3 October 2012

Dr Richard Grant
Acting Secretary
Parliamentary Joint Committee on
Corporations and Financial Services
Department of the Senate
Parliament House
CANBERRA ACT 2600

By email: corporations.joint@aph.gov.au

Dear Dr Grant

Corporations Legislation Amendment (Derivative Transactions) Bill 2012

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Corporations Legislation Amendment (Derivatives Transactions) Bill 2012 (Bill).

AFMA is the leading industry association in promoting efficiency, integrity and professionalism in Australia's financial markets and provides leadership in advancing the interests of all market participants. These markets are an integral feature of the economy and perform the vital function of facilitating the efficient use of capital and management of risk. Market participants perform a range of important roles within these markets including those for over-the-counter (OTC) derivatives.

1. Reform Background

This Bill heralds a major structural change to the derivatives market in Australia that is taking place in conjunction with reforms in other G-20 countries. AFMA supports passage of this legislation because the certainty from having a legislative framework in place will allow market participants to plan and start on the process of working on the details of implementation.

Following the 2008 financial crisis, authorities around the world have sought to improve the post-trade infrastructure for OTC derivative transactions. The Financial Stability

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Board (FSB) identified the need to further enhance the safety in the OTC derivatives market. This led G-20 leaders to agree in September 2009 that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCP). As a result, authorities in G-20 jurisdictions have put forward policy initiatives aimed at encouraging greater use of CCPs for OTC derivatives markets. The G-20 Pittsburgh communiqué required OTC derivatives market reforms to take place no later than the end of 2012. The Dodd-Frank Act reforms in the United States are already having a big influence on derivatives trading and clearing around the world. This creates another imperative for the legislation to protect against Australian-based businesses being disadvantaged in their offshore dealings.

While the ideal of international coordination of regulation for interconnected global financial markets such as for OTC derivatives is strongly supported by industry, there is increasing apprehension that regulation in different G-20 jurisdictions may be creating conditions which will lead to fragmentation of markets, protectionism, and regulatory arbitrage, ultimately decreasing the ability of global regulators to effectively regulate an increasingly global capital marketplace. Different jurisdictions are enacting changes in a way that creates an uneven playing field. Even differences that may appear relatively minor can in practice give rise to major problems and therefore be a significant hurdle to meeting the G-20 objectives.

Major jurisdictions, such as the United State and the European Union, are creating rules which are ambiguous and which create problematic extraterritorial challenges and issues of legal uncertainty and misunderstanding which might give rise to material risk. Key jurisdictions seek to have at least some extraterritorial effect in relation to their regulations relating to derivatives.

Banks and other financial institutions that undertake significant cross-border activities are particularly concerned that they may be subject to overlapping regulatory requirements in different jurisdictions and may need to comply with two or more different regimes. Areas of concern include duplication of registration and licensing requirements, clearing obligations, transaction and position reporting, collateral and margining requirements, and prudential obligations. There is also the possibility that it may be impossible for an institution to comply with conflicting requirements in different jurisdictions. Even where compliance with two or more overlapping requirements is possible, this is likely to lead to additional administrative and compliance costs.

In considering this Bill it is important to bear in mind that OTC derivatives are a diverse group of financial instruments which play a vital role in supporting underlying commercial activity and promoting business efficiency, and their users have quite distinct needs and roles in the market.

A derivative transaction allows the parties to allocate an identified risk to the party best placed to manage that risk. OTC derivatives are usually an efficient way to achieve this, but similar economic results can be achieved in a number of other ways. There are many other forms of contract that do the same thing: insurance, guarantees, letters of credit, factoring and repurchase agreements. Alternatively such exposures may be a natural

consequence of other economic activity which could be used to create or transfer the exposure if desired.

It is important to distinguish between risks (such as counterparty risk, i.e. the risk of non-performance by a party to a derivative transaction) that are attributable to the derivative transaction itself and the underlying economic exposures (such as interest rates, share prices, or other volatile and fungible risks) which the derivative transaction allocates between the parties and to which it relates. These economic exposures will continue to exist whatever rules or regulations are introduced in relation to derivatives. Derivatives are simply one tool (of several) to help manage them.

