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Dear Sir,

Consultation on Proposed Amendments to CPS 226 - Substituted Compliance for Margin Requirements for Non-Centrally Cleared Derivatives

I am a lawyer with over 15 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 on substituted compliance for margin requirements for non-centrally cleared derivatives. I would like to contribute by offering a few brief comments on the proposed amendments to Prudential Standard CPS 226.

Harmonising the extraterritoriality of G20 margin rules is undoubtedly one of the biggest challenges faced by regulators worldwide. It is also unavoidable if we are to realise the G20's vision of a well regulated global derivatives market. For this reason I fully support the move by APRA towards greater harmonisation with the rules of other key G20 jurisdictions. APRA proposes to harmonise simultaneously with the regimes issued or administered by 14 foreign regulators (not counting the individual regulators in each member state of the EU). This is an ambitious proposal and the differing extraterritorial reach of each regime presents a genuine test to APRA's principle-based approach. In this submission I will restrict my comments to consideration of harmonisation between the Australian and the EU[1] margin regimes, although the points made are relevant in a broader context.

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

- the meaning of "margin requirements or provisions" as used in paragraphs 62, 63 and 64 of the draft amendments to CPS 226
- the meaning of "subject to" as used in paragraph 64 of the draft amendments to CPS 226
- portfolio margining
- the risk of circularity
- the administration of substituted compliance

[1] As set out in Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**"), as amended, and related technical standards.

The meaning of "margin requirements or provisions"

The proposed new paragraphs 62 to 64 of CPS 226 use the expression "margin requirements or provisions" to refer to the non-Australian margin rules, and use the expression "margin requirements" to refer to the Australian margin rules. Several observations may be made. First, it is not clear what additional element is intended by referring to the "provisions" of foreign regimes in addition to the "requirements" of foreign regimes. Nor is it clear why the "provisions" of foreign regimes are relevant whereas the "provisions" of CPS 226 are not relevant for substituted compliance.

Paragraph 62 states that Attachment D sets out the margin requirements or provisions that are comparable with the BCBS-IOSCO framework and the requirements of CPS 226. However Attachment D only contains a list of regulators and doesn't provide any further details of which requirements or provisions of the foreign regimes are covered. This can be contrasted with the approach of other regulators such as the CFTC where comparability determinations are made on a much more granular basis.[2] There are material differences between the margining regimes of different jurisdictions[3] and paragraph 62 as currently drafted paints with a very broad brush.

A further comment is that the rules of some margin regimes are set out in instruments which also include other rules. If these other rules are considered to be "provisions" encompassed by the term "margin requirements or provisions" then an APRA covered entity could be required to comply with these since paragraphs 63 and 64 refer to the need for substituted compliance with the foreign margin requirements or provisions "in their entirety". This could be a disincentive for an APRA covered entity to rely on substituted compliance thereby undermining the effectiveness of APRA's harmonisation efforts.

I submit that it would be helpful if APRA could provide guidance to the market as to which elements of CPS 226 are "margin requirements" and which elements of CPS 226 are margin "provisions" rather than margin requirements. For example, whether the due diligence requirement set out in paragraph 29, the margin model rules in paragraphs 33 to 44, the risk mitigation rules in paragraphs 71 to 94, and the APRA override rule in paragraph 95 are "margin requirements" eligible for substituted compliance or provisions which fall outside the scope of paragraph 63. If some or all of the rules in CPS 226, including without limitation paragraphs 29, 33-44, 71-94 or 95 are not "margin requirements" eligible for substituted compliance then there is a risk of rule duplication if an APRA Covered Entity is required to comply with the entirety of the foreign regime's margin requirements or provisions as well as the parts of CPS 226 which are not "margin requirements". This again could be a disincentive for an APRA covered entity to rely on substituted compliance.

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[2] For example the CFTC's *Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 FR 63376 (15 Sept 2016) ("**Comparability Determination for Japan**").

[3] To mention just a few examples - the CFTC Final Rules contain no rating requirements for collateral whereas EMIR does. Switzerland only recently consulted on numerous amendments to its margin rules to better align with EMIR. The Australian regime excludes covered bond SPVs altogether as covered counterparties, whereas EMIR and the Swiss regime take a different approach. The EU is currently considering further changes to EMIR to better align with the US regimes.

If APRA does not intend there to be any difference in meaning between the terms "margin requirements or provisions" and "margin requirements", I respectfully suggest that the expression "margin requirements" be used to refer to both the Australian regime and to foreign regimes.

