30 June 2016

Ms Megan Quinn
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Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

cc: Ms Zoe Cox

By e-mail: resilienceandcollateral@treasury.gov.au

Dear Ms Quinn

Completion of Reform - Protecting Collateral for Wholesale Derivatives

This letter is a follow up to the submission made by the Australian Financial Markets Association (AFMA) in March 2016 on the Corporations Amendment (Client Money) Bill 2016 and subsequent discussions with the Treasury in relation to our comments. At that time, that the proposed new section 981A(3A) was identified as a crucial amendment to enable financial institutions to comply with internationally-agreed margining requirements when dealing in over-the-counter derivatives, amongst other matters. A specialised and highly sophisticated global regime has been developed by authorities under the direction of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS-IOSCO) for dealing with collateral provided in connection with wholesale derivatives transactions. Although the new section 981A(3A) was not part of the Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016 passed by Parliament earlier this year, it is important to also pass this aspect of the reform package. Because the amendment is driven by global derivatives reform policy it is important to keep this policy justification clearly distinguished from the domestically-focussed initiative to protect client money in dealings with financial service licensees around retail OTC derivatives.

Completing Reform is Urgent

The margining framework for non-cleared derivatives developed by the BCBS-IOSCO is expected to become effective for the largest derivatives users from 1 September 2016. For other entities within the scope of the regulations, initial margin requirements will be phased in over a four-year period, but

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variation margin obligations are expected to come into force from 1 March 2017. The BCBS-IOSCO principles feature mandatory exchange of initial margin (IM) and variation margin (VM).

To cater for implementation of this regime, a huge global effort is underway to develop new market standard documentation that will facilitate compliance with the new rules. Standard market documentation for the swaps market is developed by the International Swaps and Derivatives Association (ISDA), which is currently in the process of preparing and rolling out new compliant credit support documents that set out arrangements for exchanging IM and VM under the framework of the ISDA Master Agreement. Around the world, including in Australia, the ISDA Master Agreement is used for the vast majority of OTC derivatives transactions. Counterparties are commencing preparations for negotiating a large number of new or amended bilateral agreements based on the new standard credit support documents.

One such new document (published in April of this year) is the 2016 Credit Support Annex for Variation Margin for use with New York law (the 2016 NY CSA). It is likely that certain foreign counterparties of Australian participants holding an Australian Financial Services Licence (AFSL) will require such Australian participants to exchange margin under the 2016 NY CSA.

Under the current draft legislation, it is not legally clear whether VM received by an AFSL holder under a 2016 NY CSA is covered by the Australian client money requirements. The proposed section 981A(3) is designed to clearly draw a line between client money rules and the derivatives collateral regime to avoid such uncertainty and potential overlap. Section 981A(3) (as amended in line with the suggestions below) should be put in place to remove any legal uncertainty.

Consequences of overlap between the Australian client money rules and the BCBS-IOSCO principles

Any overlap between the Australian client money rules and the BCBS-IOSCO principles in relation to VM creates significant potential conflicts and problems. In particular, restrictions on the way in which an AFSL is able to hold client money under the legislation would be incompatible with numerous standard provisions in the 2016 NY CSA (which it will not be feasible to contract out of, especially given the worldwide focus on document standardisation). For example, under the 2016 NY CSA, the collecting party has the right to:

(i) "sell, pledge, rehypothecate, assign, invest, use, commingle or otherwise dispose of, or otherwise use in its business any Posted Collateral (VM) it holds, free from any claim or right of any nature whatsoever of the Pledgor, including any equity or right of redemption by the Pledgor; and

(ii) register any Posted Collateral (VM) in the name of the Secured Party, its Custodian (VM) or a nominee for either.[1]"

From the point of view of the collecting party, it is essential that variation margin received from a counterparty is able to be treated like its own money, notwithstanding the security interest, and in turn passed to a counterparty on the other side of the exposure. This practice is permitted (and standard) under New York law but is inconsistent with the principles and provisions of the client money regime. It is also inconsistent with the statutory trust that client money is subject to under section 981H. Counterparties may therefore be unwilling to trade derivatives with AFSL holders, for example, due to fear of receiving assets as collateral which could be traced and required to be handed to their counterparty's insolvency official.

[1] Paragraph 6 of the 2016 NY CSA

Moreover, there is a possibility that the protections of Australia's netting legislation would not in every instance avoid a posting party's funds being caught up in an insolvency of the AFSL holder. AFSL insolvencies involving client money are rarely quickly resolved, and in a number of cases involve liquidators commencing court proceedings for declarations as to how client money should be dealt with. This is inconsistent with the requirement (which is set out in the BCBS-IOSCO principles and enshrined in the legal regimes of the relevant G-20 jurisdictions) that collateral must be promptly returned to the posting party following the termination and close-out of derivatives transactions..

Section 981D does not fully protect from the above consequences, because: (1) the definition of "derivative" in the Corporations Act does not cover all derivatives traded under an ISDA Master Agreement; and (2) section 981D only deals with the *use* of client money (but not various other aspects of the client money regime which may conflict with the BCBS-IOSCO principles).

Other potential conflicts between the Australian client money rules and the BCBS-IOSCO principles include:

(i) It would be operationally difficult to resolve what portion of VM received by an AFSL holder corresponded to its AFSL activities, as opposed to its offshore activity which may not be conducted under the AFSL (and therefore the Australian client money rules would not apply).

(ii) It would be operationally difficult to separate VM that corresponded to a derivative, on the one hand, from VM which corresponded to a tangible forward that was documented under the same ISDA agreement, on the other hand (the issue being that a tangible forward may not be a financial product and therefore the Australian client money rules would not apply in any event).

(iii) Client money requirements only apply to deposit funds in accounts with ADIs (section 981B(1)(a)), or approved foreign banks (regulation 7.8.01 – and we understand none of these exist) would be too limiting to cover all of the currencies that could be posted under BCBS-IOSCO compliant margining regimes.

(iv) The requirements in relation to licensees to licensee payments (regulation 7.8.02(1A)) and permissible investments (regulation 7.8.02(2)) could undermine the BCBS-IOSCO principles.

Because of the global scale and complexity of implementing the margining regime, local complications or legal doubts such as those identified above, as well as any others which may exist, may cause foreign counterparties to take the pragmatic approach of ceasing to trade or reducing trading in derivatives with AFSL holders. Intra-Australian trading could also be adversely impacted. Even problems that could be dealt with by way of operational or documentation changes would likely not be feasible for most parties and international infrastructure providers, particularly at a time when the entire industry is struggling to implement the BCBS-IOSCO required changes. AFSL holders could therefore find their access to derivatives risk markets impaired.

Drafting comment on the proposed section 981A(3)

The proposed requirement to obtain the wholesale client's agreement (as proposed in paragraph (d) of section 981A) is not workable in the context of global standard market documentation discussed above. No other subparagraph in section 981A requires written agreement from the client in order for relevant money (e.g. money paid by way of remuneration payable to the licensee) to not constitute client money. The requirement to obtain the wholesale client's agreement will impose an unnecessary administrative burden on the market and serves no useful function, and should therefore be removed.

AFMA members and I are would be pleased to discuss this matter further with you. I can be contacted on 02 9776 7995 or dlove@afma.com.au.

Yours sincerely

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