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Dear Sir,

APRA's Discussion Paper "Margining and risk mitigation for non-centrally cleared derivatives"

I am a lawyer with over 10 years of experience in the area of derivatives law and practice and welcome the opportunity to comment on the Australian Prudential Regulation Authority's consultation package on margining and risk mitigation requirements for non-centrally cleared derivatives. I would like to contribute to the consultation by offering a few brief comments on the drafting of Prudential Standard CPS 226.

As the past years have shown, perhaps the most fundamental challenge in implementing derivatives reform is to achieve sufficient consistency – both at the international level and within the domestic regulatory framework. With this in mind I have taken a comparative perspective with regard to the risk mitigation approaches envisaged in Singapore[1], Hong Kong[2], the EU[3], Switzerland[4] and the United States,[5] alongside Australia's existing domestic regulatory framework. From this perspective I agree with many of APRA's policy choices in relation to the implementation of the BCBS-IOSCO framework[6]. In particular the sensitive approach to substituted compliance and the covered bond and securitisation carve-outs will be, I believe, beneficial to the global derivatives market.

In summary, I would like to touch on the following areas of CPS 226 in this submission:

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1 As set out in consultation paper P017-2015 "Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives" published by the Monetary Authority of Singapore ("**MAS**") in October 2015 (the "**MAS Paper**").

2 As set out in the draft Supervisory Policy Manual CR-G-14 (the "**HKMA SPM**") forming part of consultation paper CP15.02 "Non-centrally Cleared OTC Derivative Transactions – Margin and Other Risk Mitigation Standards" published by the Hong Kong Monetary Authority ("**HKMA**") in December 2015 (the "**HKMA Paper**").

3 As set out in the "Final Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012" published by the European Securities and Markets Authority, the European Banking Authority and the European Insurance and the Occupational Pensions Authority on 8 March 2016 (the "**EMIR RTS**").

4 As set out in the Financial Market Infrastructure Ordinance of the Swiss Federal Council of 25 November 2015 (the "**FMIO**") implementing the Financial Market Infrastructure Act of 19 June 2015 (the "**FMIA**").

5 Prudential Regulators, *Margin and Capital Requirements for Covered Swap Entities*, Final Rule, 80 Fed. Reg. 74840 (November 30, 2015) (the "**PR Final Rule**"); CFTC, *Margin Requirements for Covered Uncleared Swaps for Swap Dealers and Major Swap Participants*, Final Rule, 81 Fed. Reg. 636 (January 6, 2016), Part 23, Subpart E (*Capital and Margin Requirements for Swap Dealers and Major Swap Participants*) (the "**CFTC Final Rule**").

6 The margin requirements for non-centrally cleared derivatives as set out in the March 2015 paper by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), "Margin requirements for non-centrally cleared derivatives".

- the overall scope of the rules
- the definitions of "covered counterparty", "netting agreement" and "non-centrally cleared derivative"
- the approach to umbrella funds in paragraph 24
- initial margin holding requirements in paragraph 27
- the prohibition on re-hypothecation in paragraph 28
- the minimum transfer amount in paragraph 29
- the due diligence requirement in paragraph 30
- the "substantial similarity" cross border rules in paragraphs 66 and 67
- the approach to non-netting jurisdictions in paragraph 68
- base currency optionality
- the approach to equity options

Scope of CPS 226

It would be helpful for APRA to clarify whether the requirements of CPS 226 apply to the margining of all non-centrally cleared derivatives, even if such margining is not required by CPS 226. For example, if an APRA covered entity is not required to post or collect initial margin due to collateral arrangements being questionable upon default of the counterparty (paragraph 69), but the APRA covered entity elects to collect margin, do any of the margin rules in CPS 226 apply? Paragraph 2 of CPS 226 specifies that the rules apply in respect of "business operations" which could be interpreted to encompass all margining, even margining not required under the standard. However I submit that the margining rules should be limited in scope to cover only mandatory margining practices.[7] Counterparties should be free to agree different margining arrangements in situations where mandatory margining is not required. This includes agreeing different haircuts, using different models and specifying different eligible collateral beyond that prescribed in CPS 226. Clarification of this point would be welcome.

