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Re: Implementation of a framework for Australia's G20 over-the counter derivatives commitments (Consultation Paper, April 2012)

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) welcomes the opportunity to comment on behalf of its members on the consultation paper issued by The Treasury of the Commonwealth of Australia. The GFXD was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 22 global FX market participants[1], collectively representing more than 90% of the FX market[2]. Both the GFXD and its members are committed to ensuring a robust, open and fair market place and welcome the opportunity for continued dialogue with global regulators.

The FX market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. Corporations and investors regularly participate in the market for operational needs: to reduce risk by hedging currency exposures; to convert their returns from international investments into domestic currencies; and to make cross-border investments and raise finance outside home markets.

Many of the current legislative and regulatory reforms will have a significant impact upon the operation of the global FX market and we feel it is vital that the potential consequences are fully understood and that new regulation improves efficiency and reduces risk, not vice versa. The GFXD is committed to ensuring a robust, open and fair market place and welcomes the opportunity to set out its views in response to your consultation paper.

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Section 3.1

[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi, Barclays Capital, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State St., UBS, and Westpac.
[2] According to Euromoney league tables

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

The consultation paper sets out the legislative framework and highlights under section 3.1 that the Minister may, by legislative instrument, prescribe a derivative as being subject to one or more of the reporting, clearing and execution obligations. In the absence of prescription, the statutory obligation will not apply.

As noted in our responses below, there are products within the foreign exchange asset class, specifically FX forwards and FX swaps which should be appropriately exempted from most, but not all, regulatory requirements. An exemption for FX forwards and FX swaps is being considered by a number of jurisdictions, including the United States, Hong Kong and Singapore. Recitals in the OTC derivatives, central counterparties and trade repositories legislation in Europe also provide for certain classes of transaction to be exempted from central clearing on the basis of their risk characteristics and international convergence. Public comments by European Commission officials suggest this is, in part, directed towards the treatment of FX forwards and swaps.

We would also like to point out that the application of the proposed obligations (reporting, clearing and execution) should ensure that the spot market is not inadvertently captured. Accordingly, and consistent with common market definitions, practice and understanding, we would request clarification that transactions with value dates less than or equal to T+2 business days fall outside the obligations as well as taking into account any jurisdictions where 'spot' is considered greater than this (for example some smaller markets are T+3) Furthermore, FX trades also act as supporting trades for security settlements, which may occur on a greater than T+2 basis. Such supporting transactions, up to the standard security settlement maturity in the relevant currency and market, which may be up to T+5, should be excluded from the scope of the rules.

Finally we would request that, whether under amendments to the Act or through DTRs or other regulations issued, that significant focus be placed on ensuring that rules are not unnecessarily prescriptive about how market participants should go about ensuring compliance (except, of course, where this is required). Workflows in each of the asset classes are different as a result from the different market infrastructure that has evolved to satisfy the needs of participants. By focusing on the regulatory outputs that are required, industry participants can develop the most efficient ways to meet Australian regulatory objectives whilst leveraging existing infrastructure and minimising any potential disruption and increase in systemic risk. An example of this would be around trade reporting requirements. Whilst ensuring that an obligation to report exists, we feel that there should be no need to be prescriptive as to whether a single (one party submitter) or dual (both parties submitting trade details) submission model should apply provided that the Australian regulators have appropriate access to high quality data. Achieving that quality may require different models for different asset classes.

<u>Section 3.2</u>

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

No comment

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

The definition of party highlights the key issue of extraterritoriality. In some circumstances overreaching extraterritoriality increases the obligations participants face in each jurisdiction e.g. reporting the details of the same trade to two different regulators. In other cases it raises simple but potentially enforceable compliance conflicts e.g. requirements to clear a cross-border trade. We note that in committing to further regulatory oversight of the international financial markets, the G20 also undertook to 'take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage.' We believe this is vital for the efficient functioning of the FX markets.

A key aspect of extra-territoriality is the regulatory nexus that applies. But equally important is developing an appropriate recognition regime that would allow international infrastructure to satisfy Australian regulatory requirements and vice versa e.g. global CCPs and trade repositories. In order for the latter to occur, we would encourage Australian regulators to ensure that legislation is developed in a timely fashion with overseas jurisdictions to minimise the impact on both domestic and foreign participants that may wish to utilise both domestic and foreign infrastructure interchangeably.

<u>Section 3.3</u>

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

Following on from our comments in the response to question 3, we believe that in all cases 'such other entities prescribed by regulation' should enable global infrastructure to qualify for meeting domestic Australian regulatory requirements.

For trade reporting, we support a common, global approach to trade repositories rather than fragmented local repositories. We believe global data sets are of more benefit to regulators in terms of comprehensive oversight and more efficient in terms of data capture. This is particularly the case for the FX market which is characterised by vastly higher number of transactions and participants when compared to other asset classes given its position as the basis of the global payments system.

Comprehensive oversight

Trade repository information must be as consistent and complete as possible in order for it to be meaningful, both for market surveillance and systemic risk monitoring. Global trade repositories provide a centralised point for submission of data, giving regulators access to both on and offshore trades and allowing them to build a complete picture regarding the positions of overseen entities. Since local regulators may typically only exert jurisdiction over local firms, currencies traded offshore by offshore entities would not be subject to regulation. They would therefore not be reported to the local repository, limiting the usefulness of that subset of data. Building an accurate picture of systemic risk or trade activity becomes significantly more difficult where the trade population is fragmented across a number of localised trade repositories, particularly considering the volume of participants and transactions present in the FX market, and in the absence of standardised global formats. The value of a comprehensive data set can also extend to implementation of other regulatory initiatives, for example, in analysing whether to mandate clearing for particular products and in establishing block trade sizes and appropriate reporting delays.

Efficiency

There are a number of efficiency arguments for global trade repositories from all market participants' perspectives.

- Cost – global trade repositories reduce the implementation costs related to building out and connecting to relevant trade repositories for both regulators and market participants alike. For reporting parties, global trade repositories allow a centralised reporting channel with common technology, messages and trade formats. Given the number of market participants engaging in cross-border transactions, local repository reporting may add significant costs for both buy and sell side participants as they are required to report to a number of repositories. Hardest hit might be the smaller, regional banks that would likely be expected to undertake the burden of international reporting on behalf of their clients. Centralised client due diligence would also produce significant savings.
- Data consistency and common standards – agreed global data formats and standards for LEIs and product and trade identifiers would also promote significant benefits for all users. The industry is making progress in this regard. Where local repositories prevail, regulators will need to be able to interpret and aggregate data across a number of differently formatted outputs, which can be inefficient at best. Timely access to and interpretation of a comprehensive data set will be important in times of market crisis and this will be hindered if regulators are required to seek trade and position data from a number of repositories.
- Implementation – global trade repositories may also help to minimise the risks of conflicting implementation deadlines and reduce time to market.

Section 3.4

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

We agree with this principle.

Section 3.5

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

We have no specific comments in this regard other than to reiterate our point regarding avoiding unnecessarily prescriptive rulemaking.

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

We believe that there should be a minimum consultation period of sixty days.

