ISDA Safe, Efficient Markets

By E-mail

19 May 2016

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Dear Sir,

Consultation on margining and risk mitigation requirements for non-centrally cleared derivatives

Introduction

The International Swaps and Derivatives Association ("**ISDA**")[1] is grateful for the opportunity to provide comments on the Discussion Paper on margining and risk mitigation requirements for non-centrally cleared derivatives (the "**Discussion Paper**") and the corresponding draft prudential standard CPS 226 (the "**Draft CPS**"), each issued by the Australian Prudential Regulation Authority ("**APRA**") on 25 February 2016 (the "**APRA Proposals**"). Individual members of ISDA may have their own views on the APRA Proposals, and may therefore provide their comments to APRA directly.

ISDA and its members strongly support the goals of strengthening resiliency in the non-centrally cleared derivatives market by establishing margin requirements. While the APRA Proposals represent an important step forward for establishing a detailed set of requirements for the collection and protection of margin in the OTC derivatives market in Australia, we submit that it is important for APRA to continue to focus on the practical issues relating to the implementation of any rules and the overall purpose of reducing systemic risk. This submission is intended to continue the constructive ongoing dialogue between APRA and derivatives market participants and to focus on the practical concerns and risks surrounding the implementation of the margin rules, including the harmonisation of such rules with those of foreign regulators. We hope that our comments in this submission will assist APRA with its preparation of the new margin rules for non-centrally cleared OTC derivatives in Australia ("**Margin Rules**").

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[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 67 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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International harmonisation

In order to ensure the efficient functioning of the global derivatives market and to eliminate operational risks, we strongly support Australia adopting rules that are harmonised and consistent with other jurisdictions, and are broadly comparable to the final policy framework for margin requirements for non-centrally cleared derivatives as proposed in the paper (the "**BCBS/IOSCO Paper**") issued in March 2015 by the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**"). Without this harmonisation, the market will become increasingly fragmented and its liquidity impaired as counterparties struggle to meet inconsistent margin requirements of various international regulators. Moreover, for margin requirements, inconsistent rules will potentially be incompatible in practice. International consistency will also prevent regulatory arbitrage and lead to a more level playing field between competitors in different jurisdictions.

In this respect, we note that APRA has made a detailed consideration of the interaction between the Draft CPS and the margin rules of other jurisdictions. We are grateful for APRA's approach and further note that APRA has endeavoured to be largely consistent with the margin framework set out in the BCBS/IOSCO Paper.

After the Margin Rules are finalised, it will be necessary for market participants to have sufficient time to allow for the legal, operational, risk management and technological enhancements necessary to effectively and safely implement the new requirements. In particular, market participants will need time to build, test and receive approvals for IM models that are very new to the market and to re-paper credit support documents (including negotiating new documentation, such as custodial arrangements). Regulators will also need time to formalise the regulatory approval processes for IM models across multiple jurisdictions. To the extent that market participants are proposing to outsource certain functions in relation to the margin requirements, such as the calculation of IM and the calling of IM, market participants would need time to complete such applications or filings, and the regulators would need time to consider them. Moreover, the ability of the market to make the necessary enhancements will depend on the outcome of the comparability assessments, and this could further slow the implementation process.

Given the relatively short timeframe until initial implementation, we therefore encourage APRA to finalise the Margin Rules as soon as possible.

Outline of submission

We have divided this submission into three parts. Part 1 sets out our comments on the entity-level scope of the proposed margin requirements, in particular as regards the applicability of the rules to different types of entities (both onshore and offshore). Part 2 sets out our comments on the transaction-level and implementation aspects of the proposed margin requirements. Part 3 sets out our comments on the proposed risk mitigation standards outlined in paragraphs 70 to 92 of the Draft CPS.

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Part 1: Entity-level scope of the proposed margin requirements

1.1 Application of margin requirements to every entity in a Level 2 group (paragraph 4 and 6, Draft CPS)

ISDA strongly opposes the proposal that the parent entity of an APRA-regulated Level 2 group must ensure that all entities within the Level 2 group, including foreign subsidiaries of APRA covered entities, comply with the APRA margin requirements. This is a substantially broader and more onerous approach than that taken in all other jurisdictions,[2] and imposes a significant legal and operational burden on APRA covered entities and their affiliates (particularly those offshore). ISDA submits that the margin requirements should only apply to transactions involving the specific entity or entities within a margining group that meet the 'APRA covered entity' definition.

This submission is supported on the following bases:

(i) Imposing margin rules on a similar basis as capital rules are imposed would be inadvisable, as margin and capital have different objectives. The BCBS/IOSCO Paper helpfully contains some consideration of this issue.[3] While capital is focused on the financial soundness of entities, margin is focused on systemic risk created by portfolios of derivative transactions.

(ii) Derivatives transactions (if any) entered into by members of a Level 2 group (in particular, non-financial entities in the group) which are not, themselves, APRA covered entities (or covered entities under a foreign regime) do not pose a systemic risk to the market and should not be subject to the same margin requirements as transactions entered into directly by APRA covered entities. Applying margin requirements to non-financial entities which are not systemically important is inconsistent with the recommendations made in the BCBS/IOSCO Paper. It is also noted that the Level 2 group definition captures not only many covered bond/securitisation SPVs (which are excluded from the margin requirements by paragraph 5 of the Draft CPS), but also many special purpose entities (**"SPEs"**) that hold a single asset and that enter into only one or two hedges. Such SPEs should not be required to comply with the APRA margin requirements (including, potentially, the IM requirements) simply by virtue of such a small volume of derivatives activity.

(iii) In addition, a foreign incorporated subsidiary within a Level 2 group will be covered by the applicable margin requirements (if any) in its jurisdiction of incorporation. ISDA submits that the appropriate regulator for margin purposes in respect of any such entity is the regulator in that jurisdiction.[4] Accordingly, requiring a foreign subsidiary to comply with the APRA Margin Rules is extra-territorial and would give rise to potential regulatory conflicts. It would also result in

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[2] The US margin rules, for example, are imposed on swap dealers and major swap participants. This is a status that these entities have because of, essentially, their level of derivatives trading with US-connected persons and not solely because of US prudential regulation or any affiliation with a US prudentially regulated entity.

[3] BCBS/IOSCO Paper, page 4.

[4] This is consistent with the approaches taken in foreign margin rules published thus far.

divergence from "Key principle 7" in the BCBS/IOSCO Paper: "Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally cleared derivatives across jurisdictions". In order to give effect to this key principle, the BCBS/IOSCO Paper envisages that locally established subsidiaries of foreign entities will be regulated in that local jurisdiction.[5]

(iv) A company in a Level 2 group (whether a financial or non-financial entity) could be subjected to the APRA Margin Rules as a result of paragraph 4 of the Draft CPS in circumstances where other similar companies in its industry or jurisdiction (but which do not form part of a Level 2 group) are not subjected to mandatory margining requirements. This creates a competitive disadvantage for the entities in a Level 2 group, with no substantive policy benefit. For foreign subsidiaries of locally-incorporated APRA covered entities, this is particularly problematic when the foreign subsidiaries are located in jurisdictions which do not mandate margin requirements or where the enforceability of close-out netting and/or collateral arrangements is questionable.

(v) Finally, the vast majority of transactions in the Australian OTC derivatives markets involve at least one ADI as a contracting party.[6] The proposed extension of the margin requirements to Level 2 entities would therefore have very little practical effect on systemic risks in the Australian derivatives market, but would come at a significant cost.

Application of the Level 2 group requirement to foreign ADIs

If, notwithstanding the submissions made above, the Level 2 group concept is to be retained in the final Margin Rules, ISDA requests that APRA expressly clarify that paragraph 4 of the Draft CPS does not apply if the "Head of a Level 2 group" (as defined in paragraph 10(j) of the Draft CPS) is a foreign ADI. In the absence of such a clarification, based on the current definition of ADI in both the Banking Act 1959 (Cth) and APS 001, paragraph 4 could be interpreted as obliging a foreign-incorporated bank that has merely established a branch in Australia to ensure that all of its foreign subsidiaries comply with the APRA Margin Rules.[7] ISDA would very strongly oppose such a broad extra-territorial approach.

Further to the submissions immediately above, ISDA requests that paragraph 6 be amended to clarify that, for foreign ADIs, the Margin Rules will only apply if the transaction is booked in the accounts of an Australian branch of that ADI. Again, the APRA Margin Rules would have a very significant extra-territorial effect if a foreign-incorporated bank that has merely established a branch in Australia were

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5 BCBS/IOSCO Paper, page 23.

6 This was expressly noted by ASIC in its Regulatory Impact Statement on the mandatory central clearing of OTC interest rate derivative transactions (see paragraph 14).

7 It is noted that this would have a vastly disparate impact on foreign banking groups that have established a local branch in Australia, as compared with those that have established a local subsidiary in Australia, with no apparent justification for this discrepancy under the BCBS-IOSCO framework.

required to ensure that its head office and all of its foreign branches comply with the APRA Margin Rules. ISDA would oppose such an extra-territorial approach.

