FCA FINANCIAL CONDUCT AUTHORITY

12 Endeavour Square
London
E20 1JN

Tel: +44 (0)20 7066 1000
Fax: +44 (0)20 7066 1099
www.fca.org.uk

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Dear Chief Executive,

Our supervisory strategy for benchmark administrators

This is our third letter to benchmark administrators (BMAs). You can find previous letters published in 2022 and 2020 and the Dear CEO Letter on the ESG Benchmarks Review from March 2023. It reflects our views on the key risks we have identified in the portfolio, our expectations of you and a summary of the work we intend to do over the next two years.

The FCA has a strategic objective to ensure that financial markets function well, with high levels of market confidence, integrity, and participation. Benchmarks are embedded throughout the financial system and have steadily increased in importance and prominence, as the usage of benchmarks by a wide variety of participants continues to develop. Good governance and strong leadership lie at the heart of ensuring BMAs operate in accordance with the requirements of the Benchmarks Regulation (BMR), ensuring accurate and reliable benchmarks are being made available and reducing the potential for harm to users and end-investors.

We have seen some progress by BMAs in response to the risks identified in our previous letters, with more to be done particularly in the areas this letter highlights. The key risks below have been identified in the context of a rise in passive investing and a drive towards users demanding more complex, custom benchmarks to meet their preferences. In this environment, it is important that the robustness of BMAs' underlying systems and controls, as well as their strategic oversight and scrutiny, keep pace.

Our supervisory priorities for benchmark administrators are set out below.

1. **Corporate governance and Oversight**

Our view of the risks

It is important that BMA governance is commensurate with the level of importance and embeddedness of benchmark usage throughout the financial system.

Through our engagement with BMAs, we observed examples of ineffective and immature boards and management bodies. This includes, where BMAs are part of larger global groups, strategic decisions around UK-BMA regulated activities being taken by entities outside the UK management body. We noted a lack of documentation around governance responsibilities, and the absence of enterprise risk management frameworks. Senior management also may not be receiving appropriate management information (MI) detailing risks and trends in the BMA business which inhibits their ability to take informed decisions.

What we expect from you

We recognise that BMAs have different governance arrangements. Regardless of a specific firm's structure, we expect your management body to effectively oversee strategic decision-making, risk management and regulatory compliance. This is in addition to having a permanent and effective oversight function as referred to in Article 5 of the BMR.

We also expect the management body to provide robust challenge to the business. In the case of BMAs which are part of global organisations, the management body should contribute to driving strategic decisions for the UK BMA to drive positive change.

All BMAs should have effective enterprise risk management frameworks. Where the BMA operates as part of a bigger group/global organisation, the framework must reflect the specific structure of the UK BMA. The management body should be continuously sighted on the risks deriving from any planned or ongoing change management programmes and risks arising from outsourcing and/or key data providers.

In line with the above, we would expect you to be able to share with us your own assessment of the effectiveness of your overall governance along with any plans you have to address any weaknesses.

What we will do

We will conduct a governance review in late 2025 to assess how the UK-regulated BMA business is governed and led by UK Approved Persons under the Senior Managers Regime, and to what extent they are able to oversee the full range of risks to which the firm is exposed. This will consist of a multi-firm review, involving engagement with the management body, including observation of key meetings and a review of relevant documentation.

2. Data quality controls

Our view of the risks

The findings from our recent Operational Resilience Questionnaire flagged third-party management as one area where improvements are needed.

BMAs need to be confident that their control frameworks reflect the risks associated with third-party data sources. We have observed instances where firms have not appropriately enhanced their data input controls as their product offerings evolve, leading to an increased risk of inaccurate benchmarks being produced, potentially harming end-users.

BMAs are also increasing their use of innovative and nascent non-price data inputs to produce their benchmarks, such as ESG or AI-generated data. These inputs are obtained from third-party data providers (including intra-group data providers). We recognise BMAs need to incorporate a variety of non-price data to meet the evolving demand for custom benchmarks. However, these data sources are typically unregulated and often subjective, relying heavily on modelling and estimates, so your oversight and controls should be especially robust.

We understand that the unregulated nature of ESG data and ratings in particular may cause particular challenges for BMAs in assessing the robustness and accuracy of data provided by third-parties. The government has recently confirmed its intention to bring ESG ratings providers within the regulatory perimeter, and published a draft Statutory Instrument (SI) in November 2024. Once technical comments on the draft SI have been received, the government intends to lay the legislation before Parliament in 2025 (subject to Parliamentary time allowing).

In 2023, we supported the launch of an industry-led Code of Conduct for ESG ratings and data product providers, which is grounded in the IOSCO recommendations. We continue to encourage both ESG data and ratings providers to sign up to the Code. We believe these initiatives will support the reliability and transparency of the ESG data and ratings market as a whole. Notwithstanding these regulatory developments, in recognition of these inherent risks, it is important that BMAs take proactive measures to assure the quality and reliability of all the data on which they base their products.

What we expect from you

We expect you to employ robust and regularly reviewed due diligence processes when selecting data providers. Before onboarding, you should thoroughly assess all potential risks arising from their use. You should also review any operational changes with the data providers you use, and ensure these relationships stay within your risk appetite.

After the initial onboarding process, we expect that your relationship with third-party data providers is kept under review, with adequate processes and MI to monitor data providers on an ongoing basis. Regular, good quality MI, including analysis on the quality and timeliness of the data you receive, should inform future decisions with respect to their ongoing use. You should also develop a plan to mitigate the risks and impacts that may arise if replacement providers are unavailable for specific types of data.

