraph 24.

[44] The Task Force should note that the term "survey-based" does not seem applicable to the majority of the relevant indices and benchmarks, while the term "panel-based" seems too generic. We recommend distinguishing between "survey-based" mechanisms, where submitters provide an opinion, estimate or view, and "contribution-based" mechanisms, where submitters provide a specific number or price that they derived from various inputs. We use the term "contribution-based" throughout our response, as we believe it more accurately describes the nature of the information that we collect for our indices.

[45] ESMA and EBA Consultation Paper: Types of data used to calculate benchmarks.

has shown that there is indeed an optimal panel size at any moment in time, and that increasing the size of a contributor panel per se does not automatically improve the quality of the pricing, and sometimes might have the opposite effect.[46] We believe that the optimal panel size for a contribution-based benchmark will depend on the number of parties that are active in the underlying market. Equally, the decision whether further contributors should be added to a given panel should depend on whether firms that are not panel members are likely to contribute independent, accurate and knowledgeable information. Finally, the optimal size of the panel will not be static and it will be important to review panel membership on a regular basis in order to reflect changes in the relevance and activity of the contributors.

A. General framework for benchmarks setting

Question 3. General Principles for BMs: Do you agree with the principles cited in Section A? Would you add or change any of its principles?

The Task Force proposed a set of principles applying to benchmarks that include methodology, governance structure, supervision, transparency, and continuity.

We believe that these principles, and the underlying details for each of those, are generally sensible. However, some elements seem too broad and could easily lead to unintended results. Also, some requirements are not sufficiently clear in terms of how compliance could be achieved.

A.1 Methodology

The Task Force states that "actual market transactions should, as a matter of preference, be used as a basis for a benchmark, where appropriate."[47] Although we appreciate that the Task Force acknowledges that market transaction data may not always be appropriate, we believe it also needs to recognize that actual market transactions may not always be available. The data inputs that are used for the calculation of benchmarks and index products generally depend on the structure and liquidity of the underlying market. For example, compared to other asset classes, liquidity in the bond and OTC derivatives markets is limited and the majority of trading occurs bilaterally outside of exchanges or trading venues. Index providers for these asset classes can therefore rely on transaction data only to a limited extent and will often have to use contributed pricing or a variety of alternative pricing sources instead.

Our experience has shown that a number of factors need to be considered by the sponsor to ensure the integrity of voluntary submissions to indices/benchmarks:

- **Data accuracy**

We agree with the Task Force that the BMA should establish mechanisms that help maintain the accuracy of individual benchmark submissions and enhance the integrity of the benchmark.[48] However, we believe this principle would apply not only to contribution-based inputs but to *every* input into a benchmark, regardless of its nature. To the extent that relevant information beyond the actual submissions is available, the BMCA should use this information to corroborate submissions in conjunction with employing sophisticated and robust cleansing techniques. Specifically, for Markit's European bond indices, we derive pricing of the index constituents from contributed quotes that are submitted by active market makers in the relevant markets[49] and we validate this data against end-of-day book-of record prices. For Markit's US bond

[46] Simply adding further contributors to a panel will often result in reducing the quality of the resulting index, not improving it. For example, for a product with only 5 active market makers, the goal of the index sponsor should be to encourage those 5 firms to contribute to the service. Adding a further 5 contributors that are not market makers and do not follow the market on an ongoing basis will only add "noise" to the composite price and reduce its quality and informational content.
[47] ESMA and EBA Consultation Paper: General framework for benchmarks setting
[48] "A framework for any benchmarks-setting process should include the following principles in order to instill confidence in financial markets and market participants, and guarantee the necessary accuracy and integrity for the benchmark formation process." ESMA and EBA Consultation Paper: Principles of good conduct for benchmark setting.
[49] Relevant markets from an index perspective are the market segments from which the index constituents are drawn.

indices, where post-trade transparency exists for the underlying market, we derive pricing of the index constituents from a variety of sources that include TRACE[50] transaction levels, quotes and end-of-day book-of-record prices. These data inputs, coupled with the use of sophisticated pricing technology and specialist evaluators, form the basis for the production of accurate, transparent and timely pricing of the bonds underlying these indices.

