ASIC
Australian Securities & Investments Commission

REPORT 460

Response to submissions on Consultation Paper 231 Mandatory central clearing of OTC interest rate derivative transactions

December 2015

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 231 *Mandatory central clearing of OTC interest rate derivative transactions* (CP 231) and details our response to those issues.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Contents

A Overview

1 In response to the global financial crisis, the leaders of the Group of Twenty (G20) (including Australia) agreed to a range of reforms to over-the-counter (OTC) derivatives markets at the 2009 Pittsburgh summit. One of the reforms was mandatory clearing of OTC derivative transactions.

2 In May 2015, Treasury consulted on:

(a) a draft Ministerial determination specifying the OTC derivatives products that were proposed to be subject to mandatory central clearing requirements (clearing requirements); and

(b) amendments to the Corporations Regulations 2001 (Corporations Regulations), setting out some of the details of the proposed clearing requirements.

3 In August 2015, the Minister made the Corporations (Derivatives) Amendment Determination 2015 (No. 1) (Determination), which gave ASIC the power to make rules requiring central clearing of OTC interest rate derivatives denominated in Australian dollars (AUD interest rate derivatives), and in US dollars, euros, British pounds and Japanese yen (G4 interest rate derivatives).

4 In August 2015, the Corporations Amendment (Central Clearing and Single‑Sided Reporting) Regulation 2015 (Central Clearing Regulation) was made, setting out some limits on ASIC's power to make rules in relation to mandatory central clearing.

Response to consultation

5 On 28 May 2015, we released Consultation Paper 231 *Mandatory central clearing of OTC interest rate derivative transactions* (CP 231) and draft ASIC Derivative Transaction Rules (Clearing) 2015 (derivative transaction rules (clearing)) for consultation. CP 231 proposed to implement clearing requirements for AUD and G4 interest rate derivatives.

6 In response to CP 231, we received eleven submissions (including three confidential submissions) over the course of the consultation period which ended on 10 July 2015.

7 Since the close of consultation we have engaged with stakeholders in further targeted consultation on particular issues, including the cross-border scope of the proposed clearing requirements.

B Key issues

Key points

This section outlines the key issues raised in the submissions to CP 231, and our responses to those issues, including:

- entities subject to the clearing requirements;
- cross-border scope of the clearing requirements;
- transactions and asset classes subject to the clearing requirements; fulfilling the clearing requirements;
- deadline for mandatory central clearing;
- prescription of clearing facilities;
- alternative clearing;
- exemptions;
- notifications and record keeping; and
- calculation and commencement dates.

Entities subject to the clearing requirements

8 In CP 231, we proposed to adopt the definitions for 'Australian clearing entities' and 'foreign clearing entities' set out in the Central Clearing Regulation (i.e. entities with more than $100 billion total gross notional outstanding in OTC derivatives may be included as Australian or foreign clearing entities). We also specified how the $100 billion threshold would be calculated, specifically that foreign entities should include trades booked in Australia and entered into in Australia ('entered-into' transactions) when calculating the threshold.

9 We also proposed that the central clearing mandate apply to transactions between two clearing entities, as well as transactions between a clearing entity and a foreign internationally-active dealer.

10 Overall, industry was supportive of the proposals relating to the definitions of Australian clearing entities and foreign clearing entities. Some respondents considered that foreign clearing entities should not be required to include 'entered-into' transactions when calculating the threshold or, alternatively, should only include 'entered-into' transactions that are transacted after 25 February 2015.

11 Feedback was mixed on foreign internationally-active dealers, with some respondents being supportive of the proposal and others opposing the inclusion of foreign internationally-active dealers.

ASIC's response

We have considered the submissions on foreign internationally-active dealers and consulted with Treasury, the Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA).

We consider it important for foreign clearing entities to include 'entered-into' transactions when calculating the mandatory central clearing threshold to ensure the appropriate entities are captured by Australia's mandatory central clearing regime. However, we have adopted industry's proposal that foreign clearing entities should only include 'entered-into' transactions that are transacted on or after 25 February 2015.

We also consider it important for the clearing requirements to apply to transactions between a foreign internationally-active dealer and an Australian clearing entity or foreign clearing entity. This would help to maximise the potential for substituted compliance or equivalence under foreign mandatory central clearing regimes, and is consistent with the scope of the Australian mandatory clearing regime under the Central Clearing Regulation.

