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Dear Sirs,

Chatham Financial (“Chatham”) is pleased to respond to the G4 Central Clearing Mandate Proposals Paper issued by the Australian Treasury on February 27, 2014.

Chatham is a leading, independent consulting firm that advises financial and non-financial end users of derivatives on managing interest rate, commodity, and currency risks. We are a global firm with operations in the United States, Europe, Australia and Asia, and we work with clients from virtually all business sectors. Our clients include nonfinancial corporations, public and private owners of real estate, infrastructure investors, micro-finance funds, real estate and private equity funds, and regional and community banks. Our clients do not use derivatives for speculative or investment purposes. We assist our clients with all facets of the hedging process, from analyzing risk, to structuring and executing hedges, to providing ongoing valuations, reporting, and accounting support. Throughout the policy debate over regulation of the OTC derivatives market, Chatham has advocated for strong but effective regulation that is targeted toward market participants whose use of derivatives pose a threat to our financial system. Chatham supports the broad policy objectives of the G20 reform agenda and commends the Treasury’s emphasis on international consistency in its proposed implementation of its G20 commitments.

### **Proposed Central Clearing of G4-IRD**

Chatham supports the proposed central clearing of interest rate derivatives denominated in US Dollar, Euro, British Pound, and Yen (“G4-IRD”), as applied only to large financial institutions with significant cross-border activity in these products (“G4 Dealers”). The suitability and success of any clearing requirement rests in large part on the liquidity and standardization of the products subject to central clearing, as well as the ability of market participants to meet the clearing mandate. As G4 Dealers are already subject to central clearing in the U.S., they have already obtained access to central clearing houses and are well positioned to meet an Australian clearing mandate. In addition, there is significant activity and liquidity in G4-IRD internationally and in Australia. Requiring G4 Dealers to centrally clear G4-IRD will impose the least burden possible while most effectively reducing the risks created by systemically significant market participants.

Chatham further supports the proposed clearing mandate from the perspective of international consistency and cooperation. It is important that Australia’s clearing mandate not meaningfully conflict with clearing requirements imposed by foreign jurisdictions, and instead create a framework in which Australia’s regulations are more likely to be deemed equivalent by foreign regulators. For example, the U.S. and the EU have both recognized, in varying forms, that end users who use derivatives for hedging purposes do not pose systemically significant risks and generally should not be subject to central clearing. By limiting the clearing proposal to G4 Dealers, Australia’s proposal implicitly embodies this same concept and is thus consistent with the clearing regime in the U.S. and the EU. As the Treasury is aware, an assessment by the CFTC or the

European authorities that the Australian central clearing mandate is comparable or equivalent will minimize regulatory burdens on both Australian and non-Australian entities by permitting them to comply with only one regulatory regime. Australia's restrained, outcomes-based central clearing proposal will foster greater coordination with foreign regulators and avoid conflicting implementation of G20 commitments across jurisdictions.<sup>1</sup>

### **Costs of Clearing on Smaller Financial Entities**

Chatham is pleased to respond to the Treasury's request for feedback on the costs of complying with a mandatory clearing obligation, especially with respect to financial entities that use derivatives to reduce risk and whose derivatives portfolios are insufficient to pose risk to the financial system. Dozens of Chatham clients are presently subject to clearing requirements in the U.S. and have on-boarded with the Futures Commission Merchants that serve as members of the clearinghouses. We have assisted them in clearing nearly a thousand trades since the clearing obligation took effect in the U.S. in June 2013.

Some of our clients transact with limited frequency and find that their low transaction volumes make the cost of clearing prohibitively expensive. Chatham has assisted many clients establishing their clearing relationships and we are thus acquainted with clearing member fees. Due to the significant fixed costs associated with a clearing member's participation in clearinghouses, clearing members typically establish minimum monthly fees. When an entity transacts infrequently, the transaction fees generated by their transaction activity are generally insufficient to overcome these monthly minimum fees, and so they are subject to the minimum fees. These fees can range from approximately AUD 5,000 per month (i.e., AUD 60,000 per year) to AUD 32,000 per month (i.e., AUD 384,000 per year). One Futures Commission Merchant that offered clearing services without such monthly minimum fees has now exited the clearing business, likely because it was unable to attract market share from the more established players, each of whom charge minimum monthly fees. As such, to the extent particular financial institutions opt to provide certain of their clients with fee arrangements that do not include monthly minimum fees, it may be regarded as an anomalous or temporal.

Legal or consulting fees necessary to establish a clearing relationship (estimated at AUD 32,000, one time) further burden market participants with limited transaction volume. Additionally, Chatham assists companies in storing and accounting for cleared and uncleared swap positions, and generally charges fees based on the size and complexity of a client's portfolio. Because fees contemplate both cleared and uncleared swaps, it is difficult to assess the incremental systems cost associated with cleared trades, however it is reasonable to assume that the costs are more than de minimis.

