Report on the Australian OTC Derivatives Market

November 2015

Australian Prudential Regulation Authority
Australian Securities and Investments Commission
Reserve Bank of Australia

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1. Introduction and Executive Summary

At the Pittsburgh summit in September 2009, the G20 leaders committed to reform over-the-counter (OTC) derivatives markets, specifically that:

> All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.

The G20 leaders later added to these commitments, agreeing that international standards on margining of non-centrally cleared OTC derivatives should be developed. To complement these margin requirements, in January 2015 the International Organization of Securities Commissions (IOSCO) finalised international standards on risk mitigation techniques for non-centrally cleared derivatives.

Since 2009, the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) (together, the Regulators), have been working towards implementing these reforms in the Australian OTC derivatives market. As these reforms cut across the responsibilities of all of the Regulators, and involve advising the Minister on the case for mandatory trade reporting, central clearing or platform trading obligations, the Regulators have coordinated this process through the Council of Financial Regulators. In particular, the Regulators have carried out periodic assessments of the Australian OTC derivatives market, and produced reports based on the results. This report constitutes the Regulators' latest advice to the Minister. Previous reports were published by the Regulators in April 2014, July 2013 and October 2012.[1]

In conducting their assessment, the Regulators have drawn on both quantitative and qualitative information. The Regulators continued to monitor developments through ongoing discussions with market participants and financial market infrastructure (FMI) providers and, as in previous assessments, have also been informed by surveys of market participants' OTC derivatives market activities and practices, in this case administered in mid 2015. In preparing this report, the Regulators have also used trade repository (TR) data.

Under the *Corporations Act 2001*, the Minister is required to take into account such advice from the Regulators before issuing a determination that mandatory reporting, central clearing or platform trading obligations should apply. In accordance with recommendations made in previous reports, in September 2015 the government issued a Ministerial determination imposing mandatory central clearing obligations in Australia for OTC interest rate derivatives (IRD) denominated in Australian dollars, US dollars, euros, Japanese yen and British pounds. The government also released amendments to the *Corporations Regulations 2001*, which restrict the institutional scope of the determination to internationally active dealers.

In addition to setting out the latest advice from the Regulators to the Minister on mandatory clearing obligations, this report contains a framework for assessing the case for mandatory trading obligations and an assessment of the Australian market's preparedness for compliance with the margin requirements developed by the Basel Committee on Banking Supervision (BCBS) and IOSCO, and IOSCO risk mitigation standards for non-centrally cleared derivatives.

[1] The Regulators also published a report in May 2009, prior to the establishment of the regime for implementing mandatory obligations.

1.1 Central Clearing

In accordance with their stated approach to considering the case for mandatory clearing obligations, the Regulators have considered the case for extending the clearing obligation to products for which a foreign authority has recently introduced a clearing mandate and products currently available for clearing by central counterparties (CCPs) licensed to operate in Australia. Specifically, the Regulators have considered IRD denominated in 15 different currencies as well as US dollar/Indian rupee forwards.

Consistent with previous assessments, the Regulators have focussed on the incremental benefits and costs of imposing mandatory clearing, relative to allowing the market to transition to central clearing in response to private or other regulatory incentives. For the majority of products considered the level of activity in the Australian market is relatively low. While there is significant activity in New Zealand dollar-denominated IRD, a large proportion of this activity is already being centrally cleared. Consequently, the incremental systemic risk benefits associated with a mandatory central clearing obligation for these products are likely to be limited. Furthermore, since the New Zealand dollar is not subject to a central clearing mandate in any foreign jurisdiction, there are no international consistency benefits to introducing a central clearing mandate in Australia.

With respect to those products subject to a central clearing mandate in a foreign jurisdiction, the absence of clear frameworks for substituted compliance or equivalence apart from in the European Union and the United States limits the likelihood that Australian market participants would receive material cross-border regulatory compliance benefits if these products were subject to mandatory central clearing in Australia. There is also limited scope for regulatory arbitrage, due to the domestic focus of these mandates.

> **The Regulators therefore do not see a case at this time for extending the scope of the Australian central clearing mandate to include IRD denominated in currencies other than the Australian dollar, the US dollar, the euro, the British pound and the Japanese yen. Similarly, the Regulators do not recommend a central clearing mandate for US dollar/Indian rupee forwards at this time.**

The Regulators will, however, continue to review activity in the Australian market on an ongoing basis. This process of ongoing monitoring will be aided by the availability of trade reporting data. Going forward, the Regulators will periodically assess the case for extending the clearing mandate. However, the Regulators propose formally to report on these assessments only if one of the following conditions is met:

- *Reduction in systemic risk*. The level of trading in the product is giving rise to significant bilateral counterparty credit exposures and the product meets the preconditions for central clearing.
- *International consistency*. There is substantial evidence that a central clearing mandate is likely to have material substituted compliance or equivalence benefits for Australian market participants, or there is material potential for regulatory arbitrage resulting from the lack of a mandate in Australia.

1.2 Platform Trading

The Regulators see in-principle benefits from increased use of trading platforms. Platform trading has the potential to promote greater competition, increased participation, better transparency, and improved market oversight, thus contributing to the realisation of the G20 Leaders' objectives of improving transparency in the derivatives market, mitigating systemic risk, and protecting against market abuse.

The Regulators will continue to consider the case for promoting the use of trading platforms, including by introducing a trading mandate. While the Regulators are not making specific recommendations on the appropriate scope of mandatory trading obligations in this Report, the Regulators consider it timely to give market participants and international regulatory peers more clarity around how they will assess the case for introducing trading mandates. In particular, the Regulators have clarified in this Report the means by which they will monitor developments in the Australian OTC derivatives market, and the criteria that the Regulators will consider when providing advice to the Minister under the Corporations Act.

In prioritising their considerations, the Regulators will consider the standardisation of a product's contractual terms and operational processes, and a product's liquidity. For products that meet these preconditions, the Regulators will consider:

- The implications of introducing a mandatory trading obligation for the *efficiency, integrity and stability of the Australian financial system* as a whole, as well as the *regulatory impact* on market participants and financial market infrastructures active in the Australian market. For each product identified and prioritised, the Regulators will focus on the incremental benefits and costs of imposing mandatory trading, relative to allowing the market to transition to platform trading in response to private or overseas requirements.
- *Relevant international standards and international commitments.* The Regulators will consider whether, in the absence of broadly harmonised requirements, there may be potential for regulatory arbitrage or other distortions in market participants' choices, including choices as to where to execute or book trades or the platforms that may be used to execute trades. The Regulators will also consider the implications for other jurisdictions' assessments of the equivalence of the Australian regime, and the potential to mitigate unintended consequences for Australia of overseas mandatory requirements.
- In the case of commodity derivatives, the Regulators will pay particular attention to the potential impact of imposing a platform trading mandate on *underlying commodity markets* and the participants in these markets.

1.3 Risk Management Practices

Australia intends to implement the BCBS-IOSCO margin requirements framework and IOSCO's risk mitigation standards in its regulatory regime. In the first instance this will be through APRA's prudential standards. This reflects that the Australian market is dominated by a small number of APRA-regulated institutions and large foreign institutions that would be subject to foreign rules. While the volume of transactions and level of risk associated with transactions that would not be captured (directly or indirectly) by either APRA prudential standards or foreign rules is not expected to be material, the Regulators will consider the approach for non-APRA regulated institutions in 2016.

In anticipation of implementing these requirements, the Regulators have surveyed and met with a range of APRA-regulated entities to gauge their preparedness for compliance with the BCBS-IOSCO margin requirements and IOSCO risk mitigation standards for non-centrally cleared derivatives. In general, the larger Authorised Deposit-taking Institutions (ADIs) in Australia are well aware of requirements, and appear to be working towards complying. Indeed, some ADIs have indicated that they expect to voluntarily comply with foreign rules before becoming directly subject to the margin requirements under Australian rules. However, it is recognised that there are currently legal impediments to posting initial margin in a bankruptcy-remote manner, which is one of the requirements under the BCBS-IOSCO framework. Consequently, the government is in the process of considering legislative proposals that would better support the exchange of initial margin.

The remainder of this report is structured as follows:

- Chapter 2 provides an overview of developments across all aspects of OTC derivatives reforms.
- Chapters 3 to 6 focus on trade reporting, central clearing, platform trading and risk management practices, respectively. These chapters provide updates on domestic and overseas regulatory developments relevant to each of these commitments, as well as further assessment and recommendations, as appropriate.
- Chapter 7 describes the next steps.

2. Overview of Regulatory Developments

The G20 OTC derivatives reforms cover trade reporting, central clearing, platform trading and risk management practices. Before turning to developments specific to each of these areas, this Section provides an overview of domestic and international developments that cover the breadth of the reform agenda. Internationally, much of this work has focussed on monitoring implementation and addressing cross-border regulatory conflicts and inconsistencies.

2.1 April 2014 Report on the Australian OTC Derivatives Market

The Regulators published their third periodic Report on the Australian OTC Derivatives Market (the Report) in April 2014.[2] To inform the Report, the Regulators conducted two surveys: a survey of dealers active in the Australian market and a non-dealer survey. The Report reconsidered the case for introducing a mandatory clearing obligation for Australian dollar-denominated IRD, and North American, European and Japanese referenced credit index derivatives. The Report also considered the case for including non-dealers within the entity scope of the central clearing mandate.

The key recommendations arising from the Report were that:

- The government should consider a central clearing mandate for trades between internationally active dealers in Australian dollar-denominated IRD. The Regulators had previously recommended that this mandate cover trades in US dollar, euro, British pound and Japanese yen-denominated IRD.
- The Regulators did not see a case for implementing a central clearing mandate for North American, European and Japanese referenced credit index derivatives at the time of the Report, particularly since most Australian market activity in these products involved at least one European Union- (EU) or United States- (US) headquartered company.
- The Regulators judged that is was not appropriate to mandate central clearing for non-dealers at the time of the Report. Nevertheless, the Regulators undertook to continue to monitor the availability of client clearing for OTC IRD and the incentives-led migration to central clearing, particularly by non-dealers with access to sufficient liquidity, and to review the impact of international regulatory developments.

The Report also considered the case for mandating platform trading. The Regulators did not recommend a mandatory platform trading obligation, making three key observations:

- The Regulators would prefer to see further consensus emerge among key jurisdictions on the characteristics of trading platforms eligible for discharging trading mandates before establishing such a mandate.
- Liquidity for many asset classes in Australian OTC derivatives markets was not high by international standards.
- The Regulators would prefer to await the outcome of Treasury's review of the Australian Market Licence regime before recommending any platform trading obligations.

The Regulators nevertheless committed to continue monitoring developments in this area, noting that international consistency could become a higher priority if platform trading was mandated overseas for products traded actively in Australia.

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[2] APRA, ASIC and RBA (2014), *Report on the Australian OTC Derivatives Market*, April. Available at <http://www.cfr.gov.au/publications/cfr-publications/2014/report-on-the-australian-otc-derivatives-market-april/>.

The Regulators also considered developments in risk management practices for derivatives markets. In particular, it was noted that the legal and operational arrangements that underpin these collateralisation arrangements would be relevant as the Regulators considered the implementation of margin requirements for non-centrally cleared OTC derivatives.

2.2 Implementation Monitoring

2.2.1 OTC derivatives reforms

Since the 2014 Report, the Financial Stability Board (FSB) has published three progress reports on the implementation of OTC derivatives reforms.[3] The FSB publishes these reports periodically, at the request of the G20 leaders, in order to monitor jurisdictions' progress and to encourage consistent and timely implementation of OTC derivatives reforms.

The most recent report, published in July 2015, reaffirmed that implementation was most advanced for trade reporting and higher capital requirements for non-centrally cleared derivatives. As of June 2015, trade reporting and higher capital requirements were in effect, at least for some transactions, in 16 FSB jurisdictions (Table 1). Frameworks for central clearing of standardised OTC derivatives were also well advanced, though the degree of progress within those frameworks varied across jurisdictions and across asset classes. In contrast, the majority of FSB jurisdictions were found to have implemented only the legislative framework or other authority necessary to implement margin requirements for non-centrally cleared derivatives and platform trading.

Table 1: Progress of OTC Derivatives Market Reforms

As at end June 2015, Number of FSB jurisdictions

	Trade reporting	Central clearing	Capital	Margin	Platform trading
No existing authority and no steps taken to adopt such authority	-	-	-	2	2
Legislative framework or other authority in force	2	5	3	12	12
Standards/requirements have been published for public consultation[(a)]	1	2	-	5	1
Standards/requirements have been adopted for at least some transactions[(a)]	2	5	3	-	3
Standards/requirements are in effect for over 90 per cent of transactions[(a)]	14	7	13	-	1

(a) For central clearing and platform trading this includes where criteria for determining when products should be centrally cleared/platform traded have been published for public consultation/adopted for at least some transactions/are in effect for over 90 per cent of transactions

Source: FSB

3 FSB (2015), *OTC Derivatives Market Reforms: Ninth Progress Report on Implementation*, July. Available at <http://www.financialstabilityboard.org/wp-content/uploads/OTC-Derivatives-Ninth-July-2015-Progress-Report.pdf>. FSB (2014), *OTC Derivatives Market Reforms: Eighth Progress Report on Implementation*, November. Available at <http://www.financialstabilityboard.org/wp-content/uploads/r_141107.pdf>. FSB (2014), *OTC Derivatives Market Reforms: Seventh Progress Report on Implementation*, April. Available at <http://www.financialstabilityboard.org/wp-content/uploads/r_140408.pdf>.

Progress in Australia is in line with other jurisdictions, with trade reporting and higher capital requirements in effect, the criteria for determining when product should be centrally cleared in force, and the legislative framework for margin and platform trading in force as of June 2015.

The FSB also noted that the availability and use of centralised infrastructure to support OTC derivatives reforms continued to expand. As of June 2015 there were 19 TRs authorised to operate in at least one of 12 FSB jurisdictions, eight of which were authorised to accept trade reports under multiple regimes. A further six jurisdictions had TR-like entities established to accept trade reports.

At the same time, 14 FSB jurisdictions had authorised at least one CCP that cleared OTC IRD; however, only nine jurisdictions had authorised CCPs that cleared one of the other asset classes. There was also evidence of growing cross-border recognition of CCPs, with 16 CCPs authorised to operate in more than one FSB jurisdiction, including one authorised to operate in six jurisdictions. Nevertheless, 12 CCPs had applications for recognition in the EU either pending or under consideration, and five were operating in the US under temporary exemptions.

The FSB will provide a further update to the G20 Leaders ahead of the November 2015 G20 summit.

2.2.2 FMI regulation

In June 2015, the Committee on Payments and Market Infrastructures (CPMI) and IOSCO published an update on the first stage, or 'level 1', assessments of the implementation of the *Principles for Financial Market Infrastructures* (PFMI) across 28 jurisdictions.[4] The report found that as of January 2015 most jurisdictions, depending on the type of FMI, had final implementation measures in force. Australia was found to have final implementation measures in force for all FMI types in the previous update, which was assessed as of January 2014.

In February 2015, CPMI and IOSCO also published the first set of 'level 2' assessments. This set of reports focused on peer reviews of whether the implementation measures in the European Union, Japan and the United States were complete and consistent with the requirements in the PFMI for TRs and CCPs. A similar assessment of Australia is currently in progress; however, the assessment of Australia covers all FMI types. Other jurisdictions will be assessed at level 2 over time.

In July 2015, CPMI and IOSCO announced the start of the first 'level 3' assessments, which will examine consistency in the outcomes from implementing the requirements in the PFMI.[5] The first level 3 review will focus on a subset of requirements in the PFMI in the area of financial risk management by CCPs including the standards related to governance, stress-testing, margin, liquidity, collateral, and recovery. This first review will consider a sample of globally and locally active CCPs that clear derivative products, including ASX Clear (Futures) Pty Limited (ASX Clear (Futures)), Chicago Mercantile Exchange Inc. (CME) and LCH.Clearnet Ltd (LCH.C Ltd). The results of this first set of level 3 assessments are expected to be published in mid-2016.

Finally, a peer review assessing the extent to which relevant authorities, including ASIC and the RBA, are observing the 'Responsibilities for Central Banks, Market Regulators and other Relevant Authorities for FMIs' (the Responsibilities) has been carried out during the year and is expected to be published by the end of 2015. The Responsibilities set out the expectations with respect to authorities' powers and resources, disclosure of policies, adoption of the PFMI and cooperation with other authorities.

4 CPMI-IOSCO (2015), *Implementation Monitoring of PFMI – Second Update to Level 1 Assessment Report*, June. Available at <http://www.bis.org/cpmi/publ/d129.htm>.

5 CPMI-IOSCO (2015), *CPMI and IOSCO Begin First "Level 3" PFMI Principles Assessment*, Press release, 9 July. Available at <http://www.bis.org/press/p150709.htm>.

2.3 Cross-border Issues

In their February 2014 Communiqué the G20 Financial Ministers and Central Bank Governors recognised the importance of resolving cross-border issues in OTC derivatives and other post-crisis regulatory reforms. They stated:

> We want to promote resilience in the financial system and greater certainty in the regulatory environment to support confidence and growth. We will implement these reforms in a way that promotes an integrated global financial system, reduces harmful fragmentation and avoids unintended costs for business. We commit to cooperate across jurisdictions with a renewed focus on timely and consistent implementation supported by meaningful peer reviews, including OTC derivatives reform. In relation to this reform, we agree that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulatory regimes.[6]

To support this aim the G20 Leaders have given the FSB and the OTC Derivatives Regulators Group (ODRG) the task of settling the OTC derivatives issues related to overlapping cross-border regulatory regimes, and regulatory arbitrage.

OTC Derivatives Regulators Group

The ODRG comprises 12 market regulators from major jurisdictions, including ASIC. In September 2014, the ODRG published a report to the G20 Leaders on its progress in addressing cross-border implementation issues identified in its March 2014 report.[7] In particular:

- *Organised trading platforms.* The ODRG agreed that to avoid an unnecessary burden and unintended consequences for foreign organised trading platforms, consistent with their respective statutory and other legal requirements they would consider (a) recognition, (b) registration and substituted compliance, or (c) registration categories and exemptions. They also agreed that whenever possible the details of laws and regulations applicable to foreign organised trading platforms should be made clear before their implementation, and there should be appropriate transitional measures with a reasonable but limited transition period.

- *Implementation mandatory platform trading obligations*. The ODRG announced that it was developing a framework for consultation among authorities on mandatory trading determinations, similar to the framework that it had developed for mandatory clearing determinations.

- *Barriers to reporting information to TRs.* The ODRG wrote to the FSB in August 2014 highlighting the existence of barriers that prevented reporting of counterparty-identifying information to TRs. The ODRG suggested setting an ambitious but realistic deadline by which such barriers should be addressed. In addition, the ODRG noted that it was considering the possibility of having a deadline by which the masking of counterparty-identifying information in reports to TRs would not be permitted. The ODRG also called on the FSB to address this issue in its peer review of trade reporting (discussed in Section 3.4.4).

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6 G20 (2014), 'Communiqué', Meeting of Finance Ministers and Central Bank Governors, Sydney, 22–23 February. Available at <https://g20.org/wp-content/uploads/2014/12/Communique%20Meeting%20of%20G20%20Finance%20Ministers%20and%20Central%20Bank%20Governors%20Sydney%2022-23%20February%202014_0.pdf>.

7 ODRG (2014), 'Report of the OTC Derivatives Regulators Group on Cross-Border Implementation Issues', March. Available at https://g20.org/wp-content/uploads/2014/12/10 per cent20Report per cent20of per cent20the per cent20OTC per cent20Derivatives per cent20Regulators per cent20Group per cent20on per cent20Cross-Border per cent20Implementation per cent20Issue_0.pdf.

Another focus for the ODRG has been consideration of how deference to foreign regimes may work in practice, including how to monitor the continued effectiveness and comparability of foreign legal regimes after equivalence or substituted compliance has been granted. The ODRG will provide a further progress report to the G20 Leaders ahead of the November 2015 G20 summit.

FSB Report on Deference

In September 2014, the FSB published a report on jurisdictions' current capabilities and processes for deferring to another jurisdiction's OTC derivatives regulatory requirements applicable to 'infrastructure providers' (TRs, CCPs and trading platforms), and to market participants.[8] The report found that, while there were some broad similarities in approach, the basis, standards and processes for deference varied both across jurisdictions and across types of entities, and also depended on the scope of deference being granted.

