Submission to the IOSCO Financial Benchmarks Consultation Report

February 2013

1. Do you agree with the scope of the report and intended audience? Are there other Benchmarks or stakeholders that have idiosyncrasies that should place them outside of the scope of the report? Please describe each Benchmark or stakeholder and the idiosyncrasies that you identify and the reasons why in your view the Benchmark or stakeholder should be placed outside of the scope of the report.

The Australian Financial Markets Association (AFMA) agrees that the Financial Benchmarks Consultation Report (the *Report*) is relevant to a wide range of stakeholders because of the special role of benchmark rates within the financial system and the economy. This includes benchmark administrators and regulators, as a consistent approach across jurisdictions and product classes is important to restoring confidence in international benchmarks.

AFMA is concerned that the *Report* contains no discussion of the concept of a benchmark, which is a significant omission as this is central to defining its scope and to identifying the range of relevant stakeholders. Moreover, there is no consistency between the definitions adopted by various bodies preparing best practice guidance and regulation in this area, including IOSCO, the European Commission and the Global Financial Markets Association (GFMA). AFMA believes a structured consultation to examine this definitional issue is necessary.

An examination of the definitional issue with regard to benchmarks may lead to further consideration of issues around minimum liquidity and transparency in underlying markets. There are currently some highly illiquid markets with very limited transactions that use the 'benchmark' nomenclature. As regulation of benchmarks may attract expectations, warranted or otherwise, of minimum liquidity standards it may be beneficial for regulators to consider this scoping question in the first instance. This threshold issue would benefit from a structured, detailed and substantive separate consultation process. AFMA would be pleased to contribute to such a process.

The definition of a benchmark used in the *Report* is too broad and captures data that is not generally considered to be benchmark data by users. Unrefined, such a broad definition would be counterproductive and harmful by impeding the flow of price information through regular data sources to market users. Indeed, we suspect that some providers of data within the scope of the broad definition are not aware that the *Report* is relevant to them and, thus, the consultation may not reach all relevant stakeholders.

We support the view that it is not necessary at this time to consider benchmark administration by public bodies to be within scope. This is a pragmatic assessment reflecting the immediate policy priority. Public bodies do need to manage a range of risks, including operational, publication and governance matters, which also need to be

managed in the interests of a fair and efficient market and may warrant review in the future.

Given the very high degree of complexity and jurisdictional specificity in the breadth of international benchmarks, IOSCO's intention not to make specific recommendations relating to any given benchmark is appropriate. The IOSCO principles should have a clear objective and articulate the framework within which the objectives can be met but should not be prescriptive about the associated implementation mechanisms.

2. Do you agree that the design of a Benchmark should clearly reflect the key characteristics of the underlying interest it seeks to measure?

It is important that the design of a benchmark takes into account relevant features of the underlying market; eg taking account of the effectiveness of cross-checks that the market would support.

If the underlying market is actively traded, a key condition for a sound benchmark is that the process for determining it is robust and the outcome is a fair representation of the market. A second important condition is the effective regulation of transactions in the underlying market, as this provides assurance that pricing in the market is a fair reflection of the demand and supply conditions in the market.

If the underlying market is not actively traded, then the substantive risk to the integrity of the benchmark rate will reside in the submissions and calculation process. This presents a different calibre of risks to be managed to preserve the integrity of the rate set process.

Benchmarks should be designed taking into account the characteristics of the underlying market. For example, a benchmark should not demand more transparency than is available or could reasonably be made available without harming the overall quality of the market, including its price signals and liquidity.

In this context, we note that an additional characteristic of a credible benchmark to those mentioned in Chapter 1 of the *Report* is durability; so it can serve over the time horizon for which it is used and is robust at times of stress or change in the market or the financial system. This aspect is implicit in the discussion in the *Report* but needs to be explicitly factored into the design of the methodology for a benchmark rate. For example, benchmarks that rely on observations or trade data from traded markets should have contingency measures to deal with periods of low liquidity.

Some markets and some methodologies may not be appropriate for the construction of benchmark rates, particularly if regulation of benchmark rates results in perceptions,

warranted or otherwise, that use of the term 'benchmark' implies a sound regulatory oversight. A structured exploration through an IOSCO consultation on the elements appropriate to benchmarks may suggest limiting benchmarks to markets of minimum liquidity or quality.

A benchmark by definition is used in contracts for a variety of products and that are traded on multiple markets. Often the most efficient way to manage financial risk, having regard to transaction costs and other factors, results in derivatives markets are much larger than the underlying market. However, if the relative size of these markets is not of itself necessarily an issue for concern, though it is a very relevant factor in determining the tools required to manage risks to the rate set process.

Regulatory intervention should be careful to avoid creating inefficiency by limiting the use of benchmarks. It is our experience that market participants are best placed to determine which products should be referenced by which benchmark.

3. What measures should Administrators take to ensure the integrity of information used in Benchmarking-setting and that the data is bona fide? Please highlight any additional measures required where Benchmarks are survey based. Please also comment on each of the factors identified in the discussion on the 'vulnerability of data inputs' such as voluntary submission, discretion exercised by Administrators. Are these measures adequately reflected in the discussion of roles and responsibilities of the Administrator discussed in section E?

Data Sampling

An appropriate data sample size for each targeted piece of information in the benchmarking process is a key element in ensuring that data used in benchmark setting is robust, whether reported by submitters or automatically generated. Some benchmark rate processes by their design inherently facilitate more robust analysis and offer greater statistical precision than others. To be effective, the IOSCO Principles and regulation in general must discriminate between different rate set types. To do this effectively a sophisticated categorisation methodology may be appropriate.

IOSCO has recognised that a 'one size fits all' approach is not appropriate and has indicated it does not intend to make recommendations in respect of specific rates. However, it would be consistent with this approach to recommend that regulators should review methodologies for benchmark rates in their jurisdiction to ensure they conform to appropriate statistical standards in relation to data sampling.

Benchmark rate set processes may justifiably operate in quite different ways but this also means that the associated input trimming process will have different consequences from

a statistical perspective, which then has implications for the best approach to managing the risks presented by the particular rate set process.

For example, in the case of some surveyed rates, the information targeted is a particular borrowing rate of *each* bank that submits a rate into the benchmarking process, ie the survey attempts to determine many information targets. To determine each of these rates a *single data sample is taken* for each (the rate submitted by that same bank).

The rates eliminated by a trimming process (usually 'topping and tailing') applied to such input rates is *not designed to eliminate potentially inaccurate rates*; rather its purpose is to eliminate rates submitted by banks whose borrowing costs are significantly different from that of banks on average. For instance, a bank's input rate may be precisely accurate but be eliminated purely because it has a higher/lower borrowing cost than other banks due to its relative credit rating. Conversely, a rate for a bank may be markedly inaccurate and yet, as the bank's credit rating (net the inaccuracy) is in the middle band of rates, may not be eliminated. Use of trimming of rates in methodologies where many information targets are pursued may not improve the accuracy of the rate in statistical terms.

In contrast, other rate sets focus on one particular borrowing rate and the trimming process may function as a design feature that eliminates potentially inaccurate input submissions, and may contribute to netting of any residual bias. In this case, the trimming process is integral to improving the statistical robustness of the benchmark rate.

Thus, it is important to understand that the trimmed mean process that follows for each type of benchmark rate has different implications for its vulnerability to manipulation. In particular, rate sets that offer few data sample points per observation present a greater risk of manipulation through the rate submission process. Of course, these rate sets remain valid provided these risks are appropriately managed and the relevant features of this process are made transparent to users. In contrast, a rate set that takes multiple data samples for each targeted piece of information and trims statistical outlier data samples presents a substantially reduced risk from malevolent submissions, as they are much more likely to be observable to the administrator and the market and also would likely be removed through the trimming process. Further as multiple views of a market are after trimming typically averaged this can contribute to netting out any residual biases that survive the trimming process where there is a spread (no matter how small) in the remaining contributions.

