



Australian Government

Implementation of Australia's G-20 over-the-counter derivatives commitments

Proposals Paper

AUD-IRD central clearing mandate

July 2014

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CONSULTATION PROCESS

Request for feedback and comments

This paper seeks stakeholder views on a proposed central clearing mandate with respect to interest rate derivatives denominated in Australian dollars, as part of ongoing implementation of Australia's commitments in relation to global over-the-counter derivatives markets reforms.

Treasury has published a consultation website that will allow you to post comments on the paper. These comments will be added to the website and made publicly available immediately. Treasury will moderate the comments after they are submitted on the website. Please refer to the moderation policy on the website for more information. The consultation website is available at <https://financialmarkets.tspace.gov.au>.

This paper is also available for you to download from the Treasury website (www.treasury.gov.au) and you can still provide your submission via the Treasury website online form or by post.

Submissions should include the name of your organisation (or your name if the submission is made as an individual) and contact details for the submission, including an email address and contact telephone number where available.

While submissions may be lodged electronically or by post, electronic lodgement is strongly preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. Any future request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 1 August 2014.

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1. EXECUTIVE SUMMARY

This Proposals Paper (the Paper) seeks stakeholder views on a potential mandatory requirement for central clearing of interest rate derivatives (IRD) denominated in Australian dollars (AUD), as part of the ongoing implementation of global reforms to over-the-counter (OTC) derivatives markets in Australia.

The proposal set out in this Paper is based on a recommendation put forward by the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (Reserve Bank) — collectively ‘the Regulators’ — in their *Report on the Australian OTC Derivatives Market* published in April 2014 (the Report).¹ In this Report, the Regulators recommended that the Government consider a central clearing mandate for trades between internationally active dealers in AUD-IRD. It is recommended that this Paper be read in conjunction with the Report.

In their previous market assessment report published in July 2013 (the 2013 Report) the regulators recommended the Government consider a central clearing obligation with respect to IRD denominated in 4 global currencies, being US dollars, euros, yen and British pounds (G4-IRD).² A subsequent Proposals Paper issued by the Australian Government in February 2014 (the Proposals Paper) consulted stakeholders on a specific proposal for implementing a G4-IRD mandate.³

This Paper consults stakeholders on a proposal to combine the recommended G4-IRD and AUD-IRD mandates into a single determination to be issued by the Minister. The scope of the central clearing obligation would be confined to a relatively small set of internationally active dealers, as recommended by the Regulators for both G4 and AUD-IRD mandates.

The Regulators have repeatedly noted that there would be a substantial financial stability benefit from increased central clearing of AUD-IRD. While the Regulators are of the view that regulatory and commercial incentives will eventually be effective in encouraging the industry to transition to central clearing, they have acknowledged the benefit of adopting an approach that is consistent with that of overseas regulators, who are proceeding with mandatory clearing across a range of instrument classes. Having monitored Australian-headquartered dealers’ progress in implementing appropriate clearing arrangements, the Regulators are satisfied that the incremental cost of mandatory central clearing of AUD-IRD would be very low for trades between internationally active dealers in the Australian market. This is based on the Regulators’ assessment that most large dealers have established the necessary operational arrangements for clearing, and that there are sufficient options for direct clearing available in Australia.

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- 1 Report on the Australian OTC Derivatives Market, April 2014, available at: <http://www.cfr.gov.au/publications/cfr-publications/2014/report-on-the-australian-otc-derivatives-market-april/index.html>
 - 2 Report on the Australian OTC Derivatives Market, July 2013, available at: <http://www.cfr.gov.au/publications/cfr-publications/2013/report-on-the-australian-otc-derivatives-market-july/index.html>.
 - 3 Implementation of Australia’s G-20 over-the-counter derivatives commitments: G4-IRD central clearing mandate, February 2014, available at: <https://financialmarkets.tspace.gov.au/2014/02/28/proposals-paper-g4-ird-central-clearing-mandate-february-2014/>.