In considering whether to grant deference to a foreign regulatory regime, most jurisdictions reported that they looked at the regulatory outcomes of the foreign regime, compliance with relevant international standards (such as the PFMI) and the comparability of oversight and enforcement by authorities in the foreign jurisdiction. Jurisdictions typically maintained their supervisory authority by requiring entities to register, be licensed or apply for an exemption, even if deference was granted for a wide range of oversight responsibilities and requirements. As a condition for granting deference many jurisdictions required the relevant foreign authorities to enter into information sharing or cooperation arrangements.

All but five jurisdictions reported having some capability to defer to OTC derivatives requirements in another jurisdiction. Among those jurisdictions that had a framework for deference, fewer reported having the ability to defer with respect to requirements placed on market participants, compared to those for infrastructure providers. Nevertheless, as of July 2014 only Australia, Canada and the US reported having deference arrangements in place. As of that date, the Australian authorities deferred, at least partially, to:

- the EU authorities with respect to CCP regulation
- the EU, Hong Kong, Japan and the US authorities with respect to TR regulation in the context of reporting by foreign entities
- Germany, Hong Kong, Singapore, the United Kingdom and the US authorities with respect to market participant regulation
- Canada, EU, Hong Kong, Japan, Singapore and the US authorities for trade reporting requirements.

Subsequent to the report the Australian authorities have extended deference to Singapore's TR regulation and the US Commodity Futures Trading Commission's CCP regulation (discussed further in Sections 3.2.1 and 4.3.2). The Australian Government has also recently prescribed CCPs in the EU, Hong Kong and Singapore for the purposes of fulfilment of mandatory clearing requirements in Australia (see Section 4.1).

IOSCO Cross-border Task Force

IOSCO has established a Task Force on Cross-Border Regulation, with a mandate to:

- develop a common terminology around cross-border regulatory options, highlighting the impact that each of the various approaches may have on investor protection, markets and systemic risk.

[8] FSB (2014), *Jurisdictions' Ability to Defer to Each Other's OTC Derivatives Market Regulatory Regimes*, September. Available at<http://www.financialstabilityboard.org/wp-content/uploads/r_140918.pdf>.

- lay a foundation for the development of guidance on how a particular tool can be used to protect investors, ensure markets are fair, efficient and transparent, and reduce systemic risk.

In September 2015, the Task Force published a final report that identified three general categories of approaches:

- *National treatment.* Foreign persons, entities, and products are generally treated in the same manner as domestic ones irrespective of the foreign regulatory regime. As a result, there is no need for the domestic regulator to develop a detailed understanding of foreign regulatory regimes.
- *Recognition.* Upon assessing that the foreign regulatory regime is sufficiently comparable, the domestic regulator relies on the other jurisdiction's regulatory regime. Recognition may be unilateral or mutual.
- *Passporting.* A single authorisation/registration, which allows for provision of services under the supervision of a single authority. This may require authorities to establish a common set of rules, and may involve the creation of a supra-national authority.[9]

The Task Force noted that the cross-border approach adopted by a jurisdiction might, to varying degrees, involve elements or characteristics of more than one tool. The report concluded that the trend towards greater engagement aimed at solving cross-border overlaps, gaps and inconsistencies through a combination of more granular international standards (where appropriate) and an increasing emphasis on recognition of equivalent laws and regulations. However, the Taskforce acknowledged the practical reality that at this stage recognition mostly occurred on a bilateral basis.

[9] IOSCO (2015), *IOSCO Taskforce on Cross-border Regulation*, September. Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD507.pdf>.

3. Trade Reporting

Implementation of trade reporting in Australia is well advanced, with the Regulators now focussing on examining the quality of the data reported. Internationally, work is focussing on overcoming legal and other barriers to the reporting, sharing and aggregation of key information from TRs.

3.1 Australian Mandatory Requirements

The final phase of mandatory trade reporting of OTC derivatives in Australia came into effect on 12 October 2015. Since the Australian trade reporting obligation first commenced in October 2013, the Council of Financial Regulators (CFR) agencies have continued to engage with industry. In particular, since the last Report ASIC and Treasury have taken a number of actions to improve the efficiency and effectiveness of the regime (discussed below). In February 2015, ASIC also issued a Regulatory Guide, which explains the reporting regime and gives guidance to assist reporting entities' understanding of how to comply with the reporting obligations.[10]

3.1.1 Amendments to the Derivatives Transaction Rules (Reporting)

On 9 February 2015, ASIC made a number of minor amendments to its *Derivative Transaction Rules (Reporting) 2013* (Reporting DTRs).[11] The key amendments:

- introduced the option of end-of-day ('snapshot') reporting instead of intraday ('lifecycle') reporting[12]
- introduced a 'safe harbour' from liability for reporting entities using delegated reporting, where such reporting is done under a written agreement and the reporting entity makes regular enquiries reasonably designed to determine whether the delegate is reporting on behalf of the reporting entity
- expanded the ability for foreign firms to rely on foreign reporting requirements in order to comply with their obligations under the Reporting DTRs (known as 'alternative reporting')
- introduced a requirement for foreign entities who use alternative reporting to designate ('tag') transactions as being reported under the ASIC Reporting DTRs to facilitate access to that information by the Australian Regulators.

The areas amended address aspects of the regime where the Reporting DTRs were either overly burdensome to industry, or did not allow the Australian Regulators to obtain all of the information that they were originally designed to capture. These changes were made following industry consultation, and in some cases provided permanent solutions to issues that had been addressed through time-limited relief in the form of exemptions.[13]

[10] ASIC (2015), *Regulatory Guide 251 – Derivative Transaction Reporting*, February. Available at <http://www.asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-251-derivative-transaction-reporting/>.

[11] *ASIC Derivative Transaction Rules (Reporting) Amendment 2015 (No. 1)*, available at <https://www.comlaw.gov.au/Details/F2015L00132>.

[12] The amendments allow ASIC to require the reporting of intraday trades in a derivative or class of derivative. While ASIC does not presently intend to exercise this power, for market integrity purposes it continually reviews the need to require certain intraday OTC derivatives transactions, such as for contracts for difference or margin foreign exchange derivatives, to be reported.

[13] The full list of exemption relief is available at <http://www.asic.gov.au/regulatory-resources/markets/otc-derivatives-reform/derivative-transaction-reporting/exemption-relief-for-reporting-entities/>.

3.1.2 Class exemptions

As noted above, ASIC has also provided relief from certain requirements in the Reporting DTRs in the exemptions. Some of these exemptions provided time-limited relief to address implementation issues, while others are more permanent.

'Entered into' transactions

One prominent area of permanent relief is in relation to the circumstances in which foreign entities are required to report their OTC derivatives transactions. The Reporting DTRs specify that a foreign entity must report its OTC derivatives under the Australian regime if they are booked to the profit or loss account of the entity's Australian branch or 'entered into' by the entity in Australia.

To facilitate the development and implementation of the required information technology, systems and processes to identify 'entered into' transactions, ASIC issued a temporary exemption, which expired on 1 February 2015. In June 2014, ASIC issued guidance specifying that foreign entities should use the principles of Australian contract law to determine whether an OTC derivative is entered into in Australia. Nevertheless, industry still had concerns about the complexity of making such determinations. Consequently, in February 2015 ASIC issued relief that provides for an alternative approach.[14] Under this approach, the location of the sales person or trader is used to determine whether a trade was entered into in Australia.[15] This is known as the 'nexus test'. The requirement to report nexus trades commenced on 25 May 2015.

Postponement of reporting by Phase 3 entities

ASIC also used a class exemption to postpone the date that the reporting obligation came into effect for Phase 3 entities, which are financial entities that had less than $50 billion notional principal outstanding as at 31 December 2013.[16] Phase 3 entities were originally due to begin reporting interest rate and credit derivatives on 1 October 2014. In June 2014, ASIC issued a class exemption that split Phase 3 into two smaller phases:

- *Phase 3A* entities with notional principal OTC derivatives outstanding between $5 billion and $50 billion
- *Phase 3B* entities with notional principal outstanding below $5 billion.[17]

Under the exemption, the commencement of mandatory reporting requirements for Phase 3A and 3B entities was linked to the licensing of the first TR in Australia. As a result of the licensing of DTCC Data Repository (Singapore) Pte Ltd (DDRS, see Section 3.2.1 for further details), Phase 3A entities were required to commence reporting their credit and interest rate derivatives on 13 April 2015. Reporting of all other OTC derivatives by Phase 3A entities commenced on 12 October 2015. The reporting obligation for Phase 3B entities was also due to commence on 12 October, but as some entities revised their business decisions in light of the government's decision to allow single-sided reporting (see Section 3.1.3), ASIC postponed the commencement date to 4 December 2015.[18]

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[14] *ASIC Derivative Transaction Rules (Nexus Derivatives) Class Exemption 2015*, available at <https://www.comlaw.gov.au/Details/F2015L00100>.

[15] Reporting entities must notify ASIC in writing if they intend to use this alternative approach.

[16] Financial entities refers to ADIs, Australian Financial Services Licence holders, CS Facility Licence holders and exempt foreign licensees.

[17] Measured as at 31 December 2013.

[18] *ASIC Corporations (Derivative Transaction Reporting) Amendment Instrument 2015/0925*, available at <https://www.comlaw.gov.au/Details/F2015L01642>.

3.1.3 Single-sided reporting for Phase 3B

Under the Reporting DTRs, a financial entity is required to report all OTC derivatives transactions, even if its counterparty is also subject to the Reporting DTRs (so called 'two-sided' reporting). However, an entity can delegate this responsibility to a third party – including to its counterparty.

Following engagement with industry, in December 2014, the government announced that it would provide relief from the trade reporting requirements by allowing 'single-sided reporting' for entities with low levels of OTC derivatives transactions. On 3 September 2015, the government implemented this relief through an amendment to the *Corporations Regulations 2001*, which specifies that a financial entity with less than $5 billion OTC derivatives outstanding is not subject to the reporting obligation where its counterparty is required to report the transaction under the Reporting DTRs.[19] This condition ensures that all transactions booked or entered into in Australia are reported by at least one counterparty.

3.2 Trade Repositories

To fulfil a mandatory trading obligation under the Reporting DTRs, a transaction report must be made to a licensed TR or one that is prescribed by regulation. An Australian entity is required to report to a licensed TR where one is available.

3.2.1 Licensed Trade Repositories

DTCC Data Repository (Singapore) Pte Ltd

On 15 September 2014, ASIC granted an Australian derivative trade repository (ADTR) licence to DDRS.[20] The granting of DDRS' ADTR licence followed detailed analysis by ASIC to ensure that DDRS complied fully with requirements set out in ASIC's Derivative Trade Repository Rules (DTRRs). These rules implement the relevant parts of the PFMI, which are the international standards for TRs and other FMIs.

Since DDRS is established in Singapore, the Monetary Authority of Singapore (MAS) is its primary supervisor, and therefore is responsible for day-to-day oversight. To minimise duplication of regulatory requirements ASIC has granted DDRS relief from certain provisions of the DTRRs conditional on its compliance with specified Singaporean law requirements and other specified conditions.[21] However, ASIC remains closely engaged with the MAS and DDRS, particularly on issues such as cybersecurity and governance.

Another key criterion for ASIC in the licensing of a foreign TR is ensuring that the Australian Regulators are able to access data reported to that TR (for further details see Section 3.3).

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[19] *Corporations Amendment (Central Clearing and Single‑Sided Reporting) Regulation 2015*. Available at <www.comlaw.gov.au/Details/F2015L01411>.

[20] *Australian Derivative Trade Repository Licence (DTCC Data Repository (Singapore) Pte Ltd) 2014*, Instrument No. 14/0912. Available at <http://download.asic.gov.au/media/1915139/ddrs-adtr-licence-15-september-2014.pdf>.

[21] ASIC (2014), *Exemption Instrument No. 14/0913*, Available at <http://download.asic.gov.au/media/1915145/ddrs-adtr-licence-15-september-2014-exemption.pdf>.

Chicago Mercantile Exchange Inc.

On 23 October 2015, ASIC granted CME an ADTR licence.[22] Under the terms of the licence, CME is allowed to act as a TR for commodity, credit, foreign exchange and interest rate derivatives transactions that are subject to ASIC's trade reporting requirements. CME is also licensed by the Commodity Futures Trading Commission (CFTC). ASIC and the CFTC have an existing memorandum of understanding (MoU) in place to support the cooperation and exchange of information in the supervision of regulated entities, such as CME, that have cross-border operations in the United States and Australia.

3.2.2 Prescribed Trade Repositories

Under the Reporting DTRs foreign entities that are subject to substantially equivalent overseas reporting regimes can fulfil their obligations under the Reporting DTRs by reporting under those regimes (i.e. alternative reporting). Currently, the reporting requirements in Canada, the EU, Hong Kong, Japan, Singapore and the US are recognised as substantially equivalent. This provision addresses the potential for duplicative requirements due to the cross-border nature of many derivatives transactions.

Nevertheless, even under alternative reporting, a foreign entity must report to a licensed or prescribed TR. Initially, the government temporarily prescribed a list of TRs.[23] In the interim, the government issued a Corporations Regulation setting out a class of TRs that ASIC can prescribe; namely, TRs where:

- the facility substantially observes or the relevant foreign jurisdiction has substantially adopted the requirements in the PFMI relevant to TRs
- adequate arrangements exist for cooperation between ASIC and an appropriate authority responsible for licensing, authorising or registering the facility as a derivative TR in the foreign jurisdiction.

On 25 June 2015, ASIC announced its determination that the following TRs met these criteria and were therefore prescribed.[24]

- DTCC Data Repository (US) LLC
- Derivatives Repository Ltd
- DTCC Data Repository (Japan) KK
- DTCC Data Repository (Singapore) Pte Ltd
- UnaVista Limited
- the Monetary Authority appointed under section 5A of the *Exchange Fund Ordinance* of Hong Kong.

This prescription has no expiry date.

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[22] *Australian Derivative Trade Repository Licence (Chicago Mercantile Exchange Inc.) 2015*, Instrument No. 15/0910. Available at <http://download.asic.gov.au/media/3379988/australian-derivative-trade-repository-licence-chicago-mercantile-exchange-inc-2015-dated-23-october-2015.pdf>.

[23] Initially, this temporary prescription was due to expire on 30 June 2014, but it was subsequently extended to 30 June 2015.

[24] This list is available here: <http://download.asic.gov.au/media/3276186/asic-prescribed-trade-repositories-determination-15_0591.pdf>.

3.3 Access to and Use of Trade Repository Data

Data Access Memoranda of Understanding

To facilitate access to trades reported to foreign TRs, the Australian Regulators have established, or are in the process of establishing, MoUs with the primary supervisors of such TRs in the EU and Singapore.[25] These MoUs allow TRs located in these jurisdictions to provide data to the Australian Regulators for the purpose of enabling each Regulator to fulfil its respective responsibilities and mandates, while ensuring that the privacy of that information is appropriately protected. Consistent with the guidance on authorities' access to TR data issued by CPMI and IOSCO, these MoUs allow Australian Regulators to access data relevant to their respective mandates, even if the data are not reported under ASIC's Reporting DTRs.[26]

ASIC's data access MoUs with the European Securities and Markets Authority (ESMA) and the MAS also provide for authorities in these jurisdictions to access data reported to an ADTR. To facilitate this, the government has prescribed in regulation EU authorities and the MAS as persons able to access data from an Australian-licensed TR.[27] Consistent with the framework set out by CPMI and IOSCO, the regulation specifies the type of data that can be requested from an ADTR and the purposes for which the data may be used.

Regulators' use of TR Data

The Regulators have focussed their efforts accessing data held in two TRs – DDRS and UnaVista (a European TR, which is prescribed by ASIC). Both TRs offer regulators access by either a web portal or through a secure file-transfer process. To enhance their ability to analyse the data, both ASIC and the RBA upload these data into internal databases. ASIC uses its existing market surveillance system for this purpose, while the RBA is developing a new business intelligence platform.

At this stage, the Regulators' use of TR data has focussed largely on examining the quality of the data reported. To support this work, the Regulators have established a monthly forum where they discuss key data quality issues with industry. Regulators have also used TR data to support the analysis and recommendations contained in subsequent chapters of this Report.

3.4 International Developments

A prominent focus of the international regulatory community has been work to overcome legal and other barriers to the reporting, sharing and aggregation of key information from TRs.

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25 The ASIC-ESMA MoU is available at: <http://www.esma.europa.eu/system/files/esma_asic_mou.pdf>. The RBA-ESMA MoU is available at: <http://www.rba.gov.au/payments-system/legal-framework/pdf/memorandum-2015-03-06.pdf>. The ASIC-MAS MoU is available at: <http://download.asic.gov.au/media/2067384/monetary-authority-of-singapore-mou-2014.pdf>. The RBA-MAS MoU is available at: <http://www.rba.gov.au/payments-system/legal-framework/pdf/memorandum-2015-04-27.pdf>.

26 CPMI and IOSCO (2013), *Authorities' Access to Trade Repository Data*, August. Available at <http://www.bis.org/cpmi/publ/d110.pdf>.

27 The prescription for EU authorities and the MAS can be found in parts 7.5A.150A and 7.5A.150B in Volume 2 of the *Corporations Regulations 2001*, available at <https://www.comlaw.gov.au/Details/F2015C00514/Html/Volume_2>.

3.4.1 FSB Aggregation Feasibility Study Group

In September 2014, an FSB Aggregation Feasibility Study Group (AFSG) published its final report on options for aggregating information from TRs and sharing information among authorities.[28] The report found that either a physically centralised aggregation model or a physically decentralised data collection and storage model that used a logical index to aggregate data from local TR databases, were highly preferable to the current practice of each authority collecting and aggregating data individually.

Irrespective of which option was pursued, the report identified the following steps as being necessary for aggregating TR data:

- establish and adopt uniform global identifiers – for example the Universal Transaction Identifiers (UTIs), Universal Product Identifiers (UPIs) and Legal Entity Identifiers (LEIs)
- develop international guidance on harmonisation of data elements
- undertake a more detailed study on the legal and regulatory changes, and the technological and data requirements that would be needed to implement an aggregation mechanism
- consider the appropriate governance structure of an aggregation mechanism
- undertake a detailed assessment of potential costs of implementing any of the options.

The FSB, in close cooperation with CPMI-IOSCO, is currently taking the recommendations forward through a number of streams of work, some of which are discussed below.

3.4.2 CPMI-IOSCO Data Harmonisation Working Group

Consistent with the recommendations in the AFSG's final report, CPMI and IOSCO have established a Data Harmonisation working group to develop detailed guidance to facilitate the harmonisation of data elements across TRs. Over the next two years, this group plans to develop guidance on the definition, format and usage of key data elements, including technical guidance on the form of UTIs and UPIs As a first step, in August this group began consultation on the form of UTIs.[29] This was followed in September by the publication of a consultative report on harmonisation of a first batch of key data elements.[30] The Data Harmonisation working group plans to issue its final guidance on UTI, UPI and other data elements by end-2016.

3.4.3 Legal entity identifiers

There has been continued progress towards adopting a system of LEIs that allows counterparties to be uniquely and consistently identified. In June 2014, one of the main components of the system of LEIs, the Global LEI Foundation (the Foundation), was formally established as a Swiss not-for-profit organisation. The Foundation acts as the central operating arm of the global LEI system, and issues global operational standards and protocols. The other main component – the Local Operating Units (LOUs) – are responsible for issuing LEIs.[31] The Foundation and LOUs are overseen by the LEI Regulatory Oversight Committee (ROC), which is comprised of over 60 member authorities, including ASIC.

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[28] FSB (2014), *Feasibility Study on Approaches to Aggregate OTC Derivatives Data*, September. Available at <http://www.financialstabilityboard.org/wp-content/uploads/r_140919.pdf>.

[29] CPMI-IOSCO (2015), *Consultative Report - Harmonisation of the Unique Transaction Identifier*, August. Available at <http://www.bis.org/cpmi/publ/d131.pdf>.

[30] CPMI-IOSCO (2015), *Consultative Report - Harmonisation of Key OTC Derivatives Data Elements (Other Than UTI and UPI) – First Batch*, September. Available at <http://www.bis.org/cpmi/publ/d132.pdf>.

[31] In September 2015, APIR Systems was endorsed as the first Australian pre-LOU.