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

This will depend upon the obligation, the specific asset class or class of derivative and the market participants involved. An orderly and efficient transition of the OTC derivatives market to the new market structure and regulatory regime required by financial reform is critical. A phased approach to implementing any mandatory obligations would be sensible to limit implementation risks.

As a priority, we believe the regulators should focus on reporting obligations. Once a meaningful dataset is compiled for FX, Australian regulators will be better positioned to determine future regulatory policy targeting clearing and execution based on analysis of actual market activity.

Within each obligation itself, we would ask the Australian regulators to take into account existing market structures and the time needed to implement the necessary changes. This would need to be done on an asset class by asset class basis. An example of this is in the US where reporting obligations for credit and rates have been set in advance of those for FX, equities and commodities, recognising the existing infrastructure and readiness of those asset classes to respond to the reporting requirements.

Additionally, phasing should take into account the ability of market participants to comply with such obligations. We suggest that phasing should occur by sub-categories of market participant. Hence an initial phase should focus on major / systemically important participants, with subsequent phases dealing with other financial institutions and corporates (if not subject to an exemption).

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)?

As discussed in our response to question 17, we believe that the primary objective of regulatory change should be to address systemic risk. Regulation should therefore focus on capturing those counterparties whose use of financial instruments is systemically significant. Where an end-user does not pose a material risk, it would be proportionate to exempt that end-user from mandatory obligations – as, for example, in the case of commercial end users whose use of derivatives is to hedge business risk.

Section 3.6.1

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?

Trade reporting

The FX market presents some unique challenges when compared with other asset classes. There is a high volume of transactions in FX compared to any other asset class. In addition, the universe of participants is also significantly wider given that FX forms the basis of the global payments system.

The BIS data below shows that, for April 2010, spot, forward and swap transactions accounted for 95% of 2010 daily traded volumes on a global basis. Equivalent RBA data shows that these trades account for some 98% of 2011 market turnover with swap transactions comprising 63% of overall market turnover.

US$bn	Global Apr-10	%	Australia Apr-11	%	Oct-11	%
Spot	1,490	*38%*	48	*22%*	48	*29%*
Outright forwards	475	*12%*	13	*6%*	10	*6%*
Swaps	1,765	*45%*	150	*70%*	103	*63%*
Options and other	207	*5%*	3	*2%*	3	*2%*
	3,938		**213**		**164**	

Sources: Australian data taken from AFXC semi-annual data; global data taken from BIS Triennial Survey

		Seven days or less	Seven days to 1 year	Over 1 year
Outright forwards	Australia Apr-11	32%	65%	3%
	Australia Oct-11	35%	57%	8%
	Global Apr-10	45%	52%	2%
Swaps	Australia Apr-11	69%	31%	0%
	Australia Oct-11	85%	14%	0%
	Global Apr-10	74%	25%	1%
Options	Australia Apr-11	24%	72%	4%
	Australia Oct-11	24%	71%	5%

Sources: Australian data taken from AFXC semi-annual data; global data taken from BIS Triennial Survey. Global Options data not available.

Given the high proportion of the Australian FX market that comprises swap transactions and the relatively high prevalence of spot transactions, further analysis of the maturity breakdown suggests that almost 86% of Australian FX trades settle within 7 days with c. 0.7% settling over one year. Excluding spot trades from the analysis shows that almost 80% by volume of all forward, swap and option trades settle within 7 days, with 19% settling in the 7 days to 1 year bracket and only 1% settling greater than one year.

The majority of FX transactions are therefore overwhelmingly short-term. It is questionable what material value is derived from capturing expired trade data. As such, we would recommend that backloading for trade reporting be limited to open positions as at any compliance date.

Clearing

We do not support the proposal to require backloading of contracts. Such contracts would not have been priced to factor in the costs of clearing fees and funding initial margin. Because clearing changes the fundamental nature of the cash flows of the trade, they may render such contracts no longer commercially viable even though they were viable at the time the deal was struck. We also note that since the average tenor of Australian FX trades is short term, the risk reduction achieved from a backloading requirement would be minimal.

Section 4.2.2

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?

In principle yes, subject to our comments in relation to spot markets (question 1) and in respect of thresholds.

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?

In general, we agree with this approach in order to ensure coverage of relevant trades for reporting to a trade repository. However, as described in our response to question 1 above, we would recommend that the rules not be unnecessarily prescriptive in how the data set is populated. We would also recommend that an entity be able to use a third party to report on its behalf (and this should include the other counterparty to any trade i.e. allowing a smaller corporate to designate its financial counterparty to report on its behalf). There are various scenarios that would make this beneficial. Non financial intermediaries executing a low-volume of trades (depending on where the relevant thresholds are set), for instance, may not have, or desire to build, the necessary infrastructure to fulfil the reporting requirements. Such participants may find the build-out costs to be prohibitive, or will prefer to avoid them. This will be particularly prevalent given the number of market participants in FX.

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

Please see our comments in respect of inter-affiliate trades (question 14.1).

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

Please see our response to 13.2.

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?

Given the sheer volume of trades in the FX market, we have previously suggested to regulators the concept of setting a notional threshold (subject to periodic revision) so that the noise of small scale FX transactions is filtered out. This will leave trade repositories to focus on materially significant transactions. In the absence of such a threshold, the global data set is likely to be overwhelming. A notional threshold of USD1m or equivalent would be a reasonable, initial starting point. This may be particularly relevant for retail banks offering cross-border payment services.

In the absence of a carve-out for smaller trades, we would recommend allowing reporting counterparties the option of aggregating smaller trades to reduce the reporting burden. Trades could be aggregated by relevant criteria, for example, by currency-pair, trade-date, value-date, counterparty and / or direction (average buys / average sells; the average buys / average sells is used so to obtain a true FX trade without odd rates or amounts in either of the aggregated currencies). Aggregation might then occur by time of day (e.g. before end of day in each region), up to a pre-defined total notional exposure for each counterparty and / or for trades not greater than a pre-defined size e.g. USD 1m or equivalent (if an input ticket is too large it would be passed through without aggregation). It may also be possible to use number of tickets in the aggregate as a cut-off in order to accommodate the IT capabilities of the receiving systems. Note that the regulator would still have access to the underlying trades via a reporting counterparty's record keeping.

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?

At this stage we cannot comment on an appropriate threshold for end users but in general are supportive of minimizing the impact of reporting for end users, who may wish to rely on third parties or dealer counterparties to report trades on their behalf.

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?

Due to volumes involved in the FX markets, and differing risks of some transactions we believe certain transactions should be excluded. Please see our comments in relation to spot transactions (question 1) and inter-affiliate trades (question 14.1 below).

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

We believe that trades that settle with affiliated third parties (intra-group transactions) should be out of scope of the regulation.

Inter-affiliate trades represent allocation of risk within a corporate group and do not give rise to the same systemic risk issues that are raised by trades by one corporate group with another. Many millions of trades occur daily between different affiliates of the same institution which are not relevant to that institution's external market positioning. They are a common feature of international financial markets and enable clients to deal with local entities whilst providing those firms with the ability to manage risk in a consolidated way. Regulators are able to consider a firm's consolidated risk position, the need for which is acknowledged in the consultation paper.

