Implementation of a framework for Australia's G20 over-the-counter derivatives commitments

Response to April 2012 Consultation Paper – 20 June 2012

To: Manager, Financial Markets Unit, Corporations and Capital Markets Division, The Treasury.

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This submission is prepared in response to the Consultation Paper referred to above. It is made on behalf of those banks named above (the "Group" or "We") in their role as market participants and liquidity providers and reflects a common view on the proposals contained in the Consultation Paper as they relate to their markets businesses. Other submissions may be presented by any or all of the Group reflecting particular issues that require an individual response.

In general, we are broadly supportive of the approach taken in the Consultation Paper and believe the course proposed will assist in meeting the G20 commitments. We have in subsequent pages provided responses to the questions asked. In approaching these questions the key themes remain ensuring the Australian framework is as consistent as possible with other international regulatory regimes, that requirements on the Australian market should not disadvantage or dislocate a functioning market.

In view of other countries' efforts to meet the G20 commitments we expect a number of countries to create some form of mutual recognition or substituted compliance. Our expectation is that some form of mandate would be required for clearing and trade reporting to maintain a consistent position with other jurisdictions and achieve equivalence or substituted compliance where available.

The Group has also raised some other issues which require attention and may be the subject of specific individual feedback from members of the Group, including:

1. Potential Withholding Tax concerns in relation to dealing with offshore Central Counterparties and brokers The impact of the Personal Property Securities Act on clearing and margins held by Central Counterparties

2. Requirements to amend standard International Swaps & Derivatives Association (ISDA) Agreements in order to meet offshore requirements

3. The impact of the Bankers' duty of confidentiality and potential privacy concerns in relation to trade reporting

4. The need to ensure trade compression is mandatory in any future CCP servicing the AUD interest rate derivative market.

Responses to Individual Questions

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

We are comfortable with the approach outlined in 3.1 subject to the definitions of transaction and party (see below).

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

In general, we support the approach taken. We would point out that any definition should be clear, unambiguous and consistent with other regulatory regimes (in particular the US and the EU).

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

Yes. Setting too broad a definition of 'party' without adequate exemptions could, in the case of clearing requirements, cover entities which may not be able to meet the requirements of initial and ongoing (i.e. variation) margin posting, and lock them out (effectively) from OTC Derivative markets. Our preference is that certain entity types ought to be excluded from the obligation to comply with the reforms. These entity types should be identified in the Corporations Act, and lower level law be used to provide further definition in a way that may be responsive and adaptable.

Equally, the framework's applicability to foreign entities may cause some problems. Take as an example the situation of an Australian user (which may or may not be exempted) transacting with a foreign entity with no other connection to Australia. In that case, clearing and or trade reporting may or may not be required of the Australian entity, while the foreign entity might be subject to reporting and clearing requirements offshore. In such a situation, how would regulators in Australia oversee clearing and ensure trade reporting? Extra-territoriality and harmonisation of laws is one of the most fraught aspects of the regulation of something as international as derivatives, and we would like this aspect very clearly resolved as it applies to each strand of derivatives law reform.

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

Similar to the comments for question 3, the scenario described would result in clearing potentially via a clearer not eligible in Australia. If the Australian counterparty was not in a position to dictate the clearer for the deal, how would the Australian counterparty be left? It cannot clear to an eligible clearer as the foreign counterparty has the right to determine the clearer, and would be forced to clear to an ineligible clearer. We would recommend the definitions and regulations are consistent with offshore regulatory regimes and deal with conflicts raised above.

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

Yes, however the safety and risk controls of the eligible facility need to be taken into account when determining the criteria which is considered non-discriminatory. As an example, some discrimination based on capital and financial strength must be available to CCPs.

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

Provided the requirement for ASIC to consult with the other regulators and stakeholders and to take the comments into consideration when determining rules promoting the functioning of the market is a hard requirement, we are comfortable with the proposed powers.

