



Our ref: ICAEW Rep 26/13

Your ref: CR 01/13

Mr Alp Eroglu
International Organisation of Securities Commissions (IOSCO)
Calle Oquendo 12
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Spain

Via email: benchmarksconsultationresponses@iosco.org

Dear Alp,

ICAEW Rep 26/13 – Our response to CR 01/13 Financial Benchmarks

ICAEW is pleased to respond to your request for comments on *CR 01/13 Financial Benchmarks*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

CR 01/13 Financial Benchmarks

Memorandum of comment submitted in February 2013 by ICAEW, in response to the International Organisation of Securities Commissions (IOSCO) consultation report *Financial Benchmarks* published in January 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation report *CR 01/13 Financial Benchmarks* published by IOSCO on 10 January 2013, a copy of which is available from this link. <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD399.pdf>

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services including a monthly magazine *FS Focus*.

MAJOR POINTS

Support for the initiative

5. We support the initiative of the IOSCO in seeking to bring greater credibility to financial benchmarks through increasing integrity by further formalising the way in which benchmarks operate.
6. ICAEW's priority in this area is how the work of auditors can help support confidence in financial benchmarks. Over the past months we have particularly focussed on the integrity of LIBOR, primarily through the provision of assurance over LIBOR submissions and compilation as required by regulation and demanded by the market in the future. To this end ICAEW has published an *Exposure Draft and Interim Guidance for the Performance of Assurance Work on Benchmarks and Indices*¹ in February 2013.

Other considerations

7. When considering a framework for benchmark submission, particularly in the case of a complex benchmark like LIBOR, it must be borne in mind that judgements have to be made, even in fully liquid markets. For example trades made, even in high volume, may not be representative of the definition due to size or counterparty for example. As such those responsible for submission make judgements about the adjustments required to use actual trade data to meet the LIBOR definition, which adds inherent complexity to the process.

¹ <http://www.icaew.com/~media/Files/Technical/Financial-services/icaew-03-13fsf-guidance-for-assurance-on-benchmarks-and-indices-final.pdf>

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Q1: Do you agree with the scope of the report and intended audience? Are there other Benchmarks or stakeholders that have idiosyncrasies that should place them outside of the scope of the report? Please describe each Benchmark or stakeholder and the idiosyncrasies that you identify and the reasons why in your view the Benchmark or stakeholder should be placed outside of the scope of the report.

8. We agree with the scope of the report. We do not feel there are any obvious omissions with regard to idiosyncratic benchmarks or stakeholders which would impact the scope of the report.
9. An issue which needs to be further explored in the discourse of financial benchmarks is the business model for administrators. There is a strong 'public' good aspect to at least some benchmarks, for example LIBOR which is embedded within the financial system. Given propose new and enhanced responsibilities of administrators they must be able to capture revenue from the benchmark to meet the costs of providing it.

Q2: Do you agree that the design of a Benchmark should clearly reflect the key characteristics of the underlying interest it seeks to measure?

10. As a general rule, yes, a benchmark should clearly reflect the key characteristics [as set out in Exhibit 2, page 12 of CR01/13] of the underlying interest it seeks to measure. However, the design should not be so rigid so as to reinforce negative effects, should the underlying market or interest suffer problems (e.g. the impact of liquidity drying up had on LIBOR). For example, an insistence on observing a minimum number of actual trades could be problematic if markets become illiquid.
11. There are inherent tensions with respect to financial benchmarks between transparency and stability. Where the LIBOR process was highly transparent (with individual submissions being published on a daily basis) this facilitated signalling amongst banks and market participants which destabilised the market.
12. A policy decision may need to be made particularly with regard to transparency in systemically important benchmarks with systemically important submitters.
13. Market concentration would also need to be considered carefully. Banking in the UK, for example, is a quite concentrated market, and additional submitters would not necessarily increase the quality of LIBOR.

