International Organization of Securities Commissions (IOSCO)

To the attention of Ken Hui

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Public Comment on Consultation Report on Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives

ACI - The Financial Markets Association is a leading non-profit but also a non-political association of wholesale financial market professionals contributing to the market development through education, market practices, technical advice. Members of ACI are in a large part engaged with financial trading or sales environment in the global financial markets representing for foreign exchange, interest rate products and other securities, banknotes, precious metals and commodities and derivatives.

ACI counts some 13,000 international members from more than 68 countries.

The ACI supports the IOSCO's global initiatives to fulfil the reform programme objectives regarding improved global financial stability and financial markets transparency, which were declared at the 2009 G20 Pittsburgh Summit[1]. A key component of this reform programme was the proposed central clearing of standardised OTC derivatives. Since not all OTC derivatives are appropriate for central clearing, in 2011 the G20 requested that the international standard setters develop standards for margin requirements for non-centrally cleared OTC derivatives. In September 2013 the final framework establishing the minimum standards on margin requirements for non-centrally cleared OTC derivatives was published by IOSCO and the Basel

[1] G20, Pittsburgh summit declaration, www.g20.utoronto.ca/2009/2009communique0925.html

Committee on Banking Supervision (BCBS)[2.] Nevertheless, there are other techniques, which may be deployed to facilitate the reduction or mitigation of risk in the non-centrally cleared OTC derivatives market .e.g. documentation, confirmation, portfolio reconciliation and compression, valuation, and dispute resolution. This IOSCO consultation presents the proposed standards for these techniques and seeks market participant response to the proposals.

The IOSCO Consultation proposes that there are three main intended benefits of the proposed risk mitigation standards:

1. Promoting legal certainty and facilitating timely dispute resolution
2. Facilitating the management of counterparty credit and other risks
3. Increasing overall financial stability[3]

The ACI concurs its support for these intended benefits. Nevertheless, and with reference to the 2009 G20 reform programme mentioned previously, which included four elements to mitigate risk in order to prevent or minimize future financial crisis:

- All standardised OTC derivatives should be traded on exchanges or electronic platforms, where appropriate.
- All standardised OTC derivatives should be cleared through central counterparties (CCPs).
- OTC derivative contracts should be reported to trade repositories.
- Non-centrally cleared derivative contracts should be subject to higher capital requirements ,

The ACI would advocate caution in that rules or standards introduced to fulfil the aforementioned four elements should not cause the emergence of new systemic risks or migration of risks to unregulated jurisdictions, thus threatening (global) financial stability anew. In particular, we would urge consideration regarding:

- the potential costly and onerous burden of compliance requirements, which might cause the migration of risk to unregulated financial systems
- the over-concentration of risk within central counterparties (CCPS), which could lead to a "TBTF" situation
- the required reliance on collateral as a capital safety/risk mitigation mechanism, which, in the context of various global regulatory initiatives, may have a detrimental impact on liquidity and cause shortages in particular currency securities

<u>With reference to proposed Standards 1-3</u>

In reviewing the scope and objectives of the consultation, the ACI would concur and support the proposed standards that counterparties should agree in advance or contemporaneously upon transaction the economic and legal terms of a non-centrally cleared trade and those terms should be reconciled and confirmed promptly. i.e. as soon as practical after execution of the transaction

[2] Margin Requirements for Non-Centrally Cleared Derivatives, Report of the Basel Committee on Banking Supervision and the Board of IOSCO. Sep 2013, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf

[3] IOSCO, Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives Consultation Paper, September 2014, ("Consultation Paper")pages2-3

With reference to proposed Standards 5, 6 & 9

As noted in the IOSCO consultation[4] survey, several jurisdictions already impose some risk mitigation requirements on non-centrally cleared OTC derivatives e.g. EU authorities and US CFTC[5], while other authorities impose risk mitigation requirements as part of a broader prudential or risk management regulatory requirement, or as part of the business conduct regulation of brokers and dealers . We would encourage that these initiatives should be taken into consideration and evaluated on their individual merits. To this extent, it would be prudent if any proposed standards embraced the following flexibility to avoid any potential for regulatory arbitrage through conflicting regulation:

