

June 5, 2017

General Manager, Policy Development  
Policy and Advice Division  
Australian Prudential Regulation Authority (“APRA”)  
PolicyDevelopment@apra.gov.au

Dear General Manager

**Substituted compliance for margin requirements for non-centrally cleared derivatives**

The International Swaps and Derivatives Association, Inc. (**ISDA**)<sup>1</sup> is grateful for the opportunity to comment on the May 2017 consultation draft of *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (“**Draft CPS 226**”), in which APRA proposes to recognise substituted compliance with respect to the margin requirements or provisions issued or administered by the bodies specified in Attachment D of Draft CPS 226. Our members may choose to make their own individual submissions on Draft CPS 226 and our submission is limited to the specific issues raised in this submission.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements and collateral arrangements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

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<sup>1</sup> **About ISDA:** Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 68 countries. These members comprise a broad range of 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, such as exchanges, intermediaries, clearing houses 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 website: [www.isda.org](http://www.isda.org).

ISDA acknowledges and supports the general policy intention evidenced in the letter dated 9 May 2017 accompanying Draft CPS 226 to recognise substituted compliance with respect to foreign margin requirements. However, there are a number of points which we consider important to clarify at this stage before Draft CPS 226 is finalised.

## *Submissions*

For the reasons set out below, ISDA submits that clarification of each of the following would significantly enhance the effectiveness of the policy intention:

- (a) **Please clarify the application of substituted compliance in respect of risk mitigation requirements and provide further guidance regarding the content and the scope of these requirements**

We note that the proposed substituted compliance provisions in paragraphs 62 to 64 of Draft CPS 226 currently only apply in respect of the margin requirements in CPS 226 (and not the risk mitigation requirements). However, we note that the “deference” regime in paragraph 65 of Draft CPS 226 and the “Level 2” compliance regime in paragraph 66 of Draft CPS 226 also apply in respect of the risk mitigation requirements of Draft CPS 226.

We kindly request that APRA clarify if, and when, the substituted compliance provisions in paragraphs 62 to 64 of Draft CPS 226 will be extended to the risk mitigation requirements which apply under CPS 226.

Also, we welcome that the risk mitigation requirements set out in Draft CPS 226 are principles-based. We would welcome a dialogue with APRA as to how to implement these principles and would be grateful if APRA could please consider providing further guidance as to both the content and the scope of these requirements so as to facilitate APRA covered entities putting in place the required policies and procedures and documentation. We would be grateful if APRA could please consider whether the risk mitigation requirements would be satisfied through use of, and compliance with, the ISDA documentation and protocols which have been published for use with the equivalent requirements under the European and US regimes. For example, we refer to the *ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol*, *ISDA August 2012 DF Protocol*, the *ISDA March 2013 DF Protocol* and the *ISDA Amendment Agreement relating to HKMA Risk Mitigation Standards*.

- (b) **Please clarify the scope of transactions in respect of which an APRA covered entity may rely on substituted compliance under paragraphs 62 to 64 of Draft CPS 226**

Paragraph 63 of Draft CPS 226 provides that the margin requirements of Draft CPS 226 do not apply “to transactions” in which an APRA covered entity complies with the relevant foreign margin requirements or provisions issued or administered by the foreign bodies listed in Attachment D of Draft CPS 226 (“**Foreign Requirements**”) in their entirety (subject to paragraph 64). Paragraph 64 of Draft CPS 226 further provides that substituted

compliance is only available “*in a transaction*” where the APRA covered entity is transacting with a covered counterparty that is subject to the Foreign Requirements “and/or” the APRA covered entity is directly subject to the Foreign Requirements.

On one view, paragraphs 63 and 64 of Draft CPS 226 can be construed as allowing an APRA covered entity to rely on the entity’s general compliance with Foreign Requirements for a transaction where either or both of the conditions of paragraph 64 are satisfied (eg where the APRA covered entity is directly subject to the Foreign Requirements), irrespective of whether the Foreign Requirements actually impose a specific requirement to exchange margin in respect of the transaction.<sup>2</sup> However, the reference to “transactions” and “in a transaction” in these paragraphs of Draft CPS 226 could be construed as restricting the availability of substituted compliance to transactions in which the Foreign Requirements actually impose an obligation to exchange margin in respect of that transaction.

