ISDA® Safe, Efficient Markets

1 August 2014

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

Email: financialmarket@treasury.gov.au

Dear Sirs,

AUD-IRD Central Clearing Mandate

The International Swaps and Derivatives Association, Inc. (**ISDA**) [1] is grateful for the opportunity to respond to the proposals paper on the "AUD-IRD Central Clearing Mandate" issued by the Australian Treasury (the **Treasury**) in July 2014 (the **Proposals Paper**). The industry supports Australia's commitment to implement mandatory clearing as part of the G20 over-the-counter (**OTC**) derivatives regulation and support the proposed central clearing of Australian dollar denominated interest rate derivatives (**AUD-IRD**) by internationally active dealers such as those large domestic and foreign financial entities above the AUD 100 billion gross notional over-the-counter (**OTC**) derivatives outstanding threshold (otherwise referred to as the **AUD 100 billion clearing threshold**) with significant cross-border activity (referred to as **Dealers**). Some of our members may have their own views on different aspects of the Proposals Paper and may provide their comments to Treasury independently.

Entities subject to the clearing mandate

As an overarching comment, it is of utmost importance that the clearing mandate is not extra-territorial in nature. The clearing requirement should not be imposed on any foreign financial entity, rather it should be restricted to a foreign company registered (or a foreign company which ought to be registered) under Division 2 of Part 5B.2 of the Corporations Act 2001 (**FI**) or a foreign Authorized Deposit-taking Institution (**FDI**) that exceed the AUD 100 billion clearing

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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threshold for their transactions that are "entered into" in Australia and should only apply to the transactions that are "booked in" Australia. In other words, for an FI or FDI, only the G4 and AUD-IRD transactions that are "booked in" Australian branches will be subject to the clearing mandate. As the aim for central clearing is to promote financial stability in Australia, transactions that are "entered into" in Australia but booked to another jurisdiction do not impinge on Australia's financial stability as the risk for these transactions do not reside in Australia but in the jurisdiction to which it is booked. Similarly, the AUD 100 billion clearing threshold should also be based on transactions that are "booked in" Australia only. However, as there may a portion of transactions that are "entered into" in Australia but not "booked in" Australia and to facilitate the policy objective of determining a "large foreign financial entity with significant levels of cross-border activity"[2], we accept the proposal that the AUD 100 billion clearing threshold should be based on outstanding gross notional of OTC transactions that are "booked in" and "entered into" in Australia. As noted earlier, the risks for transactions that are "entered into" in Australia do not reside in Australia and therefore these transactions should not be subject to the clearing requirement, although they may form part of the AUD 100 billion clearing threshold calculation.

However, if "entered into" in Australia transactions is to form part of the population of transactions that count towards the AUD 100 billion clearing threshold, there is an urgent need for a practicable and workable solution to define what constitutes an "entered into" in Australia transaction. As you may be aware, under the Australian Securities and Investment Commission (**ASIC**) Frequently Asked Questions[3] (**FAQ**), relating to the interpretation of ASIC's Derivative Transaction Rules (Reporting) 2013, the definition of "entered into" in Australia means the "place where the acceptance of the offer to enter into the contract is received, where an instantaneous form of communication is used to communicate the acceptance"[4]. Although this definition is based on Australian contract law, there are significant practical issues in implementing and determining which transactions, including historical transactions, should be classified as transactions which are "entered into" in Australia and count towards the AUD 100 billion clearing threshold. According to ASIC's guidance, when determining if a transaction is "entered into" Australia, it would require a financial entity, at the point in time the contract is entered into, to identify the location of not just its own personnel but also its counterparty's relevant personnel at that particular point in time. This information would need to be ascertained every time a transaction is entered into and impacts the determination as to whether a transaction should be classified as "entered into" in Australia. Even where the location of the representatives of each FI or FDI entering into a transaction can be determined with any certainty and recorded, the question of where a contract is formed through offer and acceptance will vary on a trade by

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2 http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Central%20clearing%20of%20OTC%20AUD/Key%20Documents/PDF/Proposals-Paper-20140707.ashx, Australian Treasury, *Implementation of Australia's G-20 over-the-counter derivatives commitments*, Proposals Paper, AUD-IRD Central Clearing Mandate, Page 2, July 2014.

