Manager
Banking, Insurance and Capital Markets Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

24 July 2017

Dear Sirs

Treasury Consultation: Reform of the regulation of financial benchmarks

We refer to the Treasury consultation on the reform of regulation of financial benchmarks, including the draft proposed legislation and explanatory materials published on 26 June 2017 (the **Consultation**). Westpac recognises the importance of establishing a strong regulatory regime for financial benchmarks in line with international standards and welcomes the opportunity to respond to the Consultation.

Westpac supports the general aim of the new benchmarks regulatory framework to ensure the quality, integrity, availability, reliability and credibility of financial benchmarks. In our view, the key to achieving this outcome will be implementing a regime that imposes appropriate obligations on benchmark administrators and market participants and serious consequences for genuine misconduct, while not adversely affecting the operation of relevant markets or fettering the legitimate activities of market participants.

To this end, it is critical that the regime:

1. takes account of the specific nature of the markets to which it will apply, and how market participants operate in those markets; and
2. draws very clear lines for traders, compliance professionals and institutions in terms of what amounts to acceptable and unacceptable conduct.

A lack of clarity in terms of how the proposed rules and offences will apply, when combined with the introduction of very significant penalties for institutions and individuals, is likely to have a material detrimental effect on the operation of relevant markets. Institutions and their relevant employees will be reluctant to participate in markets where there is a risk of inadvertent breach of the benchmark laws. By contrast, eliminating any uncertainty will likely promote liquidity in the markets, thereby contributing to the reliability and credibility of the relevant benchmarks.

These considerations are also relevant in the context of younger, developing markets to which the new regime might apply. Increased conduct risk and compliance burdens are likely to impede the

deepening of those markets, thereby impacting the evolution of the broader Australian financial markets landscape.

While Westpac is in general agreement with the direction of the new regime, we are concerned that certain aspects do not adequately take account of the key considerations outlined above. We set out our comments on these aspects below.

References to sections in this response are to the relevant sections in the *Corporations Amendment (Financial Benchmarks) Bill 2017* published by Treasury on 26 June 2017.

1. The proposed benchmark offences

a) Concept of "artificial" level

The proposed benchmark manipulation offence in section 908DA refers to the financial benchmark being generated or administered at an "artificial level".

The term "artificial" is not defined in the proposed draft legislation or in the current market misconduct provisions of the Corporations Act which employ that term in a different context. In the absence of a definition, the meaning of the term is uncertain. While the term has been considered in some market manipulation cases in the context of a "price for trading" in a financial product, it is far from clear that the existing case law considering that term assists in relation to money markets and benchmarks (or other OTC markets).

This is, in part, because there are other legitimate factors and purposes for trading besides price that may be relevant when trading in those markets. For example, in the bank bill market, the following other factors could potentially be relevant:

- the characteristics of certain investors and the holistic investor relationship (e.g. certain investors may have longer behavioural lives or larger volumes which are valuable to an issuer);
- the requirement to make a market by quoting a two-way spread;
- there may sometimes be a different price for greater volume which may be considered;
- credit risk limit management when investing (for example, if a market participant is close to full credit limit/appetite); and
- a bank may need to ensure that investors in its name do not become unduly concentrated for liability management purposes (for example, limits on an investor owning >x% of its total programme).

Under the current proposals, trading for these genuine reasons might conceivably not be consistent with acquiring or selling at the best available price. This uncertainty leaves traders and market participants in a difficult position in terms of assessing whether their conduct is acceptable. When combined with the strong penalties being proposed for the benchmark offences in the new regime, this is likely to discourage market participants from trading in the market which will reduce (or is at least unlikely to improve) liquidity in the market.

Further, the concept of "artificial" price or level may be particularly problematic when applied in the context of other financial markets which may be somewhat illiquid, and where there are few participants and large variances in size. It is also likely that the connection between trading and its influence on any benchmark may not necessarily be straightforward or clear. Depending on the benchmark rules that might ultimately be pronounced by ASIC in relation to each designated benchmark, there could be genuine uncertainty as to how any particular conduct (or omission) might impact the generation or administration of the benchmark at a level that is artificial. That is to say, there is difficulty both in the concept of "artificial" and in the way the (as yet unknown) ASIC rules may impact a market participant's interaction with the benchmark in question.

