EXPLANATORY STATEMENT

Issued by authority of the Assistant Treasurer

Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016

Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016

Section 353 of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) and section 253 of the *Life Insurance Act 1995* (the Life Insurance Act) each provide that the Governor-General may make regulations prescribing matters required or permitted by the relevant Act to be prescribed, or necessary or convenient to be prescribed for carrying out or giving effect to the Act. Subsection 31(1) of the SIS Act provides that regulations may prescribe standards applicable to the operation of regulated superannuation funds and to trustees and Registrable Superannuation Entity (RSE) licensees of those funds.

The *Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016* (the Regulation) will enable trustees of superannuation funds and approved deposit funds (Superannuation Funds) regulated under the SIS Act and life companies regulated under the Life Insurance Act, to provide margin by way of security in relation to derivatives and foreign exchange contracts in the manner required to access international capital markets and liquidity. The reforms will allow trustees of RSEs and life companies to grant security in certain specified circumstances, to allow those entities to access liquid global markets such as the US cleared over-the-counter (OTC) derivatives market through Futures Commission Merchants (FCMs) so that these entities can effectively manage their risks and access optimal pricing and products.

Trustees of Superannuation Funds

Currently, trustees of Superannuation Funds are restricted from granting security (more precisely, from giving a charge) over an asset of the fund, subject to certain exceptions (Regulation 13.14 of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations).[1]

Whilst an exception to this restriction on granting charges in the context of 'derivatives contracts'[2] applies under regulation 13.15A of the SIS Regulations, it is not entirely clear whether this exception would allow trustees of Superannuation Funds to charge the assets of the relevant Superannuation Fund with respect to the OTC derivative transactions, whether cleared or uncleared.

1 This restriction constitutes an 'operating standard' applicable to the operation of Superannuation Funds and to trustees and RSE licensees of those funds, and significant penalties apply in respect of breaches of the operating standards.

2 A 'derivatives contract' is defined to mean an options contract or a futures contract relating to any right, liability or thing.

Regulation 13.15A currently provides that a trustee may give a charge over, or in relation to, an asset of a fund if:

a) the charge is given in relation to a derivatives contract entered into by, or on behalf of, the trustee; by a broker on the instructions, or on the account, of the trustee; or by a broker for the benefit of the trustee;

b) the charge is given in order to comply with the rules of an approved body (being specified domestic and international exchanges and associated clearing houses listed in Schedule 4 to the SIS Regulations) that requires the performance of obligations in relation to the derivatives contract to be secured;

c) the fund has in place a derivatives risk statement that sets out certain prescribed information; and

d) the investment to which the charge relates is made in accordance with the derivatives risk statement (which must include prescribed criteria).

This Regulation may not be broad enough to enable trustees of Superannuation Funds to grant charges in the manner contemplated under the laws of certain foreign jurisdictions (or under domestic and foreign prudential standards mandating margin requirements for uncleared OTC derivatives transactions which will take effect over the coming years) for a number of reasons, including that:

a) the term 'derivatives contract' is not broad enough to capture other OTC derivatives such as foreign exchange forwards and swaps and interest rate swaps utilised by Superannuation Funds;

b) this exception does not contemplate third parties who may assist the trustee to access the approved body (i.e. a trustee's clearing member) (including in circumstances where the trustee is not a direct participant of the approved body) being granted a charge in respect of the trustee's dealings or with the approved body if that charge is not contemplated in the rules of the approved body;

c) the current schedule of 'approved bodies' is outdated and does not include some important OTC derivatives clearing houses which clear a high volume of OTC derivatives (e.g. LCH.Clearnet Ltd).

Similarly, it is not clear that the broad exception in regulation 13.15 which provides that the standards stated in regulations 13.12, 13.13 and 13.14 of the SIS Regulations, do not apply to an assignment or charge that is permitted, 'expressly or by necessary implication', by the SIS Act or SIS Regulations covers the granting of security in the context of cleared or uncleared OTC derivatives.

