FX Week conference "State of play, state of flux: a regulator's perspective"

Introduction

1. Ladies and Gentleman, thank you for the invitation to present to you this afternoon.

2. Looking around the room, I know a number of you. For those I haven't met, my name is Oliver Harvey, I am the head of ASIC's Financial Market Infrastructure division.

3. There are few things I've been asked to talk about today, and a few related and topical issues that I want to also discuss with you.

4. I've planned some time at the end for Questions, so please feel free.

5. At the outset, I'll touch briefly on ASIC's areas of focus in the FX market, and make some observations in particular on the retail market, and more generally, how we see our role.

6. I will also talk about the implementation of some of the G20 OTC derivative reforms including developments around the possible mandating of platform trading for some asset classes.

7. As part of these reforms, I want to take this opportunity to announce work ASIC and the other regulators are planning for later in the year which will likely have a focus on platform trading, among other topics.

8. I also want to discuss the OTC trade reporting initiative which is starting to yield some interesting data on the trading of FX and other derivatives by our reporting entities.

Retail FX

9. Clearly as you have heard several speakers discuss already today, the FX market is an enormously important market to a small, open economy like Australia.

10. One of ASIC’s strategic objectives in relation to all financial markets is to advance an environment that supports efficient capital allocation to fund the real economy and, in turn, economic growth and prosperity for all Australians.

11. We have also said that another strategic objective is aimed at making sure Australians have trust and confidence in the financial system.

12. Both have a lot of resonance for ASIC's role in the FX markets.

13. I don’t have to tell you that retail FX trading in particular, has been in the spotlight of late.

14. Clearly the Swiss Central Bank's decision to unpeg the Swiss Franc affected a number of players in the market, including retail investors and brokers, and highlighted the need to ensure the financial soundness of retail FX providers.

15. ASIC also took action along with the AFP against two people last year in respect of their involvement in amongst other things, illegal FX trading based on inside information obtained from the ABS.

16. But even before recent events, ASIC has been very active in relation to retail investment in foreign exchange, especially margin trading.

17. We maintain the firm perspective that retail investors trading in the FX market should do so with their eyes very much open to the risks.

18. For this and other reasons, we have also been active in educating investors about the risks of margin FX trading. For example:

    a. we have focused on disclosure to investors against the disclosure benchmarks set out in our Regulatory Guide (227); and

    b. on giving clear messages that retail investors should take the steps needed to fully understand their issuers' client money handling practices.

19. Our regulatory activities in the retail investment space have resulted in ASIC taking action in relation to margin FX licensees and other retail OTC derivatives issuers.

20. Following recent events around the Swiss Franc, ASIC has been also monitoring the situation and liaising with relevant stakeholders.

21. As was also covered in the media last week, from a licensing perspective, we will also look to have regards to these recent events when considering applications by proposed new entrants to the market.

22. This includes considering the implications of such events on the licence applicant's business model and their risk management processes.

Benchmarks

23. Now looking more broadly at the wholesale FX markets – as many of you would be aware, ASIC is currently making inquiries about potential misconduct in relation to BBSW and FX benchmarks.

24. Without going into ASIC's current inquiries, I would reiterate that banks must ensure their trading practices in the wholesale market, including trading activity surrounding benchmark fixings, is consistent with their obligations under law.

25. Matters to particularly focus on to meet their obligations include:

    a. protecting confidential client information; and

    b. ensuring trading activity is consistent with genuine activity in the market.

26. As conduct regulator, ASIC will take enforcement action where we find that banks have failed to meet their obligations.

27. Clearly we have not finalised our investigation, but whatever the outcome, our expectations of banks' trading practices and conduct are also legitimate expectations for you to have of your colleagues and counterparts in the industry.

28. Any failures in this regard are not just a breach of the law but consistent with the strategic objectives I mentioned earlier, also have the potential to:

    a. erode investor confidence in our financial system; and

b. undermine the efficient allocation of capital, potentially impacting the prosperity of all Australians.

Trade reporting

29. Turning now to changes in overseas regulation and following the GFC, in 2009 Australia committed along with the other G20 countries, to a range of key reforms to the OTC derivative market.

30. As part of this, ASIC along with the other regulators, is well advanced in implementing the trade reporting regime in Australia in respect of OTC derivatives, which include FX derivatives.

31. Under the rules, all Australian financial entities of a certain size, and foreign financial entities that trade derivatives in Australia are required to report.

32. Reporting obligations are being phased in and for FX derivatives commenced on:

    a. 1 Oct 2013 and 1 Oct 2014 for phases 1 and 2 reporting entities; and

    b. 12 October 2015 for phase 3 reporting entities, in other words financial entities not covered by phases 1 and 2.

    These phases are determined by entity derivatives book size.