Prior to the establishment of the Foundation, as an interim measure, pre-LOUs had been issuing pre-LEIs, which ROC members had agreed would be accepted globally for regulatory reporting purposes in their jurisdictions. Presently, the ROC has been working closely with the Foundation to transition from the interim system to operational management by the Foundation. During this transition period, the ROC will continue to endorse LOUs and monitor their compliance with the LEI policies.

3.4.4 FSB peer review of trade reporting

Another stream of work that has been initiated in response to the AFSG's final report is the FSB peer review of trade reporting in its member jurisdictions, which was launched in late 2014. The main objectives of the review were fourfold:

- to examine the extent OTC derivatives are being reported to TRs
- to identify legal barriers that may hinder reporting or limit authorities' access
- to identify other challenges to comprehensive reporting
- to highlight good practices and lessons learned.

The final report is expected to be published shortly.

3.4.5 OTC Derivatives Regulators Forum

In late 2014, the OTC Derivatives Regulators' Forum (ODRF) revised its scope and objective to focus its activities on issues around TR data quality and solutions to accessing TR data.[32] This change was made to ensure that the group could continue to add value and avoid duplication of work that was being carried out by other international bodies. To support its new activities, the ODRF has also set up a technical working group of TR data experts to provide a forum to share experiences and technical knowledge, amongst other things. ASIC and the RBA are members of the ODRF and the technical working group.

3.5 Overseas Developments

3.5.1 European Union

Since the 2014 Report, ESMA has focused on improving the quality and consistency of the data reported to TRs. This has mainly been through updates to its Questions and Answers document, which promotes common supervisory approaches and practices by providing responses to questions posed by the general public, market participants and competent authorities in relation to the practical application of the European Market Infrastructure Regulation (EMIR).[33] The updates include responses to questions on how specific fields related to collateral and valuations should be reported; these fields have been required since August 2014.

The updates also provide greater detail on how TRs should validate the completeness and accuracy of the reports submitted by reporting entities. TRs are required to implement this validation by end October 2015, after which they are expected to reject reports that are not submitted in line with the EU reporting requirements. This requirement builds on previous validation exercises, where TRs were required to specify which fields were required to be completed in all circumstances and the conditions under which some fields could be left blank.

[32] The ODRF's revised framework is available at: <http://www.otcdrf.org/documents/odrf_framework_may2014.pdf>.

[33] The latest version of the Question and Answer document is available at: <http://www.esma.europa.eu/system/files/2015_775_qa_xii_on_emir_implementation_april_2015.pdf>.

In November 2014, ESMA also published a consultation paper proposing changes to the technical standards of its mandatory trade reporting regime.[34] The proposal sought to incorporate certain elements of the Questions and Answers into the standards. ESMA would also introduce other minor improvements.

In May 2015, the European Commission commenced a review of EMIR. The purpose of the consultation is to obtain feedback from stakeholders on their experiences in the implementation of EMIR to date. As part of this, the consultation document published by the Commission included a number of possible changes to the trade reporting regime.[35]

3.5.2 United States

US Commodity and Futures Trading Commission

Under CFTC rules, the five largest Australian banks are required to report to 'swap data repositories' (TRs licenced by the CFTC). However, having provisionally registered as foreign swap dealers, these banks are eligible to apply to the CFTC for an assessment of the comparability of the Australian trade reporting regime. If the Australian regime is deemed comparable, the CFTC's substituted compliance regime may permit these banks to meet the CFTC requirements by complying with the requirements of their domestic regime. Since the CFTC is yet to conduct these substituted compliance assessments, CFTC staff have granted no-action relief to Australian and other non-US swap dealers until 1 December 2015, relieving them of the requirement to report trades with non-US persons to CFTC-supervised swap data repositories.[36]

US Securities and Exchange Commission

In February 2015, the US Securities and Exchange Commission (SEC) adopted rules that will require security-based swap data repositories to register with the SEC.[37] At the same time, the SEC issued rules that require security-based swap dealers to report their security-based swaps to these repositories. The SEC also proposed certain additional rules, rule amendments and guidance related to the reporting and public dissemination of security-based swap transaction data.

3.5.3 Other jurisdictions

Canada

In Canada, the provincial securities commissions are responsible for implementing trade reporting. Ontario and Québec, being the provinces in which the vast majority of OTC derivatives are booked, are the most advanced (along with Manitoba) in implementing these requirements. The first phase of Canada's OTC trade reporting requirements, which involve dealers and clearing agencies, came into effect in these provinces in July 2014; the requirement to report trades involving other entities commencing in September 2014. Mandatory reporting requirements in the remaining provinces are expected to come into effect in the first half of 2016.

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[34] ESMA (2014), *Consultation Paper – Review of the Technical Standards on Reporting under Article 9 of EMIR*, November. Available at: <http://www.esma.europa.eu/content/Consultation-Paper-review-technical-standards-reporting-under-Article-9-EMIR>.

[35] European Commission (2015), *Public Consultation on Regulation (EU) No. 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories*, May. Available at <http://ec.europa.eu/finance/consultations/2015/emir-revision/docs/consultation-document_en.pdf>.

[36] CFTC (2015), 'Further Extension of Time-Limited No-Action Relief for Swap Dealers and Major Swap Participants from Compliance with Reporting Obligations Under 17 CFR § 45.4(b)(2)(ii)', CFTC Letter No. 15-38, June. Available at <http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-38.pdf>.

[37] SEC (2015), 'Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information', Release No. 34-74244, February. Available at <https://www.sec.gov/rules/final/2015/34-74244.pdf>.

The Canadian authorities have adopted a single-sided approach to trade reporting, with the rules specifying which counterparty is required to report. The Canadian authorities have authorised the three TRs located in the US – CME, DTCC Data Repository (U.S.) LLC and ICE Trade Vault – to receive reports under Canadian rules. Subject to certain conditions, Canadian authorities have allowed compliance with CFTC or EMIR reporting as a substitute for reporting under Canadian rules.

Hong Kong

In July 2015, the Hong Kong *Securities and Futures (Amendment) Ordinance 2014 (Commencement) Notice 2015* came into effect.[38] This ordinance replaces interim reporting requirements, which took effect from August 2013. Consistent with the interim requirements, under the Ordinance banks, licensed corporations, approved money brokers and certain CCPs will be required to report certain foreign exchange and interest rate derivatives to the TR operated by the Hong Kong Monetary Authority (HKMA). The mandatory reporting requirement is two-sided and covers transactions to which the Hong Kong entity is counterparty and where the Hong Kong entity has conducted the transaction in Hong Kong on behalf of an affiliate.

In September 2015, the HKMA and the Hong Kong Securities and Futures Commission launched a consultation on the second phase of mandatory reporting.[39] In this phase they are proposing that the reporting requirement be extended to cover all OTC derivatives products and that a broader range of information would be required to be reported.

Japan

Trade reporting requirements in Japan came into effect in April 2013, with no significant changes to the regime introduced since that time.

Singapore

Reporting by banks under the MAS's *Securities and Futures (Reporting of Derivatives Contracts) Regulations 2013* commenced in April 2014, with the requirement extending to other 'significant derivatives holders' in October 2014.[40] The Singaporean requirement is two-sided and covers transactions booked or traded in Singapore. While banks are required to report interest rate, credit and foreign exchange derivatives transactions, other significant derivatives holders are currently only required to report interest rate and credit derivatives transactions. The extension of reporting requirements for foreign exchange derivatives, as well as reporting of equity and commodity derivatives transactions will be phased in in future stages.

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[38] *Securities and Futures (Amendment) Ordinance 2014 (Commencement) Notice 2015*, available at <http://www.legco.gov.hk/yr14-15/english/subleg/negative/ln095-2015-e.pdf>

[39] HKMA and HKSFC (2015), *Consultation Paper on Introducing Mandatory Clearing and Expanding Mandatory Reporting*, September. Available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/doc?refNo=15CP4>.

[40] *Securities and Futures (Reporting of Derivatives Contracts) Regulations 2013*, available at <http://www.mas.gov.sg/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Funds-Management/Regulations/2013/Securities-and-Futures-Reporting-of-Derivatives-Contracts-Regulations-2013.aspx>.

4. Central Clearing

Since the April 2014 Report, the government and ASIC have taken steps to introduce mandatory clearing obligations consistent with the Regulators' recommendations. Given the growing use of CCPs, further international work has been conducted, or is underway, to examine various aspects of CCP resilience, recovery and resolution. At the same time, there have been developments in the regulation and services of OTC derivatives CCPs licensed in Australia.

In addition, foreign regulators have continued to progress the implementation of mandatory clearing requirements in their respective jurisdictions. In light of these developments, the Regulators have assessed the case for extending the clearing obligation to products for which a foreign authority has recently introduced a clearing mandate and other products currently available for clearing by CCPs licensed to operate in Australia.

4.1 Australian Mandatory Requirements

Consistent with the Regulators' recommendations in the previous two Reports, in September 2015, the government issued a determination imposing mandatory clearing obligations in Australian dollar-, US dollar-, euro-, British pound- and Japanese yen-denominated IRD.[41] Shortly afterwards, the government also released amendments to the *Corporations Regulations 2001*, which restricts the institutional scope of the determination to internationally active dealers.[42] In particular, the mandate is restricted to trades between entities that fall in any of the following categories:

- Australian financial entities with the equivalent of $100 billion or more in gross notional OTC derivatives outstanding
- foreign entities with the equivalent of $100 billion or more in gross notional OTC derivatives outstanding booked or entered into in Australia
- US CFTC- or SEC-registered Swap Dealers, to the extent that they trade with entities captured under the other categories.

Entities will also be able to opt in to being subject to the clearing mandate. The institutional scope was developed after extensive engagement with industry, including through formal consultation and industry workshops.

In parallel to the consultation on the determination, ASIC consulted on *Derivative Transaction Rules (Clearing) 2015* (Clearing DTRs) that set out the details of the mandatory clearing requirement.[43] In particular, the proposed Clearing DTRs:

- specify how entities should calculate whether they are above the $100 billion threshold
- provide more detail on the products scope
- set out the notification requirements associated with becoming or ceasing to be above the threshold, and the record-keeping requirements associated with complying with the requirements

41 *Corporations (Derivatives) Amendment Determination 2015 (No. 1)*. Available at <www.comlaw.gov.au/Details/F2015L01392>.

42 *Corporations Amendment (Central Clearing and Single‑Sided Reporting) Regulation 2015*. Available at <www.comlaw.gov.au/Details/F2015L01411>.

43 ASIC (2015), *Consultation Paper 231 – Mandatory Central Clearing of OTC Interest Rate Derivative Transactions*, May. Available at <www.asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-231-mandatory-central-clearing-of-otc-interest-rate-derivative-transactions/>.

- provide exemptions to the clearing requirement in specific areas, for example when the transaction is between two affiliated entities which are part of the same group

Recognising the cross-border nature of many derivatives transactions, the proposed Clearing DTRs also establish a regime for 'alternative clearing' under which entities can satisfy their obligations through foreign clearing requirements, under certain conditions. Once finalised, the requirements in the Clearing DTRs are expected to come into effect on 4 April 2016.

Prescribed CCPs

Under the *Corporations Act 2001*, a mandatory clearing obligation can be fulfilled only by clearing through a CCP that is licensed in Australia, or in certain circumstances, a 'prescribed' CCP. Where a CCP does not meet the criteria to be 'operating in Australia' for the purposes of the Corporations Act (see Section 4.3.7), and therefore would not be required to be licensed in Australia, but nevertheless clears trades in products that are subject to the Australian clearing obligation, the Australian framework includes the flexibility to prescribe that CCPs. The government has used this flexibility to identify a list of prescribed CCPs in the Corporations Regulations. They are:

- CME Clearing Europe Limited
- Eurex Clearing AG
- Japan Securities Clearing Corporation (JSCC)
- NASDAQ OMX Clearing AB
- OTC Clearing Hong Kong

As a result, these CCPs – along with ASX Clear (Futures), LCH.C Ltd and CME, which are all licensed CCPs – can be used to fulfil the Australian mandatory clearing obligation.

The Corporations Regulations also set out the criteria ASIC must use when prescribing additional CCPs. Specifically:

- the facility must be authorised to operate as a CCP in the country it is established
- the regulatory regime in the CCP's principal place of business must have substantially implemented PFMI
- adequate arrangements must exist for ASIC and the RBA to have access to information about the level of clearing activity by participants that are incorporated or formed in Australia.

4.2 International Regulatory Developments

4.2.1 CCP work plan

In light of their growing systemic importance as the central clearing of OTC derivatives and other types of financial products becomes more widespread, the FSB has taken a deeper interest in CCPs. With this in mind, in April 2015, it was announced that the chairs of the BCBS, CPMI and IOSCO, along with the chairs of the FSB's Standing Committee on Supervisory and Regulatory Cooperation and Resolution Steering Group, had developed a work plan concerning the resilience, recovery planning, resolvability of CCPs, and their interdependencies.[44]

The key elements of the work plan include:

[44] The work plan, including an update on implementation as of September 2015 are available at <http://www.bis.org/cpmi/publ/d134.htm>.

- evaluating existing measures for CCP resilience, including loss-absorption capacity and stress testing
- conducting a stocktake of existing CCP recovery mechanisms, including loss allocation tools, and considering whether there is a need for more detailed standards
- reviewing existing CCP resolution regimes and resolution-planning arrangements, and considering whether there is a need for more detailed standards or for additional prefunded financial resources in resolution
- analysing the interconnections between CCPs and the banks that are their clearing members, and potential channels for transmission of risk.

CPMI-IOSCO is leading the work on CCP resilience and recovery planning, with its Policy Standing Group conducting a stock-take of existing CCP practices.

4.2.2 Recovery and resolution

The review of CCP recovery and resolvability under the CCP work plan follows on from guidance on recovery planning and resolution for FMIs, including CCPs, issued in October 2014.

CPMI-IOSCO Guidance on Recovery Planning

In October 2014, CPMI-IOSCO published final guidance on recovery planning for FMIs, which supports the recovery-related requirements of the PFMI.[45] In itself, the report does not create additional requirements for FMIs or authorities beyond those set out in the PFMI. However, the guidance will assist FMIs in developing their recovery plans. The publication of the guidance follows extensive engagement with the industry and other interested stakeholders, including two rounds of formal consultation.

At a high-level, a comprehensive and robust recovery plan will be expected to:

- identify the critical services offered by the FMI
- identify stress scenarios that may threaten the continued provision of the FMI’s critical services
- set out a range of tools to fully and effectively address threats to the FMI’s viability.

In addition, the guidance elaborates the desirable characteristics of tools that an FMI may use to fully allocate any unfunded losses, address liquidity shortfalls and restore a matched book following a participant default. These include that the tools applied should be comprehensive, effective and transparent, and should both minimise negative impacts and create appropriate incentives. The guidance also provides examples of tools that an FMI may use for these purposes.

FSB FMI Resolution Annex

To complement the CPMI-IOSCO guidance on recovery planning, in October 2014, the FSB published an Annex to the *Key Attributes of Effective Resolution Regimes* (Key Attributes), which are the international standards for resolution regimes.[46] The Annex sets out sector-specific considerations for how the Key Attributes should be applied, including to particular classes of FMI. In particular, the Annex contains detail on the objectives, scope and content of an effective resolution regime for FMIs, as well as guidance on the resolution authority and the resolution powers that should be available in the case of an FMI. Guidance is also provided on how FMIs

[45] CPMI-IOSCO (2014), *Recovery of Financial Market Infrastructures - Final Report*, October. Available at <www.bis.org/cpmi/publ/d121.htm>.

[46] FSB (2014), *Key Attributes of Effective Resolution Regimes for Financial Institutions*, October. Available at <www.financialstabilityboard.org/2014/10/r_141015/>.

should be designed to accommodate the resolution of a participant. The FSB is monitoring jurisdictions' progress in implementing the Key Attributes through a series of peer reviews.

4.3 Australian-licensed CCPs

4.3.1 Overseas recognition of Australian CCPs

European Union

In October 2014, the European Commission adopted Implementing Acts to give effect to the ESMA's positive regulatory equivalence assessment of the regulatory regimes in Australia, Hong Kong, Japan and Singapore. This was followed by the conclusion of an MoU between ASIC, the RBA and ESMA in late November 2014 to govern information sharing and cooperation between the authorities in respect of any Australian CCPs recognised under EMIR.[47] With these preconditions having been met, ESMA announced on 29 April 2014 that ASX Clear (Futures) and ASX Clear Pty Limited, as well as CCPs in Japan, Hong Kong and Singapore, had been recognised as third-country CCPs under EMIR.

In June 2015, the European Commission also extended by six months the period for transitional relief from penalty capital requirements for exposures to CCPs that had not been authorised or recognised by ESMA. The relief, which had previously been extended in December 2014 and June 2014, now expires on 15 December 2015. Under the relief, EU banks do not face significantly higher capital changes for exposures to CCPs that have not been authorised or recognised by ESMA. The extension of this relief will give EU authorities time to complete the process of recognising additional non-EU CCPs.

As part of its response to the European Commission's review of EMIR, ESMA has recommended changes to the process of third-country CCP regulation and recognition. ESMA queried whether the current approach to third-country CCP regulation under EMIR – i.e. full reliance on third country rules and supervisory arrangements – should be rethought, with consideration given to granting European regulators closer scrutiny over third-country CCPs. Should the current system of equivalence be maintained, ESMA proposed that third-country equivalence determinations should be adopted by ESMA Regulatory Technical Standards rather than European Commission Implementing Acts.

US

In August 2015, the CFTC granted ASX Clear (Futures) an exemption from the requirement to register as a derivatives clearing organisation (DCO), on condition that it does not clear trades by US clients. The requirement to register as a DCO usually applies to all CCPs that clear OTC derivatives for 'US persons'. Prior to being granted a permanent exemption, ASX Clear (Futures) was operating under time-limited relief issued by the CFTC. To support the exemption, in June 2014, ASIC and the RBA concluded an MoU with the CFTC that covers cooperation and the exchange of information in the supervision and oversight of CCPs operating on a cross-border basis in both the US and Australia.[48] This MoU also supports CME's clearing and settlement (CS) facility licence, discussed below.

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47 ESMA, ASIC, RBA (2014), *Memorandum of Understanding Related to the European Securities and Markets Authority's Monitoring of the On-going Compliance with Recognition Conditions by Central Counterparties Established in Australia*, November. Available at <www.rba.gov.au/payments-system/legal-framework/pdf/memorandum-2014-12-04.pdf>.

48 CFTC, ASIC, RBA (2015), *Memorandum of Understanding: Cooperation and the Exchange of Information Related to the Supervision of Cross-border Clearing Organizations*, June. Available at: <http://www.rba.gov.au/payments-system/legal-framework/pdf/memorandum-20140606.pdf>.

4.3.2 Licensing of CME

In September 2014, the responsible Minister granted CME a licence to operate a CS facility in Australia.[49] CME is a US-based CCP primarily regulated by the CFTC that provides clearing services for exchange-traded futures and options on futures, as well as for OTC derivatives transactions. Under its Australian licence, CME is permitted to offer clearing services in OTC IRD and certain non-Australian dollar denominated exchange-traded IRD.[50]

Two important preconditions had to be met before CME as an overseas CS facility could be licensed:

- That the operation of the facility in its home country was subject to requirements and supervision that were sufficiently equivalent to those in the Australian regime. This was verified in advice provided by ASIC and the RBA to the Minster.[51]
- That the Minister consider whether adequate arrangements existed for cooperation between ASIC, the RBA and the authorities responsible for the supervision of the facility in its primary place of business. To meet this condition, a joint MoU between ASIC, the RBA and the CFTC was concluded in June 2014.

ASIC and the RBA also provided advice on other matters relevant to the Minister's consideration of CME's application, including on proposed regulatory measures to manage any systemic risk arising from the facility if licensed. At the time of CME's licensing, the RBA determined a set of regulatory priorities for CME to ensure that its operational and governance arrangements would promote stability in the Australian financial system. However, to date, CME does not have any Australian-based participants. Accordingly, CME is not expected to make substantial progress on the regulatory priorities related to the provision of its CCP services in Australia until such time as it has material direct Australian-based participation in these services. The RBA expects to publish an initial report on CME's progress towards these priorities in early 2016.

4.3.3 New products

The two existing CCPs licensed to clear OTC derivatives – ASX Clear (Futures) and LCH.C Ltd – have also expanded or announced plans to expand the scope of OTC derivative products that they clear.

ASX Clear (Futures)

ASX Clear (Futures) has announced plans to introduce deliverable swap futures in the fourth quarter of 2015.[52] ASX Clear (Futures) intends to offer these contracts with a three-month term over fixed-for-floating interest rate swaps with tenors of three, five and 10 years.