The Australian benchmark rate (BBSW) targets only one piece of information, being the borrowing cost (as observed in a traded market for bank paper and NCDs) for a group of homogenously traded banks, called 'Prime Banks'. These Prime Banks are selected for

this purpose by the market through an election and ongoing review process as those the market wishes to trade homogeneously and it is the rigour of this process that supports homogeneity and statistical precision of the rate (see the attachment to this paper: *AFMA BBSW*
A Guide to the Bank Bill Swap Reference Rate for more details on the structure and functioning of BBSW).

The trimmed mean process that is then undertaken in relation to BBSW is designed to remove *outlier data samples* (ie statistically inaccurate submissions) in respect of that single target rate, as opposed to eliminating *outlier bank rates*. It is a more statistically efficient process because it generates a large number of sample points (14 in the case of BBSW) for the single targeted data point that is used in determining the benchmark rate.

Data Filtering

This highlights the second feature of appropriate data sampling to ensure the integrity of information used in benchmark rate setting – that of appropriate filtering of data sets for outliers with respect to each piece of information targeted by the rate set process. For some benchmarks, as noted, there is effectively no filtering of each data sample for outliers as there is only one input for each bank's rate. In these instances, substantially greater reliance must be placed on governance controls and regulation to protect the integrity of the benchmark, which requires more extensively regulatory intervention than is appropriate for benchmarks with more robust statistical features.

In relation to BBSW most of the submissions are trimmed – normally there are 14 submissions and of these only six are accepted with the rest discarded. Trimming is used as it removes the rates from the final calculation. Trimmed rates affect the rate only insofar as they contribute to determining which of the rates are in the middle group that will be averaged.

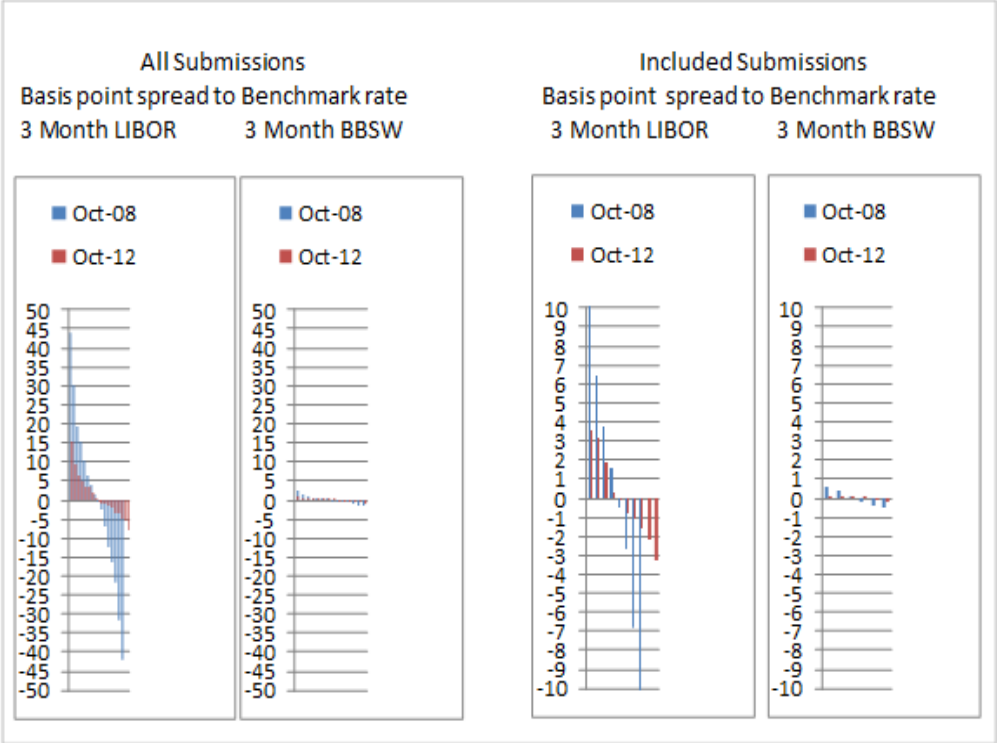
However, as a single rate is targeted in BBSW, this accepted submissions group is typically very tightly spaced in any case. For the 2.75 years to 28 September 2012, the accepted submissions for over 98 per cent of days' rates were within 1 basis point.

The averaging process, as it is done in relation to a single data target, then contributes to netting out any residual bias in these tightly grouped accepted submissions.

An example of the qualitative difference between different types of rates set is given in Figure 1. This provides a comparison of the spread to the benchmark rate for all submissions made in the BBSW and Libor (USD) rate sets for sample months and also the submissions included in the rate calculation after trimming. The rate set in each clearly

has different statistical characteristics, which need to be dealt with by appropriately differentiated regulation.

Figure 1



Mechanical Methodologies

Benchmark rates that use prices or yields that are systematically scraped from the market may be considered for highly liquid markets. These processes, such as those based on Volume Weighted Average Price (VWAP), should also adhere to these same principles of sufficient data sample size and appropriate filtering.

The advantage of using systematic, or mechanical, scraping and calculation of traded-prices to generate a benchmark rate has valuable attributes – in particular, it reduces reliance on subjective data input from benchmark panellists and introduces greater objectivity into the rate setting process (also reducing regulatory risks for submitters). In an ideal world, benchmarks would generally be determined in this manner.

However, there are significant practical challenges to adopting this approach in many markets, including markets that have strong relative liquidity features. For instance, when trading volume is light, or between a small number of parties, or there are a small number of transactions, then non-representative trades risk impacting these benchmark

methodologies and creating vulnerability to manipulation. Filtering of trade data inputs is needed to ensure that unrepresentative trades are not able to unduly impact the benchmark. The filtering process needs to be flexible to account for changes in the characteristics of the market.

Another disadvantage of mechanical trade-data-only methodologies is that they do not deal well with markets that have intermittent or ongoing bouts of low liquidity. In low volume environments these methodologies are particularly vulnerable to manipulation through unrepresentative trades and transactions, and can fail to report prevailing pricing which may be sound and deep despite a lull in transactions. There is also the possibility that trade data may in these circumstances be 'stale'.

Thus, unless set in the right conditions, mechanical rate sets may be vulnerable to statistical risk (eg insufficient data to generate a reliable fixing) and behavioural risk (eg through manipulative trades). Mechanical transactional or trade-based-only methodologies do not benefit from intelligent contribution from professional traders where there are inconsistent or intermittent indicators of market pricing.

The risk of regular absences of pricing outcomes in purely mechanical methodologies is also significant as this can increase systemic risk and decrease market confidence and liquidity. Risk management practices typically discourage participation in markets where benchmark pricing may be intermittent, as the incomplete price data can frustrate proper risk assessment.

Committed Quote Methodologies

Committed quote methodologies benefit from submission inputs that have strong information content, especially in markets where spreads are low, and they are more durable than mechanical processes. In particular, they can deal better with periods of low or limited trading activity through their ability to provide uninterrupted benchmarks based on market data.

Committed quotes are the primary basis for determining market prices in most markets. Equity markets are typically defined by their bid-ask spreads, recent trading activity is generally a secondary consideration. Electronic market makers in equity and option markets notably use committed quote data rather than trade data when making markets, trade data is assumed to be stale and of limited utility in determining prevailing prices.

Committed quote methodologies assume sufficient connections between markets exist or can be constructed to remove crossed or conflicting market pricing in markets where there are multiple execution venues.

Trading activity is an important confirmation of the validity of committed quote pricing (particularly for volume) but in many, even liquid, markets it is intermittent. Trading can also be used to refine pricing for benchmark purposes to a particular side of, or position, within a spread.

BBSW's primary input is reports of committed quotes in an actively traded, brokered interbank market. BBSW pricing has been found to be tight and reliable even when a particular tenor does not trade on a particular day.

BBSW contributors use trading data to assist in further refining the mid-point of the spread. For example, a market may be quoted at a one basis point spread but all trades may be going through on one side of that spread. In this case the market mid-point would be quoted at that side of the spread.