33. While reporting is still being phased in, we already have an enhanced ability to analyse market activity in terms of the size of open positions.

[Slide 2, OTC FX derivatives – currency pairs]

34. For example, this slide shows FX derivatives currency pairs by open gross notional.

    a. While AUD/USD (Aussie/US) is the main currency pair at 27% of gross notional (in dark brown) for our reporting entities;

    b. other currency pairs are also material – for example the USD/EUR (US/Euro) and USD/Chinese Yuan (US/Chinese Yuan) currency pairs each make up 13%.

35. This is different from AFMA's *Australian Financial Market Report* (2013-14), which shows the AUD/USD pairing made up 61% of turnover in currency options.

36. The turnover in other currency pairs was much lower, with USD/EUR (US/Euro) at 5% of turnover.

[Slide 3, OTC FX derivatives: types of instruments]

37. This slide gives a breakdown of the types of FX instruments. The majority of gross notional open positions – 86% – is concentrated in the FX forward contracts (dark and light purple).

38. By comparison, AFMA's financial market report shows swaps make up the majority of turnover activity at 68%. Forward contracts only make up 6% of turnover.

39. These differences could tell a few stories. For example, it may be that forward contracts are more likely to be held to maturity, while entities are more likely to trade in and out of swaps and options contracts.

40. Now I am not expecting you to be especially overwhelmed at this point by these observations. As I said, these trade reporting

initiatives for OTC derivatives are still being phased in Australia and the provision of data is at an early stage.

41. But you can see that these large scale market reforms are starting to provide some early additional and complementary data points to traditional sources of information, which assist in increasing the transparency of the FX derivative market and that of other OTC derivatives.

42. What should impress you a bit more, I hope, is the early steps we are taking to determine how to most effectively integrate this type of data in to our state of the art market surveillance system which we currently use for real-time monitoring of exchange traded activity in this country.

43. This system is at the cutting edge of global surveillance system technology with an extraordinary capability to:

    a. mine data and detect trading patterns;

    b. across masses of trading information and unearth unacceptable or manipulative behaviours in a matter of seconds.

    It is truly remarkable.

44. As far as we know, no global regulator has yet taken this step of integrating newly available OTC derivatives trade data into a listed products surveillance environment.

45. If done effectively, we would be at the forefront of gaining the fullest value from the OTC data possible as a market integrity regulator.

46. As an interesting aside, as more trading moves on to platforms whether by mandate or commercial drivers, there is the view that a number of important market conduct prohibitions – typically predicated on the product being 'traded on a financial market' – become increasingly relevant to the traditional OTC market.

OTC derivatives platform trading

47. On this, I also want to talk about some of our upcoming work on the ongoing implementation of OTC derivatives reforms.

48. As most of you know, the G20 leaders in 2009 agreed that in addition to requirements around the reporting and central clearing of OTC derivatives, standardised OTC derivatives should also be traded on exchanges or trading platforms, where appropriate.

49. These reforms seek to achieve the objectives of greater:

    a. transparency;

    b. financial stability; and

    c. market integrity.

50. Alongside trade reporting, central clearing has been implemented by jurisdictions including Japan and in the US under the CFTC regime, and is being implemented in other jurisdictions including the EU and in Australia.

51. Platform trading has been on a slower track but there are regulatory moves afoot globally:

a. Mandatory trading on Swap Execution Platforms (SEFs) has been implemented by the US CFTC since February 2014.

   The CFTC has asked its Global Market Advisory Committee to look at a potential clearing mandate for FX non-deliverable forwards (NDFs);

b. In the EU, ESMA is consulting on technical standards to implement mandatory platform trading under EMIR and MiFID II.

   Recently ESMA has decided not to propose a central clearing mandate for NDFs for the time being; and

c. On 29 January this year, the Canadian Securities Administrators also jointly released a consultation paper on a proposed Derivative Trading Facility regime for Canada.

52. While we are on the topic of NDFs, ASIC is getting trade reporting data about NDF contracts under ASIC's OTC derivative reporting rules.

53. If the Australian regulators were to consider any of the mandatory requirements for NDFs, we would want to better understand these figures further. For example, we would want to explore things like:

    a. the nature of the counterparties to these NDF contracts;

    b. changes in volume over time; and

    c. what the implications of any further mandatory requirements might be for these products.

54. Like everything in this space, we will be monitoring the progress of the US and EU in this area, whether it may have an impact on our markets, and what it means from a regulatory harmonisation standpoint.

Australia – the role of market assessments and the legislative regime

55. In Australia, we have legislation in place that allows the Minister to make a determination, that certain classes of OTC derivatives are subject to any of the G20 reforms, being:

    a. mandatory trade reporting;

    b. mandatory clearing; and

    c. mandatory platform execution.