1.2 Investment funds, RSEs, trustees of trusts and responsible entities of managed investment schemes

We request that APRA clarify the treatment of funds, RSEs, trusts and managed investment schemes (together, "**investment vehicles**") under the Margin Rules, and seek to ensure that such treatment is aligned with the approach taken by other global regulators. Clear guidance should be provided on when investment vehicles managed by a single investment advisor (or having the same RSE licensee, trustee or responsible entity, as applicable) can be considered separately, so as not to improperly constitute those investment vehicles (or their respective advisors, RSE licensees, trustees and responsible entities) as a single group for the purposes of the Margin Rules (e.g. for the application of the IM qualifying level to a "group").

In light of this general principle, ISDA requests that the treatment of investment vehicles be clarified and expanded upon in the Margin Rules. In particular, the Margin Rules should make clear that (subject to certain requirements, such as the absence of any cross-collateralisation or guarantee):

(i) investment funds, RSEs, trusts and managed investment schemes will be considered distinct entities for the purposes of the Margin Rules that may be treated separately from both: (i) the investment advisor, RSE licensee, trustee and/or responsible entity for that investment vehicle; and (ii) any other investment vehicle (whether having the same investment advisor, RSE licensee, trustee and/or responsible entity or not); and

(ii) the separate treatment of investment vehicles should apply for all purposes under the Margin Rules (rather than just for the purposes of the IM qualifying level).

We also request that the Margin Rules clarify that an APRA covered entity (or, if applicable, any member of its Level 2 group) will not be required to comply with the VM and IM requirements when acting in an agent or representative capacity (e.g. an investment manager) or as trustee for any investment vehicle, and that any derivatives entered into by an entity acting in a representative capacity will not be taken into account for the purposes of determining the "aggregate month-end average notional amount" of a margining group. We note that, at present, there is a risk that an entity which engages in derivatives transactions in a representative capacity and which also engages in derivatives transactions in a personal capacity (or which is part of a group that engages in derivatives transactions in a personal capacity) will be required under the Draft CPS to comply with the margin rules to the same extent in both capacities. This would be a very distorted outcome, as the systemic risks associated with, for example, an APRA covered entity (or a member of its group) acting as agent on behalf of a small investment fund are likely to be vastly different from the systemic risks associated with that entity acting in its personal capacity.

In addition, the requirement that the fund or RSE (or trust or managed investment scheme) be a "distinct legal entity" set out in paragraph 24 of the Draft CPS should be removed as this is unclear and in many

cases does not accurately describe the distinction between separate investment vehicles. Whilst funds, RSEs, trusts and managed investment schemes are legal constructs, they cannot necessarily be described as "separate legal entities" (in contrast to, for example, two distinct corporations).

The changes and clarifications requested above would also better align the Margin Rules with approach taken by ASIC in the ASIC Derivative Transaction Rules (Clearing) 2015.

1.3 Definition of "financial institution" (paragraph 10(i), Draft CPS)

APRA proposes that an APRA covered entity will be required to adhere to the margin requirements in the Draft CPS in its transactions with covered counterparties. A "covered counterparty" is either a financial institution or a systemically important non-financial institution. "Financial institution" is defined very broadly and covers a wide range of institutions "engaged substantively" in financial activities domestically or overseas. As a general point applicable to the definitions of "financial institution" and "systemically important non-financial institution", ISDA understands that institutions in Asia face a practical difficulty in obtaining representations from their counterparties as to their status (whether by adhering to protocols or by returning representation letters). Very often, counterparties are slow to confirm their status or fail to respond, leading to a potential tradability issue. ISDA would encourage APRA to harmonise the applicable definitions as far as possible with other jurisdictions and define the terms by reference to objectively available sources or an existing foreign definition (e.g. global systemically important bank, swap dealer and financial end user pursuant to the US regulations, or FC / NFC+ under the EU rules) such that existing outreaches can be leveraged upon.

We also request that the definition of "financial institution" be modified so as to reduce its scope in certain specific respects:

(i) the reference to "leasing" should be removed as many entities which engage in leasing activities (e.g. SPEs) do not pose any systemic risk and trades with those entities should therefore not be subject to the margin requirements;

(ii) the inclusion of "portfolio management" appears to capture asset managers when the focus should instead be on the underlying investment vehicle (as discussed further in paragraph 1.2 above); and

(iii) the reference to "management of securitisation schemes" should be removed as this appears to contradict the express exclusion of securitisation SPVs from the definition of "covered counterparty", and also because in many cases the manager of a securitisation scheme will enter into derivative transactions in connection with the relevant securitisation scheme for administrative purposes only (i.e. without assuming any substantive obligations). It should be clarified that such transactions do not fall within the scope of the Margin Rules.

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1.4 Covered counterparties

Definition of "covered counterparty" (paragraph 10(f), Draft CPS)

ISDA requests that the following entities be excluded from the definition of "covered counterparty":

(i) any SPE established by an investment fund for the purpose of acquiring and holding real estate or other physical assets on behalf of or at the direction of the investment fund; and

(ii) any SPE established for the purpose of acquiring or investing in real estate.

We understand that the final margin rules adopted in Canada include a similar exemption.

Due diligence in respect of covered counterparties (paragraph 30, Draft CPS)

We note that the APRA Proposals provide that "an APRA covered entity must apply a reasonable level of due diligence to determine whether its counterparty is a covered counterparty whose non-centrally cleared derivatives activity exceeds the applicable qualifying level" and that, in practice, "this process … will likely rely on a combination of self-identification by a counterparty and reasonable due diligence undertaken by an APRA covered entity". However, an APRA covered entity will not have any relevant knowledge relating to the derivatives business of its counterparty and, in particular, it will not be possible to obtain reliable information about the gross notional amount of a counterparty's derivatives positions at any time (other than by way of representations provided by that party).

Accordingly, to align with the requirement in the US, ISDA requests that APRA amend the draft Margin Rules to clarify that APRA covered entities are entitled to rely in good faith on representations given to them by their counterparties, including in industry standard disclosure documents.

Given that the APRA consultation is open until late May 2016, the timeline for meeting the applicable VM implementation date will be very compressed and ISDA's members are concerned as to whether this can be achieved in time. In order to comply with the requirements, APRA covered entities will need to classify and/or obtain self-declarations from each of their counterparties as to whether their portfolios exceed the relevant qualifying levels and then to negotiate or update documentation, all prior to the applicable VM implementation date. As no equivalent classification exercise has previously been completed within Australia, it is likely to be time-consuming and challenging to explain the relevant background and requirements to counterparties, and then to carry out the negotiation and re-documentation exercise. We acknowledge that there are some lists available for "registered entities" on various regulator websites, but these do not reference industry identifiers such as LEI/Avox/Swift. The lists are also not exhaustive. We would be grateful if APRA could provide guidance as to whether other jurisdictional classifications can be used in connection with the Margin Rules (e.g. FC and NFC+ under the EU rules and "financial end user" under the US regime), as these have previously been required for other regulatory classification exercises.

1.5 Substituted compliance

Outcome-based approach to comparability assessments (paragraph 63, Draft CPS)

We support APRA's outcome-based approach for comparability assessments. However, we note that, under paragraph 63 of the Draft CPS, substituted compliance will only be available where the relevant foreign regime is comparable in its outcomes to both the BCBS-IOSCO framework and the requirements in the Draft CPS. It is important to recognise that foreign margin standards may be compliant with the BCBS-IOSCO framework and yet may have different product and entity coverage which are not comparable to the Australian Margin Rules. Given the different approaches of national regulators in implementing their margin frameworks, it is submitted that the comparability assessment should be based on comparability with the BCBS-IOSCO framework alone, and not with the Australian Margin Rules. This would also better align the substituted compliance framework with the deference framework set out in paragraphs 66 and 67 of the Draft CPS (which only requires the relevant foreign margin requirements to be substantially similar to the BCBS-IOSCO framework).

Comparability assessments should be made available to all APRA covered entities and with sufficient notice prior to the implementation date of the Margin Rules

We welcome APRA's proposal on substituted compliance and believe that this would assist in achieving a workable cross-border framework. We note that the regulators in the US, Japan, Canada and Switzerland have issued final margin rules, the EU has published the final draft Regulatory Technical Standards, and the regulators in Hong Kong and Singapore have proposed margin requirements based on the BCBS/IOSCO Paper. We recommend that, with respect to jurisdictions that adopt margin requirements that are based on the BCBS/IOSCO Paper, APRA performs a comparability assessment on its own initiative (rather than requiring each APRA covered entity to make a separate request for comparability assessment) and confirms that substituted compliance will be available to the applicable APRA covered entities in respect of those jurisdictions. Such treatment would be a fitting recognition of the extensive consultative process by which the BCBS/IOSCO Paper was developed. In addition, we suggest that such comparability assessments be made as soon as possible after the Margin Rules are finalised and before the phase-in dates of the Margin Rules. Finally, we suggest that APRA publishes in advance a clear timeline for the projected comparability assessments that will be made. This will greatly facilitate the implementation of the Margin Rules.

