15 June 2012

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Dear Mr McAuliffe

Implementation of a Framework for Australia's G20 Over-the-Counter Derivatives Commitments

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the consultation paper 'Implementation of a framework for Australia's G20 over-the-counter derivatives commitments'.

AFMA represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include banks, stockbrokers, treasury corporations, traders across a wide range of financial and energy markets and industry service providers. We appreciate the opportunity to make a submission to the consultation paper. Our submission, attached, primarily focusses on the provision of financial intermediation services to Australian businesses and investors.

There will be much work to do for both government and industry as we move to the implementation phase for the framework. We propose that consideration be given to forming an implementation user group which would have formal regular meetings with the regulators to deal with operational, rule writing and assessment issues. Such a user group would bring together relevant industry associations, stakeholders and Treasury with the regulators. AFMA stands ready to assist with the establishment of such a group.

Please contact me at dlove@afma.com.au or (02) 9776 7995 if you wish to discuss the matters raised in this submission.

Yours sincerely

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Implementation of a Framework for Australia's G20 Over-the-Counter Derivatives Commitments

June 2012

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1. EXECUTIVE SUMMARY

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the consultation paper 'Implementation of a framework for Australia's G20 over-the-counter derivatives commitments'. Overall, implementation of the proposed framework is supported and a number of comments are directed at making this law effective in practice. As a framework, much of the practical implementation detail will be filled in through the regulations which will support the principal legislation. AFMA looks forward to working with Treasury and the regulators on the next phase of this project.

The following principles have guided the preparation of this response and summarise our general view on the framework.

1. AFMA agrees that market forces and a range of other mechanisms, in particular capital incentives, will lead to adoption of centralised clearing of OTC derivatives accepted for clearing by broadly supported central counterparties (CCPs) within a timeframe that is consistent with adoption of centralised clearing in other G20 jurisdictions.
2. While market forces are considered sufficient to lead to adoption of central clearing, a mandatory clearing requirement is supported if it is linked to the following commitment from the Government. The benefit of accepting a mandatory clearing requirement would be its linkage with a Government commitment to ensure that other laws, such as tax and insolvency laws, do not have adverse consequences for entities complying with the new regime, which would otherwise impede the systemic stability objectives of the OTC derivatives reforms.
3. AFMA supports the proposal to amend the Corporations Act to create regulation making powers to prescribe a class of derivatives as subject to one or more mandatory obligations for the purposes of: a) trade reporting; b) central clearing; and c) trade execution.
4. Mandatory obligations for trade reporting and trading platforms are premature while market infrastructure is still at an early stage of development.
5. Prescription of classes of derivatives should be made after consultation with stakeholders in the form of regulations made by the Government; not in the form of delegated rule making power exercised by ASIC.
6. The classes of persons subject to the framework should be equivalent to that in other jurisdictions, such as the US and the EU, in a way that does not conflict with regulations in those other jurisdictions.

2. REGULATORY FRAMEWORK ISSUES

2.1. General Framework

1. Do you have any comments on the general form of the legislative framework?

AFMA supports the general proposition that a legislative framework be introduced on the basis of the following formulations. There is a distinction in the wording of the formulation from that proposed in the consultation paper in that it refers to enabling the imposition of obligations through regulations with the prescription of particular relevant infrastructure being a matter dealt with through Derivatives Transaction Rules (DTRs) administered by ASIC.

The reasoning behind the reformulation is set out in responses to later questions.

2.1.1. Trade Reporting

AFMA supports the Government introducing a legislative framework under the Corporations Act which enables the imposition of obligations through regulations requiring a party to a transaction in a prescribed derivative to report the transaction to an eligible trade repository or prescribed government authority.

The nomination of a particular 'eligible trade repository' or 'prescribed government authority' is a suitable matter to be dealt with through DTRs administered by ASIC as it deals with the particular not the general.

2.1.2. Clearing

AFMA supports the Government introducing a legislative framework under the Corporations Act which enables the imposition of obligations through regulations requiring a party to a transaction in a prescribed derivative to ensure the transaction is cleared through an eligible clearing facility.

The nomination of a particular 'eligible clearing facility' is a suitable matter to be dealt with through DTRs.

2.1.3. Trading Platform

AFMA supports the Government introducing a legislative framework under the Corporations Act which enables the imposition of obligations through regulations requiring a party to a transaction in a prescribed derivative to ensure the transaction is executed on an eligible trading platform.

The nomination of a particular 'eligible trading platform' is a suitable matter to be dealt with through DTRs.

2.1.4. Prescription of Derivatives

Prescription of classes of derivatives should be made after consultation with stakeholders in the form of a legislative instrument made by the Minister. AFMA supports the framework enabling the Minister, by legislative instrument, to prescribe a derivative as being subject to one or more of these obligations.

2.2. Definition of 'Transaction' and 'Party'

2. Do you have any comments on the definition of 'transaction'?

There is a lack of exposition in the consultation paper regarding the use of the word 'transaction' in defining the scope of activity. The word 'trade' is a pre-existing Corporations Act definition used in relation to financial product market activity. The term certainly has wide legislative usage in the US and the international commitments and is a useful one as it connotes the movement from a trade to a settled outcome encompassing the operational steps in between.

As described in the consultation paper the term 'transaction' presupposes that it already has defined form, to which is being added the idea of "includes the making, modifying or termination of contract for derivatives". At present the term only has specialised definition for the purposes of the voidable transactions provisions of the Corporations Act, but nothing further. As it stands there is an existing definition of 'trade' applying to derivatives which is satisfactory for execution related purposes. In relation to clearing, only the 'making' of a derivatives contract is necessary as its making allows it to be cleared. The reference to 'modifying or termination' is not an appropriate extension for the definition with regard to clearing and trading and such actions make the affected derivative ineligible within the system. In this regard, we draw your attention to our objections to the idea of back loading in response to Question 10 on the basis of the legal problems it raises.

It would be useful to have a more fulsome explanation as to why the term 'transaction' is being used and what it is intended to encompass. Alternatively, consideration could be given to use of the term 'dealing' which is already used to cover activities with financial products, including derivatives.

3. Do you have any comments on the definition of 'party'?

Generally, further consideration needs to be given to reliance on the defined term 'party' to bring within coverage persons who will be subject to quite distinct obligations with regard to trading, clearing and reporting. The classes of persons subject to the proposed obligations are not uniform and there should be greater differentiation, i.e. 'reporting entity' for a person required to report.

2.2.1. Dealing

The reference to a 'party' meaning any domestic or foreign person who is dealing in a derivative (including on its own behalf) and is a party to a derivative transaction is understood to be reliant on the meaning of 'dealing' as defined in s766C of the Corporations Act.

In general terms, the classes of persons subject to the framework should be equivalent to that in other jurisdictions, such as the US and the EU in such a way that does not conflict with regulations in other jurisdictions where recognition is given to the inappropriateness of applying requirements to small end-users and non-financial counterparties. Further comment is made below in answer to specific questions about which parties should be subject to the various clearing, trade reporting and trading platform requirements.

