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Dear Oliver,

**Request for ASIC Class Order relief: Central Clearing of Swaps Resulting from Transactions in Swaptions Entered Into Prior to the Clearing Commencement Date**

The International Swaps and Derivatives Association, Inc. (“ISDA”) and the Australian Financial Markets Association (“AFMA”) (the “Associations”) are submitting a request for a Class Order exemption, on the basis of a minor and technical departure from existing policy. This request relates to the concern raised by our members that under the *ASIC Derivative Transaction Rules (Clearing) 2015* (“Clearing Rules”), an interpretation of the Clearing Rules could result in certain interest rate swaptions entered into before the commencement of mandatory clearing in Australia (“Pre-Mandate Swaptions”) which are subsequently exercised giving rise to swaps (“Underlying Swaps”) which must be cleared. This obligation would arise, notwithstanding the pricing of that Pre-Mandate Swaption having been based on the Underlying Swap being a bilateral transaction (and not centrally cleared), and the implications that such a requirement would have for the legal certainty inherently formed within derivative contracts at the time of execution.

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 ISDA's web site: [www.isda.org](http://www.isda.org).

ISDA is actively engaged with providing input on regulatory proposals in the United States (the “US”), Canada, the European Union (the “EU”) and Asian jurisdictions, including Singapore and Hong Kong, among others. The Associations’ comments are derived from this international experience and constant dialogue, and reflect the views of both firms in the Asia-Pacific region and from further afield. As OTC derivatives tend to be cross-border in nature, we wish to highlight the importance of ensuring that regulatory requirements have a consistent domestic and cross-border effect, so as to not disproportionately impact any one sector of what is a global market. In the context of this request, we note that similar relief to that being requested under this request has been granted under the central clearing regimes of the US and EU, and we are engaging with the regulators of the Hong Kong and Singapore OTC derivative markets on similar issues.

We set out our reasoning for this request below.

### **Problem**

Under the Clearing Rules, Pre-Mandate Swaptions entered into before 4 April 2016 (“**Clearing Commencement Date**”) which are subsequently exercised may give rise to Underlying Swaps which must be centrally cleared. In the absence of a central clearing requirement in Australia for these Underlying Swaps at the time at which the Pre-Mandate Swaption was entered into, the pricing of the Underlying Swap, and therefore the overall price of the Pre-Mandate Swaption, would and could not have contemplated the non-trivial impact of a central clearing requirement.

Requiring such Underlying Swaps to be cleared would materially and irrevocably change the fundamental economics of those swaptions and swaps, and would serve to significantly undermine principles around the enshrined legal certainty of the terms of a contract at the point of execution, and the intention to only apply clearing requirements on a prospective basis. It would also entail significant pricing, resourcing and operational costs for clearing entities, as detailed below.

### **What are the Facts?**

The Clearing Rules set out the various specifications for the types of derivatives within the interest rates asset class, requiring that if a derivative falls within these specifications, it be centrally cleared where entered into after the Clearing Commencement Date. However, the Clearing Rules do not currently distinguish between derivatives where the impact of the central clearing requirements (now that they have been finalised) can be factored into the

pricing of the contract, and those historical transactions for which pricing has already been finalised and executed against by reference to the original terms of the contract, including the underlying components being bilaterally cleared. Therefore, in the absence of relief, the central clearing requirement would disproportionately and negatively impact Pre-Mandate Swaptions, as well as their contingent future Underlying Swaps, as clearing entities would need to identify, reprice and re-execute these swaptions, having fundamentally altered their constituent terms.

It is also a well-established principle that having legal certainty of the terms of a transaction at the point of its execution should not be undermined. This principle underpins the entire legal framework of the OTC derivative markets, and therefore any requirement which had the effect of advertently or inadvertently detracting from this, including the current requirement to clear Pre-Mandate Swaption Underlying Swaps, would have significant flow-on implications for the inherent legal certainty governing all financial contracts at the time of execution.

