

**Summary of Discussions of the
Study Group on Regulation of Financial Benchmarks**

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Study Group on Regulation of Financial Benchmarks

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Introduction

In light of international developments related to financial benchmarks, the Study Group on Regulation of Financial Benchmarks was convened in the Planning and Coordination Bureau of the Financial Services Agency as an administrative and management forum for discussion and exchange of views on Japan's regulatory framework for financial benchmarks in the light of technical and practical issues. Beginning in November 2013, the Study Group held three meetings to discuss the issues on hand from technical and practical perspectives.

This report presents a summary of the Study Group's discussions. In view of the critical role played by financial benchmarks in Japan's financial and capital markets, the Study Group expects that the accuracy and credibility of such benchmarks will be ensured by designing an appropriate regulatory framework in line with the contents of this report.

1. Background

a) Issues Raised by Fraudulent Manipulation of Financial Benchmarks

Financial benchmarks are widely used in the determination of lending base rates, payments resulting from derivative transactions, and the valuation of securities. By functioning as a foundation for financial transactions, financial benchmarks play a critical role in Japan's financial and capital markets.

In the past, administrations of financial benchmarks were not subject to regulation in Japan and other countries. However, cases involving manipulation of London Interbank Offered Rate ("LIBOR")¹ undermined confidence in the accuracy and credibility of financial benchmarks. These developments raised the following questions and led to discussions on the introduction of regulation in various countries.

- Data submitters have the incentive and opportunity to manipulate the data in the submission process.
- The lack of the disclosure of benchmark-setting process and methodology limits the possibility of assessing the credibility of benchmarks, and has led to tolerance and acceptance of manipulation.
- Conflicts of interest exist in both the submission and determination processes.

b) International Developments

While various countries were investigating and taking action against financial institutions in connection with possible manipulation of financial benchmarks, the International Organization of Securities Commissions ("IOSCO") released its "Principles for Financial Benchmarks: Final Report" ("IOSCO Principles") in July 2013, containing 19 principles pertaining to the governance of administrators, quality of the benchmark, quality of the methodology, and accountability of administrators in relation to benchmarks used in financial markets. IOSCO also announced that, within an 18-month period following the publication of the IOSCO Principles, it would review the extent to which the Principles were being implemented.

At some time around 2009, the UK regulatory authorities launched investigations of possible manipulation of LIBOR and other financial benchmarks. Investigations were conducted with the cooperation of various

¹ Benchmarks indicating market interest rate in financial transactions conducted in the London interbank market.

foreign authorities and covered a number of financial institutions. These revealed that LIBOR had been manipulated for the following purposes. Traders and others at financial institutions had acted on submitters to manipulate LIBOR to benefit their positions in derivatives transactions. At the time of the Lehman Shock, LIBOR had been manipulated to indicate that interest rates were lower than they actually were in order to prop up the creditworthiness of financial institutions.

After examining the problems that were revealed, the HM Treasury released the “Wheatley Review of LIBOR” in September 2012 and its proposals for reforming LIBOR, recommending the introduction of legislative reforms covering the administration and submission of LIBOR. Thereafter, the Financial Services Act 2012 was enacted in December 2012, and related rules were published in March 2013. This regulatory and supervisory framework applies to both administrators and submitters, and contains provisions for managing conflicts of interest, disclosure requirements, and mechanisms for the identification and reporting of suspicious and fraudulent acts (implemented in April 2013).

Against this backdrop of progress through international coordination, the European Commission published its “Proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts” in September 2013. The proposed regulatory and supervisory framework applies to administrators and submitters, and proposes various provisions, including the provisions for managing conflicts of interest and disclosure requirements.

The proposal of the European Commission stipulates that any non-EU financial benchmarks to be used within the EU must be examined by the European Commission to determine whether the legal framework and supervisory practice of a third country ensures that administrators authorised or registered in that third country comply with binding requirements which are equivalent to the proposed EU regulations (“Equivalence Assessment”). The document goes on to propose that the status of compliance with the IOSCO Principles should be taken into account in making the assessment.

At the G-20 Saint Petersburg Summit held in September 2013, the IOSCO Principles were endorsed and an agreement was reached on reforming financial benchmarks used internationally in the banking industry and in financial markets, consistent with the IOSCO Principles.

2. Identifying the Problem

The actions taken by IOSCO and various countries with regard to financial benchmarks, the critical role played by financial benchmarks in financial and capital markets, and the necessity of responding to the various problems that have been identified in the financial benchmarks and their

setting process all point to the need for Japan to introduce regulations for strengthening the governance of administrators of financial benchmarks and improving transparency in the benchmark-setting process.

