3 July 2015

Manager
Banking and Capital Markets Regulation Unit
Financial Systems and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Attention: Mr Michael Lim

By email: financialmarkets@treasury.gov.au

Dear Mr McAuliffe

OTC derivatives central clearing and single-sided trade reporting - Draft Regulations

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the OTC derivatives central clearing and single-sided trade reporting – Draft Regulations. These comments build on the long standing dialogue which AFMA has with the Treasury and the other members of the Council of Financial Regulators and the support AFMA gives to the ongoing implementation of the OTC derivatives reforms.

AFMA is generally supportive of the Draft Regulations. Our comments are directed to areas of concern where the interaction of the proposed regulations is affected by application of nexus rules by ASIC with extraterritorial consequences and greater regulatory burden for 3B reporting entities than was intended by the policy objective and creating a problem with regulatory neutrality between reporting counterparties.

Clearing Mandate

1. Clearing threshold

1.1. The proposed clearing threshold of AUD 100 billion is considered to be consistent with the objective of encompassing Australian transactions which are currently being cleared for commercial reasons.

1.2. AFMA has previously cautioned about introducing extra-territorial complications through an overly engineered nexus rule into the clearing mandate. For this reason the clearing threshold calculation should be based on OTC derivative transactions booked into Australia only.

Australian Financial Markets Association
Level 25 Angel Place, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488

1.3. One of the main policy intentions of the clearing mandate communicated previously has been to increase efficiency, integrity and stability of the financial markets in Australia. The 'entered into' concept was brought in to assist ASIC to meet its market surveillance objectives and transparency. It is not appropriate for inclusion in a mandate based on increasing efficiency, integrity and stability of the financial markets in Australia. The policy objectives here are very distinct from the market surveillance and transparency objectives that are sought with transaction reporting.

Extraterritorial reach of 'entered into'

1.4. The interaction of the related ASIC nexus rules with the proposed clearing mandate has consequences in the framing of these regulations which should be taken into policy consideration.

1.5. The extraterritorial scope of the clearing mandate should be limited in nature and should only apply to OTC derivative transactions booked in Australia. In other words, where a foreign clearing entity is involved, only in-scope G4 or AUD-IRD transactions that are booked in its Australian branches or potentially guaranteed by an Australian entity should be subject to the clearing mandate.

1.6. The inclusion of 'entered into' in Australia transactions within the mandate is an inappropriate extraterritorial extension. Market surveillance policy objectives resulted in the inclusion of 'entered into' in Australia transactions within the reporting mandate but the clearing mandate has always been justified in policy terms on the basis of increased efficiency, integrity and stability of financial markets; not market surveillance. Including 'entered into' in Australia transactions in the mandate is a matter of considerable practical significance and any extension should be limited to where one of the foreign entities is guaranteed by an Australian entity.

1.7. To include 'entered into' in Australia transactions in the mandate increases the potential for the Australian mandate to conflict with the rules in other jurisdictions, will significantly increase the compliance and build costs associated with the mandate for FCEs and have a number of potentially negative outcomes.

1.8. A complex nexus rule associated with the mandate will significantly increase likely compliance and build costs for FCEs / FIADs and have a likely effect on competition and the efficiency of the market. The complexities created by the inclusion of 'entered into' in Australia transactions could potentially result in an increase in systemic risk in Australia as FCEs will have to consider reducing the scope of transactions they arrange or execute from Australia and could result in reduced liquidity within the Australian market.

2. Agency transactions by investment managers

2.1. It is unclear whether the clearing mandate would apply to transactions that investment managers enter into in an agency capacity on behalf of clients, and whether clients who are subject to central clearing mandate will be able to delegate the central clearing obligation to agents such as their investment managers who enter into the relevant trades on their behalf.

2.2. It is proposed that it be made clear that the mandate does not apply to transactions that investment managers enter into in an agency capacity on behalf of clients.

Single-sided Reporting

3. Reporting status is unclear depending on counterparty

3.1. Our buy-side membership who would fall into the 3B category have given feedback that the single-sided reporting relief is hard to rely on in practice because of its contingent nature as it looks to the reporting status of the counterparty. The industry preference, which in line with AFMA's earlier representations, is to have a bright line rule which simply relies on a threshold. By the nature of the current system with Phase 1, 2 and 3A entities required to report, the system is already capturing systemically important transactions in accordance with the basic objective of the regime.