Cross-border scope of the clearing requirements

12 In CP 231, we proposed to apply the clearing requirements to certain transactions between two clearing entities, and between a clearing entity and a foreign internationally-active dealer. For transactions involving a foreign clearing entity, we proposed that the transaction be subject to the clearing requirements if the foreign clearing entity books or enters into the transaction in Australia, or the transaction is a 'nexus transaction' as defined in the derivative transaction rules (clearing).

13 There was strong industry opposition to the proposal, with industry seeking to exclude transactions that are entered into in Australia. Industry was concerned about the difficulty of identifying transactions entered into between two foreign clearing entities and transactions entered into between a foreign clearing entity and a foreign internationally-active dealer, where the foreign clearing entity does not book the transaction in Australia. In order to identify these types of transactions, financial entities would incur additional costs and be required to build new technology systems and monitor the nature of their counterparties and transactions.

ASIC's response

Having considered the additional information provided by industry, we recognise the compliance and cost implications for entities of identifying these transactions for the purposes of complying with the clearing requirements.

More importantly, following consultation with the RBA and APRA, we consider the importance of these transactions is less significant to the management of systemic risk in Australia and, therefore, the current regulatory benefit from requiring these transactions to be cleared is not outweighed by the regulatory burden. As such, we have removed these transactions from the clearing requirements.

Transactions and asset classes subject to the clearing requirements

14 In addition to the Ministerial determination which imposed clearing requirements on certain interest rate derivatives, in CP 231 we proposed to require four types of interest rate derivatives to be subject to the clearing requirements (i.e. fixed–to-floating swaps, basis swaps, forward rate agreements and overnight index swaps).

15 Although we proposed that existing transactions generally not be required to be centrally cleared, as an anti-avoidance measure we also proposed that existing transactions be required to be centrally cleared if the maturity of an existing trade is extended by more than 12 months (extended maturity derivatives).

16 While industry was supportive of these proposals, they provided specific feedback that, currently, there is limited availability of clearing facilities that can centrally clear AUD-denominated forward rate agreements and overnight index swaps. As such, industry proposed these contracts should not be subject to the clearing requirements at present.

17 Industry also proposed that extended maturity derivatives should not be subject to the clearing requirements because it would not achieve a material additional regulatory benefit and it would be costly for entities to comply with. Industry also submitted that there are currently no similar requirements in place in other jurisdictions.

ASIC's response

We acknowledge that the availability of central clearing services for AUD-denominated forward rate agreements and overnight index swaps is limited. We also understand these clearing services are under development or consideration by clearing facilities. As such, we have provided for:

(a) a six-month delay to the commencement of the clearing requirements for AUD-denominated overnight index swaps; and

(b) a two-year delay to the commencement of the clearing requirements for AUD-denominated forward rate agreements.

We also considered industry's submissions on the regulatory benefits and compliance costs of centrally clearing extended maturity derivatives. We recognise the value of aligning our rules with overseas regimes and, as such, have removed the requirement to clear extended maturity derivatives.

Fulfilling the clearing requirements

18 In CP 231, we proposed that clearing entities be required to clear each derivative transaction subject to the clearing requirements through an eligible clearing facility, being a licensed clearing and settlement (CS) facility or a prescribed central counterparty (CCP). We also proposed to define the types of central clearing arrangements that may be used to meet the clearing requirements.

19 Overall, industry agreed with the proposal. However, it was submitted:

(a) that each clearing facility that can be used to meet the clearing mandate should be treated as a qualifying CCP for the purposes of determining banks' prudential capital requirements; and

(b) whether the definition of eligible central clearing arrangements would allow industry to use both principal and agency central clearing arrangements, particularly the Futures Commission Merchant (FCM) arrangement used in the United States.

ASIC's response

We consider the derivative transaction rules (clearing) allow the use of principal and agency central clearing arrangements, including the FCM arrangement. We also note that prudential capital requirements are a matter for APRA.

Deadline for mandatory central clearing

20 The draft derivative transaction rules (clearing) proposed mandated trades to be cleared as soon as practicable after entry into the arrangement and by no later than the end of the business day following the day on which the clearing transaction was entered into (commonly known as T+1).

21 Industry was generally supportive of this proposal. However, a small number of entities were concerned that, in exceptional cases, circumstances that may be outside the entity's control could delay central clearing and result in the entity breaching the T+1 deadline.

22 Industry also emphasised the importance of aligning the derivative transaction rules (clearing) with overseas requirements.

ASIC's response

To address the concern expressed by a small number of entities, and to clarify that the derivative transaction rules (clearing) are intended to impose a similar requirement to overseas requirements, we have amended the derivative transaction rules (clearing) to require transactions to be cleared as soon as reasonably practicable. Reflecting industry practice, we expect that transactions would be centrally cleared by T+1 unless there are exceptional circumstances.

