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Financial Markets Unit
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The Treasury
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Dear Mr Bell

Implementation of Australia's G-20 OTC Derivatives Commitments

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the *Implementation of Australia's G-20 OTC derivatives commitments* Proposals Paper (Proposals Paper).

The generality of this legislation creates considerable scope for industry uncertainty and confusion. The practical challenges with implementation, particularly with regard to trade reporting, are enormous and there is much further consultation that will need to be carried out during the course of practical implementation. Settling the details will demand considerable commitment of time and resources.

1. Trade Reporting

1. Do you have comments on the costs and benefits of complying with the trade reporting obligation, as outlined in this document, from the point of view of your business and/or that of your customers?

The benefits of trade reporting are in the nature of a public good while the costs are borne by reporting entities with little countervailing benefit to their businesses. The identified public policy benefit of a trade report stems from the improved market transparency facilitated by its record keeping function, the integrity of information it maintains and effective access to this information by relevant authorities and the public in line with their respective information needs. Data recorded in a trade repository cannot be substituted for the records of transactions at original counterparties.

Therefore, although trades are reported, market participants must still maintain their own records of the transactions that they are a counterparty to and reconcile them with their counterparties or trade repositories on an ongoing basis for their own risk management and compliance purposes.

Because the costs associated with implementation are borne by market participants, industry is keen to see that implementation is as efficient as possible and duplication is avoided to the greatest extent possible. This entails coordination with implementation of matching derivatives trade reporting in other jurisdictions.

Systems need to be put in place to ensure compliance with reporting obligations. One of the biggest challenges for market participants is to bring together the required data from a wide and diverse range of systems, including trading and settlement system as well as confirmation and collateral management systems. Having to report to two or more depositories requires the implementation of multiple reporting conduits incurring initial establishment costs and higher ongoing costs. A multiplicity of trade repositories and system reporting standards would increase costs exponentially. Leveraging off systems and standards that have been developed in the United States and European Union for derivatives trade reporting should be a high priority.

Any infrastructure to be licensed or built in Australia must seek to be compatible with existing global infrastructure already in use by major Australian banks as well as the global players. Strong links must be established with the Depository Trust and Clearing Corporation (DTCC) in order to ensure that global infrastructure run by that service provider is properly plugged in to any local solutions that are established.

Careful consideration needs to be given to the purpose of a trade repository. Members that are already reporting offshore have encountered operational issues where repositories are required to 'match' transactions; where both sides are required to report trades and those trades are checked against each other. This significantly increases the regulatory burden of reporting. For this reason a single-sided reporting model is preferred in the first phase. However, this question needs further evaluation passed on market experience as implementation moves through further phases.

Electronic matching systems such as MarkitWire and DSMatch are already widely used in the over-the-counter (OTC) marketplace. Duplicating the effort of transaction confirmation further downstream in the trade reporting infrastructure would increase cost and complexity and should be avoided.

With regard to benefits from reporting, a report produced on a weekly basis by asset class rather than trade by trade would have the greater utility. A consolidated weekly view would provide valuable insight and is in line with the CFTC proposal.

2. Do you have comments on the proposal to mandate a broad range of derivatives subject to the phase-in and exceptions outlined in the document? Or is there another option you prefer? If so why?

A phased-in approach based on the most actively traded products in Australia starting with AUD interest rate swaps is a sensible approach.

In setting out a definition of reportable transactions, it is important that reporting can be successfully implemented via an automatic, rather than manual, process and which achieves the objective of OTC post-trade reporting discussed above. Therefore the definition of reportable transactions needs to be clear and unambiguous and to enable transaction data to be cut from existing trade-capture fields common to all market participants. It should focus on parties to transactions rather than the internal booking processes of those parties.

For example, definitions which seek to identify transactions according to where they are executed are to be avoided as they are extremely difficult to implement without heavy manual intervention. Conversely, definitions that utilise currency of denomination or the jurisdiction of incorporation of the transaction participants to determine eligibility to report are preferred as such variables are easy to determine from existing trade booking information.

The Proposals Paper suggests broad generic classes of derivatives as the basis for a determination. AFMA considers greater specificity in the setting of classes of derivatives, consistent with guidance in Note 2 of subsection 901B(2) of the Corporations Act, would assist clarity and certainty in the early implementation of the reporting requirement.

A 'class' should be determined based on a product classification system that is aligned with international financial standards. The Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) published their final report in January 2012 on the OTC derivatives data that should be collected, stored and disseminated by trade repositories. With regard to the development of a standard international product classification system the Task Force recommended that CPSS-IOSCO or the Financial Stability Board (FSB) make a public statement calling for timely industry-led development, in consultation with authorities, of a standard product classification system that can be used as a common basis for classifying and describing OTC derivative products. The Task Force went on to recommend that the FSB direct, in the form and under the leadership the FSB deems most appropriate, further consultation and coordination by financial and data experts drawn from both authorities and industry, on a timely basis, concerning this work.