Q3: What measures should Administrators take to ensure the integrity of information used in Benchmark-setting and that the data is bona-fide? Please highlight any additional measure required where Benchmarks are survey based. Please also comment on each of the factors identified in the discussion on the vulnerability of data inputs such as voluntary submission, and discretion exercised by Administrators. Are these measures adequately reflected in the discussion of roles and responsibilities of the Administrator discussed in section E?

14. The enacted rules must be sufficiently clear and precise to avoid an 'expectations gap' (similar to that found within any audit or assurance engagement) about what the administrator of the benchmark is or is not accountable for.
15. Some of the rules proposed in the FSA consultation paper 12/36 *The regulation and supervision of benchmarks*² for example, have the potential to significantly increase the time requirement and cost of administering a regulated benchmark. In particular, the administrator requirement to '*Corroborate the submissions of individual submitters, identify breaches of*

² <http://www.fsa.gov.uk/static/pubs/cp/cp12-36.pdf>

submission practice standards, and notify the FCA when it suspects attempted or actual manipulation.' (para 2.5) needs to be clearly understood and defined.

16. The standard of 'corroboration' could vary greatly, from the benchmark administrator questioning outliers or submissions which deviate from that of the previous day with no discernible reason, to an audit style corroboration of vouching the submission made to source documents or calculations made by the submitter. Depending on who becomes the administrator, there may be pre-existing relationships which give rise to a conflict of interest if there is a high standard of corroboration required.
17. Given that corroborating submissions is a significant expansion of the role of the administrator and likely to be costly, as well as attracting potential liability, it may deter potential administrators.
18. Such corroboration processes are more likely to be associated with closed access 'pay to play' type benchmarks, which are very much opposite to the way in which LIBOR is used by the wider market. These requirements may also place inherent limitations on the type of firms which would be able to become administrators, for example accounting firms would be unlikely to be able to do so due to their independence requirements.
19. We consider the FSA's suggestion of quarterly publishing of aggregated statistics to be an improvement to current practice. It should promote greater stability by reducing the signalling effect of daily publication of named submissions.

Q4: What measures should Submitters implement to ensure the integrity of information provided to Administrators? Are the measures adequately reflected in the discussion of a code of conduct for Submitters discussed in section E.? In particular, should Submitters submit all input data, and not a selection of such data so as to maximise the representation of the underlying market? Please comment on any practical issues that compliance with such an approach may give rise to.

20. We believe the code of conduct described in section E provides a good starting point in terms of measures submitters could implement to ensure integrity of information provided to administrators.
21. We would further advocate submitters outlining a comprehensive set of control objectives which would support and underlie a higher level code of conduct. An example of what such control objectives might look like can be found within our recently published '*Exposure draft and interim guidance for the performance of assurance work on benchmarks and indices*'.³ A code of conduct would speak to the behaviour required of the submitter, whereas a clear set of control objectives are practical, assisting organisations and individuals in the execution of their duties in a way that complies with a code.
22. It may be the case for many benchmarks that the submission of all input data as opposed to a selection would lead to less timely provision of calculated benchmarks and be onerous on the administrator. The FSA in their consultation on the regulation and supervision of benchmarks⁴ proposed that the submitter send to the administrator, along with their submission, all the data and calculations used in the production of that submission. We presume this is to allow the required corroboration of submissions by the administrator. This does however raise issues around the sharing of commercially sensitive data, and of data security, amongst other things, all of which will add, not insignificantly, to the cost of the benchmark. We would encourage the regulator consider the processes around this and how they would like the administrator to deal with the large volumes of information.