The G20 derivative reforms[3] and associated legislative changes which have been introduced across the world, particularly the Dodd–Frank Wall Street Reform and Consumer Protection Act and Commodity Exchange Act in the United States of America, have directly and indirectly affected trustees of Superannuation Funds and their counterparties by imposing on them a range of additional requirements relating to derivatives. For example, it is understood that, under US law, customer funds and property (including property posted to the Futures Commission Merchant's (FCM's) to margin or guarantee derivatives trading) must be kept apart from the FCM's own funds and property. Additionally, segregated customer funds are held for the benefit of the FCM's customers and are subject to a preference regime on the insolvency of the FCM. Due to this legislative structure, the FCM cannot receive margin from the trustee on an absolute transfer basis (because the 'customer funds' would then become the FCM's property which is understood to be inconsistent with US law). It is understood that this necessitates FCMs requiring that their clients grant security over the customer's property which is provided to the FCM as margin in respect of derivatives trading (i.e. the client is required by the FCM to grant security over posted margin). Trustees of Superannuation Funds cannot currently grant such security to the FCM due to restrictions imposed by the SIS Regulations.

The existing uncertainty as to the scope of the current 'derivatives contract' exception is also an issue for non-centrally cleared OTC derivative transactions under which margin may be provided by way of security.

The margin requirements to be introduced as part of the international G20 derivatives reforms are expected to result in more derivatives and foreign exchange transactions being conducted via central counterparties and so managers of Australian Superannuation Funds will face increasing cost and administrative burden in trading uncleared OTC derivatives and will not, under current regulation, be able to access markets through FCMs.

The margin requirements may also result in trustees of Superannuation Funds being required to provide margin by way of a security (as opposed to margin by way of absolute transfer which is currently more common in the Australian market). This may occur directly if the trustee of the Superannuation Fund is itself required by law to provide margin by way of security or indirectly, due to the prudential and regulatory capital requirements imposed on the trustee's counterparty.

Similar issues may arise if a trustee of a Superannuation Fund is not able to grant security to counterparties in respect of margin required to be provided for uncleared

3 In the aftermath of the recent financial crisis, the Group of Twenty (G20) initiated a reform agenda to improve transparency in derivatives markets, mitigate systemic risk and protect against market abuse. In Pittsburgh in September 2009, the leaders of the G20 agreed that 'All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.' (Financial Stability Board (FSB), *Implementing OTC Derivatives Market Reforms* (Financial Stability Board, 25 October 2010), iii. In 2011, the G20 agreed to add margin requirements on non-centrally cleared derivatives to the OTC derivative reform agenda.

OTC derivative transactions by international prudential standards or where, for commercial reasons, it is beneficial for a trustee of a Superannuation Fund to grant security.

Life companies

Life companies are also subject to significant restrictions on granting security. Section 38(3) of the Life Insurance Act provides that a life company must not mortgage or charge any of the assets of a statutory fund except:

a) to secure a bank overdraft; or

b) in connection with the undertaking of a major development project and in accordance with section 40 of the Life Insurance Act; or

c) for such other purposes, and subject to such other conditions, as are prescribed by the *Life Insurance Regulations 1995* (Life Insurance Regulations).

The exception to this restriction to granting security which is set out in the Life Insurance Regulations also needs to be updated to accommodate current derivative trading arrangements. This is for similar reasons to those described above in respect of Superannuation Funds.

The existing 'derivatives contracts' exception in regulation 4.00A of the Life Insurance Regulations is not currently broad enough to cover granting security in the context of cleared or uncleared OTC derivatives. The exception in regulation 4.00A is similar to the exception which applies in respect of Superannuation Funds in regulation 13.15A of the SIS Regulations.

Allowing trustees of Superannuation Funds and life companies to cleared and uncleared OTC derivatives markets is consistent with Australia's commitments in respect of the G20 derivatives reforms.

The proposed amendments to the Regulation in respect of both the SIS Regulations and Life Insurance Regulations will apply to charges given on and after the commencement of the Regulation.

Life Insurance Regulations

The Regulations amend the Life Insurance Regulations to provide two circumstances in which a charge may fall within the exception to the restriction of life companies granting security. This is achieved by repealing the existing paragraph 4.00A(1)(b) and providing instead that the charge must comply with either sub regulation (1A) or (1B).

