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Benchmark Regulations: What does it mean for funds?

Background

In the wake of various scandals involving the manipulation of interest rate benchmarks such as the LIBOR and EURIBOR, the European Commission has introduced a new regulatory regime governing the provision of, contribution to and use of benchmarks within the EU. While provisions relating to the mandatory administration and contribution to "critical" benchmarks have applied since 30 June 2016 the Benchmarks Regulation (the "BMR") takes effect in each Member State on January 1, 2018, subject to some important transitional arrangements as outlined below.

While funds would not typically be providers of benchmarks or contributors to benchmarks, they may be subject to certain provisions of BMR if they are "users" of benchmarks. The rules relating to use of a benchmark are imposed on "supervised entities" which is defined in the BMR as including UCITS, UCITS management companies and AIFMs.

What follows is a brief overview of the implications for any in scope fund that is deemed to be a "user" of a benchmark within the provisions of the BMR.

What is a benchmark?

The BMR defines a benchmark as any index by reference to which the amount payable under a financial instrument for which a request for admission to trading on a trading venue has been made or which

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is traded on a trading venue or a financial contract (essentially, EU consumer credit agreements and residential mortgages), or the value of a financial instrument, is determined, or an index that is used to measure the performance of an investment fund with the purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees.

The BMR defines an "index" as meaning any figure:

(a) that is published or made available to the public; and

(b) that is regularly determined:

(i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and

(ii) on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes or other values or surveys.

The European Commission has provided guidance on what is meant by "published or made available to the public" in the Commission Delegated Regulation on technical elements of the definitions set down in the BMR. The Commission has provided that a figure shall be considered to be made available to the public where the figure is made accessible to a potentially indeterminate number of persons either directly or indirectly as a result, inter alia, of its use by one or more supervised entities as a reference for a financial instrument it issues or to determine the amount payable under a financial instrument or a financial contract, or to measure the performance of an investment fund, or to provide a borrowing rate calculated as a spread or mark-up over such figure. The Commission Delegated Regulation also provides that access may take place in a variety of ways, free of charge or upon payment of a fee, including, but not limited to, telephone, file transfer protocol, internet, open access, news, media, through financial instruments, financial contracts or investment funds referencing the figure or by way of request to the users. Therefore, the requirement to be "published or made available to the public" can be met by the provision of a figure to a single supervised entity for its use in the aforementioned manner.

There are a number of entities and arrangements that are out of scope, including central banks, central counterparties (CCPs), where they provides reference prices or settlement prices used for CCP risk-management purposes and settlement and the provision of a single reference price for any financial instrument.

Am I a benchmark user?

Firstly it will be necessary to determine whether the fund "uses" a benchmark within the meaning of the BMR.

Where a fund uses a benchmark to measure its performance for the purpose of (i) tracking the return of the benchmark, (ii) defining the asset allocation of the portfolio or (iii) computing performance fees payable by it, such use will fall within the provisions of the BMR.

A fund may also be considered to use a benchmark where it enters into a derivative contract (the underlying of which is a benchmark) which is traded on a trading venue unless the terms of that contract are set by (i) the trading venue on which the derivative is being traded, (ii) the counterparty where that counterparty is an investment firm acting as a systematic internaliser or (iii) the CCP clearing the relevant trade.

What are the implications if I am I a benchmark user?

Benchmark administrators must comply with the BMR regime

Subject to some important transitional arrangements, a benchmark can only be "used" by a fund within the meaning of the BMR if:

(i) In the case of an EU index provider, the index provider is authorised or registered with ESMA as a benchmark administrator; or

(ii) In the case of a non-EU index provider, certain equivalence, recognition or endorsement procedures have been complied with.

The applicable transitional arrangements will depend on whether the index provider is located in the EU or outside of the EU and the date on which it first began providing benchmarks in the EU. By way of example only, the ESMA Q&A on the BMR on the BMR makes clear that EU index providers that were providing benchmarks in the EU on 30 June 2016 will have until 1 January 2020 to apply for authorisation or registration under the BMR and during this period, funds may continue to use benchmarks provided by such index providers.

Written Contingency Arrangements

Users of benchmarks must also put in place certain written contingency arrangements setting out the steps which will be taken in the event that the benchmark ceases to exist or materially changes. Where possible and appropriate, these arrangements should identify a replacement benchmark and explain why such replacement benchmarks are deemed suitable. The BMR requires that these contingency arrangements should be reflected in contracts with clients.

These contingency arrangements must be in place by 1 January 2018 and must be provided to the Central Bank upon request.

Prospectus Disclosures

Where the prospectus of a UCITS fund references a benchmark, the prospectus must include information on whether the index provider complies with the BMR. This disclosure must be included in the prospectus of all new UCITS authorised on or after 1 January 2018. Existing UCITS must incorporate such disclosure the next time they are updating their prospectuses after that date and in any event no later than 1 January 2019.

No equivalent disclosure requirements are imposed on AIF funds under the BMR.

Action to be taken by affected firms

Firstly it will be necessary to determine whether or not the fund is "using" any benchmarks within the meaning of the BMR.

If the use of the benchmark falls within the scope of the BMR, the following steps should be considered:

(i) engage with the index provider to determine their plans to comply with the BMR;

(ii) prepare and put in place written contingency arrangements by 1 January 2018; and

(iii) if a UCITS fund, ensure that the relevant disclosures are included in the prospectus.

For further assistance in ensuring compliance with the BMR or if you have any questions in relation arising from this briefing, please contact your usual Dillon Eustace contact.

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