In light of the factors discussed in the paragraph headed "*International harmonisation*" above, if APRA is not able to make a comparability assessment as soon as a jurisdiction issues final rules based on the BCBS/IOSCO Paper, and in any event before 1 June 2016, then we ask APRA to make a two-year transitional comparability determination during which the Margin Rules will not apply to in-scope derivatives where either or both of the APRA covered entity or the covered counterparty is subject to the margin requirements of the relevant foreign regime.

We propose that APRA makes its comparability determinations and the considerations it takes into account in coming to such determinations publicly available so that they can be relied upon by all APRA covered entities, and that APRA maintains an updated list of comparable jurisdictions.

APRA not to have the ability to limit the scope of or impose conditions on recognised substituted compliance (paragraph 64, Draft CPS)

We note that the Draft CPS gives APRA the ability to limit the scope of or impose conditions on recognised substituted compliance, even when a positive comparability determination has been made. Doing so would create bespoke margin requirements and unnecessarily add to the compliance burden. Given the tight implementation timeline that the industry is facing and the complexity of implementing the margin requirements in cross-border transactions, we request that this be removed.

1.6 Foreign branches and subsidiaries

Compliance by foreign-incorporated APRA covered entities with their foreign jurisdiction's margin requirements in lieu of the APRA requirements (paragraphs 66 and 67, Draft CPS)

It is not entirely clear whether paragraphs 66 and 67 of the Draft CPS must be read together with paragraph 63. We request that APRA clarify that a foreign APRA covered entity may comply with its home jurisdiction's margin requirements or those of a jurisdiction deemed equivalent by its home jurisdiction[8] in lieu of complying with the margin requirements in the Draft CPS (as contemplated by paragraph 66) irrespective of whether APRA has formally issued a determination under paragraph 63 in respect of the relevant foreign regime (provided that, following a request from APRA, it can demonstrate (i) how it is directly subject to margin requirements of such foreign regime and (ii) that such foreign regime's margin rules are substantively similar to the BCBS-IOSCO framework). In addition, it would be helpful to the industry if APRA could publish a list of the foreign regimes that it considers are "substantially similar" to the BCBS-IOSCO framework, in the same manner as ASIC provided a list of the "substantially equivalent" reporting regimes in Regulatory Guide 251 on derivative transaction reporting (RG 251.74).

We would also request that paragraph 67 be amended to reflect equivalent clarifications as those set out above and also to remove the requirement for the relevant foreign-incorporated APRA covered entity to obtain approval from APRA in advance.

It would also be helpful if APRA could clarify the scope of paragraph 67: is it intended to be read together with paragraph 4 of the Draft CPS and to apply in respect of foreign subsidiaries of both

[8] This is to cover the case where a foreign-incorporated APRA covered entity chooses to comply with equivalent requirements instead of the requirements of in its home jurisdiction. This would be a more flexible approach and would not, it is submitted, have any adverse consequences (as compared with limiting deferred compliance to only the home jurisdiction of the relevant foreign APRA covered entity).

Australian-incorporated and foreign-incorporated APRA covered entities? In this regard, please refer to the submission immediately below.

Interaction between paragraphs 66 and 67 of the Draft CPS and the Level 2 group concept

If, notwithstanding the submissions made in paragraph 1.1 above, the Level 2 group concept is to be retained in the final Margin Rules and is expressed to apply to foreign ADIs, ISDA seeks clarification from APRA that, if a foreign ADI that is the Head of a Level 2 group is in compliance with the applicable margin rules in its home jurisdiction (or, if applicable, another relevant foreign jurisdiction), then all entities within its Level 2 group (including foreign subsidiaries of the foreign-incorporated ADI) will also be exempt from the APRA Margin Rules.

1.7 Jurisdictions where netting and/or collateral is not enforceable *(paragraphs 68 and 69, Draft CPS)*

ISDA supports the proposal for APRA covered entities to be exempt from the VM and IM requirements in respect of transactions where either: (i) netting of derivatives is not enforceable upon insolvency or bankruptcy of the counterparty; or (ii) collateral arrangements are questionable or not legally enforceable upon default of the counterparty. We agree with APRA's analysis that an APRA covered entity would be exposed to additional risk if close-out netting is not enforceable and/or if it cannot be assured that posted collateral is sufficiently protected against the default of its counterparty. In addition, we note that such counterparties (in particular smaller banks and non-bank financial institutions in Asian emerging markets) often do not have infrastructure in place to calculate, exchange and manage VM and IM. Imposing margin requirements on non-centrally cleared derivatives transactions with these categories of counterparty would therefore not only expose APRA covered entities to additional risk but would also disrupt established trading relationships and severely limit hedging and financial flows between Australia and those jurisdictions.

We note that institutions may have different views as to whether netting is enforceable in a particular jurisdiction or not. The validity and enforceability of netting may also vary according to the different counterparty types in a given jurisdiction (for example, the legal analysis may vary according to whether the counterparty is a bank; an insurance company or some other type of entity). Given the above considerations, we are concerned that if an APRA covered entity's opinion on legal enforceability of netting in a given country is not consistent with APRA's opinion, then the covered entity may be deemed to be non-compliant with the Margin Rules. Accordingly, ISDA requests that APRA allows institutions to make their own individual assessment on whether a jurisdiction is "netting-friendly" in accordance with the method that they use to determine this for capital adequacy purposes. In the event that an institution is uncertain on the legal netting analysis, it should be open to that firm (in its discretion) to approach APRA to discuss the most appropriate treatment of transactions with entities in the relevant jurisdiction, bearing in mind that in most cases there will be a capital benefit to firms in treating a jurisdiction as netting-friendly notwithstanding the potential advantage of falling outside the margin rules if the jurisdiction is

determined to be one where netting is not enforceable, and also that margin rules in other jurisdictions may have a different approach for non-netting jurisdictions.

We also note that there are different regulatory standards which are applied to determine whether a jurisdiction is netting-friendly for capital adequacy purposes. For example, Australia applies a "beyond doubt" standard in APS 112 to netting determinations; whereas the US applies a "well founded basis" standard. This may result in a situation where the same circumstances would lead to different netting determinations. We request that APRA allow APRA covered entities the flexibility to determine how these determinations should be applied based on their home state requirements and exchange margin accordingly with a counterparty in any jurisdiction where the netting determination differs from the Australian standard set out in APS 112.

In addition, we note that paragraph 6.3 of the Discussion Paper advises that ADIs are required to hold "more counterparty credit risk capital on exposures where there is no eligible netting bilateral agreement and no margin collected". Given this is not reflected in the Draft CPS, we request APRA to clarify exactly how much more capital would be required, or whether this would be at the ADI's discretion.

Jurisdictions where posting collateral offshore is prohibited

We request that APRA also allow institutions the flexibility to not post collateral to counterparties located in jurisdictions where the posting of collateral offshore is prohibited. For example, in India, under a circular published by the Foreign Exchange Dealers Association of India (FEDAI), onshore entities (e.g. Indian branches of foreign banks and Indian banks) are prohibited from posting collateral offshore under the Foreign Exchange Management Act (FEMA). An APRA covered entity may have to rely on local intermediaries to collect collateral in India, exposing itself to additional risks.

1.8 Certain definitions

"asset class" (paragraph 10(b), Draft CPS)

ISDA submits that the asset class "commodities" should be amended to read "commodities, including gold, silver and platinum" to avoid confusion as to whether precious metals are included in the currency or commodity asset class.

"margining group" (paragraph 10(m), Draft CPS)

Consistent with the approach taken in the US, we request that this definition allow for relevant entities to use foreign equivalent accounting standards.

"sovereign" (in definition of "covered counterparty", paragraph 10(f), Draft CPS)

ISDA requests that APRA clarify that the definition of "sovereign" includes sovereign wealth funds.

Part 2: Technical implementation of the proposed margin requirements

2.1 Covered transactions

Definition of "derivative"

We note that the APRA Proposals provide for "derivative" to have the same definition as will be set out in the Netting Act (the "**Netting Act**") (following its amendment pursuant to the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016 (the "**Bill**")) and that the draft Bill provides for the definition of "derivative" in the Netting Act to cross-refer to the definition of "derivative" in Chapter 7 of the Corporations Act 2001. This definition does not align with standard taxonomy in the derivatives industry and may inadvertently capture other types of transactions (e.g. loan sub-participations). Accordingly, ISDA requests that APRA adopt a definition of "derivative" for the purposes of the Margin Rules which more closely aligns with the corresponding definitions used overseas. Cross-referring to the ISDA product taxonomy, as was done in the Australian transaction reporting rules, would achieve the objective.

Definition of "non-centrally cleared derivative" (paragraph 10(q), Draft CPS)

Subject as provided below, ISDA agrees with the current definition of "non-centrally cleared derivative" and submits that the definition need not distinguish between whether a derivative is cleared with a qualifying central counterparty (QCCP) or a central counterparty (CCP) which is not a QCCP. If a derivative is cleared (and therefore margin is provided in accordance with the rules of the relevant CCP), the derivative should be outside the scope of the margin rules and the status of the relevant CCP should not be relevant.

