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Dear Sir/Madam

Submission to Consultation Paper on *Implementation of a framework for Australia's G20 over-the-counter derivatives commitments* dated April 2012

The proposed reforms to the regulation of over-the-counter (**OTC**) derivatives in Australia and in other jurisdictions around the world are set to introduce significant changes to the way in which OTC derivatives are transacted, the operations of participants in the OTC derivatives market and the documentation of OTC derivatives transactions.

We are pleased to be given the opportunity to make submissions to the Treasury in relation to its consultation paper entitled *Implementation of a framework for Australia's G20 over-the-counter derivatives commitments* dated April 2012 (**Consultation Paper**). We believe that Australian regulators should strive to develop and implement regulations that are both clear in their application and harmonious with other regulations being developed around the world so as to ensure certainty and efficiency for market participants. In this submission we have limited our responses to those questions that directly relate to issues of law and the structure of the proposed legislative reforms. Accordingly, we make specific comments on questions 1, 2, 3, 5, 6, 10, 18, 19, 27 and 28 raised in the Consultation Paper. Our responses to these questions and other general comments are set out below.

By way of background, lawyers at Norton Rose Australia have extensive experience advising financial institutions, asset managers and corporates regarding the application of Australian laws and regulations (such as Australian licensing requirements) to their activities in the OTC derivatives market and the legal documentation for both OTC and exchange-traded derivatives.

Our colleagues at Norton Rose LLP in Europe have also been involved in helping clients to understand and, in some places, shape, the Regulation on OTC Derivative Transactions, Central Counterparties and Trade Repositories (**EMIR**), including by assisting clients in preparing submissions on particular aspects of the draft legislation. They are now assisting clients to implement what is an almost final regulation. Please refer to the "OTC Oracle" microsite on the Norton Rose website (which can be found at http://www.nortonrose.com/knowledge/technical-resources/oracle/) for further information and technical resources developed by the Norton Rose Group in relation to its involvement in OTC derivatives regulation reform in other jurisdictions.

1 General comments

1.1 Whilst the Consultation Paper provides some indication regarding what will be proposed under Australia's OTC derivatives regulatory framework, it is clear that further detailed regulations will need

to be provided in order for market participants to provide practical feedback regarding the implications of the proposed approach to implementing a legislative framework. For instance, the paper lightly touches on exemptions from the clearing obligation (eg for hedging transactions) but does not go into sufficient detail as to how these exemptions will operate. We look forward to the further consultation on the proposed rules.

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

2.1 The mandatory obligations described in section 3.1 of the Consultation Paper envisage that a party "must" ensure that the relevant obligation is complied with. It would be desirable if the legislative framework expressly acknowledged that a party may satisfy its obligations via an agent acting on its behalf. For example, a corporate entity entering into derivatives transactions for hedging purposes with a bank counterparty may not have the technical or operational capabilities in place to report trades to a trade repository. An efficient outcome could be achieved if the legislative framework would permit one party to a transaction to satisfy its obligations to report a transaction (but still remaining liable for the principal reporting obligation) by allowing the other party to do so on its behalf (ie reporting of the transaction by one party could satisfy the obligations of both parties). By way of analogy, agency arrangements are permitted under the *Anti-Money Laundering and Counter Terrorism Financing Act 2006 (Cth)* in relation to customer identification procedures.

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

3.1 The Consultation Paper provides that only certain prescribed classes of derivatives will be subject to, the mandatory obligations of trade reporting, central clearing and trade execution. Whilst we understand the government's desire to adopt a flexible approach to the definition of transaction, this needs to be balanced against the need for certainty.

3.2 To ensure greater certainty, it would be desirable for the prescribed class of derivatives to be defined with a high degree of precision. At this stage, it is not clear from the Consultation Paper whether the suggested definitions for "party" and "transaction" will incorporate the definition of "derivative" in the *Corporations Act 2001 (Cth)* (**Corporations Act**), which adopts a broad definition of derivative.

3.3 We suggest that careful thought be given to any prescribed class of derivatives so that the exact types of derivatives to be caught under each prescribed class are specified in sufficient detail for the relevant mandatory obligation. If a general broad definitional approach were taken (as is the case with the definition of "derivative" in the Corporations Act) for each prescribed class, the regulations would be likely to capture derivatives for which it would be difficult and impractical to comply with the mandatory obligation. For example, if the view is taken that AUD denominated interest rate swaps should be subject to clearing, the class of derivative could be specified by reference to a derivative transaction where one party pays a fixed amount and another party pays a floating amount, in each case determined by reference to a fixed or variable rate. This would be preferable to an approach which sought to define such a derivative by reference to a transaction whereby the parties seek to manage their AUD interest rate exposure.