3 http://www.asic.gov.au/asic/asic.nsf/byheadline/ASIC-Derivative-Transaction-Rules-%28Reporting%29-2013-—-FAQs?openDocument, Australian Securities & Investments Commission, *Derivative Transaction Reporting and Trade Repositories – FAQs*.

4 http://www.asic.gov.au/asic/asic.nsf/byheadline/ASIC-Derivative-Transaction-Rules-%28Reporting%29-2013-—-FAQs?openDocument, Australian Securities & Investments Commission, *Derivative Transaction Reporting and Trade Repositories – FAQs,* Question 4, 6 June 2014.

trade basis as the fact pattern relating to each verbal/written/electronic dialogue forming the transaction will differ. It will only be possible to determine where the offer and the acceptance have taken place after a transaction is executed and Dealers are likely to face significant costs and resource challenges in training personnel or hiring legal experts who are able to undertake relatively complex legal analysis to identify offer and acceptance for each trade in the applicable reporting timeframes. Due to the uncertain and subjective nature of such analysis it is very likely that counterparties will come out with different conclusions in respect of the same trade resulting in further inconsistencies in the data reported to the trade repository. No other regime in the region or globally currently requires derivative market participants to undertake this sort of analysis and the costs involved will be very significant for the industry with a result that does not necessarily meet the overarching G20 policy goal of greater transparency for ASIC as the quality and consistency of data is likely to be negatively impacted. The costs of auditing or enforcing such reporting obligations are also likely to be very significant. The resulting additional regulatory burden for reporting entities who engage with the Australian market also appears to be inconsistent with the Australian Government's deregulation agenda, in particular its objective of reducing the annual cost of red tape for business.

Consequently, to reduce the substantial regulatory and compliance burden in determining the AUD 100 billion clearing threshold, the concept for "entered into" in Australia needs to be redefined from the current Australian contract law based definition. The definition of "entered into" in Australia should not be based on an assessment of when and where a contract was "entered into" but should be based on a simpler and clearer test such as location of trader. Also it should not be the case that Dealers are required to incur very significant costs attempting to build and design systems and processes to address the legal and compliance risks associated with the determination of which transactions are "entered into" in Australia simply to determine if they have crossed the AUD 100 billion clearing threshold. Some Dealers may be able to avail themselves of the 'foreign entity' exemption under the reporting rules and, consistent with the policy goals underlying such exemption, should be able to continue benefit from the 'substituted compliance' relief that this exemption provides simply by complying with the substantially equivalent reporting requirements in their home jurisdiction

We support the proposal that the clearing mandate should only apply if both parties to the G4 or AUD-IRD transaction, which is "booked in" Australia, are subject to the clearing mandate, i.e., both parties to the transaction are either a domestic or foreign financial entity above the AUD 100 billion clearing threshold and party to the transaction that is "booked in" Australia.

Additionally, the choice of which CCP a Dealer chooses to use to clear its AUD-IRD transactions should not be dictated by the clearing mandate. The Dealers should be allowed the choice of clearing via CCPs located inside and outside of Australia. This is because Dealers would have existing connectivity with CCPs and would not need to conduct the necessary due diligence required for a new CCP. By allowing a Dealer to select a CCP of its choice, this will allow for a competitive environment as a Dealer would not be limited by the clearing mandate to only clear through a single CCP. The clearing mandate should only be introduced after a CCP in Australia, such as the London Clearing House (**LCH**), is open during Australian business hours. As the clearing mandate will place an obligation on the Dealers to clear their G4 or AUD-IRD through a CCP, a Dealer will be required to submit its G4 or AUD-IRD to a CCP for clearing. The CCP usually performs certain checks prior to accepting or rejecting the transaction for