Estimate-based Markets

Estimate-based methodologies that are not based on observations of transparent, quoted and traded markets risk an inability for independent verification by multiple parties. This can result in increases in vulnerability to manipulation and, thus, requires enhanced oversight and control procedures relative to those required for those based on committed quote or mechanical methodologies.[1] This illustrates the need for flexibility in the proposed Principles to enable regulatory and industry responses that are proportionate to the risks presented.

It is important to distinguish between methodologies that rely on single sample estimates of rates that may not be readily observable and those that rely on multiple reports of readily observable market rates.

The function of multiple reporting is fundamentally different in each case. For rates that are based on multiple single estimates, multiple reporting seeks to increase the range of rates that are targeted to be observed. For rates that rely on multiple reports of a single readily observable market rate, the function of surveys is to remove submissions with bias or error.

IOSCO's work may benefit from a further exploration of the implications of different rate designs for governance including the development through consultation of a detailed categorisation system.

[1] Assuming the underlying market structure provides a sound basis etc.

Voluntary Submissions and Participation

Benchmark rates are in the nature of a public good, which generates behaviours that need to be factored into the approach taken in the Principles to voluntary submissions. In essence, because the benefit from a benchmark rate is freely available to individual users (as distinct from the industry as a whole), there will be a temptation for current submitters to withdraw from benchmark rate setting processes if the costs or risks (regulatory or reputational) increase. It is inevitable that the enhanced regulation and controls that form part of the Principles will increase these costs, which thus presents a substantial risk to benchmarks.

One solution to this conundrum of enhancing the integrity of benchmarks without in practice undermining them would be to mandate participation by firms in their calculation. However, we believe this would be the wrong answer for a number of reasons including the practical difficulty of determining and maintaining a submitter panel, potentially counterproductive outcomes for some methodologies,[2] the loss of submitter ownership (and, hence, to some degree responsibility) for the benchmark process and the fact that conscripting firms to make submissions is incompatible with the values that inform business relationships in liberal democratic societies.

A better solution, and we believe the only one that should be contemplated by IOSCO, is to develop Principles and promote their use in a way by regulators that promotes a proportionate, thoughtful and targeted application of regulation to benchmarks. One size does not fit all but, in our experience, the application of regulated control requirements for benchmarks designed to solve a problem in one jurisdiction can have adverse implications if it is applied without modification in another. Proportionate regulation would set compliance costs for submitters and benchmark rate administrators at a level that would increase the chances of successfully managing the public good issue for different categories of benchmarks. These categories could include detailed consideration of the methodology risks and underlying market characteristics. This approach would not preclude the use of mandatory submissions where this is necessary for a particular methodology to operate on a sound basis.

Mandating submissions may lead to lower quality data as firms may do the minimum to supply low-risk submissions, rather than actively engaging with the informed discretion desired to ensure data quality. Constituting and maintaining the right panel of submitters presents an important challenge in the absence of market selection

[2] For example, if a mandatory approach were applied to a committed quote methodology, it would be logical to seek to require contributions for the most active traders, as they would be most skillful in judging market prices. However, this could adversely affect liquidity in the market, as the compliance costs involved would incentivise traders to keep below a volume threshold that would see them mandated to participate in the benchmark rate set.

mechanisms, as the firms who best understand market conditions may be outweighed by other mandated submitters who are more peripherally involved and not as well informed. If the quality of the benchmark is adversely affected or it become less predictable for active traders, then this would constitute greater risk for traders and adversely affect liquidity.

It is not clear to us how underperformance by a submitter would be managed in a mandatory submitter regime. Consequential exclusion from the panel, which is the approach taken in the BBSW market selection process, could actually be seen as more of a reward than a penalty under a mandatory regime. The alternative might be fines for non-submissions or submission of sub-par rates (eg regular outliers), which would seem to be highly interventionist and prescriptive and difficult to administer.

Financial markets are built on willing participation and it is not possible to mandate their strength and robustness. Regulators risk decreasing willing participation and the migration of financial business and liquidity away from schemes and jurisdictions that involve mandatory participation.

As such, AFMA supports IOSCO's comments that administrators of benchmarks should develop procedures and policies to address submission discipline and frequency in respect of an individual fixing or determination. In the case of AFMA BBSW these measures are long established.

Benchmarks have always relied on support from their contributors and in return they provide a useful service to their respective financial markets. Attempts to force firms to participate in markets that they do not wish to may fail or result in unintended outcomes. At the very least they may negatively change the nature of the relationship between the rate administrator and contributors.

Administrator Discretion

AFMA supports discretion in relation to the selection of inputs for benchmark rates as described in the *Report* with appropriate controls as a means of ensuring appropriate flexibility of a benchmark to changes in its environment.

In the case of AFMA's Prime Bank category used in BBSW, while this is decided by the market through an election process, if Prime Bank paper begins to trade on a non-homogeneous basis (and for any other reason) AFMA reserves the discretion most likely on the advice of its Market Governance Committee to call another Prime Bank election. This is appropriate flexibility to ensure that the Prime Bank category reflects market practice.

Composition of Submitting Panels

It is both entirely appropriate and desirable, given the capacity of their staff for knowledge and understanding of the markets, for those firms submitting rates to benchmarks to be active participants in the underlying market.

While some firms may indeed seek election to the panel in part due to the size of their participation in the market this is of itself not of concern. Conflicts of interest in benchmark submission processes are a normal part of large financial organisations and only need to be appropriately managed.

AFMA agrees that the size and composition of a panel should be representative of the underlying market and should respect the more informed view of the underlying market of more active participants. Any incentives to influence rate outcomes inappropriately should be offset by internal firm procedures and policies and sanctions, rate administrator policies and sanctions and regulatory requirements and sanctions.

It is correct to observe that in cases where submitters also own, control or are represented by the benchmark administrator, conflicts of interest require robust governance safeguards. However, the materiality of the risk presented in this regard will depend on the particular membership attributes of the benchmark administrator and also its internal governance processes for the rate set process.

The suggestion that requiring membership of a trade association is necessarily limiting is incorrect. Membership of trade associations can capture all trading members in the interbank market as membership of some trade associations including AFMA is not limited to banks and is open to all participants in the financial markets.

AFMA's panel of contributors for the BBSW process is selected by an election process by market participant members. Buy-side firm members are encouraged to nominate and vote in this process.

In relation to governance, AFMA's core membership base is both large and diverse; it has over 120 members and covers domestic and foreign banks, stockbrokers, futures brokers and clearers, financial market operators, asset managers, specialised traders in the institutional and retail over-the-counter (OTC) markets, state treasury borrowing agencies, energy companies and remittance providers, amongst others.

Prime Banks constitute less than 4 per cent of members and directors from Prime Banks comprise less than 20 per cent of the AFMA Board. BBSW panellists constitute 11 per cent of the overall AFMA membership. Hence, neither the Prime Banks nor the panellists are well placed to dictate or unduly influence the governance of AFMA in

respect of benchmark rates or policy generally.

The broad base of members enhances scrutiny of activities, especially those like BBSW that present significant reputation risk for the Association. All members have a vital interest in the management of AFMA's reputational risk to ensure it can represent them effectively and no segment of the membership has a controlling position in relation to the activities and policies of the Association.

This broad collective interest in the effective management of BBSW risks supports the development and implementation of robust governance safeguards within the Association. Moreover, the impetus to effect internal management of BBSW is reinforced by the reputation risks for participants in the BBSW rate set process, which has become a compelling force since high profile regulatory actions have been taken against contributors to some international benchmarks.

Filtering of Submissions

It is appropriate to have in place processes to check submissions for clear errors and to notify submitters and ask them to confirm their submissions. While doing so assists in ensuring the maximum number of submissions is received it is a process that needs to be managed to ensure that it does not influence the final result inadvertently or provide any opportunities in relation to influencing rate outcomes.

Beyond checking for manifest errors (ie implausible submissions) it is appropriate to check submissions and resulting benchmark fixings for consistency with related rates, previous rate sets, contribution quality on a contributor basis, variance between submissions on a per rate basis, and for confidence in the submissions process and fixings with market participants. This should include a formal market quality assessment program, complemented with communications with the central bank on a regular basis and the regulator as required.