3.4 The definition of "transaction" in the Consultation Paper also states that it "includes" certain actions regarding a contract for derivatives. Again, to ensure greater certainty, consideration should be given to adopting an exhaustive definition. In our view, the reference to "making, modifying or terminating a contract for derivatives" should be sufficient to capture all relevant dealings in derivatives for the purposes of the proposed mandatory obligations.

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

4.1 The Consultation Paper provides that the mandatory obligations of trade reporting, central clearing and trade execution will apply to "a party to a derivative transaction". The concept of when a person is a party to a derivative transaction should be considered carefully. For example, if an investment manager enters into a derivative as agent for the trustee of a fund (ie so that the trustee is the principal), who will be the "party" for the purposes of the regulations and, therefore, the person primarily responsible for ensuring compliance with the relevant mandatory obligation?

4.2 Both the asset manager and the trustee could be said to be "dealing" in a derivative (one on its own behalf and the other as agent) and to be a "party" (one as contracting party and the other as the legal (principal) party). The legislative framework should clearly identify which party the mandatory obligation applies to and/or provide that one party may satisfy its obligations if the other party does so (ie that the trustee can satisfy any obligations via the investment manager), as agent (see paragraph 2.1 above).

4.3 The concept that a foreign person will be a party for the purposes of the regulations if it performs an act within Australia that "contributes" to it becoming a party to a transaction will also potentially capture insignificant actions. For example, if an officer at an Australian branch of an offshore bank refers a potential counterparty to one of its offshore offices and the Australian officer plays no further role in finalising and executing the transaction, will this mean that an act has been performed in Australia that has contributed to a foreign person becoming a party to a transaction? In our view, active solicitation rather an isolated act should be the test.

This also needs to be considered in light of other issues, such as whether the offshore office of the foreign bank would also be subject to similar mandatory obligations in its home jurisdiction. In our view, parameters should be specified as to the nature of the contribution that results in the transaction which look at the commercial reality of the circumstances. For example, if all negotiations and pricing relating to the transaction were conducted in Australia and the transaction was simply "booked" offshore, then there would be merit for the mandatory obligations to apply to the foreign person.

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

5.1 If mandatory trade reporting, central clearing and trade execution is to be specified for a particular class of derivative transaction, then the ability of participants in the OTC derivatives market to access the applicable eligible facility (such as a CCP for clearing) for that derivative is an important issue, particularly if there is only one eligible facility.

5.2 Considering CCPs only, it is anticipated that market participants will either become direct members of the CCP or access the CCP's facilities by becoming a client of a CCP member, depending on whether the participant is able to meet the rules that the CCP imposes on its members and whether the participant wishes to assume the additional obligations imposed on it by virtue of becoming a direct member of the CCP.

5.3 By requiring eligible facilities to provide "non-discriminatory access on fair and open terms", we assume that it is not intended that CCPs make their facilities available to any person that wishes to enter into an OTC derivative that is subject to the mandatory clearing obligation. In our view, the legislative framework should require that any CCP should establish clear rules and requirements that are applied consistently to establish the eligibility of a market participant to participate in the CCP and that all derivatives transacted through a member of the CCP are treated the same in terms of margin and collateral requirements. The objective of this approach would be that an indirect participant in the CCP should, in terms of margin/collateral requirements, be indifferent as to who it uses as its clearing member. We note that in EMIR, admission criteria must be non-discriminatory, transparent and objective and ensure that clearing members have sufficient financial resources and operational capacity for their roles, and that criteria to restrict access may only be permitted to the extent their objective is to control risk for the CCP. We suggest that Treasury considers taking this approach in the development of any rules relating to non-discriminatory access.

6 ***Question 6: Do you have any comments on the rule-making power that will be available to ASIC?***

6.1 We note that as part of the implementation process, a legislative instrument (**Instrument**) amending the Corporations Act will provide for, among other things, ASIC power to create derivative transaction rules (**DTRs**) to give effect to the relevant mandatory obligations associated with the prescribed classes of derivatives.

