Florian Nitschke
Market Infrastructure and Policy (MI&P)
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

13th February 2013.

Dear Mr Nitschke,

The Chartered Financial Analyst Society of the United Kingdom (CFA UK) welcomes the opportunity to respond to the consultation The Regulation and Supervision of Benchmarks CP 12/36. This response has been prepared by CFA UK's Professional Standards and Market Practices Committee (PSMPC) and we have not surveyed our members. However, key themes in our response have been based on the CFA Institute's responses to the European Parliament[1] and European Commission[2]. In these responses CFA Institute does cite the results from its survey of the global membership.

About CFA UK and CFA Institute

CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

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[1] Comment Letter to the European Parliament on Market Manipulation: Lessons and Reform Post LIBOR / EURIBOR

[2] Comment Letter to the European Commission on the Regulation of Indices Serving as Benchmarks

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

Members of CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct. Since their creation in the 1960s, the Code and Standards have served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its society.

Context and scale of the scandal

"We will never know the amounts of money involved, but it has to be the biggest financial fraud of all time….. Libor is the basis for calculating practically every derivative known to man."

Adrian Blundell-Wignall, a special adviser to the secretary-general of the Organization for Economic Cooperation and Development in Paris.[3]

The scandal of the manipulation of the London Inter-Bank Offered Rate (Libor), has provided another sad reminder of the extent to which some firms allowed their interests to be placed ahead of their customers. This debacle has caused pubic outrage, moreso because fines do not appear to be enough to compensate for the betrayal of trust. As CFA UK stated when the news of the Barclays fine was announced[4] –

[3] "RBS libor rigging in quotes", The Guardian, 6 February 2013 http://www.guardian.co.uk/business/2013/feb/06/rbs-libor-rigging-in-quotes

[4] "Banks need to commit to much higher standards of ethical and professional behaviour – CFA UK responds to the FSA's Libor investigation" https://www.cfauk.org/about/profile-history-annual-reports.html?id=43

"The FSA's on-going investigation reveals an absence of integrity and the routine placing of personal or firm interest ahead of that of the market and clients. With reference to our specific standards[5]*, standard I(c) of our code requires members not to knowingly make any misrepresentations, while standard 1(d) demands that members should not engage in any professional conduct involving dishonesty, fraud, or deceit. In addition, standard II(b) states categorically that members must not engage in practices that distort prices."*

Libor affects not only lenders and borrowers but also investors that have invested in products linked to Libor. Major pension funds and others that use liability driven investment approaches may have also been affected by the manipulation of Libor. Derivatives related to foreign exchange and other products will also be affected by Libor manipulation. The $300 trillion quoted in the CP 12/36 may well be on the conservative side. One source sees the figure as high as $800 trillion[6]. While we appreciate the desire to move on, we must ensure we do not forget this sorry episode. We must remember the lessons from it.

Given the enormity and scale of this manipulation and its consequences; it is appropriate that the regulator takes strong action against the perpetrators. CFA UK welcomes the regulator's initiative to enhance the governance surrounding the setting of Libor. CFA UK also welcomes the regulator's desire to ensure that firms and their employees will be aware of the much stronger sanctions should they engage in similar behaviour in the future.

Diagnosis and the key lesson that needs to be learned

'We had no controls, absolutely. Libor has been going since the mid 1980s, and we had no controls in place". Sir Philip Hampton, Chairman of Royal Bank of Scotland.

The Wheatley Review found three key weaknesses that resulted in the manipulation of Libor:

• Insufficient independence of the governance structures, which relied too heavily on the participating banks and their own industry organisation.

• Inadequate oversight structures, such as the lack of systematic oversight of systems and controls within contributing banks.

• Limited transparency and accountability of the governance structures.

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[5] CFA Institute Code of Ethics and Standards of Professional Conduct
http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1

[6] "The rotten heart of finance," The Economist (print edition) 7th July 2012

CFA UK proposes a different diagnosis. There was no governance failure because there was no governance. Essentially, there was an absence of checks and balances to verify the integrity of the inter-bank rates that were being submitted in the UK and elsewhere. In short, the governance structure was simply relying on the "word" of the submitters. There was no desire to verify the submissions by the British Bankers' Association (BBA) or any other body.

Given the importance inter-bank rates play in signalling the pricing and allocation of capital; one would have hoped that integrity of the system would have been examined much sooner. The key weakness of Libor has always been the lack of verification. Any benchmark that relies on assessments or other inputs that cannot be verified will always be vulnerable to manipulation. This should be the key lesson for the regulator. Regulatory intervention should be limited to any reference rate or benchmark that is based on inputs that cannot be verified.