Definition of "covered counterparty"

Licensed clearing and settlement facilities

I submit that licensed clearing and settlement facilities, in particular CCPs, should be exempted from margin posting in relation to hedging forming part of the default management process of a facility. The definition of "financial institution" in CPS 226 is non-exhaustive and so there is some uncertainty whether a CCP or other licensed clearing and settlement facility would be considered a

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[7] This would be comparable to the approach of the CFTC , see CFTC Final Rule §23.150 (*Scope*).

financial institution. Even if it is not, it is possible that a clearing and settlement facility would fall within the definition of "systemically important non-financial institution" and therefore be or become a covered counterparty.

Whilst the margining of day-to-day uncleared derivatives entered into by a clearing and settlement facility is not objectionable, a CCP may enter into non-centrally cleared derivatives as part of its default management process upon the default of a clearing member.[8] The flexibility for a CCP to do this is important in order to mitigate and manage systemic risk and it is possible that the notional of such hedging would exceed AUD 50 billion in the default of one of the bigger clearing members. Subjecting these hedging transactions to mandatory margin requirements could impose a liquidity burden on the CCP which constrains efficient management of a default, potentially exacerbating risk rather than mitigating it in a period of market stress. A further consideration is that CCPs are subject to separate risk mitigation requirements as part of their prudential regulation.

The partial exemption could be implemented in a number of ways. One approach would be to expressly exclude a licensed clearing and settlement facility from the definition of "covered counterparty", thereby taking it outside the scope of the mandatory margining rules. A more nuanced approach would be to exclude non-centrally cleared derivatives entered into by a licensed clearing and settlement facility as part of its default management process from the definition of "non-centrally cleared derivative". Separate risk mitigation rules for these trades could be fashioned based on prudent risk management principles.

I note that exempting approved CCPs from the mandatory margin rules would be consistent with the approach taken by the EU. Under the EMIR RTS a collecting counterparty is permitted to have risk management procedures which provide that no initial margin or variation margin is collected from CCPs which are authorised credit institutions.[9]

Multilateral development banks

It would be beneficial for APRA to provide guidance on which entities will be considered to be "multilateral development banks" for the purposes of the definition of "covered counterparty". This will remove uncertainty as to the scope of the MDB exemption, since there are differing interpretations in different regions of the world. In the United States the PR Final Rule and the CFTC Final Rule both include a definition of "multilateral development bank". This definition is broader than the multilateral development banks exempted from EMIR[10]. In Hong Kong the HKMA has specified various MDBs pursuant to local ordinance. On the domestic front, it is unclear whether (i) the list of institutions which qualify for a zero per cent risk-weight under APS 112[11]

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8 For example, in the case of ASX Clear (Futures), as provided in paragraph 2 (*DM Hedging Transactions and DM Hedging Transaction Costs*) of Schedule 3 (*Default Management Process*) to the ASX OTC Rulebook.

9 EMIR RTS, Art 6 (*Treatment of OTC derivative contracts in the context of a CCP's position management upon the insolvency of a clearing member*).

10 It includes "the Islamic Development Bank and any other entity that provides financing for national or regional development in which the U.S. government is a shareholder or contributing member or which the relevant Agency determines poses comparable credit risk".

11 APS 112, Footnote 5.

and/or (ii) the MDBs exempt from clearing requirements under Regulation 7.5A.64 (*Persons on whom clearing requirements cannot be imposed*) of the Corporations Regulations 2001, have any relevance to the interpretation of CPS 226. For all of these reasons, clarification of the scope of this exemption would be welcomed.

Definition of "netting agreement"

The proposed definition of netting agreement is similar to the definition contained in APS 112. However it does not contain all of the interpretative guidance included in APS 112. This leads to some uncertainty as to its scope. For example, it is not clear that only bilateral netting agreements are in scope or whether multilateral netting agreements are also covered. It is not clear whether the "netting agreement" can in fact be only netting provisions within a master agreement. I suggest that the APS 112 guidance is imported into CPS 226 to assist with clarity.

In addition, I submit that the definition of netting agreement should acknowledge that a party's right to close-out is subject to stays under applicable resolution and recovery law. This is to avoid any technical uncertainty as to whether a netting arrangement is a "netting agreement" while any stay applies, since during this period the parties to the agreement do not "have the right" to close-out, as specified in the netting agreement definition.