Unlike other asset classes, the FX market is characterised by a high number of both trades and participants. A clearing requirement for intra-group transactions would increase operational risk due to the volumes of transactions that would clear, without materially reducing counterparty risk. Similarly, a reporting requirement for these intra-group trades would significantly increase ticket volumes at any trade repository without increasing transparency and without giving meaningful indications about the overall FX market or the overall exposure of the relevant corporate group.

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?

No comment.

Section 4.3.2

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?

International convergence is paramount for FX forwards and FX swaps where the predominant risk is settlement risk. Following extensive study of settlement risk by the central banks as a source of systemic risk for the FX market and therefore the global financial markets, the FX market went to considerable lengths to address this risk, ultimately leading to the creation of CLS Bank (CLS) in 2002. CLS' settlement system today eliminates virtually all settlement risk to its participants. Additionally, CLS' activities are subject to a cooperative oversight protocol arrangement among 22 central banks whose currencies are settled, which includes the Reserve Bank of Australia for the Australian dollar.

In the case of certain FX trades – FX forwards and FX swaps – an exemption from clearing has been proposed in the United States, and also Hong Kong and Singapore, for a number of reasons including the availability of CLS. (Please refer to our response to question 18 for details.) In Europe, the recitals in EMIR reflect that ESMA should take these same reasons into consideration. Broadly, these exemptions and the EMIR recitals recognise that for these FX trades, settlement risk is the main risk, and the risk mitigation that clearing provides is not the most appropriate mechanism for addressing such risk. With this in mind, margin and capital requirements for such products should either not apply, or should be set at levels that do not incentive clearing for such products because this could very well increase rather than decrease potential systemic risk, especially in times of crisis.

In the case of the US, an exemption from clearing for FX forwards and FX swaps would have the effect of excluding these definitions from the definition of "swaps" (effectively the equivalent of "derivatives" in Australia). As a result, FX forwards and FX swaps would not only be exempt from mandatory clearing and/or trading requirements, but also any mandatory margin or capital requirements that may apply to "uncleared swaps". We agree with and support this approach, and believe the overriding objectives for regulators internationally should be to implement measures that are proportionate to the systemic risks being addressed. Should the Australian authorities, however, take a contrary view, margin and capital requirements should be set at levels that only address specific, unmitigated risks, are appropriately calibrated (i.e., not be duplicative/additive) and do not incentivise clearing for such products because this could very well increase rather than decrease potential systemic risk, especially in times of crisis.

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

It is our view that regulators should focus on the systemic risk arising from a participant's use of instruments. Where an end-user does not pose a material risk, it would be proportionate to exempt that end-user from mandatory clearing and capital, margin and / or collateral requirements.

Affordable access to appropriate methods of hedging is vital to end-users to mitigate risks. We therefore support an approach that exempts certain classes of participants from any clearing and margin requirements, as the increased collateral and operational requirements would be too burdensome and the reduction in systemic risk insufficient to justify the imposition of these costs. OTC positions which are hedges of business risk should be exempt from any central clearing or margin obligations. Any mandatory clearing requirement would affect end-users' ability to use derivatives for risk management purposes as many of these firms, especially non-financial end-users, need their most liquid assets for working capital and investment purposes.

Dealers facing end-users that do not pose a threat to financial stability should be permitted to evaluate and underwrite the credit risk of such end-users and negotiate bilateral collateral or credit support arrangements as they deem necessary.

These issues are particularly pertinent for the FX market, which differ from the OTC derivatives market in that it has many more participants and transactions that will be affected and is predominantly very short dated. The impact of disproportionate mandatory clearing and margin / collateral requirements will therefore be felt widely.

Please see response to question 18 for specifics.

17.1 What metrics should be used to determine any thresholds?

No comment.

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?

No comment.

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

No comment.

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

As mentioned in our response to question 16 above, FX forwards and FX swaps should be excluded from any clearing requirements due to the systemic relevance of this market and its distinguishing characteristics. This will help ensure that the application of a clearing obligation would not result in undue risk being assumed by the market and overall financial system.

- **FX is at the heart of all international commerce.** Corporations and investors regularly participate in the market for real operational needs: to reduce risk by hedging currency exposures; to convert their returns from international investments into domestic currencies; and to make cross-border investments and raise finance outside home markets. The FX market, which is the world's largest financial market, is a central component of the global payment system. It also underpins other financial markets and the global economy generally. The Bank for International Settlements estimated that average daily market turnover in FX increased to $4 trillion in April 2010, up from $3.3 trillion in April 2007.[3]

- **FX markets are different from other derivative markets.** The majority of FX trades are simple exchanges of currency. There are no contingent outcomes for FX forwards and swaps (cash flows are known at the outset of the trade) and they are overwhelmingly short-term in nature. For example, latest analysis conducted by Oliver Wyman of the BIS 2010 survey and the FXJSC/FXC figures (both collected in April 2010), estimates the following global maturity profile for FX forward and swap trades:

[3] BIS, Monetary and Economic Department, *Triennial Central Bank Survey: Report on global foreign exchange market activity in 2010* (Dec 2010).

Up to 7 days maturity = 68.0% of daily traded volumes;

7 days – 1 month = 13.3%; and

1 month – 6 month = 16.2%

This evidences a global FX forwards and swaps daily traded market total of 81.3% under 1 month maturity and 97.5% under 6 months, with 1.5% maturity between 6 months and 1 year and only 1% over 1 year. And unlike other OTC derivatives which are typically settled on a net, cash-settled basis, FX forwards and FX swaps are typically physically settled by delivery of the underlying currency.

- **FX faces different and specific risks when considering counterparty credit risk**. In FX forwards and swaps, the main counterparty risk is settlement risk, not mark-to-market risk (settlement risk is the risk that one counterparty does not deliver their side of the currency exchange while the other counterparty has delivered their side). Unlike most derivatives markets where trades are settled financially, the FX market is currently predominantly physical, i.e. trades settle via exchange of currencies. For FX instruments with maturity less than 6 months: 94% of max loss exposure is settlement risk; mark-to-market risk is only a residual risk (6%)[4].

- **CCPs are designed to mitigate "mark-to-market" risk – not settlement risk.** In FX markets, the residual mark-to market risk is today mitigated through credit support annexes (CSAs) and may in the future subject to bilateral risk mitigation requirements. In the case of FX, the use of CSAs in supporting the resilience of the FX market during 2007/2008 has been well documented. Given the significant benefits offered by the use of CSAs to further mitigate credit risk in FX, the Foreign Exchange Committee (FXC) updated its core best-practice guidance documents surrounding their use.[5]

- **Mandatory clearing in FX markets could have unintended consequences whilst addressing a disproportionately low residual credit risk exposure.** For FX, a CCP clearing mandate/solution is not the optimal solution for dealing with the predominant risk – settlement risk – for this market. Key unintended consequences of mandating clearing for FX forwards and FX swaps include potentially undermining the efforts that have been made in addressing settlement risk to date; creating a single point of failure where none exists today; and increasing costs and risk for corporate and buy-side end-users of FX.