Bearing in mind that manipulation of financial benchmarks has involved fraudulent acts in the submission of data, in order to ensure the accuracy and credibility of financial benchmarks, it is necessary to require the establishment of some form of discipline not only for administrators but also for submitters.

3. Basic Approach to Government Regulation

In introducing new regulations, the aim should be to ensure the accuracy and credibility of the specific financial benchmarks that are used as the basis of financial transactions in Japan's financial and capital markets. At the same time, due attention must be paid to maintaining continuity so that the functions of financial benchmarks currently being determined are not undermined.

a) Form of Regulation

If the regulations are to be based on legislation, in light of the points listed below, it would be appropriate to revise the Financial Instruments and Exchange Act to include provisions applicable to administrators of financial benchmarks.

- The problems on hand arose from fraudulent acts primarily related to derivatives transactions.
- Maintaining the accuracy and credibility of financial benchmarks is consistent with the purpose of the Financial Instruments and Exchange Act, which includes the fair price formation of financial instruments.

b) Scope of Regulation

Numerous financial benchmarks published in Japan are used in such areas as equities, government bonds and corporate debentures, interbank interest rates, commodities and weather conditions. It would be appropriate not to regulate all benchmarks but rather to consider the scope of regulation based on the fact that maintaining the accuracy and credibility of financial benchmarks is critical for Japan's financial and capital markets.

i. Benchmarks to Be Covered

Financial benchmarks can be examined under two broad categories. The first comprises benchmarks that are mechanically determined as a result of market transactions, etc. The second comprises submission-based benchmarks that are determined based on submissions from financial institutions and others.

Regarding submission-based benchmarks, it is likely that the submitted data leaves room for discretion and can be subject to fraudulent manipulation, indicating a more pressing need to improve the governance of administrators and submitters. Therefore, it is appropriate to emphasize on submission-based benchmarks in considering a regulatory framework.

More specifically, in light of the points listed below, it is appropriate to adopt a basic stance of starting the process by subjecting Tokyo Interbank Offered Rate (“TIBOR”)² to regulation.

- TIBOR is widely referred to as the benchmark interest rate in derivatives transactions and others. Therefore, maintaining the accuracy and credibility of TIBOR is critical for Japan’s financial and capital markets.
- Submissions used in determining TIBOR contain data subject to the submitter’s judgment and estimation, leaving more room for fraudulent manipulation and incentives for manipulation compared to mechanically determined benchmarks.
- Regulations are being introduced for LIBOR and European Interbank Offered Rate (“EURIBOR”),³ which, as in the case of TIBOR, are interbank offered rates.

On the other hand, IOSCO and various countries are adopting and proposing regulatory frameworks that are not limited to submission-based benchmarks and which can cover a broad range of financial benchmarks. In light of this fact, it is appropriate to consider a regulatory framework that can cover benchmarks other than TIBOR as the need arises in the future.

As the IOSCO Principles do not apply to financial benchmarks determined by a National Authority for public policy purposes, it would not be necessary to cover such benchmarks in the scope of regulation.

² Benchmarks indicating market interest rates in financial transactions conducted in Japan’s unsecured call market (Japanese Yen TIBOR) and Japan’s offshore markets (Euroyen TIBOR).

³ Benchmarks indicating market interest rates in financial transactions conducted in European interbank markets.

ii. Entities to Be Covered

In view of the points listed below, it would be appropriate to consider administrators as the primary entity subject to regulation.

- Administrators determine and publish financial benchmarks in their own names, and can be expected to play a leading role in ensuring the accuracy and credibility of financial benchmarks.
- IOSCO Principles are mainly focused on regulations applicable to administrators.

However, in order to achieve consistency with the UK regulations and the proposed EU regulations, it would be appropriate to establish some form of discipline not only for administrators but also for submitters of data on which the benchmarks are based. In so doing, due attention must be paid to avoiding an outcome that unduly lowers the motivation of submitters to submit data.

c) International Consistency

Cases of manipulation of financial benchmarks have occurred in the determination of LIBOR and other financial benchmarks administered in Japan and other countries. In light of this fact, it is important to design regulations that are internationally consistent and to ensure their effectiveness through international cooperation.

From this perspective, the basic stance in considering the adoption of a regulatory framework should be to ensure compliance with the IOSCO Principles that have already gained international consensus. At the same time, due attention should be paid to achieving consistency with the UK regulations and the proposed EU regulations.

