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Department of the Treasury, Australian Government paper ‘Handling and use of client money in relation to over-the-counter derivatives transactions’

This letter contains the response of the International Swaps and Derivatives Association, Inc. (“ISDA”) to the Australian Government paper on the *Handling of client money in relation to over-the-counter derivatives transactions* of November 2011. ISDA thanks the Australian Treasury for the opportunity to comment on these issues and welcomes further dialogue with the Australian Treasury on this letter.

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

As the Australian Treasury is likely aware, ISDA is actively engaged with providing input on regulatory proposals in the United States, Canada, the European Union and in Asia. Our response is derived from these efforts and from consultation with ISDA members operating in Australia. Our response is not focussed on technical changes to Australian law or regulation related to the implementation of reform.

Accordingly, we have limited our submission to the treatment of collateral in the context of OTC derivatives in the wholesale market. ISDA believes that there are fundamental differences between wholesale and retail markets that warrant different considerations as to the treatment of money paid by clients in each market. Retail clients are generally less sophisticated than wholesale clients and less likely to understand fully the risks associated with posting collateral or the complex protections afforded to certain types of collateral under the Corporations Act. The paper appears to recognise this distinction and indeed the Corporations Act in its current form enshrines this distinction. In addition, it should be noted that the collapse of MF Global has not highlighted problems with the way collateral is

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managed in the wholesale OTC derivatives markets but has instead highlighted concerns over the manner in which MF Global was treating collateral received from retail clients trading contracts for difference products and other increasingly popular retail- oriented derivative products.

In this context, ISDA also notes that the best protection of money paid by a client results from dealing with a counterparty with a sound balance sheet and proper control procedures in place to prevent misappropriation of client funds. Arrangements such as fully segregated accounts do not of themselves offer complete protection against fraud, or other misappropriation of client accounts.

As the Australian Treasury (and the Australian financial regulators) is aware, the provision of collateral by counterparties to each other is an important part of the wholesale derivatives market. Indeed, the increased use of such collateral arrangements is recommended in the May 2009 paper published by the Reserve Bank of Australia, the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission: *Survey of the OTC derivatives market in Australia*. Also, it was commented on as an important feature of the Australian wholesale OTC derivative market in the subsequent paper published by the same authorities in June 2011: *Central clearing of OTC derivatives in Australia*.

In Australia (as in England, but not as in the United States¹) this collateral is usually provided by an absolute transfer under a Credit Support Annex published by ISDA (and which is referred to in the *Survey of the OTC derivatives market in Australia*). It is a fundamental part of the commercial and legal operation of the title transfer collateral arrangements used in Australia that there are no client money restrictions in relation to the collateral which has been provided. If regulatory requirements were imposed which derogated from the absolute nature of this transfer then these collateral arrangements would not achieve the credit risk mitigation objectives intended by the parties, or desired by the regulators of these markets. Accordingly, it is important that they are able to operate without an overlay of regulatory requirements which could conflict with their purpose and current structure. Whilst it may be technically possible for the market to move to a security interest based approach this would involve a massive renegotiation exercise that would inevitably lead to market disruption and increased costs for wholesale market participants.

Therefore, if the client money protections contained in the Corporations Act are tightened in any way in response to recent events, we would strongly argue that either (i) the current exemptions/safe harbours on which the wholesale OTC derivatives market depends to enable it to continue with title transfer collateral arrangements should be preserved for wholesale clients and the client money protections currently applicable to wholesale OTC derivatives collateral arrangements which are not title transfer should not be further tightened; or (ii) preferably, new provisions should be included in the Corporations Act that clearly create a safe-harbour or exemption for all types of wholesale OTC derivatives related collateral arrangements.

¹ In the United States, such collateral is usually provided by the granting of a security interest (under a different Credit Support Annex which is also published by IDSA). The different methods reflect the different legal frameworks in these countries.



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

Yours sincerely,

A handwritten signature in black ink that reads "Keith Noyes".

Keith Noyes

Regional Director, Asia Pacific

International Swaps and Derivatives Association, Inc.