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49 *Australian CS Facility Licence (Chicago Mercantile Exchange Inc.) 2014*, available at <http://download.asic.gov.au/media/2018403/cme-cs-facility-licence-signed-30-september-2014.pdf>.

50 The exchange traded derivatives must be traded on the CME or Chicago Board of Trade markets, and permitted by CME to be portfolio margined with the OTC interest rate derivatives.

51 RBA (2014), *Initial Assessment of Chicago Mercantile Exchange Inc. against the Financial Stability Standards for Central Counterparties*, September. Available at <http://www.rba.gov.au/payments-system/clearing-settlement/assessments/chicago-mercantile-exchange/2014/cme-assess-2014-09.html>.

52 ASX (2015), 'Notice – ASX to Launch Deliverable Swap Futures', 20 March. Available at <http://www.sfe.com.au/content/notices/2015/0247.15.03.pdf>. Deliverable swap futures are futures contracts that result in the delivery of an at-the-money OTC interest rate swap at expiry. The contracts will allow users to gain exposure to the underlying swap rate, with generally lower collateral and initial margin requirements compared with a standard OTC swap. Since the products transition to OTC products at the point of expiry, participants must either be OTC clearing participants, or close out their positions at least five days prior to expiry.

LCH.Clearnet Ltd

In April 2015, LCH.C Ltd added zero-coupon inflation-indexed swaps (inflation swaps) to the range of products available for clearing through its SwapClear service. As LCH.C Ltd's pre-existing CS facility licence permitted the SwapClear facility to provide clearing services for transactions in IRD only, a variation to LCH.C Ltd's CS facility licence was required in order for LCH.C Ltd to offer clearing services for inflation swaps to direct Australian clearing participants of SwapClear. This licence variation was granted by the Minister in July 2015.

4.3.4 Client clearing

To support its client clearing service for OTC derivatives, and provide the required choice of segregation models for futures clients, during the second half of 2013, ASX Clear (Futures) developed a new client segregation model to sit alongside the existing omnibus client account. In particular, clearing participants may offer individual client accounts, which separately record the positions of each client and related initial margin requirements. This supports portability by making it more likely that clients would have sufficient initial margin transferred with their positions to ensure that their full margin requirements could be met after transfer. The new account structure was implemented for OTC derivatives in April 2014.

However, while initial margin is calculated on a gross basis at the level of each client account under the model, it is managed by ASX Clear (Futures) as a commingled pool of collateral for each clearing participant. As a result, the return of the specific securities posted was, until recently, not possible under the segregation model. Collateral posted by clients in excess of initial market requirements was also not protected under the segregation model. However, ASX has now implemented rule changes to protect excess client collateral posted with ASX Clear (Futures) and ASX Clear. A solution has been devised to segregate cash amounts and securities lodged as margin or excess collateral for individual clients. Under these arrangements, ASX would transfer or return the total value of collateral (including excess collateral) attributed to an individual client account (net of any close-out costs); the securities transferred or returned would be 'equivalent' to those that had been attributed to that account. ASX implemented the processes and system functionality to support the lodgement of excess client cash in ASX Clear (Futures) in September 2015 and plans to implement for ASX Clear by November 2015.

Separately, in October 2015, LCH.C Ltd gained approval from ASIC and the RBA to allow its Australian SwapClear clearing participants to offer client clearing services to their customers. This did not require a variation to LCH.C Ltd's CS facility licence; however, at the time that the SwapClear service was licensed, LCH.C Ltd agreed it would not offer such services until ASIC and the RBA had conducted appropriate due diligence. This work has been finalised and Australian clearing participants are now able to offer client clearing services, subject to internal risk governance approval from LCH.C Ltd.

4.3.5 Recovery planning

In October 2015, ASX released a set of rule changes to implement a package of tools to enhance its ability to effectively recover from a severe financial shock. A particular focus is on tools to deal with circumstances in which one or more participant defaults exhausted ASX Clear (Futures)' (or the equity CCP's, ASX Clear's) prefunded financial resources. The chosen tools reflect extensive consultation with participants and other stakeholders by ASX, including with ASIC and the RBA. The tools are also designed to be broadly consistent with the CPMI-IOSCO guidance on recovery planning (see Section 4.2.2). Indeed, the RBA applied the CPMI-IOSCO guidance in a detailed assessment of the ASX CCPs' recovery plans, published as part of its broader formal annual assessment of the ASX CCPs and securities settlement facilities in September.[53] LCH.C Ltd and CME are also refining their recovery plans in light of the CPMI-IOSCO guidance.

4.3.6 FMI resolution regime

While an FMI's recovery plans, such as those of the CCPs licensed in Australia, should be comprehensive, it is acknowledged that there may be circumstances where the FMI may be unable to fully implement its recovery plan, or implementing the plan may not be desirable on stability grounds (for example, if the method of comprehensively addressing the loss compromises financial stability). The availability of a special FMI resolution regime as an alternative to general insolvency would allow actions to be taken by a resolution authority with a system-wide perspective.

In February 2015, the government, on the advice of the CFR, released a consultation paper seeking stakeholder views on a proposal to establish a special resolution regime for FMIs.[54] The scope of the proposed resolution regime set out in the consultation paper is domestically incorporated and licensed:

- CS facilities
- TRs that are identified as being systemically important in Australia.

The RBA would be the resolution authority for CS facilities, and ASIC would be the resolution authority for TRs. The RBA's overarching objective in taking resolution actions would be to maintain overall stability in the financial system. An additional common key objective of both resolution authorities would be to maintain the continuity of CS facility and TR services that were deemed to be critical to the smooth functioning of the financial system. Under the proposal, the powers of the resolution authority and safeguards under the regime would be aligned with the FSB's Key Attributes (see Section 4.2.2).

Feedback from consultation revealed strong industry support for the establishment of a special resolution regime for FMIs.

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[53] RBA (2015), *2014/15 Assessment of ASX Clearing and Settlement Facilities*, September. Available at <http://www.rba.gov.au/payments-system/clearing-settlement/assessments/2014-2015/index.html>.

[54] Australian Government (2015), *Resolution Regime for Financial Market Infrastructures: Consultation Paper*, February. Available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Resolution-regime-for-financial-market-infrastructures>.

4.3.7 Operating in Australia

In March 2015, the CFR released a consultation paper proposing amendments to the Corporations Act that would implement a new approach to assessing whether an overseas CS facility should be subject to regulation in Australia.[55] The proposal seeks to provide greater clarity regarding the circumstances in which a CS facility must be either licensed in Australia or exempted from the Australian CS facility licensing regime.[56]

Under the proposal, the test of whether an overseas CS facility should be subject to regulation in Australia would comprise two components, both of which would have to be met:

- *Domestic connection.* The first component would be a test to establish objectively whether there was any connection at all to the Australian financial system. The factors that would constitute a domestic connection include: the location of a CS facility's operations in Australia; the provision of CS services for financial products connected with Australia; the provision of CS services to one or more Australian participants; or having arrangements with the operator of a domestically licensed or exempted financial market or CS facility.
- *Materiality of the connection.* Where the first component was met, the second component would assess the materiality of that connection from a public policy perspective. A CS facility's domestic connection would be considered to be material if its current or expected activities were likely to have implications for the safe, efficient and effective functioning of the Australian financial system or dealing in financial products by Australian investors. To capture reliance on the facility by Australian investors, the tests under the second component would look beyond direct participation to a broader definition of 'user'.

The implementation of this approach would not be expected to change the current scope of Australia's CS facility licensing regime. Rather, the proposal is intended simply to provide greater clarity to all stakeholders on the scope of the existing regime.

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55 CFR (2015), *Overseas Clearing and Settlement Facilities: The Australian Licensing Regime*, March. Available at <http://www.cfr.gov.au/publications/cfr-publications/2015/overseas-clearing-and-settlement-facilities-australian-licensing-regime.pdf>

56 The proposal also aims to underpin the requirement that all systemically important and strongly domestically connected CS facilities incorporate domestically and become domestically licensed, so as to fall within the scope of the proposed special resolution regime discussed above.

4.4 Overseas Mandatory Clearing Requirements

4.4.1 European Union

EMIR includes the obligation to centrally clear certain classes of OTC derivative contracts in CCPs that have been authorised (for European CCPs) or recognised (for non-European CCPs) under the EMIR framework. Following the first CCP authorisations in early 2014, ESMA issued a series of consultation papers which presented proposals to mandate central clearing of certain classes of IRD,[57] credit derivatives[58] and foreign exchange non-deliverable forwards (NDFs)[59]. These papers included draft regulatory technical standards (RTS), which must be endorsed by the EC prior to any central clearing mandate becoming effective. Subsequent to these consultations, ESMA issued a number of further documents clarifying ESMA's policy position for each asset class.

With respect to IRD, ESMA issued a final report on 1 October 2014 which contained draft RTS that were submitted to the EC for endorsement.[60] In December 2014, the EC notified ESMA that it would endorse the draft RTS with amendments; the EC subsequently issued a delegated regulation adopting the amended rules on 6 August 2015.[61,62] This regulation needs to be reviewed by the European Parliament and the Council of the European Union before it is published in the Official Journal and the regulation becomes effective.

The product scope captured by the mandate covers basis swaps, fixed to floating swaps, forward rate agreements and overnight index swaps denominated in US dollars, euros, British pounds and Japanese yen (the 'G4 currencies').[63] The RTS set out four different categories of counterparty, each with a different phase-in period.[64]

- *Category 1 entities*, comprising financial and non-financial counterparties that are, as at the date of entry into force of the delegated regulation, direct clearing members of at least one of the relevant authorised or recognised CCPs and for at least one of the classes of IRD subject to the clearing obligation, have a phase-in period of six months.
- *Category 2 and 3 entities*, comprising financial counterparties or alternative investment funds with average month-end gross notional outstandings of non-centrally cleared derivatives above (for category 2) or below (for category 3) €8 billion, have phase-in periods of 12 and 18 months respectively.

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57 ESMA (2014), *Consultation Paper: Clearing Obligation under EMIR (no. 1)*, July. Available at <http://www.esma.europa.eu/consultation/Consultation-paper-Clearing-Obligation-no1-IRS>. This paper also considered the case for mandating central clearing of certain equity derivatives, as well as interest rate options and futures; however, the paper recommended exempting these products from any future central clearing mandate.

58 ESMA (2014), *Consultation Paper: Clearing Obligation under EMIR (no. 2)*, July. Available at <http://www.esma.europa.eu/consultation/Consultation-paper-Clearing-Obligation-no2-CDS>.

59 ESMA (2014), *Consultation Paper: Clearing Obligation under EMIR (no. 3)*, October. Available at <http://www.esma.europa.eu/consultation/Consultation-clearing-obligation-under-EMIR-no3>.

60 ESMA (2014), *Final Report: Draft Technical Standards on the Clearing Obligation – Interest Rate OTC Derivatives*, October. Available at <http://www.esma.europa.eu/system/files/esma-2014-1184_final_report_clearing_obligation_irs.pdf>.

61 ESMA (2015), *Revised Opinion: Draft RTS on the Clearing Obligation on Interest Rate Swaps*, March. Available at <http://www.esma.europa.eu/system/files/2015-511_revised_opinion_on_draft_rts_on_the_clearing_obligation.pdf>.

62 The delegated regulation is available at <http://ec.europa.eu/finance/financial-markets/docs/derivatives/150806-delegated-act_en.pdf>.

63 Forward rate agreements and overnight index swaps denominated in Japanese yen are exempt from the scope of the central clearing mandate.

64 For transactions between two entities in different categories, the longer phase-in period applies.

- *Category 4 entities*, comprising non-financial counterparties that do not fall into category 1, have a phase-in period of three years. There is also a three-year phase-in period for intragroup transactions involving a non-EU entity.[65]

Entities in categories 1 and 2 are subject to a 'frontloading' requirement, whereby in-scope interest rate derivative contracts entered into after 18 March 2014 (the date of the first authorisation of a CCP under EMIR) are also subject to the clearing mandate. Category 1 entities will have two months from the date of entry into force of the delegated regulation to comply with the frontloading requirement, while category 2 entities will have five months to comply. As part of its response to the EC's review of EMIR, ESMA highlighted a number of issues with the frontloading requirement and recommended that the EMIR review consider whether this requirement should be removed.

In May 2015, ESMA issued another consultation paper seeking views on a proposal to establish a clearing obligation for additional classes of OTC IRD.[66] The additional classes are fixed to floating swaps denominated in the Czech koruna, Danish krone, Hungarian forint, Norwegian krone, Swedish krona and Polish zloty, as well as forward rate agreements denominated in the Norwegian krone, Swedish krona and Polish zloty. ESMA has published the responses received to this consultation but has not yet issued any follow-up documents.

With respect to credit derivatives, ESMA's initial consultation paper proposed to mandate central clearing of index credit default swaps linked to two references indices: iTraxx Europe Main and iTraxx Europe Crossover. ESMA subsequently submitted draft RTS to the EC for endorsement on 1 October.[67] The RTS are consistent with both the product scope set out in the initial consultation and with the counterparty scope and phase-in timetable set out by the delegated regulation implementing the IRD clearing mandate. The RTS are currently under consideration by the EC.

With respect to NDFs, ESMA issued a feedback statement on 4 February 2015 which summarised the responses to the consultation and stated that ESMA would not be proposing a central clearing mandate for non-deliverable forwards at this time. In the statement, ESMA noted comments from stakeholders highlighting the relative lack of depth in CCPs clearing this asset class and the need for international coordination of any potential NDF clearing obligation.

4.4.2 United States

The CFTC's central clearing obligation for US dollar-, euro-, British pound- and Japanese yen-denominated interest rate swaps and North American and European-referenced credit default swap indices has been in effect for the full scope of entities since September 2013.

On 5 December 2014, the Foreign Exchange Markets Subcommittee of the CFTC issued a memorandum in which it outlined a timeline and methodology for implementation of a clearing mandate for NDFs, should the CFTC decide to proceed with such a mandate. The memorandum considered the question of whether an NDF clearing mandate was appropriate but did not recommend or commit the CFTC to such a mandate. The memorandum highlighted the small size and the short-dated average tenor of the of the NDF market as factors which would limit the systemic risk benefits of a central clearing mandate for NDFs.

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[65] Under EMIR, entities can apply for an exemption from the clearing obligation for intragroup transactions if both entities are established in the EU or if the third-country entity is established in a jurisdiction that has been deemed equivalent under EMIR. During the three year phase-in, intragroup transactions with entities in third country jurisdictions without an equivalence decision are exempt from the clearing obligation.

[66] ESMA (2015), *Consultation Paper: Clearing Obligation under EMIR (no. 4)*, May. Available at <http://www.esma.europa.eu/consultation/Consultation-No-4-Clearing-Obligation-under-EMIR>.

[67] ESMA (2015), *Final Report: Draft Technical Standards on the Clearing Obligation – Credit Derivatives*, October. Available at <http://www.esma.europa.eu/system/files/2015-1481_final_report_clearing_obligation_index_cds.pdf>.

The memorandum emphasised the need for harmonisation across major jurisdictions in the implementation of an NDF clearing mandate. This is reflected in the proposed timeline, which aims to synchronise EU and US implementation based on ESMA's published guidance as at December 2014. However, the timeline for the implementation of a clearing mandate has since been pushed back (see ESMA's February 2015 statement covered in Section 4.4.1). The CFTC has not yet indicated its official position in light of ESMA's statement.

4.4.3 Other jurisdictions

China

In January 2014, the People's Bank of China released a notice stipulating that Chinese renminbi-denominated interest rate swaps between financial entities would be subject to mandatory clearing through the Shanghai Clearing House from 1 July 2014.[68] The product scope is currently limited to swaps referencing the interbank seven-day fixing repo rate, overnight Shanghai interbank offered rate (SHIBOR) or three-month SHIBOR.

The Shanghai Clearing House also launched CCP services for US dollar–Chinese renminbi foreign exchange derivatives in November 2014, and standardised bond forward and interest rate swaps in April 2015.

India

To coordinate implementation of the G20 reform agenda in India, representatives from the Reserve Bank of India and market participants have established an Implementation Group on OTC Derivatives Market Reforms. In March 2014, the group published a report which contained a number of recommendations relating to OTC derivatives market reform, including that a central clearing mandate for interbank transactions in foreign exchange forwards be imposed.[69] The Chief Executive of the Foreign Exchange Dealers' Association of India subsequently issued a statement to members of the Association requesting all members to comply with the requirement.[70] In practice, the product scope of the requirement is US dollar-Indian rupee foreign exchange forwards with maturities of up to 13 months.[71]

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68 The People's Bank of China (2014), *PBC Notice on Establishing a Centralized Clearing Mechanism for OTC Financial Derivative and Launching Centralized Clearing of RMB Interest Rate Swap* (English translation), April. Available at <http://www.pbc.gov.cn/publish/english/955/2014/20140408162107938969555/20140408162107938969555_.html>.

69 This report is available at <https://rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=762#A1>.

70 Foreign Exchange Dealers' Association of India (2014), 'Forex Forward Guaranteed Settlement (FFGS) through the Clearing Corporation of India (CCIL): Mandate to the Banks', May. Available at <http://www.fedai.org.in/DocumentUploadFiles/News/SPL0-5_CCIL-FFGS_2014_9th%20May%202014.pdf>.

71 This is the scope of foreign exchange forward products offered for clearing by The Clearing Corporation of India Ltd, India's sole OTC derivatives CCP.

Hong Kong

In September 2015, HKMA and the Hong Kong Securities and Futures Commission consulted on the first phase of mandatory clearing requirements.[72] It is proposed that mandatory clearing requirements would apply for fixed-to-floating swaps and basis swaps denominated in G4 currencies and the Hong Kong dollar, as well as overnight index swaps denominated in US dollars, euros and British pounds. Under the proposal a trade would only be subject to the mandatory clearing requirement if at least one counterparty was an authorised institution, approved money broker or licensed corporation. Both counterparties would also need to have outstanding OTC derivatives positions (excluding deliverable foreign exchange forwards) in excess of the relevant clearing threshold. For local entities it is proposed that the clearing threshold will be US$20 billion, whereas for overseas entities the proposed clearing threshold is US$1 trillion globally or US$20 billion of outstanding positions that have been booked in Hong Kong.

Japan

Further to the commencement of client clearing services for yen-denominated interest rate swaps at JSCC in February 2014, the Japan Financial Services Agency (JFSA) has expanded the scope of entities subject to mandatory clearing in Japan. Financial entities with more than JPY 1 trillion gross notional outstanding of OTC derivatives became subject to mandatory clearing from the first quarter of 2015, and financial entities with more than JPY 300 billion gross notional outstanding as at 1 December 2015 will be subject to the mandate during the first half of 2016.[73] Previously, Japan's clearing mandate captured only direct clearing members of JSCC.

In the third quarter of 2014 the JFSA also expanded the scope of products subject to mandatory clearing to include yen-denominated interest rate swaps referencing the Tokyo interbank offered rate (TIBOR).

Korea

From 30 June 2014, financial institutions licensed for OTC derivatives business in Korea were required to centrally clear Korean won-denominated vanilla interest rate swaps. The mandate was issued by the Financial Services Commission in an amendment to the Financial Investment Business and Capital Markets Act and the associated enforcement decree and enforcement rule.[74]

Mexico

Banco de México (BDM) published an amendment to its derivatives transaction rules in April 2014, specifying that Mexican peso-denominated interest rate swaps referencing the 28-day Equilibrium Interbank Interest Rate would be subject to a mandatory clearing requirement.[75] Market participants will have to clear through CCPs established in Mexico or recognised by BDM. The first set of entities subject to the mandate will be required to comply by 1 April 2016.

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[72] HKMA and HKSFC (2015), *Consultation Paper on Introducing Mandatory Clearing and Expanding Mandatory Reporting*, September. Available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/doc?refNo=15CP4>.

[73] The revised entity scope covers Financial Instruments Business Operators and Registered Financial Institutes. Insurance companies and pension funds are not captured.

[74] *Financial Investment Services and Capital Markets Act*, available at <http://www.fsc.go.kr/eng/lr/list03.jsp>.

[75] Banco de México (2014), *Circular 8/2015 – Asunto: Modificaciones a la Circular 4/2012 (Operaciones Derivadas)*, April. Available at <http://www.banxico.org.mx/disposiciones/circulares/%7b9EA848A6-2376-3AB8-A8D8-45943278029C%7d.pdf>.

