20 August 2012

Mr Daniel McAuliffe
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By email: financialmarkets@treasury.gov.au

Dear Mr McAuliffe

Corporations Legislation Amendment (Derivatives Transactions) Bill 2012

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the exposure draft of the Corporations Legislation Amendment (Derivatives Transactions) Bill 2012 (Bill).

AFMA supports the prompt introduction of this legislation subject to our comments. The certainty from having a legislative framework in place will allow market participants to plan and start on the process of working on the details of implementation. This legislation heralds a major structural change to the derivatives market in Australia. The generality of this legislation creates a lot of scope for industry uncertainty and confusion. The practical challenges with implementation, particularly with regard to trade reporting, are enormous and there is much further consultation that will need to be carried out with the development of the regulations and derivative transaction rules. Settling the details will demand considerable commitment of time and resources over the next few months. AFMA stands ready to work with Treasury and the regulators to clarify implementation of this law to give industry the certainty it very much needs.

General structure and scope

The logic behind introducing this high level form of principles based framework legislation and intended areas of focus is understood from previous consultations. However, the broadness of its potential coverage due to a lack of definitional constraint does cause serious concern to certain industry sectors because potentially requirements may be inappropriately applied to them. In particular, the potential for the legislation to

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apply to energy derivatives transactions in the National Electricity Market (NEM) is an area for attention.

The introduction of mandatory clearing and trading requirements would change the risk profile of the energy sector. Energy OTC derivatives meet specific needs of NEM counterparties that cannot be adequately addressed through standardised exchange traded and cleared products. For example, the timing of payments and receipts are commonly matched with the underlying revenue and expenses. Forced standardisation would result in loss of hedging flexibility with the result that market participants would no longer be able to tailor cost effective market risk management strategies.

To address the concerns of market sectors outside the intended scope of the legislation it is suggested that an assessment process in the form of guidance be set out in the Explanatory Memorandum to assist the Minister making a determination and to guide the preparation of ‘derivative transaction rules’ (DTR) by ASIC. Much of the material for such guidance already exists in the text of the Council of Financial Regulators proposals to the Government.

There is also a broad structural problem in that the legislation attempts to use the same coverage definitions for all three areas of trade reporting, clearing and execution. Problems with vagueness and overreaching scope flow from this approach. As we suggested in our previous submission on the proposals a more differentiated approach would have been preferred, for example, creating the definition of a ‘reporting entity’ for trade reporting purposes.

Section 761A (c) Derivative transaction definition

Paragraph 761A (c) in referring to ‘any other transaction relating to a derivative’ is vague and open-ended in the extreme. Such drafting is ripe material for unintended consequences. For example, it could encompass any commercial transaction for which the derivative is being used to manage risk. Paragraph (c) needs to be deleted as it creates endless uncertainty in its present form.

There are three quite clear objectives for this legislation:

- the reporting of all OTC derivatives to trade repositories;
- the clearing of all standardised OTC derivatives through central counterparties; and
- the execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

The drafter should work within the bounds of these policy objectives and specify clearly what type of transaction is to be covered within the scope of the above points and refrain from catchall terminology.

Sections 798H (3) and 901E (2) Interpretation of rule priority not justified

The rationale for section 798H (3) being made a statutory provision is unclear. While an interpretive provision dealing with priorities between statutory provisions in different laws can have merit and be justified on the basis of reconciling broad principles based provisions and because of the challenges in amending legislation, it has no merit when it comes to administrative rules which can be readily changed to deal with practical implementation issues. ASIC should not create inconsistent rules in the first place and if it inadvertently does so it should speedily remedy the situation. This provision invites careless rule drafting.

These two provisions should be deleted.

Section 900A Extraterritoriality

Paragraph 900A (c) extends the theoretical scope of legislation to 'a place outside Australia'. In other words this legislation has no bounded jurisdiction whatsoever. It was noted in our submission on the proposals that while jurisdiction can readily be exercised over those entities having a presence in Australia through being incorporated in or having a branch in Australia, a law that attempts to impose jurisdiction on offshore parties is likely to fail where the entity does not carry out the activity in Australia and has no presence here. Reference to 'derivatives' and 'derivative transactions' will not widen the territorial scope in an effective way in the absence of a person having a connection with Australia that allows the court to impose an enforceable order or claim on them.

