

8 September 2022

Dear CEO,

**Our supervision strategy for benchmark administrators**

The FCA's strategic objective is to ensure that financial markets function well. Benchmarks are integral to financial markets. By designing, calculating, administering, and publishing benchmarks, benchmark administrators add value in financial markets and can have a critical role in outcomes for products, firms and markets.

We supervise benchmark administrators according to the UK Benchmark Regulations (UK BMR) and applicable FCA Principles and Rules, including the Senior Managers Regime and Conduct Rules.

As part of our supervisory cycle, we have recently reviewed the areas where compliance with the relevant regulations may be most at risk of falling below our expectations. This review considered a range of information including data requested from administrators. We are grateful for administrators' engagement with that data gathering process.

We recently set out the final rules and guidance for a [new Consumer Duty](#) that will set higher and clearer standards of consumer protection across financial services. Although benchmark administration activities are not within scope of the Duty, it is likely to apply to other firms in the distribution chain of products in which benchmarks are used. Firms are required to put their customers' needs first. It's in this spirit that we expect benchmark administrators to support users of their benchmarks in meeting their obligations under the Duty, for example by making relevant information and disclosures available to them.

Our supervisory priorities for benchmark administrators are set out below.

**Disclosure***Our view of the risks*

Good disclosure is fundamental for users to understand how a benchmark is derived and assess its representativeness, relevance and appropriateness for its intended use. Users should have fair and easy access to benchmark statements containing sufficient, clear and

transparent information. Administrators should operate and administer their benchmark methodologies transparently and ensure that key elements are properly explained.

We have concerns that some benchmark administrators have not accurately described the economic reality that their benchmarks measure. Further, we have observed that where benchmark administrators broadly group their benchmark families for the purposes of their benchmark statements, for example, at an asset class level, this can lead to poor disclosure.

While good disclosure is fundamental for all regulated benchmarks, we have particular concerns in relation to ESG benchmarks and Credit Sensitive Rates (CSRs).

The ESG sector is rapidly growing, and fund data show increasing flows into passive equity funds promoted as sustainable. We believe that the subjective nature of ESG factors, and how ESG data and ratings are incorporated into benchmark methodologies, give rise to an increased risk of poor disclosures in ESG benchmark statements. The quality of the resulting benchmarks may not align with the expectations of their users and/or end investors. This may also impact the transition to a net zero economy.

With the transition away from LIBOR close to its final stage, we do not want to see CSRs emerge as successor rates. We have already communicated to the market [our view of the risks embedded in CSRs](#), which we think are similar to those we have seen in LIBOR. As CSRs measure a small underlying market, risks would arise if the volume of usage became disproportionate to the number of transactions underpinning the benchmark. We also have concerns that CSRs do not consistently reflect the credit risk in underlying transactions, and may instead at times be overly exposed to illiquidity and consequent price volatility in the markets they seek to measure.

#### *What we expect from benchmark administrators*

We expect all benchmark administrators to promote transparency by reviewing their benchmark statements and methodologies to ensure they contain key disclosures and remain accurate. Where necessary, you should make improvements to disclosures, so that they are readily understandable to users and end investors assessing whether the use of the benchmark is appropriate for their investment strategy.

*Grouping benchmarks disclosure* - Poor design, description and naming of benchmarks, including ESG benchmarks, could create a trust deficit in the market for passively managed sustainable investment products. We have observed that grouping ESG and non-ESG benchmarks in the same family can result in a poor level of disclosure.

*ESG benchmarks* - It is important that benchmark administrators ensure good quality of disclosure for ESG benchmarks through benchmark statements and methodologies. This ensures that intermediaries and investors can assess both the underlying economic reality or market which is being measured and the sustainability claims of the benchmark. Benchmark administrators must ensure that their benchmark names fairly reflect the methodology and contents of the benchmark so that users' reasonable expectations are met. Where the methodology for the ESG benchmark uses ESG ratings provided by a third party (e.g. an ESG ratings provider) to determine its constituents, benchmark administrators should ensure that the underlying rating methodology is clearly presented and explained to users.