  In addition, as noted above, the US Treasury has issued a Proposed Determination to exempt FX forwards and swaps from the definition of a "swap". The proposed determination recognises the different characteristics of FX products and the way the market functions at present. Following a study and consultation over many months the US Treasury:

[4] According to analysis conducted by Oliver Wyman.
[5] *See* FXC, *Tools for Mitigating Credit Risk in Foreign Exchange Transactions,* November 2010. The FXC includes representatives of major financial institutions engaged in FX trading and is sponsored by the Federal Reserve Bank of New York.

- Acknowledges the **high levels of transparency and liquidity** existing in the FX markets as a result of the heavy trading on electronic platforms and the diverse availability of market pricing information.

- Points to **additional transparency through trade reporting to a trade repository**, the requirements of which are already being addressed with GFXD members.

- **Recognises the unique factors limiting risks in the FX forwards and swaps market,** pointing to the fixed terms (i.e. non-contingent outcomes), the physical exchange of currencies, the well-functioning settlement process and the shorter duration of contracts.

- **Highlights the existing strong, comprehensive and internationally coordinated oversight framework prevalent in the FX markets.**

- Notes the **complexities around introducing CCP clearing** into the FX market – specifically:

    - The large currency and capital needs that would arise if CCPs were also responsible for guaranteeing settlement given the sheer size and volume of trades in the FX (forwards and swaps) market.

    - The operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement – concluding that these significantly outweigh the marginal benefits from central clearing.

In respect of the issues around guaranteeing settlement, final principles for financial market infrastructures as issued by the BIS in conjunction with CPSS/IOSCO in March 2012[6] outline a number of key principles that need to be considered for CCPs in the FX market. The industry has been focused on these principles over the past twelve months in the context of FX Options. Notable are Principle 7 – Liquidity Risk, Principle 8 – Settlement Finality, and Principle 12 – Exchange-of-Value settlement systems. Taken as a whole, and confirmed through our conversations with key regulatory oversight groups, it is our understanding[7] that these principles require any CCP looking to clear FX products to meet fully the following requirements:

- An FX CCP will need to guarantee the full settlement of currencies of the trade[8];

- An FX CCP must be able to deliver required currency at the latest by the end of the settlement day; and

[6] See BIS Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, "Principles for financial market infrastructures", April 2012 at http://www.bis.org/publ/cpss101a.pdf.

[7] See Global FX Division Discussion Document at http://www.afme.eu/AFME/What_We_Do/FX%20Clearing%20Settlement%20Challenges%20Discussion%20Document%201%203.pdf

[8] This applies to the vast majority of FX trades where settlement is via exchange of principal; clearly it does not apply to the small proportion of FX trades involving non-deliverable contracts, e.g. NDFs.

- An FX CCP must be covered against Settlement Halt Risk[9].

The FX industry has been working with regulators and CCPs and is acutely aware that to meet these requirements for the mainstream FX market a CCP would face significant challenges. This is especially true in light of the need for immediate access to sufficient liquidity in all currencies to be able to meet in full the settlement obligations of a defaulting member, and in a manner that does not put the CCP itself at significant risk during stressed market conditions. The specific settlement characteristics of the FX market make this issue significantly more acute than in other asset classes. This is a formidable challenge for which, to date, no satisfactory solution has been found.

Introducing CCPs into the FX market without ensuring that they only bear risks that they can properly manage would clearly increase, rather than decrease, potential systemic risk, especially in times of crisis.

Clearing mandates – granular grouping of OTC derivatives within product types. With applying a clearing mandate to any class or type of OTC derivative, the "grouping" of derivatives needs careful consideration and we believe that a one size fits all approach is inappropriate for determining whether derivatives should be mandatorily cleared. The Australian authorities should have the ability to subdivide within each asset class. We firmly believe that appropriateness for a clearing mandate is likely to depend on the characteristics of each of the different underlying products. FX products are not homogenous, and the possibility of different trade features requires that each currency pair should be reviewed and separately approved. In particular, liquidity by currency pair varies significantly. We believe that clearing is only warranted for the most liquid currencies that offer a material reduction in replacement risk across the market. As CCP's launch additional products, we believe that the Australian authorities should give each new product due and careful consideration to ensure that any mandatory clearing is warranted. Approving FX derivatives (e.g., FX non-deliverable forwards (NDFs)) by currency will also enable consideration of the pace of development at competing CCPs to ensure market participants have a choice of venues to ameliorate systemic risk and encourage competition.

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?

Yes. We believe that end-user transactions entered into for the purposes of hedging be excluded from the rulemaking power.

In addition, we believe that intra-group trades should be excluded from the clearing requirement. Unlike other asset classes, the FX market is characterised by a high number of both trades and participants. A clearing requirement would increase operational risk due to the volumes of transactions that would clear, without materially reducing counterparty risk.

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

[9] This is the potential risk of mark to market loss on settlement day if settlement is halted intra-day and therefore not all trades settle (NB: this is different from FX settlement risk).

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?

No comment.

Section 4.4.2

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.

At this stage, we do not believe there is sufficient evidence to support a mandate for trading in specific classes of derivatives. Nor do we believe that the Australian regulators should be specific about which venues would qualify as eligible for any trading mandate.

As noted above, we believe the regulators should focus, and therefore prioritize, efforts on mandatory reporting. Once data has been compiled for FX, the Australian regulators will be better positioned to determine which, if any, products exhibit sufficient liquidity to be subject to any mandatory clearing obligations as well as trading requirements. Mandatory trading on exchanges or other trading facilities is not a necessary condition for financial stability and could have a negative impact, for example, in reducing liquidity in the market where the mandatory trading rules apply.

The FX market has been at the forefront of electronic trading, developing a range of execution methods including multi-dealer and single dealer platforms. As an OTC marketplace, these venues take into account the specific nature of the end client, size of order and credit worthiness. The choice of venue for trading in OTC markets should be driven by both the type of contract and type of customer. Any requirements governing market structures and trading venues, to the extent that they are applicable, should preserve the flexibility that exists to trade across existing execution venues.

Mandatory trading obligations, depending on how they are applied, can restrict the ability of end-users to enter into hedging arrangements by forcing economic standardisation of products to fit e.g. an exchange-traded model. We are strongly against this since the main use of the OTC FX market is to allow users to hedge specific future exposures in a tailored manner.

Should a mandatory trading obligation be imposed at a future date, we believe the Australian regulators should consider single dealer platforms (SDPs) in the FX market as qualifying venues for such a trading obligation.

SDPs provide significant liquidity to the dealer-to-customer FX market (c. 25% of dealer-to-customer flows[10]), facilitating a direct trading relationship and promoting innovation and quality in executing client business. The model is highly competitive, providing end users with a variety of products based on their specific needs particularly given the bespoke hedging nature required for FX products. SDPs also enable clients to develop relationships that cover more than solely execution including research and advice.