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

These time periods should permit full consultation by ASIC with market participants, as well as with other Australian (and as necessary, offshore) regulators. The length of such consultation and the length of implementation periods (relevant to question 8 below) should vary as appropriate to the content of the DTR. Some factors which could be relevant include:

(a) Whether the DTR imposes obligations involving significant investment or new processes for participants.

(b) Whether the DTR takes a different approach to that taken by offshore regulators.

(c) Whether the DTR implements new reforms / obligations, or modifies existing ones.

In relation to the last point, it is almost certainly the case that some of the reforms to derivatives markets globally will have impacts that are not fully understood or appreciated at the moment. Some of these could be adverse to markets and regulators' objectives. Something consistent with the Australian government's very deliberate and considered approach to derivatives reform would

be an ability for agencies to immediately scale back a piece of regulatory reform if it appears that its impact is unacceptably adverse, or requires more consideration before its implementation is continued. Particularly in this situation, we would be supportive of the Government's proposal to be able to make rules "expeditiously, should the circumstances warrant this".

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

We don't believe a set timeframe can be set: the time required will depend on the scale of the change which results from each DTR and the level of technical or technological changes required. A DTR may require changes only of a configuration nature (hence easily achieved), while other DTRs may require considerably more work effort and change. In the absence of knowing all of the details it is difficult to respond to this question.

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)?

We agree that broad exemptions would be appropriate and should be set in a manner which allows some flexibility. There is a difficulty with fixed thresholds as they then introduce artificial strata to markets, with consequent impacts as parties creep close to a threshold. Qualitative criteria would be preferred which enable counterparties to be exempted up-front based on the nature of their business or dealings in derivative products (eg derivative use for hedging). There should also be other exemptions available on a case by case basis

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?

Backloading of transactions to trade repositories represents less of a concern than backloading of bilateral trades onto a central clearing platform. However, even backloading historical transactions to repositories (depending on what exactly is required for these) could present a significant burden on industry that should be carefully considered before being implemented.

We would suggest that a mandatory obligation regarding backloading of transactions to central counterparties ("**CCPs**") would be particularly inadvisable, for the following reasons:

(a) Novating a transaction to a CCP has an economic impact. This might be positive or negative to one or both parties. Regardless, it is an impact that was not necessarily considered at the time that the pricing of the transaction was agreed. It therefore represents the potential to disadvantage participants.

(b) Various commentators on global OTC reform have suggested that backloading of transactions to CCPs, where it has been debated in other jurisdictions, could be associated with legal challenges, as a result of its retrospective impact. We do not express any view on this point, but would suggest that it be closely considered before any backloading obligation is imposed.

(c) It is not possible for a market participant to unilaterally comply with a backloading obligation, without the agreement of the counterparty, each party's clearing intermediaries (if applicable) and the relevant CCP. We would like to avoid being subject to a mandatory obligation that cannot be met.

Our view is that backloading of historic transactions to CCPs is best approached by reliance on (using the wording from question 16) "market forces and … other mechanisms, such as capital incentives".

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?

Transaction reporting should not be required in respect of any transaction type that is not mandated for reporting by both the EU and US, for these reasons:

(a) To achieve desired goals of international harmonisation.

(b) If "Australia-specific" aspects of transaction reporting are kept low, costs of accessing the services of already-established offshore repositories like DTCC will be too.

(c) Compliance by internationally-active participants will be more efficient if the marginal cost of compliance is low.

(d) There would not seem to be any aspect of transaction reporting that is unique to Australia that would justify a departure from the principles of transaction reporting which have developed internationally.

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?

Yes, however we believe there should be exclusions for end-users as they generally will not have the capacity to report these transactions. Transactions conducted via electronic trading venues and/or CCPs should be reported by those facilities. Reporting of uncleared trades is a significant issue for the industry and care must be taking when prescribing such reporting. The US regime has attempted to deal with this issue by ensuring as much as possible that the "counterparty that has the easiest, fastest, and cheapest access to the set of data in question" be the one that report. [75 FR 76581]. Swap dealers, major swap participants, trading houses and clearers are more likely to possess the resources and technological wherewithal to report, whereas unsophisticated end-users are not.

