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Implementation of a framework for Australia's G20 over-the-counter derivatives commitments

We refer to the request by the Australian Treasury for written submissions on its consultation paper on the above subject. We appreciate the opportunity to make this submission.

We have limited our submission on the questions asked in the consultation paper to those aspects of the consultation paper that relate directly to Australian legal issues. Our responses to these questions are set out in turn below. In addition we make some further observations on some Australian legislative matters which should be considered in connection with the central clearing aspects of the proposed reforms.

Initial comments

Question 1: *Do you have any comments on the general form of the legislative framework?*

The general form of the legislative framework appears to be aimed at achieving the flexibility which will be needed to apply the desired regulation to the complexity of the over-the-counter (OTC) derivatives market.

However, it is important that introducing this flexibility does not have the unintended consequence of overriding other legislation fundamental to the financial markets, such as the *Payment Systems and Netting Act* and the *Personal Properties Securities Act*, or of allowing such legislation to be overridden by regulations or derivative transaction rules (DTRs). This could be addressed by clarifying that regulations and DTRs remain subject to this legislation.

In addition, to the extent that consequences of breaches to the legislative framework are being addressed, it is important that those consequences be confined to the person who has committed the breach, rather than other parties or the transactions which were involved. For example, if the enforceability of transactions were affected by breaches of the legislative framework then an undesirable uncertainty would arise which could affect the ordinary functioning of the market.

Question 2: *Do you have any comments on the definition of 'transaction'?*

The proposed definition is: "A 'transaction' includes the making, modifying or termination of a contract for derivatives."

We make the following comments on this:

- This definition is very broad. As it is an inclusive definition, it is difficult to be clear on what a transaction actually is (or, is not). This does not seem to be the same approach as that adopted in Part 7.1 of the *Corporations Act* which, for example, specifically sets out what actions amount to "dealing" in derivatives.

- Assuming that the definitions of the *Corporations Act* will be adopted, by using the defined term, "derivative" types of transactions to which the new regulations are not expected to cover may be caught. This would mean that specific definitions would need to be used in the regulations and DTRs so that the regulatory regime could function properly.

- Some clarity should be included if particular transactions are to be excluded from all proposed regulatory requirements. For example, spot foreign exchange transactions have their own definition under the *Corporations Act* and presumably, as a result, they are not intended to be caught by this definition. Further, if other FX transactions are to be excluded, then this exclusion should be noted initially in the legislation rather than waiting for regulations on DTRD to perform this function.

- The same definition of transaction is not appropriate for all of the requirements of reporting, clearing and trade execution. For example, terminations may be subject to reporting requirements, but it seems unusual to require them to be cleared or conducted through an execution facility. Also, terminations conducted through portfolio compression activities, or close-out procedures on default, would not be conducted through clearing or execution facilities. Also, some modifications would not seem to be relevant to any of the proposed regulatory requirements. For example, a change to an address for notices or settlement instructions is not something that necessarily needs to be reported, cleared or conducted through an execution facility. This could be addressed by providing for that the modifications need to vary the economic terms of the relevant derivative in order to be caught.

Question 3: *Do you have any comments on the definition of 'party'?*

The proposed definition is: "A 'party' means any domestic or foreign person who is dealing in derivatives (including on its behalf) and is a party to a derivative transaction."

We make the following comments on this:

- Assuming that definitions in the *Corporations Act* are to be adopted, "dealing" will not be limited to persons who are carrying on a business of dealing. Accordingly, this will apply to a range of entities and people. If obligations are not intended to be imposed on such persons then the regulations or DTRs will need to exclude them.

- The definition of "foreign person" is to depend on performance of an act which contributes to the entity becoming a party to the transaction within the Australian jurisdiction. Consideration should be given to clarifying whether certain acts are deemed to occur within the Australian jurisdiction. For example, if a person outside of Australia transacts with a party in Australia by phone or electronically this should not be considered an act within the Australian jurisdiction by the foreign person. Also, the reference to "contributes" is broad and difficult to apply. For example, Australian dollar payments are likely to make some processing in Australia. However, it does not appear to be intended that every derivative with an Australian dollar payment obligation is intended to be caught.

Question 4: *Do you have any comments on the definition of 'eligible facility'?*

As the protections provided by Part 5 of the *Payment Systems and Netting Act 1998* are critical to the protection of a clearing facilities in an Australian insolvency, we suggest that an eligible facility for central clearing should be required to be a "netting market" for the purposes of that Act. Holding a Clearing and Settlement Facility Licence under the *Corporations Act* is part of this, but a Ministerial approval under the *Payment Systems and Netting Act* or regulation is also required.