These new sub regulations allow the giving of security in respect of any derivatives or foreign exchange contracts (including exchange-traded derivatives, cleared OTC derivatives and uncleared OTC derivatives) and the existing narrower definition of 'derivatives contract' has been replaced by a broad definition in which a derivatives contract means a derivative (within the meaning of Chapter 7 of the *Corporations Act 2001* (Corporations Act) or a foreign exchange contract (within the meaning of that Chapter).

This reflects the evolution in financial markets, and the transactions entered into by life companies, since the introduction of the original regulation 4.00A(1)(b) and the legitimate commercial imperatives which apply to life companies to enter into a range of cleared and uncleared OTC derivatives in order to effectively manage their risk. [***Schedule 1, item 1, Paragraph 4.00A(1)(b) and item 4, Sub regulation 4.00A(2) (definition of derivatives contract)***]

The first circumstance, set out in sub regulation 4.00A(1A), is if the charge is given in order to comply with a requirement that the performance of obligations in relation to the derivatives contract be secured in either:

a) rules governing the operation of an approved body; or

b) a law of the Commonwealth, a State, a Territory or a foreign country (including a part of a foreign country) that applies to dealings in the derivatives contract. The reference to 'law' should be interpreted broadly to include legislation, regulations, legislative instruments, delegated legislation, prudential standards, capital requirements and any other requirements imposed by domestic or foreign financial market regulators and central banks (such as the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) and similar foreign regulators). [***Schedule 1, item 2, After sub regulation 4.00A(1), sub regulation 4.00A(1A)***]

The giving of security by a life company to the approved body itself (i.e. the exchange or clearing house), the life company's clearing member or broker, or some other person would satisfy the requirement in paragraph 4.00A(1A)(a) — provided that the rules governing the operation of the approved body require the life company to give that security.

Paragraph (1A)(b) is intended to facilitate the giving of security by the life company where the giving of security is contemplated by Australian or foreign law; and could also be satisfied where the law imposes the relevant requirement on the life company's counterparty or other party to the transaction (like the clearing house or exchange) rather than the life company itself (e.g. if margin requirements are imposed on the life company's counterparty even if those requirements aren't directly imposed on the life company itself).

For instance, under the new Regulation, a life company would be able to provide security when dealing with a FCM (because, due to the requirements imposed on the FCM under US law to hold customers funds separately, the FCM takes security in respect of posted margin to ensure the segregation of customer funds and property). Another example would be where the life company, or its counterparty to an uncleared derivatives arrangement, is required under prudential standards to post or collect margin (even if the life company is not subject to a legal requirement to give that security itself).

The second circumstance, set out in sub regulation 4.00A(1B), applies irrespective of whether the life company is required to grant security under the rules governing the operation of an approved body or a law and may apply in respect of any derivatives or

foreign exchange contracts (including exchange-traded derivatives, cleared OTC derivatives and uncleared OTC derivatives).

A charge will satisfy sub regulation 4.00A(1B) if all of the following are satisfied:

a) the asset over which the charge is given is financial property (the definitions of financial property and intermediated security are taken from the *Payment Systems and Netting Act 1998* (PSN Act))[4] [***Schedule 1, item 5, Sub regulation 4.00A(2), 'financial property' and 'intermediated security' definitions***]; and

b) the obligations secured by the financial property are any of the following:

   i) an obligation of the life company that relates to a derivatives contract;

   ii) an obligation of the life company to pay interest on an obligation of the life company that relates to a derivatives contract;

   iii) an obligation of the life company to pay costs and expenses incurred in connection with enforcing a charge given in respect of an obligation of the life company that relates to a derivatives contract or obligation to pay interest on such an obligation; and

c) the financial property is transferred or otherwise dealt with so as to be in the possession or under the control of:

   (i) the secured party; or

   (ii) another person (who is not the life company), who acknowledges in writing that he, she or it has that possession or control of the financial property on behalf of the secured party. [***Schedule 1, item 2, After sub regulation 4.00A(1), sub regulation 4.00A(1B)***]