ISDA requests that, when an APRA covered entity transacts with a covered counterparty in circumstances where either or both parties are subject to foreign margin rules (in addition to the APRA Margin Rules), the parties be permitted to use the definition of "non-centrally cleared derivative" (or its equivalent) under any of the regimes to which they are subject for the purposes their margining calculations. This would eliminate the need for counterparties to make multiple different calculations to take into account different definitions or different product scopes in each different jurisdiction, and would therefore also likely reduce the risk of errors and disputes. Furthermore, allowing the use of a broader set of products in cross-border netting sets would facilitate the process of margin collection and reduce systemic risk. This approach would align with the final draft Regulatory Technical Standards (RTS) on margin requirements for non-centrally cleared derivatives in the EU (the "**final draft EU RTS**").[9]

[9] See recital 11 and article 5(1) of the final draft EU RTS, available at https://www.esma.europa.eu/press-news/esma-news/esas-publish-final-draft-technical-standards-margin-requirements-non-centrally

Physically-settled FX forwards and swaps and equity options

ISDA welcomes the exemption of physically-settled FX forwards and swaps from the IM requirements in the Draft CPS. However, physically-settled FX swaps and forwards are within scope of the VM requirements under the Draft CPS. ISDA notes that physically-settled FX forwards and swaps are exempted from both the IM and VM requirements set out in the BCBS/IOSCO Paper and the final US, Japanese and Canadian margin rules, as well as the proposals in Singapore. ISDA requests that APRA take an approach which is consistent with these other jurisdictions and exempt physically-settled FX forwards and swaps from the Draft CPS.[10] The existing proposal (i.e. in the absence of any such exemption) could result in a competitive disadvantage for the local banks caught by the APRA rules, and the real likelihood of this business moving outside Australia. In particular, Australian super fund counterparties, who may be covered counterparties under the Draft CPS, often have a very legitimate need for these products for end-user hedging purposes. The mismatch between APRA's proposal and each of the US and Japan margin rules could likely result in these counterparties hedging with the US or Japanese banks, or not hedging at all. This would clearly be a sub-optimal outcome and an unintended effect of APRA's proposal.

Notwithstanding the above view, we note that a few members have a preference for the Australian Margin Rules to be aligned with the final draft EU RTS. If APRA were to impose variation margin requirements on physically-settled FX forwards and swaps, we would request APRA to align the compliance date in respect of those instruments with that stated in the final draft EU RTS.

Similarly, single-stock equity options and index options should be excluded from both the VM and IM requirements for an initial three year period. This is consistent with article 39(7) of the final draft EU RTS, and is necessary to align with the US and EU regimes.

Amended trades and new trades resulting from multilateral portfolio compressions should be exempt from margin requirements

The Draft CPS proposes that the IM and VM requirements shall only apply to new contracts entered into after the relevant phase-in dates, so that derivatives entered into prior to the entry into force of the relevant phase-in dates ("**Legacy Derivatives**") are excluded. We note that, under footnote 3 of the Draft CPS, genuine amendments to existing derivatives contracts will not qualify as a new derivatives contract. We seek APRA's confirmation that the following will not be subject to the margin requirements:

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[10] We note that the BCBS/IOSCO Paper states that, in developing variation margin standards for physically-settled FX forwards and swaps, national supervisors should consider the recommendations in the 2013 BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions (the "BCBS Supervisory Guidance") which requires VM for physically-settled FX swaps and forwards. We do not oppose VM for physically-settled FX swaps and forwards. Rather, we intend to ask APRA to better align with the majority of jurisdictions to exclude physically-settled FX forwards and swaps from the scope of the full set of VM requirements in the Draft CPS, and instead address VM for these products via adoption of the BCBS Supervisory Guidance.

(i) *trades amended in a non-material manner (or arising from life-cycle events)*: so long as an amendment does not create any new significant exposure under the Legacy Derivative, the act of amending the derivative (or the occurrence of a life-cycle event) should not bring it within the scope of the Draft CPS; and

(ii) *new derivatives that result from multilateral portfolio compression*: portfolio compression is designed to reduce complexity in the derivatives market and has been generally encouraged by regulators. However, if the result of portfolio compression of Legacy Derivatives would cause the resulting trades to be subject to margin requirements, it would severely reduce the incentives of market participants to conduct portfolio compression. In addition, excluding such new trades would be consistent with APRA's proposals, since the exposure with respect to the new derivatives would be materially similar to that under the Legacy Derivatives, which are excluded from the Margin Rules.

(iii) *wholesale novations completed in connection with a group restructuring*: trades resulting from a wholesale novation carried out in connection with a group restructuring should not be considered as "new" trades.

APRA covered entities should have right to include Legacy Derivatives in margin calculations and models

Notwithstanding the above, we request that APRA confirm that APRA covered entities would have the discretion to include Legacy Derivatives in their margin calculations and models for the purposes of the Margin Rules, provided that they do so in a consistent manner. Parties should have the option to document their Legacy Derivatives under the same credit support document as new transactions entered into after the relevant phase-in dates, so that all of the transactions entered into under that credit support document will be subject to the same margin requirements.

Legacy Derivatives and covered transactions may be subject to the same "netting agreement"

Further to the comments above, we note that the use of the phrase "netting agreement" in the Draft CPS (e.g. in paragraphs 17 and 37) implies that transactions subject to the same netting agreement must be included in variation and initial margin calculations, and that Legacy Derivatives which are not subject to the margining requirements would therefore need to be governed by a separate netting agreement. We request that APRA clarify that Legacy Derivatives (which may be subject to a separate credit support document) may be subject to the same netting agreement as covered transactions, without necessarily being subject to the same margin requirements. The creation of multiple netting agreements is not desirable from a risk management or operational perspective. We suggest that APRA follows the US approach of permitting netting sets under separate credit support documents and for such netting sets to be permitted to be documented under a single netting agreement. This would give APRA covered entities the flexibility to determine the best legal and operational approach for each covered counterparty.

2.2 Broad product set should be permitted for margin calculation

ISDA has written to BCBS, IOSCO and the regulators in the US, the EU and Japan (the **"Product Set Letter"**) addressing the need for ISDA members to have the flexibility to use a product set that is broader than the minimum product set required by applicable regulations.[11]

The scope of products subject to proposed margin requirements is not consistent across jurisdictions. For cross-border OTC derivative transactions, if two parties have to use two different regulatory product sets to calculate margin, there will be two different margin determinations using the two sets of rules. Dealers would need to develop systems that could simultaneously run two sets of margin calculations based on two different product sets. These same issues also arise within one jurisdiction if two different sets of margin rules apply.

ISDA would like to request that its members have the option of using the broad product set in their implementation of applicable margin rules, including development of models and supporting systems. To the extent that substituted compliance does not apply to trades, ISDA and its members need the flexibility to adopt broad product sets that include the various definitions of derivatives that apply to each of their counterparties in their respective jurisdictions. This is necessary because it is very challenging, in the available time frame, to build systems that can determine margin based on a different product set for each party to a swap. In this respect, we note that the margin requirements in Japan and the EU allow out-of-scope OTC derivative transactions to be included in the in-scope portfolio for the purpose of calculating the regulated VM and IM, as long as the in-scope entities consistently take such approach on a per counterparty ongoing basis.

Under our proposal, for any counterparty pair, the parties may choose to use a broader product set than the set required by either party's applicable regulation. Netting within this broad product set will be permitted to the same extent, and under the same conditions, that would apply to netting of products subject to the Margin Rules. The broad product set will be used for VM and/or IM and will include derivatives as defined by the rules applicable to each counterparty in its respective jurisdiction.

Please refer to the Product Set Letter for our detailed discussions on this point.

2.3 Intragroup transactions *(paragraphs 58 to 62, Draft CPS)*

Clarification of certain provisions

We request that paragraph 58 of the Draft CPS be clarified by inserting the word "only" before the word "subject" in the first line, as we understand from the Discussion Paper that intra-group transactions are otherwise intended to be exempt from the VM requirements (paragraph 59 is clear as regards exemption from the IM requirements).

[11] The Product Set Letter is available at https://www2.isda.org/functional-areas/wgmr-implementation/page/2

Paragraph 60 of the Draft CPS provides that "[t]he intra-group variation margin requirements in paragraph 58 ... do not apply to an APRA covered entity that is a foreign ADI, Category C insurer or EFLIC". However, the application of this paragraph is unclear, as paragraph 58 appears to operate as a partial exemption from the general VM requirement set out in paragraph 12 of the Draft CPS (rather than a distinct requirement). If the intention is to exempt all intra-group transactions in circumstances where one of the counterparties is a foreign ADI, Category C insurer or EFLIC (as appears to be the intention in paragraph 2.5 of the Discussion Paper), we request that this be more clearly stated.

Exemption of certain intra-group transactions from the margin requirements (paragraph 61, Draft CPS)

ISDA requests that APRA clarify the basis upon which it will provide exemptions for certain intra-group transactions, and confirm whether APRA intends to issue further guidance, or any class exemptions, relating to paragraph 61 of the Draft CPS. We note that both the US and EU rules refer to criteria such as centralised risk management.