³ <http://www.icaew.com/~media/Files/Technical/Financial-services/icaew-03-13fsf-guidance-for-assurance-on-benchmarks-and-indices-final.pdf>

⁴ <http://www.fsa.gov.uk/static/pubs/cp/cp12-36.pdf>

Q5: What level of granularity with regard to the transparency of Methodologies would enable users to assess the credibility, representativeness, relevance and suitability of a Benchmark on an on-going basis and its limitations with respect to their intended use? Relevant factors could include; criteria and procedures used to develop the Methodology, type of data used, how data is collected, relative weighting of data used, how and when judgement is used, contingency measures (e.g., methods when transaction data is unavailable, etc.), publication of information supporting each Benchmark determination, etc. Please provide examples where you consider there are currently significant gaps in the provision of this information.

23. In principle high transparency is required to inspire confidence in the benchmark, but complete transparency is unlikely to be possible as there will most likely still be judgemental elements within the benchmark process, particularly with regard to submissions.
24. However, it may be appropriate for administrators not to reveal certain aspects of the calculation process if they consider that would reduce potential for manipulation.
25. What is considered to be an appropriate level of transparency will be highly dependent on the type of benchmark – systemically important or not – and the demands of users as well as the nature of participants.

Q6: What steps should an Administrator take to disclose to Market Participants and other stakeholders the contingency measures it intends to use in conditions of market disruption, illiquidity or other stresses?

26. Publication of a statement about use of contingency measures could still cause issues and unrest in the market. The steps that should be taken will depend upon the nature of the benchmark and the level of policy intervention deemed necessary. For example, it is assumed that regulators and governments would seek to be fairly interventionist with a systemically important benchmark like LIBOR.

Q7: What steps should an Administrator take to notify Market Participants of material changes to a Benchmark Methodology (including to Benchmark components) and to take their feedback into account?

27. We have no specific comments on this question.

Q8: How often should the Administrator review the design and definition of the Benchmark to ensure that it remains representative?

28. Stability and the length of benchmark referencing contracts should be taken into account when the Administrator considers the design and definition of a particular benchmark. It is hoped that design and definition would be fairly static in stable economies, however composition of contributors etc could be reviewed more frequently, for example on an annual basis.

Q9: The Consultation Report discusses a number of potential conflicts of interest that may arise at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties. Are there other types of conflicts of interest that have not been mentioned that you consider may arise? If so, how best should these conflicts of interest be addressed? Are the measures discussed in the Consultation Report sufficient to address potential conflicts of interests at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties?

29. We consider the conflicts of interest set out within the consultation to be comprehensive. The measures suggested should set out a sufficient framework, but more detail could be required. An example of what such control objectives might look like can be found within our recently

published '*Exposure draft and interim guidance for the performance of assurance work on benchmarks and indices*'.⁵ We believe that illustrative examples can facilitate higher quality.

Q10: Do you agree that the Administrator's oversight committee or other body could provide independent scrutiny of all relevant activities and management of conflicts of interest? Please comment if and why any different approaches might be appropriate for different kinds of Benchmarks. For example, where Administrators simultaneously act as the trade body for Submitters to the Benchmark. What is the minimum level of independent representation this committee or body should include?

- 30.** Yes, we believe this would be within the remit of an oversight committee. As with an audit committee for a listed company, arrangements will vary so as to be proportionate. The objective of the committee would be to act independently, and have a frank and open relationship with the benchmark regulator and external assurance provider, as well as having a good flow of information from management.
- 31.** The committee would certainly need a minimum number of independent members, requisite relevant and recent experience, sufficient resources and a level of remuneration sufficient to compensate them for their time and the onerous nature of the publicly high profile duties they will have to undertake, especially within the first few years of such arrangements being in place in view of the public interest in benchmarks due to recent scandals.

Q11: Should the Submitters establish accountability procedures to assess their compliance with operational standards and scrutiny of Benchmark submissions?

- 32.** Yes.

Q12: Are the measures discussed in the Consultation Report (e.g., Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure the accountability of the Submitters? Should additional mechanisms be considered?