Beyond Libor the concerns remain

CFA UK is concerned that the Libor scandal may be used to tar every benchmark with the same brush. The absence of any governance mechanism for a reference rate/benchmark will always make it vulnerable to manipulation. CFA UK also hopes that the UK regulator conveys this key lesson to EU regulators so that they too, can have the insight as to why Libor was prone to manipulation. So far there are some encouraging signs with the FSA investigating the allegations of the manipulation of wholesale gas prices[7] (which are based on quotes and assessments).

It appears that the outcome of regulatory actions related to Libor has seen some participants in other markets respond in a progressive manner. Major brokers in the natural gas markets have become pricing agencies themselves by creating benchmarks ("Tankard" indices) that are based on actual transactions rather than bids, offers and assessments. This initiative was helped by regulatory pressure and demonstrates how the regulator and market participants can collaborate to bring about better outcomes.

Despite these encouraging developments, expanding this practice to other markets where pricing is based on quotes and assessments has met with opposition. The recent attempts to reform the benchmarks used in oil markets have collapsed. Hence, given the size of the Libor scandal and its repercussions there are still markets where the integrity of the benchmark

[7] "Commodities brokers launch gas benchmarks", Javier Blas, Financial Times, 6 February 2013
http://www.ft.com/cms/s/0/afe87484-7047-11e2-ab31-00144feab49a.html#axzz2RrJQJsan

cannot be assured. The UK regulator should focus on benchmarks/reference rates where there is little or no verification. Not every benchmark invites the attention of the regulator.

Support for regulatory intervention

CFA Institute surveyed its global membership on how to address the issues related to Libor. 70% of CFA Institute members surveyed on the reform of Libor believe that the Libor submission process should be a regulated activity. By extension, CFA Institute believes that the entities that input into the setting of interest rate benchmarks such as Libor and Euribor should be regulated.

Regarding the benchmark itself, 55% of CFA Institute members (59% in Europe, Middle East and Africa) responded that administration of Libor should remain with industry bodies but should be subject to regulatory oversight. Accordingly, interest rate benchmarks such as Libor and Euribor should be subjected to regulatory oversight.

56% of CFA Institute members responding to the survey said that the most appropriate methodology for the setting of Libor would be an average rate based on actual inter-bank transactions only; a further 32% thought that a hybrid methodology using actual and estimated rates would be appropriate—meaning that approximately 88% of members think that actual transaction rates should be used as at least part of the basis for Libor (and other similar interest rate benchmarks).

One possible drawback with actual transaction rates, however, is the illiquidity in parts of the interbank loan market. Approximately half of the respondents who said that only actual transaction rates should be used felt that some use of estimated rates would be acceptable if the underlying market was very illiquid. We hope the UK regulator takes this into account in its assessment of the new regime.

UK regulatory response so far

According to the Wheatley Review[8] the need to intervene is because -

"at present neither submitting to LIBOR, nor administering LIBOR, is a regulated activity under FSMA. As a result, while the FSA is currently taking regulatory action in relation to attempted manipulation of LIBOR by firms, this action is proceeding on the basis of the connection between LIBOR submitting and other regulated activities, and there is no directly applicable specific regulatory regime covering these activities. This affects the FSA's ability to supervise and take enforcement action in relation to these activities, even when carried out by a firm that is regulated in respect of its general business activities."

The actions taken by the regulator demonstrate that firms can be held to account for breaching one or more of the Principles for Businesses. In the case of the Royal Bank of Scotland (RBS), it was found to have breached Principles 3 and 5[9], the latter breach considered the 'most serious'. The table summarises the areas of inappropriate conduct uncovered by the UK regulator. The table also demonstrates the nature and severity of the breaches involved.

Principle 3 - Management and control *A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.*	**Principle 5 – Market conduct** *A firm must observe proper standards of market conduct*
The breaches of Principle 3 were as follows: • *Failure to identify and manage risks of inappropriate submissions.* • *Absence of any submissions-related systems and controls until March 2011.* • *Inadequate transaction monitoring systems and controls.* • *Failures of management oversight.*	The breaches of Principle 5 were as follows: • *Manipulation of RBS's own submissions* • *Collusion with Panel Banks and Broker Firms.* • *Management awareness of manipulation* • *Motive – RBS sought to manipulate LIBOR in order to improve the profitability of its derivatives trading books.*

[8] The Wheatley Review http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf

[9] FSA Final Notice http://www.fsa.gov.uk/static/pubs/final/rbs.pdf

These actions demonstrate that while the setting and administration of Libor were not regulated activities; the regulator did have the mandate to take action. The question remains whether the fines imposed so far are a sufficient deterrent; especially when one observes the differences between the UK and US penalties. It appears that had the UK regulator been more active in supervising the existing regulations as far back as 2005; the scale of the Libor debacle may have been a lot less.