APRA discretion (paragraph 62, Draft CPS)

We submit that the discretionary power of APRA to bring intra-group trades into scope of the Margin Rules greatly undermines legal certainty of the margin framework. It is well recognised that inter-affiliate swaps provide an important risk management role within corporate groups and that, rather than increasing risk, inter-affiliate swaps allow entities within a corporate group to transfer risk to the group entity best placed to handle it.[12] Further, ISDA is concerned that APRA would be most likely to invoke this power at times when the relevant group is in financial distress. Any such action taken at this time would be inherently pro-cyclical and would require the group to fund liquidity at a time of market stress. ISDA believes this would have a counter-productive effect on the market.

Another fundamental point to note is that margining intra-group trades would significantly increase costs (as entities would have to set aside margin for the intra-group trade as well as the trade with third parties) without a corresponding benefit in the mitigation of contagion risk. Intragroup derivative transactions are generally not a factor for the transmission of systemic risk beyond a corporate group. They also typically do not increase group-wide leverage or systemic risk. However, if such transactions had to be margined, the group would suffer an extra liquidity burden. The cost of funding this intra-group margin could discourage the management of risk through intra-group derivative transactions. Discouraging these transactions would increase group-wide credit risk by increasing the extent to which APRA covered entities must trade with third parties to hedge their market risk exposures, thus overall increasing the group's exposure to third parties.

As such, we would request that APRA remove this discretionary power.

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[12] See, for example, statement of Commissioner J. Christopher Giancarlo regarding Final Rule on Margin Requirements for Uncleared Swaps, published by the CFTC on 16 December, 2015.

If, notwithstanding the above submissions, the discretionary power is retained, we request that APRA clarify that intra-group transactions will not be subject to the margin requirements retrospectively if and when the discretionary power is exercised.

2.4 Margin – general

Collateral treatment requirements should not apply to margin that is not required to be collected under the Margin Rules

To the extent counterparties voluntarily exchange collateral greater than the minimum applicable requirements (or where the margin requirements do not apply at all), we request that parties retain the discretion to determine the eligibility and other requirements associated with such exchange. Imposing eligibility criteria and other requirements on voluntarily posted collateral would have significant consequences for all collateral arrangements. Credit support arrangements with persons that are otherwise exempt from the Margin Rules, for example, would have to be extensively re-negotiated. In many cases, it may not be feasible to maintain voluntary collateral in accordance with the Margin Rules, thereby restricting the ability of parties to negotiate additional protections where necessary to address credit risk in an appropriate way. We request that APRA clarify this point in the final Margin Rules.

Substitution of collateral (paragraph 50, Draft CPS)

ISDA requests that APRA remove subclause (a) of paragraph 50 as this subclause is unnecessary where the parties have agreed that substitutions may take place under the terms of their agreement per paragraph 50(b) of the Draft CPS.

2.5 Variation margin – general

AUD 3 billion minimum qualifying level (paragraph 12, Draft CPS)

The BCBS-IOSCO framework does not contemplate a minimum qualifying level for the phase-in of VM, and nor is such a qualifying level provided for in foreign regimes. ISDA also notes that the final margin rules of the US and Canada, the final draft EU RTS, and the proposed margin requirements of Hong Kong and Singapore do not provide for a *de minimis* threshold for VM requirements. ISDA is concerned that the AUD 3 billion minimum qualifying level contemplated in the APRA Proposals may have an impact on foreign regulators' comparability assessment of the APRA Margin Rules and the availability of substituted compliance. In this regard, we note that paragraph 7(b) of the BCBS/IOSCO Paper states that where a transaction is "subject to two sets of rules (duplicative requirements), the home and the host regulators should endeavour to (1) harmonise the rules to the extent possible or (2) apply only one set of rules, by recognising the equivalence and comparability of their respective rules". Accordingly, we urge APRA to adopt rules that are sufficiently consistent and non-duplicative with other foreign regimes. As previously discussed in the paragraph headed "International harmonisation", rules that are not harmonised would result in fragmentation of the market and a reduction of liquidity. It would also have the

inadvertent consequence of creating competitive advantage for entities that are not subject to foreign regimes.

We note that the US exempts "small banks" from VM requirements and the final margin rules adopted by Japan have a JPY 300 billion *de minimis* threshold for VM requirements. Under the US exemption, the threshold is calculated based on the total assets of the relevant entity – the exemption is available to small banks, saving associations, farm credit system institutions or credit unions with less than USD 10 billion in total assets who use swaps for hedging purposes. We also note that, although the Japan margin rules include a *de minimis* threshold for VM based on trading volume (i.e. JPY 300 billion average notional outstanding amount of OTC derivatives subject to the trade reporting requirement in Japan), requirements to exchange VM at a sufficient frequency based on transaction and risk size still apply to regulated financial institutions whose trading volumes fall below the *de minimis* threshold according to the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, Etc. issued by the Financial Services Agency of Japan. Similarly, under the US Safety and Soundness Guideline, a Covered Swap Entity (CSE) should collect VM in respect of uncleared swaps at such times and in such forms and in such amounts that the CSE determines appropriate to address the credit risk posed by the counterparty and the risks of such non-cleared swaps. Accordingly, the scope and application of the VM threshold or exemptions are more limited in the US and Japan, as compared to the APRA Margin Rules. While we appreciate APRA's regulatory intents to limit the competitive impact and costs imposed on smaller entities and to avoid creating disincentives for using non-centrally cleared derivatives for hedging purposes, we would suggest that APRA adopt approaches other than the AUD 3 billion minimum qualifying level to achieve these objectives.

Notwithstanding the above view, we note that our buy-side members have expressed that they are supportive of the proposed AUD 3 billion minimum qualifying level.

Three-stage phase-in (paragraph 13, Draft CPS)

Under the BCBS-IOSCO framework and the foreign regimes which have introduced margin requirements thus far, VM is to be phased-in over 2 stages (i.e. from 1 September 2016 and 1 March 2017). The introduction of a third phase for VM implementation (from 1 September 2017) may make it difficult for entities which are subject to foreign regimes to achieve compliance with the implementation timing for such foreign regimes in respect of their counterparties that are subject only to the APRA Margin Rules. The three-stage phase-in may also reduce the likelihood of foreign regulators making a substituted compliance assessments in respect of the APRA Margin Rules. If this three-stage phase-in is to be retained, we request that APRA confirm with its foreign counterparts that it will not impact any substitute compliance assessments.

Definition of "variation margin" (paragraph 10(bb), Draft CPS)

We suggest amending the definition of variation margin by adding the words "or paid" after "collateral that is collected" in the first line of the definition. This is to make it clear that VM is not subject to the same requirement for segregation as IM (and may be posted on an absolute transfer basis).

ISDA

2.6 Initial margin – general

Flexibility to be permitted in the use of standardised model approach and the internal model approach (paragraph 4.7, Discussion Paper)

ISDA members have requested the flexibility to use both standardised and internal models within the same asset class, provided that they do not do so on an arbitrary basis. This flexibility will be helpful in many circumstances, for example:

(i) where certain transactions are booked into a new or smaller foreign branch (where it may be difficult or very costly to implement full margin infrastructure); or

(ii) where a standardised approach needs to be used because the valuation of a particularly exotic product is difficult to determine for modelling purposes.

The use of a standardised approach in the above circumstances should not mean that the standardised approach must be used for all other transactions entered into in the relevant asset class.

Segregation of IM (paragraph 27, Draft CPS)

We support APRA's proposal that IM collected is to be held in such a way that it is readily available to the collecting party upon the default of the posting party and is subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters insolvency. ISDA supports the outcome-based approach set out in paragraph 27 of the Draft CPS in favour of mandating specific types of segregation structures.

In respect of the segregation requirement applicable to cash IM, we are of the view that cash IM held by a third party custodian should be viewed as being adequately safeguarded without needing to be held under a trust arrangement so long as the cash IM is held in an account that is not the property of the collecting party. This is because, in practice, cash is often placed on deposit with custodians, or reinvested in suitable investments upon agreement of the parties.

We submit that, in assessing whether an IM arrangement complies with the requirements of the Draft CPS, APRA covered entities be entitled to rely on standard industry-wide legal advice developed by market participants. Counterparties should not be required to obtain bespoke legal advice with respect to each new segregation arrangement, which could prove time-consuming and expensive. If industry-wide legal guidance is available with respect to certain standard segregation arrangements, such arrangements will be faster to implement and easier for both counterparties and regulators to analyse. In addition, counterparties should be able to rely on suitable opinions obtained by service providers such as custodians.

Holding of Margin with Third Party Custodian

In order to facilitate international harmonisation (e.g. with the final draft EU RTS), ISDA requests that APRA clarify whether or not margin must be posted to a custodian which is not affiliated with the posting party.

Re-investment of cash IM

ISDA requests that the Margin Rules clarify that cash collateral may be invested in other eligible assets upon agreement of the counterparties. This would be consistent with current market practice, and would allow counterparties to minimise their credit risk to the custodian or collecting counterparty whilst potentially earning higher returns than on a deposit account. We note that a custodian would only do so at the direction of, and subject to the control of, the counterparties, and not at its own discretion.