Definition of "non-centrally cleared derivative"

The definition of non-centrally cleared derivative is the bedrock of CPS 226. In addition to the cross border issues raised by this definition (as discussed in the section of this letter headed "Cross border application" below), two observations are pertinent.

Securities Financing Transactions

Securities financing transactions (SFTs) are expressly excluded from the definition of non-centrally cleared derivative. However the definition of SFTs only encompasses financing transactions involving securities. I submit that this definition is too narrow. Other types of financing transactions should be included in the definition (and thereby excluded from the margining requirements in CPS 226). Specifically commodity repos and commodity buy/sell backs (which are an important feature of the commodity financing market), repos in respect of money market instruments or units in a collective investment scheme and margin lending structures should be carved out, provided such transactions include a margin leg.

The rationale for this broader category of exclusions is that these financing transactions are not derivatives in the strict sense even though they share some attributes with derivatives and may fall within the definition of a derivative for the purpose of CPS 226. In addition, if the structure of these transactions includes an adequate margin component there is no logical reason to overlay additional margin requirements.[12] I note that the HKMA Paper proposes a broader exclusion than

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[12] I note that the recently adopted EU regulation on securities financing transactions includes commodity repos in the definition of SFT (Regulation (EU) 2015/2365 of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012).

CPS 226 to exclude: "other transactions, such as repurchase agreements and securities lending transactions, that are not themselves derivatives but share some attributes with derivatives".[13]

ISDA CSA

Under the terms of the widely used ISDA Credit Support Annex (Bilateral form – Transfer) governed by English law ("**CSA**"), the credit support arrangements themselves are stated to constitute a "transaction".[14] This approach facilitates closeout netting of posted collateral. I see some uncertainty whether the definition of "derivative" and the references in CPS 226 to margining "derivative contracts"[15], "derivative transactions"[16] and "transactions"[17], would cover the transaction arising under the CSA. I submit that it would be circular to require margin to be posted on the margining arrangements under the CSA. CPS 226 should make clear that the CSA "transaction" and similar margining transactions, are not themselves non-centrally cleared derivatives subject to margining requirements.

Segregated funds

Paragraph 24 provides that funds which are separate legal entities may be considered distinct entities for the purpose of the initial margin threshold in certain circumstances. This is consistent with the BCBS-IOSCO framework, but I submit that the rule should be expanded in two ways. First, it should cover segregated portfolios and other contractually segregated funds, even if such segregated funds are not themselves "legal entities". Thus if an investment manager manages multiple funds on a contractually segregated basis and such funds do not cross-collateralise each other, each fund should not be treated on a group basis for margining. This change would rationalise the initial margin rules for the many fund structures which operate within a single umbrella legal entity. This approach would also be consistent with the EMIR RTS which focusses on the broader concept of "pools of assets" rather than "separate legal entities".[18]

In addition, recognising ring-fencing only for the "initial margin threshold" is too restrictive. Ring-fencing recognition should apply in all respects, including in relation to the qualifying level determination for IM and VM, the AUD 75,000,000 IM threshold and the minimum transfer amount cap. Only recognising ring-fencing for the IM threshold is of questionable benefit. I suggest paragraph 24 could be reworded as follows:

> "An investment fund or RSE that is managed by an investment adviser is considered a distinct entity that may be treated separately (and not as part of any margining group) when applying the initial margin threshold and when determining whether a minimum transfer amount exists or will arise, as long as the fund or RSE is a distinct ~~legal entity~~

13 HKMA SPM s 2.1.2.

14 See introductory paragraph of the CSA.

15 See for example paragraphs 13 and 19.

16 See for example paragraphs 14, 16 and 20.

17 See for example paragraphs 17 and 22.

18 EMIR RTS, Arts 8(3), 9(3) and 39(4).

> segregated pool of assets that is not collateralised by or otherwise guaranteed or supported by other funds or an advisor in the event of insolvency or bankruptcy."