3.2. A foreign entity does not have to report all its trades under the ASIC rules (compared to a domestic entity). The availability of the relief for Phase 3B entities is therefore qualified (and dependent) on the basis of what the counterparty is required to report under the ASIC rules. We have received feedback that this introduces unintended competitive distortions into the market place. It is AFMA's position that competitive neutrality should be a characteristic of all financial market regulation.

3.3. Initial market reaction suggests that 3B entities will have a preference to trade based on a counterparty's situation to enable continuous reliance on the relief. 3B clients facing foreign entities would assess the merits of having no obligation to report against incurring an obligation to self report or delegating such obligation for certain trades not caught by the regulation.

3.4. The Explanatory Guide provides that *"This relief would accordingly be subject to the condition that the counterparty to the transaction is an entity that is required to report the transaction"* and goes on, *"This would, for example, be the case where the counterparty is a phase 1, 2 or 3A entity."* This suggested outcome is not achieved in a number of cases since the outcome is different depending on whether the putative reporting counterparty is a foreign or domestic entity.

Explanation of the problem

3.5. The wording of sub-regulation (2)(b)(ii) is unclear as to whether it is confined to 3B entity vis-a-vis 3B entity or 3B entity vis-a-vis any reporting entity. If the latter is the case, we are concerned about over-reporting and protection from liability under section 907C Corporations Act because SR 2(b)(ii) refers specifically to "in accordance with the DTRs". If the protections under section 907C are intended to continue to apply then it should be made clear in the regulation/explanatory guidance.

3.6. The distinction between a "requirement to report under the DTRs" and "reporting in accordance with the DTRs" seems to be lost when applied to a foreign entity - it's unclear how the two are distinct unless SR 2(b)(ii) is read to only apply to 3B vis-a-vis 3B trade.

3.7. If SR (2)(b)(ii) should apply to any reporting entity, this should be clarified in the regulations/explanatory guidance. (The Explanatory Guidance provides, "*If the counterparty is another phase 3B entity, one of the two parties to the transaction will have to agree to report*".) Guidance should be provided as to how reporting by the counterparty under SR (2)(b)(ii) would be documented (absent this SR 2(b)(ii), a foreign entity is not required to report these trades).

3.8. The legal risk arising from this regulation should be addressed. There is an indirect expansion of the scope of what a foreign entity must report (despite not technically being required to report under the ASIC reporting rules) in order for the purpose of Phase 3B relief to be fulfilled. Expanding the scope of reportable trades to non-Australian trades (and thereby expanding liability and responsibility for any breaches in reporting of such trades) was not contemplated by the ASIC rules for foreign entities. And the operational risk attaching to reporting such non-Australian trades would have to be taken into consideration (arguably it would not be possible to guarantee operational oversight of trades Australian clients conduct overseas involving no Australian personnel/Australian nexus).

3.9. On the basis of the above, the legal risk arising from this regulation should not pass to foreign entities (other than a foreign 3B entity that agrees to report the trade when facing another 3B entity). This should be made clear in the regulations. Additional issues also arise in respect of the interpretation of this regulation including but not limited to where assigning legal risk to 3B entities amounts to a delegated reporting arrangement.

3.10. In our view deregulatory policy intent for single sided reporting does not appear to be fulfilled by the draft regulations since relief availability is determined by counterparty status (as opposed to status of the 3B entity).

3.11. The counterparties are subject to different treatment based on whether they are domestic or foreign which should not be the intent nor effect of the legislation. Also, there is regulatory uncertainty surrounding the operation, scope and legal risk relating to SR 2(b)(ii) which needs to be assessed.

Solving the problem

3.12. As proposed in section 3.1 a simple bright line threshold which removed the contingent nature of the exemption would provide clarity to 3B reporting entities. Without detracting from this optimal solution we also suggest a secondary approach which is aimed at ameliorating the identified problem.

3.13. To address this problem it is suggested that the condition for the exemption should focus on whether or not the Phase 3B entity is trading with an entity (other than another Phase 3B entity) subject to the reporting rules and not go further into whether each particular transaction is or is not actually reported / tagged to ASIC.

3.14. Supporting this would be a safe harbor for 3B entities to discharge their reporting obligations so long as they obtain representations from the relevant counterparties that they are subject to reporting obligation to ASIC without any further due diligence to be conducted by the 3B entities.

