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Financial Market Infrastructure
Australian Securities and Investments Commission
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Sydney NSW 2001

By email: financial.benchmarks@asic.gov.au

Dear Ms Luo

Financial Benchmarks Regulatory Reform

The Australian Financial Markets Association (AFMA) is making comment on the consultation paper issued the Council of Financial Regulators (CFR) on Financial Benchmarks Regulatory Reform. In making comment AFMA is doing so in its role as the financial markets public policy body, not as an existing benchmark administrator.

In Australia there has been a high degree of integrity in systemic benchmark administration, which satisfies the global standards set by IOSCO and has served our financial system well. The existing regulatory framework is designed to address the risk of misconduct, as evidenced by recent regulatory actions relating to financial benchmark activities.

Nevertheless, because Australian financial markets are integrated with the global markets, this creates strong pressure to align regulation in Australia with practices in the key overseas jurisdictions. Reflecting on the international experience and taking account of the effect of recent domestic regulatory actions, there is a case to support ongoing confidence in financial benchmarks by upgrading the regulatory framework for benchmarks in Australia.

1. Summary

Regulatory reform should have these characteristics:

1. AFMA agrees with the list of identified significant benchmarks, including BBSW.
2. Benchmarks such as BBSW are only significant in relation to particular tenors. Only such tenors should be include in the defined significant benchmark.
3. Nominate by regulation significant benchmarks rather than by some general class definition.
4. Significant benchmark administration is a form of financial market infrastructure (FMI) and should be regulated consistently with the approach to other FMI through a dedicated licensing regime.

5. A power to compel benchmark submission is a last resort, temporary fallback mechanism.
6. The proposed offence provision should only be applied to manipulation of a significant benchmark.
7. Bills of exchange would need to be formally included as a financial product to bring them within scope of Chapter 7 regulation.

2. Defining Financial Benchmarks in general

The absence of a definition of financial benchmark in the Consultation Paper is surprising given its central role in the proposed regulation. It is an important omission as the boundary of the definition effectively determines the scope of the proposed new regulation.

The definition of financial benchmark adopted by IOSCO, which we presume underpins the Consultation Paper proposals, is very broad. IOSCO acknowledges that the strict application of its Principles to the range of rates and prices covered by its benchmarks definition would be highly problematical in practice, especially for 'benchmarks' of limited application and use. Consequently, IOSCO states that the Principle should be applied in a proportionate manner to benchmarks that have less economic significance.

Unfortunately, there is little practical guidance on how IOSCO's Principles should be applied in a proportionate manner and the combination of the associated uncertainty with regulatory risk aversion on the part of financial entities has meant that many useful but not systemic rates have been unable to survive. Amongst other things, this has reduced transparency in the financial system.

The approach taken to resolving this problem in some jurisdictions that adopt a definition consistent with IOSCO's definition is to limit the application of associated regulation to systemic benchmarks. For example, Singapore is proposing this approach citing its concern that such a broad application of the regulatory framework, without consideration for the market impact and risk profile of a financial benchmark, would not be the most efficient use of regulatory resources. Instead, it is looking to use a calibrated approach focusing on certain financial benchmarks, which it considers a more proportionate regulatory response.

AFMA recommends that the CFR should either:

- adopt a narrow definition of benchmark that only covers those of systemic importance, or
- adopt broad IOSCO type definition and apply the additional formal regulation only to benchmarks that are of systemic importance, which in the language of the Consultation Paper means those that are 'significant'; and continue to apply existing law to non-systemic (non-significant) benchmark activities.

3. Defining Significant Financial Benchmarks

The CFR formulation that a benchmark is significant if it is systemically important is sound. A key factor in the assessment of systemic significance is the materiality of impact on market participants if the benchmark is disrupted. Application of this approach appropriately produces a small number of significant benchmarks.

The limited class of benchmarks and the major consequences that will flow from being associated with a regulated significant benchmark, such as licensing obligations and offence provisions means that there should be no vagueness about which benchmarks are significant, such as by some general class description. Significant benchmarks should be specifically nominated under a regulation.

A significant benchmark is a market standard which enjoys broad recognition and support by relevant market participants through regular use in financial contracts. A significant benchmark does not arise in the abstract. The mere claim by an administrator or other promoters that a reference rate is a benchmark does not make it one automatically. It must attain the status of being a benchmark through widespread adoption in the relevant market.

Attaining the status of 'benchmark' is therefore a process, which starts at creation of a price determination process, its promotion and the passing of a tipping point where it gains widespread acceptance. A driving force for adoption is the incentive for market participants to reap the information-related benefits of a benchmark such as lower search costs, higher market participation and better matching efficiency.

