Benchmarking the Fairness of Markets

By Emma Davey

The fairness and effectiveness of markets has been an issue of concern among regulators, politicians and the public at large since the financial crisis more than six years ago. As more issues such as the rigging of Libor and foreign exchange rates come to light, reviews of how to ensure that markets are robust and functioning in a fair and compliant way have emerged, ranging from a review of critical benchmarks to broader discussions on financial market conduct.

The most recent large-scale attempt to address the operations of markets is the Fair and Effective Markets Review in the U.K. The review–which is being conducted jointly by the Bank of England, the Financial Conduct Authority and the U.K. Treasury–was announced by the Chancellor in June 2014, and its stated purpose is to conduct a comprehensive and forward-looking assessment of the way wholesale financial markets operate and help restore trust in those markets.

The review is being led by the Bank of England's deputy governor, Minouche Shafik, with FCA's chief executive officer Martin Wheatley and Treasury's director general of financial services Charles Roxburgh as co-chairs. The review includes an independent market practitioner panel led by Elizabeth Corley, chief executive officer of Allianz Global Investors.

The first stage of the review was a proposal from Treasury on benchmarks, which raised eight questions about benchmarks and, in particular, whether a number of them should be brought into the same scope of regulation that already applies to Libor. The benchmarks under consideration include: the ISDAFix; Sterling Overnight Index Average (SONIA); Repurchase Overnight Index Average (RONIA); WM/Reuters' FX benchmark rates (WMR); LBMA Silver Price; London Gold Fix; and ICE Brent Index.

The benchmarks consultation outlined three criteria which benchmarks must meet in order to be recommended for inclusion in the U.K. regime. They were:

- Benchmarks that are major FICC benchmarks, i.e., those that have the greatest usage within the FICC product markets and would have the biggest impact on retail and wholesale investors if they were distorted or abused and would represent the greatest source of systemic vulnerability and risk if their integrity were questioned.
- Benchmarks where the main benchmark administration activities are located in the U.K., allowing Treasury and FCA to ensure that these benchmarks are brought quickly into regulation
- Benchmarks that are based on transactions in financial instruments which are either not covered comprehensively by existing market abuse regulation or which are linked to instruments outside the scope of the market abuse regime and therefore may require additional mechanisms to monitor against potential sources of abuse.

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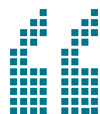

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MARK CARNEY, FSB CHAIRMAN

In late December, the Financial Conduct Authority took the next step in the process, announcing that it will regulate these seven benchmarks starting in April. The FCA also launched a consultation on how to extend its rules for regulating benchmarks, which was designed for the Libor interest rate benchmark, to these other seven benchmarks. In addition, the Treasury announced that it will extend the legislative regime established for the regulation of the Libor benchmark to the seven additional benchmarks, including criminal sanctions for those found manipulating the benchmarks.

Concerns about Fragmentation

The benchmark consultation led to a number of responses from the market and other regulators, including FIA Europe, which stated that unilateral action in the U.K. "risks causing a fragmentation of liquidity and market disruption; could actively harm competition and choice; and could result in an uneven playing field across Europe."

FIA Europe encouraged Treasury to await the outcome of current discussions at a European Union level on the regulation of benchmarks in order to avoid duplication of efforts, as any new U.K.-specific regulation will be superseded by new EU legislation.

Similar concerns about the need for a coordinated, global approach on the regulation of benchmarks were made by Timothy Massad, the chairman of the Commodity Futures Trading Commission. In December, Massad said the proposed EU legislation would have "adverse market consequences" because of its impact on non-European benchmarks and markets.

"In particular, benchmarks created by administrators located in countries outside the EU could not be used by European supervised entities, such as banks and asset managers, unless the European Commission determines that any non-EU administrator is authorized and equivalently supervised in the non-EU country," Massad said during a Congressional hearing. Given that the U.S. does not have a similar regulatory regime for benchmark administrators, he warned that the proposed equivalence could block European customers from accessing U.S. markets.

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ment-sponsored supervisory regime for benchmarks," Massad told Congress. "Accordingly, in light of the EU's equivalence standards, the new proposed benchmark regulation could prohibit EU institutions from hedging using thousands of products traded on U.S. futures exchanges and swap execution facilities."

Massad encouraged European officials to consider the work of the International Organization of Securities Commissions in this area. "I hope that we can continue to work with our international counterparts to ensure benchmark integrity in a way that recognizes that most benchmarks are not administered by a government agency," he added.

Meanwhile, the latest draft report on the European Parliament's proposed regulation echoes concerns about unilateral approaches to regulating what are essentially global instruments. The report, which was drafted by Cora van Nieuwenhiuzen, a Member of Parliament from the Netherlands who was chosen to serve as the "rapporteur" for this legislation, warns that divergent approaches from individual member states would result in "fragmentation" of EU markets since administrators and users of benchmarks would be subject to different rules in different Member States.

"Thus, benchmarks produced in one Member State could be prevented from being used in other Member States," the report states. "In the absence of a harmonised framework to ensure the accuracy and integrity of benchmarks used in financial instruments and financial contracts in the Union it is therefore likely that differences in Member States' legislation will create obstacles to the smooth functioning of the internal market for the provision of benchmarks."