The Proposals Paper requested preliminary stakeholder views on the imposition of an AUD-IRD central clearing mandate. As indicated below, responses show that the majority of stakeholders that responded to this question support imposing such an obligation, provided it is confined to internationally active dealers.

It is accordingly proposed to:

- make a determination, in the second half of 2014, that will allow ASIC to make rules requiring the central clearing of G4-IRD and AUD-IRD; and
- limit this obligation to large financial institutions with significant levels of cross-border activity in these products, referred to in this paper as dealers.

Additionally, and as explained in further detail below, the commencement of the AUD-IRD central clearing obligation could be coordinated with the introduction of similar obligations in key overseas jurisdictions. Stakeholder views on this issue are invited (see Question 6).

Next steps

The Government seeks feedback on these proposals and, following assessment of stakeholder views, may modify the approach originally put forward in the Proposals Paper by extending the scope of the central clearing mandate to cover AUD-IRD in addition to G4-IRD.

The Minister will then, subject to obtaining all necessary approvals, make a determination identifying those classes of derivatives that will be subject to the central clearing mandate. The Minister will also expose for comment draft regulations defining the scope of ASIC rulemaking under the framework.

It is intended that the Ministerial determination and the regulations will be made in the second half of 2014.

2. MARKET ASSESSMENT AND RECOMMENDATIONS BY AUSTRALIAN REGULATORS

In April 2014, the Regulators released the Report recommending a central clearing mandate for AUD-IRD. This followed the publication of the 2013 Report which recommended the introduction of a clearing mandate for G4-IRD.

MARKET ASSESSMENT

The Report was compiled following a survey of market participants' OTC derivatives market activities and practices. The survey consisted of two parts, the first covering the activities of internationally active dealers, and the second focusing on those of non-dealers, including entities such as fund managers and corporates.

To supplement the written survey, the Regulators held meetings with a representative sample of dealers and non-dealers. In addition to data from the survey, the Report drew on OTC derivatives markets data collected and published by the Bank for International Settlements, the Australian Financial Markets Association and other sources.

CENTRAL CLEARING OF AUD-IRD

The Report reiterates the Regulators' conclusion in earlier reports that there would be a substantial financial stability benefit from increased central clearing of AUD-IRD. The Regulators note that their analysis indicates that AUD-IRD account for more than half of notional principal outstanding of all IRD in Australia, which indicates the importance of this product in the Australian OTC derivatives market.

The Regulators found clear evidence of an increase in central clearing in this market among Australian participants, such that the Report asserts that substantially all new AUD-IRD transactions between dealers are now centrally cleared. While there is still a significant backlog of old uncleared interdealer transactions, it has been suggested that over time these transactions may be 'backloaded' into central counterparties (CCPs) after undergoing compression.

Until recently the advance of central clearing in this market was limited by the lack of availability of direct clearing for domestic market participants in Australia. However, there are now two CCPs that are licensed to offer clearing of AUD-IRD directly to Australian participants (ASX Clear (Futures) Pty Ltd and LCH.Clearnet Ltd). A number of Australian participants have established operational arrangements and are clearing transactions as direct clearing members of these CCPs. ASX Clear (Futures) has also started an indirect clearing service catering for non-dealer financial institutions and other smaller users of OTC derivatives.

Given the important position of AUD-IRD in the OTC derivatives market in Australia, the fact that most new transactions are already being cleared, and the availability of central clearing by two CCPs, the Regulators recommended that the Government consider a central clearing mandate for this product class for transactions between internationally active dealers.

OTHER RECOMMENDATIONS

The Report included a separate survey of the activities of non-dealers in the OTC derivatives market. The Regulators were not convinced of the public policy case for introducing mandatory central clearing of OTC derivatives for non-dealers. The Regulators found that, with few exceptions, non-dealers' activity in OTC derivatives is relatively limited and motivated primarily by hedging of underlying cash flows and exposures. Accordingly, even though there may be some systemic risk reduction benefit from central clearing by non-dealers, it is likely to be limited. Indeed, where small financial institutions and especially non-financial entities have restricted access to liquid assets to meet CCPs' initial and variation margin requirements, new sources of risk could emerge. The Report accordingly does not recommend extending the clearing obligation to cover non-dealers at this time, but notes that the regulators will keep the matter under review.