The above approach is consistent with the approach taken in Switzerland where the prevailing market view is that ring-fencing applies broadly.[19]

Holding arrangements – Paragraph 27(a)

Paragraph 27(a) requires initial margin to be "immediately available" to the collecting party in the event of the posting party's default. This reflects the BCBS-IOSCO framework, but unfortunately the framework does not provide any commentary on how to interpret this requirement. I submit that this requirement is ambiguous and has at least two interpretations, one potentially unworkable and one improbable. One interpretation is that it refers to the time at which collateral must be available to the collecting party (ie, "immediately"). If this is the meaning, then I submit it may be unworkable in practice because it does not take account of potential stays under insolvency law which delay the enforcement of a security interest or other action by the collecting party. In addition, if the initial margin is held with a custodian then the custodian would need some time to undertake relevant verifications and input transfer instructions. Although this may be done within a matter of hours, it is unclear whether this small delay would breach the requirement for collateral to be "immediately available".

Another interpretation is that "immediately available" refers to collateral being available for use without needing to clear (for example, fed funds). Generally this expression is only seen in the case of cash since most securities are of course held in a clearing system. The PR Final Rule and the CFTC Final Rule appear to have adopted this narrower interpretation, only using the term "immediately available" in the context of specifying that "immediately available cash funds" are eligible collateral.[20] It is improbable in my view that paragraph 27(a) is intended to require margin securities in a clearing system to be removed from the clearing system in order to render them "immediately available" to the collecting party.

To clarify the correct approach, I respectfully suggest that APRA provide guidance on what "immediately available" means in paragraph 27(a). An example of an attempted clarification is that of the HKMA in footnote 22 to the HKMA SGM, which provides:

> "Stays or other restrictions as well as potential delays with collateral held at third party custodians could make this provision difficult to comply with. These and similar situations are therefore deemed to be in compliance with this module so long as the collateral is available to the surviving counterparty as soon as legally possible."

Whilst adopting an "as soon as legally possible" standard would harmonise with the HKMA proposal, there is also an ambiguity in the HKMA approach because it does not prevent counterparties from agreeing to an arrangement where it is only legally possible to obtain the

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19 Based on an extension by analogy of FMIO Art 76.

20 See CFTC Final Rule § 23.156 (*Forms of margin*).

collateral after a lengthy delay. Therefore I suggest that APRA consider whether it would be preferable to clarify that "immediately available" means "available in a timely manner". This would align with the standard in APS 112 for the recognition of risk mitigation for regulatory capital purposes.[21]

Holding arrangements – Paragraph 27(b)

Paragraph 27(b) requires initial margin holding arrangements to protect the posting party to the extent possible under applicable law in the event of the collecting party's insolvency. However no express segregation rule is included. A few observations are apposite.

First, it would be helpful for APRA to clarify which "applicable law" must be diligenced. I anticipate that the applicable laws would include (i) the law of incorporation of the collecting party and if a foreign branch of the collecting party is involved, the law of the jurisdiction in which the branch is located, and (ii) the governing law of the margin and custody arrangements. In addition the law of the place of any relevant custodian and the law of incorporation of the posting party would be relevant in the scenario where the custodian and/or posting party also becomes insolvent.[22] However the diligence burden on collecting parties is heavy if "applicable law" encompasses the jurisdictions of the custodian, the posting party and all jurisdictions where collateral may be located, since intermediated securities collateral may raise the spectre of diligencing the jurisdictions of numerous custodians and intermediaries (notwithstanding the application of PRIMA[23] principles), depending on the type of collateral posted from time to time. APRA clarification would be welcome to minimise unnecessary legal due diligence costs for collecting parties.

Secondly, the meaning of "to the extent possible" is ambiguous. It could be read as permitting any type of holding arrangement, on the basis that the posting party will be protected by receiving credit for the posted collateral value through the close-out netting process. Provided close-out netting is enforceable upon the insolvency of the collecting party, then posted margin could be transferred on a pure title transfer basis and/or commingled with other property of the collecting party. Such arrangements may not facilitate the prompt return of posted collateral upon the insolvency of the collecting party due to issues such as the anti-deprivation principle. However an argument could be made that the arrangements satisfy the wording of paragraph 27(b) on the basis that the anti-deprivation principle does not make it possible to return the collateral. In other words, such arrangement does protect "to the extent possible under applicable law".

