Attachment - UK Fair and Effective Markets Review

	Question	AFMA Comments
What does 'Fair and Effective' mean for FICC markets?	Q1: The Review would welcome respondents' views on the definition of 'fair and effective' FICC markets proposed in Section 3. Does it strike the right balance between safeguarding the interests of end-users without unnecessarily impeding the effectiveness of FICC markets? Are the concepts of transparency, openness and equality of opportunity appropriately specified? And how does the definition compare with those used in other markets, jurisdictions, organisations or legislation?	**Defining effective markets** The proposed definition of effective embodies two characteristics: • Enabling investment, funding and risk transfer; underpinned by robust infrastructure, • Competitive prices. Economic growth is positively related to capital productivity. Accurate price signals through the price formation process are key to the efficient allocation of capital and risk. Hence, accuracy of prices could be considered as a relevant criterion for effective markets. However, accuracy of prices may not always equate with competitive prices. For example, a price may be drawn from a competitive market but its level of accuracy may be constrained by factors such as a ban on short sales that impacts market quality, by a transactions tax that makes some transactions uneconomic or by manipulation of a market if integrity protections fail. The proposed focus on robust infrastructure is appropriate but associated costs are also a consideration. Unnecessarily high intermediation costs from whatever source (eg exercise of a market power) may limit the fineness of pricing accuracy in a market as well as having a direct cost burden that may limit the effectiveness of the market. Higher intermediation costs ultimately have a negative influence on economic growth. **Defining fair markets** Fairness matters because whether it is an institutional dealer assessing the operational risk of doing business with a trader in another institution or a retail client seeking to rely on advice being given to them by a financial planner in relation to an investment in bonds, the business will only take place if there is confidence in the competence and trustworthiness of their counterparty.

		In addressing this issue, a clear delineation between retail and wholesale clients must be built into the regulatory framework in order to maintain the efficiency and, therefore, the effectiveness of the FICC markets. Regulatory rules must reflect this distinction, such that associated constraints on market activity are proportionate to the risks they seek to contain. Retail investors require greater protection through policy intervention than do sophisticated investors. For example, a hedge fund is typically a knowledgeable and sophisticated counterparty, whereas a retail investor may have limited market experience and lack resources to protect his/her interests. The imposition of retail regulatory protection obligations on wholesale markets would increase costs without generating offsetting benefits. This does not obviate the need for the law to provide protections for all market participants that are justified by market failure analysis. For example, measures to deter misconduct such as misleading and deceptive conduct, market manipulation and insider trading, failure to manage a conflict of interest etc. These protections are essential to the effective operation of wholesale markets (as well as retail markets). To promote a fair and effective market, these base line protections provided in the law should be supplemented by professional standards in the industry. The effective operation of financial markets is dependent on the competence of its participants and trust in their capacity to provide their services in a secure and fair way. In other words, a professional approach by market participants is central to the success of the financial markets in serving the needs of the economy. In summary, it is important to strike the right balance in regulation, to avoid constraining the effective operation of wholesale markets. This should be complemented by standards of market practice so that participants have confidence that their counterparty is trading in a manner that is in keeping with good market practice.