2.2.2. Extraterritoriality

The proposal includes the idea of defining, by regulation, a 'foreign person' as an entity that must perform action within the Australian jurisdiction that contributes to that entity becoming a party to the transaction in a prescribed derivative. The extraterritorial implications of the proposed formulation require some consideration and are likely to raise questions of certainty and sufficiency in the jurisdictional nexus. Neither of the phrases 'domestic person' and 'foreign person' has defined meaning under the Corporations Act and the reference to 'person' is understood to have the meaning used elsewhere in the Corporations Act.

In geographical terms the market for derivatives can be divided into dealings related to location of the counterparties:

1. Onshore – onshore
2. Onshore – offshore
3. Offshore – offshore

Dealings between counterparties that are both onshore from an Australian perspective are straightforward with regards to jurisdictional reach.

Dealings between counterparties both located offshore are in a practical sense very difficult to capture. Reliance on tenuous links such as whether the trading is in Australian dollars is problematic, as the law is attempting to assert extraterritorial jurisdiction. Extraterritorial laws normally rely on the party having some physical connection with the jurisdiction, such as through the location of assets or personnel, even if they are not directly connected with the dealing in question.

Dealings between counterparties where one of the parties is located offshore may also be problematic from a jurisdictional point of view. The same questions regarding establishing a sufficient connection with Australia are faced, although the fact that there is activity going on with a person in Australia means that the offshore person is more likely to have assets and personnel located here as well. Offshore entities that do business with Australian counterparties will potentially be subject to conflicting legal obligations from other jurisdictions.

The question is the extent to which it is intended that law should have extraterritorial effect and the jurisdictional reach of these requirements extending to persons outside Australia. It is not disputed that it is within power of the Parliament to makes laws with extraterritorial effect. Several of its powers under section 51 of the Constitution can be read as contemplating federal legislation applying outside Australia's boundaries. The two most obvious are the trade and commerce power (s 51(i)) and the external affairs power (s 51(xxix)). Furthermore, since the *Statute of Westminster 1931* (UK) and the *Statute of Westminster Adoption Act 1942* (Cth), it is no objection to the validity of a law of the Commonwealth that it purports to operate outside Australia.

The Federal Court of Australia and its jurisdiction are derived from the *Federal Court of Australia Act* 1976. The court has jurisdiction to deal with substantive matters that are within the power of Parliament as defined in the Constitution, and set out in the laws of the federal Parliament. The Federal Court is not a court of general jurisdiction and is confined to the exercise of such powers which either are expressly conferred by statute, impliedly conferred by statute or linked and necessary to the exercise of these conferred powers. On the question of the extraterritorial enforcement of the Corporations Act the views of Siopis J in *PCH Offshore Pty Ltd v Dunn* [2009] FCA 553 are noted. In this case he held that statutory duties of duties of directors, officers and employees of an Australian company were not limited to acts or omissions within Australia and they could apply to acts or omissions occurring outside Australia. Accordingly, the Court had jurisdiction in relation to the alleged breaches which arose from the respondent’s acts which took place overseas. A director or officer of an Australian company can therefore be held accountable in Australia for breaches of their statutory duties to the company, even where the relevant acts take place outside Australia.

Where the Federal Court hears a matter arising under legislation with extraterritorial effect it will have jurisdiction to make determinations about events and circumstances occurring outside Australia and to order remedies and impose penalties in respect of those events or circumstances. However its orders will only be enforceable within the territorial jurisdiction of the court. While the extraterritorial scope of the legislation will increase the scope of the evidence and issues to be considered by the court it will not in strict terms increase the territorial scope of the remedies available from the court.

The conclusion from this comment on the jurisprudence is that jurisdiction can readily be exercised over those entities having a presence in Australia through being incorporated in or having a branch in Australia. However, while a law may be made that validly attempts to impose jurisdiction on offshore parties the imposition of that jurisdiction through the court is likely to fail where the entity does not carry out the activity in Australia and has no presence here. Use of additional characteristics, such as whether the activity relates to Australian dollar denominated contracts will not widen the territorial scope in an effective way in the absence of a person having a connection with Australia that allows the court to impose an enforceable order or claim on them. Such additional characteristics merely increase the practical likelihood that parties will have a connection to Australia that could allow the effective exercise of jurisdiction over them.

The law should be drafted so that the geographical scope is clearly defined to avoid any unnecessary uncertainty or ambiguity in interpreting the legislation. It is important that authorities around the globe seeking to regulate OTC derivatives activity cooperate to ensure that businesses are not subject to conflicting obligations because of incompatibility between overlapping jurisdictions.

2.3. Definition of 'Eligible Facility'

4. Do you have any comments on the definition of 'eligible facility'?

AFMA supports the definition of 'eligible facility' as set out in the consultation paper in the following terms:

- For trade reporting, an eligible facility means:
  - the holder of an Australian trade repository licence which has been authorised to operate a trade repository for the prescribed class of derivative; or
  - such other entities as prescribed by regulation;

    : this might include a prescribed government authority
- For central clearing, an eligible facility means:
  - a CSFL which has been authorised to operate a central counterparty for the prescribed class of derivatives; or
  - such other entities as prescribed by regulation.
- For trade execution, an eligible facility means:

— an AML which has been authorised to operate a market for the prescribed class of derivative; or

— such other entities as prescribed by regulation.

2.4. Non-discriminatory Access

5. *Do you agree that non-discriminatory access requirements should be imposed on eligible facilities?*

While the concept of ‘non-discriminatory access’ has been used elsewhere in Australian legislation, such as in relation to competition law relating to national monopoly infrastructure like the National Broadband Network, its application to contestable financial market infrastructure facilities run on a commercial basis may prove to be highly problematic in practice and at odds with risk management objectives of the system being created by this framework. Operators of CS facilities need to be able to control participation access for risk control purposes.

While AFMA supports the competition review of Financial Market Infrastructure (FMI) currently being conducted by the Council encompassing an examination of access arrangements to market infrastructure, particularly infrastructure which is provided most efficiently on a non-contested monopoly basis such as settlement systems, the imposition of a broad statutory concept of non-discriminatory access would be disruptive outside of a holistic set of measures dealing with FMI reform taking into account competition issues.

The current ‘Participation’ requirements in the RBA Financial Stability Standard for Central Counterparties provides an appropriate formulation of ‘fair and open access’ for current purposes under this framework and do not require legislative reform as part of present proposed changes. The RBA’s formulation provides that the requirements for participation in the central counterparty must promote the safety and integrity of the central counterparty and ensure fair and open access. Participation requirements must:

- be based on objective and publicly disclosed criteria;
- ensure that participants in the central counterparty are of a sufficient financial standing such that the central counterparty is not exposed to unacceptable credit risks;
- require that participants have the operational capacity to settle their obligations with the central counterparty in a timely manner; and
- allow the CS facility licensee as operator of the central counterparty to suspend or cancel the participation of an institution which breaches the applicable participation or other risk-control requirements.

2.5. Derivative Transaction Rules

6. Do you have any comments on the rule-making power that will be available to ASIC?

As noted in answer to question 3.1, AFMA supports the proposal to amend the Corporations Act to create regulation-making powers to prescribe a class of derivatives as subject to one or more mandatory obligations for the purposes of: a) trade reporting; b) central clearing; and c) trade execution.