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21 See for example APS 112, Attachment G (*Guarantees*), para 2: "A guarantee must also be unconditional; there must be no clause in the guarantee outside the direct control of an ADI that could prevent the guarantor from being obliged to pay out **in a timely manner** in the event that the original counterparty fails to make the due payment(s)"; APS 112, Attachment H (*Simple and comprehensive approaches to the recognition of collateral*), para 9: "The legal mechanism by which collateral is pledged or transferred must allow the ADI the right to liquidate or take legal possession of the collateral **in a timely manner**." (emphasis added)

22 This scenario is contemplated in the PR Rule and the CFTC Final Rule respectively in the definition of "eligible master netting agreement".

23 The place of the relevant intermediary approach.

Thirdly, I submit that the wording of paragraph 27(b) does not reflect requirement 5 of the BCBS-IOSCO framework. This provides that "collected collateral must be segregated from the initial margin collector's proprietary assets. In addition, the initial margin collector must give the customer the option to segregate the collateral it posts from the assets of all the initial margin collector's other customers and counterparties (ie individual segregation)."[24] Silence on segregation weakens posting party protection and puts CPS 226 out of step with other jurisdictions.[25] I suggest express operational segregation requirements ought to be included in CPS 226 for initial margin which is required to be posted under the rules. This would still permit initial margin to be transferred on a title transfer basis, albeit it would be held on a segregated basis in an account subject to appropriate client money protection and/or subject to a charge back in favour of the posting party. The account could be with the counterparty or with a third party custodian provided relevant segregation agreements are in place. This approach is consistent with the EMIR RTS and the approach in Switzerland.

Use of cash initial margin

Paragraph 28 prohibits re-hypothecation, re-pledge or re-use of posted initial margin. Although this no doubt reflects a policy decision by APRA, I note that re-investment of cash margin by the third party holder or custodian is permitted under the EMIR RTS on the basis that it is common market practice[26]. The CFTC permits limited re-use of cash collateral.[27] Additionally the MAS[28] and the HKMA[29] have each proposed to permit limited re-hypothecation (which is also contemplated in the BCBS-IOSCO framework[30]). Re-hypothecation is not permitted under the Swiss regime[31], although the Swiss market is currently in discussion with FINMA to address harmonisation between the Swiss rules and the EMIR RTS in a number of areas. The Swiss margining rules were released prior to the final EMIR RTS and some discrepancies are likely to be eliminated prior to the go-live dates through changes or interpretative guidance from FINMA. Consideration should be given to the risk of regulatory arbitrage due to the divergent approaches emerging in various jurisdictions.

Minimum transfer amount

Paragraph 29 states that there must be a minimum transfer amount ("**MTA**") that must not exceed AUD 750,000. I agree with the policy of imposing a cap on the MTA, but submit that including an MTA should be optional rather than mandatory. In addition, I suggest that it be

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24 BCBS-IOSCO framework, para 5(iv).

25 See EMIR RTS Art 33 (*Segregation of initial margins*); FMIO, Art 102(3) (*Treatment of initial margins*) ("counterparties must keep the initial margins received separate from their own assets and conclude a segregation agreement") and FMIA Art 110(2); MAS Paper para 7.2(b) ("arrangements shall ensure that the IM collateral collected is legally segregated from the collecting party's proprietary money and assets"); HKMA Paper para 3.5 (*Segregation of IM*) ("IM collected should be segregated from the IM collector's proprietary assets…"); CFTC Final Rule § 23.157 (*Custodial arrangements*).

26 See EMIR RTS pp 11-12 and Art 34(2) (*Treatment of collected initial margins*).

27 CFTC Final Rule § 23.157(c).

28 See MAS Paper paras 7.5 and 7.6.

29 See HKMA SPM, 3.4.4.

30 BCBS-IOSCO framework, para 5(v).

31 FMIO Art 102(2).

clarified that the MTA cap is to apply on a "per fund" basis (see my comment "Segregated Funds" above), and in addition it should be clarified that the MTA can be specified in non-AUD (see my comment "Base currency optionality" below). Paragraph 29 could be reworded as follows:

> "The combined variation margin and initial margin amount required to be posted or collected under this Prudential Standard ~~must~~ may be subject to a *de minimis* minimum transfer amount that must not exceed AUD 750,000 or the equivalent amount in another currency."