In fixed income:	Q5: Is greater use of electronic trading venues for a wider range of market participants possible or desirable? Are there barriers preventing a shift to a more transparent market structure?	Not all markets are of a nature and scale to support standardised transactions of the type that would make electronic trading economically viable. The Australian Council of Financial Regulators "Report on the Australian OTC Derivatives Market" April 2014, states: "…it is generally acknowledged that the benefits and costs of platform trading will depend on the characteristics of the trading platform. The international consensus on what constitutes an acceptable trading venue for mandatory trading obligations is still developing. While the CFTC has progressed the implementation of its regime, the EU is still in the process of finalising changes to its regulatory framework for trading platforms. Most other jurisdictions (including the US Securities Exchange Commission, as well as peer jurisdictions in Asia such as Hong Kong, and Singapore and Japan) have yet to introduce mandatory trading rules, having chosen to prioritise other aspects of OTC derivatives reform." "….The G20 acknowledged that trading on exchanges or electronic platforms may not be appropriate for all standardised OTC derivatives contracts. For a product to be effectively traded on a centralised venue there must be sufficient liquidity for buyers and sellers to enter and exit their positions without unduly affecting market prices. If there is insufficient liquidity, the pre-trade transparency from trading on a platform could move market prices in anticipation of the trade, which could act as a disincentive to trade and further reduce market liquidity. Without adequate publication delays for large trades, post-trade transparency provided by trading platforms may also further reduce liquidity in already illiquid asset classes." [Excerpts from Section 4.3 of the Report]
	Q6: Is standardisation of corporate bond issuance possible or desirable? Should standardisation be contemplated across a broader range of fixed income products? How could that be brought about?	Standardisation is generally desirable as a means to support liquidity in a market, which may in turn promote fair and effective markets. However, this should not preclude the ability to provide bespoke products to meet the specific needs of clients.

		The final report of the Financial System Inquiry in Australia, released by the Government in December 2014, recommends steps to "Reduce disclosure requirements for large listed corporates issuing 'simple' bonds and encourage industry to develop standard terms for 'simple' bonds" - Recommendation 33. AFMA supports this approach in the Australian context.
Regulatory measures:	Q11: Are there any areas of FICC markets where regulatory measures or internationally co-ordinated regulatory action are necessary to address fundamental structural problems that exist?	International coordination of regulation is required to promote common regulatory approaches and market practices, within a framework that permits recognition of specific jurisdictional matters, and to avoid fragmentation of liquidity.
Promoting effective competition through market forces	Q15: To the extent that competition is currently ineffective in any of the FICC markets, are there market-led initiatives, technological or structural changes that may remedy this situation?	Market led codes of conduct and best practice principles may have application, as considered below.

Benchmarks	Q21: Do current domestic and international initiatives by industry and regulators to improve the robustness of benchmarks go far enough, or are further measures required?	The IOSCO Principles for Financial Benchmarks (July 2013) have gained international standing and are the global standard. As such, they play a useful role by offering common points for the understanding and assessment of international benchmark rates. AFMA is the benchmark administrator for the BBSW benchmark rate in Australia. AFMA has reviewed its compliance with each of the 19 IOSCO principles in respect of this benchmark. As part of this process an independent expert was engaged to conduct a review in accordance with the Australian Standard on Assurance Engagements (ASAE 3000 Assurance Engagements Other Than Audits or Reviews of Historical Financial Information), in regards to the controls AFMA has in place to achieve these objectives for BBSW. The conclusion of this review in August 2014 is that the BBSW controls are suitably designed to give conformance to the IOSCO Principles. AFMA's experience is that the Principles provide a useful framework within which to check that key attributes of an effective benchmark are satisfied. For example, the BBSW transitions policy is better structured consequent to its review in the context of IOSCO Principle 13. As is the case with standards generally, experience in applying the IOSCO Principles will identify refinements that will improve them. One area for consideration in this regard is its very broad definition of a financial benchmark. IOSCO states that consistent with its objective of creating an overarching framework of principles for benchmarks used in financial markets, it has adopted a very broad definition of a benchmark that includes rates used for valuation purposes. The definition is expansive and captures many prices/rates that are not in the character of financial benchmarks as generally understood. In our experience, the effect of this is to deter participation in and production of 'benchmarks' that are at the outer part of this definition, which has reduced the flow of information to the market. The nature of benchmarks that have systemic importance is such that they have to be retained.