- 33.** At ICAEW our primary focus with regard to benchmarks is the role that assurance practitioners can play in restoring trust and integrity to benchmarks. As such we would encourage IOSCO to consider our '*Exposure draft and interim guidance for the performance of assurance work on benchmarks and indices*'⁶ for a comprehensive consideration of how external requirements can assist in ensuring accountability.

Q13: How frequently should Submitters be subject to audits? Should these be internal or external audits?

- 34.** In order to ensure maximum accountability submitters should be subject to internal and external audits.
- 35.** The frequency of internal audits will depend upon what will be most effective taking into account the nature of the benchmark (is it published, daily, weekly, or annually for example, as well as taking into consideration the degree of discretion in submissions and the complexity of calculations) and could take into account what will facilitate a smoother external audit.
- 36.** In our considerations of LIBOR we have said that external audits should be annual which is congruent with the view taken by regulators (the FSA and the US CFTC) to date.

⁵ <http://www.icaew.com/~media/Files/Technical/Financial-services/icaew-03-13fsf-guidance-for-assurance-on-benchmarks-and-indices-final.pdf>

⁶ <http://www.icaew.com/~media/Files/Technical/Financial-services/icaew-03-13fsf-guidance-for-assurance-on-benchmarks-and-indices-final.pdf>

Q14: Are the measures discussed in the Consultation Report (e.g. complaints process, Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure the accountability of the Administrator? Should additional mechanisms be considered?

37. Yes, the measures are a good starting point. Additional mechanisms will depend upon the nature of the benchmark and its users' needs.

Q15: If recommended, how frequently should Administrators be subject to audits? Should these be internal or external audits?

38. See Q13 above. If an 'end to end' piece of assurance is required to give confidence in the final published benchmark, the Administrator will also require assurance, and this should be performed in cycle with submitter assurance periods to ensure coverage is congruent.

Q16: Is public self-certification of compliance with industry standards or an industry code another useful measure to support accountability? This approach might also contemplate explanation of why compliance may not have occurred. If so, what self-certification requirements would make this approach most reliable and useful to support market integrity?

39. Public self-certification is unlikely to support market integrity at a time of such low trust, but may be useful in the future.

Q17: The Consultation Report discusses elements of a code of conduct for Submitters. Are the measures discussed (e.g., adequate policies to verify submissions, record management policies that allow the Submitter to evidence how a particular submission was given, etc.) sufficient to address potential conflicts of interest identified or do you believe that other control framework principles should be added?

40. The elements discussed in the consultation report provide a good basis. We are of the belief that the code should be fairly simple and principles based.

Q18: What would be the key differences in the code of conduct for Benchmarks based on different input types, for example transactions, committed quotes and/or expert judgement?

41. A code of behaviours would not necessarily have to be different based on different input types as behaviours should be consistent. Wider ethos and tone at the top inspire more sustainable ethical behaviour than codified rules, especially at a time when tick box compliance has been proved ineffective.

Q19: What are the advantages and disadvantages of making Benchmark submissions a regulated activity?

Q20: What are the advantages and disadvantages of making Benchmark Administration a regulated activity?

42. The benefits of regulation will be dependent on the nature of the benchmark. Systemically important benchmarks could benefit from regulation. The test should be framed in the public interest, ie, does the public interest need protecting, is the cost of regulation proportionate, and can it be borne by the industry, as opposed to the public.

43. In principle it is preferable for the private sector to take responsibility for its actions, rather than relying on regulators to enforce high standards. However, in view of the scandals surrounding LIBOR, enhanced public regulatory scrutiny will be an important element in rebuilding trust.

Q21: Do you agree with the factors identified for drawing regulatory distinctions? What other factors should be considered in determining the appropriate degree of oversight of Benchmark activities (discussed in Chapter 3)? Please provide specific recommendations as to how the distinctions discussed in Chapter 3 should inform oversight mechanisms.

44. We agree that these are relevant factors.

Q22: What distinctions, if any, should be made with regard to Benchmarks created by third parties and those created by regulated exchanges?