In this regard, AFMA directs your attention to the *ISDA OTC Derivatives Taxonomies for Credit, Interest Rate, Commodity, Foreign Exchange and Equity* as the basis for a globally consistent taxonomy for derivatives. The International Securities and Derivatives Association (ISDA) developed standardised taxonomy (classification) for OTC derivatives are intended to support regulatory mandates to increase transparency through public and regulatory reporting. In addition to the coordination of the market discussions that led to the proposed taxonomies for the different asset classes, ISDA put a governance model in place to oversee the development of the taxonomies and ensure proper support going forward.

The final taxonomies will be included in the FpML data standard to facilitate the reporting process. Coordination with other international standards such as ISO to align with the ISDA taxonomies is ongoing.

Post-trade OTC derivatives trade reporting is used fundamentally to determine exposure of a given entity to OTC derivative transactions. It is not an appropriate tool for monitoring market conduct or other activity.

Electricity derivatives

Given the additional consultation requirements and the short implementation timeframes relating to electricity derivatives it is appropriate to exempt electricity derivatives from the determination.

This exemption should not be conditional on completion of the current Australian Energy Market Commission (AEMC) Financial Resilience review process. This review is dealing with a related, but specific, issue (i.e. robustness of the ROLR provisions) and not the broader relationships with the financial system.

Longer-term, any consideration to incorporate electricity derivatives would need to be initiated by a detailed assessment of the market and potential risks to market functioning and whether the benefits outweigh costs of mandatory reporting[1]. This is expected to form part of the consultation process with the Minister for Energy and Resources.

3. Do you have a preference for the timetable being prescribed in regulation or implemented by a phased approach to ASIC rule-making?

The implementation of trade reporting is dependent on one or more trade repositories being licensed and other preliminary administrative actions being taken by the Australian Securities and Investments Commission (ASIC). Past experience with financial market infrastructure licensing suggests that the application approval process can be quite protracted and subject to considerable uncertainty until a ministerial decision is made. Accordingly, it would be appropriate to provide ASIC with discretion in its rule-making power to determine that appropriate timing for commencement of trade reporting requirements that is dependent on conditions precedent relating to approvals and rule-making being fulfilled.

4. Do you have comments on the proposed timetable for implementing the trade reporting obligation? Or is there another option you prefer? If so, why?

The trade reporting requirements should be phased in not only according to institution-type but also by asset class, rather than adopting a ‘big bang’ approach. Therefore rates

[1] The Regulators’ October 2012 Report indicated that electricity OTC derivatives would not be suitable for mandatory clearing. On this basis it is unclear what benefit trade reporting would deliver. The report also indicated that “these product classes would not appear to present immediate concerns for the financial system”.

products might be implemented in the first instance, followed by credit and then equity products.

Information technology solutions often require significant adjustment and modification in order to facilitate OTC derivatives trade reporting. Often, this modification cannot take place until the reporting rules have been set and are not subject to further change; only then can build work to meet the requirements begin. Therefore a lead time of six months from the date reporting requirements are set would be reasonable, provided that implementation is carried out one asset-class at a time, as suggested above.

In addition, given the required lead times to implement the necessary technological changes enabling reporting, a six month period should be given between mandatory compliance dates.

In order to protect reporting entities from delayed regulatory implementation leading to unrealistically short deadlines being set for the start of reporting, a minimum period of six months should be set between the formal public announcement by ASIC of a reporting deadline and the actual date of the deadline.

As noted in answer to Question 3 infrastructure needs to become available and this requires some flexibility with regard to the implementation timetable.

It is noted that trade reporting is already required for US swap dealers based in the United States. This extends to non US dealers with regard to trades by US persons. In the view of those firms which are already being required to report under US law they are at a disadvantage compared to firms which are not yet required to report and they would like to see mandatory reporting obligations that apply to all firms in the same way to ensure a level playing field.

5. For Phase 1, do you have a preference for referencing legal status, thresholds of activity, or size proxies? For Phases 2 and 3, do you prefer activity thresholds or size proxies?

Clarity with regard to the legal obligation to report is of primary importance. Therefore tests should be objective by nature. While legal status offers the greatest degree of certainty, activity needs to be given the highest priority coupled with size proxy thresholds to avoid excessive demands being placed on occasional users of derivatives.

While the concept of trade reporting thresholds is straightforward they are in practice more subtle and difficult to put into effect. Current US experience illustrates the practical difficulties being encountered by firms in determining their obligations. The Dodd-Frank Act CFTC Rules make exception to the swap dealer definition based on a de minimis threshold for swap dealing activity in any twelve month period of $3 billion, with a threshold phase-in period that sets the initial threshold at $8 billion. Consequently, if an entity's swap dealing activity over the past year results in swap positions with an aggregate gross notional amount of less than $8 billion, then it is not required to register as a dealer. Swaps that do not constitute dealing activity (including those, such as inter-affiliate swaps, that are specifically excluded under the Rules when analysing if a person is a dealer) are not taken into consideration for the purposes of this calculation. Significantly, though, the notional thresholds to the de minimis exception encompass swap dealing positions entered into by an affiliate controlling, controlled by or under common control with the person at issue. This complicates the de minimis test analysis for large corporate groups that engage in swap dealing activities through multiple entities. The de minimis threshold exempts many smaller market participants from having to register as a dealer, and delayed the need to register for some entities. The overall effect has been to cause uncertainty for firms with regard to the obligation to report because variability in trading volumes may affect whether the threshold is crossed.