The Report also does not recommend mandating central clearing of North American, European and Japanese referenced credit derivatives at this time. With respect to trading platforms the Report concludes that the Regulators will continue to monitor their use overseas and in Australian OTC derivatives markets.

3. PROPOSAL — MANDATORY CENTRAL CLEARING OF AUD-IRD

This section seeks stakeholder views on a Ministerial determination made under the relevant provisions in Part 7.5A of the *Corporations Act 2001* and related regulations. This determination would allow ASIC to make rules requiring central clearing of AUD-IRD trades between internationally active dealers. As mentioned the same determination would also enable ASIC rule-making requiring central clearing of G4-IRD trades between dealers.

The objectives associated with the central clearing requirement for OTC derivatives are explained in section 5 of the Proposals Paper. Please refer to this section for a fuller explanation.

3.1 RESPONSES TO THE PROPOSALS PAPER

The Proposals Paper asked stakeholders for their preliminary views on the possible introduction of a central clearing mandate for AUD-IRD. It also asked whether stakeholders had any views on the appropriate timing of such a mandate, and whether there were any preconditions that needed to be met before the mandate is imposed.

About half of the 23 responses received addressed these questions. The clear majority of the responses supported combining the AUD-IRD with the G4-IRD determination, subject to certain conditions, the main ones being the following:

- That the mandates should only apply to G4-IRD and AUD-IRD transactions between internationally active dealers, as recommended by the Regulators; and
- That in implementing the AUD-IRD central clearing obligation, allowances are made so that an AUD-IRD trade does not have to be cancelled because the CCP that is being used to clear the trade does not have opening hours that are consistent with Australian and Asian trading hours.⁴

The AUD-IRD central clearing mandate put forward in this Paper would only be imposed on internationally active dealers, as proposed by the Regulators and supported by stakeholders. It is expected that the issue concerning CCP opening hours would if necessary be considered by ASIC in determining the detailed implementation timeline of any AUD-IRD central clearing obligation decided by the Government.

One submission explicitly opposed the introduction of a central clearing obligation for AUD-IRD, mainly because of the compliance costs imposed on entities with low levels of trading in this product such as corporate end users. The proposal put forward in this paper would only affect transactions between internationally active dealers, as recommended by the Regulators. There is no intention at this stage to extend the mandate to cover smaller financial institutions or end users.

⁴ Currently one of the CCPs is in effect closed during most of the Australian and Asian trading day. It is expected that this problem will be resolved by the time any clearing mandate comes into force.

A number of submissions supported an AUD-IRD mandate in principle but preferred that timing should be coordinated with a similar mandate in other key jurisdictions.

3.2 PROPOSAL

It is proposed that a determination be made that will allow ASIC to make rules requiring the central clearing of AUD-IRD trades between internationally active dealers (and similarly with respect to G4-IRD, as explained in detail in the Proposals Paper). The timing of the commencement of the central clearing requirement would be determined through ASIC rulemaking, and following public consultation by ASIC on proposed rules. This could take into account similar moves in other major jurisdictions, notably the United States (US) and the European Union (EU). The AUD-IRD central clearing mandate could therefore commence later than the G4-IRD mandate, even if it is included in the same Ministerial determination.

3.2.1 Benefits and costs of an Australian mandate on central clearing of AUD-IRD

Clearing of OTC derivatives through a CCP reduces counterparty risk through multilateral netting of transactions and mutualisation of losses through a default fund. It also imposes costs on clearing participants, including in the form of contributions to default funds and margin payments. A detailed explanation of the benefits and costs associated with central clearing can be found in section 5.3 of the Proposals Paper. These benefits and costs are also likely to apply to a central clearing requirement for AUD-IRD.