*Credit sensitive rates* - Due to the increased risks relating to use of CSRs, we expect UK-regulated benchmark administrators to continue to notify us in advance if they intend to administer CSRs and make them available for use in the UK.

### *What we will do*

We will continue to monitor the quality of disclosures made by benchmark administrators. Further to our initial diagnostic work on a sample of benchmark administrators who administer ESG benchmarks, we will be further scrutinising the construction and labelling of these benchmarks.

### **Quality of data and data controls**

#### *Our view of the risks*

The integrity of input data and a transparent methodology are key to a benchmark accurately and reliably representing the market or economic reality that it intends to measure. The sector increasingly relies on third parties to provide benchmark input data. Such arrangements often include unregulated entities and those based overseas.

We have observed occurrences of poor data quality and controls (e.g. calculation errors and poor validation of data inputs) and are concerned these may impact the reliability and representativeness of benchmarks. We perceive particular risk with data inputs to cryptoasset benchmarks as these often measure fragmented, opaque markets.

#### *What we expect from benchmark administrators*

Benchmark administrators should establish processes to monitor both input data and the correct implementation of the methodology. This includes, where applicable, ensuring, prior to publication of the benchmark, that filters and or parameters used in the calculation are based on accurate and up to date information. These control arrangements should be reflective of the size, scale, nature and increasing complexity of the benchmarks administered. When you are using price or non-price input data from third parties, you should ensure there is a proportionate framework for robust monitoring, checking and challenging of these inputs.

Administrators should notify the FCA where they suffer incidents relating to data quality, including non-price data inputs, taking into account the usage of the benchmark, the severity of the incident, whether harm was caused to users and whether any complaints were received. Administrators should be able to demonstrate how they use past incidents as "lessons learned" to identify gaps and the improvements they have made.

*Cryptoasset benchmarks* – Because of the unregulated nature of the underlying market, we expect firms in our portfolio to notify us of their intention to start administering cryptoasset benchmarks before these are made available, and to engage constructively with us should we highlight any areas of concern.

#### *What we will do*

We plan to conduct multi-firm work on quality of data including non-price data inputs and incident reporting, to identify shortfalls and outliers. We will provide specific feedback to firms on our findings and assess the effectiveness of firms' actions to address these.

### **Operational resilience**

#### *Our view of the risks*

Operational disruptions can create risks to the financial system. This is why we have set out [our final rules and guidance](#) on new requirements to strengthen operational resilience in the financial services sector.

Benchmark administrators must be operationally resilient to ensure the smooth functioning of their business and the production of accurate and reliable benchmarks. Benchmark administrators should have in place an effective control framework that ensures their benchmarks are provided and made available in accordance with the UK BMR. This includes the management of operational risk, adequate and effective business continuity and disaster recovery plans, and contingency procedures in the event of a disruption to the provision of the benchmark.

We have observed some examples of an ineffective control framework. In some instances, this may have caused incidents such as late publication, non-publication and calculation errors which could impact the reliability of the benchmark. We are also concerned that firms are not consistently reporting operational incidents to us in a timely manner.

Benchmark administrators have also reported operational incidents occurring within third parties to whom key functions have been outsourced. This underlines the need for appropriate oversight of third parties as part of administrators' control frameworks.

#### *What we expect from benchmark administrators*

We expect your firm to be operationally resilient to different types of disruption that could impact the reliability of benchmarks, such as cyber-attacks. Where you have outsourced functions, you remain fully responsible for discharging all the administrators' obligations under the UK BMR. As part of that, we expect you to have appropriate oversight of third-party firms and intra-group service providers to ensure appropriate business continuity arrangements. This includes retaining sufficient expertise to supervise the outsourced functions, managing the risks associated with outsourcing and having adequate contingency plans regarding service outages. If your firm or your outsourced provider suffers material technological failures or cyber-attacks, we expect you to contact us promptly as part of your responsibilities under Principle 11. Where you are reliant on third parties who repeatedly breach service level agreements, you should take steps to ensure the service is improved, find an alternative provider, or bring the function back in-house.