Prescription of clearing facilities

23 In CP 231, we proposed to allow a clearing entity to use a licensed CS facility or a prescribed CCP to comply with the clearing requirements.

24 Industry supported this proposal and provided feedback asking:

(a) Treasury and ASIC to prescribe as many CCPs as possible in order to prevent risk being concentrated among a handful of CCPs; and

(b) ASIC to make it clear which CCPs it is considering prescribing.

25 One respondent submitted that a CCP should only be allowed to be used if Australian regulators consider they have an appropriate level of regulatory influence over the CCP.

ASIC's response

The Australian Government has prescribed five CCPs as prescribed CCPs in the Central Clearing Regulations. Regulatory influence is a matter for the CS facility licence regime.

Alternative clearing

26 In CP 231, we proposed to allow Australian and foreign clearing entities that are subject to the clearing requirements to comply with these requirements by clearing in accordance with clearing requirements in a foreign jurisdiction (alternative clearing).

27 Overall, industry supported this proposal. However industry also proposed that foreign entities that are allowed to access alternative clearing should be allowed to use any CCP that is permitted under foreign rules, not just licensed CS facilities and prescribed CCPs.

ASIC's response

The requirement to use licensed CS facilities or prescribed CCPs to meet the clearing requirements is imposed under the Corporations Act. The Australian Government has specified five CCPs as prescribed CCPs under the Central Clearing Regulation.

The Central Clearing Regulation also enables ASIC to prescribe further CCPs that meet the small number of minimum requirements set out under the Central Clearing Regulation. We consider these provisions would ensure that an adequate number of CCPs are permitted to be used to meet the clearing requirements.

Exemptions

28 In CP 231, we proposed exemptions from the clearing requirements in the derivative transaction rules (clearing) including:

(a) an exemption for derivative transactions between two entities in the same corporate group (the intra-group exemption); and

(b) an exemption for derivative transactions that result from conducting multilateral trade compression offered by a third party (the multilateral compression exemption).

29 In relation to the intra-group exemption, we proposed to exempt intra-group transactions from clearing if notice is given to ASIC at least one day before entering into the intra-group transaction. Overall, industry supported the proposal. However, industry also proposed that the derivative transaction rules (clearing) permit notifications to be given within one day after the clearing transaction to allow flexibility to hedge, as required.

30 Industry generally supported the multilateral compression exemption proposal. However, industry proposed that the exemption go further to provide an exemption for bilateral compression exercises. Industry submitted that the distinction in the derivative transaction rules (clearing) between bilateral and multilateral compression exercises would provide a disincentive for firms to participate in both multilateral and bilateral compression rounds and would introduce a new pricing risk for participants.

ASIC's response

In relation to the intra-group exemption, we have reconsidered the need for notification to be given to ASIC and decided to remove the notification requirement.

In relation to providing an exemption for trades created during bilateral compression exercises, we have not identified any precedence in overseas regimes for extending the exemption to bilateral compression. We also considered that, relative to multilateral compression, there are fewer safeguards to ensure the exemption is being applied as intended. As such, we have decided not to extend the exemption to bilateral compression.

Notifications and record keeping

31 In CP 231, we proposed that the draft derivative transaction rules (clearing) require entities to maintain records of their compliance with the rules, and provide information to ASIC on request.

32 Overall, industry supported the proposal but suggested removing or clarifying the scope of the requirement. They considered the requirement to duplicate AFS licence record-keeping requirements, and that ASIC could obtain this information from trade repositories or CCPs.

ASIC's response

We have considered industry's proposals. However, we consider the record-keeping requirements are necessary to facilitate monitoring of compliance with the derivative transaction rules (clearing). As such, we have decided to maintain these requirements.

Calculation and commencement dates

33 In CP 231, we proposed that the clearing requirements would commence in April 2016. Overall, industry supported this proposal. However, some respondents proposed that the clearing requirements commence at the same time as the clearing requirements proposed in the European Union—so that EU-incorporated entities may rely on alternative clearing.

ASIC's response

At present, we propose to maintain the April 2016 start date for the commencement of the clearing requirements. However, we will keep under review the likely date for the commencement of a clearing requirements in the European Union.

Appendix: List of non-confidential respondents

- Australian Financial Markets Association
- ASX Limited
- Chicago Mercantile Exchange Inc.
- FIA Asia
- International Swaps and Derivatives Association, Inc.
- Japan Securities Clearing Corporation
- King & Wood Mallesons
- LCH.Clearnet Limited