		The primary factor of scope should be if a particular price, rate or index is regarded and widely used in the market as a benchmark, as the term is normally understood. A benchmark should have to have a systemic relevance to attract comprehensive regulation or controls of the type required to meet the IOSCO Principles. If a particular rate is not used as a term in financial contracts, then it should not be treated as a benchmark but rather it should be treated as another form of data service and regulated accordingly. Finally, the IOSCO Principles have a significant orientation towards submissions based benchmarks and could in the future be further developed to provide greater in principle guidance on operational issues, especially where information is extracted directly from trading venues.
Industry-level measures	Q22: What steps could be taken to reduce the reliance of asset managers and other investors on benchmarks?	Development of a broader range of benchmarks, including risk-free rate benchmarks, may be of assistance in this regard. It would assist if regulators were to adopt a common, pragmatic definition of a financial benchmark, which in application would more accurately mitigate and manage real benchmark risk.
	Q23: What additional changes could be made to the design, construction and governance of benchmarks?	Greater international regulatory cooperation is essential to avoid the emerging threat of harmful extraterritorial application of benchmarks regulation. As mentioned earlier, the IOSCO Principles have gained global standing and are a valuable common reference point. However, there is a significant question mark over their full value in this regard, as draft European regulations for benchmarks currently under consideration would apply to some third country benchmarks and a benchmark's compliance with the IOSCO Principles would not of itself be sufficient to meet the criteria for acceptability under this regulation. This approach is at odds with the objectives of G20 and IOSCO and its effect could be to fragment markets and impair their effectiveness. AFMA believes that recognition of a third country (non-EU) administrator should be based solely on an administrator's conformance with the IOSCO

		principles. It would be appropriate to expect a benchmark administrator to provide an independent, external audit of their conformance with the IOSCO Principles to provide comfort that the embedded standards are being met. The EU's regulation of financial benchmarks provides an opportunity for it to accept IOSCO compliance as adequate for acceptance under its proposed regulation and, thus, to give leadership to efforts to enhance the coordination and consistency of cross-border regulation. As discussed in the answer to Q21 above, the definition of benchmark should be more tightly focussed on rates/prices that are referenced in financial contracts. In addition, the IOSCO Principles and regulation needs to distinguish between benchmarks of systemic importance and other benchmarks or price/rates information. More guidance on degrees of the proportionate application of such principles or regulation to less important benchmarks.
Regulatory action	Q25: What further measures are necessary to ensure full compliance with the IOSCO Principles for financial benchmarks by all benchmark providers?	As discussed above, a practical and uniform definition of what constitutes a financial benchmark would exclude many information sources that are not in the nature of a benchmark and, thus, may struggle to satisfy the IOSCO Principles. Greater practical guidance on the application of the IOSCO Principles, especially in the proportionate way they contemplated to apply, would be of assistance. In addition, IOSCO should be in a position to answer questions and provide practical guidance as sought by benchmark administrators.
	Q26: How can the regulatory framework provide protection to market participants for benchmarks administered in other jurisdictions in a proportionate way?	As discussed above, recognition of the IOSCO Principles provides a sensible common framework within which benchmarks in other jurisdictions can be reliably assessed.

