7 August 2015

Ms Rhonda Luo
Senior Manager, OTC Derivatives Reform
Financial Market Infrastructure
Australian Securities and Investments Commission
Level 5, 100 Market Street
Sydney NSW 2000

Email: OTCD@asic.gov.au

Dear Ms Luo

Mandatory central clearing of OTC interest rate derivative transactions
Consultation Paper 231

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on Mandatory central clearing of OTC interest rate derivative transactions Consultation Paper 231.

AFMA is generally supportive of general purpose of the rules, but does consider there is a degree of over-engineering of these proposals. We question why there needs to be such extensive and detailed rules for a market which is working well without such rules. We suggest that there be a substantial rethink and move away from a micro-management, "cover all bases" approach to a simpler approach which supports the Government's regulations. This goes back to the fundamental principle that if there is no market failure there is no need or justification for intrusive detailed regulation.

Revised Approach to the Rules Needed

Our recommendation is that the rules should concentrate on essential matters needed to give market participants certainty but do without detailed rules on compliance. These essential elements are:

1. Entities subject to the clearing requirements
2. Calculation of the clearing threshold
3. Transactions and classes subject to mandatory central clearing
4. Maximum time period T+3
5. Prescription of clearing facilities
6. Alternative clearing
7. Intra-group exemption
8. Multilateral compression exemption

9. Notification of status as clearing entity
10. Calculation and commencement dates

Non-essential elements that can be removed are:

1. Cross-border scope of the clearing requirements – reliance should be made on alternative clearing.
2. Fulfilling the clearing requirement – submission to a clearing facility is all that is needed.
3. Transactions that extend the maturity date of existing derivatives.
4. Record keeping requirements.

After consideration of the questions which seek out cost of regulation information, we believe that the approach of industry having to calculate costs for not having rules which do not yet exist and do not have a demonstrated need in order for them not to be introduced to be counter to sound logic. The rules to which we object add marginal compliance costs onto an existing heavy compliance burden in this area. The estimated additional amount of marginal compliance cost is a moot point. Our contention is that there should be zero additional compliance burden.

Questions

We have comments to make in respect of the following questions set out in the Consultation Paper.

B1Q1 Do you agree with the proposed scope of entities that may be subject to mandatory central clearing?

The definition covering ADIs, AFS licensees, Foreign clearing entities and trusts and registered schemes that exceed the clearing threshold is broad enough to include entities that are intended to be included under the proposed enabling regulations.

B1Q2 Do you agree with the proposed definitions of 'Australian clearing entity', 'foreign clearing entity', 'opt-in Australian clearing entity' and 'opt-in foreign clearing entity'?

If an entity prefers to clear its trades, but it is not considered as an Australian or Foreign Clearing Entity, it can still do so on a voluntary basis.

B1Q3 What is the likely impact of our proposals?

Overall as the market is generally clearing transactions where possible of its own volition the proposals are of negligible impact in relation to market activity. However, the rules are extensive and intrusive and introduce a high degree of additional compliance burden which is both undesirable and costly.

B2Q1 Do you agree with our proposal to adopt the clearing threshold set by the Australian Government of $100 billion gross notional outstanding in OTC derivatives, for entities other than those acting in a representative capacity?

The proposed clearing threshold of AUD 100 billion is considered to be consistent with the objective of encompassing Australian transactions which are currently being cleared for commercial reasons. While there are a range of views on the merits of a more comprehensive clearing mandate the AUD 100 billion amount reflects the consensus that was reached in industry consultation last year.

Consistent with our comments on the scope of the clearing mandate the clearing threshold calculation should be based on OTC derivative transactions booked into Australia only.

B2Q2 Do you agree with the proposed application of the clearing threshold in relation to transactions entered into on behalf of a trust or registered scheme?

It is unclear whether the clearing mandate would apply to transactions that investment managers enter into in an agency capacity on behalf of clients, and whether clients who are subject to central clearing mandate will be able to delegate the central clearing obligation to agents such as their investment managers who enter into the relevant trades on their behalf.

It is proposed that it be made clear that the mandate does not apply to transactions that investment managers enter into in an agency capacity on behalf of clients.

B2Q4 Do you agree with our proposals for determining whether an Australian financial entity or foreign financial entity is a clearing entity, and when a clearing entity ceases to be a clearing entity?