45. It is possible that some economy can be made in regulatory burden and costs where a Benchmark is calculated by a regulated exchange.

Q23: Assuming that some form of enhanced regulatory oversight will be applied to an asset class Benchmark, should such enhanced oversight be applied to the Submitters of data as well as the Administrator?

46. The FSA in the UK has proposed that the FCA will directly regulate individual LIBOR submitters.

Q24: What are the considerations that should be taken into account if the Submitters to a Benchmark operate in an otherwise unregulated market (e.g., physical oil, gold or agricultural commodity markets) and are not otherwise under any obligation to submit data to an Administrator?

47. As stated above in our answer to Q19 and Q20 regulation must be effective and economical. Bringing further benchmarks into the regulatory net would have to have clear purpose and market demand.

Q25: Do you believe that a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2? What measures should be established in conjunction with a code of conduct? For which Benchmarks is this approach suitable?

48. The code of conduct provides a good basis. Regulatory oversight will depend upon the systemic nature of the benchmark. The scale of formality of the internal and external assurance procedures required will also depend upon the nature of the benchmark and market importance.

Q26: What other measures outlined in the report, if any, should apply in addition to a code of conduct? If you believe a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2, what type of code of conduct should apply (e.g., a voluntary code of conduct, an industry code of conduct submitted to and approved by the relevant Regulatory Authority, a code of conduct developed by IOSCO, etc.)?

49. Please refer to our answer to Q25 above. Development of a code would require significant industry input to ensure there is sufficient expertise present, but also adequate external oversight to ensure credibility.

Q27: Do you believe that the creation of a Self-Regulatory Organisation (e.g., one that exercises delegated governmental powers) and itself subject to governmental oversight, whether or not in conjunction with industry codes, is a viable alternative for sufficient oversight and enforcement to mitigate the risks that have been identified in Chapter 2? For which Benchmarks is this approach suitable? What if any complementary arrangements might be necessary, such as new statutory obligations or offences for Administrators and/or Submitters?

50. It is unlikely that high profile benchmarks can be just self-regulating. A combination of regulatory rules and civil (and possibly criminal sanctions) will be needed, with offence depending on the benchmark. A new offence has been created with respect to manipulation or attempted manipulation of a regulated benchmark in the UK. We are of the view the Fraud Act 2006 also provides a legislative base for offences in the UK.

Q28: Do you believe that for some Benchmarks reliance upon the power of securities and derivatives regulators to evaluate products that reference a Benchmark or exercise their market abuse or false reporting powers creates sufficient incentives for the Administrator to ensure that Submitters comply with a code of conduct?

51. We believe this is difficult, as an Administrator is not a quasi-regulator.

Q29: Do you believe that users of a Benchmark, specifically the users who are regulated or under the supervision of a national competent authority, should have a role in enhancing the quality of Benchmarks? Which form should this role take: on a voluntary basis (e.g., the user being issued a statement that will only use Benchmarks that follow IOSCO principles), or on a compulsory basis (e.g., the competent authority could request that users who are registered under their jurisdiction should only use Benchmarks that fulfil IOSCO principles)?

52. We have no specific comments but support the free use of benchmarks as a public good supported by market demand. Credible benchmarks demanded by the market are likely to be compliant with the substance of the IOSCO principles.

Q30: Do you agree that a Benchmark should be anchored by observable transactions entered into at arm's length between buyers and sellers in order for it to function as a credible indicator of prices, rates or index values? How should Benchmarks that are otherwise anchored by bona-fide transactions deal with periods of illiquidity due to market stress or long-term disruption?

53. Yes, however this is likely to be less frequent than desired, especially with benchmarks like LIBOR. As part of our development of guidance as referred to above we have considered from a practitioner perspective how and what levels of evidence we would be able to assure.⁷ Please refer to the 'Design of substantive procedures at the submitter' section on page 20.