In relation to BBSW AFMA conducts verification of submissions for implausible contributions, although in practice errors are rare. AFMA also conducts comprehensive checking of submission and rate set outcomes and monitors market confidence with a formal process.

AFMA also compares fixes to trade information as supplied by brokers in the market and is implementing trade collection systems to collect trade data directly from market participants to ensure all relevant trades are also captured.

The Use of Third Parties

AFMA agrees with the *Report's* approach to the outsourcing or insourcing of rate calculation, data collection and/or dissemination of benchmark rates.

4. What measures should Submitters implement to ensure the integrity of information provided to Administrators? Are these measures adequately reflected in the discussion of a code of conduct for Submitters discussed in section E? In particular, should Submitters submit all input data and not a selection of such data so as to maximise the representation of the underlying market? Please comment on any practical issues that compliance with such an approach may give rise to.

The measures reflected in the discussion of a code of conduct for submitters discussed in section E provide a sound foundation for ensuring the integrity of information provided to rate administrators and accord with the approach AFMA is implementing.

In relation to benchmark rates derived from traded markets, while in general there should be a preference for more data, each market is different and as such it may be inappropriate to be too prescriptive.

5. What level of granularity with regard to the transparency of Methodologies would enable users to assess the credibility, representativeness, relevance and suitability of a Benchmark on an on-going basis and its limitations with respect to their intended use? Relevant factors could include; criteria and procedures used to develop the Methodology, type of data used, how data is collected, relative weighting of data used, how and when judgement is used, contingency measures (e.g., methods when transaction data is unavailable etc), publication of information supporting each Benchmark determination, etc. Please provide examples where you consider there are currently significant gaps in the provision of this information.

AFMA both supports and complies with IOSCO's proposed approach to the transparency of benchmark rate methodologies, which we think is necessary to confident and informed markets. Policies, conventions and procedures are available on the public AFMA website.

AFMA defines standard market parcels in its BBSW Convention. As noted the Prime Banks are the result of an election process and are named in the relevant convention on the AFMA website.

AFMA publishes all contributions to the rate-set process contemporaneously with the publication of BBSW. This allows recreation of rates from inputs.

AFMA is currently reviewing and updating the procedures around transparency to look for further opportunities to increase public transparency.

6. What steps should an Administrator take to disclose to Market Participants and other stakeholders the contingency measures it intends to use in conditions of market disruption, illiquidity or other stresses?

It is appropriate that clearly defined contingency measures that address issues of market disruption, illiquidity or other stresses are made publicly available by rate administrators. Dissemination of this information by website or other public documents should be sufficient.

AFMA publishes on its website the contingency measures it uses in the event that for any reason a rate is not able to be published. The relevant standard ISDA documentation schedules designed to accompany these contingencies are also published as part of the BBSW conventions.

7. What steps should an Administrator take to notify Market Participants of material changes to a Benchmark Methodology (including to Benchmark components) and to take their feedback into account?

Changes to benchmark methodologies and components should be clearly and publicly communicated. The appropriateness of consultation with market participants will vary with the content of the changes. For minor changes, notification may be sufficient. For more significant changes, a structured consultation process may be appropriate.

Where the rate administrator is an industry body the connection between changes and appropriate consultation is inherent. Where there is separation between the underlying market and the administration of a benchmark, significant issues may need to be managed to ensure market confidence is maintained

AFMA has a structured process that incorporates member consultation for all changes to the OTC market conventions that we manage. This includes the conventions that support the BBSW process. All substantive changes to the BBSW methodologies are subject to approval by AFMA's internal committees (including the BBSW Committee) which are comprised of a wide range of market participants in order to be representative of the broad range of market interests in the rate. The committees also include buy-side and broker representation and the central bank (RBA) as a Regulatory Observer.

The Market Governance Committee (MGC) is an elected Committee, membership of which typically includes senior staff from domestic and international banks, state treasury corporations, OTC brokers, energy market participants and fund managers. The MGC oversees all significant changes to benchmark methodology.

Once approved the content of these changes are mailed to AFMA's main contacts at each member organisation and included in a monthly policy and markets brief circulated to staff of member firms. Notices of significant changes are placed on the website along with the revised convention.

8. How often should the Administrator review the design and definition of the Benchmark to ensure that it remains representative?

Benchmark design and definition is not a set and forget process. Ongoing review is essential to ensure that the benchmark responds to changes in the underlying market, its usage, contribution performance and the broader regulatory environment.

The AFMA BBSW Committee and MGC meets at least quarterly to consider the performance and design of the benchmark. More meetings are held on a needs basis. AFMA considers this an appropriate frequency.

Signalling

The signalling risk identified at B.4 requires more detailed analysis. In the case of rates that target only a single rate for calculation input this is addressed by inherent design features.

A single rate means that the great majority of submitters will have negligible conflict in relation to signalling as they will be quoting a rate unrelated to their own.

A group-of-banks rate means that no bank is quoting only its rate. For the small number in the group-of-banks, these contributors will be contributing a rate that is for a number of their peers (as well as their own). Further, as these banks are those that will in many designs be those with the highest credit ratings by definition – 'Prime Banks' (and in contrast to the approach of some other benchmarks) their credit rating will be of the least concern within the market.

As the quoted rate may be readily discernible to market participants any aberrant submission would similarly be obvious to other parties.

As distinct from benchmarks where submitters are each quoting different rates (their own) where a single rate is being targeted by all submitters there is no information that can be discerned about the likely future direction of each individual submitter's submissions.

This is to say, in benchmarks where each submitter is submitting their own-rate the trend of these submissions may give guidance as to likely future submissions for each

submitter, and this information may be used by those seeking to manipulate a rate to assist in targeting their manipulative submission. This contrasts with the situation where all submitters are targeting the same rate in the submissions, and there is no data as to the likely 'trend' of their individual future submissions. Moreover, AFMA's checks, as a benchmark administrator, submissions for any trends to outliers by individual contributors – a facility that would not be available under some other benchmark methodologies.

As a result of this design there is no reason to delay publication of individual submissions (and significantly decrease transparency of the benchmark process) in relation to single target rate methodologies. Immediate publication of individual submissions is, further, preferable as it contributes to greater and immediate transparency. This transparency allows for immediate analysis by other contributors of the validity of other contributions and increases the ability for firms participating in the rate set or market to conduct their own monitoring of its integrity. In practice, while rare, it allows for immediate feedback from participants in the form of queries of individual submissions.

We note the importance of a depth of analysis that considers the broad range of benchmark rates and their respective issues.

9. The Consultation Report discusses a number of potential conflicts of interest that may arise at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties. Are there other types of conflicts of interest that have not been mentioned that you consider may arise? If so, how best should these conflicts of interest be addressed? Are the measures discussed in the Consultation Report sufficient to address potential conflicts of interests at the level of the Submitters, between Submitters at different entities, and between Submitters, Administrators and other third parties?

Conflicts of interest management is an important consideration in relation to benchmark rates. However, it too requires a significant depth of analysis that the current timeframe for consultation does not permit.

The Principles should, after a sufficient consultation, provide guidance as to the effective management of conflicts of interest in a way that properly discriminates between benchmarks in accordance with the particular risks that each presents.

It is appropriate to have physical or 'Chinese wall' separation between traders on related markets that are affected by outcomes of a rate set (such as swap traders) and those submitting the rates.

However, it would likely be to the detriment of the quality of submissions and the benchmark rate itself if those that participate in the markets underlying a benchmark are also similarly separated from the submitters in the case of benchmark rates that rely on reports of underlying markets.

Isolating submitters from those participating in the underlying market who are typically those most likely to have a much deeper understanding of the market dynamics and best placed to assist in applying discretion and intelligence in submitting rates may be a non-optimal outcome.

AFMA's experience has, as noted, supported the proposition that when market participants are all attempting to determine the same information from the market the spread between submissions is very tight, particularly when outliers are trimmed to leave only accepted submissions. Accepted submissions for BBSW were one basis point or less, 98 per cent of the time. If submitters to market-based rates were removed from direct participation in markets this spread may increase.

Spreads in benchmark rates methodologies with multiple targeted bank rates are necessarily much wider (see Figure 1).