Regarding reporting obligations on foreign entities, reporting of a transaction that is subject to different reporting obligations in different jurisdictions is less problematic than a situation where inconsistent clearing obligations are imposed. However, our view is that efficiency and comity is best served by having:

(a) a clear and simple Australian requirement in relation to what parties are captured by transaction reporting obligations;

(b) no broad extra-territorial reach;

(c) such approach enshrined in the Corporations Act - in the interests of market certainty.

Our suggestion is that this nexus be no more aggressive than covering transactions booked by a party in Australia. Consequently a trade entered into by a foreign entity's Sydney branch would be reportable in Australia, whereas a trade entered into by an Australian bank's Singapore branch would be reported in Singapore and not Australia. We would suggest that the following connections to Australia are too remote to be applied in the context of transaction reporting:

(a) contracts denominated in Australian dollars;

(b) contracts where the underlying reference entity is resident or has a presence in Australia;

(c) contracts traded by market participants having a presence in Australia, where by "presence" we mean something less concrete than a booking branch used to book the relevant transaction.

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

Most end-users or small/irregular users.

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

It is difficult to suggest metrics for setting such thresholds other than notional face value of individual transactions. Otherwise there would be a need to define a series of metrics for counterparties which would complicate the process.

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?

Please refer 13.1

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?

See 12 &13.1

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?

Include a broad range of derivatives consistent with requirements in the US and EU..

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

No, subject to the comments in answer to questions 2 and 11

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?

Yes, however practical implementation requires co-operation between regulators and trade repositories. A trade by a foreign bank with a domestic (exempted) end-user should be available to a domestic regulator.

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?

While we would expect, over time, higher capital requirements to encourage clearing, the time frame is uncertain and adoption would be subject to individual circumstances. There are also international regulatory alignment considerations to be taken into account. If equivalence or substituted compliance are available from offshore regulators, we would expect a mandate to clear to be required to achieve this result.

In our view a mandate is sensible provided market inefficiencies are avoided and local regulatory requirements are met by prospective CCPs.

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

We believe end-users should be exempt for hedging activities.

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

We believe intent (ie to hedge a commercial exposure) should be the primary consideration rather than thresholds which may capture hedging activity.

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?

The Group's view is that if a counterparty is making markets or is a significant swap user they should be required to clear. However, it may be necessary to consider various ways of determining what entities should clear, and relevant to this would be how the Australian framework interacts with regimes offshore.

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

Refer 17.1

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

Hedging transactions for end-users: clearing hedging transactions complicates the economics and treatment of hedge transactions.

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. In addition, care should be taken when proposing rules to consider the position of smaller financial institutions. If clearing for these counterparties were mandated, they would potentially require third party access to clearing as they would be unlikely to qualify for direct access. Our experience shows this is not a trivial exercise. At the very least, transitional arrangements would be required for these counterparties.

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

In principle yes, however this approach would present a problem if one side is Australian, while the other is offshore and not required to clear the trade (outside the G20) but would be required to clear if Australian. Further, what would happen if an AUD deal is required to be cleared by the offshore jurisdiction in a CCP which is not eligible in Australia? We would recommend the requirements be kept consistent with requirements in offshore jurisdictions and market practice.

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.

We agree with the Council's advice that it would be premature to impose any mandatory obligation to execute on trading platforms, for the reasons enumerated in 4.4.1. Some other observations in support of the Council's position include:

(a) The G20 commitment wording recognises that it is not always appropriate for derivatives trading to take place on organised trading platforms.

(b) A mandate requirement which forced the market into a limited range of derivative transaction types linked to particular platforms could potentially increase systemic risk, as clients would not have the ability to hedge their unique risks (or face basis risk in trying to do so).

(c) Public transparency can have downsides as well as benefits. Commentators on the US and EU reforms on SEFs / OTFs have noted some downsides for markets that are mandated to trade on platforms. Partly for this reason there is significant debate within the US about how a mandatory trading obligation ought to be structured.[1] Not implementing a trading mandate as part of initial reforms would provide Australian law-makers with the benefit of seeing how this area develops offshore before proceeding.