The draft rules cover only those foreign entities that in addition to being an ADI, Exempt Foreign Licensee or financial services license holder are also a Part 5B2 registered or required to be registered foreign company. It is not necessarily the case that every ADI, Exempt Foreign Licensee or financial services license holder will also be a Part 5B2 registered or required to be registered foreign company. Irrespective of any overlap between the requirement to be registered as a Part 5B2 company and an entity's licensing status, these remain two distinct regimes (the former being subject to analysis based on common law principles (in addition to any statutory tests)). Therefore one should not be conditional upon the other as forming part of the definition of foreign clearing entity.

The definition of Financial Entity in the draft rules does not include reference to Foreign ADI whereas this is referred to in the Consultation Paper as an entity category.

B2Q5 Do you agree with our proposal to apply the clearing requirements on the first Monday three months on or after the second calculation date?

There has been no technical problems identified with this timing.

B3Q1 Do you agree with the proposal to apply the clearing requirements in each of the circumstances listed in proposals B3(a)(i)–B3(a)(v)?

No B3(a)(iii) and B3(a)(v) proposals are an unnecessary complication, that adds redundant complexity to the regime.

The extraterritorial scope of the clearing mandate should be limited in nature and should only apply to OTC derivative transactions booked in Australia. This means that where a foreign clearing entity is involved, only in-scope G4 or AUD-IRD transactions that are booked in its Australian branches or potentially guaranteed by an Australian entity should be subject to the clearing mandate.

The inclusion of 'entered into' in Australia transactions within the mandate is an inappropriate extraterritorial extension. Market surveillance policy objectives resulted in the inclusion of 'entered into' in Australia transactions within the reporting mandate but the clearing mandate has always been justified in policy terms on the basis of increased efficiency, integrity and stability of financial markets; not market surveillance. Including 'entered into' in Australia transactions in the mandate is a matter of considerable practical significance and any extension should be limited to where one of the foreign entities is guaranteed by an Australian entity.

To include 'entered into' in Australia transactions in the mandate increases the potential for the Australian mandate to conflict with the rules in other jurisdictions, will significantly increase the compliance and build costs associated with the mandate for FCEs and have a number of potentially negative outcomes.

B3Q3 Do you agree with our proposed approach to defining 'nexus derivative', and to allow foreign clearing entities to opt-in to centrally clear nexus derivatives?

A complex nexus rule associated with the mandate will significantly increase likely compliance and build costs for FCEs / FIADs and have a likely effect on competition and the efficiency of the market. The complexities created by the inclusion of 'entered into' in Australia transactions could potentially result in an increase in systemic risk in Australia as FCEs will have to consider reducing the scope of transactions they arrange or execute from Australia and could result in reduced liquidity within the Australian market.

This is an example of undesirable complexity.

B3Q4 Do you see any practical challenges for clearing entities trying to determine whether they are trading with an entity that is subject to the clearing requirements in each of the circumstances listed in proposals B3(a)(i)–B3(a)(v)?

This proposal is likely to prove complex in practice. Clearing entities will have to determine whether their counterparties are subject to the clearing requirements or not, given that the entities subject to the clearing requirements may change over time (based on quarterly eligibility or entities may voluntarily opt-in).

Given that ASIC will have knowledge of which entities are required to clear in a given period, ASIC should publish a list upon which reliance could be placed.

B3Q5 What is the likely impact of our proposals? (Please see page 4 for the information required.)

Given the complexity of the rules it may prove simpler to conduct transactions in another jurisdiction with a consequent diminution of derivatives transactions in Australia

B4Q1 Do you agree with the proposed definitions for 'swap', 'fixed-to-floating swap', 'basis swap', 'forward rate agreement' and 'overnight index swap' in the draft derivative transaction rules (clearing) attached to this paper?

No technical problems have been identified with using these commonly understood market descriptions.

B4Q2 Do you agree with the proposed asset class specifications in proposal B4(a) and Table 2?

Market participants view mandated clearing as problematic to them when there is no choice of CCP. The proposal is that an asset class should only be the subject of a clearing mandate when there are a least two licensed or prescribed CCPs able to clear an asset class.

Accordingly, it is not considered appropriate at this time to designate AUD denominated FRAs at this stage. This is a product where there is still only limited voluntary clearing and the situation has not reach a stage of infrastructure support to justify a mandate.

B4Q3 Do you agree with our proposal that mandatory central clearing should only apply to the entry of an arrangement that is a derivative (other than in the circumstances outlined in proposal B7)?

Members are supportive of this proposal.

B4Q4 Do you agree with our proposal to mandate central clearing of AUD-denominated forward rate agreements? If not, why not?