Due diligence

Paragraph 30 requires an APRA covered entity to undertake a reasonable level of due diligence to assess whether a counterparty is a covered counterparty. It would be helpful for APRA to clarify that an APRA covered entity may rely on representations from its counterparty in this regard, and that APRA covered entities are not expected to conduct verifications of the representations unless they are actually aware that those representations are incorrect.[32] This clarification would assist with the drafting of margining agreements.

Cross border application

The cross border aspects of the rules present a formidable challenge for regulators and international market participants. APRA's proposed substituted compliance rules as set out in paragraphs 63 to 65 are sensible in that they focus on comparable outcomes between home and host country regimes. However I have some reservations about the cross border rules set out in paragraphs 66 and 67. These paragraphs appear to permit asymmetric margining in a situation where a foreign ADI, Category C insurer or EFLIC is transacting with an Australian incorporated entity, if the non-Australian jurisdiction's rules are substantially similar to the BCBS-IOSCO framework. The term "substantially similar" is not defined, and is presumably a lower standard than the standard of "comparable in its outcomes" which applies for substituted compliance. I assume this is a lower standard because if the non-Australian jurisdiction's rules were comparable in outcome then the substituted compliance rules set out in paragraphs 63 to 65 would apply rather than the rules set out in paragraphs 66 and 67.

Paragraph 66 does not state whether it is APRA that will determine whether the foreign rules are "substantially similar" or whether this is a determination one or both counterparties must make. It is also unclear what the parameters are for determining substantial similarity, and whether it is an objective or subjective test. I submit that implementing an asymmetric margining rule risks putting some counterparties at a competitive advantage over other counterparties and therefore jeopardises the level playing field. For example, assume that a foreign jurisdiction implements the BCBS-IOSCO framework in a way which results in less margin needing to be posted than is required under CPS 226, but the implementation is still substantially similar to the BCBS-IOSCO framework. This could arise, for example, due to the foreign jurisdiction having a narrower definition of "derivative" such that the aggregate month-end average notional amount thresholds do not include as many transactions as are included by Australian incorporated ADIs in their

[32] This would be consistent with ESMA's approach.

calculations. The Sydney branch of a foreign ADI could therefore trade derivatives while posting less margin than would be required to be posted by an Australian incorporated ADI. This could give foreign ADIs a competitive pricing advantage and fragment the domestic market.

This risk would be minimised by APRA clarifying that it is the determining party for substantial similarity,[33] and clarifying that it will make determinations with due regard to the need to ensure a level playing field for local and foreign entities. I suggest that APRA include an additional rule to provide that when a foreign jurisdiction's definition of "derivative" differs from that set out in CPS 226, a foreign ADI, Category C insurer or EFLIC must post margin on the basis of the Australian definition as well as the definition of the foreign jurisdiction. Thus there would be no recognition of substantially similar definitions of "derivatives". In addition, recognised substituted compliance under paragraph 64 would be subject to the condition that the local and foreign definitions of "derivative" are applied by both counterparties. This addresses the fundamental difficulty that different jurisdictions have different definitions of what constitutes a "derivative", and that the BCBS-IOSCO framework does not provide a global standard definition of "derivative". My suggestion accords with the EU approach, which provides that where a counterparty is domiciled in a third country using a definition of OTC derivative contracts that is different from that of EMIR, counterparties must calculate margins for all contracts that meet either definition of an OTC derivative contract.[34]

Non-Netting Jurisdictions

Paragraph 68 disapplies the margining requirements where netting of derivatives is not enforceable upon insolvency or bankruptcy of the counterparty. Several observations may be made.

First, it would be helpful to clarify that the netting referred to is close-out netting, rather than other types of netting such as payment netting or netting by novation. The definition of close-out netting in APS 112 could be used here for clarity.