- **Composition of submitting panels**

We agree with the Task Force in principle that a BMA is responsible for establishing "robust methodologies for the calculation of the benchmark", it should appropriately oversee its operations and it should make sure that "the appropriate level of transparency" is provided to the market regarding the rules of the benchmark."[51] We believe that the rules that govern participation in panels of contributors to benchmarks need to be transparent and result in panels that appropriately reflect the nature of the benchmark and ensure accurate representation of the relevant market segment. However, the Task Force should note that it will be very difficult, and highly subjective, to determine whether a panel is an appropriate reflection.

For the various indices that we sponsor, we generally work to ensure that contributor panels include the vast majority of the active market makers[52] in the underlying products. Our experience has shown that increasing the size of a contributor panel per se does not automatically improve the quality of the pricing, and sometimes might have the opposite effect.[53] We believe that the optimal panel size for a contribution-based benchmark will depend on the number of parties that are active in the underlying market. Equally, the decision whether further contributors should be added to a given panel should depend on whether firms that are not panel members are likely to contribute independent, accurate and knowledgeable information. Finally, the optimal size of the panel will not be static and it will be important to review panel membership on a regular basis in order to reflect changes in the relevance and activity of the contributors.

- **Use of discretion by the BMA**

We believe that the BMA's activities should largely rely on the methodology that has been specified in the control framework and has been made transparent to users of the index.[54] However, the Task Force should note that sometimes it will be necessary for the BMA to exercise discretion. For example, for indices that are subject to regular reviews to be "most representative" the Administrator may occasionally decide to postpone a roll date in view of unexpected or extreme market conditions.[55]

- **Representativeness of the benchmark**

We agree that a key element of a successful benchmark or index is that it adequately represents the market to which it refers, and measures the performance of a representative group of underlyings in a relevant and appropriate way. We believe that this is a key principle based on which those sponsors of benchmarks and indices that are commercial entities operate on.[56]

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[50] TRACE: Trade Reporting and Compliance Engine. TRACE is the Financial Industry Regulatory Authority's (FINRA) corporate and agency bond market real-time price dissemination service. More information on TRACE is available here.
[51] ESMA and EBA Consultation Paper: Principles for benchmark administrators.
[52] We consider active market makers to be institutions that are making two-way markets on a significant portion of the traded instruments in a market segment.
[53] Simply adding further contributors to a panel will often result in reducing the quality of the resulting index, not improving it. For example, for a product with only 5 active market makers, the goal of the index sponsor should be to encourage those 5 firms to contribute to the service. Adding a further 5 contributors that are not market makers and do not follow the market on an ongoing basis will only add "noise" to the composite price and reduce its quality and informational content.
[54] "The methodologies for the calculation of a benchmark, including information on the way in which contributions are determined and corroborated, should be documented and be subject to regular scrutiny and controls to verify its reliability." ESMA and EBA Consultation Paper: General framework for benchmarks setting.
[55] For example, at the time of the Lehman default, Markit as the index sponsor deemed it appropriate to delay the roll of the various Markit CDX products in order to maintain liquidity in the product.
[56] ESMA and EBA Consultation Paper: General framework for benchmarks setting

However, we respectfully disagree with the Task Force's view that "the underlyings should be sufficiently liquid".[57] We believe that such requirement would be inconsistent with the needs of the marketplace where many benchmarks and indices are created specifically to add transparency to the less liquid sectors of the financial markets. Further, the Task Force should consider that even markets that are liquid today might become illiquid at some point in the future. As discussed in the ESMA and EBA public hearing, we would therefore encourage the Task Force to modify this Principle as such that BMAs shall provide users of the benchmark with "sufficient transparency about the liquidity of the underlying market".

We appreciate that the Task Force recognizes that actual market transactions should be used only "where appropriate".[58] However, we would recommend adding "and available" to clarify that the ability for different types of data to be used will depend on the individual circumstances.