The G20 commitment refers to moving trading in standardised OTC derivatives to exchanges or electronic trading platforms. SDPs, in our view, clearly qualify as electronic platforms and

[10] According to Oliver Wyman analysis

are referred to in the IOSCO Report on Trading of OTC Derivatives (the "Trading Report"), published in February 2011. The Trading Report does not make a clear recommendation as to whether SDPs should or should qualify as a venue for mandatory trading. However, certain IOSCO members recognised that "benefits can be realised where the opportunity to seek liquidity and trade with multiple liquidity providers is offered within a product market as a whole, irrespective of whether a particular platform offers access to multiple liquidity providers" further recognising that "benefits of centralisation may differ according to market structure [and] that a market consisting of a mix of single and multi-dealer platforms for standardised derivatives may also provide systemic risk benefits." The Trading Report conclusion advocates for a flexible approach encompassing a range of platforms that would qualify as "exchanges or electronic trading platforms".

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?

We are not clear as to the reference made in the question to 'applying the same approach' as for clearing. However, in terms of the trading obligation there are a number of considerations that should be taken into account:

- Whether the product is subject to mandatory clearing (and therefore reasonably standardised)
- Whether there is sufficient trading liquidity in the product both on a current and ongoing basis
- What the levels and types of activity in the contract are and which types of counterparties are involved and their ability to meet an obligation to trade on an eligible platform (i.e. should certain counterparties be exempt)
- What the capacity of existing market infrastructure is to absorb a shift of trading to eligible platforms
- Whether the transaction is of large notional or block size and therefore should be excluded from the trading obligation

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

No. We do not believe it follows that just because a product is cleared it should necessarily be mandated for execution on a trading platform. There are additional considerations that should be taken into account as described in our response to question 21. Furthermore, the answer depends on what qualifies as an eligible trading platform is defined (see response to question 20).

In general, if a product is mandated to be cleared and reported then appropriate execution methods will evolve taking into account criteria such as the number and types of participants and the liquidity profile of the product. The removal of credit as a trading factor creates an opportunity for new entrants to enter the market and compete with existing participants, driving competition and execution innovation. This type of environment can be enhanced by anti-manipulation rules and surveillance rather than necessarily being prescriptive about methods of execution.

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?

Yes, we agree that mandatory execution requirements should not apply to any entity or transaction until, at a minimum, a CCP clearing mandate applies to such entity and transaction. Where there is insufficient liquidity and transparency of prices to support CCP clearing, then mandatory execution requirements would simply not be feasible.

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?

No comment.

<u>Section 5.2.2</u>

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?

We have discussed above the principle of supporting global, centralised data sets and repositories. One of the key impediments to this is local confidentiality and data privacy laws.

A number of jurisdictions place restrictions on the trade details that may be reported to a trade repository. Reporting participants may therefore face legal conflicts arising from local data protection and client confidentiality laws. Whilst obtaining client consent may mitigate these issues, there is a risk that consent may not be forthcoming or that this maybe insufficient in certain jurisdictions.

We believe the appropriate course is for relevant local laws to be changed to allow disclosure of such details in specific circumstances to support data gathering by repositories, including through third party service providers. This provision is present in European legislation. Until such conflicts are resolved we urge the Australian regulators to provide appropriate exemptions where local confidentiality laws prohibit trade reporting. In the meantime, data may need to be submitted by masking certain trade details such as client names. Even in doing this, submitting firms may face legal and reputational risks.

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?

Trade repositories should not be permitted to disclose reported data except to the submitter of that trade data and to fulfil regulatory reporting obligations. It is our view that data within any trade repository should remain the property of the submitter.

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

Trade repositories should not be able to use the data for any other purpose than for meeting regulatory reporting obligations. There should be no commercial use of data without the explicit consent of the submitting counterparty.

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)?

Sharing of data between TRLs should not be permitted except for meeting regulatory reporting requirements. Sharing of data between regulators should take account of specific privacy and confidentiality laws and should ensure requests are vetted and appropriate for the specific nature of the issue being investigated – i.e. there should be no open access to all data. There should be an equivalence in relation to data protection.

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?

Any public reporting of data should be done so in a manner which protects the confidentiality of market participants, market liquidity and ability to lay off risk.

Certain jurisdictions have proposed addressing this through reporting delays or exemptions. Exemptions and delays should be tailored not just to asset classes but to categories of types of swaps within those asset classes. A one-size-fits-all approach is almost certain to be inappropriate given the different levels of liquidity in different markets. For FX, dynamic reporting periods and block sizes based on liquidity factors and taking into account size to average notional in the market is clearly appropriate when considering different types of transaction and the full range of currency pairs. The key determining factors would need to be reviewed more fully but for FX could cover the following: Currency pair, product; size and tenor; time of day / year; and strike price.

Determining the appropriate calibrations and exemptions is critical to preserving liquidity for end-users. Sub-optimal disclosure may hinder a market maker's ability to hedge, impacting liquidity or increasing end-user costs to compensate for increased risk. It cannot be stressed enough how some instruments in the market have very low liquidity and the adverse impact immediate public reporting would have on dealers' abilities to make reliable markets for end-users. This also needs to take into account the 24 hour, global nature of the FX markets, where we see liquidity differ for certain currencies in each region at different times (for example Australian market hours will see greater Australian dollar trading).

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?

Please see our general comments above in response to question 4.

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?

No comment.

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)?

As discussed above, we believe that trade repositories should not be permitted to provide data to third parties except without the explicit consent of the owner of the data.

<u>Section 5.2.3</u>

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

We strongly believe that the data should remain the property of the submitter.

<u>Section 5.3</u>

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?

No comment.

<u>Section 6.2</u>

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

We agree with the factors identified in section 6.2, but draw attention to several additional and/or more detailed factors noted in our response to question 18 above.

In reviewing a class of an OTC derivative for mandatory clearing, we urge Australian authorities to require specific information from CCPs on the end-to-end testing conducted with its clearing members for that market. For example, in the case of FX derivatives (e.g., FX NDFs), specific information should be required on:

(1) the scenario analyses / stress testing performed by the CCP, the default management processes for the CCP and resulting impact on the underlying liquidity in the FX Product(s) that the CCP clears or plans to clear, and the arrangements in place to address management of sovereign risk events (e.g., suspension of trading, sovereign default, unexpected bank holiday or other significant disruption to valuation, payment or settlement processes; and

(2) a description of the manner in which the CCP has provided information to the central banks of the relevant currencies on its clearing of FX Products, including but not limited to (1) above, and a summary of any views expressed by the central banks to this information.

Because the FX market is a central component of the global payment system, central banks have expressed a need to understand and evaluate the impact of clearing by CCPs, individually and collectively, on the FX market from a broad policy perspective.

We also believe that the greater the relevance of the market, the longer the period of time the historical data should cover. The more critical the market is the overall financial system and liquidity in particular, the more rigorous the assessment of mandatory clearing should be to ensure the CCPs' clearing activities for the relevant class of derivatives does not become a source of systemic risk.

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

Please refer to our response to question 31 above.

<u>Section 6.3</u>

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

No comment.

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

We hope for continued dialogue with regulators. Experience of other consultations has shown that due to the nature of the FX market, it is valuable for market practitioners to engage continuously with the rule makers during any subsequent detailed rule making phase and we would offer for the GFXD to provide this ongoing liaison.