6.2 Notwithstanding that Ministerial consent is generally required to approve DTRs, the Instrument should enumerate specific guiding principles to be followed by ASIC in formulating DTRs regarding OTC derivatives. Without any set limits, there is a risk that DTRs may go beyond the ambit of, or could be inconsistent with, the G20 commitments regarding OTC derivatives (**G20 Commitments**). We set out below some options as to how this could be addressed.

(1) Option 1: The Instrument should contain, or at least refer to, a list of objectives that ASIC should have regard to when formulating the DTRs and these objectives should align with the G20 Commitments.

(2) Option 2: In framing what areas the DTRs deal with, specific details on what the DTRs can cover should be included so as to appropriately define their scope.

6.3 We suggest that the level of detail under Option 2 should go beyond what was included in the *Corporations Amendment (Financial Market Supervision) Act 2010 (Cth)* which gave ASIC the power to create the *ASIC Market Integrity Rules (ASX Market) 2010 (Cth)* with little restrictions set (other than Minister consent).[1] This is because the latter legislation appeared to provide ASIC with the unfettered ability to create rules covering a relatively broad scope eg "activities or conduct of licensed markets".

6.4 The above have been provided as examples only. Careful thought should be given to the exact legislative wording needed to set any relevant limits regarding the scope of the DTRs.

7 ***Question 10: Do you have any concerns around "backloading requirements?"***

7.1 Clearly, backloading of transactions would present practical and logistical issues for market participants to consider. From a legal perspective, it would be prudent if the legislative framework provided for a transitional period for compliance with any backloading requirements. For example:

(1) existing transactions should be required to be backloaded within a specified transitional period, except for those transactions that terminate within the transitional period;

(2) if an existing transaction is modified during the transitional period, it should immediately become subject to any applicable mandatory obligation (ie as if it were a new transaction entered into after the commencement of the regulations).

We note that under EMIR, there is a "backstop date" that applies to the clearing obligation, meaning that contracts entered into or novated before that date (which relates to the date on which the first CCP to be authorised to clear the relevant contract is notified by its national regulator to the European Securities and Markets Authority (**ESMA**)) are not required to be centrally cleared. We understand that there was some debate about backloading in Europe on the grounds that mandating it for too many contracts could create unnecessary risk to the CCP which has to assume a large volume of historical contracts in a short period of time and which could require clearing members to put up a significant amount of margin as a result.

8 ***Question 18: Are there specific classes of transaction that should be excluded from the potential reach of trade clearing DTRs?***

Q18.1: In particular, should some transactions entered into for certain purposes (for example, hedging, commercial risk mitigation) be outside the potential reach of the rule-making power?

8.1 We support the implementation of a hedging exemption as this is consistent with current regulation practice in areas such as financial services, and the proposals under EMIR. For instance, we note

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[1] We note the *ASIC Market Integrity Rules (ASX Market) 2010 (Cth)* were implemented by the *Corporations Amendment (Financial Market Supervision) Act 2010 (Cth)* which amended the Corporations Act. We assume a similar legislative approach will be adopted for the ASIC DTRs.

that under the Corporations Act, there is an exemption from the Australian financial services licensing regime for entities that deal in derivatives and/or foreign exchange contracts for hedging purposes (as part of their ordinary course of business) and such dealing is not a significant part of the entity's business (see regulation 7.6.01(1)(m) of the *Corporations Regulations 2009 (Cth)*). Under EMIR, certain hedging transactions do not need to be included in a non-financial counterparty's positions for the purposes of determining whether it exceeds the threshold over a predefined period of time, although once that threshold has been exceeded, all transactions are subject to the obligations regardless of their purpose. We understand that the Monetary Authority of Singapore (**MAS**) has also proposed a hedging exemption in their consultation paper titled *Proposed Regulation of OTC Derivatives* issued in February 2012.

8.2 We consider that the rules should clarify what constitutes a hedging transaction so there is certainty for those seeking to rely on this exemption. In the MAS consultation paper, "hedging transactions" refer to transactions which qualify for hedging treatment under Singapore Financial Reporting Standards or other internationally accepted reporting standards such as those of International Accounting Standards Board or US Financial Accounting Standards Board.

8.3 In principle, we also support the addition of a threshold restriction on the hedging exemption, subject to understanding how such thresholds would be determined and the scope for changing the thresholds over time as appropriate.