A.4 Transparency

We generally agree with the transparency-related Principles that the Task Force proposed.[59] However, we believe that some of them would benefit from some further clarification.

For example, the Task Force states that a benchmark should be designed to provide "fair and open access to it."[60] We believe that the Task Force should further clarify its intentions in this respect, and specifically what kind of access it had in mind. Additionally, the Task Force proposed that "the full methodology should be disclosed wherever possible. Where this is not possible, the relevant information such as weightings and prices of components should be disclosed prior to any rebalancing."[61] The Task Force should note that such requirement would raise intellectual property concerns because, for example, BMAs often do not own the intellectual property rights for the underlying BM components and would hence not be in a position to display them. Finally, we believe that the Task Force should clarify the disclosure principles in this respect, i.e. whom would the methodology need to be disclosed to? Does this information need to be available to the public or to users of the BM and at what terms? We believe it would be adverse to the development of reliable and high-quality BMs to adopt principles that deteriorate the commercial value of creating good benchmarks for their sponsors.

B. Principles for firms involved in benchmark data submissions (where relevant for a benchmark)

Question 4. Principles for firms involved in BM data submissions: Do you agree with the principles cited in section B? Would you add or change any of the principles?

The Task Force proposed that Submitters to benchmarks establish internal policies covering the submission process, governance, systems, training, record keeping, compliance, internal controls, audit and disciplinary procedures. It also expects them to create effective organizational and administrative arrangements to avoid conflicts of interest.

We further believe that BM Submitters should be required to provide the relevant data underlying their submissions to the BMA if so requested by the BMA. This is because access to this data will allow the BMA to validate or question submissions on the level of the individual Submitter with much more confidence and to perform sophisticated analysis on a higher level across the various Submitters. However, the Task Force should recognize that Submitters sometimes might not be in a position to submit all relevant data, for example for confidentiality reasons. Also, the amount of data might sometimes surpass the ability of the BMA to receive it, particularly if some underlying information is of more qualitative nature and cannot be processed easily. Submitters should therefore only be required to submit all input data to the BMA if and where so requested by the BMA.

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[57] ESMA and EBA Consultation Paper: General framework for benchmarks setting
[58] "Actual market transactions should, as a matter of preference, be used as a basis for a benchmark, where appropriate."[58]
[59] ESMA and EBA Consultation Paper: General framework for benchmarks setting.
[60] ESMA and EBA Consultation Paper: General framework for benchmarks setting.
[61] ESMA and EBA Consultation Paper: General framework for benchmarks setting.

B.8 Transaction Data

The Task Force noted that the controls performed on the data submitted should include "comparisons with actual, transaction-based, verifiable data."[62] In line with our above comments for Question 3, we believe that the Task Force should add "where available and appropriate" to acknowledge that different types of data may be the preferred source of information depending on asset class, product and circumstances.

The principles further mention that "any reverse transaction" subsequent to a submission should be recorded. We encourage the Task Force to clarify what is meant by "reverse transaction" [63] and by "recorded" as we believe these aspects are not entirely clear.

B.11 Self certification

The Task Force proposed to require Submitters to publicly disclose a confirmation by the management of the relevant entity of compliance with the above principles. We respectfully advice the Task Force against establishing such requirement as we believe it is unnecessary on the one hand, and could cause significant harm to the functioning of existing benchmarks on the other.

We believe that, if implemented as proposed, this requirement could have a detrimental impact on various contribution-based services. We sympathize with the comments that were brought forward during the ESMA and EBA public hearing that certain contributors[64] would not submit themselves to these requirements and would hence simply stop contributing to the various benchmarking services. Instead, we believe that the Task Force's objectives of ensuring compliance with its principles can be achieved via effective supervisory oversight of regulated entities that are users of benchmarks or are involved in the benchmarking process.

C. Principles for benchmark administrators

Question 5. Principles for BMAs: Do you agree with the principles cited in section C? Would you add or change any of the principles?