Market Structure and Conduct

While the proposed regulation of benchmarks is one of the more immediate goals of the U.K.'s review of fair and effective markets, the longer term agenda is much broader. In October the Bank of England, FCA and Treasury extended the review by issuing a joint consultation on the fairness and effectiveness of fixed income, currency and commodities markets, with responses due by the end of January.

The objective is to establish what needs to be done to reinforce confidence in the fairness and effectiveness of these markets. In particular, the consultation seeks to assess the areas where fairness and effectiveness are currently deficient; the extent to which ongoing regulatory, organisational and technological change that has taken place since the financial crisis is likely to address these deficiencies; and what further steps are needed to help ensure fair and effective FICC markets.

The main assessments will be announced in June 2015 in the form of recommendations. The review acknowledges that the FICC markets are global and observes that industry-led initiatives must form an important part of the response, rather than just further regulation. The review also makes clear that the regulators are well aware of the European and U.S. regulatory initiatives that implement the G20 commitments and that the implementation of those initiatives should be considered as "a given."

Defining "Fair and Effective"

As described in the October consultation, the review considers that the characteristics of "fair" and "effective" are as follows:

Fair: clear and consistently applied standards of market practice; transparency; open access; competition on the basis of merit; and integrity

Effective: enabling investment, funding and risk transfer, underpinned by robust infrastructure, in an environment where market participants are able to trade at competitive prices, set through a price discovery process reflecting the current and expected balance of supply and demand

The review seeks views on further steps that might be needed to boost fairness and effectiveness in particular FICC markets. Possible actions may include:

- Industry-led standardisation of more FICC assets;
- Initiatives led by the market or public authorities to improve transparency, for example through greater use of electronic platforms;
- Enhancements to market-driven competition;
- Industry-led improvements to benchmark design; and
- Steps to encourage greater compliance of benchmarks with international standards.

In discussion with industry associations, FCA has recognised that the review addresses a considerable market and it does not expect any particular regulation to emerge from it following the conclusion of the review. Instead, the review aims to make recommendations in June 2015 to the U.K. Chancellor. It is also the FCA's ambition to carry the review to a global level—possibly with the development of a global code of conduct for FICC markets—with the aim of involving IOSCO and the Financial Stability Board to pick up the outcome of the consultation and work on it further at the global level.

Benchmark Regulation		
Proposed EU Regulation on Indices Used as Benchmarks in Financial Instruments and Contracts	**Ongoing**	This regulation, first proposed in 2013, is still in discussion with Member States. The latest proposal is that there should be a two-tiered approach to determine the criticality of a benchmark – based on size (benchmarks with very large reference values in excess of EUR 500 billion) and systemic relevance. It also suggests the introduction of partial equivalence decisions – recognition of individual third administrators at least until equivalence decisions can be adopted.
HM Treasury Fair and Effective Markets Review	**September 2014**	Raised eight questions about benchmarks and in particular whether a number of benchmarks should be brought into the scope of regulation, including the ISDAFIX; SONIA; RONIA; WMR; LBMA Silver Price; London Gold Fix; and ICE Brent Index.
FSB Report on Foreign Exchange Benchmarks	**September 2014**	Sets out recommendations for reform of the FX markets and in the benchmark rates that have been identified as pre-eminent by market participants, in particular the WM/Reuters 4pm London fix. It includes recommendations on the calculation methodology; IOSCO's review; publication of reference rates by central banks; market infrastructure in relation to the execution of fix trades; and the behaviour of market participants around the time of the major FX benchmarks.
IOSCO's Principles for Financial Benchmarks	**July 2013**	Published with the aim of creating an overarching framework for benchmarks used in financial markets. These principles address benchmark governance, benchmark and methodology quality, and accountability mechanisms, in an effort to promote the reliability of benchmark determinations. This has been followed up by reviews of how these principles have been implemented by interest rate administrators and in foreign exchange. Separately, IOSCO has also issued Principles for Oil Price Reporting Agencies, published in October 2012.
ESMA and EBA Principles for Benchmark-Setting Processes in the EU	**January 2013**	Sought to address the problems in the area of benchmarks until a formal regulatory and supervisory framework for benchmarks has been devised for the EU. Although the provisions were without binding legal effect, they provided benchmark users, benchmark administrators, calculation agents and publishers and firms involved in benchmark data submissions with a common framework to work together and provide a transition path toward potential future legal obligations.

Global Action

An important signal of the importance of this project to global regulators came in November, when Bank of England Governor Mark Carney gave a major policy address in Singapore on the "future of financial reform." Carney is also the chairman of the Financial Stability Board, the international body set up by the Group of 20 in 2009 to spearhead the global financial reforms.

In his speech, Carney reviewed the progress of financial reform since the crisis of 2008 and outlined several major initiatives that should be part of the next phase of financial reform. One of these should be rebuilding trust in the financial system, which he said is critical to maintaining "the social license" for finance to operate. That license has been severely tested by taxpayer bailouts, a perception that "clients have become counterparties" and "egregious examples of misconduct and rigging of markets."

The solution must go far beyond enforcement actions and financial penalties and target fundamental changes to market structure and conduct, Carney said. He outlined the main objectives of the U.K.'s fair and effective markets review and called for IOSCO and the FSB to forge international agreements on common standards in these areas. "Only with such global action can we begin to move on decisively from the scandals of recent years to slowly rebuild the trust of society in finance," he said.

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