It is possible for a benchmark to acquire the characteristics of a significant benchmark over time as its utility and reliability gains widespread recognition. Only certain reference rates have the potential to become significant benchmarks. By their nature, as widely used systemically important pricing tools, significant benchmarks will be limited in number. To prematurely designate a reference rate as a significant benchmark where there is a lack of liquidity in the underlying market from which it is calculated or a lack of market support could result in the rapid failure of a reference rate and prove to be counterproductive unless the path ahead is well prepared. Given the limited number of significant benchmarks that can arise and the considerable regulatory consequences it is best to deal with them through a dedicated legal regime

It is the widespread acceptance and use of a rate to the point where it is referenced by many third parties which is the key defining characteristic of a significant benchmark. This creates a large legal risk situation in benchmark administration which cannot be effectively bounded or controlled through normal legal risk management techniques. Many what are now important benchmarks started life as a reference rate for a small group of wholesale market users calculated for their own convenience and made available to the world as a public good. For those involved with the supply of data and the administration of a benchmark widespread market reliance has led to an unconstrained duty of care to the whole world being implied and now becoming a regulated obligation. The supply of a significant benchmark to the world is no longer a service that can be provided on an altruistic basis. The forthcoming compliance burdens and attendant legal risk mean that benchmark administration needs now to be approached in the same way as other financial market infrastructure (FMI). This will unfortunately result in increased costs to the community and a possible change in usage patterns.

4. Importance of distinguishing tenors

The dispersion of trading activity can affect the utility of reported trades for market participants. There is also quite limited use of some benchmark tenors as reference prices for contractual purposes in the financial system, which can in part be related to the prevalence of trading. Users seeking to evaluate prices will find information on instruments traded at similar points on the yield curve or in similar forward tenors to be focussed at certain points. Trading patterns demonstrate that, for the major products, a significant proportion of activity is concentrated in a small group of the most

commonly traded tenors. An insufficient transaction volume on a low demand tenor makes such tenors of minor relevance as a significant reference point.

This means that low demand tenors should not form part of a significant benchmark. For example, 4 and 5 month trading in BABs and NCDs should not form part of a regulated BBSW benchmark. Indeed, the CFR has suggested that AFMA should consider discontinuing 2, 4 and 5 month tenors as their usage appears to be rare.[1]

5. Benchmark administration

AFMA agrees that a regulatory framework which embeds compliance with the IOSCO Principles is an appropriate and workable approach. AFMA's pioneering work in operating in conformance with the IOSCO Principles demonstrated how compliance with them can be achieved in practice.

With regard to the regulatory framework significant benchmark administration is a form of FMI and should be regulated consistently with the approach to other FMI through a dedicated licensing regime.

There is discussion in the Consultation Paper around the possibility of using the financial services licensing (AFSL) as a way of regulating benchmark administration. Benchmarks are not a financial service. Benchmark administration is clearly not in the nature of a financial service as defined under the Corporations Act. The reference to the approach taken with credit rating agencies identifies a sub-optimal regulatory mechanism which is a very poor precedent. AFMA noted in reference to the licensing for CRA activities that the AFSL regime was not designed as a regulatory tool for the purposes of institutional supervision, particularly of an entity like a CRA. The AFSL is directed at regulating the quality of the provision of financial services rather than as a means for making an organisation accountable to the regulator. Such a rickety approach also falls short when dealing with equivalence and substituted compliance issues that are important in the cross-border use of significant benchmarks.

The approach that should be taken, consistent with the approach to take to the regulation other FMI, is to create a new form of benchmark administrator license. The recent precedent of the regime created for the licensing of derivatives trade repositories provides a model approach.

Introduction of a benchmark administrator license is desirable when considering equivalence to European regulation of administrators and possible other comparable regimes. EU law makers are now processing the text of the new EU Regulation[2] on financial benchmarks. The Regulation will impose new requirements on firms that provide, contribute to or use a wide range of interest rate, currency, securities, commodity and other indices and reference prices. The rules in the text are the accepted compromise step and they are now going through the formalities of the EU law making process. It is expected that the new rules will be published in mid-2016 and will apply in early 2018.

Of particular interest from the Australian perspective is the "equivalence" requirement for non-EU benchmark administrators. See Art 20 ff. An EU supervised entity may only use a benchmark produced by an administrator established in a non-EU jurisdiction where the European Commission has adopted an equivalence decision in relation to that jurisdiction. In order for the Commission to adopt such a decision, the non-EU jurisdictions whose benchmarks are used in the EU would need to have in place

[1] CFR, Evolution of the BBSW Methodology, Discussion Paper, 9 February 2016.
[2] Proposal for a Regulation of the European Parliament and of the Council on indices used as benchmarks in financial instruments and financial contracts Brussels, 4 December 2015, 14985/15.

legislation equivalent to the proposed EU Regulation. A properly constituted dedicated Australian licensing regime would provide clear proof of equivalence.

