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Global Asset Management

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Manager, Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: financialmarkets@treasury.gov.au

Dear Sir/Madam,

CONSULTATION PAPER: IMPLEMENTATION OF A FRAMEWORK FOR AUSTRALIA'S G20 OVER-THE-COUNTER DERIVATIVES COMMITMENTS

Colonial First State Global Asset Management (CFSGAM) is one of Australia's largest investment managers, with more than AUD$150 billion of funds under management across a diverse range of asset classes including Australian and global shares, short term investments, fixed interest and credit, direct property and infrastructure. CFSGAM is a wholly-owned division of the Commonwealth Bank of Australia.

CFSGAM welcomes the opportunity to respond to the Treasury's consultation paper on the design of a framework to implement Australia's G20 commitments regarding over-the-counter (OTC) derivatives. We support measures to enhance the integrity and stability of Australia's financial system. Accordingly, we welcome trade reporting but firmly believe that certain participants who are not systemically important, such as managed investment schemes, or where the risks imposed by clearing, including liquidity, are greater than the benefits derived, should be exempt from central clearing requirements. We understand other comparable jurisdictions are also considering similar carve-outs.

We also support Treasury's commitment to undertake further market analysis and additional consultation before implementing the rules. In our view, a phased approach should be adopted whereby trade reporting should commence initially and this data will be used to inform the scope of the proposed clearing framework, including the assessment of systemically important entities.

Our responses to the specific questions from the consultation paper are enclosed.

We welcome the opportunity to provide further information as required. Should you have any questions, please do not hesitate to contact Tony Adams (Co-Head of Global Fixed Interest & Credit) on 02 9303 6398 or at Tony.Adams@colonialfirststate.com.au.

Yours sincerely,

David Dixon
Chief Investment Officer
Colonial First State Global Asset Management

3.1 Obligations

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

   Colonial First State Global Asset Management (CFSGAM) supports the general framework and approach proposed.

3.2 Definition of 'transaction' and 'party'

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

   Additional clarity around this definition is required. While the making and termination of a contract is generally well understood and accepted, additional clarity around what constitutes a modification of a contract is required.

   This would need to apply only to the reportable terms of the contract and would explicitly need to exclude actions such as rate sets or collateral calls from the definition.

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

   Additional clarity is also required here especially as it refers to transactions undertaken by investment managers on behalf of underlying clients. It is important that any obligation be clearly applied to either but not both parties to such a transaction.

   We believe that the best approach is where the obligations fall on the party and where the risk ultimately lies – that is the client/principal rather than the agent/ investment manager.

   Consideration need also be given where one party is a non-G20 party or sovereign wealth fund which would prohibit their inclusion in the framework.

3.3 Definition of 'eligible facilities'

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

   CFSGAM supports the definition of 'eligible facility'.

3.4 Non-discriminatory access

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

   Yes. In addition, a reference to non-discriminatory pricing as well as access needs to be included.

3.5 Derivative transaction rules (DTRs)

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

   None.

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

   This would depend on the expected impact of any Derivative Transaction Rules (DTRs). As a general rule we would expect the minimum consultation period to be three months.

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

   The minimum notice period should be three months.

   We suggest ASIC consider the implications of any DTR when setting the actual notice period for each DTR and implement longer consultation periods where the impact of any such DTR is likely to be significant or require substantive changes to infrastructure.

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)?

   CFSGAM supports a framework which allows the exclusion of particular types of entities or parties to derivatives transactions from the requirements of these obligations.

   It is difficult to envisage a threshold based approach (as opposed to a party class or transaction purpose based approach) providing an appropriate, non-arbitrage methodology to achieve this aim.

3.6 Regulatory options

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?

    Yes. Our concerns are in relation to clearing, but we are satisfied from a reporting perspective.

    Clearing changes the cost and liquidity of previously priced and transacted arrangements, which are not contemplated at the time of initial pricing and may negatively impact the economics of locked in transactions.

    CFSGAM has no fundamental concerns with back loading of any reporting requirement.

4.2.2 Options for imposing trade reporting obligations

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?

    Yes.

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.

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

    No.

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

    Not applicable.

    ii. 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?

    Not applicable.

    iii. What is an appropriate threshold to exempt end users from the mandatory obligation to report OTC derivatives transactions to a trade repository or regulator?

    There should be no threshold and all end users should report Over the Counter (OTC) transactions to a trade repository or regulator.

    As previously outlined, clarification needs to be provided on where the reporting obligation (and thus any exemption) exists in the case where an investment manager is acting as the agent for a principal/fund/client.

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?

    Yes.

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

    No. CFSGAM believes that the trade reporting obligation should cover all classes of transactions that could impact upon market risk.

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. CFSGAM agrees with the wide definition of a transaction. We are further concerned that the definition captures all trades on an aggregated basis and should be based upon the market participant being a resident or having an investment/operational presence in Australia.

4.3.2 Options for imposing central clearing obligations

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?