The meaning of "subject to"

Both limbs of paragraph 64 include a condition that the relevant entity be "subject to" the margin requirements or provisions of the relevant foreign jurisdiction. Three observations may be made. First, the expression "subject to" is ambiguous. It may refer to any entity which falls within the scope of a foreign regime's margin rules. For example, in the case of EMIR, any legal or natural person established in the EU that is a legal counterparty to a derivative contract is in one sense "subject to" EMIR, even if it is not required to exchange margin thereunder (for example due to such entity being an "NFC-"). I submit that an entity should not be considered to be "subject to" a margin regime unless such entity is legally required to exchange margin under such regime's margin rules. Thus in the case of substituted compliance with EMIR, an NFC- should not be considered to be "subject to" EMIR.[4] This interpretation would ensure that substituted compliance is not available on a voluntary basis to a party that is not legally required to comply with a foreign margin regime. Clarification from APRA that this is indeed the correct interpretation of the expression "subject to" would be helpful.

Secondly, subparagraph 64(b) uses the term "directly subject to", whereas subparagraph 64(a) only refers to "subject to". This could be taken to indicate that APRA intends to capture covered counterparties which are <u>directly or indirectly</u> subject to foreign margin rules in paragraph 64(a). Identifying covered counterparties which would be considered to be indirectly subject to foreign margin rules is not entirely straightforward. Experience has shown that some OTC derivative regulation has an indirect extraterritorial effect due to entities which are subject to such regulation encouraging or requiring their cross border counterparties to comply with it in order to ensure their own compliance. This indirect extraterritorial effect is clearly evidenced for example when it comes to trade reporting, where even counterparties that are not legally required to report are still required by their counterparties to provide information such as an LEI before they are permitted to trade. In my view this type of indirect extraterritorial effect should not be a sufficient basis for subparagraph 64(a). As stated in the preceding paragraph, my view is that substituted compliance should only be available where one or both of the APRA covered entity and the covered counterparty are <u>legally required</u> to comply with a foreign margin regime. I submit that criteria based on being directly (or indirectly) subject to a foreign margin regime introduces ambiguity into the rules.

This leads to the third point which relates to how in practice an APRA covered entity can verify that it is facing a counterparty that is subject to foreign margin requirements or provisions. I submit that paragraph 29 of CPS 226 should be extended to allow an APRA covered entity to also rely on a self-declaration or public disclosure from a covered counterparty that it is subject to a foreign

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[4] I note that since a covered counterparty must be a financial institution it is likely that most covered counterparties would be considered to be a financial counterparty (FC) rather than an NFC- for the purposes of EMIR if such party were established in the EU.

margin regime. The determination of whether a covered counterparty is subject to a foreign margin regime is not always straightforward and an APRA covered entity will often not be in the best position to assess this. For example, if a covered counterparty is established outside the EU then one of the ways in which it could fall under EMIR is if it benefits from a guarantee which, *inter alia*, exceeds certain cumulative thresholds. It imposes an undue burden on an APRA covered entity to have to diligence that guarantee and it would be reasonable for the APRA covered entity to be able to rely on a representation from the counterparty that it is legally subject to a foreign margin regime.

In addition I suggest that APRA consider reserving for itself the power to require an APRA covered entity to provide, or to procure that its covered counterparty provide, as the case may be, a legal opinion in support of its claim that it is subject to a foreign margin regime. This will allow APRA to verify the appropriate use of substituted compliance. I suggest APRA provide guidance as to whether such opinions need to be from reputable external counsel or can also be provided by in-house counsel.

Portfolio Margining

A significant issue in relation to substituted compliance is whether it takes effect on a portfolio basis or only on a transaction by transaction basis. To illustrate this point in the case of EMIR, let us assume that the European Commission has not declared Australia's margin rules to be equivalent to EMIR and that a covered counterparty established outside the EU enters into three OTC derivative transactions:

1. first, an OTC derivative transaction with an APRA covered entity incorporated in Australia and acting through its Sydney branch ("**APRA covered entity A**") which does not have a direct, substantial and foreseeable effect within the EU and which is not designed to evade EMIR ("**Transaction 1**");

2. one week later, an OTC derivative transaction with a different APRA covered entity ("**APRA covered entity B**") which does have a direct, substantial and foreseeable effect within the EU ("**Transaction 2**"); and

3. one week later, an OTC derivative transaction with APRA covered entity A which has a direct, substantial and foreseeable effect within the EU ("**Transaction 3**").

When Transaction 1 is entered into the covered counterparty is not subject to EMIR. The Australian margin rules will apply to Transaction 1. This is uncontroversial.