8.4 Another exemption proposed by EMIR is that certain intra-group derivatives transactions be exempt from the clearing obligation. We consider this to be appropriate for various reasons including that it would not be in the market's interests to move risks out of a group to an unaffiliated third party (ie the central clearing party). Further, the imposition of a clearing obligation would, in most cases, fetter the ability of group management to allocate risk, capital and functions among group members. It is important that groups are able to retain such flexibility given they have a better understanding of the financial positions of their members and accordingly are in a better position to make determinations on any capital allocations needed or restructuring of the swap transactions (eg where one group entity does not have the capital to support its obligations under an intra-group derivatives transaction). For the above reasons we consider the exclusion of intra-group trades would be welcomed by market participants.

8.5 We note EMIR has proposed that derivatives transactions entered into by certain pension schemes be exempt from the clearing obligation for three years in certain conditions. We understand this exemption has been provided in recognition of the difficulties pension schemes might have in meeting the variation margin requirements of CCPs. Treasury should consider adopting a similar exclusion for derivatives transactions entered into by Australian superannuation funds. The availability of such an exemption could be subject to compliance with specific criteria.

8.6 In terms of products excluded, we understand other regulators such as MAS propose to exempt certain derivatives from the clearing obligation (eg foreign exchange forwards and swaps) on the basis that the main source of systemic risk arising from these products is settlement risk, and there is already an established international settlement process to mitigate such risk. The MAS paper notes that the proposed exemption is in line with the US approach to exempt these instruments from the clearing and trading requirements under the *Dodd-Frank Act*. The Australian Consultation Paper identified Australian dollar denominated interest rate swaps as priority products that should be subject to the clearing obligation and we agree with the reasoning behind this as reflected in the discussion paper titled Central clearing of OTC derivatives in Australia issued in June 2011 by the Council of Financial Regulators.[2]

9 ***Question 19: Do you agree with the option of requiring central clearing for derivatives where at least one side of the contract is booked in Australia and either: (a) both parties to the contract are resident or have presence in Australia and are entities that are subject to the clearing mandate; or (b) one party to the contract is resident or has a presence in Australia and is subject to the clearing mandate, and the other party is an entity that would have been***

[2] Some of the reasons cited include that the duration of counterparty risk exposures of these instruments is long-term in many cases and, the dominant products (such as forward rate agreements, overnight indexed swaps and interest rate swaps) are all relatively standardised and hence likely suited to central clearing.

subject to the clearing mandate if it had been resident or had a presence in Australia? If not, what definition do you prefer?

9.1 Given the global nature of the OTC derivatives market, the precise jurisdictional scope of any mandatory obligation to centrally clear a derivative is an important consideration and perhaps the most difficult to completely resolve absent international harmonisation of requirements with one central global CCP. In our view, any formulation of the jurisdictional scope is not likely to completely avoid a situation where there would be a simultaneous obligation for two parties to an OTC derivative to clear a transaction on more than one CCP. In this case, the scope of any exemptions granted by ASIC or the mutual recognition of clearing via foreign CCPs will be of critical importance to market participants. ASIC has, in principle, recognised this issue as regards financial services licensing by conferring licensing relief for some overseas dealers or market makers in derivatives and foreign exchange contracts.[3] Other ASIC licensing relief applies more broadly where a foreign entity is licensed by certain designated regulators and fulfils specified conditions.[4] We understand that further details regarding these requirements will be issued in later consultations.

10 ***Question 27: Is it appropriate for ASIC or another regulator to have the power to grant licenses to trade repositories, or should the Minister have this power? What checks and balances should there be on ASIC's power to grant trade repository licenses?***

10.1 We note the proposals to establish a licensing regime for trade repositories. Given it is proposed that ASIC will be making the rules that govern the operation of trade repositories, we consider it is appropriate that ASIC also have the power to grant and revoke trade repository licences.

10.2 We observe that under existing laws[5], an overseas entity that operates a financial market in a foreign country may apply for an Australian financial services licence if the entity meets certain criteria including that it is authorised to operate the financial market in its own jurisdiction and that the Minister will need to be satisfied that regulation of the market in the entity's home jurisdiction is sufficiently equivalent to regulation under the Corporations Act.

10.3 Having regard to the above observation, we suggest adopting a similar approach in granting trade repository licences, or trade repository licence exemptions, to overseas trade repositories. That is, the Minister and ASIC should be required to have regard to whether the regulatory regime of the home jurisdiction is sufficiently equivalent to the proposed regulation of domestic trade repositories. It is important that ASIC take a facilitative approach in relation to licensing of overseas trade repositories so as not to discourage their participation in Australian markets or access by Australian counterparties. Access to the information collected by foreign entities as well would no doubt assist Australian regulators in their oversight of the OTC derivatives market.