IM should be made available in a "timely manner" (paragraph 27(a), Draft CPS)

Paragraph 27(a) of the Draft CPS proposes that APRA covered entities will be required to collect and hold IM such that it is immediately available to the collecting party in the event of the posting party's default. We support the creation of robust segregation regimes, but the "immediately available" standard will not be possible to apply in practice and should instead be replaced with a requirement for IM to be available in a "timely manner".

In particular, stays or other restrictions on the availability of IM upon bankruptcy of the posting party may have an impact on when IM will be available. Where IM is held with an independent third party custodian, IM will only be available to the collecting party after the custodian goes through its required procedures. These procedures include the necessary operational steps for transferring the IM and may include verification of the legitimacy of the collecting party's claim for IM. Custodians may also insist on payment of their fees before releasing collateral from custodial liens. In addition, the parties may also agree that the posting party has a right to object to release of the collateral by the custodian if the posting party can claim that the demand is not appropriate. Such stays, restrictions or delays should not have an impact on the ability of APRA covered entities to enter into derivatives transactions with counterparties in jurisdictions that prevent immediate access to collateral upon a bankruptcy or to enter into arrangements with independent third party custodians.

Further, the bulk of collateral collected as initial margin is likely to be intermediated securities held in a clearing system, which will require the collateral provider (or the custodian on its behalf) to deliver appropriate instructions and wait for delivery of the relevant securities in accordance with standard settlement cycles.

In this respect, we note that the final draft EU RTS have replaced the "immediately available" standard with "available in a timely manner" and we submit that this would be a more appropriate standard.

One time rehypothecation should be permitted (paragraph 28, Draft CPS)

For consistency with the BCBS/IOSCO Paper, we ask APRA to permit one time rehypothecation of IM. While ISDA recognises that there are many conditions around the one-time rehypothecation of IM, and

hence that a one-time right to re-hypothecate collateral would be of very limited use, ISDA members would nevertheless like to have this option.

Calling and exchange of margin

Timing

We welcome APRA's proposals for VM to be called on a daily basis and for IM to be calculated and called on a regular and consistent basis upon changes in the measured potential future exposure. We also welcome the requirement for VM and IM to be settled "promptly" rather than on the basis of specific deadlines. As pointed out in the Discussion Paper, a T+1 settlement timeframe may not be feasible in all circumstances due to time zone differences and cross-border issues. A principle-based approach would allow for flexibility for the variety of factors impacting the call and settlement timelines. We note that there are ongoing global discussions regarding settlement timing and would urge APRA to actively participate in such discussions.

We request that APRA clarify what is meant by "at the outset of a transaction" in paragraph 22 of the Draft CPS. Would this require IM to be calculated prior to a transaction being entered into and then posted at the point of trade? Such a requirement would not be aligned with foreign margin regimes or market practice (whereby, once a trade is entered into, IM is then determined based on a portfolio calculation and is subsequently posted in a timely manner). It is also unlikely to be possible in the majority of cases. We request that APRA clarify or amend paragraph 22 of the Draft CPS in a manner which is consistent with the global rules and market practice.

Satisfying the obligation to post margin

We note that a posting party cannot deliver margin unless the counterparty is ready to receive it and has given appropriate instructions to its custodian or bank. Therefore, a posting party should be permitted to satisfy its posting obligation by delivering a notice, in accordance with the required timeframe, to its counterparty that the counterparty has the right to call for margin. A posting party should not be in violation of its posting obligations if the counterparty fails to accept the margin and the posting party delivers the notice in accordance with this paragraph.

Disputes

Paragraph 16 of the Draft CPS provides that, in relation to VM, "[i]n the event of a dispute, the undisputed amount must be exchanged between the two counterparties until the dispute is resolved." We would recommend that, consistent with the approach taken in article 14(6) of the final draft EU RTS, an equivalent provision be included in the Draft CPS in relation to IM.

2.7 Eligible collateral and haircuts

FX Haircut in respect of VM not exchanged in Termination Currency (paragraph 3 of Attachment B, Draft CPS)

We note that paragraph 3 of Attachment B to the Draft CPS requires an additional FX haircut of eight per cent to apply in respect of non-cash collateral posted as VM where the currency of the collateral asset differs from the termination currency (with the meaning of termination currency being set out in footnote 18). The concept of termination currency is more relevant to the FX haircut applicable to IM and the standard form of credit support annex in respect of VM does not include a concept of termination currency. The final draft EU RTS have clarified that an additional haircut in respect of non-cash VM should apply where the currency of the collateral asset differs from that "agreed in an individual derivative contract, the relevant governing master netting agreement or the relevant credit support annex", rather than the "termination currency" (which is used in the context of the FX haircut for IM only).[13] We request that APRA amend paragraph 3 such that it takes a consistent approach with the draft final EU RTS in order that the haircut applying to non cash VM does not have a broader scope of application than other regimes.

Multiple "termination currencies" to be permitted (Attachment B, Draft CPS)

The Draft CPS proposes that the 8% FX-haircut apply where collateral is denominated in a different currency from the "termination currency" agreed by the parties in the relevant contract.

We request that parties be permitted to agree on two termination currencies (i.e. each party may choose one currency) for the purpose of exchanging VM and IM (both cash and non-cash collateral). This will help alleviate the heavy penalising effect of the proposed FX haircut and is in line with the final draft EU RTS as well as the proposals of other foreign regimes.

Additionally, ISDA submits that the APRA regime should follow the more concessionary US approach. For IM purposes, the US rules impose a haircut on any collateral that is denominated in a currency other than the currency of settlement or a single termination currency so designated under an eligible master netting agreement. The Preamble to the US rules allows for each counterparty to have a different termination currency. The margin rules issued by the US prudential regulators define "currency of settlement" to include any currency in which settlement may be made under the relevant netting agreement, credit support document or individual contract.[14]

Wrong way risk (Paragraph 48 of the Draft CPS)

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[13] See paragraph 7, table 3 of Annex II to the final draft EU RTS.

[14] 80 FR 74903. Section_.2 provides that: "Currency of settlement means a currency in which a party has agreed to discharge payment obligations related to a non-cleared swap, a non-cleared security-based swap, a group of non-cleared swaps, or a group of non-cleared security-based swaps subject to a master agreement at the regularly occurring dates on which such payments are due in the ordinary course."

APRA should define "related or associated with" for the purposes of identifying wrong way risk. This definition should be consistent with today's practice in terms of available hierarchy information.

2.8 IM models

Paragraph 25 of the Draft CPS to be deleted

Paragraph 25 of the Draft CPS requires that triggers that may lead to a large discrete call for additional initial margin and would have a pro-cyclical effect should be avoided wherever practicable. ISDA members have noted that it is difficult to see what specifically is required of them to discharge this responsibility.

ISDA urges APRA to remove paragraph 25 of the Draft CPS. Procyclicality is a dimension to be taken into account in the specification and calibration of a model, not the output per se. A key purpose of the margin requirements is to have market participants cushioned, by large amounts of margin, from risks presented by counterparties. If a model built to comply with the margin requirements, and approved by regulators, could in certain circumstances result in large discrete IM calls, then prohibiting or avoiding this consequence is antithetical to the objective of protecting a participant from exposure to its counterparties. It would be unduly onerous to require market participants to comply with the margin requirements dictated by approved IM models whilst simultaneously complying with paragraph 25 of the Draft CPS.

It may also be helpful to understand what triggers APRA has in mind in paragraph 25. If these are things like credit rating downgrade triggers, this is something that can be avoided in the composition of the relevant model. If recalibration of the model is considered to be a trigger, this will be harder to avoid. SIMM models will be recalibrated annually, and more frequently as market conditions warrant. This is to comply with WGMR rules as implemented in other jurisdictions (e.g. the US).

Paragraph 26 of the Draft CPS to be clarified

ISDA requests that APRA clarify what is intended by this requirement. In particular, would a provision in a credit support document recording the parties' agreement in broad terms to call/post IM based on a particular model be sufficient?

Requirement for APRA approval for internal IM models (paragraphs 31 and 34, Draft CPS)

Paragraphs 31 and 34 of the Draft CPS propose that an APRA covered entity seek formal approval from APRA before using a model for the calculation of IM for some or all of its portfolio. We query whether this requirement for pre-approval by APRA is necessary, particularly when bearing in mind the short period prior to implementation of the Margin Rules. We request APRA to align with the EU approach (which does not require pre-approval of the relevant model), and permit firms to self-attest that the model meets the applicable criteria, and then to use the model from the compliance date onwards. APRA could reserve the right to inspect the model at any point in time.

We note that the industry has developed the ISDA SIMM Model, which could be used by market participants. In relation to such industry models, we request that APRA clarify if these would still be subject to APRA's approval. In the event that the use of an IM model is also subject to the approval of another regulator, this could give rise to the situation where one regulator (such as the home regulator of a market participant) has approved the model but another regulator (such as APRA) has not. Insofar as APRA intends to retain the approval requirement, we request that APRA confirm that after an IM model has been approved by another regulator or follows the ISDA SIMM Model, market participants that intend to use that model need only notify APRA and need not seek further approval from APRA. We further request that APRA confirm that such notification by a market participant need only be performed on a one-off basis in respect of all transactions that will use that model and in respect of the market participant's margining group.