The rule-making power should deal with matters relating the administration and supervision of the regime. It is the role of the Parliament through its acts to set out the framework of the regime and the parameters within which it should operate. Establishing classes of persons and products and the rules which they need to observe when coming within the scope of the regime are properly matters for policy-making and Parliamentary decision. Where flexibility is required this can be achieved through regulation-making powers. Administration of the law is about how rules set by Parliament of general application are to apply in practice to specific circumstances and persons and then ensure that the law is followed. It is not the role for administrators to creatively expand the scope of the law, even where broad discretions are granted. Discretions are granted by Parliament in order that the law may be applied in a rational, common sense way to particular circumstances in a constantly changing world.

Usurpation by the Executive arm of government and it agents of Parliamentary prerogatives is a matter that needs to be vigilantly guarded against in order to safeguard our democracy. The views of the Senate Scrutiny of Bills Committee should be noted in this context. They comment that the trend towards quasi-legislation, through the use of delegated rules guidelines, codes and policy directives using the authority given by an act which delegates the power to direct, determine, notify, order, instruct, declare, issue or publish is one that Parliament is forever vigilant lest there is an usurpation of its prerogatives. Actions taken under such delegated powers are not always purely administrative in nature, but can involve decisions on matters of policy, which certainly should be subject to scrutiny by the legislature. The problems are threefold: to distinguish between matters of administration and those of policy; to ensure that significant policy matters are brought to the attention of the legislature, for their acceptance or disapproval; and to ensure that any such quasi-laws which affect individuals are reasonably available to them.

In preparing delegated legislation heed should be paid to the criterion in Senate Standing Order 24(1)(a)(iv) which requires the Senate Committee to draw the Senate's attention to legislation where Parliament's power to make laws may have been delegated inappropriately. In considering this criterion, a threshold question sometimes arises: is the power proposed to be delegated legislative in nature? Possible instruments that might empower another body or person to make legislation that should properly lie with the Parliament include ministerial guidelines, codes of practice, codes of conduct or practice statements. They are often described as made under a power to direct, determine, notify, order, instruct, declare, issue or publish. Examples of provisions that may inappropriately delegate legislative power include those which provide that matters which should be regulated by Parliament are to be dealt with by subordinate legislation.

7. *What should be the minimum period of consultation imposed on ASIC in developing DTRs?*

The Government's Best Practice Regulation Handbook at page 41 states that timeframes for consultation should be realistic to allow stakeholders sufficient time to provide a considered response. Holiday periods and the end of the financial year should be avoided, particularly where stakeholders are small businesses. The amount of time required will depend on the specifics of the proposal (for example, the diversity of interested parties or the complexity of the issue).

A period of at least three months should be considered a practical minimum for simple measures with the above official guidance indicating longer periods would be appropriate depending on the complexity of the proposals and the stakeholders involved. Policy matters of great importance such as market structure reform have wide ranging economic and enduring consequences and warrant a deliberately measured approach.

8. *What should be the minimum period of notice between when a DTR is made and when any obligation under the DTR commences?*

The changes that are taking place under these framework reforms amount to a total restructuring of market processes and practices. Recent experience with other major reforms, such as equities market supervision, have demonstrated that a huge amount of detailed preparation and refinement is required to prepare for the changes which often then have to be implemented through IT system changes absorbing large amounts of time and human resources. Firms need enough lead time to plan for changes though their normal annual business planning cycle. For this reason twelve months is normally insufficient lead time. Beyond this where there is reliance on infrastructure allowance needs to be made for whether it already exists. If infrastructure still needs to be developed/found this needs to be taken into account in setting implementation timeframes.

Overall, no definitive period should be set as this is an area where common sense judgements need to be made on a case-by-case basis.

9. *Although the possible counterparty scope is set broadly, should minimum*

thresholds for some or all types of counterparty be set by regulation, so that no rule that is made will ever apply to those counterparties (unless the regulation is subsequently changed)?

Yes. The scope of the requirements under the framework will have major impacts on the operations of affected businesses and need considerable lead time and stakeholder consultation before changes are implemented. The impacts on the nature and functioning of the market from the framework are matters of major importance to economic activity in Australia and direction of development.

2.6. Back Loading

10. *From the point of view of your business and/or of your clients, do you have concerns around any 'back loading' requirements? For example, are there any problems with obligations applying to transactions that are outstanding at the time the rule is made?*

AFMA does not favour back loading requirements. The policy objective is to reduce systemic risk through better clearing and settlement processes. Back loading increases legal uncertainty, credit and operational risk through retrospective regulatory requirements. Generally, retrospective measures should not be contemplated.

Back loading derivatives trades in central clearing raises a host of legal and practical problems for market participants. It would require a huge logistical effort involving terminations and renegotiations of contracts. This introduces additional legal, credit and operational risk into the system. It could also raise legal claim issues for the Commonwealth as the change in commercial arrangements could be connected with retrospective legal obligations being imposed.

3. OPTIONS FOR IMPLEMENTING MANDATORY OBLIGATIONS

3.1. Trade Repositories

11. Do you agree with the option of prescribing a broad range of derivative classes to be subject to the mandate for trade reporting? If not, what other option do you prefer?

Comprehensive trade reporting is the most ambitious goal of these reforms. While industry understands and accepts the importance of trade reporting and the need to take on the responsibility for catalysing this, it will require a major commitment of time, resources and money to achieve. There is a broad universe of derivatives data on which the authorities here and overseas want to capture through trade reporting. Combined with the nascent state of development for trade repositories, or complete lack of existing infrastructure for many classes of asset, it would not be practicable to prescribe at this time a broad range of derivatives classes to be subject to the mandate for trade reporting.

With all jurisdictions working towards the G20 requirements for financial stability, there will be a need to aggregate data coming from differing reporting schemes in different jurisdictions. The Financial Stability Board (FSB) in its October 2011 second progress report on the implementation of reforms to the OTC derivatives market commented on the Committee on Payment and Settlement Systems and International Organization of Securities Commissions (IOSCO) concerns including the risk that trade repositories will not provide effective access to comprehensive OTC derivatives trade data that can be readily aggregated on a global basis unless further internationally coordinated action is taken. The FSB stated that data will need to be aggregated from the trade repositories, the central banks and other governmental authorities for the purposes of analysis on a global basis to ensure such potential fragmentation is not problematic.

Market participants have significant concern with the lack of global coordination by authorities and the legal uncertainty this creates for market participants. There is a real possibility that the same transaction might need to be reported to multiple repositories in different locations. From a practical point of view a single trade repository by product type is preferable. The obligation should fall on national authorities to arrange their own access to the data a trade repository holds if it is located offshore.

3.1.1. Privacy Restrictions

The most serious legal risk facing members relates to privacy law considerations. While some domestic protection exists under Australian law[1] for information provided domestically and offshore where there is a compliance requirement this does not

[1] Section 13D, Privacy Act

extend to information held on offshore clients located in jurisdictions which prohibit the passing on of such information. Seeking individual consent from existing clients is deemed impractical, and may not be granted in any event.

Members consider it important to be lawfully allowed to transfer information overseas when they are required to do so by law. Analysis is required of member legal advice and consideration of the question of whether statutory protections are required under Australian law akin to those passed in the US to protect reporting entities providing trade data to offshore trade repositories. If there is a problem it would need to be taken up as an international policy issue by the Australian government.