It is further contended that at no stage prior to the publication of the list of Australian Clearing Entities and Foreign Clearing Entities by ASIC (following ASIC's receipt of notifications from those entities under Rule 3.1.1 of the Clearing Rules) would it have been possible for such entities to know that a Pre-Mandate Swaption may require clearing of its components after the Clearing Commencement Date.

Regulators globally have actively listened to the industry's concerns such as those above, and have provided clarification or explicit relief from these requirements, as follows below.

#### International Approaches - EU

The European Securities and Markets Authority (“**ESMA**”) has previously set out its stance on the issue of Pre-Mandate Swaptions and Underlying Swaps. Although the issue is slightly more complicated due to the frontloading requirements under the European Market Infrastructure Regulation (“**EMIR**”), OTC Answer 20(b) of the Questions and Answers on Implementation of the Regulation (EU) No. 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)<sup>1</sup> (“**EMIR FAQ**”) clarifies ESMA's position insofar as it would be directly applicable to the Australian context:

*“A swap which results from the exercise of a swaption is subject to the clearing obligation when any of the following conditions are met:*

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<sup>1</sup> <https://www.esma.europa.eu/file/16092/download?token=NIO5kn11>

- (i) *the swap and the corresponding swaption are entered into on or after the date on which the clearing obligation takes effect...*”

### International Approaches – CFTC

The US Commodity Futures Trading Commission (“**CFTC**”) has considered this matter previously, in the context of its administration of swap mandatory clearing requirements under the Dodd-Frank Act and related legislation, and has clarified that the Underlying Swaps of Pre-Mandate Swaptions in the US are not required to be cleared. Indeed, the CFTC Clearing Requirement Determination Under Section 2(h) of the CEA<sup>2</sup> states:

*“ISDA reasoned that the parties to a swaption or an extendible swap would not have taken into account the cost of clearing the resultant swap if they negotiated the price of the option before a clearing requirement was applicable to the Underlying Swap or extended swap...The Commission agrees that the cost of clearing may not be reflected in the pricing of the swaption or extendible swap if the clearing requirement for the Underlying Swap or the extendible swap arises after the execution of the swaption or extendible swap. The Commission is thus clarifying that the clearing requirement only applies to swaps resulting from the exercise of a swaption or extendible swap extension if the clearing requirement would have been applicable to the Underlying Swap or the extended swap at the time the counterparties executed the swaption or extendible swap.”*

We would also take this opportunity to inform ASIC that ISDA is holding similar discussions with the regulators of the Hong Kong and Singaporean OTC derivative markets as they finalise their clearing regimes, to seek similar clarifications and dispensations to those under this submission. To the extent possible, and in light of recent examples of very constructive pan-Asian regulator discussions on industry issues such as implementation of the unique transaction identifier (“**UTI**”), we would encourage regulatory convergence across the jurisdictions on the substance and form of relief.

### **What is the Impact of the Problem?**

If it were required that all swaps resulting from the exercise of swaptions, without distinction as to when the swaption was entered into, were to be subject to the clearing obligation, this would not only require entities to materially adjust the economics of legacy transactions, but also be contrary to principles around the need for legal certainty at the point of execution, and

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<sup>2</sup> <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister112812.pdf>

the intention to only apply the clearing requirements on a forward-looking basis. Without the swaption being entered into, the Underlying Swaps would never have come into existence. It would be therefore misleading and counterproductive to consider the exercise of swaptions in isolation of the trade date of the swaption.

### Pricing Impacts

Because there was no legal certainty or expectation that Underlying Swaps resulting from the exercise of Pre-Mandate Swaptions would be subject to a clearing obligation, such legacy swaptions will have traded and been priced on a bilateral, non-cleared basis. Moreover, it is also likely that some legacy transactions were traded before a clearing mandate was even contemplated in Australia. The impact of this is seen in the example whereby a contractual right to terminate due to rejection of the Underlying Swap by the CCP may have been inserted and priced in to the Pre-Mandate Swaption if a clearing mandate had been in existence.

