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Submission on Exposure Draft - Corporations Legislation Amendment (Derivative Transactions) Bill 2012

We refer to the request by the Australian Treasury for written submissions on the exposure draft of the Corporations Legislation Amendment (Derivative Transactions) Bill 2012 ("**Exposure Draft**") released on 25 July 2012. We appreciate the opportunity to make this submission.

We have set out our submission below on the following topics:

- Scope of certain definitions
- Hierarchy of rules
- Implications under privacy laws

1 Scope of certain definitions

We submit that some care needs to be taken with the scope of the definitions of "derivative trade repository" and "derivative transaction" for the reasons set out below.

(a) "*derivative trade repository*"

Under s761A of the Exposure Draft, the definition of "derivative trade repository" includes:

"a facility to which information about derivative transactions, or about positions relating to derivative transactions, can be reported..."

This definition refers to a facility to which information "can" be reported. Accordingly, it is extremely broad. We understand that the regulations will describe the "classes" of derivative trade repositories to which the licensing requirement applies and we assume this is the mechanism by which the regime narrows the types of facilities to which it applies. This is critical as if obligations are imposed on "derivative trade repositories" generally, then, based on this definition, a large and undefinable scope of entities could be caught as the definition refers to facilities which can receive this information, not entities that carry on a

business of actually receiving that information. To clarify this, we suggest that the intention behind the use of this definition be included in the explanatory memorandum to the Bill.

(b) “derivative transaction”

Under section 761A of the Exposure Draft, the definition of “derivative transaction” includes both

“the modification or termination of such an arrangement”

in paragraph (b) and:

“any other transaction relating to a derivative”.

in paragraph (c).

The inclusion of paragraph (b) will give rise to complications if this definition is applied uniformly across reporting, clearing and execution requirements. For example, modifications and terminations are unlikely to be cleared, and terminations because of default would not happen through an execution facility. However, we expect that this breadth is included on the assumption that the use of this paragraph will be tailored appropriately in the relevant regulations or derivative transaction rules (“DTRs”). Assuming that this is the case, we suggest that this intention be included in the explanatory memorandum to the Bill.

The inclusion of paragraph (c) does potentially add a greater level of complication. This is because the effect of it is to include transactions which are not intended to be regulated under the new regime. For example, if interest rate hedging is entered into relating to a financing transaction then paragraph (c) may include that financing transaction (as well as the interest rate hedging). This does not seem to be within the intent of the Exposure Draft. As it is difficult to draw boundaries in this regard (different levels of “relating” are hard to articulate) we suggest that some consideration be given to deleting paragraph (c). Alternatively, considerable clarity would need to be provided as to what is intended to be included in “derivative transactions” other than transactions that are the entry into a derivative.

Due to the difficulty in describing what is a derivative transaction, it is still possible that foreign regulations may regulate derivative arrangements which are defined in a different manner than that contained in the Exposure Draft. This could be relevant if equivalent regulation in Australia is needed for Australians to be exempted from the foreign regulation (eg through substituted compliance). With this in mind, it may be beneficial to contemplate an extension of the definition of derivative transaction if such extension is needed to obtain the benefit of exemptions from foreign regulation. For example, you may consider adding the following to the definition:

“(d) anything which is not included in (a), (b) or (c) and which is included in any instrument (including any legislation, rules, orders or regulations) enacted in a jurisdiction other than this jurisdiction (“foreign regulation”) which is equivalent or comparable to Part 7.5A and which, if included in this definition, would enable an Australian entity’s compliance with Part 7.5A to:

(i) substitute for the Australian entity’s compliance with; or

- (ii) *exclude or exempt the Australian entity from being required to comply with,*

that foreign regulation in accordance with the requirements of that foreign regulation.”

A further point which is worth clarifying in the explanatory memorandum is that the definition of “derivative transaction” is not intended to have any application in the existing licensing regime in Chapter 7 of the Corporations Act (which still applies in respect of “derivatives”).

2 Hierarchy of rules

Subsections 822B(2) and 793B(2) of the Exposure Draft describe the hierarchy that is to apply in respect of various sets of rules. We submit that consideration of the implication of these provisions is required for the reasons set out below.

(a) **Impact on the application of the Payment Systems and Netting Act**

Subsection 822B(2) of the Exposure Draft provides that if there is an inconsistency between the operating rules of a licensed CS facility and any of the DTRs or derivative trade repository rules (“DTRRs”), the DTRs or DTRRs (whichever is relevant) prevail over the operating rules to the extent of the inconsistency. Subsection 793B(2) of the Exposure Draft makes a similar provision for the operating rules of a financial market.

The implications of these provisions should be considered very carefully. As certain operating rules of these facilities and markets are critical to the operation of the Australian financial system, significant detriment could be caused to the market if these operating rules are inadvertently overridden by a DTR or DTRR. Importantly, if the effect of this is that provisions of the rules of a licensed CS facility or a financial market which are important for the operation of the *Payment Systems and Netting Act 1998* are overruled then significant unintended consequences could result. Because of the importance of this, we suggest that the following words are added to these provisions:

“except to the extent that this would cause the application of the Payment System and Netting Act 1998 to cease to apply to the operating rules of the licensed CS facility.”

(b) **Changing the terms of transactions**

As noted above, subsection 793B(2) of the Exposure Draft provides that, amongst other things, DTRs prevail over the operating rules of a financial market in the event of an inconsistency between any of them.

If the terms of the derivative contracts themselves are contained in those operating rules, it is important for market stability and certainty that the DTRs are not able to override the very terms of those contracts themselves. To effect this, wording of the following type could be considered for inclusion:

“However, this does not mean that the rules described in (a), (b) or (c) may change the terms of a derivative which has been entered into.”

3 Implications under privacy and confidentiality laws

The Exposure Draft does not specifically address privacy and confidentiality issues arising as a result of the requirement to report derivative transactions (for example, under the *Privacy Act 1988* (Cth), the Banker's duty of confidentiality and the Code of Banking Practice). Our previous submission dated 15 June 2012 described these issues in greater detail.

We submit that the Exposure Draft should be amended to make it clear that the reporting obligations override the privacy and confidentiality obligations under both legislation and general law. For example, you may consider adding the following section at the end of subdivision B of Division 2 of Part 7.5A:

"A disclosure of personal or confidential information in accordance with the reporting requirements:

- (i) is taken to be required and authorised by law for the purposes of the Privacy Act 1988 and any other obligation of confidence; and*
- (ii) is permitted to be made to a person described in section 901A(6) even if that person is not in Australia."*

This approach is consistent with that taken in section 35A(3) of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth).

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We welcome the opportunity to discuss the above matters and other issues in connection with the Exposure Draft with you. Please contact Scott Farrell (+61 2 9296 2142, scott.farrell@au.kwm.com) or Kate Jackson-Maynes (+61 3 9643 4326, kate.jackson-maynes@au.kwm.com) of our offices if we may be of further assistance.

Thank you for your consideration.

Yours faithfully

A stylized, handwritten signature in black ink, consisting of a large, sweeping 'K' followed by a 'W' and a 'M', all connected together. Below the signature is a thick, curved horizontal line.