GLOBAL RATE SET SYSTEMS

*Leaders in Financial Benchmarking Services*

# Financial Benchmark Regulatory Reform

Submission in response to

## A Consultation Paper by the Council of Financial Regulators

**Date:** April 2016

29 April, 2016

Council of Financial Regulators
Financial Market Infrastructure
Australian Securities and Investments Commission

**Submission by email:** financial.benchmarks@asic.gov.au

Dear Sir/Madam,

## Re Financial Benchmark Regulatory Reform – Consultation Paper 2016

Global Rate Set Systems (GRSS) is pleased to provide our comments to the Council of Financial Regulators (The Council) on Financial Benchmark Regulatory Reform.

GRSS supports the objective of this consultation process to gain feedback from stakeholders on this important reform process. GRSS recognises the critical role that benchmarks perform in financial markets and the flow on effect to the broader economy.

The Consultation Process addresses reform in three key areas of benchmarks; Administration, Submission and Misconduct. Our submission provides GRSS's responses to the first two key areas, but we have chosen not to offer any view on the legal questions concerning misconduct and the classification of bank bills and NCD's as financial products.

## About GRSS

GRSS is a leading independent, specialist business that provides professional services within the financial benchmark arena to promote benchmark excellence. We offer our services, technology, and intellectual property and expertise to Financial Market Associations, Institutional Banks, Central Banks and Regulators to meet their Benchmark Administrator and related responsibilities.

GRSS has recently formed a new subsidiary company, *Australian Financial Benchmarks Facility Ltd,* to provide services to Benchmark Administrators in Australia. The scope of our services range from providing assistance to current benchmark administrators as a calculation agent or benchmark data licensing facilitator through to assuming overall responsibility for a benchmark should the current administrator wish to withdraw from their role.

In September 2013 GRSS was appointed the official Calculating Agent to the European Money Market Institute for the calculation of Euribor, a systemically important benchmark. Additionally, GRSS software is used by the European Central Bank for the calculation of EONIA.

## About this response

GRSS has assembled a highly experienced team of professionals who have worked for industry associations that manage benchmarks, companies that provide calculation agent services and financial market regulators. This response has been authored by a number of those GRSS's people, each of whom has direct experience within the financial benchmark space.

GRSS is cognisant of the challenges that benchmark administrators face in ensuring that their benchmark(s) remain trusted, reliable and robust. Aside from ensuring that the appropriate governance, benchmark quality, methodology, submitter conduct and accountability are present (requirements of the IOSCO Principles for Financial Benchmarks July 2013) a significant challenge is to ensure that sufficient data is being collected to maintain the integrity of the benchmark in an environment where evidence suggests that benchmark setting itself and increased regulatory scrutiny is pushing market liquidity away from rate set periods and discouraging submitters from participating in the submission process. The appropriate balance needs to be achieved between regulatory certainty and stakeholder engagement.

GRSS believes that ideally a Benchmark Administrator is completely independent of financial market intermediation (i.e. neither an intermediary itself or a body, such as an industry association, that represent the interests of intermediaries). This independence requires the appropriate oversight governance to be established to ensure that an independent benchmark administrator has access to market intelligence to ensure the benchmark remains relevant and reflective of changing market conditions.

The responses to the consultation questions below are based upon the experience of GRSS's people and from the perspective of an independent benchmark administrator such as the Australian Financial Benchmark Facility (should it assume such a role in the future).

## Responses

**1. Do you have any comment on the proposed definition and scope of significant financial benchmarks?**

The definition of financial benchmark is consistent with the IOSCO definition and to that extent is a suitable definition.

With regard to the scope including only significant benchmarks within regulation for administration and submissions is appropriate, whilst protecting the integrity for all benchmarks by applying the new offence of benchmark manipulation broadly.

The European Union (EU) and the United Kingdom (UK) have given considerable consideration to the design of new regulatory regimes for benchmarks and indices. Their regulatory responses are future looking and designed to prevent behaviour which could be harmful to benchmarks.

The draft EU regulation on *indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds Dec 2015* states that "the scope of this Regulation should be as broad as necessary to create a preventive regulatory framework."

Their regulation specifically wishes to prevent the opportunity for benchmark manipulation, conflicts of interest and administration transition issues from damaging the integrity and longevity of benchmarks. Their regulation is flexible to allow for

benchmarks to evolve over time, transitioning where appropriate from a non-significant benchmark to a significant benchmark and to ensure sufficiency of data inputs by creating a framework which can mandate submissions from participants. Their regulation is in the context of how benchmarks will evolve over time and other jurisdictions. Australia can benefit by emulating certain elements of benchmark regulation from the UK and Europe which will also assist with third country benchmark regulatory recognition.