We have noted in relation to B4Q2 that it is premature to mandate AUD-denominated forward rate agreements. This would not cause a problem with cross –border recognition as ESMA does not mandate clearing AUD.

B5Q1 Do you agree with our proposal to require clearing entities to clear each clearing transaction through a clearing facility?

Given the overall mandate set out in the regulations and determination this requirement appears to be redundant and would have no material effect if it was deleted.

B5Q2 Do you agree with the proposed definition of 'cleared through' a clearing facility in the draft derivative transaction rules (clearing) attached to this consultation paper. Do you agree with our proposal to allow direct, indirect or client clearing arrangements to be used?

The 'cleared through' definition should permit clearing arrangements in foreign jurisdictions that adopt an agency model for clearing (for example the FCM model in the US).

Our understanding from the Consultation Paper is that ASIC does intend this to be the case (however this does not appear to be reflected in the draft rules). Confirmation of this should be provided specifically for those foreign jurisdictions in which the Treasury has prescribed CCPs and jurisdictions that ASIC intends to prescribe CCPs for the purposes of alternative clearing under the draft rules. Without such confirmation, the clearing entity will not be able to satisfy the requirement to clear and be considered in breach of the clearing provision (as a consequence of the clearing model being used). Draft rule 2.1.1 covers clearing based on the principal model (as opposed to agency) where each Clearing Entity is a participant at the CCP and where each Clearing Entity is not a participant at the CCP but instructs a participant to clear on its behalf.

B5Q3 Should the clearing requirements be subject to exceptions? For example, are there any circumstances where a derivative transaction cannot be centrally cleared and should, therefore, be exempt from the clearing requirements?

If a trade is rejected for clearing due to credit limit constraints of a CCP, the trade should be allowed to exist in the bilateral space until it can be unwound.

B5Q4 Should the derivative transaction rules (clearing) impose a prohibition on derivative transactions being de-cleared after they have been centrally cleared? If so, are there any circumstances where a mandatorily-centrally cleared derivative transaction should be permitted to be de-cleared?

CCPs need to run regular compression cycles to reduce the volume of economically redundant trades in the clearing house and to reduce margin burdens and capital charges

for clearing members. The process of portfolio compression can require the de-clearing of certain trades in order to achieve the greatest compression efficiency. The rules should not act as barrier to the beneficial risk management practice continuing.

B5Q5 Do you agree with our proposal to that counterparties must have substantially no further rights and obligations arising under the derivative contract after it has been cleared through the clearing facility?

This is another example of a rule which serves no practical purpose.

B6Q1 Do you agree with our proposed deadline of T+1 for the clearing of clearing transactions?

In general, T+1 would fit with current clearing practice where it is done in Australia. The design of this rule is another example where undue complexity and compliance burden for those clearing in offshore CCPs is introduced into the law with no apparent practical benefit. A simpler approach would be to specify a generally accept outer limit period of T+3

The time given to clear a trade to comply with ASIC clearing and alternative clearing in a foreign jurisdiction should be consistent. (Currently T+1 compared to T+3). If nexus trades continue to remain in-scope, there needs to be additional thought given towards the clearing timeline when the trades are being booked on a foreign balance sheet.

B6Q2 Do you agree with our proposal that the deadline for clearing be calculated according to business days and AEST or AEDT, as applicable in Sydney, Australia?

Members have some concerns that if nexus trades continue to remain in-scope, these trades would likely be booked to a US/European balance sheet and, if cleared at one of the alternative clearing facilities in a foreign jurisdiction, it may be more appropriate for the deadline to be calculated according to the T+1 business day close in the jurisdiction of the clearing facility. This obviates the scenario in which there is a public holiday in the jurisdiction of the clearing facility, but not in Sydney, on T+0 or T+1 that could result in the Sydney deadline passing before the trade can be cleared.

B6Q3 If you believe the deadline should be based on the time the derivative transaction was entered into (e.g. 24 hours after the derivative transaction was entered into), how should the deadline for clearing be determined if the derivative transaction is entered into on a cross-border basis by two counterparties located in different time zones?

The complexities which this rule creates could be addressed by having a simple T+3 maximum period.

B6Q4 Do you agree with our proposal that the clearing requirements will not be breached if a clearing transaction is not cleared and is terminated before T+1?

This proposal is supported.

B7Q1 Do you agree with our proposal that mandatory central clearing be applied in the circumstances outlined above?