If, notwithstanding the above, APRA intends to retain an independent approval requirement in respect of IM models that have been approved by another regulator or which follow the ISDA SIMM Model, we request that APRA covered entities be expressly permitted to use a model on an interim "deemed approval" basis (i.e. approval is deemed until such time as APRA reviews the relevant model), as long as, before doing so, they have carried out the independent review referred to in paragraph 41 of the Draft CPS. This should alleviate some of the timing pressure in light of the first IM phase-in date of 1 September 2016.

To the extent that APRA requires that market participants make such approval applications, we request that APRA provide further information and clarification on the procedural aspects of how this would be done and the timeframe anticipated for the approval process. ISDA requests APRA to clarify how long in advance APRA covered entities should submit models to APRA for approval if the APRA covered entity wishes to use the model on 1 September 2016.

10-day time horizon for initial margin calculation (paragraph 35, Draft CPS)

As presently drafted, the second sentence of footnote 7 to paragraph 35 of the Draft CPS adds one more day to the minimum time horizon than it should. This sentence should be amended by deleting "10 days plus the number of days in between variation margin exchanges" and replacing it with "10 days plus the number of days in between variation margin exchanges, minus one day".

Model changes should not require prior approval (paragraph 45, Draft CPS)

ISDA is concerned that the requirement for prior approval from APRA before making material changes to an approved model will lead to delays where there are a large number of model approval requests. ISDA proposes that there should be an interim process of "deemed approval" if the proposed change has been notified but review by APRA has not been completed.

In addition, for recalibration of existing models, APRA is requested to make it clear that a subsequent notification should be sufficient for changes arising out of a back-testing process.

ISDA

Part 3: Risk Mitigation Standards

While ISDA welcomes APRA's efforts in implementing the IOSCO Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives (the "**IOSCO RMS**") as set out in the paper dated 28 January 2015 (the "**IOSCO RMS Paper**"), we submit that APRA's assumption that implementation of risk mitigation standards is not a big task and is achievable for 1 September 2016 is misguided (for the reasons outlined in paragraph 3.1 below). Accordingly, ISDA requests that APRA launch a separate detailed consultation on the risk mitigation standards which are set out in paragraphs 70 to 92 of the Draft CPS. In particular, ISDA requests that APRA de-couple the implementation of risk mitigation standards from the implementation of the margin requirements set out in the Draft CPS as the urgency to implement margin requirements is not present for other risk mitigation standards. This would help provide the industry with much-needed time to implement the margin requirements under the Draft CPS (a minimum of 12 months before the effective date of implementation of the risk mitigation standards is requested).

If APRA is not minded to make the risk mitigation standards the subject of a separate and deferred consultation, we have outlined in paragraph 3.2 below a series of proposed modifications to the draft standards which we think could be workable and would be consistent with both APRA's policy objectives and the IOSCO RMS.

As regards the content of the proposed risk mitigation standards themselves, we strongly support Australia adopting rules that are harmonised and consistent across jurisdictions, and are broadly consistent with the IOSCO RMS. We welcome the principle-based approach rather than imposing prescriptive requirements on APRA covered entities. We set out some more detailed comments on the draft provisions in paragraph 3.3 below.

3.1 Timing of Implementation

ISDA notes that a September 2016 deadline for the implementation of risk mitigation standards by all APRA covered entities and to transactions with all of their derivative counterparties is not practically achievable. Some of the reasons for this are as follows:

(i) At present, documentation and procedures broadly reflecting the proposed standards have only been put in place by entities that are subject to (1) the EMIR risk mitigation requirements and/or (2) the CFTC swap dealer/major swap participant obligations, and even then only in respect of dealings with counterparties within the scope of such rules.[15] Therefore, the majority of Australian market participants are not currently required to comply with, and have not taken any steps to implement, the proposed standards.

(ii) In order to be implemented, most of the risk mitigation standards require re-papering of existing contractual documentation. The ISDA DF March Protocol (which relates to the CFTC rules) and

[15] For example the CFTC rules only apply to the five Australian swap dealers when dealing with US-connected counterparties.

the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol (which relates to the EMIR rules), each implemented on ISDA Amend, were the means by which most market participants facilitated their compliance with the relevant CFTC and EMIR rules. These Protocols involved months of industry effort to draft and finalise their provisions and several additional months for implementation on ISDA Amend. At the same time, bilateral documentation was developed for use with entities that did not adhere to the relevant Protocols. This was a very substantial re-papering exercise (even just for the subset of counterparties which did not adhere to the Protocols). These exercises benefitted from considerable lead times between rule publication and compliance dates, and by the market dedicating substantial resources to the process. The APRA proposals provide insufficient time to conduct a similar exercise, and moreover they impact a broader range of entities and covered counterparties than the equivalent CFTC and EMIR regimes. There is no ISDA (or other market standard) protocol currently existing that can be applied to address APRA's risk mitigation standards and it is not feasible to put one in place in time. APRA covered entities may be rendered uncompetitive if they are seen as demanding additional documentation standards over what their international competitors require. Accordingly, the APRA proposals present a real risk that APRA covered entities will be unable to access certain markets. In light of the above, ISDA submits that proposed implementation date of 1 September 2016 is neither achievable nor advisable.

(iii) Compliance with the risk mitigation standards is proposed to come into effect at a time when industry participants will be devoting all available resources to what is the largest re-papering and operational exercise the industry has ever seen (in order to comply with the applicable margin requirements). It will be particularly difficult to convince counterparties to make documentation changes beyond those which are required for the purposes of margin. With a view toward these types of issues, paragraph 8.3 of the IOSCO RMS Paper explicitly recognises that authorities should "consider the feasibility of implementing these standards and the margin requirements around the same time", and, "[i]n implementing the standards, authorities may have regard to the time needed by the covered entities to put in place the necessary infrastructure and systems to adhere to the requirements". As noted above, the documentation infrastructure necessary to implement the proposed Australian risk mitigation standards does not exist at this time.

(iv) Paragraph 83 of the Draft CPS indicates that the valuation processes referred to therein are "for the purpose of exchanging margin". In general, the only document in the derivatives market which sets out the process for determining the value of transactions for the purpose of exchanging margin is the credit support document. Accordingly, if the risk mitigation standards were to come into effect on 1 September 2016, this requirement would effectively oblige all APRA covered entities to put in place credit support documents with all of their counterparties well in advance of the margin requirements actually taking effect (which, for the vast majority of counterparties, will be no earlier than 1 March 2017). This is both inconsistent with the proposed implementation timetable for margin requirements and practically unachievable.

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3.2 Potential alternative approach

If, notwithstanding the submissions above, APRA intends to implement the risk mitigation standards at the same time as the margin requirements, we submit that the following changes to the existing proposal should assist the regime to be practically achievable:

(i) Aligning the counterparty scope of the risk mitigation standards with the IOSCO RMS. The IOSCO RMS Paper makes clear that the IOSCO RMS are only intended to apply to non-cleared derivatives transactions between two covered entities.[16] The APRA provisions are significantly wider in scope than this, as they appear to apply to derivatives with "all counterparties". We suggest that this discrepancy be resolved by providing that the risk mitigation standards will only apply to derivatives which are also subject to the VM requirements set out in the Draft CPS.

(ii) Phasing-in the risk mitigation standards in alignment with the phase-in of the margin rules. As in sub-paragraph (i) above, this could be achieved by providing that the risk mitigation standards will only apply if and when the relevant derivative transaction is also subject to the VM requirements set out in the Draft CPS. This would be consistent with the phase-in approach discussed in the IOSCO RMS Paper.[17]

(iii) Aligning the scope of the transactions to which the Margin Rules and the risk mitigation standards apply. If APRA accepts the submissions in paragraph 2.1 above (i.e. to exempt physically-settled FX forwards and swaps from the VM requirements and to exempt equity options from the VM and IM requirements for an initial three year period), we submit that the APRA risk mitigation standards should also not apply to physically-settled FX forwards and swaps and equity options (for the relevant time period, where applicable). Given that margining documentation and related processes (such as portfolio reconciliation, dispute resolution, and valuation) will be the means by which APRA covered entities comply with the APRA risk mitigation standards, applying the standards to non-margined transactions could mean that separate documentation and procedural solutions need to be established for physically-settled FX forwards and swaps and equity options. This would impose a significant additional burden on the industry at a time when all available resources are being allocated to compliance with the margin requirements.

(iv) Adopting specific amendments to the proposed risk mitigation standards so as to align with the IOSCO RMS and to permit existing industry documentation and protocols (put in place to address the US and EU requirements) to also address the Australian requirements. These amendments are summarised in paragraph 3.3 below.

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[16] See "Key considerations" set out in paragraph 1.3 of the IOSCO RMS Paper. "Covered entities" are defined as financial entities and systemically important non-financial entities in the IOSCO RMS Paper.

[17] Paragraphs 8.2 and 8.4 of the IOSCO RMS Paper.