It should also be noted that the draft EU regulation states that "the ultimate goal of the BMR *[Benchmarks Regulation]* is the same for all benchmarks, ensuring the accuracy, robustness and integrity of the benchmarks and the benchmark setting process. These principles hold for all benchmarks, irrespective of their type, their domestic or international economic impact, the underlying market/economic reality or other characteristics." The draft EU regulation defines critical, significant and non-significant benchmarks based upon certain criteria.

The European Securities and Markets Authority (ESMA) is of the opinion that "verifiability, whether it is applied to critical, significant or non- significant benchmarks it is not amenable to being implemented differentially. Indeed, even benchmarks lacking the systemic importance of critical benchmarks, if they serve as a basis for financial products (e.g. ETF's) may raise issues of transparency, market confidence, conflicts of interest and investor protection." [1] ESMA has analysed the draft EU regulation and developed detailed components for discussion.

There is also the possibility that a benchmark may change its status over time. The draft EU regulation recommends a review period every 2 years to determine the ongoing status of a benchmark. There are also options regarding benchmarks which may be considered non-significant now, but over the course of time become significant or critical. Manipulation of these benchmarks at the non-significant stage may have future consequences.

The CFR Consultation Paper March 2016 states "the CFR considers that a benchmark is significant if it is systemically important. That is, there is a material risk of financial contagion or systemic instability if the availability or integrity of the benchmark is disrupted. Other factors that may be relevant to the significance of a benchmark include the materiality of the impact on retail or wholesale investors if the availability or integrity of the benchmark is disrupted".

ASIC Report 440 Financial benchmarks July 2015 stated that "there are a number of possible statistical measures of the systemic importance of a particular financial benchmark. Two simple measures that seek to capture only the direct, and not the economy-wide, impacts, are:

a) the size or turnover of derivative positions referencing a particular benchmark; and

b) the amount of debt referencing a particular benchmark, for example, the value of inflation-linked bonds on issue."

The EU regulation defines "critical" and "significant" in terms of linked notional amounts. Critical is in excess of 500 billion Euro and significant is in excess of 50 billion Euro in linked financial products. Non-significant are for those benchmarks that don't fulfil the conditions set for significant.

[1] ESMA Discussion Paper Benchmarks Regulation February 2016 ESMA/2016/288

A quantitative approach such as this, has the following issues;

- The ability to monitor notional volumes over a period of time
- Ready access to input information about notional amounts referencing the benchmark
- Treatment of a benchmark if the notional amounts fall just below the pre-defined threshold

A purely qualitative assessment on the basis of perceived material risk, raises the question on what grounds someone is able to make this judgment.

GRSS believes that having some form of statistical measure is necessary and useful in determining whether a benchmark is a 'significant financial benchmark' rather than a non-defined measure based on 'material risk'. However, if both are to be used in tandem, it is probably practical to use quantitative proxies to guide the qualitative assessment of a benchmark's significance.

GRSS believes the regulator should define clearly:

- Which authority will be responsible for this classification
- What will be the exact qualitative and quantitative criteria used for such assessment?
- What will be the review frequency?
- What will the transition times be for benchmarks becoming significant to become compliant?

**2. Do you have a view on whether major equity indices such as the ASX200 should be subject to regulation as significant benchmarks?**

Indices are benchmarks according to the IOSCO Principles. Equity indices are already based on a regulated activity and regulated data. However,

a) the entity administering such index is not necessarily regulated itself; and

b) the determination of an index based on regulated data is a process of data derivation (or creation) for values that can display systemic importance

Therefore, equity indices should be regulated as well. However, given the fact that the underlying data comes from regulated exchanges, a principle of proportionality should exist with respect to governance and validation/verification requirements for benchmarks based on regulated data.

**3. Are there any other financial benchmarks that you consider should be subject to regulation as significant benchmarks?**

The UK regulator FCA has identified 8 benchmarks to be regulated including **WM/ Reuters London 4pm Closing Spot Rate**, which is the dominant global foreign exchange benchmark. In Australia the Australian Foreign Exchange Committee (AFXC) states on its website in the Q & A section the following: "Is there a daily exchange rate fix in the Australian market? There is no fix similar to those in the Tokyo or London markets. The AFXC in conjunction with the Australian Financial Markets Association (AFMA) and ACI Australia announced on 30 June 2008 the introduction of new methodology and timing for calculation of an Australian dollar reference rate. Under this arrangement, WM/ Reuters provides market access to its reference rate for the AUD/USD rate at 10.00 am and 4.00 pm Sydney time each day. From 1 July 2008, the WM/Reuters Australian Fix 10.00 am rate replaced the Hedge Settlement Rate which dated from when Australia had a non-deliverable market in the 1970s and was published at 9.45 am."

*The 10.00 am and 4.00 pm rate is published on the electronic media and ACI Australia's website.*

As the UK's FCA is only recognizing for regulation the London 4:00pm FX FIX there is a good argument for the Australian AUD FIX at 10:00am and 4:00pm Sydney time (each business day) to be regulated under the Australian significant benchmark regulatory framework.