As a result of these costs, many financial entities that use derivatives to reduce risk and whose derivatives portfolios are insufficient in size to jeopardize financial system stability could find the OTC derivatives market to be prohibitively expensive. Chatham therefore further supports the proposal's focus on G4 Dealers, rather than a more expansive approach that encompasses all financial entities, regardless of their contribution to systemic risk. Importantly, such an approach would avoid burdening entities that cannot undermine financial stability with costs that might prevent them from prudently managing their risks. Such an approach is not inconsistent with the U.S. clearing framework, which excludes small banks from its clearing mandate.

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<sup>1</sup> Similarly, both the U.S. and the EU recognize an exemption from clearing for intra-group or inter-affiliate trades under certain circumstances. See Article 11 of EMIR and CFTC Regulation 50.52. Accordingly, Chatham also supports an intragroup exemption under the Australian clearing mandate.

Similarly, Europe has deferred consideration of the application of its clearing requirement to pension funds. In this regard, Chatham notes and supports the proposal's exclusion of Superannuation Funds from the clearing obligation, which effectively eliminates the particular burdens a clearing obligation would place on this sector.

### **Proposed Exemption for Intragroup Trades**

Chatham works with a number of corporate end users that utilize centralized treasury units (CTUs) to manage risks within a corporate group. In a recent Coalition for Derivatives End-Users survey<sup>2</sup>, 47% of respondents indicated their companies use a CTU model to execute OTC derivatives. End user companies relying on CTUs frequently enter into transactions between the CTU and other affiliated entities. End users have actively engaged with policymakers in the U.S. and Europe to highlight the benefits of the CTU model, and to ensure that clearing obligations do not disrupt the ability of end users to rely on this model. Recognizing these benefits, we support the proposal's approach of exempting intragroup transactions from the clearing obligation.

### **Proposed Exemption of End Users from Trade Reporting**

Chatham supports making the exemption of end-users from trade reporting permanent. Chatham believes that trade reporting is fundamental to the core objective of reducing and containing systemic risk and promoting greater transparency into the OTC derivatives market. Indeed, a reporting requirement strengthens the market provided that certain precautions are taken with respect to the impact of reporting requirements on end users that do not pose a threat to our financial system.

Under Australia's current reporting regime, financial entities such as authorized deposit-taking institutions (ADI) and Australian financial services licensees (AFSL) are required to report all OTC derivatives to which they are a party to a licensed trade repository. This requirement effectively ensures that trades executed by those whose derivatives activity could threaten financial stability are already being captured and reported. When end users enter into derivatives contracts they are almost always facing an ADI or AFSL and, accordingly, the majority of derivatives into which end users enter are already being reported under Australia's reporting regime. If the Treasury is concerned that systemically important information may not be captured if a permanent end-user exemption is adopted, Chatham recommends that the Treasury exempt end-users from reporting unless and until their non-hedging derivatives activity exceeds a specified threshold.

In addition, an end-user exemption to reporting is consistent with the U.S. reporting regime, which recognizes that trade details should be reported by the entity with the easiest, fastest and least expensive access to the trade data in a readily reportable format. Accordingly, in the U.S. the burden of reporting trade details is largely borne by swap dealers and other financial institutions, which are more likely to have the existing operational resources and technological infrastructure necessary to support such reporting. End users, on the other hand, are far less likely to have adequate resources available to meet a reporting obligation. The difficulties associated with imposing a reporting requirement on end users can currently be seen in the EU, as it has been widely reported that end users have struggled and largely failed to timely comply with their reporting obligations. Meanwhile, trade repositories have become backlogged by applications and overwhelmed by end user data which provides little, if any, additional value or insight to regulators. By creating a permanent exemption for end users, Australia can avoid placing unnecessary regulatory burdens

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<sup>2</sup> <http://www.coalitionforderivativesendusers.com/uploads/sites/351/EndUserMarginSurvey3%202014%202.pdf>

on non-systemically significant market participants while still maintaining access to information necessary to monitor systemic risk.

Chatham also recommends that the Treasury adopt a narrow exemption aimed at reducing reporting obligations for non-systemically significant entities which may be otherwise captured by the current reporting rules applicable to ASFLs, including REITs and Superannuation Funds. Such entities enter into derivatives to hedge risk and do not create systemically significant market risks; at the same time, they face a lack of operational resources sufficient to permit them to readily meet a reporting obligation. Accordingly, Chatham encourages the Treasury to consider narrowing the reporting rules relative to ASFLs such that the rules only apply to those ASFLs with significant derivatives volumes (e.g., volumes in excess of AUS 50 bn).

Thank you for the opportunity to provide comments on these important issues. If you would like to discuss this response, please do not hesitate to contact me.

Sincerely,



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