The Australian National Privacy Principles (NPP) provides the framework for trans-border data flows. The NPP say that an organisation in Australia or an external Territory may transfer personal information about an individual to someone (other than the organisation or the individual) who is in a foreign country only if:

a) the organisation reasonably believes that the recipient of the information is subject to a law, binding scheme or contract which effectively upholds principles for fair handling of the information that are substantially similar to the National Privacy Principles; or
b) the individual consents to the transfer; or
c) the transfer is necessary for the performance of a contract between the individual and the organisation, or for the implementation of pre-contractual measures taken in response to the individual's request; or
d) the transfer is necessary for the conclusion or performance of a contract concluded in the interest of the individual between the organisation and a third party; or
e) all of the following apply:
    i. the transfer is for the benefit of the individual;
    ii. it is impracticable to obtain the consent of the individual to that transfer;
    iii. if it were practicable to obtain such consent, the individual would be likely to give it; or
f) the organisation has taken reasonable steps to ensure that the information which it has transferred will not be held, used or disclosed by the recipient of the information inconsistently with the National Privacy Principles.

At an international level the OECD Guidelines on the Protection of Privacy and Transborder Flows of Personal Data need to be observed. These guidelines are designed to harmonise national privacy legislation and, while upholding such human rights, would at the same time prevent interruptions in international flows of data. They represent a consensus on basic principles that are to be reflected in national legislation. In November 2011, the OECD released terms of reference for the review of the OECD Privacy Guidelines to take into account current developments.

In 2004, the twenty-one member economies of the Asia-Pacific Economic Cooperation (APEC) group agreed on the APEC Privacy Framework, which is a set of privacy principles that member economies may implement voluntarily. The Framework protects personal data transferred outside the APEC member state where they were collected by recourse to the principle of ‘accountability’. The accountability approach, which was first mentioned in the context of data protection in the OECD Guidelines, ‘ensures that the original collector of the personal information remains accountable for compliance with the original privacy framework that applied when and where the data was collected, regardless of the other organisations or countries to which the personal data travels subsequently’. The APEC framework provides that organisations (such as companies) may adopt Cross-Border Privacy Rules (CBPRs) as a way to apply protections across the organisation no matter where the data are processed.

Some APEC member economies have implemented the accountability approach in their own data protection legislation. For example, accountability is used in the Australian NPP and the concept is also contained under the Canadian Personal Information Protection and Electronic Documents Act. Accountability does not specifically restrict trans-border data flows, but imposes compliance responsibilities on parties that transfer personal data internationally. Organisations are not prohibited from transferring personal information to an organisation in another jurisdiction for processing. However, organisations are held accountable for the protection of personal information transfers under each individual outsourcing arrangement. On a practical level, accountability may require organisations to take steps such as implementing appropriate privacy policies which are approved by senior management and implemented by a sufficient number of staff; training employees to comply with these policies; adopting internal oversight and external verification programmes; providing transparency to individuals as to the policies and compliance with them; and adopting mechanisms to enforce compliance.

Linked to this is the difficulty of asserting data protection rights outside the country of export. This is an important policy issue affecting regulation of trans-border data flows. The difficulty of asserting legal rights abroad is not unique to data protection and privacy law, but results from the fact that there is no global legal framework for the assertion of consumer rights, or for the recognition and enforcement of court decisions in other countries. However, the assertion of privacy rights is increasingly based on formal or informal cooperation between regulators outside of traditional legal assistance channels such as the APEC Cross-border Privacy Enforcement Arrangement.

There is further discussion of these matters in relation to Question 29 regarding property in data.

3.1.2. Reporting Entities

12. Do you agree with the option of including a broad range of entities in the mandate to report trades? If not what option do you prefer?

AFMA agrees with the proposition in the paper that it would be more practicable and appropriate to apply the trade reporting obligation to a smaller subset of parties and transactions, though the scope of the trade reporting obligation should also seek to ensure consistency with reporting obligations imposed in other jurisdictions.

The preferred way to achieve this would be to create a broad definition for framework coverage at the level of the legislation and then allow for derivative financial products to be prescribed under the regulations to bring them within the reporting obligation. It would also be desirable for the regulations to prescribe what information / data on transactions is to be reported. The issues such as whether reports should be in a standardised format or to which trade repositories reports should be made in order to meet compliance obligations are appropriate matters to be dealt with through DTRs.

13. Are there specific classes of entity that should be excluded from the potential reach of trade reporting DTRs?

13.1. What metrics should be used to determine any thresholds?

13.2. What should be the thresholds of these metrics that trigger when an entity may be subject to trade reporting rules? Should this threshold vary depending upon the nature of the entity?

13.3. What is an appropriate threshold to exempt end users from the mandatory obligation to report OTC derivatives transactions to a trade repository or regulator?

The matters dealt with by these questions are ones where much more work needs to be done on defining the reporting entities. This is an area where there is considerable ongoing work occurring in other jurisdictions with which Australia should be aligned.

The starting proposition should be that there needs to be an exemption for non-financial entities below a certain threshold, based on asset size. Determination of this threshold needs to be done in consultation with affected stakeholders.

As the rationale for imposing a reporting mandate is to improve transparency, thus enhancing the ability of regulators to assess systemic risk and conduct resolution activities in a worst case scenario, it is not necessary to require reporting of intra-group transactions as they do not increase systemic risk. Insofar as regulated entities are concerned (for which resolution activities in a worst case scenario would be relevant), their regulators will already have access to data on the group's exposures.

3.1.3. Coverage and Thresholds

14. Do you agree with the option of including a broad range of transactions in the mandate to report trades? If not what option do you prefer?

14.1. Are there specific classes of transaction that should be excluded from the potential reach of trade reporting DTRs?

15. Do you agree with the option of using a wide definition for what would constitute a transaction in this jurisdiction for the purposes of mandating trade reporting? If not, what definition do you prefer?

In the interests of international consistency and convergence it is expected that Australia will follow the guidance in the CPSS-IOSCO report published in January 2012, which provides a detailed guideline on OTC derivative trade reporting and capturing process. For data reporting requirements the report recommends two key approaches to reporting OTC derivatives transaction data:

- Functional Reporting: segmented into collating trade repository operational data; product, counterparty and underlying information; trade economics, valuation and event data.
- Data Field Reporting: Outlines the list of potential data fields required to be captured for each asset class, i.e. commodity, credit, interest rate, foreign exchange and equity derivatives.

3.2. Central Clearing

16. Do you agree with the option of relying upon market forces and a range of other mechanisms, such as capital incentives, while monitoring the impact of such mechanisms in systemically important derivative classes and providing for possible future mandating, to ensure that central clearing becomes standard industry practice in Australia within a timeframe that is consistent with international implementation of the G20 commitments? If not, is there another option you prefer?

AFMA agrees that market forces and a range of other mechanisms, in particular capital incentives, will lead to adoption of centralised clearing of OTC derivatives accepted for clearing by broadly supported central CCPs within a timeframe that is consistent with adoption of centralised clearing in other G20 jurisdictions.

Systemically important derivative classes to which market forces will apply from an Australian perspective is understood to mean Australian dollar interest rate swaps (IRS).

There are CCPs that have already accepted Australian dollar IRS so central clearing for this class is entirely feasible and has already started occurring. CCPs have to be viable in terms of being broadly supported by the market and acceptable in terms of meeting prudential risk management obligations of market participants for them to be selected for clearing. The provision of clearing services around the globe will continue to be in a flux for some time and it is not possible for market participants to predict to which CCPs market forces will lead central clearing.