Secondly, the test in paragraph 68 is too absolute. In practice an assessment of the enforceability of netting rarely leads to a firm conclusion that netting is not enforceable. Rather, netting opinions for non-netting jurisdictions generally point to the uncertainty of netting due to either weak netting or insolvency set-off laws, or a lack of netting laws or established netting precedents. Even in the absence of netting laws and any precedent, it may be possible in theory on the basis of weak set-off laws or court discretion that a netting agreement is enforceable, although such jurisdiction would be classified as "non-netting". I suggest the test in paragraph 68 should be expressed in a manner consistent with the recognition of netting for capital adequacy purposes. For capital adequacy purposes a netting agreement may not be recognised "if there is any doubt as to the

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33 This would be consistent with the Swiss approach where FINMA makes the equivalence determination (FMIO Arts 106(1) and (2).

34 EMIR RTS Art 5(1) (*Margin calculation with third country counterparties*).

enforceability of the netting agreement".[35] Thus the first sentence of clause 68 should be reworded as follows:

> "An APRA covered entity is not required to post or collect variation margin or initial margin ~~where netting of derivatives is not enforceable~~ if there is any doubt as to the enforceability of the netting agreement upon insolvency or bankruptcy of the counterparty."

The above change would align more closely with the non-absolute test in paragraph 69 which refers to arrangements being "questionable or not legally enforceable", as well as the approach taken in the EMIR RTS which disapplies margining if, *inter alia*, "the legal review…does not confirm that the bilateral netting arrangements in the jurisdiction can be legally enforced with certainty at all times.[36] APRA covered entities which are subject to regulatory capital requirements will also be familiar with the analysis required to identify netting friendly jurisdictions which will reduce the need for such entities to develop new internal assessment processes. I note that the CFTC Final Rule is also non-absolute and is expressed positively rather than negatively, in that it recognises netting if, *inter alia*, there is "a well-founded basis" to conclude that a netting agreement is enforceable upon insolvency.[37]

Thirdly, CPS 226 does not set out any diligence requirements for parties to keep the enforceability of netting agreements and collateral arrangements under review. This appears to be an oversight in the drafting since the BCBS-IOSCO framework states that applicable netting agreements and collateral arrangements need to be "supported by periodically updated legal opinions".[38] In relation to netting I suggest that a similar diligence requirement should be included as per paragraphs 8 to 12, 16 and 21 of Attachment J to APS 112, which will minimise the operational burden for a party already performing legal assessments of netting for capital purposes.[39] A similar set of requirements should be added to CPS 226 in relation to legal opinions on collateral arrangements. It would be beneficial if APRA also provides guidance on the frequency with which such opinions need to be updated and clarifies whether such opinions may be provided by independent internal counsel as well as external counsel.

Base currency optionality

The Consultation Paper and CPS 226 express all thresholds in AUD without expressly stating that parties may select a non-AUD currency as the base currency (and termination currency) for their

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35 Prudential Standard APS 112 Capital Adequacy: Standardised Approach to Credit Risk. Attachment J (*Netting*), para 10.

36 EMIR RTS, paragraph 4(a) of Article 11.

37 Definition of "eligible master netting agreement" in CFTC Final Rule § 23.151 (*Definitions applicable to margin requirements*).

38 BCBS-IOSCO framework p16 (in relation to netting) and p20 (in relation to collateral arrangements).

39 This is consistent with the EMIR RTS, Arts 32(2) and (3), the MAS Paper, para 7.3, the PR Rule and the CFTC Final Rule (limb (4) of the definition of eligible master netting agreement).

margin documentation. It would be helpful to clarify that all thresholds set out in CPS 226 are amounts in AUD "or the equivalent amount in another currency ".[40]

Equity options

The EMIR RTS provide for a three year phase in before equity options are subject to margin requirements.[41] This is to avoid regulatory arbitrage since there is some uncertainty as to how some other jurisdictions (notably the US) will approach margining of these instruments. I submit that APRA should take a similarly cautious approach with a phase in for these products.

Thank you again for the opportunity to contribute to this important area of law reform, and for your consideration of the above points.

Yours sincerely,

Carl Baker

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[40] See for example HKMA SGM para 4.6.2 (setting out the threshold for reportable disputes as "HKD 100 million (or its equivalent in any other currency)").

[41] EMIR RTS Art 39(7).