4. Specific Content of Regulatory Framework

In considering the specific content of regulations to be established, due attention should be paid to achieving international consistency as discussed in Section 3. above. From this perspective and to ensure compliance with the IOSCO Principles, it would be appropriate to proceed by examining issues corresponding to the individual principles contained in the IOSCO Principles. Furthermore, the IOSCO Principles are based on the concept of proportionality, which suggests that the application and implementation of the Principles should be proportional to the size and risks posed by each benchmark. Hence, it is also important to consider the concept of proportionality in designing the regulatory framework.

a) Framework for Entry Regulations

A possible legal framework to be introduced in the Financial Instruments and Exchange Act for regulating administrators of financial benchmarks would include such matters as designation, registration, and authorization. As administrators determine specific financial benchmarks that play a critical role in Japan's financial and capital markets, they perform operations that are public in nature and similar to the financial infrastructure. In light of this fact, it would be appropriate to consider establishing a designation system⁴ for designating specific entities to undertake operations that are similar in nature to the financial infrastructure.

If a designation system were to be adopted, it would designate specific administrators for specific benchmarks. That is, due attention should be paid to the fact that regulation would not extend to all of the other benchmarks administered by a said designated entity.

b) Specific Mechanisms and Content of Regulations

If a designation system were to be adopted, it would be appropriate to recognize a designated entity as a "Designated Financial Benchmark Administrator" (tentative name), and to specify a financial benchmark subject to regulation as a "Specified Financial Benchmark" (tentative name), both of which would be subject to a certain regulatory and supervisory framework.

Specific regulatory mechanisms should take into account such requirements as strengthening the governance and mandating the accountability of Designated Financial Benchmark Administrators, and ensuring the quality of Specified Financial Benchmarks and their determination methodology. From this perspective, Designated Financial Benchmark Administrators should be required to formulate operational rules corresponding to the requirements of the IOSCO Principles. Moreover, the adoption and revision of such operational rules should be subject to approval by the regulatory authorities.

To ensure that Designated Financial Benchmark Administrators are appropriately and effectively performing their operations, it would be appropriate to legally obligate Designated Financial Benchmark

⁴ Under the Financial Instruments and Exchange Act, the designation system is generally adopted to regulate an entity which undertakes operations that are similar in nature to the financial infrastructure. Specifically, Alternative Dispute Resolution and Trade Repository are regulated under the designation system in the Financial Instruments and Exchange Act.

Administrators to perform their operations in compliance with laws and ordinances and their operational rules.

Furthermore, from the perspective of mandating the accountability of Designated Financial Benchmark Administrators and ensuring transparency in the determination process of Specified Financial Benchmarks, it would be appropriate to require Designated Financial Benchmark Administrators to submit explanatory documents at regular intervals and to provide for the public inspection of such documents.

In establishing specific regulations, it would be appropriate to leave the following matters to be stipulated under Cabinet Order and Cabinet Office Ordinances as necessary.

- Matters requiring flexible response to changing circumstances. (Developments in the EU regulatory framework currently under consideration should be taken into consideration.)
- Technical details contained in the IOSCO Principles.

c) Framework for Inspection and Supervision

To ensure the effectiveness of regulation on Designated Financial Benchmark Administrators, it would be appropriate to establish the following framework for inspection and supervision within the designation system outlined above.

- i. To establish methodology for monitoring the status of operations and assets of Designated Financial Benchmark Administrators, the regulatory authorities should be empowered to require the submission of reports and to undertake on-site inspections whenever deemed necessary and appropriate for securing the public interest or protection of investors.
- ii. To ensure precision and fairness in the management of operations of Designated Financial Benchmark Administrators and to provide for the protection of investors using Specified Financial Benchmarks, the regulatory authorities should be empowered to issue business improvement orders pertaining to the status of the management of operations or assets of Designated Financial Benchmark Administrators whenever deemed necessary and appropriate for securing the public interest or protection of investors.
- iii. To ensure precision and fairness in the management of operations of Designated Financial Benchmark Administrators and to provide for the protection of investors using Specified Financial

Benchmarks, the regulatory authorities should be empowered to issue business suspension orders, dismissal of officers orders and rescission of designation with regard to the management of operations of Designated Financial Benchmark Administrators whenever deemed necessary and appropriate for securing the public interest or protection of investors.

- iv. In addition to the above measures, to ensure precision and fairness in the management of operations of Designated Financial Benchmark Administrators and to provide for the protection of investors using Specified Financial Benchmarks, Designated Financial Benchmark Administrators should be obligated to fulfill the following requirements.
- To prepare and submit business operation reports to the regulatory authorities at regular intervals.
 - To receive prior authorization from the regulatory authorities before outsourcing parts of their operations to external entities.
 - To compile and maintain records of operations.

d) Regulation of Financial Benchmarks Administered in Other Countries

Among the cases of fraudulent manipulation of financial benchmarks that occurred in Japan, some pertain to LIBOR administered in the UK. From the perspective of ensuring fairness in derivatives transactions in Japan, in certain cases it would be meaningful to require foreign administrators of benchmarks used in Japan to comply with Japanese government regulations.