clearing. To minimize the uncertainty surrounding whether a transaction will be rejected or accepted by a CCP, the Dealer needs to attain a response from the CCP as to whether that transaction would be accepted or rejected (also referred to as clearing certainty). This would in turn allow the Dealer to take the necessary steps to rectify the situation as needed. In order to increase clearing certainty and reduce the time period between when a transaction is submitted to a CCP and when it is accepted, the CCP should be open during Australian business hours to allow financial entities to submit their G4 and AUD-IRD transactions during the Australian time zone.

In order to address any difference in opinion between Australian and foreign regulators as to what constitutes an appropriately regulated foreign CCP (an issue which has caused considerable difficulty in the context of the EU and the US), the Australian OTC clearing requirements should allow for relief to foreign counterparties that are required to clear (or exempt from clearing) a particular transaction under substantially equivalent clearing rules in their home jurisdiction. Formal recognition of the equivalence or comparability of foreign clearing regimes will assist in minimizing conflict and overlap between Australian and foreign G4 or AUD-IRD clearing mandates and is in line with the challenge presented to national authorities by the G20 Leaders' St Petersburg Declaration (September 2013), to resolve cross-border issues relating to OTC derivative reforms and to defer to each other when justified "based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes"[5].

Response to specific questions

The remainder of this letter sets out our comments in relation to the specific questions posed in the Proposal Paper. The headings used below correspond to the headings used in the Proposal Paper.

QUESTIONS

Question 1: Do you have comments on the specific benefits and costs of complying with a mandatory central clearing obligation for AUD-IRS, from the point of view of your business and/or that of your customers?

- **In particular, do you agree that the additional compliance costs of complying with a central clearing mandate for AUD-IRD would be low for internationally active dealers?**

The addition of AUD-IRD to the list of mandated products subject to a clearing mandate would not significantly increase the operational or compliance requirements provided only that the Australian clearing requirements permit Dealers to continue to clear via a CCP that they are already clearing through or because the Australian clearing mandate provide Dealers with substituted compliance relief/exemption such that a Dealer may meet its obligation under the Australian clearing mandate by complying with its home jurisdiction's clearing mandate where such mandate is substantially equivalent. In addition, the scope of transaction should be limited

[5] https://www.g20.org/sites/default/files/g20_resources/library/Saint_Petersburg_Declaration_ENG_0.pdf, *G20 Leaders' Declaration*, Paragraph 71, Page 17, September 2013.

to inter-dealer trades that are already being cleared rather than requiring Dealer's counterparties to sign up to new clearing arrangements.

A possible impact to clients may be the funding of Australian dollar, which is usually done earlier due to time zone differences. A client may need to setup a funding structure to handle margin calls, particularly if AUD-IRD are being cleared at a CCP located outside of Australia.

Question 2: With respect to benefits, do you have views on whether the imposition of a central clearing mandate for AUD-IRD would be likely to lead to substituted compliance benefits for dealers? If so, what would these benefits be, and would you be able to provide an estimate of the savings to your firm?

As you are aware, the United States (**US**) Commodity Futures Trading Commission (**CFTC**) introduced its first clearing mandate for certain interest rate swaps and certain credit default swaps under the Dodd-Frank Wall Street reform and Consumer Protection Act (**Dodd-Frank Act**)[6] in March 2013. Consequently, it is a possibility that the US authorities may expand the current product scope to include AUD-IRD as part of their clearing requirement. If AUD-IRD are mandated in the US and not in Australia, this may prevent Australia from attaining substituted compliance with the US. If AUD-IRD are mandated in Australia and subsequently implemented in the US, this should assist Australia in attaining substituted compliance with the US under the CFTC requirements. In much the same way Article 13[7] of European Regulation on OTC Derivatives, Central Counterparties and Trade Repositories[8] (known as **EMIR)** provides for a mechanism whereby transactions involving entities established in third countries which have regimes that are equivalent to the clearing requirements under Article 4[9] of EMIR, would be deemed to satisfy their obligations as stated in Article 4 of EMIR. Further clarity is needed on how Article 13 equivalence determinations will be made but the product scope of a clearing regime is likely to be an important factor even if it is based on an outcomes-based approach as recently recommended by the European Securities and Markets Authority (**ESMA**) in the context of Article 25 equivalence determinations.

