ISDA® Safe, Efficient Markets

28 November 2011

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Council of Financial Regulators Discussion Paper 'Review of Financial Market Infrastructure Regulation'

This letter contains the response of the International Swaps and Derivatives Association, Inc. ("ISDA") to the Council of Financial Regulators ("Council") discussion paper on the Review of Financial Market Infrastructure Regulation as of October 2011.

Since 1985, ISDA has worked to make the OTC derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

As the Council is likely aware, ISDA is actively engaged with providing input on regulatory proposals in the United States, Canada, the European Union and in Asia. Our responses to the questions posed in the discussion paper are derived from these efforts and from consultation with ISDA members operating in Australia. Our response is drawn from this international experience and dialogue and is not focussed on technical changes to Australian law or regulation related to the implementation of reform.

ISDA commends the Council for its careful consideration of these issues and welcomes further dialogue with the Council on this letter.

We have limited our submission to those aspects of the discussion paper that relate to financial market infrastructure in the context of OTC derivatives. Accordingly, we make comments on questions 6 (Location requirements), 8 (Step-in powers) and 10 (Client protection through account segregation and portability) of the paper. Our responses to these questions are set out in turn below, after some short initial comments.

Before we address the questions posed in the discussion paper, we would like to make a few general observations.

Global Markets, Regulatory Coordination and Timing

The Council recognizes in the discussion paper that the increasing interconnectedness of global markets means that the Australian regulatory framework must keep pace with developments offshore. In this context, it references the Wall Street Reform and Consumer

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Protection Act (US) 2010 ("Dodd-Frank Act"), the proposed European Market Infrastructure Regulation ("EMIR") and the United Kingdom (UK) Treasury's White Paper on Financial Markets. In that regard, it should be acknowledged that the implementation of key financial market reforms, due to their scale and complexity, is facing delay. At the date of this letter, the implementation of the Dodd-Frank Act has been put back, after the Commodity Futures Trading Commission and the Securities and Exchange Commission agreed to delay implementation from a deadline set by the U.S. Congress of July 15 to the end of the year. Similarly, the European Parliament postponed finalisation of EMIR in early July 2011.

In addition, the Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO") (collectively "CPSS-IOSCO") published a consultative report on principles for financial market infrastructures in March 2011. CPSS-IOSCO is yet to publish any final report on the principles for FMIs following its receipt of submissions on the consultation report.

We strongly agree with CPSS-IOSCO's observations in its consultative report that a single set of FMI standards would provide greater consistency in the oversight and regulation of FMIs worldwide. In that regard, the importance of an integrated analysis of the risks and regulation of FMIs and their participants should not be undervalued, recognising that these standards will interact with many other regulatory initiatives, including Basel III.

Accordingly, it is critical that these standards are developed by CPSS-IOSCO in an active dialogue with the Basel Committee on Banking Supervision, national regulators, the industry, and other stakeholders. Given the global nature of the OTC derivatives market, such coordination is essential to effectively establish international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spill-over across countries.

Liaison with and between national FMI regulators is also a prerequisite for the construction of an effective harmonized international framework for FMIs. We are concerned about the absence of detail from CPSS-IOSCO in the consultative report on how the proposed principles would interact with other regulatory initiatives impacting on FMIs and/or the derivatives markets, including the Dodd-Frank Act and EMIR and proposals such as those set out in the Council's discussion paper. This is a concern because diverse and inconsistent requirements between different supervisors will increase costs and make it less likely that robust international standards can be developed. Close international cooperation between various supervisory bodies including banks, FMIs, and systemic risk supervisors would mitigate these risks.

In addition, we urge that regulators generally consider the global nature of the markets when creating regulations for FMIs so that the regulation does not restrict the ability of Australian entities from continuing to participate and be competitive in the global derivatives markets. To this end, it is vital that regulators seek to avoid mandating duplicative, overlapping requirements and/or infrastructure where sufficient alternatives exist, including in the context of FMIs.

Comments on sections 6, 8 and 10 of the discussion paper

Q6. Location requirements

We note that the consultation paper proposes a requirement that aspects of systemically important FMIs be located in Australia. In the context of OTC

derivatives infrastructure this could present some jurisdictional challenges. As noted in our introductory comments, the OTC derivatives market is a global, rather than a local market. In this context, regulation of the infrastructure of the OTC derivatives market needs to be consistent across the many jurisdictions which are involved. Accordingly, it is critical that any location requirement be consistent with requirements in the United States and Europe to avoid fragmentation of the fundamental market infrastructure.