So far said, only Australian dollar IRS are systemically important from an Australian perspective. AFMA agrees with this proposition.

Central clearing of certain other derivative classes such as cross-currency swaps has so far not proved to be a practical proposition because of technical obstacles to their acceptance by CCPs. Mandatory requirements cannot be applied to derivative classes that are not eligible for clearing.

3.2.1. Protections

Where derivative products are being cleared on offshore CCPs appropriate protections from an Australian perspective when looking at applicants for clearing and settlement licences should be considered. These include default management participation, governance, rate sets, and effects on collateral management, for example liquidity effects on government and semi government securities.

On the regulatory front, the Committee on Payment and Settlement Systems and the Technical Committee of the IOSCO Principles for Financial Market Infrastructures contain explicit requirements to ensure that all systemically important FMIs have viable recovery plans and, if circumstances ever warrant, could be wound down in an orderly fashion without the disruption of the provision of key services. The Principles' provisions for an FMI's recovery and orderly wind down are related to the current next stage of work by CPSS-IOSCO on the potential role and attributes of official regimes for the resolution of FMIs.

While putting in place resolution arrangements is an important component of the framework for dealing with a systemic crisis the equitable allocation of losses in a failed CCP remains at the forefront of thinking when using central clearing. The belief that CCPs can reduce systemic risk is predicated on a systemic crisis arising out of an idiosyncratic shock where a single institution fails which is then propagated through market contagion causing the failures of other institutions. The world in which we are now operating is one where comprehensive systemic crisis looms from economy-wide breakdowns. In the latter, the shock hits all financial institutions simultaneously, and since the shock is of a large magnitude, this risk of default is not idiosyncratic; it is highly correlated across firms. Given such a shock, if one firm defaults, others are at elevated risk of default as well.

The collateral held by CCPs when they hold derivatives positions absorbs most of the losses due to movements in market prices. Typically the margins held by the CCP will be calculated to absorb 95-99 per cent of market moves. If the margin and CCP default waterfall resources are breached, then the members must absorb the remaining default losses, up to some pre-established commitment level. This means that CCP members can be called on to cover defaults in extreme circumstances.

Pirrong[2] has pointed out that endeavours to insure against waterfall breaches through CCP mutualisation only work when risks can be diversified. So, to the extent that the risks of default exhibit relatively little correlation across clearing members, mutualisation through a CCP can improve the allocation of risk through diversification. However this is not the case when there is the danger of high correlations between clearing member collateral manifesting. You cannot successfully mutualise loss when CCP failure results from a comprehensive systemic shock.

In a highly stressed financial crisis environment liquidity tends to decline, which tends to increase volatilities, thereby exaggerating movements in exposures and creditworthiness. It also makes it more difficult to manage the risk on exposures and to trade out of positions in order to reduce exposures. As a result wrong way risk can manifest if there are high correlations between the value of assets on financial institutions' balance sheets and the values of derivatives exposures. In such a crisis situation, dependencies between the value of the clearing members of CCPs and the exposures that CCPs are attempting to protect against are very likely to be of the wrong way kind. A big financial shock that is sufficient to cause movements in derivatives prices big enough to breach margin levels, and/or which damages one or more CCP members' balance sheets seriously enough to force them into default, is likely to be associated with severe financial difficulties at other CCP member firms. The apparent safety buffer in a default waterfall relies on mutualisation of losses at a time when clearing members are most likely to be unable to meet their commitments.

Accordingly banks considering clearing membership need to take into account such tail event risk and address the problem of unlimited liability. For this reason mechanisms for limiting liability of clearing members to place a fixed upper limit on the collateral that may be used to pay for the rebalancing of the CCP following default one or more other clearing member defaults needs to be considered.

Risk committees are the critical governance structure in the mutualised risk sharing organisation of a CCP. They are the mechanism by which those that bear counterparty

[2] Craig Pirrong, The Economics of Central Clearing: Theory and Practice, ISDA Discussion Papers Series Number One - May 2011

risks can act collectively to influence critical CCP decisions. Accordingly, the authority of a risk committee to establish CCP policies, and the membership on these committees, should align with the incidence of risk. The risk committee should play a pivotal role in decisions that affect CCP risks, and the distribution of those risks, including margins, the clearing product slate, and default management procedures.

The European Market Infrastructure Regulation (EMIR) regime will have a strong influence on governance arrangements for offshore CCPs and therefore bear consideration. The EMIR governance provisions require that a CCP's risk committee be composed of clearing members, independent directors and representatives of clients and importantly, none of these groups should comprise a majority of the risk committee. EMIR recognises that clients will post a substantial portion of the collateral received by the CCP and so have a substantial and material interest default outcomes.

A CCP risk committee will make fundamental decisions with significant influence over the day–to-day affairs of a CCP that will impact all CCP participants. For example, the risk committee of a CCP could be expected to set standards and requirements for initial and continuing clearing membership eligibility, and advise the Board of Directors about the clearing agency's risk model and default procedures. As a result, the decisions of a CCP risk committee will have profound and immediate impacts on all central clearing stakeholders, including clients. Accordingly, the governance arrangements should take account of buy-side representatives as well as clearing members.

Depending on the asset class being cleared it may also be appropriate to consider whether a CCP should arrange regional rate setting committees and collateral arrangements.

3.2.2. No Adverse Consequences

There should be a government commitment to ensure that other laws, such as tax and insolvency laws, do not have adverse consequences for entities complying with the new regime, which would otherwise impede the systemic stability objectives of the OTC derivatives reforms.

Tax

Tax issues are an area that needs particular attention to ensure that no adverse outcomes arise from meeting clearing requirements. While there are no definitive views on whether margining with CCPs will raise tax problems, addressing any tax problems that may arise needs to form part of the Government's reform commitment.

Possible tax issue is whether exemptions to the requirement to pay interest withholding tax in relation to price alignment interest would get the section 128F of the *Income Tax Assessment Act* exemption benefit because CCPs may not constitute eligible "financial institutions". The different models of central counterparty clearing being considered will raise distinct taxation issues, for example, gross collateral amounts may be more problematic from a tax perspective compared to a net collateral approach. As this is a matter dealt with through tax treaty arrangements, a CCP located in a jurisdiction where Australia does not have a double taxation treaty, like Hong Kong, would be problematic.

Tax is not the only area where issues may arise. Insolvency and data protection laws are examples of other areas where problems may arise and the Government needs to recognise this and undertake to ensure no adverse consequences will arise in general.

Insolvency

CCPs manage the risk that clearing member counterparties to market trades will become unable to fulfil their obligations when they become due. The operation of their default rules is central to their ability to manage the risks that they assume. To the extent that they are unable to enforce their default rules, the benefits and economic efficiency of their role in the market would be compromised. For this reason any stay or moratorium on close-out netting prevents the CCP from taking action to close out positions and apply collateral to offset realised liabilities. During this time the markets will continue to trade – or even if they do not, prices will change – and the values of both the positions and the collateral will remain volatile. A stay on the actions of a CCP to take these steps increases the likelihood that the margin that it holds from the defaulter may be insufficient to cover any losses and so the CCP will be forced to mutualise the loss through its default fund.

