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Asset management and investment funds

Benchmark Regulation: Key features and impact on investment funds

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*Article by **Olivia Moessner**.*

On 29 June 2016, **Regulation (EU) 2016/1011** on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "**Regulation**") was published in the Official Journal of the European Union (OJEU). It entered into force on 30 June 2016.

The Regulation aims at establishing a common regulatory framework at EU level under which benchmarks are provided, produced and used, and to restore trust in indices used as financial benchmarks. The Regulation's goal is to enhance the benchmark-setting process, improve transparency and prevent conflicts of interest in order to enhance the robustness and reliability of benchmarks, thereby strengthening confidence in financial markets.

Key aspects of the Regulation

The Regulation applies to all published indices that are used to reference the price of a financial instrument or contract, or measure the performance of an investment fund.

It introduces an authorisation and supervision framework for all benchmark providers (administrators).

- Benchmarks are classified in three categories (i) critical benchmarks (ii) significant benchmarks and (iii) non-significant benchmarks, which are subject to requirements appropriate to their size and nature, while at the same time respecting a core set of minimum requirements in line with the internationally agreed principles of the International Organization of Securities Commission (IOSCO).
  The classification of benchmarks determines the level of requirements that will be applicable to the administrators of those benchmarks.
- According to the Regulation, all benchmark administrators will have to be authorised (and supervised) by the competent authority designated by the Member State in which that person is located, or alternatively, they must be registered when benchmarks are non-significant or provided by a supervised entity other than an administrator. ESMA will establish and maintain a public register of authorised and registered administrators.
  Subsequent to authorisation or registration, administrators will have to publish a benchmark statement defining precisely what market or economic reality their benchmark measures, describing the methodology and procedures for calculating the benchmark and advising users about the possibility of a change or cessation of the benchmark and the impact this may have on financial instruments or contracts that reference the benchmark or on the measurement of the performance of investment funds.
  In order to ensure the integrity and reliability of benchmarks, administrators are subject to a number of requirements regarding governance arrangements, input data rules, benchmark methodology, code of conduct.
- Supervised entities (such as credit institutions, UCITS and their management companies, investment firms, AIFMs, insurance undertakings and trade repositories) may only use benchmarks in the European Union that are provided by an administrator authorised or registered in the EU and included in the ESMA register. A third-country regime (equivalence, recognition or

endorsement) is also provided.

- Any breaches in respect of the use of a benchmark are subject to a number of administrative sanctions including fines, which may be levied on both a firm and an individual. These range from EUR 500,000 to EUR 1,000,000 but Member States may impose higher maximum sanctions.
- Specific benchmark regimes are also in place with regard to regulated-data benchmarks (benchmarks where the input data is the net asset value of investment funds or is exclusively contributed from trading venues, approved publication arrangements, approved reporting mechanisms, electricity or gas exchanges), interest rate benchmarks (benchmarks that are determined on the basis of the rate at which banks may lend to, or borrow from other banks or agents, other than banks in the money market) and commodity benchmarks (benchmarks where the underlying asset is a commodity).

Impact on UCITS and AIFMs

The Regulation will have an impact on UCITS management companies (and self-managed UCITS) and AIFMs as supervised entities to the extent that the latter use benchmarks measuring the performance of an investment fund through an index or a combination of indices for the purpose of tracking the return of such an index or combination of indices, of defining the asset allocation of a portfolio, or of computing the performance fees.

- Use of benchmarks by supervised entities
  The use of benchmarks by these entities will be subject to the following requirements:

- They may only use benchmarks that are provided by an authorised benchmark administrator, or a non-EU provider that satisfies the equivalence requirements set out in the Regulation. These requirements include registration and the establishment of cooperation arrangements with ESMA.

- Robust written plans must be produced outlining the steps to be taken in the event that a benchmark is materially changed or ceases to be produced. These plans and any updates are deliverable to the national competent authority upon request.

- Prospectus disclosure

In addition, where the object of a prospectus to be published under Directive 2003/71/EC (Prospectus Directive) or Directive 2009/65/EC (UCITS Directive) is transferable securities or other investment products that reference a benchmark, the issuer, offeror, or person asking for admission to trade on a regulated market shall ensure that the prospectus also includes clear and prominent information stating whether the benchmark is provided by an administrator included in the register held by ESMA.

It is relevant to note that the Regulation refers to the key information document in the recitals and in the title of the transitional provisions but not in the relevant Article. The Regulation does not make reference to the AIFs prospectuses or information to be made available to investors in accordance with Article 23 of AIFMD.

Application, transition period and next steps

The Regulation will generally apply from 1 January 2018[1]. However, a transition period is provided for certain obligations:

- An index provider which was already providing a benchmark on 30 June 2016 benefits from a

transition period until 1 January 2020 to apply for authorisation or registration as an administrator;

- A non-authorised or non-registered index provider may continue to provide an existing benchmark until 1 January 2020.
- For UCITS prospectuses approved prior to 1 January 2018, the underlying documents shall be updated on the first occasion or at the latest within 12 months after that date.

In February 2016, ESMA received a request from the European Commission for technical advice on possible delegated acts. In this respect, ESMA issued on 10 November 2016 its **Final Report on the Technical Advice under the Benchmarks Regulation** dealing with the five areas identified by the Commission, namely: (i) some elements of the definitions, (ii) measurement of the reference value of benchmarks, (iii) criteria for the identification of critical benchmarks, (iv) endorsement of a benchmark/family of benchmarks provided in a third country, and (v) transitional provisions.

The delegated acts should be adopted by the Commission so that they will apply as from 1 January 2018, taking into account the right of the European Parliament and Council to object to a delegated act within 3 months (which can be extended by a further 3-month period).

Still in connection with the level 2 measures, in August 2016 the European Commission adopted an implementing regulation establishing a list of 'critical' benchmarks, i.e. those indices that are of particular importance for financial markets and consumer contracts (**Regulation (EU) 2016/1368**). EURIBOR (Euro Interbank Offered Rate), one of the most important interest rate indices in the EU, is the first to be included in the list of critical benchmarks. The Commission will review and update this list on a regular basis.

In addition, the Benchmarks Regulation requires ESMA to develop a number of draft regulatory and implementing technical standards to be submitted to the Commission by 1 April 2017. The Final Report dedicated to these technical standards is planned to be published by 1 April 2017.

In its **Work Programme for 2017**, ESMA also underlines its intention to publish guidance as regards the Regulation (and other European legislation) in the form of guidelines and Q&As. This will be part of ESMA'S work on the supervisory convergence and the market integrity in particular.

> 1. The 'critical benchmarks' provisions (Chapter 4 and Article 46 of the Regulation) became applicable in June 2016.

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The information contained herein is not intended to be a comprehensive study or to provide legal advice and should not be treated as a substitute for specific legal advice concerning particular situations.

We untertake no responsibility to notify any change in law or practice after the date of this newsletter.