It is important that substituted compliance is granted by both the jurisdictions involved, for example: Australia grants substituted compliance with the US and vice versa. This will allow foreign-based Dealers to comply with their home jurisdictions' clearing obligations and meet their clearing obligations under the Australian regime. Conversely, this will allow Australia-based Dealers to comply with their Australian clearing mandate and meet their foreign

[6] http://www.cftc.gov/PressRoom/PressReleases/pr6529-13, Commodity Futures Trading Commission, Press Release, *CFTC Announces that Mandatory Clearing Begins Today*, 11 March 2013.

[7] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF, Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ 27/7/2012, Article 13, L201/17, 27 July 2012.

[8] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF, Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ 27/7/2012, L201/24 - L201/25, 27 July 2012.

[9] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF, Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ 27/7/2012, Article 4, L201/17, 27 July 2012.

jurisdictions' clearing obligations. Substituted compliance should minimize any conflicting or differing clearing mandates between two jurisdictions, thereby promoting central clearing of products which may lead to increased transparency and liquidity in the cleared space, increased standardization of derivatives products and legal documentation. It should also be noted that the degree of reciprocity contained in the Australian requirements in the form of substituted compliance relief for counterparties complying with the European Union (**EU**) clearing requirements is also likely to be a key factor in any Article 13 equivalence determination under EMIR.

Question 3: Could you please comment on the incremental costs and benefits of merging the timing and the determinations for G4 and AUD-IRD?

We do not believe that there will be significant incremental costs of merging the timing for G4 and AUD-IRD if a Dealer is allowed to clear through a CCP that it is already using. The operational and compliance builds for the G4-IRD would be very similar to the requirements for AUD-IRD; hence, the incremental costs are not expected to be significant with the addition of AUD-IRD. The inclusion of AUD-IRD in the clearing mandate may assist in streamlining the operational requirements for clients as these clients will be able to treat all mandated currencies as "cleared transactions" instead of maintaining two separate portfolios, i.e., one for "cleared transactions" and the other for "non-cleared/ bilateral transactions".

It should be noted that the clearing mandate should apply only to products that are currently being cleared by a CCP and have sufficient product granularity to enable the industry to make a determination on which product types will be subject to the clearing mandate. Further we support the proposal that intragroup trades of a single corporate group for G4 and AUD-IRD should be excluded from the clearing mandate.

Question 4: Do you agree with the proposal to restrict ASIC rulemaking to entities that are considered to be dealers?

There exist financial entities which are as systemically important to the Australian financial system as the Dealers. Consideration should be given to the risk these financial entities may pose to the Australian financial system when extending the scope of the clearing mandate. It should be noted that in the US and the EU, the clearing mandate has been expanded to include financial entities that are not Dealers, such as swap dealers, major swap participant, Financial Counterparties (**FCs**) and non-financial counterparties above a clearing threshold (also known as **NFCs**+).

If such a clearing mandate is to be implemented for entities other than Dealers, we believe it should be phased in staring with the largest entities, followed by medium entities or entities with high volumes and lastly with smaller entities, with some exemptions, such as for end-users. For example: Phase 1 may capture Dealers, this may be followed by Phase 2 which will include entities with an AUD 50 billion clearing threshold (as per the criteria under ASIC Derivative

Transaction Rules (Reporting) 2013[10]). Lastly, this may be followed by Phase 3 which captures the remaining entities, possibly with another clearing threshold such as AUD 10 billion. The aim of this lower clearing threshold is not to take into account smaller entities which may lack the scale and infrastructure necessary to implement a clearing requirement.