56. After the Minister makes a determination, ASIC gains the power to write rules setting out the details of the mandatory obligations (we have done this previously for trade reporting and anticipate doing so too for mandatory clearing).

57. As part of the process for implementing OTC derivatives reforms, the Australian regulators have conducted regular assessments of the OTC derivatives market.

58. The market assessment cycle has formed the basis of our advice to the Minister about potential mandates.

59. In previous market assessment reports in July 2013 and April 2014, the regulators did not advise the Minister to impose a platform trading mandate in Australia.

60. Instead, we said that we will continue to monitor developments in domestic and overseas markets, and in overseas OTC derivatives reforms more generally.

61. We are conducting the next market assessment around the middle of this year. This time, we will be aiming to explain in more detail how we will assess the case for implementing a platform trading mandate.

62. Our goal is not to move to recommending a mandate in one step, but to put in place the intellectual architecture that would give clarity on when recommending a trading mandate for a particular asset class would be appropriate.

63. You should be reassured by these messages.

64. Within the G20 framework our aim is also to avoid negative market surprises and overly prescriptive regulation which might damage liquidity and, indirectly, the interests of end users of derivatives markets and Australia as a financial centre.

65. That's why this market assessment report will be setting out the factors or questions that we will consider when forming a recommendation to the Minister.

66. Australia has adopted a 'fast follower' approach to OTC derivatives reforms, and global regulation will also be a relevant factor when we consider the case for making platform trading mandatory for any particular asset class.

67. This is important when you consider that roughly 75% of the turnover in our FX derivatives market is as a result of cross-border transactions.

68. And of the 15 or so platforms offering execution in FX derivatives in Australia, many are overseas-based platforms including CFTC swap execution facilities or SEFs.

69. So, we will be looking at the US and EU as well as our peer jurisdictions in the Asian region, and thinking about the questions raised by the industry in these jurisdictions - particularly questions as:

    a. how to assess liquidity in a class of OTC derivatives;

    b. the potential impact of a trading mandate; or

    c. the options for licensing or recognising trading venues.

70. We are also mindful that the platform trading mandate only applies "where appropriate", by contrast to, for example, trade reporting which is intended to apply to all OTC derivatives.

71. Again, using some early data we have recently started receiving under the OTC derivative trade reporting obligations –

[Slide 4, Platform execution]

72. At the end of December 2014, 77% of interest rate derivatives reported under ASIC rules were traded "off-facility". This means, at most, 20% of interest rate derivatives reported under ASIC rules were traded on a SEF or another type of platform.

73. By comparison, as of November 2014 close to half of interest rate derivatives reported to CFTC Swap Data Repositories are being traded on SEFs.

74. These figures show the different state of play in platform trading in Australia and the US, and may help us to frame the questions

that we need to ask, as we approach the platform trading question.

SEF / bifurcation

75. On this, there has been industry commentary about the impact of the SEF trading requirement, and particularly whether it has created bifurcation or pockets of liquidity.

76. The Australian regulators have regularly liaised with our market participants about their experiences.

77. In the interest rates market, we have heard that there are broadly speaking two pools of liquidity particularly for products that are subject to mandatory trading.

78. But, because there are dealers and participants who can trade in both 'pools', the market participants we spoke to were not observing consistent price differences between the 'pools'.

79. Other areas of platform trading are also still evolving – and we are monitoring with interest. For example:

    a. participants' capacity to get information about trading interests across multiple platforms; and

    b. any changes in dealers' business models.

80. Coming to the FX derivatives market, we understand that platform trading remains low by comparison.

81. At least in Australia's case, this is confirmed by early trade repository data in the last slide. About 93% of FX derivatives reported under ASIC rules, were traded “off-facility”.

82. This means if and when we were to come to consider mandatory trading for FX derivatives, we would think about to what extent the rates experience can be applied to the FX derivatives market.

83. We would also look at other information, like:

    a. the experience of introducing electronic trading facilities in the physical FX market in the 1990s; and

    b. whether there are features specific to the Australian FX derivatives markets.

84. As you can see, this piece of work is still at an early stage. We are coming to this work with an open mind, and very much with our market integrity function and the G20 objectives in mind.

85. As a result, at least part of my intention in this presentation is to advertise this upcoming work to you, which is planned for closer to the middle of the year as I mentioned. Your input and perspectives will be important to ensure our thinking and next steps.

Closing remarks

86. I’d like to close by reiterating ASIC's strategic objectives in relation to financial markets generally:

    a. investor trust and confidence in the financial system;

    b. supported by markets that operate in a fair, orderly and transparent way.

87. These are recurring themes in the initiatives that I have spoken about.

88. They firmly underpin ASIC's role in the FX markets and our current priorities as a market and conduct regulator with the objective of advancing an environment that supports efficient capital allocation to fund the real economy and, in turn, economic growth and prosperity for Australians generally.

Questions?