We kindly request that APRA clarify:

- (i) that an APRA covered entity is entitled to rely on its general compliance with Foreign Requirements to which it is directly subject (or to which its counterparty is subject) in lieu of the Australian margin requirements in respect of a transaction which is required to be margined under the Australian margin requirements; and
- (ii) that substituted compliance can be relied on in the circumstances described in paragraph (i) even though the APRA covered entity is not required to exchange margin under the Foreign Requirements in respect of that transaction; and
- (iii) whether the APRA covered entity would need to comply with the Foreign Requirements in their entirety, including in respect of transactions under which margin would not otherwise need to be exchanged under the Australian margin requirements, in order to rely on substituted compliance.

This clarification is important to members because the narrower interpretation (ie that an APRA covered entity cannot rely on substituted compliance in respect of a transaction which is in-scope under Draft CPS 226 but exempt under the relevant foreign margin requirements) would largely defeat purpose of the substituted compliance regime under Draft CPS 226. This is because counterparties would need to either:

- (a) monitor every individual transaction against the relevant definition of “in-scope non-cleared derivative” under each applicable set of rules, and ensure that they comply with Draft CPS 226 for all transactions which are in-scope under the APRA

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<sup>2</sup> For example, we note the references in Draft CPS 226 to an APRA covered entity complying with “the relevant foreign margin requirements or provisions” and that, if the conditions of paragraph 64 of Draft CPS 226 are satisfied, an APRA covered entity may “substitute compliance with the margin requirements or provisions (in their entirety) of a foreign jurisdiction”.

Rules but exempt under the relevant foreign rules (which may be operationally very burdensome); or

(b) apply the “strictest of” approach to all transactions (in which case they would effectively not be relying on substituted compliance at all).

**(c) Please clarify the scope of counterparties in respect of which an APRA covered entity may rely on substituted compliance under paragraphs 62 to 64 of Draft CPS 226**

APRA has previously addressed the definition of “financial institution” in its “Response to Submissions: Margining and risk mitigation for non-centrally cleared derivatives” dated 17 October 2016 (on an earlier draft of the prudential standard). In its response to comments received on this point, APRA stated:

*APRA considers its definition of financial institution to be functionally based and internationally comparable. However, APRA recognises the challenge of determining the status of a counterparty located in a foreign jurisdiction. APRA emphasises that substituted compliance will be important in this regard in order to minimise difficulties across jurisdictions. Where APRA has granted substituted compliance in relation to the margin requirements of a foreign jurisdiction, an APRA covered entity may use the counterparty’s status under the margin requirements of the relevant foreign jurisdiction to determine whether it is a covered counterparty when applying the foreign margining regime to the transaction.<sup>3</sup>*

In light of these comments, we would be grateful if APRA could please confirm that an APRA covered entity is able to rely on substituted compliance under paragraphs 62 to 64 of Draft CPS 226 when dealing with a counterparty in circumstances where the relevant Foreign Requirements to which the covered counterparty or APRA covered entity is subject do not require the exchange of margin in respect of that trading relationship (due to the characterisation of the APRA covered entity or its counterparty under the relevant Foreign Requirements), even where the Australian margin requirements would otherwise require the exchange of margin for that relationship. This would be relevant where, for example, the APRA covered entity’s counterparty was a “financial institution” and a “covered counterparty” under Draft CPS 226 but was not a counterparty in respect of which the entity must exchange margin under the Foreign Requirements.

**(d) Please clarify that the condition in paragraph 2 of Attachment D does not affect the “deference” regime in paragraph 65 of Draft CPS 226**

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<sup>3</sup> APRA, Response to Submissions: Margining and risk mitigation for non-centrally cleared derivatives (17 October 2016), [2.4.1].