EMIR will apply to Transaction 2 when it is entered into the following week with APRA covered entity B. At this point subparagraph 64(a) becomes potentially relevant for APRA covered entity A with respect to Transaction 1 because Transaction 1 is now with a covered counterparty that is "subject to" EMIR (albeit not in respect of Transaction 1). I submit that at this time substituted compliance with EMIR should still not be available in respect of Transaction 1. That is, the parties to Transaction 1 should still be required to comply with the Australian margin rules and should not

be permitted to substitute compliance with EMIR. Subparagraph 64(a) as currently drafted does not clearly state this position and I submit that more clarity on this approach would be helpful.

The following week the covered counterparty and APRA covered entity A enter into Transaction 3. EMIR will apply to Transaction 3 and subparagraph 64(a) is clear that substituted compliance is available with respect to Transaction 3. The covered counterparty is "subject to" EMIR. The question is whether Transaction 1 at this point in time also becomes eligible for substituted compliance. This is a policy decision for APRA which isn't clearly answered by the current drafting of subparagraph 64.[5] If substituted compliance does not become possible for all transactions between APRA covered entity A and the covered counterparty then netting sets will need to be split and portfolio margining would be disrupted. In addition a party may need to make multiple margin calls under a single master agreement – one margin call in relation to the transactions covered by the Australian rules, and other margin calls in relation to transactions covered by foreign margin rules. Using the above example, a margin call in relation to Transaction 1 would be made under the Australian rules whereas a margin call in relation to Transaction 3 would need to be made under EMIR, if the parties elect for substituted compliance. I submit that market participants may be deterred from relying on substituted compliance due to concerns about splitting netting sets and the operational burden/complexity of managing margining under two or more margining regimes simultaneously. As APRA is aware, the great majority of cross-border uncleared OTC derivative transactions take place between two parties using a single ISDA Master Agreement. Maximising netting opportunities is a key concern, particularly for entities subject to prudential capital requirements. For these reasons guidance from APRA on this important point would be welcome.

Circularity

Paragraph 63 disapplies the margin requirements of CPS 226 in certain circumstances. This disapplication is permitted on the basis that the APRA covered entity complies with the margin requirements or provisions of the foreign regime instead. However this potentially gives rise to a lacuna and a form of renvoi if the foreign regime similarly dispplies its rules. In this situation the risk is that both Australia and the foreign regime defer or refer to each other such that neither regime ends up requiring margining. To illustrate how this might occur let us assume that an APRA covered entity incorporated in Australia is facing a financial counterparty established in the EU. Subparagraph 64(a) of CPS 226 is therefore satisfied. Let us further assume that the EU has adopted an implementing act declaring equivalence between the margin regimes of Australia and EMIR. In this situation Article 13(3) of EMIR would deem the provisions of EMIR to be fulfilled if the counterparties apply the Australian margining rules. The counterparties apply paragraph 63 of CPS 226 which switches off the Australian margin requirements. Each counterparty can claim that it is complying with both margining regimes although neither counterparty is actually exchanging margin.

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[5] I note that the CFTC's approach in the Comparability Determination for Japan is to limit substituted compliance to only transactions which are subject to both the CFTC margin rules and the JFSA's margin rules.

I submit that the above result cannot be intended. To avoid it, the substituted compliance provisions of foreign margining regimes should be carved out of paragraphs 63 and 64. Thus instead of providing that the foreign margin requirements or provisions must be satisfied in their entirety, CPS 226 could require the satisfaction of "foreign margin requirements or provisions[6] (other than those relating to substituted compliance)".

Administering substituted compliance

A key question in relation to substituted compliance is how APRA intends to actually verify and monitor substituted compliance in practice. Will APRA outsource the expertise of foreign margin regimes to counsel in each relevant foreign jurisdiction, or work with foreign regulators to share the supervision of foreign counterparties who are complying with the Australian rules in place of their foreign rules? Will "colleges" of regulators be established to regulate parties relying on substituted compliance, similar to the CCP colleges established to regulate CCPs under EMIR? Do additional memoranda of understanding need to be put in place with foreign regulators to facilitate the substituted compliance process? Guidance on how APRA intends to regulate APRA covered entities with respect to compliance with foreign regimes, and foreign entities with respect to substituted compliance with the Australian regime, would be most welcome.

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

[6] If the suggestion in the preceding section of this submission "*The meaning of "margin requirements or provisions*" is adopted then the words "or provisions" would be omitted from this suggested redrafting.