With respect to compliance costs, the Report concludes that dealers are already clearing the majority of new transactions in AUD-IRD, and that the additional cost of complying with a central clearing mandate would be minimal.

Imposing an AUD-IRD central clearing mandate may assist in obtaining positive assessments from overseas regulators comparing the Australian regulatory framework for OTC derivatives with their own. A positive assessment is a pre-requisite for obtaining substituted compliance relief for Australian-regulated entities from overseas regulators, allowing them to operate in overseas financial markets while remaining subject to Australian regulation and regulators. Obtaining such relief in the US and the EU is particularly important, as both are key markets for Australian entities raising funds and hedging risks.

As discussed above it is proposed to mandate central clearing of G4 and AUD-IRD in a single determination, rather than through two separate determinations. The Government would be interested in understanding whether stakeholders consider that there are any cost or savings implications from this proposal to merge the two determinations.

Feedback sought

1. Do you have any comments on the specific benefits and costs of complying with a mandatory central clearing obligation for AUD-IRD, from the point of view of your business and/or that of your customers?
 - In particular, do you agree that the additional compliance costs of complying with a central clearing mandate for AUD-IRD would be low for internationally active dealers?

Feedback sought (continued)

We request that, in commenting, you quantify compliance costs as far as possible, including whether costs are likely to change over time, are transitional or projected ongoing costs. For example, costs may include:

- legal costs;
 - staff costs — for example number of staff hours and training costs;
 - IT costs; and/or
 - increased costs of managing risks or funding projects.
2. With respect to benefits, do you have views on whether the imposition of a central clearing mandate for AUD-IRD would be likely to lead to substituted compliance benefits for dealers? If so, what would these benefits be, and would you be able to provide an estimate of the benefits or savings to your firm?
- If possible, please provide the same details as requested above with respect to the detailed breakdown of benefits and savings estimates.
3. Could you please comment on the incremental costs and benefits of merging the timing and the determinations for G4-IRD and AUD-IRD?

3.2.2 Definition of internationally active dealers

The Report recommends that the central clearing obligation should only apply to transactions between internationally active dealers. This is partly based on the conclusion in the Report that the AUD-IRD market in Australia is largely an inter-bank market, with trading concentrated among the largest dealers.

A key issue is to find an appropriate method for defining the class of internationally active dealers to whom the central clearing mandate would apply. The Proposals Paper suggested that entities subject to mandatory central clearing for G4-IRD should be financial entities (as defined under the trade reporting DTRs) which have reached a certain threshold of activities, and suggested aligning the threshold with that for phase 2 of the trade reporting obligation prescribed in ASIC's trade reporting DTRs, being \$50 billion or more gross notional OTC derivatives outstanding at a certain date. Responses to the Proposals Paper on the whole did not support this suggestion. Concerns were expressed that the proposed threshold by itself would not be effective in capturing the targeted population of internationally active dealers.

Consideration has been given to refining the definition in the Proposals Paper in line with stakeholder comments. Two options are proposed below for further consideration and comment by stakeholders. These proposals aim to define the maximum scope of entities captured by any clearing obligation. ASIC would need to consult on and finalise rules that would determine in detail which transactions and entities would be subject to a clearing obligation. This would likely take into account which transactions would have sufficient connection to Australia to be captured.

Option A

It is proposed to define the class of entities captured by the clearing mandate as:

1. any domestic financial entity with \$100 billion or more gross notional OTC derivatives outstanding;
2. any foreign financial entity with \$100 billion or more gross notional OTC derivatives outstanding booked or entered into in Australia;
3. any foreign financial institution with \$100 billion or more of gross notional OTC derivatives outstanding with domestic and foreign financial entities subject to the clearing mandate in Australia under the first two rules above; or
4. any entity that opts in to a mandatory clearing obligation in G4-IRD or AUD-IRD.

