9 August 2014

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

Attention: Mr Michael Lim

By email: financialmarket@treasury.gov.au

Dear Mr Lim

AUD IRD Central Clearing Mandate

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the AUD IRD Central Clearing Mandate Proposals Paper. These comments build on the long standing dialogue which AFMA has with the Treasury and the other members of the Council of Financial Regulators (Council) and the support AFMA gives to the ongoing implementation of the OTC derivatives reforms. The response takes account of the Council's latest assessment report of April 2014.

There is general support among dealers for clearing mandates that reflect industry practice. As the Council in its April 2014 assessment report indicated there is clear evidence of an increase in central clearing in this market among Australian participants and substantially all new AUD-IRD transactions between dealers are now centrally cleared. This outcome has borne out the view put forward by AFMA during the policy development stage of the regime that market forces would lead to voluntary adoption of central clearing by dealers.

The primary reason for supporting the mandates comes from the assistance it gives to cross-border recognition and comparability assessments of the Australian OTC derivatives regime in a context where the Australian market has to a significant voluntarily embraced central clearing of appropriate derivatives.

Australian Financial Markets Association
ABN 69 793 968 987
Level 3, Plaza Building, 95 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

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

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

The Council in its April 2014 assessment report noted that substantially all new AUD IRD transactions between dealers are now centrally cleared. The dealers that are envisaged to be covered by the mandate are already subject to clearing mandates in other jurisdictions and have otherwise voluntarily adopted central clearing where appropriate so we are advised by our members that their costs would not significantly increase the operational or compliance requirements.

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?*

    - *If possible, please provide the same details as requested above with respect to the detailed breakdown of savings estimates.*

United States

The concept of "substituted compliance" arises out of US law and it is an ongoing concern that the level of desired cross-border recognition has fallen short to date of what was hoped for by industry. In the case that an Australian dealer can obtain a substituted compliance determination in relation to its clearing rules, based on the CFTC's guidance, any trading in mandatorily-clearable swaps conducted with a US person (other than potentially certain foreign branches of US banks) would always need to be cleared under US rules.

In the case of trading with non-US persons (with the exception of entities guaranteed by or conduited to US persons) the US rules do not have an effect. Therefore, a positive determination in relation to Australian clearing rules would most likely only present a potential benefit when Australian entities are trading with Australian branches of US banks, or Australian incorporated entities in the "guaranteed by or conduited to" category. This is a compliance benefit, albeit a small one. Potentially, a larger compliance benefit may come in relation to CFTC actions in other areas of rulemaking.

European Union

Equivalence recognition under European rules brings more direct tangible benefits for Australian dealers. Under the EU regime if a mandated Australian entity is transacting with a mandated European entity in relation to a commonly mandated derivative under their respective jurisdictions' regimes the counterparties can choose which regime to comply with. Therefore, an AUD IRD mandate presents a compliance benefit for Australian dealers in terms of EMIR equivalence.

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

In order to assist orderly business planning the G4-IRD and AUD IRD mandates should be formalised by the rules at the same time. However, it does not necessarily follow that implementation of the mandate rules should occur at the same time.

An important reason for introduction of the mandates cross-border coordination and to assist in substituted compliance recognition. ASIC should be allowed to decide on the appropriate timing for introduction of the mandates taking into account the need for international harmonisation.

The operational and compliance builds for the G4 IRD would be very similar to what would be required for AUD IRD, so additional costs are not likely to be great. The inclusion of AUD IRD cleared products may also streamline the operational demands on clients. The ability to treat all mandated currencies in the same way instead of having significant cleared and bilateral books (requiring separate bespoke processes) is a potential benefit.

4. *Do you agree with the proposal to restrict ASIC rulemaking to entities that are considered to be dealers.*

Extension beyond dealers at a later date

The US and European rules go beyond the dealer community for these types of mandates. There are significant financial counterparties outside of the dealer community that are systemically important to the financial system which may justify their inclusion at some point in the future. However, at this point a voluntary approach to this broader class of counterparties is preferred in Australia.