Prior to restricting ASIC rulemaking to entities that are considered to be dealers, consideration should be given for the need to harmonize the clearing requirements across the various entity types and other jurisdictions, if the clearing mandate is expanded to include entities other than Dealers. This will assist in minimizing any potential regulatory arbitrage through a holistic oversight and prudential regulation of systemic risk across entity types as well as promote harmonization with global best practices as far as clearing mandates are concerned.

Whilst dealers are expected to be covered by the clearing mandate, it is important that the clearing mandate includes consideration of intra-group trades and ensures that trades between entities within the same group are exempt from the mandatory clearing requirement. Intra-group trades will be addressed in the reporting requirements and can be assessed for systemic importance.

Question 5: What are your views on the two options presented above to define internationally active dealers? Do you have views on additional criteria that should be used, or do you think that one or more of the suggested criteria should not be used? Or would you prefer a different methodology and if so, which one and why?

We prefer Option A with some amendments. The terms "domestic financial entity" and "foreign financial entity", as stated in points 1 and 2[11] of Option A in the Proposals Paper, are undefined terms. As internationally active dealers are defined as "domestic financial entity" and "foreign financial entity" above the AUD 100 billion clearing threshold, it is important that the definition of what is an internationally active dealer is clearly defined. As addressed earlier, foreign financial entities should only capture those which are FI's or FDI's. This will allow those entities to clearly determine if they will or will not be subject to the clearing mandate. Consequently, the concept of a domestic financial entity and an FI or FDI should align with the definition for reporting entities under the ASIC Derivative Transaction Rules (Reporting) 2013[12], such as an Australian Authorized Deposit-taking Institution (**ADI**) or a FI or FDI. Additionally, for this to be a workable option, some form of mechanism would need to be put in place that will enable the financial entities that are above the AUD 100 billion clearing threshold to identify themselves to each other.

[10] http://www.comlaw.gov.au/Details/F2013L01345, Australian Securities & Investment Commission, *ASIC Derivatives Transaction Rules (Reporting) 2013*, 9 July 2013.

[11] http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Central%20clearing%20of%20OTC%20AUD/Key%20Documents/PDF/Proposals-Paper-20140707.ashx, Australian Treasury, *Implementation of Australia's G-20 over-the-counter derivatives commitments*, Proposals Paper, AUD-IRD Central Clearing Mandate, Page 8, July 2014.

[12] http://www.comlaw.gov.au/Details/F2013L01345, Australian Securities & Investment Commission, *ASIC Derivatives Transaction Rules (Reporting) 2013*, 9 July 2013.

We support the clearing threshold of AUD 100 billion and we do not believe this threshold should be lowered. As noted earlier, this threshold should be based on transactions that are "booked in" Australia or "entered into" in Australia for the purposes of calculating the threshold only. For the threshold to include "entered into" in Australia transactions, it is imperative for a practicable and workable definition of what constitutes an "entered into" in Australia transaction to be agreed between the Australian regulators and the industry. The clearing mandate should **not** include transactions that are "entered into" in Australia and only trades that are "booked in" Australia should be subject to the clearing mandate. If "entered into" in Australia transactions are included in the clearing mandate, this would impose a clearing mandate beyond the Australian financial system, i.e., the clearing mandate would potentially apply to the non-Australian based branches or non-Australian based affiliates of a foreign FI or FDI and not just its Australian branch or entity. As noted earlier, due to the practical issues regarding the definition of "entered into" in Australia transaction, Treasury may wish to consider an alternative, such as some of the financial entities listed in the Financial Stability Board's list of globally systemically important banks (**G-SIBs**)[13] and are also a FI or FDI. However, it should be noted that not all G-SIBs listed would have a large presence in Australia; these financial entities would not pose a risk to Australia's financial stability; and they may not be large players within the global OTC derivatives market. Hence it may not be appropriate to subject such G-SIBs to the clearing mandate.