The Task Force proposed that BMAs should be required to have robust methodologies in place for the calculation of benchmarks and provide an appropriate level of transparency, establish governance and compliance functions operating effectively. [65] They should further establish sufficient internal control mechanisms, effective whistleblowing mechanisms, and, when outsourcing certain functions, retain adequate access and control.

We believe that these requirements are generally appropriate. However, in relation to the requirements to "fully disclose methodology" it is not clear what "where this is not possible" means. We believe that this could depend on the interpretation by the individual BMA which could easily lead to an unlevel playing field between BMAs and raise concerns about the protection of IP.

We believe that the Task Force's expectations in relation to the BMA's governance/compliance functions,[66] as discussed in more detail below, are overly demanding and would likely create excessive liabilities for the BMA. For example, the Task Force should keep in mind that BMAs are typically not auditors, and they can not be expected to "ensure" the quality of a benchmark.

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[62] ESMA and EBA Consultation Paper: Principles for firms involved in benchmark data submissions.
[63] "Any reverse transaction subsequent to a submission should be recorded." ESMA and EBA Consultation Paper: Principles for firms involved in benchmark data submissions (where relevant for a benchmark).
[64] The speaker explicitly mentioned the example of state-owned enterprises in China, Russia, or Saudi Arabia.
[65] ESMA and EBA Consultation Paper: Principles for benchmark administrators.
[66] ESMA and EBA Consultation Paper: Principles for benchmark administrators.

Finally, we believe that there is no need for the Task Force to require a public self-certification from the BMAs as implementation of the Principles can be achieved in a much more effective and less costly manner by benchmark users demanding it from BMAs directly, coupled with oversight of these users and regulated entities that are involved in the benchmarking process.

Oversight Committee

We are supportive of the Task Force's preference for the OC to contain "independent" members.[67] However, it should realize that it will be very challenging for the various BMAs to find a large number of independent experts that are committed to being members of an OC, particularly if all BMAs were trying to implement such requirement at the same time. We therefore believe that the Task Force should not require for the number of independent members to be a majority on the OC.

Additionally, the Task Force proposed that the BMA should "ensure" that the principles that apply to the contributing firms are implemented in order to prevent any misconduct. As explained above, we believe that the use of the term "ensure" creates the impression as if the BMA had to perform auditor-type functions, which BMAs are generally not in a position to. We therefore recommend using "establishes policies and procedures to reasonably believe" instead.

Use of expert judgment

The Task Force proposed[68] that the BMA's methodologies should "limit the use of judgment and qualitative assessments as much as possible". We respectfully disagree with this Principle. We believe that expert judgment must play an important role in the context of any contribution-based service, even if transaction levels are available. The Task Force should note that the relevance of the use of expert judgment has been explicitly recognized by other regulatory authorities.[69] We therefore believe that the Task Force should require methodologies to be established for benchmarks that contain well-defined criteria for their calculation, so that the need for the use of judgment and qualitative assessments or other opportunities for discretionary decision making is limited to the extent possible.

Transaction prices

We believe that it would be a mistake for the Task Force to assign absolute primacy to transaction prices and require them to dominate the submissions into BM pricing across asset classes, products, and market conditions. Generally, the decision on which data sources a BM calculation should ideally be based upon, amongst other factors, the nature of the underlying market, whether transactions take place on a regular basis, whether post-trade price transparency is available, the type and granularity of data available,[70] and the quality and usability of the various available data sources. Any requirements for benchmarks to prioritize certain categories of data sources as inputs must therefore be sufficiently flexible to allow benchmark sponsors to reflect the idiosyncrasies of the asset class and adjust to changes in market conditions where necessary. We also believe that this flexibility is needed to avoid stifling competition in the marketplace to create high quality and reliable products that provide investors with the tools they need.

Transparency (C.6, C.8)

We are supportive of the Task Force's goal of creating a sufficient level of transparency for stakeholders and users of benchmarks.

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[67] ESMA and EBA Consultation Paper: Principles for benchmark administrators.
[68] ESMA and EBA Consultation Paper: Principles for benchmark administrators.
[69] HM Treasury The Wheatley Review of LIBOR Final Report. September 2012.
[70] For example, price, number of trades and type of trade.