Singapore

In July 2015, the MAS issued a consultation paper on draft regulations which would introduce a mandatory central clearing requirement for certain classes of OTC derivatives.[76] The MAS is proposing to introduce mandatory central clearing of, at a minimum, Singapore dollar- and US dollar-denominated fixed for floating swaps. The MAS is also considering including euro-, British pound- and Japanese yen-denominated swaps in the first phase of products that would be subject to the mandate, and consulted on whether a broader range of contract specifications (for example, basis swaps) should also be subject to a clearing mandate. The MAS has proposed that the first phase of the mandate would apply only to banks with more than S$20 billion gross notional outstanding of derivatives contracts booked in Singapore in each of the last four calendar quarters. The final regulations are expected to be issued by the end of 2015, and will provide at least six months' notice before obligations take effect.

4.5 Assessment and Recommendations

4.5.1 Scope and prioritisation

In the May 2013 *Statement on Assessing the Case for Mandatory Clearing Obligations* (the Statement), the Regulators stated that they would apply both a top-down and a bottom-up approach to considering which products should be considered for mandatory clearing.

- Under the top-down approach, OTC derivatives products will be considered for mandatory clearing based on a broad range of information available to the Regulators about activity in the OTC derivatives market and product characteristics.
- Under the bottom-up approach, OTC derivatives products already cleared (or prospectively to be cleared) by a central counterparty licensed to operate in Australia will be considered for mandatory clearing.

The Statement noted that in prioritising products to be considered for mandatory clearing, the Regulators will consider the factors suggested in IOSCO (2012); namely, the relative systemic importance of the products, whether the product is already under a clearing obligation in another jurisdiction, and whether the product is designed as a deliberate attempt to avoid an existing clearing obligation. The Regulators have followed this approach in previous market assessments, prioritising for consideration products subject to mandates in overseas jurisdictions (namely, IRD denominated in US dollars, euros, Japanese yen and British pounds, and North American, European and Japanese referenced credit derivatives) and products that are systemically important to the Australian financial system (namely, Australian dollar-denominated IRD).

Since April 2014, a number of foreign jurisdictions have mandated products not previously considered by the Regulators for a central clearing mandate in Australia (see Section 4.4). In addition, the scope of products currently available for clearing by CCPs licensed to operate in Australia includes products not previously considered by the Regulators. In accordance with the Statement, the Regulators have, in this report, considered the case for mandating central clearing of products falling into either of these categories. This product scope includes IRD denominated in 15 currencies, as set out in Table 2; and US dollar/Indian rupee forwards.

[76] The consultation paper and draft regulations are available at <http://www.mas.gov.sg/News-and-Publications/Consultation-Paper/2015/Consultation-Paper-on-Draft-Regulations-for-Mandatory-Clearing-of-Derivatives-Contracts.aspx>.

LCH.C Ltd's product scope also includes UK, European and US inflation-linked swaps, which LCH.C Ltd began clearing in April 2015. Australian participants have been able to access this service since 21 July 2015, following LCH.C Ltd's Australian clearing and settlement facility licence variation (see Section 4.3.3). Since these products have only recently been made available for central clearing by LCH.C Ltd they have not been considered for mandatory central clearing in this assessment.

Table 2: Single-currency Interest Rate Swaps under Consideration

Currency	Available for clearing at a licensed CCP[a]		Subject to foreign mandate
	LCH.C Ltd	CME Inc.	
Canadian dollar (CAD)	✓	✓	✗
Swiss franc (CHF)	✓	✓	✗
Chinese renminbi (RMB)	✗	✗	China
Czech koruna (CZK)	✓	✓	✗
Danish krone (DKK)	✓	✓	✗
Hong Kong dollar (HKD)	✓	✓	✗
Hungarian forint (HUF)	✓	✓	✗
Korean won (KRW)	✗	✗	Korea
Mexican peso (MXN)	✗	✓	Mexico[b]
Norwegian krone (NOK)	✓	✓	✗
New Zealand dollar (NZD)	✓	✓	✗
Polish zloty (PLN)	✓	✓	✗
Swedish krona (SEK)	✓	✓	✗
Singapore dollar (SGD)	✓	✓	✗
South African rand (ZAR)	✓	✓	✗

(a) ASX Clear (Futures) not included in the table since it clears only interest rate swaps denominated in Australian dollars

(b) Not in effect until 1 April 2016

4.5.2 Interest rate derivatives

The scope of IRD under consideration in this assessment comprises two categories:

- products subject to a central clearing mandate in a foreign jurisdiction
- products available for clearing at a CCP licensed to operate in Australia that have not previously been considered for mandatory central clearing.

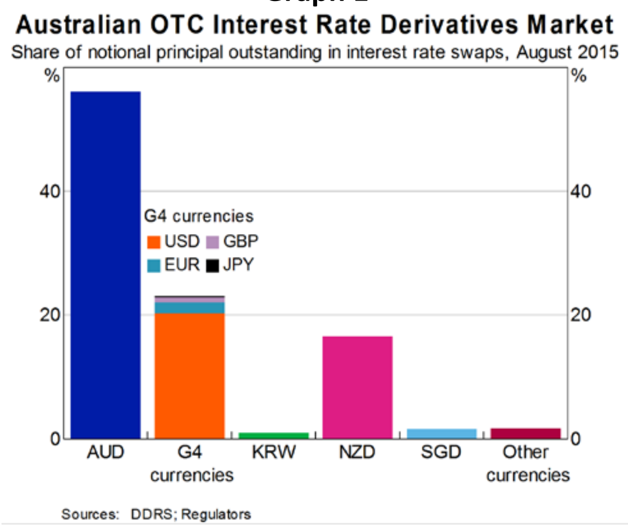
Benefits from central clearing

The potential benefits from central clearing will reflect the level of trading activity in a particular derivatives product, its characteristics and the profile of participation in the market. For instance, the stability benefit of a transition to central clearing is likely to be greatest for products that are traded widely in the Australian OTC derivatives market and which give rise to sizeable counterparty credit exposures between large financial institutions when cleared bilaterally. Conversely, the benefits of central clearing will be lower for products for which there is limited activity in the Australian OTC derivatives market.

According to TR data, around 80 per cent of the notional principal outstanding in IRD in the Australian market is denominated in Australian dollars or G4 currencies (Graph 1). Within the G4 currencies, around 21 per cent of notional outstanding of IRD is denominated in US dollars, while euro- and British pound-denominated contracts make up around 2 per cent and 1 per cent, respectively. Less than half a per cent of the notional outstanding of IRD in Australia is denominated in Japanese yen.

Survey data collected by the RBA for the BIS semi-annual survey of OTC derivatives markets indicate that, amongst large Australian dealers, a significant share of IRD denominated in Australian dollars and G4 currencies is already being centrally cleared. Around a quarter of outstanding IRD denominated in Australian dollars are being centrally cleared, and more than half of outstanding IRD denominated in G4 currencies are being centrally cleared. These numbers are expected to increase as older trades expire or are backloaded onto CCPs; most new trades are being centrally cleared.

Graph 1



Of the remaining currencies, around 16 per cent of total gross notional outstanding is denominated in New Zealand dollars, 1.5 per cent is denominated in Singapore dollars and 1 per cent is denominated in Korean won. More than 40 per cent of the notional outstanding of New Zealand dollar- and Singapore dollar-denominated IRD are being centrally cleared, and around 10 per cent of Korean won-denominated contracts are being centrally cleared.

Collectively, Chinese renminbi- and Mexican peso-denominated IRD made up less than half a per cent of total notional outstanding.

Implications of mandating for the Australian financial system and participants

Since July 2014, Chinese renminbi-denominated interest rate swaps have been mandated for clearing in China and Korean won-denominated swaps have been mandated for clearing in Korea. Mexico's central clearing mandate, which captures Mexican peso-denominated interest rate swaps, will be phased in from April 2016.

Chinese renminbi- and Korean won-denominated swaps are not cleared by any CCP licensed to operate in Australia. CME Inc. clears Mexican peso-denominated swaps and is licensed to operate in Australia; however, Australian market participants are currently relying on client clearing arrangements to clear through CME. Client clearing of Chinese renminbi-denominated interest rate swaps is available through the Shanghai Clearing House, and client clearing of Korean won-denominated swaps is available through the Korea Exchange. Survey data collected by the RBA indicate that there has been some use of central clearing services by Australian participants in Korean won- and RMB-denominated interest rate swaps.

As discussed above, activity in the Australian IRD market is concentrated primarily in Australian dollar-, US dollar- and New Zealand dollar-denominated contracts. Although New Zealand dollar-denominated IRD are not mandated (and are not expected to be mandated) for central clearing in any jurisdiction, a high proportion of outstanding trades in these contracts are currently being centrally cleared. This number is higher than the proportion of Australian dollar-denominated contracts that are currently being centrally cleared, and only slightly less than the proportion of G4 currency-denominated contracts that are being centrally cleared. As a result of this market-led transition to central clearing, the incremental benefits of mandating central clearing of New Zealand dollar-denominated products from a systemic risk perspective are likely to be limited.

International consistency

International consistency is an important consideration in assessing the case for mandatory clearing. This can be a rationale for mandatory clearing even where the level of activity is relatively low and the financial stability risks associated with the bilateral counterparty credit exposures are likely to be limited. In general, however, any benefits associated with international consistency will only be relevant for products already subject to a central clearing mandate in a foreign jurisdiction.

For those products subject to a central clearing mandate overseas, the Regulators have considered the three factors identified in the Statement in assessing the international consistency benefits:

- the likelihood of regulatory arbitrage which may arise in the absence of broadly harmonised requirements across jurisdictions
- any unintended consequences arising from the structure of the Australian market where Australian participants are subject to a mandate overseas but not in Australia
- the effect on other jurisdictions' assessments of the equivalence or comparability of the Australian regime.

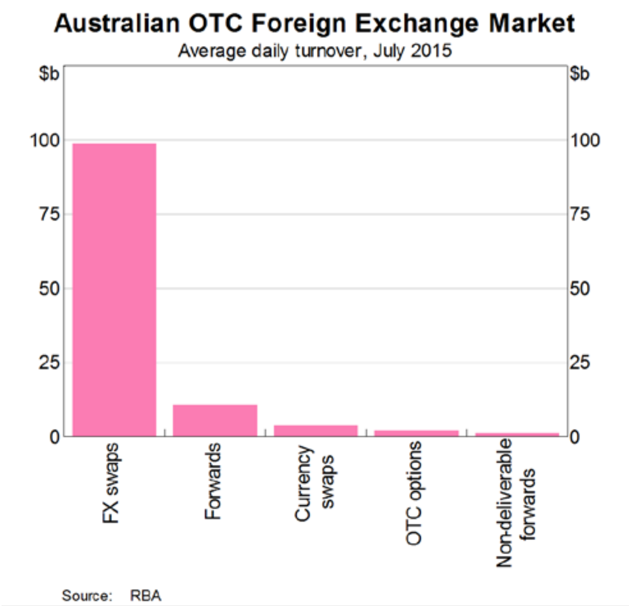
To date, the cross-border application of overseas mandatory clearing requirements appears to have been effective in preventing or limiting the scope of any regulatory arbitrage arising from these requirements. For jurisdictions such as China, Korea and Mexico, the policy intent of a central clearing mandate applicable to each jurisdiction's respective home currency is likely to have more of a domestic focus relative to mandates applicable to currencies with significant trading volumes in multiple jurisdictions (such as the US dollar or the euro). This would be expected to limit the likelihood of regulatory arbitrage arising from entities attempting to avoid central clearing requirements. It is also likely to limit the probability that unintended consequences affecting Australian participants arise from these mandates.

With respect to regulatory equivalence decisions, there is no clear framework for substituted compliance outside the EU and the US. If such frameworks were to be developed in the future for other jurisdictions, these frameworks would not necessarily require an identical (or broader) product scope in order for an equivalence decision to be made. In addition, the benefits associated with a positive equivalence decision for a given jurisdiction would need to be weighed against any costs that might need to be incurred in order for the positive decision to be granted.

4.5.3 Foreign exchange derivatives

In April 2015, average daily turnover in the Australian OTC foreign exchange derivatives market averaged $125 billion. By product, foreign exchange swaps make up around 85 per cent of total turnover in the Australian OTC foreign exchange derivatives market, outright forwards make up around 11 per cent and non-deliverable forwards make up around 1 per cent of total turnover (Graph 2). Across all products, the majority of turnover is in US dollar crosses against the Australian dollar, other G4 currencies, and the New Zealand dollar. The US dollar/Indian rupee currency pair accounts for around half a per cent of turnover in foreign exchange forwards in the Australian market, with virtually all of this turnover in non-deliverable forwards.

Graph 2



Currently, almost all activity in the Australian foreign exchange derivatives market is bilaterally cleared. This largely reflects the fact that the vast majority of derivatives traded in the Australian foreign exchange market are deliverable contracts that are not currently available for central clearing (discussed below). In a deliverable foreign exchange derivative contract, the two parties exchange principal at the beginning and/or the end of the contract; in contrast, the payoffs in a non-deliverable derivative (such as an NDF) are calculated with reference to a *notional* principal only.

The exchange of principal in a deliverable foreign exchange derivative means that any potential central clearing solution must develop a link to an appropriate mechanism for managing the settlement risk associated with the exchange of payments in two currencies. Linking to such a mechanism in a cost-effective way has been a significant challenge for CCPs looking to implement a clearing solution in these markets. However, CCPs are actively working towards such a solution, and progress is being made. In August 2015, LCH.C Ltd announced that ForexClear and CLS are jointly developing a service to allow physical settlement of cleared foreign exchange products.[77] The proposed service would initially provide central clearing of deliverable foreign exchange options, with other deliverable foreign exchange derivative products expected to follow in line with demand. The service is expected to launch in 2016, subject to regulatory approval.

Mandatory central clearing of NDFs has been considered by the CFTC's Foreign Exchange Markets Subcommittee and by ESMA (see Section 4.4). While the CFTC Subcommittee did not make a recommendation for or against a central clearing mandate, ESMA has stated that it will not be considering a central clearing mandate for NDFs at this time. In their considerations, both regulators noted that, if a mandate were to be imposed, an internationally coordinated approach would be important. Therefore, until a mandate for NDFs is introduced in other jurisdictions, there would be limited international consistency benefits to Australian market participants from mandating central clearing of NDFs in Australia. The low level of activity in NDFs in Australia would also likely limit the incremental benefits in financial system stability associated with imposing a mandatory clearing obligation. While NDFs are clearable at a number of CCPs globally, no CCP is currently licensed to provide NDF clearing services in Australia.

Currently, US dollar/Indian rupee forwards are the only foreign exchange derivative subject to a central clearing mandate in a foreign jurisdiction. The Regulators have therefore considered in this assessment the appropriateness of a central clearing mandate for these products in Australia.

Implications of mandating for the Australian financial system and participants

Under the Indian clearing mandate, Indian banks and the Indian branches of foreign banks must centrally clear US dollar/Indian rupee forwards with a maturity of up to 13 months. The only CCP that clears this product is the Clearing Corporation of India. The mandate is domestically focussed, which is expected to limit the likelihood of regulatory arbitrage arising from entities attempting to avoid central clearing requirements. It is also likely to limit the probability that any unintended consequences affecting Australian participants arise from these mandates. Furthermore, there is no clear framework for substituted compliance or equivalence, so the international consistency benefits of introducing a mandate in Australia are likely to be limited.

4.5.4 Recommendation and future consideration

As set out in the Statement, the assessment in the previous two sections has focussed on the *incremental* benefits and costs of imposing mandatory clearing, relative to allowing the market to transition to central clearing in response to private or other regulatory incentives. For the majority of products considered the level of activity in the Australian market is relatively low.

[77] LCH.C Ltd (2015), *LCH.Clearnet and CLS Partner to Deliver Settlement for Cleared FX Options,* Press Release, 3 August. Available at <www.lchclearnet.com/news-events/news/lch.clearnet-and-cls-partner-to-deliver-settlement-for-cleared-fx-options>.

The exception is New Zealand dollar-denominated IRD, for which there is significant market activity. However, a large proportion of this activity is already being centrally cleared. Consequently, the incremental systemic risk benefits associated with a mandatory central clearing obligation for these products are likely to be limited. Furthermore, as New Zealand dollar-denominated interest rate derivatives are not subject to a central clearing mandate in any foreign jurisdiction, there would be no international consistency benefits to introducing a central clearing mandate for these products in Australia.

With respect to those products subject to a central clearing mandate in a foreign jurisdiction, the absence of clear frameworks for substituted compliance or equivalence outside the US and the EU limits the likelihood of Australian participants receiving significant benefits from mandating central clearing of these products in Australia. There is also limited scope for regulatory arbitrage, due to the domestic focus of these mandates.

> **The Regulators therefore do not see a case at this time for extending the scope of the Australian central clearing mandate to include IRD denominated in currencies other than the Australian dollar, the US dollar, the euro, the British pound and the Japanese yen. Similarly, the Regulators do not recommend a central clearing mandate for US dollar-Indian rupee forwards at this time.**

The Regulators will, however, continue to review activity in the Australian market on an ongoing basis. This process of ongoing monitoring will be aided by the availability of trade reporting data. Going forward, the Regulators will periodically assess the case for extending the clearing mandate, in accordance with the Statement. However, the Regulators propose to formally report on these assessments only if one of the following conditions is met:

- *Reduction in systemic risk*. The level of trading in the product is giving rise to significant bilateral counterparty credit exposures and the product can be centrally cleared.
- *International consistency*. There is substantial evidence that a central clearing mandate is likely to have material substituted compliance or equivalence benefits for Australian market participants, or there is material potential for regulatory arbitrage resulting from the lack of a mandate in Australia.

5. Platform Trading

Since the April 2014 Report, a number of overseas jurisdictions have taken steps to introduce legal regimes for implementing mandatory platform trading of OTC derivatives, resulting in some changes in the trading of OTC derivatives in Australia. In light of these developments, the Regulators have surveyed market participants and reviewed TR data in relation to the use of voice brokers and different types of trading platforms for the OTC derivatives products that will be subject to mandatory clearing. The Regulators have also considered further the detailed criteria that would be applied to assess the case for a platform trading mandate.

5.1 Activity in the Australian Market

In this Report, the regulators have analysed the current level of OTC derivatives transactions executed on different venues across the classes of IRD that will be subject to a central clearing mandate in Australia. While this analysis focuses on these products, it is important to note the Australian legislative regime does not limit any mandatory trading obligations to only those OTC derivatives products that are already subject to a mandatory clearing obligation.

As part of this analysis the regulators issued a survey to a number of domestic and foreign OTC derivatives dealers, and a separate survey to operators of voice brokers and trading platforms. In addition to the data obtained from survey respondents, the regulators have also drawn on information reported to DDRS by reporting entities. Comparing the data sources suggests that over 90 per cent of positions in IRD denominated in Australian dollars and the G4 currencies (US dollars, euros, British pounds and Japanese yen) reported to DDRS were held by the entities that responded to the participant survey.

5.1.1 Overview

According to DDRS data at the end of May 2015, there were approximately 160 400 open positions held by reporting entities in Australian dollar- and G4 currency denominated-IRD, with a gross notional outstanding value of $18.5 trillion (Table 3). Australian dollar-denominated contracts accounted for the majority of outstanding IRD positions, followed by US dollar- and British pound-denominated IRD.