10.4 We note that under EMIR, a trade repository in a "third country" can provide its services to entities in the European Union if it is recognised by ESMA. Such a trade repository will have to apply for recognition but ESMA will grant recognition if, in brief, the trade repository is authorised and subject to effective supervision in a third country in relation to which:

(1) the European Commission has adopted an act determining that the legal and supervisory arrangements that apply to trade repositories are equivalent to those in EMIR, that there is effective ongoing supervision and enforcement and that there are guarantees of professional secrecy at least equivalent to those in EMIR;

(2) the EU has entered into an agreement regarding mutual access and exchange of information held in trade repositories which ensures that ESMA and other authorities in the European Union have immediate and continuous access to the date they need; and

(3) there are cooperation arrangements setting out a mechanism for the exchange of information and coordination of supervisory activities.

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[3] Class Order 04/1570.

[4] Class Order 03/823 (for overseas based authorised deposit taking institutions) and Class Orders 03/1099-1103 (for wholesale foreign financial services providers).

[5] See our comments in paragraph 9.1 above and paragraph 10.5 below.

10.5 Care also needs to be taken so that duplicate regulation under Australia's own licensing regimes is avoided. For instance, licensed trade repositories should not be required to hold an Australian financial services (**AFS**) licence for any activities conducted in relation to their trade repository functions. Depending on the reporting obligations of trade repositories, the reporting of certain information on OTC derivatives transactions may, in some circumstances, be treated as financial product advice. Accordingly, in such circumstances it would be appropriate to provide a clear AFS licence exemption for trade repositories who hold a trade repository licence or are exempt from the trade repository licence requirement. We note AFS licence exemptions have been granted to market operators who hold a market licence or are exempt from the requirements to hold a market licence. The Corporations Act also provides a specific AFS licence exemption in section 911A(2)(d) for activities in relation to the operation of a licensed market or a licensed clearing and settlement facility. Such licensing exemptions should be mirrored for trade repository activities.

10.6 Little detail has been provided in the Consultation Paper as to the compliance requirements of licensed trade repositories. For instance, there is no discussion on any additional capital requirements that such licensees would need to meet. We note that EMIR does not impose any capital requirements on trade repositories although they must pay supervisory fees to cover ESMA's expenditure relating to the registration and supervision of trade repositories and the reimbursement of any costs ESMA might incur. Should ASIC nevertheless decide to take a different approach and introduce new capital requirements, we request that public consultation and consultation with APRA (to avoid duplication of capital requirements where a repository is partly owned by an APRA-regulated entity), be sought early on any proposed new capital requirements. This is consistent with for instance, MAS who, among other things, is considering imposing minimum base capital requirements on trade repositories.

11 ***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)?***

11.1 Given that trade repositories may hold commercially sensitive information, it is appropriate that disclosure by trade repositories of certain information reported to them (such as identity of counterparties) be restricted to the relevant regulators and no other third parties unless the relevant counterparty has provided consent. This restriction could be enforced, for instance, through the trade repository's licence conditions. We note under EMIR a trade repository may only use data it receives pursuant to the reporting obligation in EMIR for commercial purposes if the relevant counterparties have provided their consent. We also note the following disclosure requirement that trade repositories must comply with under EMIR:

(1) a trade repository must publish aggregate positions by class of derivatives;

(2) a trade repository must have objective, non-discriminatory and publicly disclosed requirements for access by firms that are subject to the reporting requirement; and

(3) a trade repository must grant service providers non-discriminatory access to information on condition that the relevant counterparties have consented.

11.2 We support the implementation of similar disclosure requirements for Australian licensed trade repositories. It is important that market participants understand their own risks and exposures and we consider that some of the above requirements will assist with this objective.

12 ***Other comments***

12.1 Notwithstanding ASIC has released regulatory guidance on the application of the client money rules in relation to OTC derivatives dealing, consideration should still be given to revising the client money rules under the Corporations Act. This is because these rules do not adequately take into account complex arrangements, including the holding of collateral that under the current rules might not be "client money", associated with OTC derivatives transactions. We consider that any such revisions should provide more effective protection in OTC derivatives arrangements.

We would be pleased to discuss further with you our submissions in relation to the above questions. Please do not hesitate to contact Fadi Khoury ((02) 9330 8685), Vittorio Casamento ((02) 9330 8679) or Tessa Hoser ((02) 9330 8083).

Yours faithfully

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