For this reason AFMA has been seeking settlement of the Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill which was consulted upon during the course of 2011 by the Treasury in a way that takes account of an unfettered ability of a statutory manager to extend a stay period beyond 48 hours.

The only circumstances where a statutory manager should have the ability to do this are if a reputable entity (for example APRA acting with the financial support of the Australian Government) agrees to stand behind the obligations of the bank or life insurance company if the period is extended.

The issue here is that the counterparty may be required to pay away amounts owing to the bank or insurance company during an extended stay period, which it would otherwise have set off against the mark-to-market value of future amounts owing to the counterparty by the bank or insurance company if the transactions were closed out. If the bank or insurance company defaults after the counterparty has made payment but before the bank or insurance company has satisfied its obligations to the counterparty, the counterparty will be in a worse position than it would have been in if it were able to close out after the 48 hours.

The unfettered discretion of the statutory manager to extend the period leaves too much uncertainty in the outcome which may well make it less desirable to do business with Australian banks and insurance companies. Other key jurisdictions do not leave this degree of uncertainty in their bank failure resolution schemes. More circumscribed analogous arrangements apply under US and UK law.

3.2.3. Entities Covered by Central Clearing

17. *Are there specific entities that should be excluded from the potential reach of central clearing rules?*

    17.1. *What metrics should be used to determine any thresholds?*

    17.2. *What should be the thresholds of these metrics that trigger when an entity may be subject to trade clearing rules? Should this threshold vary depending upon the nature of the entity?*

    17.3. *What is an appropriate threshold to exempt end users from the mandatory obligation to clear OTC derivatives classes?*

The application of the clearing obligation to end-users presents some issues that need to be considered. If end-users were forced to clear derivatives through CCPs, the requirements to post both initial and variation margin to the clearing house or their clearing member would increase risks and introduce an unpredictable liquidity burden for them. This could have a severe economic impact on end-user firms as these will be forced to either divert significant financial resources (liquidity) to enable them to participate in CCP clearing or forego effective long term risk management through derivatives. As a result, a balanced and sensible exemption mechanism needs be introduced that reflects both the needs of corporate end-users and their systemic relevance, looking at the sum of their net positions. Importantly, the system of exemptions should be subject to global coordination to avoid confusion and asymmetric regulatory burdens from the Australian jurisdictional perspective.

With global reference points in mind, the model being developed by the European Securities and Markets Authority (ESMA) is worth consideration. The EMIR regime imposes a duty on financial counterparties to clear all clearable swaps through a clearing house. Financial counterparties are broadly defined to include investment firms, banks, insurance and reinsurance companies, registered UCITS funds, pension funds and alternative investment fund managers, regardless of whether such market participants would use derivatives as end-users to hedge risks inherent in their activities without speculation.

By contrast, a market participant that is not a financial counterparty only becomes subject to the clearing mandate if its positions exceed a clearing threshold. Once the clearing threshold has been exceeded, the market participant becomes subject to the clearing mandate for all its clearable swaps (including those positions below the clearing threshold).

The European approach means that OTC derivative contracts that protect the end-users against risks directly related to their commercial activities and treasury financing activities as well as those that do not protect against such risk but do not exceed a clearing threshold are not subject to the clearing obligation. For example, the EMIR regime envisages that swaps entered into by energy suppliers to sell future production, or by airlines to hedge against rising oil prices, would typically be viewed to be hedging commercial risks. At the point where the clearing threshold would be exceeded, the clearing obligation would apply to all OTC derivative contracts the end-user counterparty will enter into after the time that the firm has exceeded the threshold. In order to calculate whether it exceeds the clearing threshold, a non-financial counterparty is not to include in its calculation the OTC derivative contracts which are objectively measurable as reducing risks directly related to its commercial activity or treasury financing activity or that of its group.

The draft language EMIR provides the following guidelines:

- in calculating its positions, a non-financial counterparty should include contracts entered into by other non-financial entities within the group, such as parent or subsidiary entities;
- in calculating its positions, a non-financial counterparty can disregard any contracts entered into by itself or other non-financial entities within the group that "are objectively measurable as reducing risks directly linked to [its] commercial activity or treasury financing activity".

In its 16 February 2012 discussion paper on technical standards, ESMA proposed that it would consider a derivative contract entered into by a non-financial counterparty to be "objectively measurable as reducing risks directly linked to the commercial activity or treasury financing activity," when its objective is to reduce the following risks:

- the potential change in the value of assets, service, inputs, products, commodities or liabilities that the non-financial counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells or incurs (or where it reasonably anticipates doing so) in the ordinary course of its business; or
- the potential change in the value of assets, service, inputs, products, commodities or liabilities referred to above, resulting from fluctuations of interest rates, inflation rates or foreign exchange rates.

18. Are there specific classes of transaction that should be excluded from the potential *reach of trade clearing DTRs?*

Careful consideration needs to be given to differentiating derivatives products within each asset class, as a one size fits all approach is inappropriate for determining whether derivative contracts should be mandatorily cleared. The appropriateness for mandatory clearing is likely to depend on the characteristics of each of the different underlying products within each asset class.

The key requirement for clearing a transaction centrally is that it be possible to value the transaction daily for the purposes of calculating daily variation margins. One consequence of the above issue is that CCP clearing can only exist if the CCP, in agreement with its users and above all its clearing members, is able to assume the counterparty credit risk of a range of trading parties and is able to ensure efficient and adequate risk mitigation and management (by way of collateralisation of the exposure as well as by other means) in a way that it fully understands and is effectively and efficiently capable of implementing. A crucial pre-condition will be an extremely high level of certainty that the risk-transfer market will remain liquid at the time of the default of a clearing member, such that the clearing house can manage and ultimately transfer that defaulter's existing positions to another clearing member.

Foreign exchange derivatives are exempt from parallel regulations under the Dodd-Frank Act. EU market participants have argued vociferously for a parallel exemption under EMIR to mitigate the risk of regulatory arbitrage and to reflect the low level of credit risk, especially in short dated foreign currency forwards and swaps.

Exemption for Intra-group Transactions

Intra-group transactions should not be subject to a clearing or trade execution mandate. Intra-group transactions are used for aggregating risks within a group structure so that they can be centrally risk managed more efficiently. Requiring intra-group transactions to be cleared may limit the efficiency of the intra-group risk management process. Intra-group transactions simply represent an allocation of risk within a corporate group - they do not increase systemic risk or threaten the safety and soundness of entities under common control.

In addition, it is not appropriate to impose margin requirements on intra-group transactions. Margin is necessary as a risk mitigant to protect against the risk that such entity cannot meet its contractual obligations. There is no need to require margin for transactions between affiliates because any gains or losses do not create risk for the larger entity. Any gain on one entity is an equal and offsetting loss on the other resulting in a neutral position across the corporate group. There is a significant cost in locking up collateral for such intra-group trades (where the credit exposure is intra-group) but this will not result in any net benefit to counterparties.

18.1. *In particular, should some transactions entered into for certain purposes (for example, hedging, commercial risk mitigation) be outside the potential reach of the rule-making power?*

As a general principle, the question of whether a swap transaction was used to hedge commercial risk should be answered on the facts and circumstances at the time the swap is entered into, including the entity's overall hedging and risk strategy. There is merit in considering swaps that are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise qualifying for a clearing exception in the same way that occurs under the US Dodd-Frank Act requirements.