We expect data controls to reflect the relative riskiness of the data you are using. Where data sets are unregulated, innovative, or subjective, data controls should take account of these factors. We expect you to have appropriate arrangements, including clear policies and procedures in place, with detailed mapping of roles and responsibilities in the data controls processes, strong quality assurance processes and controls. Improvements to these arrangements should be introduced when you identify gaps or following errors or failures in your validation checks.

What we will do

Beginning in early 2025, we will evaluate the adequacy of the due diligence you perform on the data providers you use. Through this multi-firm data controls project, we will also seek evidence of how your control framework adequately mitigates the additional risks associated with unregulated or innovative data.

3. **Benchmarks controls**

Our view of the risks

Poor internal controls during the calculation and the rebalancing process prevent BMAs producing accurate benchmarks. Failure to identify and promptly correct potential errors in those key stages of the benchmark determination process can result in financial and non-financial harm for end-users.

We have observed instances where BMAs did not adequately adapt their controls to new types of benchmarks being administered. These included failures to apply the required filters as part of the rebalancing process and not identifying and addressing the subsequent gaps in their methodologies which had caused errors in the benchmarks.

We noted some BMAs still rely on manual quality control processes for their validation checks, further increasing the likelihood of errors. In addition, some BMAs are not conducting sufficient quality assurance checks when launching complex and custom benchmarks, which has led to errors not being identified promptly ahead of the launch.

We have also observed that some BMAs do not have a framework for identifying, escalating, and reporting errors to the FCA in a consistent way. In our view, the absence of a more structured approach to identifying errors in these firms has contributed to them being less able to prevent reoccurrences.

What we expect from you

We expect you to have appropriate processes and controls to calculate benchmarks and perform the rebalancing when due, with appropriate governance and oversight in place. These processes and controls should take into consideration the design of the benchmark, including its complexity.

You should also have in place appropriate governance and oversight for the launch of more complex and custom benchmarks, with these being signed-off at an appropriately senior level.

We expect BMAs to identify, investigate, and escalate errors of calculation or rebalancing promptly, as well as performing root cause analysis to address any gaps and prevent reoccurrences. You should use MI to continuously improve the rebalancing processes and the overall effectiveness of your control framework.

What we will do

Building on our planned multi-firm review of data input controls, in the second half of 2025 we intend to evaluate the adequacy of the end to-end benchmark controls. This will involve a second multi-firm review, across different asset types, focusing on custom and more complex benchmarks. We will seek evidence that firms have adapted their controls for the launch, calculation, and rebalancing of custom or complex benchmarks.

4. **Disclosures**

As communicated in previous supervisory letters, clear and transparent disclosures are critical for benchmark users to be able to make informed choices, aligned to the investment outcomes they are seeking to achieve.

We have been encouraged by the concrete actions certain BMAs have taken in relation to ESG disclosures in particular, especially following our Dear CEO Letter in March 2023. We expect firms to revisit their disclosures to ensure they remain fit-for-purpose, especially considering the added complexity of some multi-asset benchmarks, to ensure they comply with all rules regarding low carbon benchmarks and sustainability-related disclosures.

With the introduction of the Anti-Greenwashing Rule, you should ensure you do not make misleading claims or provide false impressions through the naming of your benchmarks. This is particularly important given that many benchmark names are incorporated into fund names, which fall under the SDR naming and marketing rules.

5. **Operational Resilience**

Operational disruptions can create risks to the financial system. Strong operational resilience helps to ensure BMAs can produce accurate and reliable benchmarks. We expect you to minimise the risk of major disruptions, and to continue improving your overall operational resilience by identifying and addressing any weaknesses in your current arrangements.

You should continue to consider any direct feedback your firm received following completion of FCA Operational Resilience Questionnaires, taking relevant actions where needed.

Other areas of focus and work impacting the portfolio

The Financial Services and Markets Act 2023 provides the legal basis for the repeal of assimilated law, following the UK's departure from the EU, and its replacement with regulators' rules. The BMR is assimilated law that will be reviewed as part of this process in due course. During this review, it is possible that changes to the regulatory framework for the provision of benchmarks in the UK will be made. Any changes will be subject to our usual consultation process. Our supervisory findings will help to inform this review and any subsequent changes to the regulatory framework.

The Wholesale Data Market Study report published earlier this year identified several issues that may limit effective competition within the benchmarks market. As noted in the report, we will look at these issues holistically as part of the wider regulatory work in wholesale financial markets and alongside international developments. Where appropriate, we will address the issues as part of, or following, the above review of the BMR, and by tackling firm specific issues using other tools such as our powers under the Competition Act 1998.

Next steps

We expect you to discuss the content of this letter with your senior management and be able to demonstrate your plans to address the expectations set out above, if asked.

We are grateful for BMAs' open and ongoing engagement with us on key supervisory and regulatory matters. We note that BMAs have generally sought to ensure greater and more timely notification of issues we would reasonably expect to be notified about; we welcome these advances and are keen to maintain positive and proactive engagement with the sector.

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

Should you have any queries about this letter, please contact us at benchmarkssupervision@fca.org.uk. This is the primary contact for your firm's day-to-day interactions with the FCA.

Yours faithfully

Jon Relleen
Director – Supervision, Policy & Competition