The purpose of including 3) is to capture trades between such financial institutions and financial entities that do book or enter into trades in Australia. Accordingly, it is expected that the obligation would be imposed on the dealer that books or enters into the trade in Australia.

In Option A, 3) refers directly to a threshold level of trades with dealers that book or enter into trades in Australia. Alternatively, regulation as a swap dealer could be used as a proxy for global financial institutions with significant cross-border activities (Option B, below).

Option B

1. a domestic financial entity with \$100 billion or more gross notional OTC derivatives outstanding;
2. a foreign financial entity with \$100 billion or more gross notional OTC derivatives outstanding booked or entered into in Australia;
3. any entity regulated as a swap dealer in the US;⁵ or
4. any entity that opts in to a mandatory clearing obligation in G4-IRD or AUD-IRD.

It is proposed to use the same definition for both G4 and AUD-IRD central clearing mandates.

The threshold would be calculated on a legal entity basis, so only the outstanding OTC derivatives entered into by the legal entity would be counted (and would not include outstandings of related entities).

In addition, for the avoidance of doubt, it is the intention that public entities such as central banks, debt offices, supra-national multilateral development banks and entities such as the International Monetary Fund (IMF) would be out of scope of any central clearing rules.

⁵ This is not intended to target US financial institutions, but as a proxy to capture global financial institutions with significant cross-border activities, most of which are expected to be regulated as swap dealers in the US.

The EU and US have both introduced an exemption from the central clearing obligation for intra-group transactions. This is to avoid a requirement to centrally clear derivatives transactions that are not transferring any risk into or out of a single corporate group. It is proposed that intragroup trades would be exempted from central clearing requirements, as defined in detail in the rules and subject to appropriate conditions (such as notification requirements).

Feedback sought

4. Do you agree with the proposal to limit ASIC rulemaking to entities that are considered to be dealers?
5. What are your views on the two options presented above to define internationally active dealers? Do you have views on additional criteria that should be used, or do you think that one or more of the suggested criteria should not be used? Or would you prefer a different methodology and if so, which one and why?

3.2.3 Timing and comparison with other jurisdictions

The Proposals Paper sets out a detailed analysis of the central clearing regimes in key overseas jurisdictions. Please refer to subsection 5.4.4 for details.

There is currently no central clearing mandate in any jurisdiction covering AUD-IRD. The existing central clearing requirements imposed in the US, for example, are limited (among others) to IRD denominated in G4 currencies. However, given the relative importance of AUD-IRD as a product category, it may be expected that it is a question of time before central clearing requirements are extended to AUD-IRD in key overseas jurisdictions. Once this occurs there will be important international consistency grounds for introducing a similar mandate in Australia.

As noted above, a number of submissions made to the Proposals Paper expressed the view that the timing of an AUD-IRD mandate should be coordinated with a similar mandate in key overseas jurisdictions. One possibility would therefore be to attempt to ensure that the commencement of a central clearing mandate for AUD-IRD in Australia was timed to coincide with the commencement of a similar mandate in a key overseas jurisdiction.

The Report notes that the institutional scope of clearing mandates differs in the various overseas jurisdictions that have announced or introduced such mandates. While the Japanese mandate only applies to financial institutions, in the US and EU regimes some non-dealers are required to centrally clear OTC derivatives, while others receive an exemption.

Feedback sought

6. Do you have comments on a possible coordination of the AUD-IRD mandate with similar overseas requirements? If so, to which key overseas jurisdictions should an Australian mandate be linked?

3.3 IMPLEMENTATION

3.3.1 Combined Implementation of G4 and AUD-IRD Central Clearing Mandates

As discussed above, it is proposed to combine the central clearing mandates for G4 and AUD-IRD in one Ministerial determination. Accompanying regulations would address a range of matters associated with the mandates, including the proposed limitation of the mandates to internationally active dealers including the nature and level of any activity threshold used to determine this class of market participants.

3.3.2 Timetable for implementation

Subject to feedback received for this Paper, the Government will proceed to putting the legal arrangements in place enabling ASIC to make the detailed rules implementing a combined G4 and AUD-IRD central clearing mandate.

