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Draft regulations: OTC Derivatives Central Clearing and Single-Sided Trade Reporting

We refer to the request by The Treasury for submissions on the proposed amendments to the Corporations Regulations in the draft *Corporations Amendment (Central Clearing and Single-Sided Reporting) Regulation 2015* (**Draft Regulations**). We appreciate the opportunity to make this submission.

We have limited our submission to those aspects of the Draft Regulations and accompanying Explanatory Guide (**Explanatory Guide**) that relate directly to Australian law or issues relating to Australian law reform. Accordingly, we make no comments on commercial or operational issues (if any) in connection with the Draft Regulations and Explanatory Guide. Further, we do not comment in this submission on the draft *ASIC Derivative Transaction Rules (Clearing) 2015*.

Our comments on the Draft Regulations and Explanatory Guide are set out below.

1 Exclusion of entities from derivative transaction rules

1.1 The Explanatory Guide to the Draft Regulations provides that the new sub-regulation 7.5A.50(2A) will exempt licensees from having requirements imposed beyond the scope of any derivatives authorisation on their licence. The drafting of the regulation seeks to achieve this by referring to entities who are not end-users only because of paragraph (3)(c), which refers to financial services licensees. It is noted in the Explanatory Guide that this approach has been taken so that entities which also satisfy paragraph (3)(a) (being Australian ADIs) are not able to rely on this new exemption.

1.2 However, it is submitted that this drafting approach has an unintended consequence because entities which have an Australian Financial Services Licence (**AFSL**) may also satisfy paragraph (3)(d). This is because of the significant breadth of paragraph (3)(d) which means that any entity cannot be an end-user if it enters into derivatives only with wholesale clients and if they have derivatives-related activities which are subject to the regulation of an overseas regulatory authority. The requirement of being subject to overseas regulation is not difficult to satisfy because

of the extra-territorial reach of overseas derivatives regulatory regimes, particularly those which seek to regulate transactions and not just participants (such as in relation to trade reporting).

1.3 Accordingly, we submit that the proposed paragraph (2A) be amended so that the new exclusion can apply if a person is an Australian financial services licensee and it is also subject to a foreign derivatives regulatory regime, for example by replacing the reference to paragraph 3(c) with "paragraph (3)(c) or both paragraphs (3)(c) and (3)(d)".

1.4 In addition, we suggest that the reference to wholesale clients in Regulation 7.5A.50(3)(d)(i) be clarified to refer to wholesale clients *in Australia* and not persons meeting that description wherever they are located in the world, as we understand that to be the Government's intention (this is further discussed in paragraph 2 below). Also, as noted in that paragraph below, the inclusion of 7.5A.62(1)(b)(iii) in the equivalent definition of *foreign clearing entity* is critical, and we suggest that its inclusion in 7.5A.50(3)(d) would also be appropriate to avoid inadvertently including entities to whom the Australian licensing regime never applied (such that they could not be said to be "exempt" from it, see below).

2 Clearing

Foreign clearing entity

2.1 Paragraph (b) of the definition of Foreign Clearing Entity is similar to, but not the same as, the wording used in paragraph (3)(d) of regulation 7.5A.50. The Explanatory Guide explains that its purpose is to include "overseas-regulated foreign entities that exceed the threshold of $100 billion, provide derivatives-related services to wholesale clients in Australia and are exempt from the licensing requirements in the Corporations Act."

2.2 However, it is submitted that the wording used in the draft regulation does not fully address this intention. This is because the regulation does not require that the wholesale clients are in Australia.[1] Therefore, an entity which satisfies the description of a wholesale client in the Corporations Act, but which is located overseas would still meet the description. If it is intended that this be limited to entities which deal with wholesale clients in Australia then this should be expressed in the regulation and not only in the Explanatory Guide.

2.3 Further, a considerable reliance is likely to be placed on subsection 7.5A.62(1)(b)(iii) by a number of overseas entities who otherwise fall within the scope of the definition because they are large overseas entities which deal with institutional (wholesale) clients internationally. Australia's licensing regime may not apply to these entities, not because of a specific exemption, but because of the limits in the application of Chapter 7 of the Corporations Act jurisdictionally. It would be very useful if the Explanatory Guide could evidence the intention that the reference that an entity "is exempt" is meant to refer to an entity which would have been subject to the requirement to hold an Australian financial services licence but for the existence of a specific exemption to that requirement, rather than just that the licensing requirements of the Corporations Act simply don't apply to them in the first place.

Exclusion of foreign government entities

2.4 Draft Regulation 7.5A.64 provides that the derivative transaction rules cannot impose clearing requirements on persons who are not Australian clearing entities or foreign clearing entities in relation to the particular transaction. The note beneath this regulation provides that the regulation "prevents the derivative transaction rules imposing clearing requirements on, among other things, a

[1] See Explanatory Guide, page 10.

range of foreign public entities including… central banks, Government debt offices, multilateral development banks; the Bank for International Settlements and other similar international organisations."