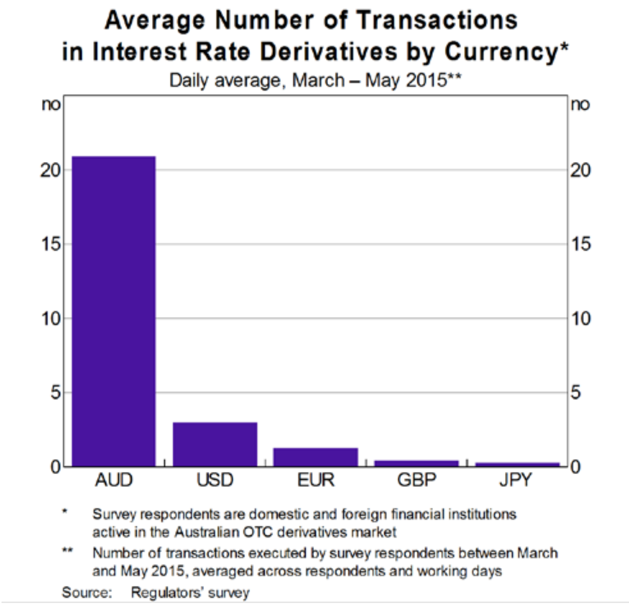
Table 3: Australian OTC Interest Rate Derivatives Market
As at end May 2015

	Number of outstanding positions (000s)	Gross notional outstanding (A$ equivalent, trillion)	Median size of position (A$ equivalent, million)
Australian dollar	126.0	15.5	50.0
US dollar	19.9	1.9	37.7
British pound	7.4	0.4	13.3
Euro	6.5	0.6	61.6
Japanese yen	0.7	0.0	21.0

Source: DDRS; Regulators

Based on the survey data received from respondents, there were approximately 15 000 Australian dollar-denominated IRD transactions on traded using voice brokers or trading platforms between March and May 2015. This equates to a daily average of around 21 trades per dealer over this period (Graph 3). However, the Regulators note there were some significant differences in trading activity amongst respondents ranging from approximately 150 trades to over 5 000 trades over this period.

Graph 3



The volume of Australian dollar-denominated IRD traded was significantly higher than that of any of the G4 currency-denominated IRD. US dollar-denominated IRD were the second most heavily traded product, with a daily average of three transactions per dealer executed on trading venues between March and May 2015.

5.1.2 Use of voice brokers and trading platforms

Voice brokers and trading platforms

The Regulators' survey considered the use of voice brokers and trading platforms for trading of OTC derivatives. In addition to voice brokers traditionally operated by inter-dealer brokers, the survey considered the use of swap execution facilities (SEF) regulated by the CFTC, multilateral trading facilities (MTF) regulated in the EU and financial market operators licensed under the Australian Market Licence (AML) regime. Reflecting recent years' focus on platform trading of OTC derivatives, a number of SEFs and MTFs have been established by interdealer brokers, while others are operated by exchange groups or newswire and data businesses.

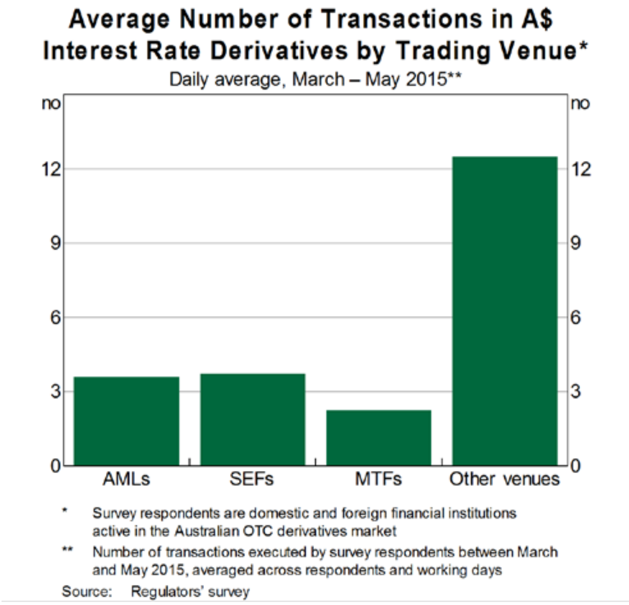
Usage of voice brokers and trading platforms

Based on survey responses across all currencies, respondents still predominantly use voice brokers for trading OTC derivatives; Australian respondents in particular still expressed a strong preference for using voice brokers over more structured trading platforms. Respondents reported using certain types of trading platforms, particularly SEFs, partly in response to overseas regulatory requirements.

Compared to the emergence of globally dominant central counterparties, there was no single dominant voice broker or trading platform that was used across all currencies and by all respondents. While respondents were, on average, connected to a total of 10 voice brokers and platforms for trading Australian dollar- and US dollar-denominated IRD, the particular voice brokers or trading platforms used differed between the two currencies. For example, for Australian dollar-denominated IRD, both survey data and anecdotal evidence confirmed that voice brokers (classified as 'other venues' in the Regulators' survey) and a particular Australian-licensed trading platform (an AML platform) are the most popular. By comparison, respondents indicated specific SEFs are dominant in the US dollar-denominated IRD market reflecting the existence of a platform trading mandate in the US.

Respondents reported trading a total of nearly 8 700 Australian dollar-denominated IRD on 'other venues' (particularly voice brokers) between March and May 2015. This equates to a daily average of around 12 transactions per dealer over this period. The average number of transactions per respondent executed on these venues was more than three times the average number of trades executed on AML, SEF and MTF trading platforms over the same period (Graph 4).

Graph 4



The limited use of SEFs for trading Australian dollar-denominated IRD among OTC dealers in Australia is also reflected in the TR data. TR data shows that, of the 125 955 Australian dollar-denominated interest rate derivative positions that were open at the end of May 2015, only 1.4 per cent were reported as having been executed on a SEF.

By comparison, the responses differed for US dollar-denominated IRD. A number of respondents indicated they were connected to, and used, SEFs where their counterparties were required to do so under US regulation. A small number of US swap dealer respondents used SEFs for a greater proportion of their trades in order to comply with US regulatory requirements. Some respondents also observed that, as a result of the US trading mandate, they also had a commercial incentive to trade on SEFs where that would enable them to access greater liquidity for US dollar-denominated IRD.

Due to data quality issues affecting the completeness of reported TR data, other than SEFs, the Regulators were unable to reliably identify the types of trading venues used from TR data. However, the Regulators are working with both the reporting entities and DDRS to improve the accuracy and consistency of information reported in relation to the execution venue. Once finalised, this will provide the Regulators with an even greater insight into the voice brokers and other trading venues used for trading OTC derivatives.

5.1.3 Trading methods

Types of trading methods

A variety of trading methods are available in Australia to trade IRD, ranging from traditional voice broking to exchange-like central limit order books. Voice-brokered trading is the dominant trading method for trades between dealers. Voice broking can refer to a variety of specific trading methods, ranging from 'pure voice' trading to 'hybrid' functionalities where voice broking is supported by other sources of pricing information, such as electronic displays, email and text messages. Electronic trading methods range from request-for-quote trading, which enable a participant to select the best price from a real-time auction with multiple previously known dealers, to central limit order books, which enable market participants to provide, observe and transact on multiple bids and offers according to some set of priority rules on a continuous or periodic basis. Other trading methods or functionalities include time-limited auctions, such as fixing and matching sessions, and 'click-to-trade'. In fixing and matching sessions registered traders submit undisclosed, indicative bids and offers that allow the calculation of an average 'fixing price', and participants then submit firm bids and offers at this price during the matching session. Click-to-trade functionality allows a participant to view a set of prices in real-time and click on the price and dealer with whom they wish to execute; the trade is then executed upon confirmation from the dealer.

Some types of trading venues are required by regulation to offer specified trading methods. For example, eligible trading methods on SEFs include request for quote to a minimum of three participants, or central limit order book. Some SEFs use an introducing broker, which allows voice-brokered transactions to be registered on the SEF.

Use of trading methods

The Regulators' survey indicated that voice-brokered trading is the dominant trading method used by respondents. This is consistent with the dominance of interdealer brokers, which offer voice-brokered trading. Respondents nevertheless reported use of other trading methods, either to comply with a regulatory requirement or because of commercial incentives. These incentives exist primarily for inter-dealer transactions. In the Australian market, market participants and trading venue operators reported that the majority of transactions occurred by request for quote or via other hybrid methods, and that little trading occurred on order books.

Where domestic entities trade on the order book, they currently do so as 'price takers' – trading at prices posted by other entities – rather than as 'price makers' – making a market by offering to buy and sell. Some entities have indicated they are considering becoming price makers on an electronic platform for Australian dollar-denominated IRD; however, they note that they would need to implement system changes before they had the capability to do so. In comparison, respondents reported greater use of order book trading when trading in US dollar-denominated IRD, particularly in US business hours and on US platforms. Respondents also reported that trades between dealers and their clients were likely to be bilateral (i.e. negotiated by phone without intermediation by a voice broker), though a small number of foreign banks reported interacting with clients on trading venues.

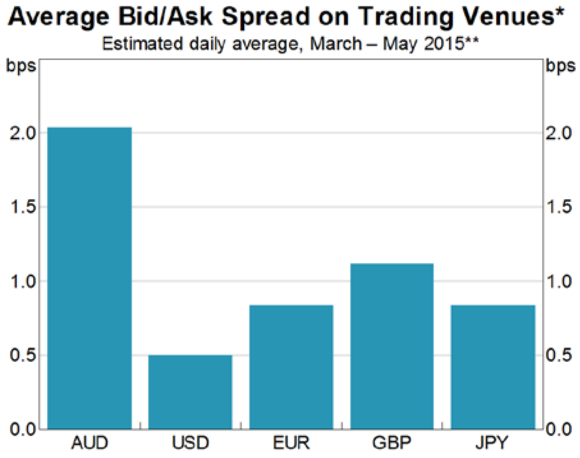
5.1.4 Pricing and liquidity

Pricing

Consistent with the finding that little trading in Australian dollar-denominated IRD occurs on an order book, respondents reported low liquidity on existing order books. As a result, the bid/ask spread for Australian dollar-denominated IRD on order books is reported to be materially wider than the prices that may be obtained via voice brokers. This is reported to make it unattractive to trade Australian dollar-denominated IRD on electronic order book-driven platforms relative to traditional voice brokers.

In contrast, the bid/ask spreads provided for US dollar-denominated IRD on the order book are reported to be 'very tight', reflecting greater liquidity in US dollar-denominated IRD and the larger number of participants/price makers (Graph 5). Respondents reported that bid/ask prices on the order book not dissimilar to the prices that may be obtained through a voice broker. As liquidity has improved at a small number of SEFs since 2013, trading activity has also concentrated around these SEFs.

Graph 5



* Survey respondents are trading venues active in the Australian OTC derivatives market

** Estimated daily average reported by trading venues responding to the survey, averaged across venues

Source: Regulators' survey

Increased liquidity on SEFs, and pricing based on the clearing venue rather than counterparty credit risk, may account for a number of other trends or developments in the US dollar-denominated IRD market observed by respondents. Some respondents provided observations about the pricing of US dollar-denominated IRD. For inter-dealer trades in the US market, the prices quoted are typically for centrally cleared trades, and pricing differences are more likely to depend on whether a trade will be centrally cleared and the clearing venue, rather than whether the trade will be registered on a particular SEF. Therefore, trading on- or off-SEF does not appear to have an impact on the pricing of these transactions.

Related to the observation on pricing, when dealing through introducing brokers, some respondents reported that they were agnostic as to whether they trade on-SEF or off-SEF, as long as the trade would ultimately be centrally cleared. For these market participants, trading on- or off-SEF was more a matter of post-trade processing. However, other market participants reported a preference for trading directly on SEF rather than through an introducing broker, because trading on-SEF was operationally more efficient.

Finally, respondents provided observations about the extent to which trading activity and decisions about where to trade followed liquidity. Some Australian respondents reported that they were 'comfortable' trading across the spread on SEF order books in the US dollar-denominated IRD market, even though they preferred to use voice brokers when trading in the Australian dollar-denominated IRD market. A small number of US asset managers have also joined SEFs to access the liquidity available on these platforms.

5.2 Overseas Developments

5.2.1 European Union

The EU adopted the final *Market in Financial Instruments Directive II* (MiFID II) and the *Market in Financial Instruments Regulations* (MiFIR) in June 2014. MiFID II and MiFIR set out the regulatory requirements that apply to classes of trading venues, including regulated markets, multilateral trading facilities, organised trading facilities and systematic internalisers.

In December 2014, ESMA published its final technical advice to the European Commission, and launched a consultation on draft RTS regarding the implementation of the MiFID II and MiFIR. ESMA submitted its final report on the RTS to the European Commission at the end of September.[78] If the European Commission endorses these standards, in the first half of 2016, ESMA plans to determine if interest rate swaps and credit default swaps subject to the clearing obligation should be subject to a trading obligation. However, any trading obligation would not be expected to enter into force before early 2017, in line with the entry into force of most of the requirements imposed by MiFID II/MiFIR.

ESMA's RTS include an obligation to trade derivatives on MiFID venues: regulated markets, multilateral or organised trading facilities (MTFs and OTFs, respectively). The technical advice also addresses increased trade transparency requirements for financial instruments including derivatives. To be subject to the platform-trading obligation, a class (or sub-class) of OTC derivatives would be determined to be subject to the clearing obligation, traded on at least one regulated market, MTF or OTF, and considered to be sufficiently liquid.

5.2.2 United States

Since February 2014, the CFTC has required certain US dollar-, euro- and British pound-denominated fixed-for-floating interest rate swaps and certain North American and European referenced credit index derivatives to be executed on either a registered SEF or a Designated Contract Market.[79] Trading on a SEF must either be in the form of a request for quote to a minimum of three participants or through the central limit order book. A number of SEFs also use an introducing broker to negotiate trades over the phone and then register trades on the SEF.

The CFTC has issued specific exemptions from the SEF registration requirement for qualifying:

- domestic financial markets operating in Australia that are licensed in Australia and regulated by ASIC (qualifying Australian licensed markets or QALMs)
- MTFs regulated in the EU.

78 ESMA (2015), *Final Report: Draft Regulatory and Implementing Technical Standards MiFID II/MiFIR*, September. Available at <https://www.esma.europa.eu/system/files/2015-esma-1464_-_final_report_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf>.

79 A complete list of products to which the mandate applies is available at <http://www.cftc.gov/ucm/groups/public/@otherif/documents/file/swapsmadeavailablechart.pdf>.

On 15 October 2015, the CFTC also extended the conditional no-action letter to Yieldbroker Pty Limited (Yieldbroker), an Australian licensed market, against a failure to register as a SEF or a DCM, and for any market participants for use of their platform.[80] The relief provides Yieldbroker time until 15 May 2016 to apply for relief as a QALM.

5.2.3 Other jurisdictions

Canada

In January 2015, the securities regulators from each of the 10 provinces and three territories in Canada (together, the Canadian Securities Administrators) consulted on a proposed framework for regulating facilities that bring together multiple buyers and multiple sellers of OTC derivatives to agree the terms of trades (derivatives trading facilities or DTFs).[81] While the framework would capture a variety of multilateral execution processes and venues, bilateral or one-to-many facilities such as single-dealer platforms would fall outside its scope. A DTF would require authorisation or exemption from the securities regulatory authority in each province/territory in which it operated. Under the proposed framework, DTFs would be required to, amongst other things, have codes of conduct and monitor participants' compliance with their rules. A DTF operator that exercised discretion in the execution of transactions would be subject to additional requirements similar to those applicable to dealers, for example, requirements relating to 'know your client', suitability and best execution.

The Canadian Securities Administrators have also proposed that OTC derivatives that meet certain criteria may be required to trade exclusively on such regulated facilities. The criteria that the Committee proposed for consideration were whether the class of derivative was:

- subject to a clearing obligation pursuant to applicable securities legislation
- sufficiently liquid to trade exclusively through a DTF, having regard to factors including average volume, frequency and size of trades; the number and characteristics of active market participants; the characteristics of the derivative, including degree of standardisation
- traded by a sufficient number of regularly participating market participants to ensure that the market was competitive and not susceptible to control by a small number of participants
- mandated to be traded on a regulated venue in other jurisdictions
- already trading through the facilities of a DTF and, if so, the execution method in use for that class of derivative.

The comment period for the consultation paper closed on 30 March 2015.

80 CFTC (2015), 'CFTC's Division of Market Oversight Extends Conditional Time-Limited No-Action Relief to Australian-Based Trading Platform Yieldbroker Pty Limited', Press Release PR7262-15, October. Available at <http://www.cftc.gov/PressRoom/PressReleases/pr7262-15>.

81 Canadian Securities Administrators (2015), *CSA Consultation Paper 92-401: Derivatives Trading Facilities*, January. Available at <https://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20150129_92-401_derivatives-trading.htm>.

Japan

On 13 July 2015, the JFSA published a notice that specifies the types of IRD that will be required to trade on electronic trading platforms.[82] The scope of the mandatory trading requirement is limited to contracts with tenors of five, seven or 10 years referencing the six-month yen London interbank offered rate (LIBOR) that are clearable through the Japan Securities Clearing Corporation and meet a number of other conditions. The requirement to execute such trades on electronic platforms will come into effect from 1 September 2015.

Singapore

In February 2015, the MAS published a consultation paper that set out a new regulatory regime for 'organised markets', which is designed to replace the existing regulation of markets by the types of products traded on that market.[83] The scope of the new regulation will cover all markets that facilitating the exchange, sale or purchase of specified products regulated under the *Securities Futures Act 2001*, which includes derivative contracts. However, entities offering voice or telephone-assisted broking will be regulated as capital markets intermediaries rather than market operators.

While the MAS has indicated that it does not currently consider it necessary to mandate trading of OTC derivatives, it has proposed legislative changes that would facilitate the implementation of such requirements if it were deemed appropriate to do so. In deciding whether to prescribe a derivative contract as subject to mandatory trading, the MAS proposes to consider the level of systemic risk, the characteristic and level of standardisation of the contract, the depth and liquidity of the market, the international regulatory approach, the nature of the persons that transact in the contract, potential anti-competitive behaviour, and the availability of approved exchanges or recognised market operators. The MAS has indicated that it will finalise this framework in the first half of 2016.

5.3 Assessment and Recommendations

While the Regulators are not making specific recommendations on the appropriate scope of mandatory trading obligations in this Report, the Regulators consider it timely to give market participants and international regulatory peers more clarity around how they will assess the case for introducing trading mandates in the future.

In particular, Box A sets out the means by which the Regulators will monitor developments in the Australian OTC derivatives market, and the criteria that the Regulators will consider when providing advice to the Minister under the *Corporations Act 2001*, including in response to a request from the Minister. The timing of any mandatory trading determination will depend on the Regulators' advice and any decisions taken by the Minister after consideration of the Regulators' advice.

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[82] Notice in Japanese is available at <http://www.fsa.go.jp/news/27/syouken/20150713-1.html>.

[83] MAS (2015), 'Consultation Paper on Proposed Amendments to the SFA', February. Available at <http://www.mas.gov.sg/News-and-Publications/Consultation-Paper/2015/Consultation-Paper-on-Proposed-Amendments-to-the-SFA.aspx>.

Box A: Australian Regulators' Statement on Assessing the Case for Mandatory Trading Obligations

A.1 Legislation

Part 7.5A of the Corporations Act establishes a regime for the imposition of mandatory requirements in respect of platform-based trade execution, trade reporting and central clearing of OTC derivatives. The regime became effective at the start of 2013.

Under this regime, the responsible Minister may issue a determination that mandatory obligations with respect to platform-based trade execution, trade reporting or central clearing should apply to a specified class or classes of derivatives. In making the decision to issue a determination, the Minister must have regard to certain matters specified in legislation or regulations. In particular, section 901B of the Corporations Act requires the Minister to consider:

- the likely effect on the Australian economy, and on the efficiency, integrity and stability of the Australian financial system
- the likely regulatory impact
- in the case of commodity derivatives, the likely impact on any relevant Australian commodities market or markets
- any other matters that the Minister considers relevant, such as relevant international standards and international commitments.

In making such determinations the Minister must consult with the Regulators. The Regulators may also provide advice to the Minister of their own accord. The government may also issue regulations that restrict the product or institutional scope of mandatory requirements, thereby providing temporary or ongoing exemptions in relation to specified products or entities.

Once the Minister has made a determination, ASIC may make Derivative Transaction Rules that apply to the relevant products. Such rules would set out the details of any requirements, including the institutional scope, product scope, transitional arrangements and the manner and form in which persons must comply with the requirements. In making these rules, ASIC must have regard to the same matters that the Minister is required to consider, and must also consult with APRA and the RBA.

A.2 Regulators' advice

While the Corporations Act does not specify the matters that the Regulators must consider when providing advice to the Minister, the Regulators' advice to the Minister can be expected to address the considerations in section 901B of the Corporations Act referred to above.

In order to inform their advice to the Minister, the Regulators are actively monitoring developments in the Australian and overseas OTC derivatives markets. As part of this, the Regulators carry out periodic assessments of the Australian OTC derivatives market and produce reports such as this one. The Regulators are also monitoring developments by analysing data reported to TRs, ongoing ad hoc engagement with participants and FMI providers, public consultations and, as appropriate, specific purpose market surveys.