Further, in the context of FMIs which are systemically important to a number of jurisdictions globally (such as FMI's related to the global OTC derivatives business), more flexibility in location based requirements might be needed, because of potentially competing regulatory requirements. For example, in response to the FCM requirements under United States legislation an OTC central counterparty is able to provide for initial margin to be located in the United States and under United States law, rather than having to relocate its operations to the United States from where they have already been established. Another example of a proposed requirement which would be difficult to impose in a workable way on global OTC central counterparties is the proposed power of pre-approval of directors of FMIs and their parent entities.

Q8. Step-in powers

The consultation paper proposes that in the most extreme example of a shortfall of assets to meet obligations as a result of an insolvency event, a statutory manager of an FMI might suspend or cancel obligations. Such a situation might arise, for example, should a CCP clearing participant fail in a period of extreme market volatility. To support this, it is proposed that the statutory manager of an FMI have powers to operate the FMI, including the ability to:

- suspend or cancel the FMI's obligations or those of an FMI participant (this may be necessary to deal with novated obligations that cannot be met because of a shortfall); and
- cancel securities or other financial products.

We understand that, in respect of the statutory management of an Australian bank, a statutory manager does not have the right to cancel contacts to which the bank is party.

It is not clear to us why the powers of a statutory manager of an FMI to suspend or cancel contracts should be greater than those of a statutory manager of an Australian bank, nor what remedies would be available to a counterparty that suffered loss as a result of such cancellation or suspension. From a financial markets perspective, it is imperative that a statutory manager not be entitled to cherry-pick individual unprofitable transactions under a single close-out netting contract for cancellation or suspension.

In addition, it is critical that these rights not interfere with the protection given to netting under Australia's Payment Systems and Netting Act. Further, as considered in our submission to the Treasury on the Financial Sector Legislation Amendment (Close-out Netting Contracts Bill 2011) dated 1 August 2011, the suspension of a counterparty's rights under a derivative contract would expose counterparties to market risk during the suspension period and, depending on the counterparties' rights

during the suspension period, clawback risk. For these reasons, if a suspension is required, then the suspension period should be as short as possible.

In relation to the proposal that the Banking Act model of interaction with insolvency law be applied to FMIs, we reiterate our comment above that it is imperative that the regulation of FMIs under Australian law does not affect the protection given to netting under Australia's Payment Systems and Netting Act, including in respect of 'close-out netting contracts', 'market netting contracts' and 'approved netting arrangements'. As these laws protect the stability of FMIs, their priority needs to be maintained in any new insolvency model.

Q10. Portability of segregated client accounts

As noted in our submission to the Council on the Council of Financial Regulators Discussion Paper 'Central Clearing of OTC Derivatives in Australia' dated August 26, 2011, the existence of reasonable legal certainty in the event of the insolvency of a FMI or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property is important, as recognised in Section 723 of the Dodd-Frank Act.

Financial stability requires legal certainty of outcome in insolvency. This is essential in order to ensure that, upon insolvency, the assumptions on which credit support levels and default management procedures were structured are well founded and reliable. It is also essential in order to mitigate concerns that may deter participation in the market or in available clearing solutions. In particular, confidence in the portability of customer accounts upon the insolvency of a clearing member is extremely important to market participants.

However, we note that ensuring the effectiveness of segregation and portability provisions and mechanisms is a substantial challenge and work in these areas continues in the United States and the European Union. For example, in order to provide further certainty of the effectiveness of segregation and portability provisions in the European Union, recent texts of EMIR contain the provision that "The [segregation and portability] requirements set out in paragraphs… shall prevail over any conflicting laws, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them". However, the enforceability of this provision (if it survives to the final text) may be more complicated.

Consequently, it is important that developments in the area of protection of segregation and portability facilitate consistency with other parts of the global market.

ISDA appreciates the opportunity to provide comments on the discussion document and looks forward to working with the Council as it continues the regulatory process. Should you require further information, please do not hesitate to contact the undersigned.

Yours sincerely,

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