We do not see a need for point 3[14] of Option A of the Proposals Paper if the intent of the clearing mandate is to be confined to a relatively small set of internationally active dealers. For example, a foreign financial entity (which is not an FI or FDI) may have AUD 100billion or more of gross notional OTC derivatives outstanding with domestic and foreign financial entities. However, this foreign financial entity may have no presence in Australia (i.e. does not carry on a business in Australia and is therefore exempt form registration) and will not be under the supervision of the Australian regulators. In such an instance, the clearing mandate would be unnecessarily extra-territorial in nature. Furthermore, the domestic financial entity and the foreign entity would already be subject to the clearing mandate. Further, it would be very difficult to track and monitor which foreign FI or FDI falls under point 3 of Option A. It would require financial entities to track which counterparties are subject to the clearing mandate in Australia and they would need to continuously identify and track the gross notional OTC derivatives outstanding of all those counterparties.

We believe the clearing mandate should only apply to transactions between any domestic and foreign financial entity above the AUD 100 billion clearing threshold. As noted in the Proposals Paper, the intent of the clearing mandate is not to cover non-dealers at this point in time. Hence, the clearing mandate should not be applicable to any transactions with counterparties either one of which is below the AUD 100 billion clearing threshold.

[13] http://www.financialstabilityboard.org/publications/r_131111.pdf, Financial Stability Board, *2013 Update of Group of Global Systemically Important Banks (G-SIBs),* Annex I, Page 3, 11 November 2013.

[14] http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Central%20clearing%20of%20OTC%20AUD/Key%20Documents/PDF/Proposals-Paper-20140707.ashx, Australian Treasury, *Implementation of Australia's G-20 over-the-counter derivatives commitments*, Proposals Paper, AUD-IRD Central Clearing Mandate, Page 8, July 2014.

Option B is not preferred as an entity that is regulated as a swap dealer in the US should not serve as a proxy for Australia as the Australian financial market is different from the US financial market. A swap dealer in the US may have a large presence in the US but may have a small presence in Australia. Hence, its impact on Australia's financial stability would be much smaller as compared to a financial entity that is not a swap dealer in the US but may have a large presence in the Australian market. If the aim of central clearing is to promote financial stability in Australia, including entities that are regulated as a swap dealer in the US may not necessarily meet this objective. Although the use of swap dealer in the US as a proxy for which financial entity may be subject to the clearing mandate, may be a clearer test in identifying which financial entity would be subject to the Australian clearing mandate, for the reasons stated above, this will pose additional compliance costs, particularly for those swap dealers that have a small presence in Australia.

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

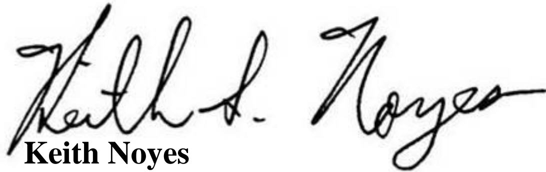
We believe the AUD-IRD mandate should be introduced prior to a similar mandate in any other jurisdiction but with an implementation start date that is similar to another jurisdiction, such as the US, as it is a possibility that the US would be the first jurisdiction to expand its current clearing mandate to include AUD-IRD as a product subject to the clearing mandate.

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

We have no major issues with the proposed timetable for implementing the central clearing obligation. As noted in our previous submission, a Dealer's ability to comply with the proposed timetable will be dependent on its ability to clear on either domestic or foreign CCPs which it is already clearing on, the availability of substituted compliance and the readiness of the Dealers to meet the Australian clearing mandate. We believe the harmonization of the AUD-IRD mandate with similar overseas requirements will be of benefit to the implementation of the central clearing obligation. If the clearing mandate is to be expanded to entities other than Dealers, we would like to request sufficient lead time be given to the industry to allow market participants sufficient time to prepare their systems and vendors to meet the clearing requirement.

Yours faithfully

For the International Swaps and Derivatives Association, Inc.



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