Question 5: *Do you agree that non-discriminatory access requirements should be imposed on eligible facilities?*

The question as to whether non-discriminatory access requirements should be imposed is not a legal question. However, we do note that there are some possible distinctions between access to eligible facilities and access to other services which Australian law already provides a legislative regime for access (in particular, whether the eligible facilities are actually "essential facilities" which exhibit "natural monopoly characteristics").

However, if it is decided that it is economically appropriate to introduce non-discriminatory access requirements then we suggest that separate consultation is engaged in as to the nature of those requirements. Australian legislation contains a range of varying requirements from those which are quite intrusive, to those which are lighter. For example, the introduction of a "negotiate-arbitrate" framework into the provision of these eligible facilities might not be appropriate. This is particularly the case because Australian regulatory requirements and also systemic stability concerns are likely to mean that access to all entities of any type is not actually possible under Australian regulation or desirable as a matter of regulatory policy. We note that although not identical, concerns of this type have led to a more flexible access regime with respect to credit card systems under the *Payment Systems (Regulation) Act 1998*.

Question 25: *From the point of view of your business and/or that of your clients, do you have concerns with reporting Australian trades to Australian and/or international trade repositories?*

Australian privacy laws would currently make it difficult for a financial institution to report trade specific (as opposed to aggregate information) to Australian and international trade repositories. To address this issue the regulations should compel reporting to the trade repository.

Unless a relevant exemption applied, financial institutions would be prohibited from:

- reporting "*personal information"* about an individual to a trade repository under National Privacy Principle 2;
- transferring "*personal information*" about an individual to a trade repository outside of Australia under National Privacy Principle 9;
- reporting information to a trade repository that is not publicly available and has any bearing on an individual's credit history, credit capacity, credit worthiness or credit standing (if the financial institution is a "*credit provider*" for the purposes of the Part IIA of the *Privacy Act*); and
- reporting "*confidential information*" about an individual or body corporate to a trade repository under the Banker's Duty of Confidentiality (and the Code of Banking Practice, if the financial institution was a signatory).

An exemption that is common to all of these restrictions is consent from the individual or body corporate (or in the case of credit information, written authorisation). However, relying on consent exposes the financial institution to risk. For example, if consent is required from existing customers the financial institution could be

forced to rely on implied consent as it is impracticable to obtain express consent from all customers. This exposes the financial institution to the risk that customers will not give their consent (in which case they may be forced to terminate the derivative (if they can)) or that customers will challenge the consent as not effective. To the extent that credit information is disclosed, written authorisation would be required and is likely to impose significant costs when considered across a whole book.

Compulsion by law is also an exception to each of the restrictions listed above. We consider that this is a more appropriate basis on which to deal with these restrictions. We recommend that the regulations proscribe that information must be reported to a trade repository (this should also include what information is to be reported).

Consistency with foreign reporting requirements is important to minimise the compliance burden

Australian financial institutions may have reporting obligations under foreign laws. For example, under the US *Dodd-Frank Act*, Australian financial institutions may be required to report information to the SEC about swaps to which it is a party.

To minimise the compliance burden on Australian financial institutions it will be important to ensure that the information that is to be reported under Australian legislation is consistent with reporting obligations under foreign laws and if possible that reporting under the Australian legislation satisfies reporting obligations under those foreign laws (this could be achieved by way of an intergovernmental agreement with the relevant foreign jurisdiction similar to that being proposed between the IRS and several European countries for the purposes of the US *Foreign Account Tax Compliance Act*).

Question 25.1: *What restrictions should there be on the disclosure of reported data by trade repositories? What requirements should be imposed in relation to data protection and privacy?*

Australian and foreign privacy laws may make it difficult for trade repositories to report data to Australian and international regulators. This should be addressed in the regulations and in the licence conditions for trade repositories.

Trade repositories would be subject to the same restrictions on the disclosure and transfer of "personal information" as outlined above. To the extent that such information was to be disclosed to an Australian or foreign regulator this would need to be compelled by law.

International trade repositories may also be restricted by privacy laws in their home jurisdiction from reporting information to regulators. For example, the European Union has very strict laws relating to the transfer of information out of the European Union. It should be a condition of any international trade repositories licence that they obtain any necessary consent to disclosure of reported data to Australian regulators and/or provide an opinion of foreign counsel that such information can be disclosed (we note that an opinion of foreign counsel in relation to the ability to disclose information under home jurisdiction laws is currently required for registration with the SEC under the *Dodd-Frank Act*).