**4. Do you have any comment on the proposed mechanism for designating the scope of regulation?**

In our response to question 1 we offered our view on the need for benchmark regulation to cater for the evolution of benchmarks over time. The regulatory design needs to have recognised that benchmarks evolve over time. A non-significant benchmark today can move to significant depending on its usage when a qualitative and qualitative assessment is applied. A hybrid model therefore listing significant benchmarks in Regulation with ASIC being able to list further benchmarks by determination is an appropriate approach to adopt. The regulation needs to consider the mechanisms for monitoring and transitioning benchmarks from non-significant to significant (and vice versa). The EU has given this considerable thought and their criteria only regulatory model monitors notional volumes of benchmarks, reviewing them on a regular basis.

The draft EU regulation states "The production of benchmarks involves discretion in their determination and is inherently subject to certain types of conflicts of interest, which implies the existence of opportunities and incentives to manipulate those benchmarks. These risk factors are common to all benchmarks, and all of them should be made subject to adequate governance and control requirements. The degree of risk, however, varies, and the approach adopted should therefore be tailored to the particular circumstances. Since the vulnerability and importance of a benchmark varies over time, restricting the scope by reference to currently important or vulnerable indices would not address the risks that any benchmark may pose in the future. In particular, benchmarks that are currently not widely used may be so used in the future, so that, in their regard, even a minor manipulation may have significant impact." [2]

**5. Which means of imposing the IOSCO Principles as a requirement of benchmark administration would you favour among the options identified, and why?**

The EU has suggested that all benchmark administrators require authorisation or registration.

"All benchmark administrators may exercise discretion, are potentially subject to conflicts of interest and may have inadequate governance and control systems in place. Further, as administrators control the benchmark process, requiring authorisation or registration and supervision of administrators is the most effective way of ensuring the integrity of benchmarks". [3]

GRSS believes that in future benchmark administrators will need to have their responsibilities clearly defined and have the support of regulation to ensure the benchmarks viability in the short and longer term. To this end, GRSS favours providing ASIC with Rule making powers as opposed to prescribing benchmark administration as

[2] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on indices used as benchmarks in financial instruments and financial contracts, 4th December 2015, Recital 8.

[3] Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on indices used as benchmarks in financial instruments and financial contracts, 4th December 2015, Recital 12

an activity to require the administrator to hold an Australian Financial Services License (AFSL). The AFSL regime has been designed and applied to firms providing one or more of the following services:

- provide financial product advice to clients
- deal in a financial product
- make a market for a financial product
- operate a registered scheme
- provide a custodial or depository service, or
- provide traditional trustee company services.

The administration of a benchmark, in GRSS's opinion, is not providing a financial service in any of the above respects and while the regime could be adapted to accommodate benchmark administration the administration of a benchmark does not involve dealing, making markets, providing advice, custodial or depository services a registered scheme or providing trustee company services.

Providing ASIC with Rule making powers is more appropriate for benchmark administration.

**6. Is there another option you prefer?**

GRSS has no other option to propose.

**7. Among the options presented, which option do you prefer for regulating benchmark submission, and why?**

A hybrid approach combining rulemaking and indirect regulation is the option GRSS supports.

**Why?**

The reality is that benchmark methodologies are moving to transaction based models and benchmark administrators may require a broader group of data submitters than they currently do. The future development of new benchmarks may require a completely new set of submitters. Regulation needs to allow for the development of rules for benchmark administrators and rules for the submitters of data to those benchmarks.

From a benchmark administrator's perspective, the ideal option is direct regulation with submitters being compelled to submit, under prescribed conditions. This is the approach that will provide for a robust methodology for a long term solution.

The next preferred option is indirect regulation, with escalation to a competent authority and prescribed responsibilities of submitters as a lower threshold. GRSS favours extending ASIC Rule making powers to cover submitters to significant benchmarks.

Indirect regulation through the Benchmark Administrator's Code of Conduct places the onus on the benchmark administrator to develop and enforce a Code. While the development of the Code is not problematical - enforcement by the administrator may be more difficult. Reducing numbers of either market participants during benchmark determination periods or submitters (given their compliance risk associated with this activity) has the likely potential to make it difficult for benchmark administrators to

capture sufficient information from the market and its participants to ensure continued confidence in the benchmark. Insufficient data is likely to undermine the integrity of the benchmark being produced.

Direct regulation through the AFSL regime is not practical as stated in our response to question 5.

ASIC Rulemaking power is a sensible approach and would be consistent with our preference for benchmark administrators to also be regulated via an ASIC Rulemaking power.

**8. Do you consider that benchmark administrators would be able to effectively regulate submitters via a Submitter Code of Conduct?**

GRSS does not believe that benchmark administrators would be able to effectively regulate submitters via a Submitter Code of Conduct without supplementary support.