CFSGAM believes that market forces plus capital incentives are likely to lead to central clearing becoming standard industry practice (interbank industry) for particular derivatives. However, this is unlikely to result in a domestic clearer becoming the market standard due to cost considerations. The use of non-Australian clearing houses could significantly impact the usefulness of the central clearing system to address issues of importance (ie systemic risk) to the Australian Financial system. The issue of how Australia could manage a non-Australia domiciled or regulated central clearer needs further consideration and clarification.

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

The specific entities that should be excluded are those entities which are not systemically important, such as registered managed investment schemes.

This is due to situations where the need to post collateral could force liquidation of underlying physical investments, thus having a negative impact on the retail investors in such schemes.

Daily margining of any type, including central clearing, may add significant liquidity risks to particular classes of investors, especially where borrowing to fund margin calls is not a viable option. The flow-on effects of such clearing may well create an overall riskier outcome for some participants. There is the need to address these additional risks within the concept of central clearing for all entities.

Investigation in relation to trade reporting needs to be undertaken over a selected period of time to ascertain who the systemic important entities in the market are (banks, government institutions etc). Once this investigation has taken place, it can be determined which non-systemic entities can be fully excluded from the mandatory clearing rules.

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

CFSGAM believes that the test for inclusion for mandatory central clearing needs to be the individual's systemic importance (i.e. if the party/entity failed on all its derivative transactions would there be systemic implications). We believe that the introduction of trade reporting across all transaction types and parties will assist in the assessment of the systemic importance of specific parties. Additionally exemptions should be considered for parties where the additional risks of participating in central clearing (particularly liquidity risk) outweigh the potential benefits to that party.

ii. 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?

Please refer to response to 17.1(i).

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

Please refer to response to 17.1(i).

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

Yes. The classes of transaction should include trades where territoriality is uncertain, such as currency transactions.

i. 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?

No. The administration burden and burden of proof of such an approach would be great. Also the purpose of the transaction does not define whether such transactions, or parties to such transaction types, are systemically important or not. Such a broad exemption is likely to exempt the largest and possibly most systemically important users of derivative transactions.

We believe that the introduction of trade reporting across all transaction types and parties will assist in the assessment of the systemic importance of transaction for specific purposes.

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?

No. CFSGAM supports a framework which allows the exclusion of particular types of entities or parties to derivatives transactions from the requirements of these obligations. We consider that only systemically important entities should be required to clear derivatives transactions regardless of size or location of the transaction.

Options for imposing trade execution obligations

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.

    No.

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?

    CFSGAM currently sees no need for a prescribed trade execution obligation. We have concerns that such an obligation could introduce market inefficiencies and higher costs.

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

    No.

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.

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?

    Yes.

5.2.2 Regulatory options

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, in relation to the use of market sensitive information and pricing. There needs to absolute boundaries on data sharing. CFSGAM believes that any mandated trade repository should be a government authority, such as AUSTRAC.

CFSGAM is also concerned on how multiple trade repositories could function in terms of aggregating and reporting data. There is a risk that trades could be reported more than once, thus providing a less accurate view of systemic risk within the Australian financial market. We are interested is how this potential conflict is intended to be addressed.

i. 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 be regulated entities only. CFSGAM prefers the model where the trade repository is a government owned entity. Appropriate firewalls need to be established to ensure conflicts are prevented.

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

Significant. Aggregated data should be only used by regulators for market monitoring and in their assessment of systemic risks. Appropriate firewalls are required.

iii. 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)?

Data sharing should only be allowed between regulated entities where the data is aggregated. No individual transactions should be shared, only aggregated data. Again appropriate firewalls are required.

iv. 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?

Individual transactions should never be made public. Criminal sanctions should be developed to ensure penalties are sufficient.

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?

Yes.

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?

CFSGAM is concerned that only one party has the ability to grant trade repository licenses.

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)?

Yes, information should only be available to regulators.

5.2.3 Property in transaction data

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

Property rights in relation to trade information are to remain the property of the participants (i.e. those reporting the transactions) and not trade repositories.

5.3 REVIEW OF FINANCIAL MARKET INFRASTRUCTURE (FMI)

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?

Government is currently considering their regulatory requirements for financial market infrastructure. Once this policy framework is finalised and implemented, we believe it should be assessed to determine its appropriateness for OTC derivative trade depositories.

6.2 ONGOING ASSESSMENT OF DERIVATIVES MARKETS

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

Yes.

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

Yes, other unintended risks and outcomes need to considered, such as effectiveness of regulations, liquidity etc. Unintended consequences, such as the cost of compliance on managed investment schemes whose underlying investors are retail investors or superannuates should be considered. CFSGAM would thus propose the following to the factors defined in Section 6.2:

- **The potential creation of other unintended risks or adverse outcomes for individual parties**

6.3 ASIC'S RULE-MAKING PROCESS

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

We acknowledge and support the proposed consultative approach whereby ASIC will work with other agencies (including APRA and the RBA) in developing DTRs.

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

CFSGAM believes it is appropriate for legislation to prescribe how risk should be addressed in the central clearing process. Counterparty risk, investment risk and operational (fraud) risk needs to be mitigated. If these risks are managed through the DTRs, they need to be sufficiently certain to be workable.

In terms of other legislation, we note that the Payments Systems and Netting Act is relevant in the context of clearing houses generally.