ESMA is also suggesting that an OTC derivative entered into by a non-financial counterparty would be deemed to be objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of that non-financial counterparty or of that group, when the accounting treatment of the derivative contract is that of a hedging contract pursuant to International Financial Reporting Standards. For example, agricultural firms fixing the price at which they are going to sell their crops, exporters shielding themselves from exchange rate fluctuations, and airlines fixing the price of their future fuel purchases will likely benefit from the hedging carve out.

The working group established by Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of IOSCO in relation to Principles for the Regulation and Supervision of Commodity Derivatives Markets, has defined hedging, in the commodity derivatives context, as follows:

> Hedge or Hedging – Conduct that is described as permissible "hedging" activity may differ among jurisdictions. Without limiting the scope of any jurisdiction to adopt its own definition, the term "hedge" or "hedging" generally refers to the taking of a position in a commodity derivative contract opposite to a position held in the physical market to minimise the risk of financial and/or economic loss from an adverse price change, or otherwise for risk management purposes. For example: The term "hedging" could mean the entering into of a derivatives transaction or a series of derivatives transactions, and the maintaining of the position or positions resulting from the transaction or series of transactions if:
>
> 1) the intended effect of the transaction or series of transactions is
>   a) to offset or reduce the risk related to fluctuations in the value of an underlying interest or a position, or of a group of underlying interests or positions; or
>   b) to substitute a risk to one currency for a risk to another currency, provided the aggregate amount of currency risk to which the hedger is exposed is not increased by the substitution;

2) the transaction or series of transactions results in a high degree of negative correlation between changes in the value of the underlying interest or position or group of underlying interests or positions being hedged and changes in the value of the derivatives with which the value of the underlying interests or positions is hedged; and

3) there are reasonable grounds to believe that the transaction or series of transactions no more than offsets the effect of price changes in the underlying interest or position, or group of underlying interests or positions, being hedged.

This definition provides a helpful global standard to follow for exempting hedges.

3.2.4. Jurisdictional Nexus

19. Do you agree with the option of requiring central clearing for derivatives where at least one side of the contract is booked in Australia and either: (a) both parties to the contract are resident or have presence in Australia and are entities that are subject to the clearing mandate; or (b) one party to the contract is resident or has a presence in Australia and is subject to the clearing mandate, and the other party is an entity that would have been subject to the clearing mandate if it had been resident or had a presence in Australia? If not, what definition do you prefer?

Cross reference is made to comments on the definition of 'party' in answer to Question 3. AFMA reiterates in this context its previous comments about the practical problems which are starting to multiply as new regulatory reforms are being implemented with extensive extraterritorial consequences. In the absence of any effective global framework for addressing the global financial crisis when it erupted in 2008, the immediate legislative and regulatory responses to the crisis have been resolutely national or, at best, regional. This approach to regulatory repair has impacted on regulatory and supervisory authorities as governments have become more closely involved in setting their agendas and policy priorities. Although some convergence in approaches has been facilitated by the governing principles and standards for post-crisis regulatory repair set by the international standard-setting bodies, national implementation has generated not just the emergence of differently-paced timetables for regulatory reforms but also substantial differences in the manner in which global standards are being or will be implemented.

OTC derivatives regulation is an area that particularly highlights the need for global action in order to ensure that there is consistency and coordination between the regulations being put in place in different jurisdictions. In light of regulations that have been proposed and in some cases approved, banks and other financial institutions that undertake significant cross-border activities in OTC derivatives are concerned that they may be subject to overlapping and contradictory regulatory requirements in different jurisdictions and may need to comply with two or more different regimes. Areas of concern include duplication of registration and licensing requirements, clearing obligations, transaction and position reporting, collateral and margining requirements, and prudential obligations.

20. *Do you consider that there are any OTC derivative classes for which an execution on trading platforms mandate would be appropriate at this time? If so, please provide any evidence which supports your view.*

OTC derivatives markets are very heterogeneous; there are different transparency solutions for each market segment (e.g. interest rate derivatives, credit default swaps, equity derivatives). Many OTC derivatives contracts are not suitable for trading on a platform as, due to their customised nature, they would trade very infrequently. Non-standardised derivatives serve the special financing and risk mitigating needs of end-users. Retail interest in OTC derivatives products is limited compared to the simple products and risk exchanged in transparent markets. These markets are also in constant evolution and need to adapt to the new conditions as a result of market demand. Platform trading of OTC derivatives should not be mandated in a competitive environment, but flow organically from commercial imperatives.

21. *Alternatively, do you agree with the option of applying the same approach to prescribing entities, transactions and derivative classes as has been applied for mandating clearing?*

The preference is to permit market forces to shape demand for execution platforms subject to the proposed assessment process in accordance with the option in this question.

22. *If a derivative class is prescribed for mandated use of CCPs should it also be mandated for execution on a trading platform?*

No. The decision surrounding eligibility for clearing is quite distinct to that for execution on a trading platform. The two should not be made interdependent. The primary concern is with handling systemic risk for which there is collective support that centralised clearing should be adopted where possible. Trading platforms are not addressing the same systemic risk issue and their adoption is much more tied into commercial and operational considerations for market participants. Therefore decisions around their mandated use should be kept quite separate.

23. *Do you agree with the option of initially excluding the same entities and transactions from the mandate to execute trades on trading platforms as those for the mandate to clear through a CCP? If not what option do you prefer?*

The proposition in this question should be the starting presumption. A lot more discussion needs to take place with stakeholders on the role trading platforms may play in the derivatives market as it evolves before a definitive answer can be given to this question.

24. Do you agree with the option of using the same definition of a transaction in Australia for the purposes of mandating executing a trade on a trading platform as for mandating clearing transactions through a CCP? If not, what definition do you prefer?

See the answer to Question 1.

4. TRADE REPOSITORIES

4.1. Regulatory Options

25. From the point of view of your business and/or that of your clients, do you have concerns with reporting Australian trades to Australian and/or international trade repositories?

The application of trade reporting requirements should be on a post trade basis, allowing consolidation of position data and regulatory reporting from a single source. This is also beneficial in terms of regulatory monitoring and accuracy.

25.1. What restrictions should there be on the disclosure of reported data by trade repositories? What requirements should be imposed in relation to data protection and privacy?

25.2. What restrictions should there be on the use of reported data by trade repositories?

Access to trade repositories should be granted to all regulators on the same terms. Trade repositories should operate under a regulatory regime with appropriate data protection safeguards. Besides appropriate data protection safeguards, other important issues to be solved are access, location, governance and regulation.

25.3. What restrictions should there be on the sharing of trade repository data between TRLs; and on the sharing of trade repository data between regulators (both domestic and international)?

Once data is reported to the repository, it should provide all relevant data to regulators and other recognised authorities in order to avoid unnecessary administrative burdens for the industry.

25.4. Should the prices and sizes of individual transactions reported to trade repositories be made publicly available? If so, do you have any views on the time frame in which the information should become publicly available? Should there be different time periods for public release of transaction data depending on the size of particular transactions?

No. The primary purpose of the trade repository is to provide transparency to regulators on market activity in each asset class.