3.3 Specific proposed amendments to the proposed risk mitigation standards

Scope of application

For the reasons set out in paragraph 1.1 above, ISDA strongly opposes the proposal for the risk mitigation standards to apply to all entities within a Level 2 group, including foreign subsidiaries of APRA covered entities. ISDA also strongly opposes any proposal for the risk mitigation standards to apply to all entities within a Level 2 group of a foreign-incorporated ADI, including foreign subsidiaries of the foreign-incorporated ADI.

In particular, certain foreign subsidiaries operate in markets where it would not be reasonable to impose requirements to have written policies and processes on portfolio compression and reconciliation, valuation and/or dispute resolution. Indeed, some of these concepts may not be well understood or required in certain markets (e.g. in Vietnam or Indonesia where some banks may have subsidiaries) and an extra-territorial application of the risk mitigation standards may therefore create a competitive disadvantage in those markets (as well as additional regulatory burden and costs of compliance), with no substantive policy benefit.

ISDA also requests that, for foreign-incorporated ADIs, the risk mitigation standards will only apply if the relevant transaction is booked in the accounts of an Australian branch. As noted in paragraph 1.1 in respect of margin, the APRA Margin Rules would have a very significant extra-territorial effect if a foreign-incorporated bank that has merely established a branch in Australia were required to ensure that its head office and all of its foreign branches comply with the APRA risk mitigation standards. ISDA would oppose such an extra-territorial approach.

Substituted compliance and automatic deference

Substituted compliance and automatic deference should not be limited to the margining provisions of the APRA Proposals and should be extended to the risk mitigation standards as well. Accordingly, ISDA requests that APRA include an equivalent of paragraph 63 of the Draft CPS in relation to the risk mitigation standards, so that an APRA covered entity may apply to APRA for approval to comply with the corresponding standards of a relevant foreign jurisdiction. In addition, a foreign-incorporated APRA covered entity should be allowed to comply with the risk mitigation standards of its home jurisdiction (as contemplated by paragraph 66 of the Draft CPS) or those of a jurisdiction deemed equivalent by its home jurisdiction, or, as applicable, the relevant foreign jurisdiction (as contemplated by paragraph 67 of the Draft CPS without obtaining the prior approval of APRA, provided, in each case, that it can demonstrate how it meets the applicable foreign risk mitigation requirements which are substantially similar to the IOSCO RMS. This will be important in order to avoid any potential time gap between initial implementation of the Australian requirements and a determination by APRA that the relevant foreign risk mitigation standards are comparable.

Trading relationship documentation (paragraphs 71 to 73, Draft CPS)

We understand that it is industry practice (where not required under Dodd-Frank and related US regulation) to enter into documentary arrangements based on credit assessments and other requirements, including "long-form confirmations" and non-ISDA mini-master agreements. This involves trading with customers on a "deemed" master agreement basis where procedures are documented by internal written policies of the relevant APRA covered entity. Counterparties are aware that the trades are done on the basis of a "deemed" master agreement but the documentation itself is executed in compliance with the timing requirements for the confirmation. ISDA requests that APRA expressly permit industry participants to comply with the requirement for trading relationship documentation through "long-form confirmations". As it is not industry practice for long-form confirmations to be executed prior to the trade being executed, we propose that confirmations made in accordance with timely confirmation timelines be considered "contemporaneous execution" for the purposes of this requirement.

Legal certainty (paragraph 72(a), Draft CPS)

Paragraph 72(a) of the Draft CPS requires that trading relationship documentation must provide legal certainty for non-centrally cleared derivatives. Whilst this is referred to in the IOSCO RMS Paper, we submit that it is not required to be expressly implemented in each jurisdiction's local rules. The reason for this is that it is a "key consideration" in the IOSCO RMS Paper (which informs what should be the actual obligations on market participants), rather than being in the nature of an obligation itself.

If it were to remain, its intersection with non-netting and collateral-unfriendly jurisdictions would need to be considered and expanded upon in the final risk mitigation standards.

APRA covered entities to establish and implement procedures for trade confirmations (paragraph 74)

We suggest that APRA amend the requirement in paragraph 74 of the Draft CPS to be that "An APRA covered entity must establish and implement policies and procedures designed to ensure the material terms…" and request that the word " confirmed" be removed in the second sentence of paragraph 74. This distinction here is important because a confirmation can only be achieved when a counterparty has cooperated, and this is to a degree out of the control of the APRA covered entities. An equivalent comment applies to paragraph 75 of the Draft CPS.

Form of trade confirmation (paragraph 76, Draft CPS)

ISDA supports APRA's proposal to require that an APRA covered entity have appropriate procedures and arrangements in place to meet the confirmation deadlines instead of prescribing hard deadlines, as in respect of any particular transaction there could be a number of reasons why one party is non-compliant or why more time may be needed.

We also note that all legally binding methods of trade confirmations should be permitted so long as they achieve a legally binding agreement and there should be no distinction between one way (negative affirmation) or two way confirmations depending on counterparty type. In this respect, we note that paragraph 3.6 of the IOSCO RMS Paper provides that negative affirmation may be used as long as it is

not prohibited under the applicable laws and regulations of a jurisdiction, and that Australian laws contain no prohibition against negative affirmation.

Accordingly, and especially in relation to counterparties that are not financial institutions, we request that APRA clarify that negative affirmation (if pre-agreed between the parties as a legitimate confirmation method) may be sufficient and that it be sufficient for the APRA covered entity to provide a signed confirmation without requiring its counterparty to provide a signed or other form of return acknowledgement. Many counterparties are not subject to APRA oversight and the APRA covered entity may not be able to compel the counterparty to provide a timely confirmation. We request that APRA not penalise an APRA covered entity that is unable to compel a counterparty, including a non-Australian counterparty, to comply with these requirements.

Portfolio reconciliation (paragraphs 77 to 79, Draft CPS)

ISDA requests APRA to clarify whether the portfolio reconciliation requirement applies to new trades entered into after 1 September 2016 (or the eventual date of implementation, as applicable) or to all trades outstanding on the implementation date.

In addition, ISDA requests APRA to clarify whether the portfolio reconciliation requirement applies to intra-group transactions (we submit that this should not be necessary).

Further, we urge APRA to consider introducing a *de minimis* threshold below which the parties would not be required to reconcile any discrepancies in valuations; e.g. the CFTC adopts a *de minimis* threshold of 10% (see CFTC Commodity Exchange Regulations Part 23, §23.502(b)(4)).

Portfolio reconciliation requires the co-operation of the counterparty. For this reason, we suggest that APRA amend the requirement in paragraph 77 of the Draft CPS to be that "An APRA covered entity must establish and implement policies and procedures designed to ensure the material terms…".

Further to the above, the first sentence of paragraph 78 could be read as requiring that the parties actually agree to a reconciliation process, rather than that each APRA covered entity have a policy designed to ensure that such a process is agreed with counterparties. We therefore request that this sentence be deleted: the requirement in paragraph 77 to have policies and procedures should be sufficient. This is also consistent with the approach taken in the US rules. Going beyond this would require industry infrastructure to be in place that does not currently exist (as noted in paragraph 3.1 above) and which cannot be put in place in time for 1 September 2016.

Valuation processes (paragraphs 83 to 86, Draft CPS)

ISDA requests that the last sentence in paragraph 86 be deleted, or that it be replaced by an obligation to have policies and procedures designed to ensure that relevant documentation is updated for any changes that result from a periodic review of the agreed upon valuation process. This is because it is not possible to compel counterparties to agree to such changes. Paragraph 4.4 of the IOSCO RMS Paper is worded as

it is because it is stating objectives, and is not limited by what a regulated entity is actually capable of achieving on its own.

Dispute resolution – material terms (paragraph 87(a), Draft CPS)

We request that the reference to "material terms" in paragraph 87(a) of the Draft CPS be deleted. At present, industry standard documentation does not provide for a mechanism to resolve disputes as to material terms, and only provides for resolution of disputes as to the value of transactions and collateral. In addition, the US and EU rules do not require dispute resolution in relation to material terms.

For the reasons provided in paragraph 3.1 above, there is no existing industry infrastructure in place that can address the proposed requirement relating to disputes as to material terms, and it is not feasible to put any such infrastructure in place in sufficient time to meet a 1 September 2016 deadline.

We note that, in any event, it is in both of the parties' interests to resolve material terms-based disputes in order to facilitate the exchange of margin, as differences in parties' material terms records are likely to result in, or coincide with, disputes as to valuation.

In the context of portfolio reconciliation, the CFTC rules state that valuation differences of less than 10% of the higher valuation need not be deemed a discrepancy (see CFTC Commodity Exchange Regulations Part 23, §23.502(b)(4)). We would recommend that APRA adopt a similar approach in relation to dispute resolution.

Dispute resolution – documenting how to resolve disputes (paragraph 87(b), Draft CPS)

Industry standard margin agreements do not include provisions of the type described in paragraph 87(b) and so this paragraph should be deleted for the reasons set out in paragraph 3.1 above.

We look forward to continuing our dialogue with you. Please do not hesitate to contact Keith Noyes, Regional Director, Asia Pacific ( ) or Jing Gu, Senior Counsel ( ) for questions related to this response.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.

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