2.5 However, as noted above, the definition of 'foreign clearing entity' is very broad and, as drafted, it would potentially catch entities who would otherwise constitute foreign public entities as referred to in the note. For example, a foreign government funding agency would be incorporated or formed outside of Australia; could provide financial services to wholesale clients (as this wording is not specifically limited to Australian wholesale clients as noted in paragraph 2.2 above); may be exempt under the Corporations Act from holding an AFSL to the extent its activities involved any Australian entities; and, as trade reporting requirements are being introduced globally, their derivatives activities could be regulated by an overseas regulatory authority. The latter is particularly problematic as foreign OTC Derivatives reforms may include public entities in some derivatives regulation, for example trade reporting.

2.6 Accordingly, although this also gives further basis for making the changes referred to in paragraphs 2.2 and 2.3 above, we also suggest that consideration be given to including specific references to entities which are intended to be excluded.

3 Single-sided Reporting

Distinction between Australian Entities and Foreign Entities

3.1 Paragraphs (2) and (3) of Regulations 7.5A.71 and 7.5A.72 have headings which distinguish them as (2) being for *Transactions involving Australian entities* and *Positions involving Australian entities* (respectively) and (3) being for *Transactions involving foreign entities* and *Positions involving Foreign Entities* (respectively). However, the wording of paragraph (2) does not limit its application to Australian entities and the Explanatory Guide does not indicate that such a restriction is intended. Accordingly, we understand that paragraph (2) can apply to foreign entities and we suggest that these headings are either amended or removed. Also, we recommend that the Explanatory Guide make it clear that an entity which wants to obtain the benefit of single-sided reporting (**Eligible Phase 3 Reporting Entity**) will have the benefit of the relief when dealing with a foreign entity which satisfies either (2) or (3).

Safe harbour

3.2 The Explanatory Guide provides that the "proposed regulation would provide an exemption from the trade reporting requirements in the reporting DTRs for a phase 3 reporting entity concluding an OTC derivatives transaction if proposed regulation 7.5.73 applies to it, and if the counterparty is required to report the transaction (i.e. is a phase 1, 2 or 3A entity) or ***agrees*** to report the transaction".[2]

3.3 However, the wording of the Draft Regulations is not as clear as this, and the mere agreement of a counterparty to report the transaction would not appear to be sufficient to meet the requirements of the Draft Regulations.[3]

3.4 Under Draft Regulation 7.5A.71(2), the exemption applies to an Exempt Phase 3 Reporting Entity if the other party to the transaction is a reporting entity that is required to report information about the transaction (and not exempt under the Draft Regulation) or reports information about the transaction. This wording appears to place reliance on a question of fact, which would need to be determined by

[2] Explanatory Guide, Page 11, emphasis added.

[3] See Draft Regulation 7.5A.71(2) and (3) and 7.5A.72(2) and (3).

the Eligible Phase 3 Reporting Entity if it is to be certain of its relief. For example, these entities would need to ensure that the counterparty was either *required to* report that particular transaction or actually *does* report that particular transaction. Otherwise the relief would not appear to apply. Also, the position of the Eligible Phase 3 Reporting Entity is not clear in the circumstances where the counterparty reported, but incorrectly.

3.5 Under Draft Regulation 7.5A.71(3), the exemption applies to an Exempt Phase 3 Reporting Entity if the counterparty is (i) subject to reporting requirements in one or more foreign jurisdictions that are substantially equivalent to requirements under the Derivative Transaction Rules (Reporting) and that counterparty both (ii) reports the information about the transaction to a prescribed repository and (iii) designates the information reported… as information that has been reported to ASIC. This would also require an assessment of facts by the Eligible Phase 3 Reporting Entity. If they were not correct, then the relief would not apply.

3.6 The reliance on this factual assessment in order to obtain the relief does not appear to be the intention expressed in the Explanatory Guide, which appears to be based on an agreement to report. It is submitted that the approach in the Explanatory Guide is more workable, particularly given the timing required to make reports. Accordingly, we suggest including a 'safe harbour' for Eligible Phase 3 Reporting Entities such that, if they obtained a representation from their counterparty of the presence of the requirements for the exemption to apply (for example, that the transaction would be reported) then this would discharge the reporting responsibility of the Eligible Phase 3 Reporting Entity.

We welcome the opportunity to discuss these matters, and other issues in connection with the discussion of the Draft Regulations, with you. Please contact Scott Farrell (+61 2 9296 2142, scott.farrell@au.kwm.com) or Sarah Hickey (+61 2 9296 2127, sarah.hickey@au.kwm.com) of our offices if we may be of further assistance.

Yours faithfully