6. Compelling submissions

The systemic importance attached to significant benchmarks and the requirement to manage sustainability identified in the CFR paper on the Evolution of the BBSW Methodology have broad application to market sourced significant benchmarks. As a result it has become obvious that an official mechanism to compel submissions could have utility as a reserve tool that provides fallback protection as the system evolves over time.

The use of the power of compulsion would necessarily raise some fundamental questions about the role of regulatory intervention and why there has been a market failure. The first order of business for a government or regulator should be to address the causal factor that has disabled the ability of the financial system to produce a benchmark of its own volition.

The need to rely on mandatory submissions is evidence that something has occurred to seriously disturb the conditions under which a benchmark is being generated. Benchmark rates by their nature are a public good. Financial entities that contribute to their production will do so because they are users of the rate themselves and recognise the national interest in maintaining effective systemic benchmarks and accept responsibility to support this. The causal factor could be something like an economic crisis or because a loss of confidence in the balance of regulatory risks or costs to participation in a benchmark.

Mandating participation by firms in the calculation of a benchmark cuts across basic free market principles on which the Australian economy is predicated. Government intervention needs to be understood as a very significant step which could have broader consequences. Compulsion would present a range of practical difficulties such as determining and maintaining a submitter panel, it being open to potentially counterproductive outcomes for some methodologies and moral hazard threats.

It is not clear to AFMA how underperformance (such as non-submission or regular outliers) by a submitter would be managed in a mandatory submitter regime. This introduces the possibility of a complex and onerous compliance regime with prescriptive indicators and the possibility of penalties. This would be difficult to administer and a highly unfair burden on those conscripted into the regime.

In summary, AFMA believes that mandatory submissions should only be applied as a last resort, only in the case of systemically important benchmarks and only on a temporary basis while the underlying causal factor is addressed as a matter of priority by the government.

7. Benchmark manipulation offence

The introduction of a benchmark manipulation offence is consistent with law reform in other jurisdictions and the IOSCO Principles. The issue is with how this would work in practice with regard to the scope of what is a benchmark.

IOSCO's definition of benchmark rate is all encompassing because it incorporates rates, prices and other factors used to measure the performance of a financial instrument. Arguably, most rate and price information generated by participants in the financial system is used for this purpose. Thus, neither this definition nor the associated principles differentiate between systemically important

benchmark rates and other price information typically made available in financial markets. As noted above, IOSCO and jurisdictions when implementing reform in this area have recognised the significant practical difficulties that this can create.

In relation to the proposed new offence provisions, AFMA is concerned that this broad definition when used for a criminal offence introduces a highly problematic and unnecessary compliance risk into the financial system. It will result in a curtailing transparency through the flow of price information as a result of compliance risk management restrictions that will have to be introduced.

In distinction to significant benchmarks there are a multitude of reference rates often calculated for revaluation purposes, which come within the broad IOSCO benchmark definition. These are rates are quantified from market data sources, typically for use in the valuation of financial market products. Valuations for profit and loss or risk calculations based on market data are preferred if available. Reference rates are often idiosyncratic and calculated off limited data sources because of a lack of liquidity in the underlying financial instruments and calculated in a way which is suited to a specific set of a limited group of users' needs. The creation and maintenance of such reference rates is user driven and they can be effectively managed by users because there is a close correspondence between the needs of the user and the provision of the rate by the calculation agent.

Reference rates reduce risk in the financial system by increasing the accuracy of mark to market measures of risk in banks. Often they are used by a limited set of sophisticated market users to complement other price data in their risk management and valuation processes. They are generally not systemic in nature and do not present the same issues as significant benchmarks for financial stability. In general, money does not change hands in relation to revaluation rates except in relation to collateral management (and this activity reduces rather than increases systemic risk). As reference rates are not critical to contractual obligations, there is not the same level of motivation for market participants to participate in their production. If there are greater regulatory costs and/or risks for entities that contribute to the creation revaluation rates, then participation may fall and the rates may decrease in reliability or cease to be published. This would increase risk for users of financial markets, as independent revaluations for certain OTC contracts would be less available and less reliable.