Despite the UK regulator's desire to take action and enhance the integrity of Libor. There is a sense that the UK regulator will need to clarify its approach further in trying to balance intervention with market forces. The following juxtaposition from CP 12/36 demonstrates this:

Para 1.6 – "it is clear there have been widespread failings in the industry-led regulation of LIBOR".

Para 4.24 - "we want LIBOR to remain an industry-led process and will proceed on that basis".

Response to questions

Q1: Do you agree that our suggested capital requirements for the administrator will give enough time for an orderly transition to a new administrator?

Given the administrator will be essential in the governance of Libor; it should be well-resourced to fulfill its role. This does raise the following questions:

1) Why the functions of the administrator are not undertaken by the regulator?
2) Why the costs of the administrator are not funded from the fines levied on the banks involved in Libor manipulation?

Q2: Are there any other rules we should consider for the administrator?

CFA UK hopes that as a regulated entity, the administrator is supervised effectively by the UK regulator.

Q3: Do you agree with our proposals for charging fees from the benchmark administrator?

Given our response to Q1 above and the importance of the administrator; why should this entity pay any fees?

The UK regulator also needs to explain why the fees for supervising the submitters will be spread across all fee blocks. One would have hoped that costs of this additional regulation would have been funded by the banks that were manipulating Libor.

Q4: Do you think there are any other rules we should consider for the submitters?

As the regulator's actions have demonstrated, the Principles for Businesses provide grounds for action where necessary. Additional rules are not required. The UK regulator needs to ensure it will supervise and enforce more effectively than in the past.

Q5: For what period should submitters be mandated to keep records?

Submitters should keep records for as long as is appropriate. Given the importance of Libor the longer the period the better. The case against Barclays revealed manipulation as far back as 2005. If a firm has failed to keep appropriate records related to its submissions; the regulator should not treat this lightly.

Q6: How frequently do you think the external audits should occur?

The frequency of external audits should occur at a frequency that can provide reassurance about the integrity of Libor. Perhaps a monthly audit to begin with and this could be extended to a quarterly audit as the new system gains momentum. However, this should not preclude the need for interim audits should concerns about any of the submitters arise. The Libor scandal should alert the regulator to the fact that the forms that need to be watched most closely are the ones with the most to gain from manipulating Libor rates. These firms should face more regular audits.

Q7: Do you agree with our proposals to apply the new CF40 controlled function regardless of where the submitting activity takes place?

The new CF40 controlled function does provide some form of direct accountability akin to the money laundering officer role. It may have been preferable to assign the integrity of submissions among the senior management of the submitting organization. The senior manager would then be responsible for the corroboration of the submissions for Libor. The UK regulator has stated it does not want to be prescriptive. However, the CF40 function may set the precedent to create further prescriptive controlled functions whenever major transgressions occur in the future.

DP1: Do you agree that the specific indicators and methodology we have identified adequately capture those institutions that will maintain the integrity of the LIBOR rates?

The integrity of Libor rates relies on the interaction of the effective governance and the effectiveness of the regulator. As long as the quality of the submissions can be safeguarded the integrity of Libor will be improved. The UK regulator should also bear in mind that from time to time there may be gaps in the Libor curve if some rates cannot be verified.

DP2: What are you views on how many institutions should form the 'super-set' that contributes to LIBOR?

It is too early to say as the investigations are on-going. However, the external audits will play a key role in providing insights as to which submitting firms can be relied on to provide credible Libor rates.

DP3: Do you agree with our approach to determining currency expertise?

No comment

DP4: What do you think is the best process for expanding the LIBOR panels and encouraging firms to participate?

Maintaining the integrity of Libor should be the main priority.

DP5: Do you agree with our proposed approach for determining the circumstances in which the FCA would take up its powers to require submission to LIBOR?

The regulator needs to provide more information as to when this would be the case. One would hope that any firm that has verifiable data regarding its inter-bank activity would submit this information to the administrator. If the regulator does have case for concerns then this should be focused on the governance rather than the quantity of submissions.

We trust that these comments are useful and would be pleased to meet with senior FSA/FCA officials to explain them or to develop them.

Yours,

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