Requirements are already imposed on Australian trade repositories in relation to data protection however these should be extended to cover other types of information and international trade repositories

Australian Trade Repositories will be subject to the National Privacy Principles in relation to the protection of any personal information they hold about an individual. Any additional requirements should be consistent with these principles.

Depending on the nature and level of information that trade repositories will hold, consideration should also be given to whether they should be subject to a specific data protection code that extends National Privacy Principle like protections to all information held (in the same way that credit reporting agencies and credit

providers are subject to a higher standard under the Credit Reporting Code of Conduct made under the *Privacy Act*).

International trade repositories may not be subject to the National Privacy Principles. Conditions should be imposed on their licences to ensure that they are required to treat reported information in the same way as Australian trade repositories.

Question 25.2: *What restrictions should there be on the use of reported data by trade repositories?*

The comments on 25.1 apply equally here.

Question 28: *Should any requirements be imposed on trade repositories with respect to obligations to provide third parties with access to the information (subject to authorisation from data providers and regulators)?*

There should be no direct third party access to information in the repositary. We suggest the repository should only be able to provide requested information to the Minister who will coordinate exchange at ministerial level (inter government exchanges, similar to a process for information exchange under tax treaties).

Question 29: *Do you have any initial views on the property rights in trade information passed to trade repositories?*

As a matter of Australian law, it would seem more likely that the rights with which a concern is being raised are either rights arising under contract or copyright. However, the issue remains, that being whether a trade repository could restrict the access to the reports and summaries which it prepares on trade activity using the information reported to it. This might be regarded as an unintended consequence of requiring reporting of transactions to the trade repository under Australian law. Given that the trade repositories will be subject to the new licensing regime, it would seem possible that this concern could be addressed through the licence conditions imposed on the trade repository which would compel it to allow access to this information.

Additional matter: *Potential improvements in Australia's legislative framework for OTC clearing*

Although there is not a separate question on this we thought it appropriate to draw to your attention a few matters in connection with Australia's legislation which are relevant to OTC clearing under Australian law:

- as noted above, we would expect that it would be regarded as important that central clearing facilities to which Australian entities are members has the protection of the market netting provisions of the *Payment Systems and Netting Act*, due to the systemic stability benefits that such protection brings. It is also worth noting that as the protection granted by the *Payment Systems and Netting Act* to market netting contracts is more comprehensive if they are governed by Australian law, there is some incentive for Australian law to govern the relevant rules of a central clearing facility, particularly from a legal certainty perspective. Australian law would also facilitate any step-in rights with respect to such a facility, particularly if they were imposed under legislative provisions similar to those in the *Banking Act*.

- although it is critical, the protection granted by the *Payment Systems and Netting Act* to market netting contracts focuses on the termination and netting of obligations which arise under market netting contracts rather than matters in connection with segregation of property and obligations, and portability of transactions and collateral. Also, the protection may not extend to bilateral contracts between a participant in a clearing system and its customers. Accordingly, further clarity of protection would be provided if the statutory protection granted by the *Payment Systems and Netting Act* were extended to cover additional aspects of clearing house arrangements. Not only could this

include segregation and portability, but also the registration and transfer of contracts. Such protection may be desirable for reasons including the following:

- first, under Australian insolvency laws, any transaction into which a company in liquidation purports to enter is void if it is effected after the date of the winding up order referable to that company or, in the case of a voluntary winding up, after the date of the resolution for the winding up; and
- second, payments and deliveries of collateral to the clearing system, and transfers of contracts, may need to be immunised from the effect of the zero hour rule.[1]

For these reasons, it is worth considering whether all aspects of the clearing house rules should be afforded protection from Australian insolvency laws. Some guidance could be taken from the protection afforded to systemically important clearing and payment systems in other jurisdictions - such as certain European laws.

- in any case, it is important that the current uncertainty in relation to the application of the close-out netting provisions to Australian ADI's in statutory management and Australian insurance companies in judicial management be resolved. However, the resolution currently proposed in relation to close-out netting contracts (ie, a 48 hour suspension of the right to close out) may not be appropriate for market netting contracts as a greater level of certainty may be needed.
- also, we note that the "client money rules" in the *Corporations Act 2001* (Cth) could be reworked to provide a greater clarity of operation and more effective protection in OTC CCP arrangements. These rules were originally created to deal with brokers who receive property to be held on a client's behalf and do not operate well in complex arrangements involving the absolute transfer of collateral.

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We welcome the opportunity to discuss these matters, and other issues in connection with the discussion paper, 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

[1] The "zero hour rule" deems an insolvency to begin at the "zero hour", that is, an instant after midnight, on the day on which the insolvency occurs.