If submission is confined to isolated submitters it may be at risk of becoming a mechanical process that does not encourage data submissions to be done in a discerning manner. Regulatory intervention in this regard risks lowering the quality of benchmarks (and hence risking liquidity in those markets) and increasing systemic risk.

As noted, however, conflicts of interest should be managed, particularly at the submitter firm level. In this regard, AFMA is developing a Best Practice Principles which will assist firms in ensuring their internal processes are aligned with those expected by the regulator in relation to conflict management.

10. Do you agree that the Administrator should establish an oversight committee or other body to provide independent scrutiny of all relevant activities and management of conflicts of interest? Please comment if and why any different approaches might be appropriate for different kinds of Benchmarks. What is the minimum level of independent representation this committee or body should include?

The *Report's* framework for understanding conflicts of interest that may present for benchmark administrators would benefit from further refinement. Importantly, it is another aspect of the *Report* where a 'one size fits all' approach would be inappropriate. In some instances, the proposal for an external oversight committee or other

independent body may be precipitous, unlikely to improve outcomes, and may contribute to reduced confidence (and liquidity) in the underlying markets.

Trade bodies, particularly those whose membership are broadly-based and open to all significant market participants, already contain all the parties relevant to balance out any perceptions of a conflict of interest.

There is no benefit, but there are risks, in having the activities of broad-based committees such as those in trade bodies subordinated to an external committee with a membership consisting of non-market participant members.

Given the potential exposures, regulators-based oversight committees may make participants in subordinate committees reluctant to engage in robust dialogue about market issues and with the trade body itself.

The contention that "Trade body members are typically the most active participants in the underlying markets and often carry large positions on products linked to the Benchmark, which may influence the way the trade body discharges its role as Administrator" does not adequately consider the inherent balances in having most or all of the significant participants in the underlying markets represented in rate administrators such as trade bodies. Where a large position is held by one member, it is likely the other side of that position is also held by another member of the trade body, so their different commercial interests supports heightened industry scrutiny of the benchmark process and of behaviours within that process. AFMA's experience is that market participants are best placed to scrutinise the marketplace and are the first to identify any emerging market issues.

The case for potentially disruptive oversight of the market's self-governance structures has not been made. We also note it may be a too finely grained proposal for inclusion in principles by a body operating at the meta-regulator level.

In the case of AFMA, the committee relevant to BBSW contains representatives from the Negotiable and Transferable Instruments market, the Swaps market, the Interest Rate Options market, as well as buy-side and broker representation and the central bank as a Regulatory Observer. The most senior market committee (MGC) typically contains senior staff from domestic and international banks, state treasury corporations, OTC brokers, energy market participants and fund managers.

The industry relationships and factors that underpin the BBSW benchmark rate process are multi-faceted and lead to an intricate role for AFMA as a trade body. For example, this role must enable the early identification of both structural change and cyclical

developments that require management by market participants collectively in order for the benchmark rate to operate on a sound and effective basis.

The Bank Accepted Bills/Negotiable Certificates of Deposit market that underpins the BBSW rate has a relatively small number of active investors (measured in dozens), relative to other markets like the share market, which has millions of investors. Moreover, there are many technical aspects of the market that may affect pricing and trading behaviour in the market in addition to structural impacts, like the Basel III liquidity reforms and the GFC that must also be factored into the considerations of the recent performance and likely future operation of the market. All of these factors should influence and reshape the conventions, risk controls and governance for BBSW but the way in which this should be done can be difficult for individual firms to determine at a point in time.

Deep knowledge of the markets and their day-to-day issues and function can only be found in those directly involved in those markets and AFMA, as a trade association, provides a unique venue through which the market can collectively assess and respond to the environmental factors that affect the efficiency and integrity of BBSW. This process has proved in practice to be effective.

There is a particular benefit in aligning the process for determining trading conventions and practices in the underlying market with those for the BBSW rate set.

AFMA is well positioned to promote timely and frank feedback from contributors and other market participants. This incorporates input from traders across the range of OTC markets and from a cross-section of the industry through AFMA's diverse membership. This is especially helpful in resolving matters that are not pertinent to formal market regulation or have not graduated to a point where intervention by the market regulators is required. In our experience, the market participants themselves are best placed to observe and report on developing concerns.

AFMA's experience is that, as a trade association, it gets line of sight across emerging issues in a timely way, as its industry self-management processes draw from a rich, ongoing dialogue between participants across a range of markets (which is especially important to BBSW as a benchmark rate that is used in many markets). Further, it can respond more rapidly and with greater flexibility than a process led by an official regulator. However, as described here, effective engagement with the regulators is an integral aspects of a trade association's role and this assists in the maintenance of an effective benchmark rate.

11. Should the Submitters establish accountability procedures to assess their compliance with operational standards and scrutiny of Benchmark submissions?

AFMA supports this principle and is consulting with members on a Best Practice Principles for rate submissions to assist member firms ensure their internal policies comply with accepted standards. These include requirements for monitoring, record keeping, and internal audit.

12. Are the measures discussed in the Consultation Report (e.g. Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure the accountability of Submitters? Should additional mechanisms be considered?

AFMA agrees that public confidence in benchmark rates will be best served by effective mechanisms to ensure the accountability of rate submitters. To achieve their purpose, the Principles should be designed with a properly differentiated approach to various benchmark rate processes, so the particular risks they present are dealt with in an effective and efficient manner. One model will not suit every benchmark and overly prescriptive Principles would impose an unnecessary economic cost.

In this context, we note that a requirement for external audit is a significant regulatory impost. It is typically larger firms that contribute rates to benchmark processes and these firms are in general capable of addressing conflict of interest issues sufficiently to provide sound internal audits. Moreover, benchmark administrators have a role in providing external oversight of contributions; eg they should conduct analysis of contributions and report any potential discrepancy to submitters' compliance departments. The relative effectiveness of these processes will depend on the particular characteristics of the rate set in question.

The case has not been made for an external audit requirement for benchmark rates in general.

Increasing the burdens associated with submission will decrease the motivations for firms to participate in benchmark processes and this may impact particularly regional rates and increase risk in the system.

13. How frequently should Submitters be subject to audits? Should these be internal or external audits?

This may be too finely grained a consideration for inclusion in regulatory principles. This may be a matter best left for regulators to refine in consultation with their markets. At

the principles level it may be appropriate to suggest 'regular audits' again noting that the case for making those audits external has not been made.

14. Are the measures discussed in the Consultation Report (e.g., complaints process, Audit Trail, external audits and requirement for regulatory cooperation) sufficient to ensure accountability of the Administrator? Should additional mechanisms be considered?

Yes. AFMA views the measures discussed in the *Report*, with the exception that the audits need to be external, as appropriate and sufficient to ensure accountability of the administrator.

15. If recommended, how frequently should Administrators be subject to audits? Should these be internal or external audits?

While AFMA would support a requirement for annual internal audit of benchmark administrators as a regulation from the domestic regulator the *Report's* discussion on accountability is brief and may not create sufficient grounds for a principle.

AFMA holds that regulatory principles should not specify whether audits should be internal or external and at what frequency in relation to benchmark rate administrators.

16. Is public self-certification of compliance with industry standards or an industry code another useful measure to support accountability? This approach might also contemplate explanation of why compliance may not have occurred. If so, what self-certification requirements would make this approach most reliable and useful to support market integrity.

This proposal would benefit from further explication in the *Report*. It is not clear what additional benefit would be gained in practice from publication of self-certification and presumably a regulation to require this outcome. The internal promotion of industry codes of conduct within a submitter is most important, as this helps to establish a culture of good behaviour in the organisation and assist staff members who may be faced with uncertainty about what is the right decision.

With regard to AFMA's Best Practice Principles, it is envisaged that compliance with these will be sufficient to satisfy local regulatory requirements. If the regulator is informed by a firm that it is compliant with industry best practice this should be sufficient to address the accountability concerns.

17. The Consultation Report discusses elements of a code of conduct for Submitters. Are the measures discussed (e.g., adequate policies to verify submissions, record

management policies that allow the Submitter to evidence how a particular submission was given, etc.) sufficient to address potential conflicts of interest identified or do you believe that other control framework principles should be added?