6. Do you have comments on the proposed regulations at Attachment A? Or is there another option you prefer? If so why?

We do not have any direct comments on the drafting, but see our comments in relation to Question 7.

7. Do you have comments on the proposal to wait until after review processes before making a decision on mandating trade reporting of electricity derivatives? Or is there another option you prefer? If so, why?

AFMA supports the proposal to wait until after review processes before making a decision on mandating trade reporting of electricity derivatives. It is noted that the operation of financial markets falls outside the AEMC's key functions and core expertise. It is the expectation of our electricity market members that any consultation with the AEMC would be transparent and where appropriate industry consulted throughout the process.

An emerging issue identified by our members relates to the phrase in the “ordinary course of business dealings”; those transactions executed to manage a person’s risk profile in relation to key financial and commodity input costs (e.g. foreign exchange trades to manage the price risk associated with the international procurement of fuel or large capital purchases). Given the similar exemptions under AML and AFSL licensing requirements, there is a case for an exclusion from the Determination (or at least in the Derivative Transaction Rules if more appropriate).

8. Are there other bodies with responsibility for underlying assets upon which a derivative is based that should be also be specified under section 901J?

No.

9. Do you have comments on the proposal to implement the trade reporting and trade repository licensing regime expeditiously, but not to impose interim reporting obligations ahead of this? Or is there another option you prefer? If so, why?

Significant resources need to be devoted to implementation of trade reporting which is a complex process. Interim reporting would add confusion and complexity and current experience indicates that it would yield only partial and impure data which would be of doubtful benefit.

The benefits from the collection of data are long term ones and we are embarking on a long journey which requires a degree of patience before the benefits of having good quality data set over periods of time can be realised. Accordingly, we do not support the idea of interim reporting from an Australian domestic perspective.

However, the need to meet extraterritorial requirements when seeking to demonstrate substituted compliance may make it desirable as a short term expedient to put in place easily implemented interim reporting arrangements. If this were to be done, subject to cross border confidentiality issues being effectively addressed, acquiring data from existing international trade repositories to which many international banks are already reporting would provide a sensible interim arrangement.

2. Central Clearing

10. Do you have comments on the proposal to not impose central clearing obligations at this stage? Or is there another option you prefer? If so, why?

The most pressing issue facing the transition to central clearing for AUD interest rate swaps is the availability of a suitable central counterparty (CCP) infrastructure to the Australian market. The approval of clearing and settlement license applications being made by interested service providers is a matter of high priority to the Australian financial services industry. The imposition of a mandatory clearing obligation without this threshold issue being settled would not make sense.

There is an industry commitment and desire to conform with government policy with regard to central clearing. The impact of higher capital requirements on bilateral trades and collateral management are major incentives to the market to get as many trades as possible into centralised clearing. A decision made as soon as possible on licensing one or more CCPs would allow market participants to move forward with settling commercial arrangements and putting in place necessary systems which require lead times and the devotion of resources. Continuing delay on a decision fosters an environment of uncertainty and planning complexity which runs counter to the objective of reducing systemic risk.

Extraterritorial considerations may make it desirable at some as yet undetermined point to mandate clearing of particular derivatives and make other regulatory changes such as those in relation to withholding tax reform, facilitation of portability and segregation of collateral.

3. Trading Platforms

11. Do you have comments on the proposal to not impose trading obligations at this stage? Or is there another option you prefer? If so, why???

The preference of many members is to permit market forces to shape demand for execution platforms. The rationale for clearing is quite distinct to that for execution on a trading platform. Trading platforms do not address the same systemic risk issue. The adoption of execution, particularly on electronic platforms, is tied into commercial and operational considerations for market participants.

Use of trading platforms may not be favoured in some circumstances because standardisation is not a suitable solution for some parts of the heterogeneous OTC derivatives markets. The need for bespoke derivatives means that liquidity is not always possible resulting in the need for different transparency solutions for various market segments and niches.

Many OTC derivatives contracts are not suitable for trading on a platform as, due to their customised nature, they would trade very infrequently. Non-standardised derivatives serve the special financing and risk mitigating needs of end-users. Retail interest in OTC derivatives products is limited compared to the simple products and risk exchanged in transparent markets. These markets are also in constant evolution and need to adapt to the new conditions as a result of market demand.

Accordingly, platform trading of OTC derivatives may not be appropriate in all circumstances.

While mandated trading many not be suitable for all market segments, there can be price transparency and liquidity benefits in moving to electronic trading, particularly to offset the costs of clearing.

As noted in the work of the Council, commercial imperatives might organically drive execution for those derivatives suited to standardisation. However, the United States has mandated both clearing and execution, on the basis they both contribute to the better functioning of markets. Regulatory intervention may be required at some stage to assist the market meet extraterritorial requirements flowing from regulation in other jurisdictions.

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

Yours sincerely

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