We are in agreement that where a legacy non-centrally cleared derivatives transaction between two clearing entities that would otherwise have been subject to the clearing mandate is amended after the commencement date of mandatory clearing such that the

maturity of the transaction is extended by 12 months or more beyond the maturity of the transaction at the time it was entered into, then that amended transaction should be subject to the application of mandatory clearing.

B7Q2 Do you agree with our proposal that a derivative transaction that is extended for 12 months (or more) should become subject to the clearing requirements? If you believe the period should be longer, please give reasons why a derivative transaction would need to be extended for a period of 12 months or more.

Please refer to B7Q1 above.

C1Q1 Do you agree with our proposal to allow clearing entities to be cleared through licensed CS facilities or prescribed CCPs?

We are in agreement, but wish to make sure that it is made clear which licensed CS facilities and prescribed CCPs are approved and the products that can be cleared.

D1Q1 Do you agree with our proposal to allow any clearing entity to comply with mandatory central clearing by using alternative clearing? If not, do you think the scope of our proposal should be narrower (e.g. restricted to foreign clearing entities)?

Yes this proposal is supported ASIC should ensure that when making such determinations there is sufficient choice for market participants as part of the exercising these powers of prescription. If ASIC has a list of CCPs they are looking at and intending to prescribe, these would be useful for industry to know in advance.

D1Q2 Do you believe that access to alternative clearing would assist clearing entities to meet their clearing requirements?

Please refer to D1Q1 above.

E1Q1 Do you agree with our proposal to allow an exemption from the clearing requirements for intra-group derivative transactions?

We welcome the inclusion of the intra-group exemption though, in practice, it is arguable that this exemption will unlikely be used under the current draft mandate (as this would require two or more clearing entities within the same group to each have in excess of $100 billion gross notional outstanding).

E1Q2 Do you have any feedback on the notification requirements?

Where the intra-group exemption is relevant such that notice is to be provided, we do not think that such notice should have to be provided 1 Business Day prior to the transaction. Instead, to retain the ability to hedge or execute trades if and when needed, providing a notification on a post- transaction basis would be the better approach. This also gives certainty to ASIC that one transaction has occurred (and an intention that others will follow in the future) as opposed to before the event/first transaction where a change of circumstances could mean that the clearing transaction does not proceed.

E2Q1 Do you agree with our proposal to allow an exemption from the clearing requirements for transactions that are created as part of a multilateral trade compression cycle? Are there any conditions that should be placed on this proposed exemption?

This is a necessary component of the rules in support of systemic stability policy objectives and is supported.

E2Q2 Do you agree with our proposal not to allow an exemption from mandatory central clearing for bilateral compression exercises?

We disagree with the proposal and believe that an exemption from mandatory clearing is justified. Bilateral compression runs reduce the amount of risk in the system and should be encouraged. We note further that the types of counterparties that would enter into bilateral compression are also likely to be the types of entities subject to BCBS-IOSCO OTC margining requirements so new OTC trades coming out of bilateral compression exercises will still be subject to collateral requirements.

E2Q3 What is the likely impact of our proposals? (Please see page 4 for information required.)

F2Q1 Do you agree with our proposal to require clearing entities to maintain records demonstrating compliance with the clearing requirements for a period of five years?

This proposal is a curious record keeping concept which is vague in character and has no apparent beneficial purpose and is inconsistent with the design of the regime which centralise information at the time of the derivatives transaction.

A key purpose of having a trade repository is that it provides the record keeping functionality for the regulator. Firms which enter into any reportable transactions will also reporting information on the transaction to the trade repository. In addition the CCP will also maintain recorded of transactions it has cleared which can be accessed by the ASIC. Therefore the information is already being stored and kept as an inherent part of the design of the regime.

F2Q2 Do you agree with our proposal to require clearing entities to provide us with these records upon our request? If not, why not?

No. See the answer to F2Q1 above.

F2Q3 What is the likely impact of our proposals? (Please see page 4 for information required.)

This is a duplication of recording keeping in the system, which adds an unnecessary compliance burden with no public benefit and the information is already gathered for regulatory purposes through CCPs and trade repositories.

G1Q1 Do you agree with the proposed commencement date of 7 March 2016 for mandatory central clearing (for those entities that are at or above the clearing threshold as at 30 September 2015 and 31 December 2015)?

No issues have been raised thorough AFMA which would create an obstacle to this timetable.

Please contact David Love at dlove@afma.com.au on (02) 9776 7995 if further clarification or elaboration is desired.

Yours sincerely

David Love
General Counsel & International Adviser