The reason for not including non-dealers in the initial implementation of the mandate centres on the present readiness with regard to systems of many counterparties to dealers. However, such a lack of readiness cannot be ignored in the longer term and this is an area where AFMA will work with its members and the regulators to hasten the adoption on a voluntary basis of central clearing so that in time a future extension of the mandate would not impose an additional burden on AUD IRD users.

It is suggested, therefore, that scope be allowed in the law for ASIC to extend the clearing mandate beyond the class of entities to be initially covered described in response to question 5.

It is important that an extension of the coverage should harmonise with mandates in other jurisdictions as they are settled.

Intra-group transactions should be excluded

Derivatives transactions within a group of an entity covered by the clearing mandate should be excluded from the clearing mandate. There should also be relief from clearing for trades between affiliated entities without conditions (such as a notification requirement) if such intra-group trades are subject to trade reporting.

5. *What are your views on the two options presented 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?*

No extra-territorial reach

AFMA agrees with the view expressed in the proposals paper that a key issue is to find an appropriate method for defining the class of dealers to whom the central clearing mandate would apply. Our concern lies with the proposal to identify "internationally active dealers" as means to identify entities on which the mandate should fall. This approach unnecessarily raises cross-border regulation issues which have bedevilled OTC derivatives reform. The mandate should not seek to impose extra-territorial obligations.

Options A or B: Not supported – AFMA Alternative

AFMA does not agree with either Option A or B for defining entities subject to the mandate set out in 3.2.2 of the Proposals Paper. Our proposed alternative is to rely on established Australian law definitions of Authorised Deposit-Taking Institution (ADI) and a "foreign company under Division 2 of Part 5B.2 of the Corporations Act 2001" that also holds an Australian Financial Services Licence. The mandate should only apply to applicable derivatives transactions that are "booked to the P&L" of the entity in Australia. In addition, a threshold should also apply in order to attract the mandate. The appropriate level for the threshold is discussed below.

Do not use "entered into"

While we suggest using the formulation "booked to the P&L" borrowed from the formulation used for the nexus definition in ASIC's trade reporting rules it is vital that the problem created by ASIC's use of "entered into" as a second limb for defining jurisdictional nexus with regard to trade reporting is not allowed to infect a nexus provision with regard to the clearing mandate.

The interpretation of the meaning of "entered into by the Reporting Entity in this jurisdiction" has been a long standing discussion point between industry and ASIC. To assist in the interpretation ASIC published a Frequently Asked Question (FAQ) answer on the meaning of "entered into by the Reporting Entity in this jurisdiction" as provided in Derivatives Transaction Rule 1.2.5. The FAQ is intended to provide guidance to market participants on the meaning of this phrase.

The FAQ provides that:

> *"Under Australian law a contract is entered into in 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."*

The FAQ is based on a contract law way of looking at the situation, which is why it has been described as a "contract law approach". While the FAQ does provide an understandable interpretation, applying it is has turned into a very difficult exercise.

Complex IT systems are needed to track where people are located when a transaction is entered into. It had been thought that the location of the trader entering the transaction into a reporting system would be the key determinant of a connection with Australia for

reporting purposes, which is the way current transaction reporting systems are configured.

A derivative transaction may be marketed, negotiated, entered into, documented and administered by many different personnel within a number of different teams of the same Reporting Entity. Some of those personnel may be located in different jurisdictions in different parts of the world. The ASIC guidance also seems to mean that a Reporting Entity may be required to report based on the location of its counterparty, each of the Reporting Entity's personnel will also need to determine the point in time the contract was entered into and then identify the location of its counterparty's relevant personnel at that particular point in time. This information would need to be ascertained every time a transaction was entered into as it could impact on the legal analysis as to whether a Reporting Entity is required to report. Building a way to capture such information into an IT system is a real challenge and not considered to be practicable

Threshold

A threshold of $100 billion based gross notional value of transaction in the relevant mandated derivatives that are "booked to the P&L" in Australia is supported.

Class of entities to be initially covered

In summary, AFMA proposes that the class of entities subject to the clearing mandate be defined as:

1. any Australian ADI with $100 billion or more gross notional outstanding of OTC derivatives subject to an Australian clearing mandate (ie G4 and AUD IRD); or
2. a foreign company under Division 2 of Part 5B.2 of the Corporations Act 2001 that also holds an Australian Financial Services Licence with $100 billion or more gross notional outstanding of OTC derivatives subject to an Australian clearing mandate booked to the P&L of that entity in Australia; or
3. any entity that opts into the Australian mandatory clearing obligation in G4 IRD or AUD IRD.