3.15. Concerns regarding market integrity should be further balanced against the fact that 3B entities are the smallest sub-category of reporting entities created under the ASIC rules and have characteristics that are akin to other end-users rather than large financial institutions/banks.

3.16. Systemic risk/market oversight/market integrity considerations would not be adversely impacted if the regulations took this approach. While one cannot be unequivocal most transactions will be reported to another foreign regulator. Therefore:

1) transactions would not go unreported within the global system;
2) foreign regulators would have oversight and power to investigate such transactions; and

3) increased co-operation between regulators would allow ASIC to investigate transactions of specific 3B entities where they consider systemic risk issues (if any).

3.17. On the last point AFMA continues to emphasise that trade reporting in Australia is part of a global system that is moving, although too slowly, towards integration. In this regard we draw your attention to a letter (Attachment 1) which AFMA with a group of 10 other industry Associations around the globe wrote to international financial sector authorities and local regulators, including ASIC and the RBA concerning the need for improved consistency in data reporting requirements. This is an issue which AFMA has long championed both locally and internationally.

3.18. While significant progress has been made in meeting a G-20 requirement for all derivatives to be reported to trade repositories to increase regulatory transparency the lack of standardisation and consistency in reporting requirements within and across jurisdictions has led to concerns about the quality of the data being reported. Poor data quality reduces the value of the data for regulators and limits their ability to fulfill supervisory responsibilities. Differences in reporting requirements also increase the cost and complexity for firms that have reporting obligations in multiple jurisdictions.

3.19. Greater consistency in the content and format of the data being reported, would improve regulatory transparency. Market participants would also benefit from greater specificity and harmonisation in their reporting across multiple regimes.

3.20. To address this problem the International Swaps and Derivatives Association, Inc. (ISDA) has developed a set of principles aimed improving consistency in regulatory reporting standards for derivatives across borders. These principle are equally applicable to other data reporting requirements that the authorities are presently considering. These principles were endorsed by the signatory associations.

3.21. While it has been suggested that tagging by Reporting Entities is a solution it is unclear to us that this approach is working effectively in practice. Core functionality issues within DTCC systems means that a viable tagging solution continues to elude us. Therefore 3B entities and their foreign counterparties will look to 7.5A.71 (2) as opposed to tagging under 7.5A.71 (3) when assessing whether the foreign counterparty satisfies the exemption.

4. Gas & Oil Commodity Trade Reporting Exemption

4.1. AFMA's energy members who in addition to electricity derivatives transact gas and oil commodity derivatives fall into the category of 3B entities that do peer to peer transactions of gas and oil commodity derivatives. Beyond electricity market participants, energy producers and suppliers more broadly may use gas and oil commodity derivatives to hedge their physical market risk. We have previously put the case that such transactions are characterised by their bespoke character and small numbers of transactions. The market for energy commodity derivatives is small and illiquid in Australia. For example, with gas commodity derivatives there are only a handful of transactions conducted a year. It is very different to the large commodity derivatives markets that are seen in centres such as Chicago and London which are considered to be systemically important to the financial system.

4.2. The collection of real-time transaction data through complex mechanisms to trade repositories is out of proportion to the burden imposed on this non-systemically important market. AFMA in line with our previous submission

continues to urge that these products be exempted from real time transaction reporting by 3B entities.

4.3. It is understood that regulators are interested in activity in this market and this could be achieved through as in the past of ASIC requiring position reporting at periodic intervals.

4.4. We are cognisant of the desirable regulation 7.5A.50(2A) which allows reporting entities who would be exempted "end-users" if they did not hold an Australian financial services licence to be exempted from the reporting requirements for classes of derivatives which are not covered by an authorisation under their licence. I am advised that a number of energy market participants just have a general authorisation for "derivatives" which does not distinguish into classes of derivatives, so they will not be able to avail themselves of this exemption.

5. Technical drafting issue

5.1. We note the following issues with draft regulations 7.5A.71 & 72. Draft regulation 7.5A.71(2) reference to "Australian entities" should be changed. The drafting covers all reporting entities. The same comment applies to draft regulation 7.5A.72(2).

Please contact David Love at dlove@afma.com.au on (02) 9776 7995 if further clarification or elaboration is desired.

Yours sincerely

David Love
General Counsel & International Adviser