MARKET NOTICE

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Subject: Swaps Reference Price Transaction Guidelines

AFMA is publishing new guidelines on its website dealing with conduct of dealers when managing swaps reference price transactions in the Australian market.

The Swaps Reference Price Transaction Guidelines apply to market participants in the Australian swaps market and set out certain expected behaviours of wholesale market participants that enter into a type of transaction common in the swaps market known as a reference price transaction (RPT).

Background

Participants enter into a type of transaction known variously as a closing price order, end of day order, but commonly known as a RPT. In a RPT all terms (including financial instrument, buyer, seller, notional, settlement date) except the execution price, are agreed and specified at the outset of the transaction. A mechanism to determine the execution price is also agreed, through later market observation of a reference price. There are a sequence of events in a RPT and a dealer will in most instances be hedging its exposure under the RPT from the time the transaction terms have been agreed. This hedging may continue through and beyond the reference time.

Since an RPT entails a risk transfer, the liquidity provider of that risk (the dealer) will at its discretion hedge that risk, and this hedging activity can take place before, during or after the reference time. Hedges executed before the reference time could exert market pressure on the price of the underlying instrument, and affect the reference price level. From a commercial perspective, the ability to hedge the RPT before the reference time means the dealer may be able to offer the client a lower spread than would otherwise be the case.

The nature of the RPT means that the client eliminates uncertainty over the difference between the reference price and the execution price. It might appear that the risk is passed to the dealer at a cost equal to the difference, if any, between those two prices. However the client (and the asset owner if different) bears the risk that market activity following agreement of the RPT, including any dealer hedging of the RPT, could result in adverse price movement for the client before the reference time.
The dealer’s risk, on the other hand, is that it is unable to hedge the RPT at the same or a better price than the execution price of the RPT, and incurs a loss. In addition, dealers sometimes hedge an RPT

with closely related financial instruments and so in those cases must also manage the associated portfolio risk – that the instruments traded as part of the hedging strategy do not match the value of the RPT.

To deal with this situation the key guidance points are:

- dealers may hedge for such purposes and in a manner that is not meant to disadvantage the client;
- dealers should be aware of and manage the possible conflicts of interest related to the formation and observation of the reference price inherent in reference price transactions;
- dealers should communicate their hedging practices to their clients in a manner that enables clients to understand their actions in the market; and
- dealers should ensure that the sole intention behind their hedging is risk mitigation.

Any queries in relation to these Guidelines should be directed to David Love, General Counsel.