#### *What we will do*

We plan to collect further information from administrators in 2022 Q4 or 2023 Q1 to conduct a baseline assessment of operational resilience, including the risk and plans around cyber-attacks. We will analyse the results to identify outliers and weaknesses and provide relevant feedback to firms, where appropriate. We will also consider how effectively firms meet their obligations under Principle 11 and disclose material incidents to us in a timely manner.

### **Oversight and governance**

#### *Our view of the risks*

Good oversight and governance are fundamental to ensuring administrators are continuously meeting their regulatory obligations. This includes recognising and managing conflicts of interest and ensuring these do not weaken the oversight function itself. We are concerned that some of the risks we have identified above may be exacerbated by conflicts of interest, weaknesses in oversight and ineffective governance.

### *What we expect from benchmark administrators*

We expect benchmark administrators to have in place robust governance arrangements. This includes a permanent and effective oversight function to oversee the implementation and effectiveness of governance arrangements. Decisions should not be overly influenced by specific user groups. Conflicts of interest must be identified and managed. We expect to see clear record-keeping and audit trails outlining the rationale behind key decisions such as changes to benchmarks, policies and procedures.

*Senior Managers Regime* - On 7 December 2020, the Senior Managers Regime (SMR) and Conduct Rules came into force for benchmark administrators. Benchmark administrators are expected to have successfully implemented and be adhering to applicable SMR and Conduct Rules requirements, which include assessing Senior Managers' fitness and propriety on an annual basis and reporting Conduct Rule breaches.

### *What we will do*

We will proactively engage with you where we have evidence of poor oversight and governance practices. We will consider employing formal supervisory tools in those instances where firms fail to meet our requirements, fail to consider our feedback or are making insufficient progress.

### **Competition**

The [FCA Call for Input on "Accessing and using wholesale data"](#) found several areas of the market for benchmarks and indices provision that may not be working well. We have heard concerns that unnecessarily complex licensing arrangements and other barriers to switching between benchmarks could be leading to an increase in prices that is not commensurate with increasing costs or improved service quality.

We expect benchmark administrators to engage with us on the Wholesale Data market study we aim to launch in November 2022. This will look in more detail at markets covered by the Call for Input. Part of this will look at how competition works between benchmark administrators.

### **Our overall expectation of the firms**

This letter does not provide an exhaustive list of the risks to consumers, market integrity or competition that benchmark administrators could create if they fail to meet regulatory requirements. Nor is it an exhaustive list of the work that we intend to undertake. Our supervision priorities may change to reflect the evolving nature of your business and markets and our view of the potential risks.

We remind you that all FCA-authorized firms must at all times comply with FCA Principle 11 (Relations with regulators): "A firm must deal with its regulators in an open and cooperative way, and must disclose to the FCA appropriately anything relating to the firm of which that regulator would reasonably expect notice". That means taking the initiative in doing so, as well as responding to our questions, in an open and timely manner. For example, you should inform us if you are making major changes to widely used benchmarks, or planning to make substantial changes to your business, such as substantially amending outsourcing arrangements, or actively considering relocating activities outside of the UK.

Firms are responsible for ensuring that they understand and comply with the regulatory requirements that apply to them. Where we see firms fail to consider our feedback, we will deploy our formal supervisory tools and, where appropriate, consider enforcement action, in line with the FCA's [Approach to Enforcement](#).

**Next steps**

You should consider the issues in this letter, and how you have ensured that you have addressed them. Should you have any queries about this letter, please contact us at [benchmarkssupervision@fca.org.uk](mailto:benchmarkssupervision@fca.org.uk). This is the primary contact for your firm's day-to-day interactions with the FCA.

Yours faithfully

Edwin Schooling Letter  
Director of Infrastructure & Exchanges  
Financial Conduct Authority