Q31: Are there specific Benchmarks for which you consider that observable transactional data is not an appropriate criterion or the sole criterion? If so, please provide a description of such Benchmarks and what value you think such Benchmarks provide?

54. We have no specific comments.

Q32: What do you consider the limitations or value in Benchmarks referencing asset classes and underlying interests where there is limited liquidity? Please describe the uses and value of such Benchmarks in the financial markets.

55. We have no specific comments.

Q33: Do you agree that the greatest weight should be given to transactions in the construction of a Benchmark and that non-transactional information should be used as an adjunct (e.g., as a supplement) to transactions?

56. Yes.

Q34: What factors and how often should Administrators (or others) consider in determining whether the market for a current Benchmark's underlying interest is no longer sufficiently robust? What effective methods of review could aid in determining the insufficiency of trading activity within the market for a Benchmark's underlying interest?

57. This will depend upon how the market is constructed. Change could be potentially damaging where a benchmark is deeply embedded in a market like LIBOR, hence reform not

⁷ <http://www.icaew.com/~media/Files/Technical/Financial-services/icaew-03-13fsf-guidance-for-assurance-on-benchmarks-and-indices-final.pdf> page 20

replacement was recommended as part of the Wheatley Review. The legal definition and substance of the benchmark would have to remain the same to avoid extensive contract frustration⁸.

Q35: What precautions by Benchmark Administrators, Submitters, and users can aid Benchmark resiliency during periods of market stress, mitigating the potential need for market transition?

58. Not making definitions overly rigid where market behaviours can change and affect how the benchmark can best be constructed.

Q36: What elements of a Benchmark “living will,” drafted by a Benchmark Administrator, should be prioritised?

59. We have no specific comments.

Q37: By what process, and in consultation with what bodies, should alternatives be determined for Benchmark replacement?

60. A transparent and probably extensive process would be required, with contract frustration considerations paramount. Contributors, the administrator, regulators and stakeholders to the benchmark should be consulted.

Q38: What characteristics should be considered when determining an appropriate alternate Benchmark? (Examples below) Should any of these factors be prioritised?

- o Level and Type of Market Activity
- o Diversity/Number of Benchmark Submitters
- o Length of historical price series for the Benchmark alternative
- o Benchmark Methodology
- o Existing regulatory oversight
- o Existing enforcement authority
- o Volume, tenors and contract structure of the legacy trades

61. No specific comment – the most significant characteristics will be dependent upon the benchmark being considered.

Q39: What conditions are necessary to ensure a smooth transition between market Benchmarks?

62. We have no specific comments but would stress the importance of providing for contract continuity and ensuring that there is widespread market support for a change in benchmark before any transition is undertaken.

Q40: What considerations should be made for legacy contracts that reference a Benchmark in transition? To what extent does a substantive legacy book preclude transition away from a Benchmark? What provisions can be included in [new and existing] contract specifications that would mitigate concerns if and when a Benchmark transitions occurs?

63. A substantial legacy book is likely to present large issues for transition, especially where the ‘last calculated rate’ is taken at a time of stress making it more difficult to justify carrying such a

⁸ Frustration occurs when something occurs after the formation of the contract which renders it physically or commercially impossible to fulfil the contract, or transforms the obligation to perform into a radically different obligation from that undertaken at the moment of the entry into the contract, for example, a change in definition which alters the way in which the benchmark is calculated or the data which is drawn upon.

rate forward for the life of legacy contracts. Identifying all legacy contract participants will also present a significant practical challenge.

Q41: How should a timeframe be determined for market movement between a Benchmark and its replacement? What considerations should be made for:

- o Altered regulatory oversight?
- o Infrastructure development/modification?
- o Revisions to currently established contracts referencing the previous Benchmark?
- o Revisions to the Benchmark Administrator?
- o Risk of contract frustration

64. We have no specific comments, see above answer to Q40.

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