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We appreciate the opportunity to share our views on this consultation paper issued by The Treasury of the Commonwealth of Australia. Please do not hesitate to contact me at +44 (0) 207 743 9319 or at jkemp@gfma.org should you wish to discuss any of the above.

Yours sincerely,

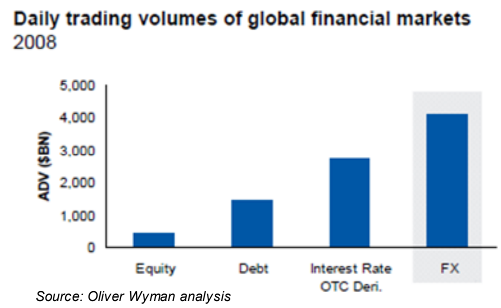
James Kemp

Managing Director

Global Foreign Exchange Division, GFMA[11]

[11] The Global Finanical Markets Association ("GFMA") brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA.

Appendix A

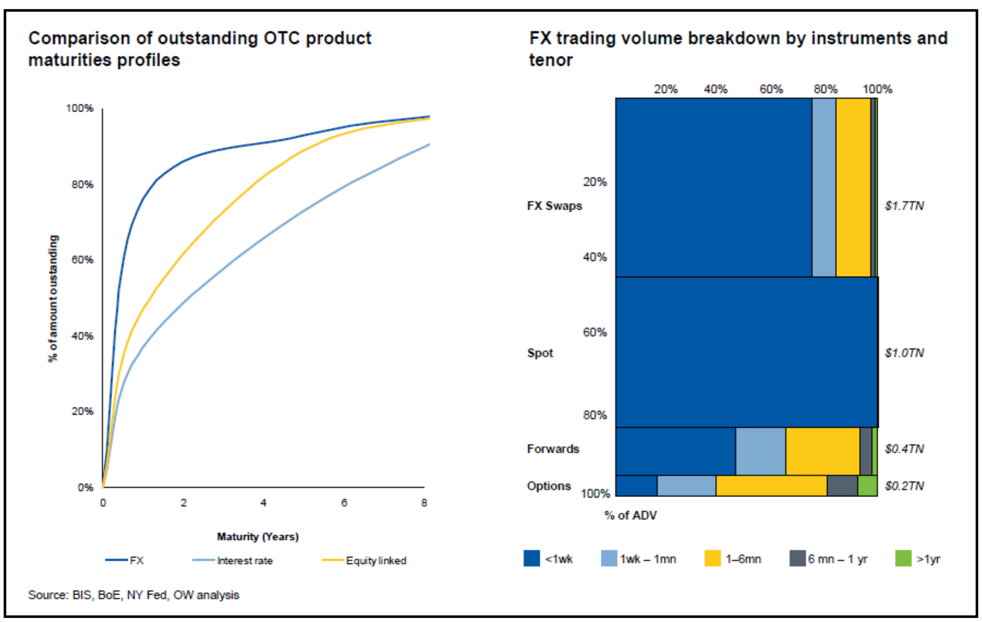


The FX market is the world's largest and most liquid financial market. It forms the basis for international trade and supports the functioning of the global payments system. Its importance in effecting monetary policy has been long established and as such has historically been subject to central bank oversight.

FX has many more participants and transactions than other asset classes. Notwithstanding this, the vast majority of transactions are simple, comprising spot, forward or swap transactions. Forwards are simply an agreement to exchange principle at a pre-determined rate, whilst swaps are simply a combination of i) a spot and a forward or ii) a forward and a forward. Crucially, there are no contingent outcomes for these types of transactions; cash flows are known at the outset. BIS data shows that these products accounted for 95% of 2010 daily traded volumes.

Instrument	1998	%	2001	%	2004	%	2007	%	2010	%
Spot	568	*37%*	386	*31%*	631	*33%*	1,005	*31%*	1,490	*38%*
Outright forwards	128	*8%*	130	*11%*	209	*11%*	362	*11%*	475	*12%*
Swaps	734	*48%*	656	*53%*	954	*50%*	1,714	*52%*	1,765	*45%*
Options and other	87	*6%*	60	*5%*	119	*6%*	212	*6%*	207	*5%*
Total	**1,517**	***100%***	**1,232**	***100%***	**1,913**	***100%***	**3,293**	***100%***	**3,938**	***100%***

Additionally, the vast majority of FX transactions are short term. The chart that follows on the left contrasts the short maturity profile of outstanding FX instruments with those of interest rate and equity derivatives. The 16% of outstanding FX contracts with maturities longer than 2 years contrasts with more than 55% of interest rate derivatives and 40% of equity derivatives with maturities longer than two years. Of daily traded volume in 2007, more than 98% of FX forwards and 99% of FX swaps were of maturities of less than a year, as illustrated in the chart that follows on the right.



The BIS Triennial survey from 2010 sets out the following statistics for foreign exchange market activity for Singapore. Outright forwards and swaps comprise, according to the BIS, USD 158bn

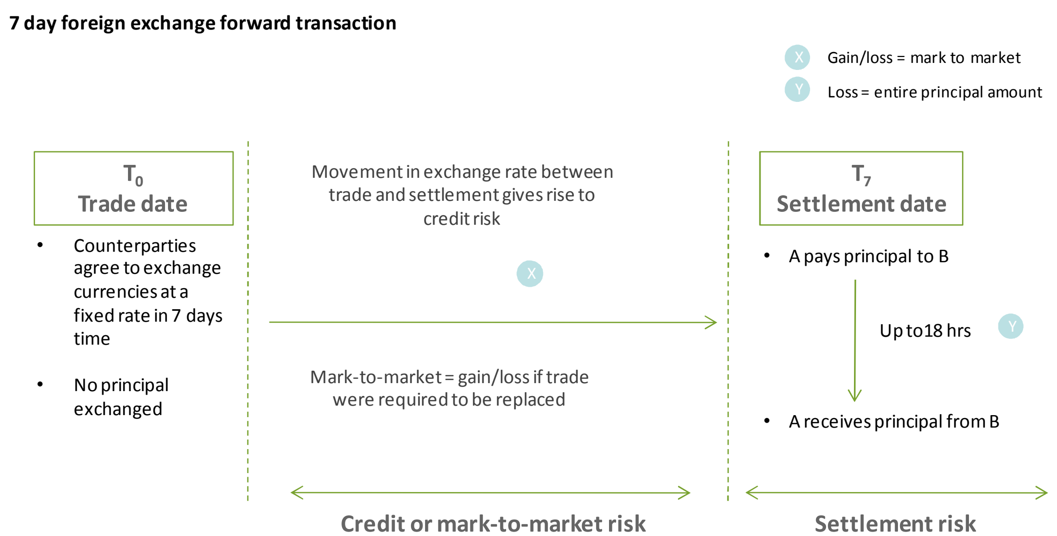
USD of USD 174bn (c. 91%) of all non-spot foreign exchange activity with the remaining 9% representing options. The majority of activity is under 1 year in maturity.