Dealings between counterparties both located offshore are in a practical sense very difficult to capture. Extraterritorial laws normally rely on the party having some physical connection with the jurisdiction, such as through the location of assets or personnel, even if they are not directly connected with the dealing in question. The law should be drafted so that the geographical scope is clearly defined to avoid any unnecessary uncertainty or ambiguity in interpreting the legislation.

The broad open-ended drafting creates the same type of uncertainty for industry that AFMA has warned against with regard to the laws of other jurisdictions, such as the Dodd-Frank Act in the United States. Major jurisdictions are creating rules which are ambiguous and create problematic extraterritorial challenges and issues of legal uncertainty and misunderstanding which give rise to material risk for financial market participants. Banks and other financial institutions that undertake significant cross-border activities are particularly concerned that they may be subject to overlapping regulatory requirements in different jurisdictions and may need to comply with two or more different regimes. Areas of concern include duplication of registration and licensing requirements, clearing obligations, transaction and position reporting, collateral and margining requirements, and prudential obligations. There is also the possibility that it may be impossible for an institution to comply with conflicting requirements in different jurisdictions. Even where compliance with two or more overlapping requirements is possible, this is likely to lead to additional administrative and compliance costs.

The effect of such regulation is to cause competitive imbalances in the international derivatives markets with market participants structuring their businesses and making decisions in relation to dealings in particular jurisdictions or with particular counterparties based on regulatory considerations rather than normal commercial grounds. The effect of such imbalances is also likely to have an effect on counterparty and ultimately consumer choice and lead to increased costs. It is important that authorities around the globe seeking to regulate OTC derivatives activity cooperate to ensure that businesses are not subject to conflicting obligations because of incompatibility between overlapping jurisdictions.

Section 901A (8)(c) and definition of 'derivative transaction' - Back loading objection

Section 901A (8)(c) leaves the way open for the possibility that a clearing requirement could be imposed retrospectively on a derivate that was not subject to a clearing requirement at the time it was entered into. In addition, paragraph 761A (b) with the definition of 'derivative transaction' includes the 'modification or termination of such an arrangement'. The reference to 'modifying or termination' is not an appropriate extension for the definition with regard to clearing and trading as such actions make the affected derivative ineligible within the clearing system.

AFMA does not favour back loading requirements. The policy objective is to reduce systemic risk through better clearing and settlement processes. Back loading increases legal uncertainty, credit and operational risk through retrospective regulatory requirements. Generally, retrospective measures should not be contemplated. Back loading derivatives trades in central clearing raises a host of legal and practical problems for market participants. It would require a huge logistical effort involving terminations and renegotiations of contracts. This introduces additional legal, credit and operational risk into the system. It could also raise legal claim issues for the Commonwealth as the change in commercial arrangements could be connected with retrospective legal obligations being imposed.

In this regard, Australian legislation will be out of step with equivalent US and European measures where no provision for back loading has been made.

Definition of 'Class'

The legislation enables the use of the concept of 'class' as a means to create a category of derivatives that may be either brought under the requirements under paragraph 901B(2) or exempted by ASIC for different purposes under sections 905A and 907D. While it is desirable to control coverage by a category of derivatives this should be done in a way which is comprehensible and usable by the market. Currently, Note 2 says that a class of derivatives can be described by reference to any matter, including (for example):

- the kind of asset, rate, index or commodity to which the derivatives relate; or
- the time when the derivatives were issued, or their date of maturity.

This is too vague and loose. It would be better to say in the note that, 'class' should be defined as a category which is based on a product classification system that is aligned with international financial standards.

Please contact me at dlove@afma.com.au or (02) 9776 7995 if you wish to discuss or have queries regarding the matters raised in this submission.

Yours sincerely

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