Public disclosure provides benefit in giving data on the size and trends in the derivative market. Only aggregated, anonymous data should be made available on a delayed basis. Aggregation should therefore be at a sufficiently high level so that there is no risk of publication impacting liquidity management or asset prices. Publication of more granular data should only be done on a lagged basis to avoid the risk of impacting pricing/liquidity.

It is essential that large institutions be able to transact in swaps without revealing information in a time frame that would be detrimental to the pricing and liquidity of the trades. In the absence of this, the regulatory regime will harm those market participants investing for super funds and the like who this regime is intended to protect.

Big asset managers that may need to transfer significant risks (trade in size) on behalf of clients stand to be impacted, as too rapid disclosure or mandatory disclosure would cause liquidity providers to widen spreads significantly, transferring the liquidity risk premium to the investor. This is because the liquidity provider will need to factor into its price the market impact of transactions entered into by other market participants based on the expectation that those market participants now have knowledge that a liquidity provider will have to hedge its exposure. This liquidity risk transfer in the form of widening of bid/ask spread is a direct cost to clients as it will be reflected in the performance of strategies and returns asset managers can deliver to their clients.

26. *Would Australian market participants support a domestic trade repository as an alternative to an international trade repository, recognising there are likely to be cost implications in establishing and maintaining a domestic trade repository?*

Ideally there should only be one trade repository for each asset class to avoid complexity and duplication of information and to achieve the benefits of scale. Where the market for the derivative product in question is global in nature this would predispose reporting to an offshore trade repository such as Depository Trust & Clearing Corporation (DTCC) for interest rate swaps.

On the other hand where the market for the derivative product is local, a domestic trade repository solution would have merit.

27. *Is it appropriate for ASIC or another regulator to have the power to grant licenses to trade repositories, or should the Minister have this power? What checks and balances should there be on ASIC's power to grant trade repository licenses?*

There should be regulatory consistency with other forms of FMI licensing, which disposes the answer to the Minister being given the power to approve a license. This would be appropriate as it is intended to align trade repository licence requirements for resourcing, and good repute of its senior management and board with those for other FMI.

If a policy review of the clearing and settlement and trade repository licensing provisions of the Corporations Act is conducted at a later date, arrangements for approval of trade repositories should be kept consistent with other forms of FMI.

28. Should any requirements be imposed on trade repositories with respect to obligations to provide third parties with access to the information (subject to authorisation from data providers and regulators)?

In order to support the protection of the intellectual property rights of reporting entities, trade repositories should be required to establish, maintain, and enforce written policies and procedures reasonably designed to protect the privacy and confidentiality of data submitted to them. Such policies and procedures should include procedures to protect the privacy and confidentiality of data the trade repository shares with affiliates and non-affiliated third parties. A trade repository should also be required to establish and maintain safeguards, policies, and procedures reasonably designed to prevent the misappropriation or misuse, directly or indirectly, of intellectual property, such as trading strategies or portfolio positions by the trade repository or any person associated with the trade repository. This should include standards for controlling persons associated with the swap data repository trading for their personal benefit or the benefit of others, and adequate oversight to ensure compliance with these obligations. A trade repository should not, as a condition of accepting data from reporting entities, require the waiver of any privacy rights by reporting entities.

4.2. Property in Transaction Data

29. Do you have any initial views on the property rights in trade information passed to trade repositories?

From an Australian law perspective the Commonwealth, State and Territory Privacy Acts serve as data protection laws which regulate the collection, use and disclosure of personal information about individuals. A variety of other legislation contains privacy protection provisions relevant to particular types of entities and/or practices, for example, the Spam Act, surveillance and listening devices acts, and many others.

Data being submitted to trade repositories is being done for the public policy reason of assisting regulators understand market dynamics. Consistent with the position in other jurisdictions, reporting entities should retain intellectual property rights in data submitted to a trade repository, including in data that is maintained by a trade repository that is not released publicly under statutory requirements.

Given the confidential and sensitive nature of the information contained within trade repositories, data should only be provided to regulators in direct support of their regulatory mission. Therefore, for example, the level of granularity of data that is appropriate to provide to central banks and prudential regulators might differ to that which is appropriate for a trade repository to provide to a market regulator.

Information disclosed to the public by a trade repository should be on an aggregated level. Furthermore we also believe that such data would, by definition, be made anonymous. This establishes the fundamental principle of public reporting; that it should not be possible, from the information provided, for any party to calculate or imply any positional or trade related information pertaining to a particular market participant, either directly or indirectly.

The nature of the OTC markets – particularly in illiquid and/or customised market segments – means that certain levels of aggregation may, when coupled with the market knowledge of some participants, convey more information than was intended by the initial proposal. A consultation process would highlight such unintended consequences and allow proposed reports to be suitably amended prior to being mandated for production. There are a range of dimensions along which this issue of unintended transparency can arise, inter alia:

- geographic location of counterparties;
- market sector of counterparties;
- location of delivery; and
- contract underlying.

Given the different nature of the markets by asset class (and often by sub asset class), the required reporting by a trade repository will differ materially by asset class. Trying to define ahead of time, for each market, a list of all the possible dimensions of disclosure that may cause unintended issues is impossible given the continually evolving nature of OTC markets.

4.3. Location Requirement for Trade Repositories

30. *Are there any reasons why the location requirements being developed for FMIs should not be applied to trade repositories? If so, are there alternate approaches you prefer?*

Based on the proposals for FMI, a location requirement could be imposed if the infrastructure is determined to be systemically important to Australia. It is not clear to us how a trade repository could be considered systemically important as it is merely a conduit for data flows.

5. FUTURE CONSULTATION PROCESSES

5.1. Ongoing Assessment of Derivatives Markets

31. Do you agree with the factors identified in section 6.2 for ongoing derivatives markets assessments?

The factors identified in section 6.2 are appropriate and supported.

32. Are there other factors that should also be included?

AFMA is prepared to assist in the creation of an industry user-group to assist with the assessment process.

5.2. ASIC's Rule-making Process

33. Do you have any comments on the rule-making power that will be available to ASIC?

AFMA concerns with ensuring appropriate delegation of legislative policy making powers, as discussed, are reiterated in answer to this question.

In our view, regulations should deal with which parties will be subject to trade reporting, clearing or execution requirements in respect of prescribed derivatives. Application of the law to a class of persons is a matter of considerable commercial importance and consequence to the economy and so is a matter properly for the law. How rules are to apply in detail and matters of timing can be left to administrative discretion.

34. Do you have any preliminary views on matters to which DTRs should apply?

This framework proposes establishing classes of persons and products to which various parts of the regime will apply. The mandating of requirements and the definition of specific persons and products as a class is properly a matter for the law and the contemplation of doing this through regulation is appropriate as a means to provide flexibility in the application of the regime.

On the other hand an open-ended discretion to make rules in the way that was granted to ASIC through the Market Integrity Rules provisions (see subsection 798G(1) of the Corporations Act 2001) is not in our view appropriate. The broad language of the grant of discretion, in terms of "the activities or conduct of licensed markets; the activities or conduct of persons in relation to licensed markets; and the activities or conduct of persons in relation to financial products traded on licensed markets", does not impose sufficient limits and policy control on administrators.

Administration of the law is about the application of general rules to the particular. There needs to be clear boundaries so that DTRs cannot be generously interpreted to extend the scope and operation of the law in a way which amounts to de facto policy-making.

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