In light of this possibility, more flexible responses may be considered. While establishing a framework that would allow benchmarks administered by foreign administrators and are critical for Japan's financial and capital markets to be covered by Japanese government regulations, the actual decision of whether or not to apply the regulations could be made depending on the assessment if the foreign administrator is adequately supervised by the home-country regulator. That is, Japanese regulations would not be applied when the home-country regulator supervises the foreign administrator adequately. In this process, it would be appropriate to examine whether the foreign administrator in question is complying with IOSCO Principles.

On the other hand, it is conceivable that some Japanese Designated Financial Benchmark Administrators would then come under the scope of foreign government regulations. In such instances, duplicated regulations could excessively burden Designated Financial Benchmark Administrators.

As can be seen from the above, financial benchmarks are used across the border and each regulator takes measures against them respectively. Hence, in introducing the regulation of financial benchmarks, it is indispensable to cooperate and coordinate with foreign regulators.

e) Discipline for Submitters

Submitters of financial benchmarks are generally not limited to Financial Instruments Business Operators, etc., which include Financial Instruments Business Operators and Registered Financial Institutions (including banks), and may include entities with varied attributes and characteristics. Therefore, it is not necessarily realistic to subject all submitters to direct regulation. For instance, in the case of TIBOR, the majority of submitters are banks, which already come under the regulations of the Banking Act and other legislation. Hence, it is necessary to exercise due caution in considering the possibility of introducing additional direct regulations.

In light of the above, the regulatory framework for submitters of Specified Financial Benchmarks (tentatively assumed to be TIBOR for the time being) should not be based on direct regulation. Instead, it would be appropriate to indirectly establish discipline through Designated Financial Benchmark Administrators by requiring them to enter into contracts with submitters stipulating their compliance with a Code of Conduct based on the requirements of IOSCO Principles, and subjecting such Code of Conduct to approval by regulatory authorities.⁵

However, in the case of Financial Instruments Business Operators, etc. that are already subject to regulation under the Financial Instruments and Exchange Act, it would be appropriate to prohibit fraudulent acts related to the submission of data on Specified Financial Benchmarks and to ensure compliance through penal provisions.

f) Ensuring Continuity in Determination of Specified Financial Benchmarks

The IOSCO Principles state that administrators bear primary responsibility in all aspects of benchmark determination process, including measures responding to unforeseen contingencies. Specified Financial Benchmarks (tentatively assumed to be TIBOR for the time being) are widely used in derivatives transactions and others, and play a fundamental role as a critical infrastructure in financial markets. In view

⁵ The IOSCO Principles also state that administrators develop the submitter Code of Conduct and adequately monitor the submitter's state of compliance.

of this fact, it would be appropriate to adopt the following rules to provide a framework for uninterrupted administration of such benchmarks.

- i. The operational rules should include requirements for the formulation of contingency plans covering natural disasters and other contingencies in which determinations of Specified Financial Benchmarks are interrupted due to reduction of the number of submitters or other reasons beyond the control of the Designated Financial Benchmark Administrator. The content of and compliance with contingency plans should be subject to confirmation by the regulatory authorities.
- ii. Any Designated Financial Benchmark Administrator intending to voluntarily suspend or terminate its operations must obtain the prior approval from the regulatory authorities.
- iii. When, due to certain reasons, a Designated Financial Benchmark Administrator is rendered unable to appropriately continue its operations, the regulatory authorities should be empowered to order the transfer of its operations to other eligible entities.

5. Other Matters

Maintaining the accuracy and credibility of financial benchmarks other than those subject to regulation (tentatively assumed to be TIBOR for the time being) is also important. However, the IOSCO Principles do not expect a one-size-fits-all method of implementation which applies the Principles to each benchmark uniformly for achieving this objective. Instead, the IOSCO Principles adopt the concept of proportionality and an approach allowing for deviation from a principle but in that case requiring explanation of how the objectives and functions of the relevant principle can be met. From this perspective, it is hoped that administrators dealing with financial benchmarks subject to the IOSCO Principles will take the following actions.

- As called for under the IOSCO Principles, benchmark administrators should voluntarily monitor and publicly disclose their status of compliance with the IOSCO Principles.
- If the status of compliance deviates from a certain principle, the benchmark administrators should explain how it is achieving the objectives and function of the relevant principle.
- When listing derivatives or other financial products that are referred to financial benchmarks subject to IOSCO Principles, the relevant Financial Instruments Exchange voluntarily checks

disclosed results of the administrators' status of compliance with the IOSCO Principles.

Moreover, it is desirable for originators, etc. of relevant financial products referred to financial benchmarks subject to the IOSCO principles to confirm the said administrator's disclosure of compliance with the IOSCO Principles before using the relevant benchmarks.