% share of trades	<= 7 days	> 7 days and <= 1year	> 1 year
Outright forwards	16	81	3
Swaps	76	24	1

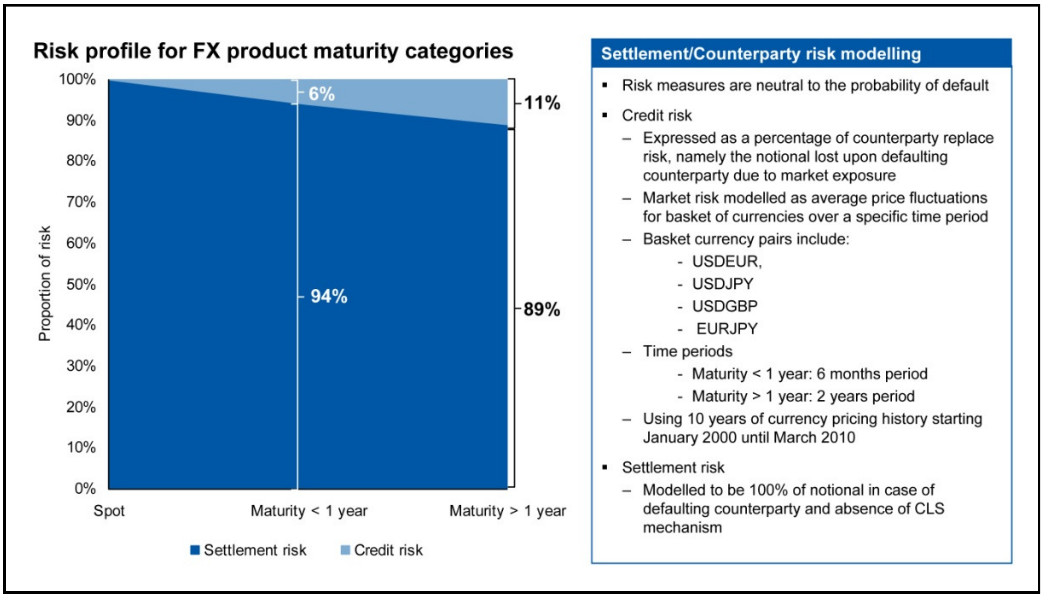
Note: The most recent SFEMC October 2011 figures confirm that similar to the global picture (and excluding currency swaps), FX forwards and swaps make up 16% and 44% of the Singapore average daily volume, with only 6% FX options and spot 34%.

Settlement risk is the key risk in foreign exchange transactions

FX transactions typically involve exchange of principal. These settlement exposures represent the key risk in a transaction. Because of their size, settlement risk loss may be sufficient to trigger insolvency, with knock on effects to other counterparties (commonly referred to as Herstatt Risk).



The graph below, based on an Oliver Wyman study, illustrates that settlement risk comprises 94% of the estimated maximum loss exposure in a trade for foreign exchange instruments with maturity of 6 months. This reduces to 89% for instruments with a maturity of 2 years.



Settlement risk is adequately addressed through CLS

CLS Bank was created in 1997 as a global settlement bank to address the concerns surrounding the systemic impact of potential settlement risk failures. By operating a payment versus payment model, whereby payments are process simultaneously, it eliminates virtually all settlement risk to its participants. CLS Bank settles almost 90% of all inter-dealer FX trades and has had no settlement failures since it was created. CLS is regulated directly by the Federal Reserve with the active support of all major central banks (including Reserve Bank of Australia). Efforts to extend the reach of CLS Bank are under way, with broad support from both FX dealers and central banks around the globe.

CCPs address mark-to-market credit risk. This is relatively small for FX transactions because of their short maturities.

Mark to market risk is the main residual counterparty credit risk not addressed by CLS. Since most foreign exchange contracts have short maturities, the foreign exchange rate is unlikely to change significantly between the inception and maturity of most foreign exchange contracts. As a result, the in-the-money portion of the trade tends to be small relative to the principal value. Accordingly, the potential loss on foreign exchange transactions consists overwhelmingly of settlement risk.

To put this into context, for FX trades with a maturity of less than one year, Oliver Wyman analysis approximates that only 6% of the maximum risk of loss is mark-to-market credit risk. This rises to only 11% for instruments with a maturity of 2 years.

Because of their short duration, these transactions stand in sharp contrast to most other swaps, for which counterparty risk is comprised almost exclusively of credit risk on the mark-to-market value of the swap, which is the risk that CCPs are primarily designed to address.

Mark to market credit risk is addressed through the widespread use of CSAs. These are particularly effective because of high price transparency and deep liquidity.

Credit support annexes ("CSAs") are heavily used in the FX market and are a particularly effective risk mitigation tool for addressing mark-to-market credit risk.

The deep liquidity and high price transparency of the market allows for a high level of confidence that initial margin levels will cover losses in these markets. Because the FX market is a highly liquid market in which prices are widely available 24 hours a day, market participants can also reliably determine the net amount of their exposure and therefore the appropriate amount of mark-to-market collateral.

Upon a default, the liquidity in the FX market means that the non-defaulting party can generally replace a transaction quickly and easily. Due to these characteristics of the FX market, existing bilateral agreements have been successful in mitigating counterparty credit risk exposures following the default of large FX counterparties, such as Lehman Brothers in 2008.[12]

The only portion of the foreign exchange market where trades are generally unsecured is where transactions are effected with corporates. Corporates use FX transactions to hedge business risks and do not generally have excess capital to use for CCP margining purposes. Aside from the issue of whether certain classes of FX are exempt from any clearing obligation, we assume that corporate would be subject to some sort of non-financial counterparty exemption, in line with other international proposals. Mandatory clearing would therefore not result in mandatory clearing for the portion of the market that is most often unsecured.

The remaining mark-to-market credit risk that would be addressed by a CCP is therefore minimal

A CCP for FX would deliver almost no incremental credit risk mitigation because most of that risk has been covered by CSAs. The Global FX Division has undertaken indicative analysis of dealers accounting for approximately 66% of the market (by reference to Euromoney league tables). This analysis indicates that approximately 85% or more of mark-to-market exposure in 2010 relates to counterparties (excluding corporates) for which CSAs have been put in place.

Applying the Oliver Wyman analysis that 6 month instruments have potential mark to market risk of 6%, we estimate the total remaining uncovered risk to be only 0.9%. On the same basis for FX transactions with maturities greater than a year, where 11% of the potential loss is mark-to-market credit risk[13], we estimate the total remaining uncovered risk to be less than 1.7%.

FX Market volume profile and Uncovered Credit Exposure (forwards & swaps)

	< 1yr Tenor	> 1 yr Tenor
Risk Profile:		
Credit / Counterparty Risk	6.00%	11.00%
Settlement Exposure %	94.00%	89.00%
CSA Usage @ 85%	5.10%	9.35%
Uncovered Credit Exposure	0.90%	1.65%

[12] Bank of England Foreign Exchange Joint Standing Committee. FXJSC Paper on the Foreign Exchange Market. September 2009. p. 2. ("**FXJSC**")

[13] These calculations assume that all trades under 1 year have the MTM credit risk vs. settlement risk breakdown of a 6 mo. trade, and that all trades over 1 year have the breakdown of a 2 yr trade (based on Oliver Wyman analysis). In reality, the MTM credit risk number is probably even lower, since 68% of FX forwards and swaps have a maturity of less than 1 week.