Consultation would also be expected to take place with regulatory authorities outside Australia regarding the mandatory central clearing rules proposed to be adopted in accordance with international agreements and to ensure appropriate harmonisation in the process of implementing mandatory central clearing requirements.

Taking these matters into account, the proposed approximate timetable for giving legal effect to the proposals in this paper is as follows:

- Third Quarter 2014 — The Government would expose for comment a draft Ministerial determination relating to G4 and AUD-IRD, with relevant accompanying regulations setting high-level parameters for ASIC rule-making.
- Late 2014 — determination and regulations made.
- The clearing mandate imposed through the determination would need to be implemented through a set of ASIC rules. ASIC would need to publicly consult on these rules, and it is therefore not expected that they would come into force before early 2015.⁶

Feedback sought

7. Do you have comments on the proposed timetable for implementing the central clearing obligation?

6 Noting as stated above that the AUD-IRD central clearing obligation may only come into effect later, depending on the necessary ASIC rule-making process and whether the timing of the implementation of the obligation is coordinated with similar overseas mandates.

4. FEEDBACK SOUGHT

In commenting on the consultation questions below, you are encouraged to read this paper in conjunction with the Report.

Feedback questions	Page
<p>1. Do you have any comments on the specific benefits and costs of complying with a mandatory central clearing obligation for AUD-IRD, from the point of view of your business and/or that of your customers?</p> <ul style="list-style-type: none"> • In particular, do you agree that the additional compliance costs of complying with a central clearing mandate for AUD-IRD would be low for internationally active dealers? <p>We request that, in commenting, you quantify compliance costs as far as possible, including whether costs are likely to change over time, are transitional or projected ongoing costs. For example, costs may include:</p> <ul style="list-style-type: none"> • legal costs; • staff costs — for example number of staff hours and training costs; • IT costs; and/or • increased costs of managing risks or funding projects. 	6
<p>2. With respect to benefits, do you have views on whether the imposition of a central clearing mandate for AUD-IRD would be likely to lead to substituted compliance benefits for dealers? If so, what would these benefits be, and would you be able to provide an estimate of the savings to your firm?</p> <ul style="list-style-type: none"> • If possible, please provide the same details as requested above with respect to the detailed breakdown of savings estimates. 	7
<p>3. Could you please comment on the incremental costs and benefits of merging the timing and the determinations for G4 and AUD-IRD?</p>	
<p>4. Do you agree with the proposal to restrict ASIC rulemaking to entities that are considered to be dealers?</p>	9
<p>5. What are your views on the two options presented above to define internationally active dealers? Do you have views on additional criteria that should be used, or do you think that one or more of the suggested criteria should not be used? Or would you prefer a different methodology and if so, which one and why?</p>	9
<p>6. Do you have comments on a possible coordination of the AUD-IRD mandate with similar overseas requirements? If so, to which key overseas jurisdictions should an Australian mandate be linked?</p>	10
<p>7. Do you have comments on the proposed timetable for implementing the central clearing obligation?</p>	10

GLOSSARY

APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
AUD	Australian dollar(s)
AUD-IRD	Australian dollar-denominated interest rate derivatives
CCP	Central counterparty
CFTC	Commodity Futures Trading Commission
ESMA	European Securities and Markets Authority
EU	European Union
G4-IRD	US dollar-, euro-, British pound- and yen-denominated interest rate derivatives
G20	Group of Twenty
IRD	Interest rate derivative(s)
OTC	Over-the-counter
Proposals Paper	Implementation of Australia's G20 over-the-counter derivatives commitments, G4-IRD central clearing mandate, February 2014
Report	Report on the Australian OTC Derivatives Market, April 2014
Reserve Bank	Reserve Bank of Australia
RIS	Regulatory Impact Statement
The Paper	This paper
US	United States of America
2013 Report	Report on the Australian OTC Derivatives Market, July 2013