



Vanguard INVESTMENTS®

31 August 2011

OTC Derivatives Central Clearing Consultation
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

IN CONFIDENCE

Dear Sirs

Central Clearing of OTC Derivatives in Australia – Discussion Paper issued by the Council of Financial Regulators (CFR), June 2011

Thank you for the opportunity to comment on the proposals outlined in the Discussion Paper issued by the CFR (the **Paper**).

Vanguard Investments Australia Limited (**Vanguard**) is an indirect wholly owned subsidiary of The Vanguard Group, Inc. (**VGI**)¹. Vanguard, as an asset management company and holder of an Australian Financial Services Licence, has approximately AUD 62 billion of assets under management for institutional, financial advisory and retail clients and offers approximately 40 investment funds in Australia (wholesale, retail and exchange traded)². As part of the prudent management of our managed investment funds and other portfolios, we enter into derivatives contracts including foreign exchange forwards (**FX forwards**) to achieve a number of benefits for our investors including hedging portfolio risk, lowering transaction costs, and achieving more favourable execution compared to traditional investments.

By and large, we believe the Paper presents a very clear explanation of competing factors going into a decision of whether or not to implement mandatory central counterparty (**CCP**) clearing of OTC derivatives in the context of the Australian domestic market. Our comments on the points raised in the Paper may be summarized as follows:

1. **Mandatory clearing with/without trading facility:** The Paper addresses mandatory CCP clearing of OTC derivatives in broad terms and notes that the CFR is considering other related matters separately including the use of trading platforms, the intent being to undertake consultations with interested stakeholders as appropriate (p1). We assume references to trading platforms encompass both exchange trading and trading through an electronic trading platform (**ETP**), sometimes referred to in the US as a swap execution facility³.

¹ Since establishing the first indexed mutual fund in the United States (**US**) in 1976, VGI has grown into one of the world's largest and most respected investment management companies. VGI is a US Securities and Exchange Commission registered investment adviser with more than USD 1.6 trillion in assets under management. VGI offers more than 170 US mutual funds and serves approximately 9 million shareholder accounts. VGI and its affiliated companies have a global presence with offices in the US, UK, Melbourne, Sydney, Tokyo and Singapore.

In the US, VGI has been highly engaged in derivatives reform rulemaking efforts. VGI has submitted numerous derivatives rule comment letters to US regulators, participated in derivatives industry roundtable discussions sponsored by US regulators, and testified before US Congressional committees. It has also contributed significantly to trade association comment letters concerning derivatives regulation.

² As at 30 June 2011.

³ Similar to an ETP, a swap execution facility is a new trading platform for derivatives in which multiple participants have the ability to trade by accepting bids and offers made by participants in the platform.

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Generally, we support the centralised clearing of OTC derivatives through a CCP because we believe it to be a strong tool to reduce systemic and counterparty risk. However, we are not supportive of compulsory exchange or ETP trading of derivatives, as we do not believe that this will necessarily reduce risk. We also have concerns that such trading practices, if mandatory, could actually have a negative impact on pricing and liquidity particularly if, for example, certain illiquid, large (i.e., block) trades must be exchange or ETP traded without an appropriate delay in reporting to allow adequate time for the offloading of market risk using trades of more liquid sizes. If Australian regulations require compulsory exchange or ETP trading of derivatives, this should not be implemented until adequate studies have confirmed that market participants will not experience a material negative impact on pricing or liquidity. In making such assessment, the CFR should recognise that OTC derivatives products do not have the same high level of trade uniformity and liquidity as do existing exchange-traded products (i.e., futures). For this reason, regulations addressing exchange or ETP trading of derivatives should allow for multiple types of trading approaches and appropriate protections to maintain liquidity for these instruments.

2. **Harmonisation with US Regulation:** At sections 1.3.1 and 4.2 of the Paper, it is noted that agencies comprising the CFR expect that Australian mandatory CCP requirements would be 'harmonised' with developments in the US exempting FX forwards and swaps from a clearing requirement. Vanguard generally believes that Australian and US derivatives clearing regulations should be harmonised or made uniform to the greatest practicable extent. Uniformity of regulations will prevent regulatory arbitrage and enhance systemic risk reduction.
3. **Special Issues Related to FX Trading.** The US has proposed to exempt FX swaps and forwards from a mandatory clearing requirement.

We understand that in the US, only physically settled (i.e., 'deliverable') FX swaps and forwards with fixed payment obligations will be exempted from the operation of new US derivatives regulations including clearing requirements⁴. We also understand that many US market participants have argued that such exemption should apply to all classes of FX forwards including non-deliverable forwards (NDFs) and not just physically-settled FX forwards. In furtherance of harmonisation, Vanguard supports the CFR proposal to exempt FX swaps and forwards in line with the US but believes that the exemption should apply to all classes of FX forwards including NDFs as such instruments have many of the same characteristics as physically settled FX forwards. That said, Vanguard believes that if FX forwards are not subject to central clearing requirements, parties should be encouraged to exchange collateral or margin (i.e., cash, securities) as an effective way to reduce counterparty risk.

It would also be helpful if regulations clarified that a 'deliverable' FX forward, for instance, does not cease to be 'deliverable' simply because a physical exchange of currencies does not take place (e.g., if an offsetting transaction is entered into prior to settlement of the first transaction).

The US regulators are currently considering these issues and have not yet adopted final rules. Is it the intent to adopt the same proposed distinctions as in the US or will the exemption in Australia extend to all types of FX swaps and forwards, both 'deliverable' and NDFs?

4. **Hierarchy for Application of Various Jurisdictional Rules:** Table 2 on page 21 of the Paper ("*Existing and Proposed OTC Derivatives Central Counterparties*") indicates among other things that in the UK and US as at May 2011, FX derivatives clearing was "proposed" through relevant 'clearing services'. This raises the question of scope and applicability of various countries' rules to derivatives transactions. Is it the intent for Australia to follow suit to mandate FX clearing in Australia if such clearing were to

⁴ FX swaps and forwards will, however, be required to be reported to a swap data repository, which will allow regulators to monitor for excessive risk build up.

become mandatory in another jurisdiction (e.g. in the UK), or would the approach in Australia also change in harmony with the US if the US exclusion of FX swaps and forwards were to change materially?

Vanguard considers harmonization of the Australian regime with that of the US desirable, subject to the point made in 3 above. Nonetheless, a potential difficulty Vanguard sees with FX derivatives clearing is how to determine which country's central clearing system will apply if clearing of an FX forward is mandatory in both the UK and the US (e.g. with respect to a USD/GBP FX forward). There would need to be clear rules concerning hierarchy – for instance, favouring the jurisdiction of the buy-side participant as the driver of the transaction (so that the buy-side participant doesn't have to link to systems across the globe to obtain relevant currency).

Thank you for considering our comments and questions.

Please do not hesitate to call Marina Dobbyn on 03 8888 3585 if you would like to discuss any matter set out above.

Yours faithfully



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