Sub regulation (1B) uses similar terms and concepts to those used in the PSN Act in respect of facilitating the enforcement of security in respect of financial property given in respect of certain financial market transactions. It is intended that the concepts of possession and control are applied in a similar way to the way in which those concepts are applied in respect of the PSN Act. Sub regulations (1C) to (1F), including the associated table, set out a range of circumstances in respect of which the possession and control test in paragraph (1B)(c) will, or would not, be satisfied. More information about these sub regulations is provided in the Explanatory Memorandum to the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016. [***Schedule 1, item 2, After sub regulation 4.00A(1), sub regulations 4.00A(1B), (1C), (1D), (1E) and (1F)***]

4 The definition of 'financial property' in the PSN Act is broad, and includes a range of property commonly provided as collateral in financial markets transactions.

Sub regulation (1B) is intended to facilitate life companies granting the security required in respect of certain financial market transactions, subject to certain safeguards, where there are commercial imperatives to do so but not necessarily any legal requirements to do so.

Sub regulations (1A) and (1B) are not mutually exclusive and, in certain circumstances, both sub regulations (1A) and (1B) may be satisfied by a particular arrangement. For example, this may occur where a charge is given by a trustee of a Superannuation Fund over financial property which satisfies the requirements in sub regulation (1B) in order to comply with a requirement under the rules of an approved body.

In order for a charge to fall within the exception in regulation 4.00A of the Life Insurance Regulations, it must also satisfy the other existing paragraphs of regulation 4.00A which relate to the circumstances in which the charge is given (paragraph 4.00A(1)(a)) and the risk management statement (paragraphs 4.00A(c) and (d)).

Transitional arrangements are set out in item 6 of the Regulation to clarify that the amendments of these Regulations made by items 1 to 5 of Schedule 1 to the Regulation apply to charges given on and after the commencement of this Regulation. [***Schedule 1, item 6, After Part 13, Part 14 — Transitional arrangements***]

SIS Regulations

The Regulation also makes similar changes to the SIS Regulations as are made, and described above, in respect of the Life Insurance Regulations. The same concepts as apply in respect of life companies in the Life Insurance Regulations apply in respect of trustees of regulated Superannuation Funds.

Generally, the change to paragraph 13.15A(1)(b) and insertion of the new sub regulations 13.15A(1A) and 13.15A(1B) is intended to facilitate the giving of security in respect of any derivatives or foreign exchange contracts (including exchange-traded derivatives, cleared OTC derivatives and uncleared OTC derivatives), subject of course to the safeguards in those sub regulations. For completeness, sub regulations (1A) and (1B) are not intended to be mutually exclusive and, in certain circumstances, both sub regulations (1A) and (1B) may be satisfied by a particular arrangement. [***Schedule 1, item 7, Paragraph 13.15A(1)(b), item 8, After sub regulation 13.15A(1), item 9, Sub regulation 13.15A(2), item 10, sub regulation 13.15A(2) (definition of derivatives contract), item 11, sub regulation 13.15A(2).***]

Similar transitional arrangements apply in respect of charges given by trustees of regulated Superannuation Funds as are set out in respect of life companies. Accordingly, it is noted that the amendments of these Regulations made by items 7 to 11 of Schedule 1 to the Regulation apply to charges given on and after the commencement of this Regulation. [***Schedule 1, item 12, at the end of Part 14***]

A public consultation on this Regulation is underway, and will be complete 5 February 2016.

The Regulation commenced on [date to be inserted once confirmed].

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the Legislative Instrument

The Regulation will enable trustees of superannuation funds and approved deposit funds (Superannuation Funds) regulated under the SIS Act and life companies regulated under the Life Insurance Act to grant security in the manner required to access international capital markets and liquidity. The reforms to allow trustees of RSEs and life companies to grant security in certain specified circumstances are intended to allow those entities to access liquid global markets such as the US cleared OTC derivatives market through FCMs so that these entities can effectively manage their risks and access and the best prices and products.

Human rights implications

This Legislative Instrument does not affect any of the applicable rights or freedoms.

Conclusion

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.