Relevantly, Draft CPS 226 contemplates an APRA covered entity being able to rely on either or both of the “substituted compliance” regime under paragraphs 62 to 64 and the “deference” regime in paragraph 65.<sup>4</sup>

We note that the substituted compliance provisions of paragraphs 62 to 64 of Draft CPS 226 are predicated on specific Foreign Requirements, which are those which are issued or administered by the foreign bodies listed in Attachment D of Draft CPS 226. These substituted compliance provisions are also subject to a condition, namely that substituted compliance is not permitted for a transaction where the APRA covered entity and the covered counterparty are both members of the same margining group (“**Condition**”).

We understand that the “deference” regime set out in paragraph 65 of Draft CPS 226 has different criteria which must be satisfied in order for it to apply (eg the APRA covered entity must do an internal assessment which positively demonstrates specified matters) and may apply in different circumstances to those set out in paragraphs 62 to 64 of Draft CPS 226, and that the Condition is not intended to apply in respect of the “deference” regime under paragraph 65.

We kindly request that APRA confirm that the Condition does not apply to the “deference” regime set out in paragraph 65 of Draft CPS 226.

- (e) Please clarify that the Foreign Requirements listed in Attachment D satisfy the requirement in paragraph (ii) of the “deference” regime in paragraph 65 of Draft CPS 226 but do not otherwise limit the requirements in respect of which an APRA covered entity may make an internal assessment under paragraph 65 of Draft CPS 226**

We understand that APRA considers the margin requirements or provisions of a foreign jurisdiction which are listed in Attachment D of Draft CPS 226 to be comparable in outcomes with the BCBS-IOSCO framework and the requirements of Draft CPS 226. In contrast, the “deference” regime in paragraph 65 of Draft CPS 226 is enlivened if a foreign ADI, Category C insurer or EFLIC is directly subject to margin requirements which are substantially similar to the BCBS-IOSCO framework or risk mitigation requirements which are substantially similar to IOSCO’s Risk Mitigation Standards respectively. In order to avail itself of the “deference” regime, the relevant APRA covered entity is required to complete an internal assessment which positively demonstrates, among other things, how the requirements of the foreign jurisdiction are substantially similar to the BCBS-IOSCO framework or IOSCO’s Risk Mitigation Standards (as applicable).

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<sup>4</sup> We note that an APRA covered entity may also apply for approval by APRA to comply with a foreign jurisdictions requirements in accordance with and as set out in paragraph 66 of Draft CPS 226.

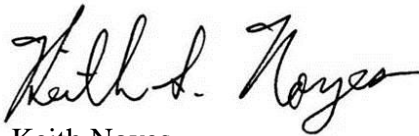
We kindly request that APRA please confirm that the Foreign Requirements listed in Attachment D of Draft CPS 226:

- (i) satisfy the requirement in paragraph 65 that the foreign ADI, Category C insurer or EFLIC must positively demonstrate how the requirements of the foreign jurisdiction are substantially similar to the BCBS-IOSCO framework or IOSCO's Risk Mitigation Standards (as applicable) in respect of those requirements (without affecting the requirement imposed on the relevant APRA covered entity to positively demonstrate the matters described in paragraphs (i) and (iii) of paragraph 65); and
- (ii) do not limit the margin requirements or risk mitigation requirements which a foreign ADI, Category C insurer or EFLIC may determine to be substantially similar to the BCBS-IOSCO framework or IOSCO's Risk Mitigation Standards (as applicable) for the purposes of its internal assessment under the "deference" regime of paragraph 65 of Draft CPS 226.

We thank you for the opportunity to respond to the consultation on Draft CPS 226. We would be very happy to discuss this matter further at your convenience. Please do not hesitate to contact Keith Noyes, Regional Director, Asia Pacific ([knoyes@isda.org](mailto:knoyes@isda.org), +852 2200 5900), Erryan Abdul Samad, Assistant General Counsel ([abdulsamad@isda.org](mailto:abdulsamad@isda.org), +65 6653 4170), Jing Gu, Senior Counsel ([jgu@isda.org](mailto:jgu@isda.org), +65 6653 4170) or Rishi Kapoor, Director, Public Policy, Asia-Pacific ([rkapoor@isda.org](mailto:rkapoor@isda.org), +852 2200 5900) if we may be of further assistance.

Yours sincerely,

For the **International Swaps and Derivatives Association, Inc.**



Keith Noyes

Regional Director, Asia-Pacific