Adopting too wide a scope for the benchmark manipulation offence would impede the development of new financial markets. Often, a key stage in development of an emerging market is the construction of a reference price to increase transparency in the market and enhance the flow of information to market users. This may develop into a benchmark to assist in pricing in the market, although the market itself is not of a scale to be systemically important. A new reference rates/benchmark carries no systemic risk and unnecessary compliance risk restrictions would act as a barrier to benchmark and market development.

It is important to note that the IOSCO Principles incorporate the principle of proportionality[3] with regard to scope of offence provisions. This is reflected in the approach taken by the United Kingdom, which is sensible and workable. Their offence[4] relates to a relevant benchmark. A relevant benchmark is one that has been declared a 'specified benchmark' which are the major eight benchmarks. Under this proposed approach the equivalent would be to make the offence relate to manipulating a 'significant benchmark'.

Manipulation is also a vague concept. Greater specificity with regard to the unlawful act required such as making a 'false or misleading statement or creating a false or misleading impression as to price or

[3] Principles for Financial Benchmarks FR 07/13, IOSCO, pages 3,4 and 5
[4] Section 91 Financial Services Act 2012 (UK)

value' would assist in both the observance and the enforcement of the law. The fault elements should follow the general principles of criminal liability set out in Chapter 2 of the Commonwealth Criminal Code.

8. NCDs and Bills of exchange

The commentary under section 6.3 of the Consultation Paper contains some perplexing language which suggest there is a lack of clarity about what are and what are not financial products. The legal questions of interpretation are well understood and long established.

At a basic level there is a fundamental distinction between bills of exchange and negotiable certificates of deposit (NCDs) with regard to their characterisations as financial products. Bills of exchange are not currently treated as financial products. NCDs are unambiguously within the financial products definition.

NCDs

An NCD is a certificate issued by a bank evidencing an interest bearing deposit with that bank being negotiable and payable to the bearer on maturity. It comes unambiguously under the express inclusions of certain financial products by virtue of s 764A(1)(i) which covers *"any deposit-taking facility made available by an ADI… in the course of its banking business…"*

Accordingly, no clarification of the law is required with regard to NCDs and to do so would be redundant.

Bills of exchange

Bills of exchange currently fall outside the current definition of financial product. This is a longstanding and clearly understood legal issue.

Bills of exchange are financial instruments, in documentary form, characterised by negotiability. Negotiable instruments are documents of title, the possession of which may confer rights. Thus, a bill of exchange or a promissory note is a document that serves as a unique and transferable physical token of intangible rights and obligations, the statutory requirements for which are set out in the Bills of Exchange Act 1909. The Act governs the issue and transfer of bills of exchange and promissory notes in the short term money market. This Act may apply to any person who is lawfully capable of becoming a party to a bill of exchange or a promissory note by drawing or accepting it, or who becomes a party to a bill or note by way of transfer of ownership. Thus, the Bills of Exchange Act applies to both the primary issue of bills or notes and to any secondary sale of bills or notes.

In guidance issued in 2003[5] ASIC addressed the status of bills of exchange as financial products under the Corporations Act. ASIC says in the FAQ that:

> *We consider that a bill of exchange, including a bank bill, issued on ordinary commercial terms, is generally not a financial product for the purposes of the Corporations Act …*
>
> *Generally, we take the view that a bill of exchange falls within the exclusion for credit facilities: regulation 7.1.06(a). A credit facility is not a financial product for the purposes of the Corporations Act…*

[5] FAQ "Is a bill exchange a financial product" issued 23 November 2003, ASIC

The FAQ adds a note of ambiguity to the interpretation of the law, which relies on a rather tangential linkage and so cannot be relied upon for general regulatory purposes:

> *However, some bills of exchange may still be a financial product under the Corporations Act if, for example, they are interests in a managed investment scheme or form part of a facility for making a financial investment.*

The general definition of financial product in s 763A(1), which captures products pursuant to which a person makes a financial investment, is subject to the exclusions in s765A. Accordingly, if a bill of exchange is an excluded credit facility under s 765A(1)(h), it cannot be a financial product under ss 763A(1)(a) and 763B, whether or not it forms part of a facility for making a financial investment.

This line of reasoning is important because as a bill of exchange sits outside the general definition it can only be expressly made a financial product by adding it to the list of the specific inclusions by regulation using the power under s 764A(1)(m).

9. Costs

We note that it is inevitable that the package of regulation that form part of the proposals in the Council's Consultation Paper will increase these costs for entities that have a direct or indirect involvement in the benchmark setting process in Australia. The additional costs and red-tape burden imposed on industry that will flow from the proposed reforms do not appear to be deciding factors in the public policy decision to go ahead with implementing this new regime.

Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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