A.3 Benefits of platform trading

Platform trading has the potential to promote greater competition, increased participation, better transparency and improved market oversight, thus contributing to the realisation of the G20 Leaders' objectives of improving transparency in the derivatives market, mitigating systemic risk, and protecting against market abuse.

Organised platform trading has the potential to bring together a larger number of market participants to trade on a specified basis, increasing competition with the result of lower trading costs and enhanced liquidity. It also provides transparency more efficiently than dispersed OTC trading, reducing information asymmetry and promoting confidence in prices, which can in turn encourage broader participation. These effects could help make the derivatives markets more diverse and less dependent on major liquidity providers, thereby helping to reduce systemic risk.

Furthermore, centralised markets can be more efficiently regulated compared to OTC trading, as they allow platform operators and market regulators to more easily aggregate, time-stamp and monitor trading activity and address abusive trading behaviour.

Finally, trading on electronic trading venues can provide additional operational benefits, such as verification of trade information through electronic confirmations and facilitation of straight-through processing to CCPs and other transaction processing systems.

A.4 Preconditions for prioritising products for assessment

Against this background, the Regulators will make periodic assessments of the need for a trading mandate in respect of particular products. In prioritising their assessments, the Regulators will consider the characteristics set out by IOSCO as to whether a product should be traded on an organised platform and the type of organised platform that may provide a practicable venue for trading.[1] Specifically, IOSCO has identified the standardisation of a product's contractual terms and operational processes, and a product's liquidity as the characteristics that should be taken into account when considering whether a move from OTC to platform trading preserves the utility of those transactions for end users. If these preconditions are not met, there could be adverse implications from a mandated move to platform trading; for example, market participants may not be able to transact at the desired volume for a product without materially affecting prices.

Standardisation

Determining a product's level of standardisation involves considering both legal and operational dimensions. Legal standardisation refers to uniform contractual definitions and terms that are common to all transactions in a particular product. Operational standardisation refers to common procedures for trade processing, including trade capture, confirmation, settlement, termination, and other aspects of procedures for handling trades. However, it should be noted that the required level of standardisation is expected to vary depending on the type of trading venue that may be used to fulfil the trading obligation.

While few jurisdictions have explicitly introduced standardisation as a precondition for mandatory platform trading, to the extent that standardisation is one factor that may be considered when establishing mandatory clearing requirements, it is implicit in their approach. Consistent with this approach, the Regulators are of the view that, if a product is subject to mandatory clearing in Australia, it is likely to be sufficiently standardised to be suitable for platform trading. However, if the Regulators were to consider mandatory trading of other products, they would explicitly consider the extent to which that product was legally and operationally standardised.

Liquidity

The second precondition for platform trading is whether a product has an adequate level of liquidity. In the Report on Trading, IOSCO has defined market liquidity as a measure of the ability to buy or sell a product in a desired quantity and at a desired price and time without materially impacting the product's price.

Considerations of whether an OTC derivative contract or a class of OTC derivative contracts would be suitable for platform trading requires an assessment of liquidity or prospective liquidity, on domestic and global markets as appropriate, and may be dependent on the characteristics of the participants, products and transactions.

The Regulators have examined the factors relevant to considerations about liquidity in overseas regulations and propose to consider factors including the following:

- average frequency and size of trades, and the range of bid/ask spreads
- number and type of market participants
- whether there are ready and willing buyers and the number of participants trading in that product.

A.5 Criteria for mandatory trading

Implications for the Australian financial system and participants

In accordance with the legislation, the Regulators will consider the implications for the *efficiency, integrity and stability of the Australian financial system* as a whole, as well as the *regulatory impact* on market participants and FMIs active in the Australian market. For each product identified and prioritised through the process described above, the Regulators will focus on the incremental benefits and costs of imposing mandatory trading, relative to allowing the market to transition to platform trading in response to private incentives or overseas requirements.

Accordingly, for each product being considered, the Regulators will take into account:

- the extent to which market participants are already trading that product on platforms, including the nature of platforms and the methods used to trade that product on platforms
- the breadth and profile of the price-makers and price-takers on a platform
- the availability or accessibility of trading platforms for that product for different types of Australian market participants, and the cost of transacting on trading platforms
- whether participants have already established appropriate commercial and operational arrangements with trading platforms (such as arrangement to be a price-maker on trading platforms), or whether such arrangements are still under negotiation for particular types of participants
- evidence of commercial incentives or the cross-border reach of regulation in other jurisdictions leading to platform trading of the product.

Where there is only one platform offering appropriate trading methods that is permitted to be used to meet a trading mandate, the issuance of a trading mandate has the potential to constrain market participants' choices or increase their costs. This could have adverse effects on market functioning, and on the efficient and competitive offering of the platform's trading services. The Regulators will similarly consider whether a trading mandate may have any potential adverse impacts on the efficiency and integrity of the market due to the other factors listed above.

The Regulators will also consider whether, under appropriate circumstances, imposing a mandate could further encourage liquidity to migrate to trading platforms, and whether that could enhance market efficiency and integrity, for example, by improving the Regulators' ability to supervise the OTC derivatives market.

The Regulators' advice to the Minister will address these questions as they apply to the specific products under consideration.

International consistency

In accordance with the scope of the Corporations Act, the Regulators will also address *relevant international standards and international commitments*. International consistency is an important consideration in assessing the case for mandatory clearing. In particular:

- in the absence of broadly harmonised requirements, there may be potential for regulatory arbitrage or other distortions in market participants' choices, including choices as to where to execute or book trades or the platforms that may be used to execute trades
- it could also affect other jurisdictions' assessment of the equivalence or comparability of the Australian regime, thereby disadvantaging Australian-based participants in their international activities
- where a product was subject to a mandate overseas but not in Australia, overseas requirements may have unintended consequences for Australia due to differences in market structure and conditions; an Australian mandate could, in such circumstances, better tailor requirements to the Australian context, while not compromising broad equivalence with overseas jurisdictions' regimes.

Should evidence suggest that there would be some benefit from mandatory trading obligations in relation to these matters, the Regulators would respond accordingly. In so doing, the Regulators will consider the approaches adopted in other jurisdictions, and the extent to which rules issued in overseas jurisdictions would affect Australian market participants.

The scope of products considered in this regard could therefore extend beyond those prioritised purely on the basis of the level of standardisation and liquidity, to capture other products for which a mandate has been introduced in other jurisdictions and for which there is material activity in the Australian OTC derivatives market. The Regulators' considerations on these issues would be informed by appropriate information exchange with overseas regulators.

Specific considerations for commodity derivatives

There is a close relationship between the functioning of commodity derivatives markets and the functioning of the underlying physical commodity markets referenced by these derivatives. Consequently, in the case of commodity derivatives, in addition to the criteria outlined above, the Regulators will pay particular attention to the potential impact of imposing a platform trading mandate on underlying commodity markets and the participants in those markets. This is consistent with the requirement in the Corporations Act that, in the case of commodity derivatives, the Minister consider the likely impact on any relevant Australian commodities market or markets.

[1] The initial report was IOSCO (2011), *Report on Trading of OTC Derivatives*, February. Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf>. This was supplemented by IOSCO (2012), *Follow-on Analysis to the Report on Trading of OTC Derivatives*, January. Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD368.pdf>.

5.3.1 Next steps

This section considers how the approach articulated above will be applied in the coming period. The Regulators' further work in this area will have a particular focus on:

- overseas regulatory developments relating to mandatory platform trading
- the degree to which Australian market participants are expected to move to trading on platforms. This will include the extent to which liquidity on some types of platforms, and the cross-border reach of current or potential overseas trading mandates may incentivise such changes
- the costs and benefits to the Australian economy and/or financial system of a mandated transition to platform trading, including the potential benefits of an Australian trading mandate in delivering regulatory consistency with overseas jurisdictions and ensuring that Australian-based participants are not disadvantaged in their international activities.

The incremental costs of mandatory platform trading, including participants' ability to transact a given volume within a certain time and at an acceptable price, would be expected to reduce if there was a material transition from bilateral transactions to platform execution. The issuance of a mandate may also assist such a transition. Consideration of these matters will therefore be important in the Regulators' analysis of the incremental costs and benefits of issuing a mandate.

To support these considerations, the Regulators will continue to work with industry to improve the quality of TR data in relation to the identification of trading venues. In addition, the Regulators' considerations will include the types of trading platforms that may be used to meet a mandatory requirement.

Considerations relating to eligible trading platforms

Under Part 7.5A of the Corporations Act, a mandatory requirement in relation to OTC derivatives can only be met by using a licensed facility or a prescribed facility. In relation to trading platforms that hold an AML, the Regulators would consider whether these platforms were authorised to operate a financial market for the relevant class(es) of OTC derivatives, whether they used appropriate trading methods for the execution of OTC derivatives, and whether they met any other applicable regulatory requirements relating to the mandatory trading of OTC derivatives. The Regulators also anticipate that the Australian market licensing regime may need to be adjusted to facilitate developments in platform trading of OTC derivatives.

There are a number of trading platforms for OTC derivatives that are not licensed as financial markets in Australia. If a trading mandate is ever to be adopted, these platforms might be prescribed facilities if they met the minimum regulatory requirements relating to prescribed platforms, so that they could also be used to meet a trading mandate. Prescription of additional trading platforms could help to preserve Australian market participants' access to offshore markets or to facilitate cross-border trades.

6. Risk Management Practices

In terms of risk management practices, the G20 commitments focus on capital and margin requirements. IOSCO has also developed international standards on risk mitigation techniques for non-centrally cleared derivatives, which are closely aligned with the requirements implemented in the EU and the US as part of their OTC derivatives reforms. Preparations are underway to incorporate these requirements across all the G20 jurisdictions, including Australia. In anticipation of this implementation, industry is also preparing to comply with these requirements.

6.1 International and Overseas Developments

Since the last Report, substantial work on developing and refining international standards on margin requirements, risk mitigation standards and capital requirements has been completed. With the implementation of these requirements due to commence in 2016, overseas authorities are in the process of incorporating them into their domestic regulatory regimes.

6.1.1 Margin requirements

In March 2015, BCBS and IOSCO announced that the timetable for implementing margin requirements for non-centrally cleared OTC derivatives was to be delayed by nine months, with the first requirements due to come into effect in September 2016.[84] The delay was in recognition of the operational and legal complexities of implementing the final framework.

At the same time, BCBS and IOSCO announced that the requirement for financial firms and systemically important non-financial entities ('covered entities') that engage in non-centrally cleared OTC derivatives trades to exchange variation margin would be implemented in two phases. From 1 September 2016, variation margin is expected to be required on trades between covered entities belonging to a group with aggregate month-end average notional principal of non-centrally cleared derivatives exceeding €3 trillion. Variation margin requirements for all other OTC derivatives trades between covered entities are due to commence from 1 March 2017.

As noted in previous Reports, the BCBS-IOSCO *Margin Requirements for Non-centrally Cleared Derivatives* (the BCBS-IOSCO framework) is designed to reduce the potential for contagion from the default of a market participant by ensuring that OTC derivatives exposures are adequately collateralised. In addition, by bringing bilateral risk management practices more into line with those used in central clearing, the framework will enhance transparency, aid risk comparisons and promote central clearing for derivatives that meet the preconditions for safe and reliable clearing.

Exchange of initial margin under the BCBS-IOSCO framework, which is designed to cover potential future exposure to non-centrally cleared OTC derivatives, represents a significant change to current business practices for non-centrally cleared OTC derivatives. Under the framework, initial margin can be calculated using either a regulator-approved quantitative portfolio margin model or the standardised margin schedule set out by the BCBS and IOSCO. While portfolio margin models are expected to better reflect the potential future exposure, different models could lead to vastly different initial margin amounts for the same portfolio. To mitigate this, the International Swaps and Derivatives Association (ISDA) has been working on a standardised initial margin model (SIMM) that, if approved, would allow market participants to better anticipate their margin obligations. In June 2015, ISDA published a discussion document and drafts of the current version of its SIMM

[84] BCBS-IOSCO (2015), *Margin Requirements for Non-centrally Cleared Derivatives*, March. Available at <http://www.bis.org/bcbs/publ/d317.pdf>.

methodology and data standards.[85] ISDA is also preparing revised documentation that will support the exchange of margin under the BCBS-IOSCO framework.

BCBS and IOSCO have also established a working group to monitor this implementation process. The working group is assessing jurisdictions' progress in implementing the framework, reviewing industry's preparations for the reforms, and reviewing whether the framework remains consistent with other international regulatory initiatives. The Regulators remain closely engaged with this work.

Consistent with the BCBS-IOSCO timetable, regulators in a range of jurisdictions are in the process of amending their regulatory requirements. Regulators in the EU, Japan and US have consulted on draft rules, with EU and US rules expected to be finalised by the end of 2015 (see below for details). Regulators in Hong Kong, Singapore and Canada are expected to consult on their draft rules before the end of the year, with Australia likely to consult in early 2016 (see Section 6.3.1, below).

Canada

In October 2015, the Office of the Superintendent of Financial Institutions issued a consultation on margin requirements on non-centrally cleared OTC derivatives between covered entities.[86] The proposed margin requirements would apply to covered entities which are defined as financial entities with non-centrally cleared OTC derivative notional amounts above C$12 billion and non-financial entities with notional amounts above C$50 billion.

European Union

Since the last Report, ESMA, the European Banking Authority and the European Insurance and Occupational Pensions Authority (together, the Joint Committee of the European Supervisory Authorities or ESAs) have published two consultation papers on draft regulatory technical standards implementing margining of non-centrally cleared OTC derivatives. The April 2014 consultation paper set out the ESAs initial proposal for the methodologies for the determination of the appropriate level of margins, the criteria that define liquid high-quality collateral, the list of eligible asset classes, collateral haircuts and concentration limits.[87]

In response to feedback, the ESAs released a second consultation paper, with revised proposals.[88] In particular, the ESAs proposed to apply the same criteria for non-financial counterparties located in third countries as it had initially proposed for non-financial counterparties established in the EU, whereas under the initial proposal non-financial counterparties in third countries below the clearing threshold would also be covered. Other revisions included timing requirements for the exchange of margin, concentration limits for sovereign debt securities, haircuts for foreign exchange mismatch, treatment of cash collateral for initial margin and criteria for exemptions for intragroup transactions. The revised proposal also aligns the phase-in with the revised BCBS-IOSCO timetable.

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85 ISDA (2015), *Discussion Document: Uncleared Initial Margin Calculations and Processes Related to the ISDA WGMR SIMM Initiative*, June. Available at <http://www2.isda.org/attachment/NzY2OA==/1. per cent20IM per cent20Discussion per cent20Paper per cent2020150615 per cent20- per cent20CLEAN per cent20- per cent20PUBLIC.pdf>.

86 Office of the Superintendent of Financial Institutions (2015), *Margin Requirements for Non-centrally Cleared Derivatives*, Draft Guideline E-22, October. Available at <http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/e22.aspx>.

87 Joint Committee of the European Supervisory Authorities (2014), *Consultation Paper: Draft Regulatory Technical Standards on Risk-mitigation Techniques for OTC-derivative Contracts not Cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*, April. Available at <http://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf>.

88 Joint Committee of the European Supervisory Authorities (2015), *Second Consultation Paper: Draft Regulatory Technical Standards on Risk-mitigation Techniques for OTC-derivative Contracts not Cleared by a CCP under*

Japan

In July 2014, the JFSA released its proposed draft amendments to the 'Cabinet Office Ordinance on Financial Instruments Business' and 'Comprehensive Guidelines for Supervision', which are designed to implement margin requirements for non-centrally cleared derivatives.[89] Under the Financial Instruments and Exchange Act, the margining requirements apply to all Financial Instruments Business Operators and Registered Financial Institutions above a de minimus threshold. The institutions below this threshold are subject to margin requirements under JFSA Supervisory Guidelines.

Singapore

In October 2015, the MAS released a consultation paper on its implementation of margin requirements for non-centrally cleared OTC derivatives.[90] The paper outlines the proposed product scope, entity scope, and the margin requirements applying to a MAS Covered Entity. The consultation paper allows for deemed compliance for cross-border transactions where a transaction may be subject to margin requirements from more than one jurisdiction. This would be based on an outcome-based comparability assessment of margin requirements in the foreign jurisdiction.

The MAS also proposes to implement margin requirements in phases, with banks scoped in first, reflecting the size and nature of their non-centrally cleared OTC derivative exposures. The policy consultation requests public feedback on a number of questions and this will be used by the MAS to inform its rules for margining.

United States

In October 2015, the US Prudential Regulators (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency) issued the final rules for margin requirements for non-centrally cleared derivatives.[91] These final rules were developed in consultation with the CFTC, which has proposed very similar rules, and the SEC.[92] The margining rules impose initial and variation margin requirements on non-centrally cleared swaps between (i) swap dealers and major swap participants (collectively, 'covered swap entities') and (ii) covered swap entities with financial end users. The margin requirements do not apply to commercial end users and smaller financial institutions with total assets below US$10 billion that use non-centrally cleared OTC derivatives for hedging purposes.

Furthermore, in June 2015, the US CFTC released its proposed rule on cross-border margining requirements for non-centrally cleared OTC derivatives.[93] This is similar to the requirements adopted by the US prudential regulators and sets out the scope of application for the US CFTC rules

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Article 11(15) of Regulation (EU) No 648/2012, June. Available at <http://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf>.

89 JFSA (2014), relevant documents are published in Japanese. Available at <http://www.fsa.go.jp/news/26/syouken/20140703-3.html>

90 MAS (2015), *Policy Consultation on Margin Requirements for Non-centrally Cleared OTC Derivatives*, October. Available at <http://www.mas.gov.sg/News-and-Publications/Consultation-Paper/2015/Policy-Consultation-on-Margin-Requirements-for-NonCentrally-Cleared-OTC-Derivatives.aspx>.

91 US Prudential Regulators (2015), *Margin and Capital Requirements for Covered Swap Entities Agencies*, October. Available at <https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery >.

92 CFTC (2014), *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, October.* Available at <http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2014-22962a>.

93 CFTC (2015), *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants–Cross-Border Application of the Margin Requirements*; Proposed Rule, July. Available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2015-16718a.pdf>.

and the provisions for substituted compliance. This has direct implications for Australian market participants who may be covered swap entities or may be transacting with a covered swap entity.

6.1.2 Risk mitigation standards

As noted in previous Reports, EU and US authorities introduced risk mitigation requirements for non-centrally cleared OTC derivatives as part of their implementation of the G20 OTC derivatives reforms. Other authorities impose risk mitigation requirements as part of a broader prudential or risk management regulatory requirement, or as part of the business conduct regulation of brokers and dealers. Given the cross-border nature of OTC derivatives markets, IOSCO has developed international standards on risk mitigation techniques for non-centrally cleared derivatives (the IOSCO risk mitigation standards). These standards are aimed at ensuring such requirements are sufficiently compatible across jurisdictions to limit regulatory arbitrage, maintain a level playing field and avoid situations in which the same transactions are subject to conflicting rules. The final standards were published in January 2015, with the entity scope and timetable aligned with the margin requirements for non-centrally cleared OTC derivatives.[94]

The IOSCO risk mitigation standards set expectations on financial entities and systemically important non-financial entities in the following areas:

- *Trading relationship documentation:* Covered entities should establish and implement policies and procedures to execute written trading relationship documentation with their counterparties prior to, or contemporaneously with, executing a non-centrally cleared OTC derivatives transaction. Such documentation should include all material terms governing the trading relationship between the counterparties.
- *Trade confirmation:* Covered entities should establish and implement policies and procedures to ensure the material terms of all non-centrally cleared OTC derivatives transactions are confirmed as soon as practicable after execution of the transaction.
- *Valuation:* Covered entities should agree on, and clearly document, the process for determining the value of each non-centrally cleared OTC derivatives transaction at any time from the execution of the transaction to the termination, maturity, or expiration thereof, for the purpose of exchanging margin.
- *Reconciliation:* Covered entities should establish and implement policies and procedures to ensure that the material terms and valuations of all transactions in a non-centrally cleared OTC derivatives portfolio are reconciled with counterparties at regular intervals.
- *Portfolio compression:* Covered entities should establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression.
- *Dispute resolution:* Covered entities should agree on the mechanism or process for determining when discrepancies in material terms or valuations should be considered disputes, as well as how such disputes should be resolved as soon as practicable. The mechanism or process should provide for the prompt notification to authorities of such disputes that remain unresolved after a reasonable period of time if the applicable regulation requires such notification.