Standards of market practice	Q31: Should there be professional qualifications for individuals operating in FICC markets? Are there lessons to learn from other jurisdictions — for example, the Financial Industry Regulatory Authority's General Securities Representative (or 'Series 7') exam?	Potentially, but the issue here will be to ensure that there is consistency across jurisdictions. Professional qualifications need to take account of all of the relevant obligations that apply in a particular jurisdiction, as well as being fully reflective of the statutory framework of that jurisdiction. At the same time, there could be efficiencies created in a cross border context (given the global nature of FICC markets) for there to be some level of portability between jurisdictions.
Can the industry help to establish better standards of market practice?	Q32: What role can market codes of practice play in establishing, or reinforcing existing, standards of acceptable market conduct across international FICC markets?	**Codes of conduct** Codes of conduct implemented by industry bodies and trade associations play, and should continue to play, an important role in the overall regulatory framework for FICC markets. In addition to the codes cited in the consultation paper (box 9 on page 39), AFMA has in place a principles based Code of Ethics and Code of Conduct[1]. This code operates in conjunction with AFMA's OTC Market Conventions, which are the industry accepted standards of practice for OTC transactions in Australia (see the following link - market conventions). The conventions are set and administered by AFMA, through our markets committee structure. Australian regulators do not have any direct role in the setting or the administration of the market conventions, however, they play a major role in ensuring the fairness and effectiveness of the OTC markets. However, it must be recognised that many industry bodies around the world, including AFMA, do not operate as a self-regulatory organisation (SRO). Indeed the concept of an SRO does not currently exist in the Australian statutory framework for the regulation of financial markets, and the financial services sector more broadly. Accordingly, while a code of conduct can set expectations about behaviour by market participants in terms of their interactions with clients and with each other, and can help to articulate the responsibility of individuals and firms to behave in a way that does not have adverse consequences for the market, codes often do not have the force of law and lack enforceability. The legal frameworks that support and give effect to codes vary from country to country.

[1] The Codes are currently under review and will be expanded.

		Where there is a community expectation that certain forms of behaviour are so egregious that punishment is required, this is the generally the role of regulators, law enforcement agencies and the judiciary. In our view, codes of conduct cannot and should not be seen as a mechanism to replace the role of law enforcement. Box 11 on page 41 of the consultation paper sets out suggested methods for ensuring compliance with codes. We offer the following observations about those methods: ***Self-certification*** – This approach would require a clear purpose to be effective (eg who are they certifying to and for what outcome?). Moreover, in some circumstances it may not be considered effective or acceptable by the wider community absent some form of external verification. ***Comply or explain*** – There is an understanding of the "comply or explain" (also known as "if not, why not") concept in the Australian regulatory environment. For example, the ASX Corporate Governance Council Principles and Recommendations require if not, why not reporting against a number of its principles. Similarly, ASIC has in the past imposed if not, why not reporting requirements against the issuers of certain types of investment products (for example, unlisted debentures). This model could potentially be applied in the FICC markets, but the nature and purpose of "comply or explain" type reporting would need to be carefully crafted. ***Contract*** – AFMA is a body that produces widely used contractual standards for the FICC markets (generally supporting international standard master agreements). AFMA also produces guides to best practice in relation to conduct (examples are available at the following link – codes and practices). The feasibility of linking codes and practices to the transactional contractual relationships between FICC market participants may be worth exploring, though this is not a simple proposition as many transactions are cross-border in nature and dispute settlement arrangements would need to be taken into account.

		Independent oversight body – There is an existing analogy in exchange traded markets in Australia in the form of the Markets Disciplinary Panel, established under the Market Integrity Rules (MIR) which are administered by ASIC. The Panel is independently chaired and has a pool of members that can be called upon to conduct a hearing, depending on the nature of the matter. The Australian Takeovers Panel is not a directly comparable body as it is established under statute and has some court-like powers. ***Official regulatory endorsement*** – The status of a market conduct code could be strengthened by formal regulatory endorsement. However, it would be more effective if regulators gave comfort that compliance with a particular code would have the effect of either giving a regulatory safe harbour or lead to a lower regulatory risk weighting for the relevant entity in respect of the activity covered. The approach taken might depend on the nature of the code and the activity in question. The form of endorsement of a code should be consistent with the needs of the wholesale market and the regulator's expectations set accordingly. It is a very significant step for an industry body to move from being the issuer of a code for behaviour to become the body that is the enforcer of this code. In AFMA's experience, there is considerable merit to an industry body developing a code or best practice guidance and the regulator then using that standard in its assessment of industry practice.[2]

[2] For example, AFMA has issued industry best practice guidance on soundings and the handling of confidential information - see AFMA Confidential information and soundings guidelines. ASIC reviewed market practices in 2014 by reference to industry guidance, including AFMA's, and published its report (Report 393) – see ASIC Report on handling confidential information.