However, we share the concern that has been voiced by some stakeholders in relation to the proposed requirement for BMAs to "fully disclose the methodology."[71] As discussed above, we believe that requiring this information to be made publicly available would likely compromise the BMA's IP rights and, in turn, harm innovation and competition in the universe of benchmarks.

We are further concerned about the proposed requirement for the BMA to "record and post minutes of relevant meetings along with details of the interactions between its oversight function on the one hand and contribution firms and benchmark calculation agents on the other."[72] We feel that this requirement is not only impractical and excessive but would also add only limited value. We therefore encourage the Task Force to clarify the purpose of such requirement and make it less onerous to comply with.

D. Principles for benchmark calculation agents

Question 6. Principles for BMCAs: do you agree with the principles cited in section D? Would you add or change any of the principles?

We generally believe that the proposed principles for BMAs are sensible.

As Calculation Agent for the Markit iBoxx indices we require market makers to contribute bond prices on a daily or more frequent basis[73] to us in order to ensure the timely calculation of the index levels.[74] Our agreements prescribe technical standards that our Contributors are expected to conform with when submitting their data to us. Such standards were designed to ensure the uniformity of the data and to minimise the potential for errors. Once received, we will apply a number of cleaning tests to the contributed dataset including its comparison to data sources that are available externally.

As part of our standard process and in an effort to ensure high quality of data we are in regular contact with the Markit iBoxx contributors and provide them with feedback on the quality of their submissions. This communication is facilitated by the provision of weekly and monthly data quality reports and regular management review meetings.

The Task Force proposed that a BMCA should "implement and maintain systems for pre- and post-submission control that are adequate to ensure consistent and timely benchmark computation."[75] We are not sure how a BMCA, given that it receives submissions from the contributors or other sources, could perform any control pre-submission. We suspect that the Task Force refers to pre- and post-publication of the benchmark levels or pre- and post submission to the BM Publisher respectively and encourage the Task Force to further clarify this aspect.

E. Principles for users of benchmarks

Question 8. Principles for users of BMs: Do you agree with the principles cited in section F? Would you add or change any of the principles?

We believe that, similar to the approach that ESMA has taken in relation to the regulation of financial indices,[76] imposing requirements on providers of benchmarks via their users that are regulated entities, might be a sensible approach to implement certain requirements in a timely manner. However, we believe that it might be difficult to achieve a full reach across all relevant Category A benchmarks via this approach.

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[71] Open Hearing on ESMA/EBA consultation paper on Principles for Benchmarks-Setting Processes in the EU.
[72] ESMA and EBA Consultation Paper: Principles for benchmark administrators.
[73] Depending on the index family, contributions will be submitted on a real-time, intra-day or end-of-day basis.
[74] A detailed description of the Markit iBoxx bond price contribution process is available here.
[75] ESMA and EBA Consultation Paper: Principles for benchmark calculation agents, paragraph D.3.
[76] "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 target market." Section F: Principles for users of benchmarks. ESMA and EBA Consultation Paper: Principles for Benchmarks-Setting Process in the EU. 11 January 2013.

For Category B and C instruments, we believe that market participants already drive the quality of indices as index sponsors must provide for users' needs in order to stay competitive.

As discussed above, we are concerned about the Task Force's use of the phrase "ensure", also in the context of how it defines the responsibilities of the benchmark users.[77] We believe that this is too high a demand for benchmark users, and wonder why the Task Force believes that achieving compliance with the Principles could not be achieved through other means. In any case, we suggest that the Task Force replaces "ensure" with "reasonable due diligence" to achieve similar results.