[94] IOSCO (2015), *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives*, January. Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf>.

These requirements are broadly consistent with those that were already in place in the EU and US. Similar requirements were introduced in Canada shortly after the IOSCO Risk Mitigation Standards were finalised.[95]

The five largest Australian-headquartered dealers that have provisionally registered with the CFTC as non-US Swap Dealers are also subject to the CFTC's business conduct rules. In December 2013, the CFTC approved substituted compliance regarding certain entity-level rules for swap dealers located in a number of jurisdictions, including Australia.[96] In part to support this substituted compliance process, ASIC and APRA have concluded MoUs with the CFTC. The ASIC-CFTC MoU was signed in September 2014 and covers cooperation and the exchange of information in the supervision of regulated entities that have cross-border operations in the United States and Australia.[97] Under the MoU, both agencies expressed their willingness to cooperate in the interest of fulfilling their respective regulatory mandates regarding derivative markets. APRA and the CFTC agreed a similar MoU in April 2015, which covers entities that are supervised by both agencies.[98]

Given the close relationship between these requirements and the margin requirements for non-centrally cleared derivatives, many jurisdictions, including Australia, are expected to implement these requirements as part of a single package of reforms. One authority that recently consulted on rules implementing the risk mitigation standards is the MAS.[99] The proposed MAS rules closely follow the IOSCO risk mitigation standards and apply them to a new category of regulated entities, OTC derivatives intermediaries.[100]

6.1.3 Capital requirements

The BCBS continues to refine the capital framework. Two such refinements that are particularly relevant to OTC derivatives are the revised standardised approach to measuring counterparty credit risk and capital requirements for bank exposures to CCPs. Both of these refinements are due to be incorporated into the capital framework from 1 January 2017.

In March 2014, BCBS set out a new standardised approach for measuring counterparty credit risk.[101] This new approach, known as SA-CCR, is intended to replace the current non-internal model approaches used to measure counterparty credit risk. In formulating the SA-CCR, one of the BCBS's main objectives was to devise an approach that is suitable to be applied to a wide variety of derivatives transactions, whether those transactions are margined or unmargined, and whether

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95 Office of the Superintendent of Financial Institutions (2015), *Guideline B-7 Derivatives Sound Practices*, January. Available at <http://www.osfi-bsif.gc.ca/eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/b7_let.aspx>.

96 CFTC (2013), *CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes*, Press Release PR6802-1320, 20 December. Available at <http://www.cftc.gov/PressRoom/PressReleases/pr6802-13>.

97 ASIC and CFTC (2014), *Memorandum of Understanding – Cooperation and the Exchange of Information Related to the Supervision of Cross-border Covered Entities*, September. Available at <http://download.asic.gov.au/media/2067637/cftc-mou-published-1-october-2014.pdf>.

98 APRA and CFTC (2015), *Memorandum of Understanding – Cooperation and the Exchange of Information Related to the Supervision of Covered Firms*, April. Available at <http://www.apra.gov.au/AboutAPRA/Documents/MoU-USA-CFTC.pdf>.

99 MAS (2015), *Policy Consultation on Regulatory Framework for Intermediaries Dealing in OTC Derivative Contracts, Execution-Related Advice, and Marketing of Collective Investment Scheme*, June. Available at <http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Policy%20Consultation%20on%20Regulatory%20Framework%20for%20OTC%20Intermediaries%20ERA%20and%20Marketing%20of%20CIS%203%20Jun%2015.pdf>.

100 The consultation on proposed licensing requirement for intermediaries dealing in OTC derivative contracts is MAS (2015), *Consultation Paper on Proposed Amendments to the Securities and Futures Act,* February. Available at <http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Consultation%20Paper%20on%20Proposed%20Amendments%20to%20the%20SFA%20Revised%20on%2016%20Feb%202015.pdf>.

101 BCBS (2014), *The Standardised Approach for Measuring Counterparty Credit Risk Exposures,* March. Available at <http://www.bis.org/publ/bcbs279.pdf>

they are bilateral or centrally cleared. Neither of the previous non-internal model approaches differentiated between margined and unmargined transactions.

In April 2014, the BCBS published a revised framework for bank exposures to CCPs.[102] This framework is designed to ensure banks' exposures to CCPs are adequately capitalised, while maintaining incentives to centrally clear. The revised framework builds upon the interim framework and incorporates the results of the Joint Quantitative Impact Study conducted in 2013. The revisions include the introduction of a cap on the capital charge for exposures to Qualifying CCPs (QCCPs), which should ensure that capital requirements for exposures to QCCPs are lower than those for exposures to non-qualifying CCPs. Under the framework, a QCCP is a licensed CCP that is based and prudentially supervised in a jurisdiction where the relevant regulator or overseer has publicly indicated that it applies, on an ongoing basis, rules and regulations that are consistent with the *Principles for Financial Market Infrastructures*.

6.1.4 ISDA Stay Protocol

In November 2014, ISDA launched the *ISDA 2014 Resolution Stay Protocol* (the Stay Protocol), which was developed by a working group of ISDA member institutions (including representatives from buy-side and sell-side institutions), in coordination with the FSB.[103] The Stay Protocol was developed in response to a request from regulatory authorities in Germany, Japan, Switzerland, UK and US. It is designed to contractually recognise the cross-border application of special resolution regimes applicable to certain financial institutions. In particular, it provides clarity over the circumstances in which a party's right to close-out and terminate OTC derivatives positions can be temporarily overridden in the event that the counterparty enters resolution, to provide regulators with time to facilitate the orderly resolution of a troubled institution.

Currently, 186 parties – including all of the globally systemically important banks – have signed the Stay Protocol. At present, the resolution regime in Australia is not covered by the Stay Protocol. Currently the Stay Protocol explicitly applies to the resolution regimes in France, Germany, Japan, Switzerland, the UK and the US. There is provision for recognition of the resolution regimes of other FSB jurisdictions, but only if they meet certain criteria. Further legislative changes, discussed in Section 6.3.2, are required before the Australian resolution regime satisfies the eligibility criteria in the Stay Protocol. The Stay Protocol is also in the process of being amended and is expected to be re-launched later this year.

6.2 Australian Market Practices

In preparing this Report, the Regulators surveyed and met with a range of APRA-regulated entities to gauge their preparedness for compliance with the BCBS-IOSCO margin requirements and IOSCO risk mitigation standards for non-centrally cleared derivatives. APRA also used the opportunity to better understand the implications for ADIs of the revised capital requirements discussed in Section 6.1.3.

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[102] BCBS (2014), *Capital Requirements for Bank Exposures to Central Counterparties,* April. Available at <http://www.bis.org/publ/bcbs282.pdf>

[103] ISDA (2014), *ISDA 2014 Resolution Stay Protocol,* November. Available at <http://assets.isda.org/media/f253b540-25/958e4aed.pdf/>

6.2.1 Margin requirements

The Regulators' survey indicated that two-way variation margin is a commonly used risk mitigation tool for non-centrally cleared OTC derivatives. The variation margin arrangements in place between larger financial institutions and dealers are reportedly largely aligned with the BCBS-IOSCO framework, with the full amount necessary to fully collateralise the mark-to-market exposure of the non-centrally cleared derivatives exchanged daily. However, for financial institutions and corporate end-users with less significant and largely one-sided exposure to non-centrally cleared derivative markets, variation margin practices differ from the BCBS-IOSCO requirements. In particular, many such entities either do not exchange variation margin or do so subject to thresholds designed to reduce the operational burden and liquidity demands of daily margining.

The majority of variation margin exchanged in the Australian market is via title transfer under English- or Australian-law Credit Support Annexes (CSAs). Title transfer means that the collecting party has outright title to the margin received and can therefore re-use the collateral. There is some use of transfer via security interest under New York-law CSAs and under standard ISDA documentation, although these arrangements generally allow the collecting party to re-use the collateral. Consistent with the results of the previous Regulators' survey, collateral is typically posted in the form of cash or government securities, although some survey participants also use assets such as other securities and gold.

In contrast, the Regulators' survey confirmed that initial margin is not commonly exchanged by Australian financial institutions, although there is some use in trades with hedge funds. Where initial margin is exchanged, it is typically a fixed independent amount that is generally received by the Australian financial institution rather than posted. In contrast, under the BCBS-IOSCO framework, two-way initial margin based on the potential future exposure that is exchanged on a gross basis will be required. Feedback from financial institutions emphasises that there will be significant implementation challenges for both local and global market participants.

While current CSAs are broadly suitable for the exchange of variation margin, the BCBS-IOSCO framework requires that initial margin be held in such a way as to ensure that the collected margin is subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy. Re-use of the collateral by the collecting party, except under certain specific conditions, is not allowed under the BCBS-IOSCO framework. Consequently, compliance with the BCBS-IOSCO requirements is expected to require substantial changes to current business practices, trading relationships and custodial documentation, quantitative models for initial margin, and collateral management and back office systems.

The survey responses and meetings confirmed that the larger ADIs in Australia are well aware of BCBS-IOSCO requirements, including the scope of the proposed foreign rules implementing these requirements. Such institutions understand that they will either be directly or indirectly impacted by foreign rules, and appear to be working towards complying with foreign requirements. Indeed, some ADIs have indicated that they expect to voluntarily comply with foreign rules prior to becoming directly subject to the margin requirements under Australian rules.

However, it appears that some smaller market participants are not aware that they could be indirectly caught by foreign requirements. In implementing the BCBS-IOSCO requirements, national regulators are required to define the financial firms and systemically important non-financial entities to which the requirements are to be applied. Consequently, foreign rules may require foreign counterparties to exchange initial and variation margin for non-centrally cleared OTC derivatives with Australian entities to the extent that such entities meet the foreign definition of financial firms and systemically important non-financial entities. This indirect impact is likely to commence in March 2017, when variation margin requirements for all financial firms and systemically important non-financial firms are due to commence.

6.2.2 Risk mitigation standards

In previous Reports, the Regulators have concluded that market participants, especially dealers, generally conform to accepted good market practice and published Australian market conventions. In the most recent survey the Regulators focused on APRA-regulated entities' practices with respect to trade confirmation, portfolio valuation, reconciliation, dispute resolution, and compression. The survey results confirm that APRA-regulated entities are generally well placed to comply with the risk mitigation standards in these areas.

Trade confirmation, portfolio valuation, reconciliation and dispute resolution

Consistent with the IOSCO standards, all survey respondents reported having policies and procedures to ensure that the material terms of all non-centrally cleared OTC derivatives transactions were confirmed. However, the survey results suggest that there are differences across asset classes in the timeframe for two-way confirmation (that is confirmation sent by one side and affirmed by the other side). The reported timeframes for credit, interest rate and foreign exchange derivatives are generally shorter than those reported for commodities and OTC equities derivatives. This is largely consistent with the observations from the previous Report and likely reflects the nature of the counterparties and products being traded, and the mix of paper-based and electronic confirmations for the different types of market participants.

Reported market practice with respect to portfolio valuation was also generally consistent with the IOSCO standards. Most survey respondents stated that they had agreed and documented processes in place with their counterparties to determine valuations for the purpose of exchanging margin. Indeed, the vast majority of survey respondents reported that they revalued their portfolios on a daily basis, using valuation models that were independently validated and monitored. In doing so, respondents reported using both internally and externally built models and systems.

In line with the findings in previous Reports, the usage and frequency of portfolio reconciliation differs depending on the size and type of counterparty. For trades amongst dealers and major ADIs, it was reported that respondents had a largely automated reconciliation process, which they used on a daily basis. Portfolio reconciliation was much less frequent for trades involving other types of counterparties, which is to be expected given the relatively small number of outstanding positions and the relatively low turnover. Nevertheless, smaller ADIs generally reported that they reconciled their portfolio more frequently with Australian ADIs than with foreign dealers and banks.

For dispute resolution, many participants reported having agreed and documented mechanisms or processes for determining and resolving disputes about material terms and valuations. The survey results suggest that most disputes were typically resolved within 10 days; although a small percentage of disputes remained outstanding beyond 30 days. One respondent to the survey noted that these longer disputes usually related to the valuation of complex products using different proprietary models and inputs, where determining the root cause of the difference was time consuming.

Compression

Portfolio (or trade) compression is the practice of reducing or eliminating either bilateral or centrally cleared OTC derivative trades by simultaneously terminating or replacing them with a smaller, more 'economical' set of trades with an equivalent exposure or for a compensating payment. Portfolio compression can be a particularly effective method for dealers with a large number of trades, but relatively small net exposures, to reduce operational risk.

Consistent with the IOSCO standards, the majority of major ADIs and dealers have policies and procedures in place to regularly assess and, to the extent appropriate, engage in portfolio compression. In the Australian market, this is conducted on both a multilateral and bilateral basis. Multilateral trade compression involves terminating trades across a number of counterparties and generally requires coordination by a service provider. While there are typically fewer offsetting positions available for termination in a bilateral compression, to the extent that trades do not completely offset, bilateral counterparties may negotiate a compensating payment or new trades designed to allow both counterparties to retain their desired risk position.

Over the year to the end of June 2015, most major ADIs and dealers reported participating in a few multilateral portfolio compression cycles and a higher number of bilateral compressions. However, most survey participants that had participated in portfolio compression noted that they had, in aggregate, terminated no more than 10 per cent of their notional principal outstanding. In general, survey respondents reported compressing interest rate swaps and cross currency swaps involving the Australian dollar, British pound Euro or US dollar. However, some major ADIs have also participated in portfolio compression cycles for New Zealand dollar-denominated interest rate swaps.

In contrast, smaller ADIs and other APRA-regulated entities indicated that they had not considered the use of portfolio compression. This is not unexpected given the size and nature of their derivative portfolios; such entities generally have a small number of directional positions, which means there are likely to be a very limited number of offsetting trades. Consequently, the costs of participating in portfolio compression could outweigh the benefits (if any).

It is better practice to have an appropriate governance framework for the implementation and operationalisation of these risk mitigation tools. This would include oversight from a committee, possibly the valuation committee, to ensure that such tools were considered and used appropriately and that any particular issues were escalated and visible to management.

6.3 Implementation in Australia

Australia intends to implement the BCBS-IOSCO margin requirements framework and the risk mitigation standards in its regulatory regime. In the first instance this will be through APRA's prudential standards. As previously noted, the current practices for the exchange of variation margin (which involve posting and receiving margin on a title transfer basis) are not suitable for initial margin as the BCBS-IOSCO framework requires that the collecting party hold such collateral in a bankruptcy-remote manner. In part, the current practice of posting and receiving margin on a title-transfer basis has arisen because of the legal impediments which currently exist under Australian law that affect the creation and enforcement of a collecting party's rights in respect of collateral provided by way of security interest. Consequently, the government is in the process of considering legislative proposals that would facilitate the exchange of margin by way of security interest. The legislative reforms under consideration may also provide clarity over the operation of temporary stays on rights to close-out transactions in the event that a statutory manager or judicial manager is appointed.

6.3.1 Prudential standards on margin and risk mitigation

The Australian market is dominated by a small number of APRA-regulated institutions (e.g. major banks) and large foreign institutions (e.g. global banks and dealers from major jurisdictions such as the US and EU) that would be subject to foreign rules. Such firms typically represent at least one of the counterparties in the vast majority of non-centrally cleared OTC derivatives transactions.

Consequently, the Regulators have focussed on the implementation of the margining and risk mitigation requirements by APRA through the development of prudential standards for APRA-regulated institutions. APRA expects to consult on its proposed implementation of margin requirements and risk mitigation standards for APRA-regulated institutions in early 2016. In addition, APRA is currently updating its capital framework in relation to counterparty credit risk and bank exposure to CCPs and will likely consult on this as part of the same package.

While the volume of transactions and level of risk associated with transactions that would not be captured (directly or indirectly) by either APRA prudential standards or foreign rules is not expected to be material, the Regulators will consider this approach for non-APRA regulated institutions in 2016. This review will assess the case for ASIC being given rulemaking powers to implement margin requirements and risk mitigation standards for non APRA-regulated institutions.

6.3.2 Legislative proposals

Facilitating the exchange of margin by way of security interest

Under the BCBS-IOSCO framework, covered entities are required to hold initial margin in a manner that ensures that it is immediately available to the collecting party in the event of the counterparty's default, but at the same time ensures that the posting party is protected in the event that the collecting party enters bankruptcy. There are two main methods of exchanging collateral: title transfer and security interest. Title transfer does not meet the bankruptcy-remote requirement as the collateral becomes the property of the collecting party. While exchanging collateral by way of security interest should ensure that the posting party is protected in the event that the collecting party enters bankruptcy (in that the collateral should not form part of the collecting party's estate on its insolvency), currently under certain circumstances the collateral posted by way of security interest may not be immediately available to the collecting party in the event that the posting party defaults. This is because the granting of security interests generally involves a number of additional enforceability, validity and perfection requirements, which means that a collecting party may be restricted from enforcing its security interest if the posting party is subject to certain insolvency proceedings.

Furthermore, under certain circumstances, the existence of priority regimes under the current legislative framework in Australia, which apply in respect of the assets of certain types of entities, may result in other parties' claims to the posting party's assets (including the collateral provided by way of security interest) having priority over the claim of the collecting party. To facilitate the exchange of margin, the government is currently considering legislative changes that would support the exchange of margin by way of security interest. In view of these changes, APRA may also need to consider the operation of its 'Assets in Australia' test.

Facilitating posting margin by superannuation entities and life companies

A number of legal impediments currently exist under Australian law that restrict the ability of some types of Australian entities to grant security. In particular, the trustees of superannuation entities regulated by the *Superannuation Industry (Supervision) Act 1993* and life companies regulated by the *Life Insurance Act 1995* are currently unable to grant a charge over assets for the purpose of fulfilling margin requirements on OTC derivatives. This restricts the ability for such entities to participate in OTC derivative markets. This restriction applies to both centrally cleared and non-centrally cleared OTC derivatives. However, there is an exemption that allows, if certain conditions are satisfied, each regulated entity to give a security interest in relation to a derivatives contract entered into by the entity in order to comply with the rules of certain exchanges and clearing houses that require the performance of obligations in relation to the derivatives contracts to be secured. Consequently, the government is considering whether the exemption should be extended so that it facilitates the granting of security interests in respect of both centrally cleared and non-centrally cleared OTC derivatives (e.g. the security interests required by Futures Commission Merchants under US law).

Resolution stay

As noted in Section 6.1.4, further legislative changes are required before the Australian resolution regime satisfies the eligibility criteria in the Stay Protocol. In particular, changes are required to clarify the circumstances in which a party's right to close-out OTC derivatives can be temporarily overridden in the event that a statutory manager or judicial manager is appointed. These changes are expected to be broadly consistent with the criteria for protocol-eligible regimes under the Stay Protocol. Amendments to Australian law which clarify the way in which close-out rights are stayed on the appointment of a statutory manager or judicial manager should provide certainty where Australian law, as applied by an Australian court, governs both the resolution regime and the relevant contract. The recognition of the Australian regime under the Stay Protocol will provide a starting point for cross-border recognition of a stay on the appointment of a statutory manager or judicial manager.

7. Next Steps

In addition to setting out the latest advice from the Regulators to the Minister on mandatory clearing obligations, this report contains a framework for assessing the case for mandatory trading obligations and an assessment of the Australian market's preparedness for compliance with the margin requirements and risk mitigation standards for non-centrally cleared derivatives.

In terms of mandatory clearing, this Report does not recommend extending the scope of the Australian central clearing mandate. Going forward, the Regulators will continue periodically to assess the case for extending the clearing mandate. However, the Regulators propose to formally report on these assessments only if they are of the view that extending the clearing mandate would lead to a reduction in systemic risk or material substituted compliance or equivalence benefits, or there is material potential for regulatory arbitrage. Consequently, the Regulators do not expect to cover mandatory clearing in the next Report.

Instead, the next Report is likely to focus on platform trading. Having set out a framework for assessing the case for introducing mandatory trading obligations, the Regulators intend to apply this framework in the next Report.

There are parallel processes in train to take forward the risk management practices work. The government is considering legislative proposals that would, amongst other things, facilitate the exchange of initial margin. It is expecting to consult on these legislative proposals by the end of 2015. In early 2016, APRA is expected to consult on prudential standards to implement margin requirements and risk mitigation standards for APRA-regulated institutions. While the volume of transactions and level of risk associated with transactions that would not be captured (directly or indirectly) by either APRA prudential standards or foreign rules is not expected to be material, the Regulators will consider the approach for non-APRA regulated institutions in 2016.