An alternative formulation which deserves further consideration in our view is for the prohibition to be framed as trading or engaging in conduct for the dominant purpose of affecting the level of the benchmark. This would remove the concept of artificiality which, as outlined above, is difficult to define (particularly in a way that takes account of the nature of different markets) and creates uncertainty.

b) Committing the benchmark manipulation offence by omission

Section 908DA contemplates that the benchmark manipulation offence can be committed where "a person does, or omits to do" some act which results in the financial benchmark being generated or administered at an artificial level. We note that the underlined wording does not appear in the existing market manipulation offence in section 1041A of the Corporations Act.

The potential to commit the offence by omission is problematic. The current drafting could conceivably capture a situation where a market participant decides not to transact in the market on a particular day for legitimate reasons (including not wishing to affect the benchmark). By way of example, in the bank bill market, a bank may have a need to raise a certain amount of funding in the market over a period. The act of choosing not to trade on a given day may conceivably constitute an offence. This creates unacceptable uncertainty for traders and will almost certainly lead to an increased compliance burden (for example, it may give rise to a need for traders to document all reasons for *not* trading on particular days).

Further to the comment at 1(a) above, the concept of artificiality becomes even more difficult to apply in the context of a manipulation offence committed by omission. It is not clear how an omission to trade can be properly understood in the context of buying or selling for the purposes of genuine supply and demand.

For the reasons outlined above, the omission aspect of the offence in section 908DA should be removed.

c) Safe harbour for market-making activity

Prime Banks are obliged to provide two-way prices in the bank bill market in accordance with their obligation under the ASX Prime Bank Conventions. Where Prime Banks are obliged to make a two-way market, they may not have a genuine desire to trade one side of the market at any price. A safe harbour should be created that protects trading conducted by reference to an identified spread. This is appropriate in circumstances where Prime Banks provide valuable liquidity to the market.

d) Drafting of section 908DA(1) and (2)

The operation of section 908DA and its interaction with section 908DE requires clarification. The current drafting in section 908DA appears to suggest that two separate offences could be committed based on the same set of facts, namely:

(i) breach of section 908DA(1) in relation to manipulating a financial benchmark; and
(ii) additionally, a breach of section 908DA(2) if the financial benchmark is "significant" or the acts or omissions result, or are likely to result in an Australian entity suffering financial or other disadvantage from use of the financial benchmark.

It is difficult to identify a scenario in which benchmark manipulation would not cause at least one entity to suffer financial or other disadvantage, so it is unclear why two separate offences are required.

e) Broad application of offences

On the current drafting, it appears that the benchmark offences will apply to *any* financial benchmark if the activity is carried out in Australia. This goes beyond the approach adopted in certain other jurisdictions. For example, we understand the UK benchmark offences apply only to specified benchmarks which meet certain criteria.

This broad application of the offences, combined with the broad definition of "financial benchmark", means that the proposed offence provisions could conceivably apply to other activities in the market that are not currently viewed as benchmarks in the strict sense, such as the publication of end of day rate sheets in the corporate bond market. If there is not complete clarity on whether this activity constitutes a "financial benchmark" and on the nature and scope of the relevant offences, there is a risk that traders or institutions could inadvertently commit a benchmark offence. This increased risk could make institutions less willing to continue to provide these other services to end users, which could in turn lead to reduced price transparency and liquidity in certain markets.

For these reasons, in our view the application of the offence provisions should be limited to significant benchmarks or, alternatively, to significant benchmarks *and* certain other benchmarks identified by ASIC (having regard to specified criteria and following an appropriate consultation process).

2. Broad rule-making power for ASIC

While we recognise the need for ASIC to have a power to make rules in relation to benchmarks, there is a risk that the broad overriding power conferred on ASIC in the new regime may reduce the consultative approach that has been taken by the ASX and AFMA to date.

That approach has ensured that benchmarks are prepared having genuine regard to the input of the industry, ensuring both the generation of an accurate benchmark and continued participation in relevant markets. Ongoing consultation by ASIC will be critical to ensure that any further proposed rules do not adversely impact the funding and trading activities of market participants and, in turn, the relevant markets on which the benchmarks are based.

The requirement in section 908CL for ASIC to consult before making rules goes some way to alleviating this concern but we remain concerned about the potential for any new process or rules to place significant burdens on market participants or materially undermine the utility of the relevant market. We would like to see more emphasis on the consultation process. This is particularly the case where the new ASIC rules may well inform the possibility of an inadvertent breach and some of the severe penalties in contemplation. For example, we suggest that a reference to allowing reasonable time for consultation be added to section 908CL(2).

Westpac would welcome the opportunity to discuss the above comments with representatives from Treasury as part of the consultation process. Please contact me (curt.zuber@westpac.com.au) if you have any questions.

Yours sincerely

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Westpac Group