Introducing a CCP to address mark to market credit risk would be disproportionate, increase operational risk and potentially systemic risk, and undermine the effectiveness of existing efforts further to address settlement risk.

Settlement of FX transactions involves extensive interconnectedness across payment and foreign exchange systems. This is illustrated by the relationships that CLS has with central banks to facilitate the funding process that supports payment-vs-payment settlement.[14]

A central clearing regime would be either global or accomplished through a network of local CCPs. A global CCP for a market the size of the FX market would pose significant systemic risk. Local CCPs would fragment the market and reduce liquidity through the dispersal of trades, positions and collateral across many jurisdictions.

The charts below illustrate the increased operational complexity and interdependencies that one or more CCPs would likely introduce into the FX market. Given the importance of foreign exchange to the global payments system, any CCP would require the same operational infrastructure, robustness and oversight currently afforded to CLS Bank.

A CCP would also introduce concentration risk, creating a potential single point of failure where none exists today, simply to address limited residual credit risk exposure. CCPs can and have failed – largely as a result of financial distress arising as a result of unmet margin calls. Because the FX market is an integral part of the global payments system, the failure of an FX CCP would likely be significant, with destabilizing effects on foreign exchange and the global economy as a whole.

Introducing CCP clearing also risks undermining the significant gains that have been made in addressing settlement risk. Efforts to introduce a CCP model could either distract from current industry plans to increase usage of CLS Bank, or worse, cause participants to cease using CLS Bank, for cost or operational reasons, thereby increasing settlement risk.

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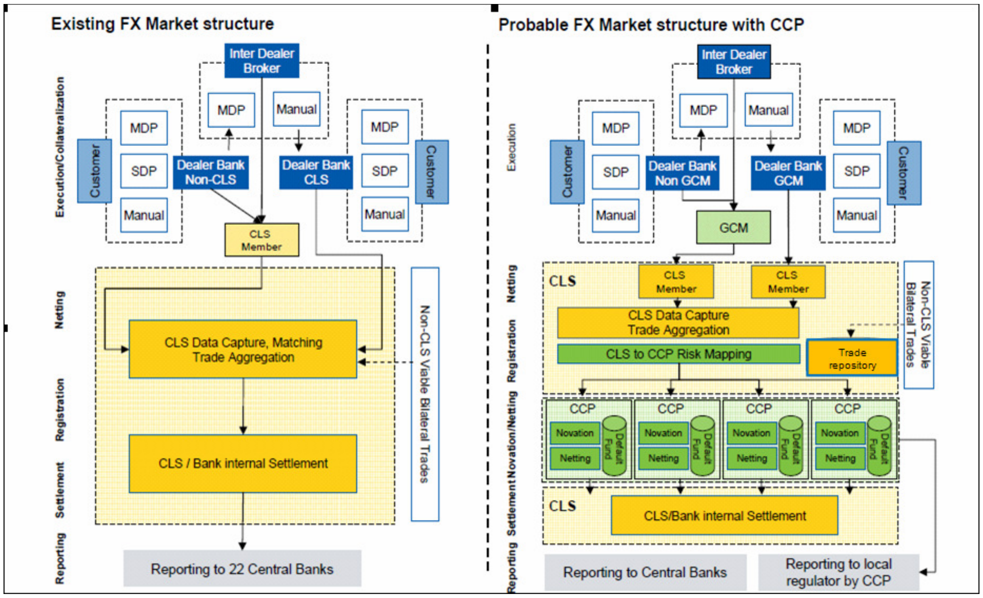
[14] In its 2008 review of the interdependencies of payment and settlement systems, the CPSS concluded:

"Over the past 30 years, technological innovations, globalisation and financial sector consolidation have fostered a broad web of interconnections among a large number of payment and settlement systems, both within and across CPSS countries. These interconnections reflect efforts on the part of systems and institutions to seek new business opportunities and to reduce clearing and settlement costs. They also reflect efforts by central banks and the financial industry to promote the low-cost and safe transfer of money and financial instruments. The focus of the CPSS on reducing foreign exchange settlement risk and the work of the G30 to reduce risk in securities settlement systems, for example, have both led to tighter, more integrated settlement processes."

"The development of tighter interdependencies has helped to strengthen the global payment and settlement infrastructure by reducing several sources of cost and risk. Yet, tightening interdependencies have also increased the potential for disruptions to spread quickly and widely across multiple systems and markets." Interdependencies Report, p. 1.



Overall, we believe that the significant operational risk and costs to the global payments system of implementing a mandatory CCP are disproportionate when compared to the benefits in addressing the 0.9% - 1.7% of mark-to-market credit risk for counterparties not using CSAs.

International convergence

The US Treasury is proposing to exclude FX forwards and swaps from the majority of regulations under the Dodd-Frank Act. The statute further exempts commodity swaps where physical delivery of the commodity is contemplated. FX is more closely related to this exempt class as it calls for the delivery of currencies. The Global FX Division has submitted a public response to US Treasury's recent invitation to comment on whether an exemption is warranted. It is also seeking to ensure that appropriate exemptions are secured under the equivalent European OTC derivatives legislation.

The proposed determination would mean that FX forwards and swaps would not be regulated as swaps under Dodd-Frank. Most importantly, this means they would be subject to neither mandatory clearing, nor mandatory trading on Swap Execution Facilities or DCMs, nor the real-time public reporting requirements. They would also be exempt from the proposed margin requirements for uncleared swaps. The proposal has clear implications for regulatory convergence, particularly in a market as liquid and global as FX.

In reaching its proposed determination, the US Treasury recognises the key characteristics of FX products and the way the market functions at present. The US Treasury:

- Acknowledges the high levels of transparency and liquidity existing in the FX markets as a result of the heavy trading on electronic platforms and the diverse availability of market pricing information
- Points to additional transparency through trade reporting to a trade repository, the requirements of which are already being addressed with GFXD members through the recent announcement of the DTCC and SWIFT as partners to provide global FX trade repository services.
- Recognises the unique factors limiting risks in the FX forwards and swaps market, pointing to the fixed terms (i.e. non-contingent outcomes), the physical exchange of currencies, the well-functioning settlement process and the shorter duration of contracts.

- Highlights the existing strong, comprehensive and internationally coordinated oversight framework prevalent in the FX markets.

In terms of identifying OTC derivatives that are capable of being cleared, we believe the overriding objectives for regulators should be to implement measures that are proportionate to the systemic risks being addressed. Consideration should therefore be given to whether mandatory clearing is a proportionate response when taking into account the pertinent systemic risks, which for FX comprise settlement risk that far outweighs counterparty credit risks that CCPs address, and the measures that are already in place to deal with those risks. The analysis should also take into account factors such as the cost of clearing and the ability of the CCP to deal with and manage the volume and risks (including risk of default) associated with clearing of relevant contracts.