Item 3 of the definition allows for voluntary opt-in to assist with substituted compliance recognition of the entity in a foreign jurisdiction.

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?*

Given the large market share of transactions conducted in the United States and the European Union, AFMA supports coordination of the AUD IRD mandate with similar overseas requirements.

At present the European Securities and Markets Authority (ESMA) has not proposed a mandate for AUD IRD. ESMA released its consultation papers on 11 July to prepare for central clearing under EMIR. The two consultation papers seek stakeholders' views on draft rules (RTS) for the clearing of IRS and CDS respectively. For equity derivatives and interest rate futures and options which are currently offered for clearing, ESMA decided that a clearing obligation is not necessary at this stage.

Most relevant is ESMA proposal for IRD of which the following products are proposed -

Type	Settlement currency	Maturity
Basis swaps	EUR;USD;GPB;JPY	28D-50Y
Fixed-to-float interest rate swaps	EUR;USD;GPB;JPY	28D-50Y
Forward rate agreements	EUR;USD;GPB	3D-3Y
Overnight index swaps	EUR;USD;GPB	7D-3Y

The table below gives an estimate for the start of the clearing mandate on the basis of ESMA proposed phased-in timeline per type of counterparty.

Type of counterparty	Proposed phased-in timeline	ESTIMATE
CATEGORY 1 current clearing members	6 months after the entry into force of the rules	CIRCA Q3 2015 1 month later for CDS
CATEGORY 2 Financial counterparties	18 months after the entry into force of the rules	CIRCA Q3 2016 1 month later for CDS
CATEGORY 3 Non-financial counterparties (exceeding the clearing threshold)	3 years after the entry into force of the rules	CIRCA Q1 2018 1 month later for CDS

In the United States, under CFTC rules the clearing mandate applies to common, single-currency IRD (comprising fixed-for-floating, basis and overnight index swaps as well as forward rate agreements) denominated in USD, EUR, GBP or JPY and certain untranched index credit default swaps. The category of mandatorily clearable interest rate swaps is limited by two negative specifications – an interest rate swap is not required to be cleared if it includes optionality or has a conditional notional amount. An interest rate swap has a conditional notional amount if the notional amount is "not clearly predictable" at the time of execution, based upon the potential effect of "defined events or conditions."

Feedback from consultations by Australian regulators with their CFTC counterparts indicates that the next planned clearing determination concerning IRD currently under review will mandate central clearing (unless an exception to central clearing applies) for fixed-for-floating interest rate swaps denominated in AUD, Swiss francs (CHF), or Canadian dollars (CAD).

It is likely that the CFTC will use the same implementation phase-in as for the interest rate and credit default index swaps, which was:

Category 1	Swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, or active funds.	90 days after publication of the clearing determination
Category 2	Commodity pools, private funds, and persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature (other than third party sub accounts or ERISA plans)	180 days after publication of the clearing determination

Category 3	All other entities not exempt from the clearing requirement	270 days after publication of the clearing determination

AFMA recommends coordination with the United States, which will likely be the first foreign to mandate AUD IRD.

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

AFMA considers the proposed approximate timetable for giving legal effect to the proposals of with regard to the first two points is sensible as described

1. Third Quarter 2014 — The Government would expose for comment a draft Ministerial determination relating to G4 and AUD-IRD, with relevant accompanying regulations setting high-level parameters for ASIC rule-making.
2. Late 2014 — determination and regulations made.

With regard to the third point -

3. The clearing mandate imposed through the determination would need to be implemented through a set of ASIC rules. ASIC would need to publicly consult on these rules, and it is therefore not expected that they would come into force before early 2015.

we have made the point earlier in this submission that coordination of cross border implementation is an important consideration and AFMA would look ASIC to take this into account when consulting on the rules.

Please contact David Love on (02) 9776 7995 or at dlove@afma.com.au in relation to follow ups on this letter.

Yours sincerely

David Love
General Counsel & International Adviser