(d) In volatile markets, participants may prefer to negotiate bilaterally with counterparties, and not via platforms. Market disruptions may in fact be caused by blocking this access.

[1] *The Voice of Reason?* Peter Madigan *Risk Magazine* May 2012, page 25

According to ISDA, during the financial crisis there was a significant drop in volumes in standardised, plain vanilla exchange traded contracts.[2]

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?

Our view is that clearing and platform trading should be approached separately in acknowledgement of the unique factors that are relevant in mandating them. Consequently a specific product might have sufficient characteristics to permit it to be cleared by a CCP, and yet not meet the criteria to be required to be traded on a platform.

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

Only if there is sufficient liquidity. While a CCP can step between 2 counterparties and take credit risk, enforcing trading on a trading facility requires liquidity: available buyers and sellers in the volume and product, term, reference etc are required. These are quite different considerations. Analysis of trade data is required before being able to mandate trading.

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?

We believe any mandate should be deferred until the market develops.

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?

[2] Comments by the International Swaps and Derivatives Association, Inc. (ISDA) on the Consultation Paper on the Proposed Regulatory Regime for the Over-the-Counter Derivatives Market in Hong Kong, 30 November 2011.
http://www2.isda.org/attachment/Mzk2OQ==/Response%20to%20HK%20CCP%20and%20TR%20Paper.pdf

Please refer to our answer to Question 23

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?

Yes, particularly where such reporting puts the reporting counterparty in breach of either foreign law or contractual restrictions. Our preference would be for laws in all relevant jurisdictions to facilitate transaction reporting, to meet both local and offshore requirements, by overriding any legal barrier in the local jurisdiction. We ask that Australian lawmakers do this as soon as is possible as a part of the reforms contemplated in the Consultation Paper.

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?

Should be restricted to parties submitting the trade and domestic regulators

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

Data should be strictly segregated and used only for statutory requirements or for use by the submitting party only.

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)?

They should be able to share on a mutually agreed basis, subject to the consent of reporting parties.

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?

We would suggest an approach of watching how public (as opposed to mere regulatory) reporting unfolds in the US before considering implementing any public reporting regime in Australia. Under the US rules, a delay of as little as 15 minutes would apply in respect of large trades. In illiquid markets it is possible that traders will have insufficient opportunity to hedge sensitive risk, and the market will move against them before hedges can be executed. ISDA and SIFMA have noted that a result of this is that:

> *liquidity providers will build into their prices the likelihood (in fact the near certainty) that the market in the infrequently traded instrument will move against them following the release of the trade information to the public. The result will be higher hedging costs for the dealer and less liquidity and higher transaction costs for investors.*[3]

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?

In the interests of achieving significant efficiency, we would rather the repositories being built for compliance with various foreign regimes are able to extend their offering into Australia.

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?

We have no comment at this stage

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)?

They should be required to obtain the consent of the submitting parties

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

[3] ISDA and SIFMA submission to CFTC RIN 3038–AD08 – Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 14 May 2012. https://www.sifma.org/workarea/downloadasset.aspx?id=8589938714

The data should remain the property of the submitting party.

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?

The concerns for Australian law-makers / regulators that location requirements would address would be quite different in the case of FMIs such as: (i) CCPs; and (ii) transaction repositories. We would prefer that any location requirement imposed on a type of FMI be supported by public policy objectives which are appropriate to such FMI. For trade repositories, provided it meets requirements for access and security, there should be no location requirement.

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

Yes. We would suggest as additional factors:

(a) Australian or foreign law conflicts presented by the obligation (e.g. breach of customer secrecy laws);

(b) Other areas where Australian law should be reformed to permit the obligation being implemented in a way which is not unnecessarily adverse to participants (e.g. removing interest withholding tax on interest payments in relation to collateral exchanged as a result of clearing).

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

No

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

As far as possible, trade information requirements should be consistent with global requirements

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

No, we would consider at the time of future consultation.

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