AFMA supports in principle, the proposal for a code of conduct for submitters as outlined in the *Report*. However, there are a number of specific elements of the proposal that may not be justified or appropriate for all benchmark rate methodologies. As noted in the *Report* a one size fits all approach is not appropriate and there is a risk that the imposition of excessive compliance arrangements, or arrangements that are incompatible with market-based rates, will result in substantial damage to rates in smaller jurisdictions.

The principles as briefly discussed in the *Report* may be appropriate for methodologies with inherently high levels of risk, such as those that use single data samples per input rate target, but may not be appropriate for rates with more inherent robustness.

Following the same reasoning, IOSCO should encourage regulators to ensure that their actions do not have extra-territorial consequences that result in damage to non-targeted benchmark rates. The current round of international regulatory actions has resulted in the withdrawal of some international banks from submission processes.

IOSCO should consider a more detailed consultation to ensure that regulatory frameworks developed by national regulators and other regulatory actions take a graduated approach to the risks they address in the underlying methodology. Regulators should also be encouraged not to proceed with extra-territorial action, particularly where that action may have substantial, if unintended, negative effects in other jurisdictions. Where regulators are do proceed with extra-territorial action a detailed exploration of potential global impacts and a categorisation framework to target actions to benchmark types that have demonstrated issues should be encouraged.

While many elements of the CFTC orders could readily be adapted by local regulators, the orders do not discriminate between rate-set types and, consequentially some aspects are incompatible with certain benchmark rate methodologies.

The CFTC requirements could be improved by limiting their scope to the category of LIBOR-type rates and specifying that they are not required for rates where participants are reporting on a transparently traded market, particularly in the case where the rate methodology has in-built protections against manipulation through submissions.

While the *Report* specifies that administrators should monitor submitters' compliance with the code, in the Australian context, the code would inform the regulatory process. The code, while voluntary from the administrator's perspective, may be expected to be complied with by the regulator. While the end result is the same these important regional distinctions in structure should be respected.

Some elements discussed in relation to the code such as the requirement for external audits, while perhaps appropriate for firms that have been found to have participated in misconduct, may not be appropriate for blanket regulatory application to all contributing firms. As external audit is a significant regulatory impost and would add costs and discourage participation across all benchmark rates globally we would suggest IOSCO not propose this as a principle.

18. What would be the key differences in the code of conduct for Benchmarks based on different input types, for example transactions, committed quotes and/or expert judgement?

AFMA sees the code of conduct as generally appropriate for quoted and traded rates, with the exception of the requirement for external audit.

A key difference between codes for benchmarks based on traded markets and those involving estimated rates is that the former require the submitter to be actively participating in the referenced market for it to be effective and efficient.

There is a specific need to ensure that codes of conduct do not disallow those participating in markets from reporting on them where the methodology of the benchmark has sufficient inherent safeguards against manipulation. That is to say that the codes need to be tailored to the risks they address and the type of benchmark methodology used to avoid being a one-size-fits-all approach.

19. What are the advantages and disadvantages of making Benchmark submissions a regulated activity?

The answer to this question depends upon the character of the benchmark and laws of the jurisdiction in question, so the Principles should not be prescriptive in this regard. As discussed above, in the first instance it is necessary to judge where the key risk to the integrity of a particular benchmark lies. For example, in a rate taken from a traded market, the main risk may present in trading activity as distinct from submission (especially if submissions fall within a very narrow range).

If submission to benchmark rates is made a directly regulated activity there is an argument that sanctions may be more readily brought to bear on those that attempt to

manipulate outcomes. Internationally as existing arrangements have been sufficient for regulators in some jurisdictions to levy fines totalling more than $1 billion for firms found at fault, this benefit may be more about legal process efficiency than any real increase in regulatory power.

Additional regulation may bring benefits but it comes at a cost, which is why governments require a cost benefit analysis to be undertaken before a regulatory proposal proceeds. The balance in practice will depend on the character of the rate set and the existing law in each jurisdiction. IOSCO should not be prescriptive but encourage an assessment to be made in each jurisdiction.

Regulation of submissions should not be seen as a panacea and should be acknowledged as only an indirect way of reducing risk for higher risk processes. Risks associated with the regulation of submissions include making compliance, or economically feasible participation, impossible and may result in firms withdrawing from benchmark processes. Another risk is that the costs of submission will significantly increase (for example by requiring external auditors) and that will also discourage participation in benchmark rates.

20. What are the advantages and disadvantages of making Benchmark Administration a regulated activity?

Although making benchmark administration a regulated activity may be appropriate in some situations, this should not be mandated by IOSCO. As illustrated by the Financial Services Authority's (FSA) analysis in relation to LIBOR, this form of regulation can impose a significant cost burden, which may or may not be justified by the circumstances in each jurisdiction.

AFMA's systems for managing BBSW has been responsible and effective and it is doubtful that regulation would improve this; to the contrary, it could complicate and delay the ongoing review and refinement process that has been a feature of BBSW. At the very least, further consultation is required than can be facilitated through the current truncated process.

A disciplined approach to the potential for regulation should be adopted by IOSCO in developing consistent standards of regulation and oversight of international benchmarks. Particularly as the work stems from enforcement actions there is a risk that the process may be driven by some of the conclusions of those processes and assume that action in relation to regulation of the administration of benchmarks may be appropriate regardless of the level of risk to be addressed.

The extent of discussion in the *Report* on this issue may not be sufficient for a reform of this type. There is evidence that the *Report* particularly on these matters has been insufficiently developed in its coverage of all benchmarks and does not provide a sound base for proceeding to recommendations that cover all benchmarks.

Further regulation of benchmark administration risks making it an unattractive activity and reducing the incentives to construct and maintain benchmarks by both increasing costs and administration risks.

Industry Standards and Voluntary Codes

The proposal to use evaluation of the success of application of IOSCO's principles set out in the *Oil PRA Principles* to determine whether industry codes will be effective in relation to financial benchmarks, their administrators and contributors is an arbitrary and somewhat unusual basis for such a determination. Particularly as existing industry standards and voluntary codes have long existed in relation to many financial benchmarks. The success of these codes may provide a more meaningful basis for analysis.

IOSCO's statement that:

> "a major criticism of voluntary codes is that they are not grounded in effective, enforceable and sanctionable legal rules, lack an independent enforcement mechanism and may not take adequate account of the wider economic and social interests affected by the Benchmark. Nonetheless, voluntary codes can have a useful function within a regulatory configuration and can be used in conjunction with other robust sanctions for market abuse and other enhanced governance safeguards. To address such shortfalls…"

may not give sufficient weight to the productive interaction between industry guidance and self-management and official regulatory action. Notwithstanding recent events in some jurisdictions, there is significant value in the industry-based approach as evident from most markets that use this approach at most times. Financial markets are, after all, the product of industry, and ultimately it is industry that will need to ensure their continuing relevance. There is an important role to play for formal regulation, but it may be inaccurate to view these frameworks as primary in the construction and maintenance of markets.

In relation to regulator confirmation of voluntary codes, AFMA would support these practices but notes that if this approach was mandated, the codes may cease to be truly voluntary. Regulators should be free to work in a cooperative way with industry to establish and maintain codes with flexibility.

In relation to the proposal for IOSCO to develop an overarching code of conduct to be implemented by administrators and submitters with explanations for any deviances from the IOSCO code, while the proposal is not clear and may benefit from further elucidation, it is critical to consider the important role of domestic regulators who have responsibility for implementing national government policy.

Regulators, should their respective governments adopt the IOSCO principles as their own policy, have responsibility for determining what local adaptations are appropriate and acceptable. Including 'requirements' to report deviances from the IOSCO principles presumably publicly may not be appropriate if the aim is to coordinate regulation.