Adequacy of the principles to any benchmark-setting process

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

With the CP having a wide scope and discussing both benchmarks and indices, the Task Force should note that many of the issues it raised will not necessarily be applicable to all products that are in scope of the report. For example, whilst governance and methodology issues are relevant to the determination of the composition of traded indices, the index price might not be calculated by the index sponsor but set bilaterally between counterparties to each transaction. The discussion about challenges in relation to contributions, methodology, and contributors will therefore not be relevant for these products.[78]

Further, as we have explained in detail above,[79] we believe that the Task Force should ensure that a regulatory regime for benchmarks is proportionate and effective in achieving the regulatory objectives. It should also not be unnecessarily burdensome to result in discouraging firms that are currently submitters from contributing to these products. To achieve these goals the regime should be carefully calibrated and proportionate. Specifically, Category A instruments should be regarded as in scope if they are "widely referenced in financial contracts". This could be coupled with the ability of regulatory authorities to persuade firms to contribute to the BM if needed to secure market functioning.[80] The Task Force should note that, given that most indices are based upon a large number of components, Category B and C products are only to a much more limited degree exposed to the challenges that exist for Category A products, e.g. the potential for manipulation. We believe that for products in Category B and C direct regulatory oversight is therefore less warranted, and ESMA and EBA should rely on market forces driving these instruments' code of conduct and transparency requirements as they will need to stay competitive in the marketplace. The Task Force should note that some specific industry principles benchmarks have already been proposed that could be used as a basis for further discussions.[81]

Legal continuity

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

We believe that Category A Libor-type benchmarks should generally be subject to more demanding expectations in respect of their continuity given their relevance to determine cash flows of products that may remain outstanding for many more years. In contrast, for Category B type indices transition issues are of a different nature and seem generally less problematic. We also believe that, when determining appropriate

[77] ESMA and EBA Consultation Paper: Principles for users of benchmarks.
[78] This applies, for example, to the traded CDS indices Markit iTRAXX and Markit CDX.
[79] See our response to Question 1 above.
[80] "We reserve the right to consider requiring firms to submit to LIBOR if we begin to have concerns that the continuity of LIBOR, or a particular currency panel, is at risk or the size of the a particular currency panel is not sufficiently representative." FSA Consultation Paper, Section 4.24. "Banks, including those not currently submitting to LIBOR, should be encouraged to participate as widely as possible in the LIBOR compilation process, including if necessary, through new regulatory compulsion." Wheatley Review of LIBOR, Section 5.19 and 5.28.
[81] GFMA Principles for Financial Benchmarks. 30 November 2012.

measures to achieve continuity of a benchmark, one needs to distinguish between cases of the transfer of an existing BM to a new BMA and the transfer to a different BM that is provided by a competing BMA.[82]

The transfer of an existing benchmark to a new BMA, i.e. the process that is currently performed for LIBOR, should generally be straightforward to handle, as long as there is no link to a specific BMA in the contracts that are referencing the BM. We believe that often a period of 6 months will suffice to transfer the existing benchmark to a new Administrator. This conclusion is based on our view that typically several providers possess the required operational capabilities to act as BMA and that, once the code of practice and the relevant contribution procedures have been established, they can continue to be used regardless of any changes to the BMA. Consequently, the major issues to be addressed during a transition period would be the process of choosing the new BMA and the benchmark submitters switching their data feeds to it once it has been chosen. We believe that these tasks could be completed within a period of up to 6 months.

Indices are used mainly for current needs and most of their users will already have standard review processes in place that would allow them to switch to another index if and when needed. Also, in many instances a number of close substitutes that provide a very similar exposure to the indices used will be available already. Finally, the transition from one index that is used for performance attribution to another generally does not have a direct economic impact or trigger any cash flows, unlike the transition from one Libor-type BM to another. That said we believe that the issues of transition and living are generally less relevant for indices compared to BMs.

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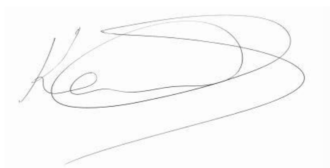
Markit appreciates the opportunity to comment on the Task Force's Consultation Paper on *Principles for Benchmarks-Setting Processes in the EU.* We would be happy to elaborate or further discuss any of the points addressed above. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com.

Yours sincerely,



Kevin Gould
President
Markit

[82] This would be the current Libor/BBA situation.