The Submitter Code of Conduct should be seen as a first line of defence for benchmark administrators. It outlines the responsibilities and potential sanctions that could be applied to submitters if they breached the agreed code. Based on GRSS's experience as the calculating agent for Euribor, benchmark contributors are nowadays significantly more cautious with respect to the legal, compliance and reputational risk they're exposed to which is why they are likely to prefer to adhere to a code of conduct rather than being publicly known to be non-compliant.

In circumstances of breaches of an agreed code benchmark administrators need to have clear powers to sanction submitters at fault, without concerns that a submitter organisation will remove itself from the submission process. Certainly, the extent of regulatory leverage a benchmark administrator may have resulting from a concrete legislative/regulatory framework may increase the effectiveness of indirect regulation.

GRSS is of the opinion that the design of the benchmark regulation needs to primarily focus on preventing behavior that could harm the integrity of the benchmark.

**9. Do you agree that it is appropriate to develop a reserve power to compel benchmarks submissions for significant benchmarks, including to official sector significant benchmarks?**

GRSS agrees that it is appropriate to develop a reserve power to compel benchmark submissions for significant benchmarks, including official sector significant benchmarks.

Historically, benchmark administrators have been industry associations who perform a degree of self-regulation within their markets. Unfortunately, it is in these circumstances that manipulation of benchmarks have occurred. Based on the future role of benchmark administrators to operate systemically important benchmarks independently, it is important that those administrators have the necessary regulatory support to ensure the ongoing integrity of the benchmarks that they manage.

Principles 7 – Data Sufficiency, of the IOSCO Principles, stresses the requirement that benchmarks are determined from sufficient data to "accurately and reliably represent the Interest measured by the benchmark." At the core of this requirement is ensuring that those entities, that have the price and transactional data available resulting from their participation in the market, provide that information to the benchmark administrators for the benchmark calculation process. As previously stated in this response market participants are less inclined to voluntarily participate in the

benchmark submission process given the legal, compliance and reputational risks that the process presents. Submitters may choose to voluntarily participate, but there needs to be a mechanism available to the benchmark administrator to mandate submissions from participants in circumstances where the non-participation would lead to data insufficiency and the potential to undermine the integrity of the benchmark.

In circumstances where the benchmark administrator is an industry association the governing body of the association is often majority populated by submitting organisations. This can place industry association secretariats responsible for managing the benchmark administration process in a compromised position i.e. how does the subservient secretary pressure its governing body to agree to voluntary submissions. An external mechanism is required to minimise that conflicting position.

**10. If so, who should be able to exercise such a power?**

ASIC should be the exerciser of such a power.

**11. Which option do you prefer for compelling submission, and why?**

GRSS believes that providing ASIC with Rulemaking powers to impose obligations on specific entities to make submissions to specific significant benchmarks. In this regard the model adopted by the UK seems to be effective.

**Why?**

ASIC, in its role as regulator, will be able to access market data required to form an opinion as to which entities should be subject to mandatory submission requirements.

**12. Do you have any comments on the suggested cohort of entities that could be made subject to such a power?**

GRSS supports the concept that a body (presumably ASIC, on the basis of criteria set out in the legislation) would be required to determine the specified benchmarks in respect of which submissions ought to be compelled. This could be specified in the ASIC rules, the Regulations or potentially another instrument type such as an ASIC determination.

The primary legislation would also need to carefully define the cohort of entities that could be made subject to such a power. It seems logical that the cohort of entities from any authorised deposit-taking institution (ADI), AFSL holder or Foreign Financial Services Provider (FFSP) could in principle be made subject to the rulemaking power.

**13. Do you have any other suggestions for how to compel submissions?**

GRSS has no further suggestions to offer.

**Questions 14 to 19.**

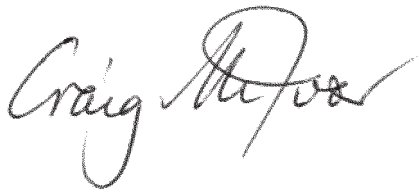
GRSS has not offered responses to questions 14 to 19.

## Conclusion

GRSS is grateful of the opportunity to participate in this important consultation process.

GRSS supports the development of a regulated framework for benchmark administration, submission and misconduct. The framework design should take cues from the regulatory work completed and in process by the UK and European regulators. In this regard a hybrid approach of regulation and regulatory powers caters for the evolving nature of benchmarks over time. Benchmark administrators should develop codes of conduct for themselves and submitters, but additional regulatory support to provide for mandatory submissions in circumstances where a deficiency of submissions could undermine the integrity, accuracy and reliability of the benchmark.

Yours sincerely,



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## Appendix

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Further information about GRSS is available from our website: www.globalrateset.com