Swaptions traded bilaterally will have typically been priced as a function of the credit support annex (“CSA”) associated with the contract. In cash-collateralised trades, the rate at which interest is paid on collateral held pursuant to the CSA is the rate used to discount the future cash-flows of the derivative – this is generally accepted to be the relevant overnight index swap (“OIS”) rate. For example, the cash flows of a US dollar-denominated fixed-to-floating interest rate swap collateralised with US dollars will be discounted using the Fed Funds rate. Whereas, if the contract was collateralised with Euros, the discount rate would have to take into account the term basis swap between the currency of exposure (dollars) and that of the collateral (euros).

Clearing houses typically require that the currency of the derivative determine the currency of the mark-to-market collateral posted daily (variation margin) – for example, a US dollar-denominated derivative must be collateralised with US dollars, and is therefore valued using the Fed Funds rate. However, derivatives concluded in the bilateral space are subject to a plethora of different collateral agreements – ranging from single currency CSAs to multi-currency, multi-instrument CSAs (many of which allow the posting of non-cash assets such as corporate bonds). Many trades are also uncollateralised, and are typically discounted at a given dealer's own costs of funds.

As a result, the resulting swap from the exercise of the swaption will be subject to a re-pricing adjustment at the point it is cleared at a CCP. Because this future revaluation will not have been reflected at trade inception (due to a lack of legal certainty or expectation by the trading counterparties), one of the parties will suffer a loss when the trade is cleared. This adjustment is typically imposed by way of a fee.

Further, only those entities who are Australian or Foreign Clearing Entities will be incentivised to engage in renegotiation to remediate impacted trades, given the application of the Clearing Rules. A Foreign Internationally Active Dealer (“**FIAD**”), which is not subject to the Clearing Rules, would be entitled to refuse or delay any renegotiation in the absence of any contractual right or regulatory obligation.

Members estimated that the pure pricing impact resulting from renegotiation, re-execution and submission of Underlying Swaps for central clearing would be in the order of 5-10 basis points, depending on tenor. The costs and time associated with investment in resources, technology, trade capture and risk book adjustment would have an additional impact over and beyond the pure pricing impact.

#### Margin Funding Impacts

In addition to the above pricing impacts, the requirement to centrally clear Underlying Swaps would also subject these contracts to initial and variation margin requirements at clearinghouses, requiring pre-funding, collateral management processes and additional arrangements which would likely not have been captured or enforced under the terms of existing bilateral CSAs. This margin would need to be funded for the life of the Underlying Swap or to the point of its unwind, together with any VM due. For longer-dated swaps, this additionally subjects the margin funding arrangements to interest rate fluctuations over the life of the swap, which could prove to be significant if global interest rates move toward a high rate environment. The savings estimates provided in this letter do not fully factor in this additional potential interest rate risk, and therefore adverse rate shifts which negatively impact margin funding costs would result in added costs over and above those stated here.

#### Volume of Impacted Pre-Mandate Swaptions

Feedback received from our members indicates that the number of potentially impacted Pre-Mandate Swaptions varies. One member estimated that less than 50 trades would be affected, while others estimated that up to 3,000 trades could be impacted.

#### Resourcing Impacts

One member estimated that approximately 1-2 full-time employees (“**FTEs**”) would be required to remediate impacted Pre-Mandate Swaptions and their Underlying Swaps. At an approximate cost of AUD 150,000 for each FTE, this means that the resourcing impact could be expected to be at least AUD 300,000 for this member.