Self-Regulatory Organisations

The discussion on Self-Regulatory Organisations (SROs) and their suitability for benchmark related activities is brief and may benefit from further consultation. The criticism that SROs may not be able to address wider concerns such as the use of benchmarks is not explicated or supported in the *Report.*

Direct Regulation of Submission, Submitters and/or Benchmark Administrators

The assertion that "The Task Force recognizes that the level of regulation will depend on factors such as the level of current oversight, any gaps in current regulation, and any specific problems identified with Benchmarks in a regulator's particular jurisdiction" appears to suggest that the question of regulatory intervention is one of degree.

We agree that it is necessary for regulation to take place but note that the level of regulation required will be dependent on the particular risks created by a specific benchmark to be managed.

While it is important for the *Report* to be cognisant of the developments quoted in relation to the Wheatley Review and the EU consultation report, its conclusion that imposing regulation of the administrator, the act of submission of data and an "Approved Persons" regime, will result in credible independent supervision oversight and enforcement, may not be appropriate in the particular form proposed without a fuller discussion of potential negative impacts of that approach. Other forms of implementation may be able to deliver similar benefits at lower cost for their particular benchmark rate.

The discussion in the *Report* of the Wheatley Review assertion that regulation may improve "how firms view" submission activities while instructive is not definitive.

Regulation of Use of Benchmarks

The recommendation that regulators give careful consideration to the regulation of the use of benchmarks, though it is noted as beyond the scope of the *Report*, is insufficiently supported.

Approaching the question of use of an input, such as financial benchmarks, does not fit into the regulatory paradigm in Australia, or as far as we are aware, in other jurisdictions. If there are particular financial products for which the use of benchmarks should be restricted then that is a matter for consideration in the context of the regulation of those products and not in terms of the benchmark itself.

21. Do you agree with the factors identified for drawing regulatory distinctions? What other factors should be considered in determining the appropriate degree of oversight of Benchmark activities (discussed in Chapter 3)? Please provide specific recommendations as to how the distinctions discussed in Chapter 3 should inform oversight mechanisms.

The *Report's* discussion of where regulatory distinctions should be drawn could benefit from more substantial development.

The assertion that there is mounting evidence "that the vulnerabilities in the Benchmark process discussed in this paper apply to Benchmarks in general, not just a specific category of Benchmarks" is unsatisfactory in the context of the scale of regulatory change contemplated. This type of generalised comment leads to generalised solutions, which may actually harm the effectiveness of some benchmarks. A better targeted approach is required based on further discussion and evidence before conclusions about regulatory reform can be reasonably reached.

If the appropriateness of drawing distinctions on whether regulation is suitable for categories of benchmarks including categories based on whether problems have been found in the design or performance and categories based on the particular design is dismissed then there is a real risk of imposing a one-size-fits-all response.

It may be quite reasonable to create divisions in terms of where regulation is required based on the design elements of benchmark rates, in particular where design elements cannot be readily undone yet make the rate vulnerable to manipulation.

Where benchmarks are based on readily observable traded markets and no substantial issues have been identified either with the performance or design of the market it may well be inappropriate to impose the costs associated with further regulatory intervention.

Before progressing to recommending regulatory frameworks a high quality analysis based on sound empirical research is required to determine what categories of benchmarks may benefit from being regulated and how.

Such an analysis may benefit from a consideration of the approach to regulation suggested in the International Council of Securities Associations (ICSA) Principles for Better Regulation (http://www.icsa.bz/img/letter_pdf/PrinciplesBetterRegulation.pdf). The ICSA Principles establish a sound framework for considering under what circumstances regulatory intervention should be considered and how it should be approached.

22. What distinctions, if any, should be made with regard to Benchmarks created by third parties and those created by regulated exchanges?

The discussion in the *Report* on the relevance of the existing regulatory status of the submitters, administrators and or the interest measured by a benchmark could benefit from further development.

Where benchmarks are created by regulated exchanges as opposed to third parties it may be appropriate that any additional conflicts of interest are appropriately addressed.

23. Assuming that some form of enhanced regulatory oversight will be applied to an asset class Benchmark, should such enhanced oversight be applied to the Submitters of data as well as the Administrator?

In principle these matters should be considered separately and on their merits. It is unclear why there should necessarily be a connection between the two. For example, a benchmark may benefit from a wider pool of contributors but this could be discouraged if to become a submitter would require institutions to come under “enhanced oversight”.

An increased regulatory burden on submitters would likely increase costs and risks to submitters.

24. What are the considerations that should be taken into account if the Submitters to a Benchmark operate in an otherwise unregulated market (e.g., physical oil, gold or agricultural commodity markets) and are not otherwise under any obligation to submit data to an Administrator?

AFMA again notes its position that contribution to benchmark rates should be a voluntary process. Regulation should not attempt to force participation in activities that are best performed by agents freely acting in the best interest of their markets.

Ultimately market participants may retreat from jurisdictions that attempt to compel them to undertake activities that involve risk and costs. The complex relationships of mutual interest that have created the world's financial markets, benchmarks and oversight cannot be mandated and regulators cannot reproduce the oversight that can be provided by those market participants acting in their mutual interest.

Where isolated issues have been identified with particular designs or in markets with insufficient liquidity these should be addressed on a targeted basis.

25. Do you believe that a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2? What measures should be established in conjunction with a code of conduct? For which Benchmarks is this approach suitable?

In the Australian context when considered in conjunction with the ongoing and substantial internal reviews and revisions taking place in investment banks and organisations connected with benchmark rates including AFMA, a code of conduct will be sufficient to mitigate the risks identified in Chapter 2.

Where benchmarks are not based on readily observable and liquid markets or where provisions of submissions are not sufficiently captured by regulation or regulated, then these measures may be appropriate.

26. What other measures outlined in the report, if any, should apply in addition to a code of conduct? If you believe a code of conduct, either on its own or in conjunction with other measures outlined within the report, would provide sufficient oversight to mitigate the risks that have been identified in Chapter 2, what type of code of conduct should apply (e.g., a voluntary code of conduct, an industry code of conduct submitted to and approved by the relevant Regulatory Authority, a code of conduct developed by IOSCO, etc.)?

IOSCO should not be overly prescriptive in this regard. In the Australian context while the code of conduct being developed will be voluntary it has been designed to address the market regulators expectations. Industry promotion of conformance with the voluntary code in an appropriate regulatory environment can increase flexibility and minimise costs associated with mandatory codes.

AFMA would not object if the regulator was to confirm the code more formally.

27. Do you believe that the creation of a Self-Regulatory Organisation (.e.g., one that exercises delegated governmental powers) and itself subject to governmental oversight, whether or not in conjunction with industry codes is a viable alternative for sufficient oversight and enforcement to mitigate the risks that have been identified in Chapter 2? For which Benchmarks is this approach suitable? What if any complementary arrangements might be necessary, such as new statutory obligations or offences for Administrators and/or Submitters?

Whether an SRO is the appropriate response for a particular benchmark in a particular regulatory context is a question that requires consideration on a case by case basis.

It would not be appropriate for IOSCO to prescribe SROs generally.

28. Do you believe that, for some Benchmarks, reliance upon the power of securities and derivatives regulators to evaluate products that reference a Benchmark or exercise their market abuse or false reporting powers creates sufficient incentives for the Administrator to ensure sure that Submitters comply with a code of conduct?

29. Do you believe that users of a Benchmark, specifically, the users who are regulated or under the supervision of a national competent authority should have a role in enhancing the quality of Benchmarks? Which form should this role take: on a voluntary basis (e.g. the user being issued a statement that will only use Benchmarks that follow IOSCO principles), or on a compulsory basis (e.g., the competent authority could request that users who are registered under their jurisdiction should only use Benchmarks that fulfil IOSCO principles)?

The approach of regulating the use or users of benchmarks in this way does not fit into the Australian regulatory paradigm. However, it is very beneficial if users of a benchmark and those that contribute to the benchmark have a direct role in monitoring and enhancing the benchmark. Industry ownership and effective management of the benchmark through an industry body with the appropriate governance structure will promote this outcome.

The proposals for issuing users of benchmarks statements or requiring them to only use IOSCO benchmarks are completely unsuitable in the Australian regulatory context. It is unclear how this links to having a role in enhancing the benchmarks.