1. Observance and compatibility with market-driven and industry-led practices and existing regulatory frameworks, which have been identified as supporting appropriately established risk mitigation standards i.e. recognised best practice
2. Awareness and observance of legal and regulatory differences and approaches by national jurisdictions, especially where these are justified by country-specific objectives

With reference to proposed Standard 4

Valuation with counterparties: the standard proposes that covered entities should agree on and clearly document the process and/or methodology for determining the value of each non-centrally cleared OTC derivatives transaction at any time from the execution of the transaction to the termination, maturity, or expiration thereof, for the purpose of exchanging margins[6].With reference to the IOSCO/BCBS "Margin Requirements for Non-centrally Cleared Derivatives," final policy framework published on September 2013[7], , it may be noted that national regulators have drafted their own margin proposals for non-centrally cleared OTC derivatives, which contain valuation processes, valuation methodology and the documentation thereof[8]. The ACI would advocate that this Consultation's proposed standards should not frustrate or undermine the national initiatives.

With reference to proposed Standard 7

Dispute Resolution: *The standard proposes that Covered entities should agree on procedures for determining when discrepancies in material terms or valuations should be considered disputes,*

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[4] IOSCO, Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives Consultation Paper, September 2014, ("Consultation Paper")page 4

[5] See: April 14, 2014, the European Supervisory Authorities published "Draft regulatory technical standards for risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 and CFTC: "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, Final Rule," 77 Fed. Reg. 55,904, 55,909 (2012).

[6] IOSCO, Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives Consultation Paper, September 2014, ("Consultation Paper")pages 2-3

[7] available at http://www.bis.org/publ/bcbs261.pdf

[8] See point 5 regarding ESA and regarding USA - September 2014, the U.S. Prudential Regulators and CFTC published proposals to govern margin requirements for non-centrally cleared derivatives. (The prudential rule is available at http://www.gpo.gov/fdsys/pkg/FR-2014-09-24/pdf/2014-22001.pdf and CFTC rule is available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister092314a.pdf)

as well as a related process for resolving such disputes as soon as practicable. The policies and procedures should provide for the prompt notification to authorities of such disputes that remain unresolved after a reasonable period of time if the applicable regulation requires such notification [9].The ACI's observation with regard to this proposed standard is that while it is imperative that a process for dispute resolution is agreed between counterparties, determining a prescribed course of action at the time of or subsequent to the derivative trade execution, is potentially too restrictive and that the language used in the proposed standard should provide the counterparties with the flexibility to resolve the dispute in a manner appropriate to the prevailing situation and under the applicable legislative environment[10].

Under proposed Standard 8, it is advocated that the Authorities should implement the standards described in this paper as soon as practicable. While the ACI is supportive of a prompt and timely implementation of risk mitigation measures in order to underpin the objectives of the 2009 G20 Pittsburgh Summit with regard to increased financial stability, we believe that the implementation of these proposed standards should be harmonised in the context of the mandatory centralised clearing mandate "timetable" whereby the "clearing product range" will increase steadily and incrementally diminishing the necessity for extensive, overarching standards for non-centrally cleared derivatives.

The ACI believes that the Consultation document, and the responses from the various market participants to the document, will help the regulators, industry participants and the public to be better informed on the Risk mitigation techniques for non-centrally Cleared OTC Derivatives. The greater awareness that comes from this knowledge will assist the industry in assuring that best practices are followed.

The ACI also appreciates the clarity with which the IOSCO Consultation was written, and thanks the authors for the manner in which the document was prepared. This unbiased reflection of the current state is helpful to the industry overall. The ACI thanks IOSCO in advance for its consideration of the views we have expressed in this Consultation response. We look forward to working with IOSCO.

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ACI Americas ACI Asia ACI Africa ACI Europe ACI Middle East

[9] IOSCO, Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives Consultation Paper, September 2014, ("Consultation Paper")page 4

[10] See: CFTC proposed similar language related to dispute resolutions; "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, Final Rule," 77 Fed. Reg. 55,904, 55,909 (2012).