Our members also believe the potential impact of not granting relief is likely to affect staff both locally and globally, due to the inclusion of both AUD and the G4 currencies within the clearing mandate. Given a proportion of the AUD interest rate derivatives client base is

located within Australia, local staff would be expected to engage with counterparties onshore on renegotiation of contracts. However, the inter-dealer scope and the specification of G4 currencies in the Clearing Rules means that a similar impact would reverberate across global centres and booking locations. This is also the case due to the level of active trading globally in the AUD interest rate swap market, and the fact that under the Clearing Rules, only one Foreign Clearing Entity needs to have booked the Clearing Derivative to the profit or loss account of a branch of the Foreign Clearing Entity located in Australia. This would require clearing entities to ascertain, on a trade-by-trade basis for each Pre-Mandate Swaption, whether its counterparty did in fact do so, to determinate whether the Underlying Swap would then be clearable.

### Total Quantitative Impact

Although members did caveat that sufficient information was not at hand to make detailed total impact estimations, the total cost if the requested relief were not granted was estimated by one member to be in the order of AUD 1-2 million. Another member noted that there would be cases where the impact on a single client relationship would be greater than the impact on a large number of transactions, which was estimated at several millions per single relationship.

### Impacts on Legal Certainty at the Point of Trade

The long-standing principles around legal certainty should apply to the exercise of Pre-Mandate Swaptions. Clearing entities cannot be expected to have factored the impact of central clearing into the component pricing of a swaption which was transacted prior to the commencement of the clearing regime and prior to any knowledge of which transactions may be required to be cleared if exercised. It is crucial that retroactive effects should be avoided for the purpose of legal certainty.

Moreover, it is also important to note that the categorisation and classification of counterparties is a primary determinant in the pricing of the swaption underlier and of the swaption itself. These classifications cannot be made until threshold calculations are performed, and therefore, until counterparties to those contracts can determine whether they breach the clearing threshold and make the necessary representations to their counterparties, it would be unreasonable to expect market participants to clear Underlying Swaps resulting from the exercise of Pre-Mandate Swaptions.

## **What is the Impact of Legislative Provisions or ASIC Policy?**

Existing ASIC policy as set out in the Clearing Rules would require Underlying Swaps resulting from Pre-Mandate Swaptions to be centrally cleared under the Australian regime. We understand, based on discussions with staff, that ASIC is mindful of the impact of the current policy, particularly with respect to the impacts on pricing and legal certainty, and therefore would be minded to grant relief where appropriate.

## **Relief Sought**

We seek relief by way of class order which specifies that an Underlying Swap which results from the exercise of a Pre-Mandate Swaption is not subject to the Clearing Rules, including where an amendment, modification or termination is made to that Pre-Mandate Swaption after the Clearing Commencement Date.

In other words, we request that the Clearing Rules concept of “entered into” be treated as referring to the entry into both (i) the swaption and (ii) the exercise which results in the Underlying Swap coming into being, and not just (ii). Put another way, we submit that the mere exercise and settlement does not count as “entry into”, since the terms of the exercise are pre-determined at the time of entry into the swaption.

We would be very happy to provide feedback on a draft of the relief instrument.

## **Why Should Relief be Granted?**

Granting of the relief requested would avoid (mis)pricing issues associated with renegotiation of Pre-Mandate Swaptions and protect the legal certainty enshrined in a derivative contract at the point of execution. It would obviate the need to reach out to multiple clients on historically-negotiated contracts to materially, fundamentally and irrevocably alter their terms, and result in the significant cost savings of up to several millions for clearing entities, as detailed above.

## **What Conditions Should be Imposed on the Relief?**

We consider it appropriate to impose a condition specifying that the relief is only applicable to swaptions entered into before the commencement of the Australian mandatory clearing regime, that is 4 April 2016.

We also encourage ASIC to give further thought to how it might be able to future-proof this concern, particularly to avoid a resurgence of the same issue if ASIC expands the scope of the clearing obligation to other asset classes or additional entities.

We thank you for your consideration of the issues in this request, and would be very happy to discuss it further at your convenience. Please contact Rishi Kapoor (ISDA) at [rkapoor@isda.org](mailto:rkapoor@isda.org) or David Love (AFMA) at [dlove@afma.com.au](mailto:dlove@afma.com.au).

Yours faithfully,



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