Data Sufficiency

30. Do you agree that a Benchmark should be anchored by observable transactions entered into at arm's length between buyers and sellers in

order for it to function as a credible indicator of prices, rates or index values? How should Benchmarks that are otherwise anchored by bona-fide transactions deal with periods of illiquidity due to market stress or long-term disruption?

In many ways the issue of data sufficiency is the critical threshold issue in relation to benchmark rates. IOSCO's analysis may benefit from moving the data sufficiency consideration nearer to the beginning of its analysis and considering governance as a later issue. Different governance arrangements might be appropriate to different levels of data sufficiency.

The depth of analysis in the *Report* is insufficient to provide a base for major structural change in all cases.

Type of Data

AFMA believes that benchmarks should, where possible, be based on liquid, readily observable markets. The relevant data from these markets should include committed quotes and transaction data.

Transaction data should not be automatically elevated above committed quotes. There may be a certain level of assumption with transactions in the regulatory responses to the LIBOR issue. While transactions do show where trades have occurred and under certain circumstances are likely to be a a good guide to market pricing, in most liquid markets, most of the time, committed quotes will be a more reliable guide.

There is a tendency to have more confidence associated with transaction data as a result of it being derived from money changing hands, but where the volume is low, the trade is non-representative due to the participants or particular state of affairs of one or more of the participants, or where volume is large but is limited to a small number of parties (such as two), transactions should not be assumed to be superior to committed quotes from markets with many participants, and further should not be assumed to be in-market.

The concept of out-of-market trades is well understood in exchange markets which have rules to accommodate them. In some exchanges the rules that allow these trades to progress, which generally include requirements relating to minimum size, also restrict these trades from contributing to the market pricing outcomes (VWAP) for the day.

Particularly as benchmark markets are typically, and as discussed, appropriately, referenced by markets with larger notional exposures, this can create incentives for large

out-of-market trades. These risks can be mitigated by balancing the role of trades with that of committed quotes.

The value of committed quotes should not be underestimated. Indeed, the term 'market' is often used as a descriptor for the committed bid and committed offer in a security. Defining markets in terms of their trade history would ignore this significant and instructive convention. Markets can be very well defined by their committed quotes even during long periods of inactivity, stress or disruption and this has been found to be the case with BBSW. The pricing of quotes can and does move to reflect relevant influences, even without transactions, as it is provided by the same traders that execute transactions when the need or opportunity arises.

Regulators must be careful not to prescribe measures that will define markets by data they might assume is more reliable but that is not aligned with how market participants would see a market.

Sample Size Sufficiency

Sample size sufficiency is the key issue and should be considered and consulted on by IOSCO in detail before proceeding to draft principles for benchmarks. As noted there are substantial differences between the different benchmark methodologies and these should be better understood.

Where a rate is based purely on all transactions reported in a market and that market trades reliably in large size with a large number of participants and has a large number of transactions the requirements for sample size and outlier elimination will be inherently satisfied. However, contingency arrangements should still be put in place for gaps in trading.

In liquid markets with a smaller number of participants or fewer transactions each targeted input (each rate) to the benchmark process should have a significant number of data samples. These should then be processed to eliminate outliers and lower the risk of manipulation and a statistical process used to determine the reported benchmark.

Target Definition

Targets for benchmark rate input data should be well defined.

Where a 'prime bank' category of banks is used, AFMA holds that the banks that are in this category should be homogeneous and the process for selecting them should be transparent and driven by market participants. The banks that are members of the prime bank group should at all times be available publically.

Categories that are ill-defined risk confusion and excessive discretion on the part of submitters. Further, when a market convention clearly defines which banks are to be considered prime this enables the paper of these banks to be traded on a homogenous basis.

31. Are there specific Benchmarks for which you consider that observable transactional data is not an appropriate criterion or the sole criterion? If so, please provide a description of such Benchmarks and what value you think such Benchmarks provide?

Where a market can be relied upon to trade in large volume every day with a large number of participants with a large number of transactions is may be appropriate for transaction data to be the sole criterion. There would still be need for a contingency even in these markets for low or nil liquidity periods due to an operational failure or some other unforeseen event.

For all other liquid markets (and a market may be liquid with tight pricing but not trade for a particular period) committed quotes (of size) should be used either alone or in conjunction with transaction data to determine benchmark outcomes.

32. What do you consider the limitations or value in Benchmarks referencing asset classes and underlying interests where there is limited liquidity? Please describe the uses and value of such Benchmarks in the financial markets.

Where markets do not have sufficient liquidity (as distinct from continuous trading) it may not be appropriate to produce reference rates that are promoted as 'benchmarks'.

33. Do you agree that the greatest weight should be given to transactions in the construction of a Benchmark and that non-transactional information should be used as an adjunct (e.r., as a supplement) to transactions?

No. This approach privileges one type of market data in such a way that may increase risks of manipulation if applied without discretion. Different markets require different uses of committed quotes and trade data. Some markets may be best represented by quote data, some by trade and some by a combination of both.

How trade data should be incorporated into observations of a committed quote market (for example what is the minimum size transaction that should be considered representative, which types of transactions are appropriate to recognize as representative of general pricing etc) require a deep understanding of each particular market. Market participants are best placed to make these judgement calls.

34. What factors and how often should Administrators (or others) consider in determining whether the market for a current Benchmark's underlying interest is no longer sufficiently robust? What effective methods of review could aid in determining the insufficiency of trading activity within the market for a Benchmark's underlying interest?

Typically the types of factors that should be considered are liquidity (in relative and absolute terms), outstanding interest, volatility tightness of spreads, relevance and importance to business activity, and trading activity.

As the particular factors will vary from market to market IOSCO should not attempt to define parameters for the determination of market suitability.

There may be a role for regulators in determining whether a market is broadly suitable for a rate to be granted 'benchmark' status in a jurisdiction but this needs to be done on a case by case basis in close cooperation with rate administrators and market participants.

35. What precautions by Benchmark Administrators, Submitters, and users can aid Benchmark resiliency during periods of market stress, mitigating the potential need for market transition?

Careful design is the key to ensure that benchmarks are resilient during times of market stress.

Allowances should be made in the design of rates for times when trading does not occur or becomes sporadic and when quoted spreads are absent or too wide to provide accurate pricing.

The number of contributors should be sufficient to ensure that a number may leave without risk to the integrity of the sample data.

36. What elements of a Benchmark "living will," drafted by a Benchmark Administrator, should be prioritised?

It is appropriate that administrators and users of benchmarks give consideration to and make preparations for the possibility that a benchmark rate may become displaced or unviable.

This is a complex area for consideration and may benefit from a more comprehensive exploration in a separate consultation paper.

AFMA has clearly defined procedures in its market conventions for times when calculation of the benchmark rate has not been possible for any reason.

AFMA has developed standard contract terms for ISDA based documentation that address publication failure for any reason.

37. By what process, and in consultation with what bodies, should alternatives be determined for Benchmark replacement?

The determination of which benchmark is appropriate for use in contracts and listed products are commercial matters for those parties directly involved.

Proper consultation with market participants before significant alterations to benchmarks including termination is appropriate by benchmark administrators.

38. What characteristics should be considered when determining an appropriate alternate Benchmark? (Examples below) Should any of these factors be prioritised?

- Level and Type of Market Activity
- Diversity/Number of Benchmark Submitters
- Length of historical price series for the Benchmark alternative
- Benchmark Methodology
- Existing regulatory oversight
- Existing enforcement authority
- Volume, tenors and contract structure of the legacy trades

39. What conditions are necessary to ensure a smooth transition between market Benchmarks?

40. What considerations should be made for legacy contracts which reference a Benchmark in transition? To what extent does a substantive legacy book preclude transition away from a Benchmark? What provisions can be included in [new and existing] contract specifications which would mitigate concerns if and when a Benchmark transitions occurs?

41. How should a timeframe be determined for market movement between a Benchmark and its replacement? What considerations should be made for:

- Altered regulatory oversight?
- Infrastructure development/modification?
- Revisions to currently established contracts referencing the previous Benchmark?
- Revisions to the Benchmark Administrator?
- Risk to contract frustration

*****