OTC derivatives, with the exception of a comparatively small range of retail products, are wholesale financial market instruments, used and traded in the main by sophisticated commercial entities with large financial risks to manage. Their defining characteristic is that they are tailored financial products, transacted on a truly bilateral basis. It is this flexibility that makes OTC derivatives especially useful to wholesale market users. Any given deal may well be unique, reflecting the specific financial risk management needs of individual entities at a given moment.

The benefit of derivatives, and the reason they raise concerns as an asset class, is that they have proven to be an efficient tool. OTC derivative contracts that protect the end-users against risks directly related to their commercial activities and treasury financing activities as well as those that do not protect against such risk but do not exceed a clearing threshold should not be subject to the clearing obligation. For example, airlines hedge against rising oil prices are hedging commercial risks. This is why this Bill does not take a one-size-fits-all approach.

The Australian authorities have been responsive and understanding of the issues facing industry and are to be commended in their efforts to deal with these international dimensions of regulation in this area with their overseas counterparts. In making its recommendations to the Government which gave rise to this Bill the Council of Financial Regulators said that regulatory developments in offshore jurisdictions are likely to have some spill over effect on the configuration and activity of the domestic market. The importance of cross-border harmonisation in regulatory approaches to OTC derivatives market reform is increasingly appreciated in all jurisdictions. The Council also recognised that the international regulatory environment is not settled.

As a result, the legislative framework does not seek to provide definitive answers to many detailed questions, such as the precise geographical scope of any domestic mandatory requirements for reporting, clearing or trading; or the interaction of any domestic requirements with requirements imposed by other jurisdictions, where more than one regime could apply to particular conduct. The framework provides an open competitive environment for market infrastructure while giving the regulators the tools to manage systemic risk. The framework recognises the need for a flexible regime that can cope with the rapid evolution that is occurring around the globe and enables market participants to adopt appropriate risk management and business decisions based on cost and liquidity.

While the need for flexibility in the legislation is agreed on, its generality creates scope for industry uncertainty and confusion. The practical challenges with implementation, particularly with regard to trade reporting, are enormous and there is much further consultation that will need to be carried out with the development of the regulations and derivative transaction rules.

2. Flexibility through Regulations

AFMA supports using regulation-making powers as the means to provide the necessary degree of flexibility. However, the Bill relies on administrative rule making over use of regulations, and as such, AFMA is concerned with the level of administrative discretion granted to ASIC by this Bill in the form of the *derivative transaction rules*.

The rule-making power should deal with matters relating to the administration and supervision of the regime. It is the role of the Parliament through its acts to set out the framework of the regime and the parameters within which it should operate. Establishing classes of persons and products and the requirements which they need to observe when coming within the scope of the regime are properly matters for policy-making and Parliamentary decision. Where flexibility is required this can be achieved through regulation-making powers. Administration of the law is about how rules set by Parliament of general application are to apply in practice to specific circumstances and persons and then ensure that the law is followed. Discretions are granted by Parliament in order that the law may be applied in a rational, common sense way to particular circumstances not for creating rules of general application.

Actions taken under delegated powers are not always purely administrative in nature, but can involve decisions on matters of policy, which certainly should be subject to scrutiny by the legislature. This is done for three reasons: to distinguish between matters of administration and those of policy; to ensure that significant policy matters are brought to the attention of the legislature, for their acceptance or disapproval; and to ensure that any such quasi-laws which affect individuals are reasonably available to them for debate and scrutiny.

This Bill seeks to set constraints on ASIC's discretion through a negative regulation power. This is done through section 901C, which enables regulations that may limit the transactions to which the rules may impose requirements. Regulations may also provide that requirements may only be imposed on certain classes of derivative transactions in certain circumstances. AFMA considers that a better approach is to have a proper hierarchy of delegation with regulations setting out the boundaries in a positive manner through requirements which are then supported by more specific rules.

This could be achieved through the general requirements set out in subsection 901A (2), namely for execution, clearing, reporting and those that are incidental to these being established through regulations not rules. The other matters dealt with in subsection 901A (3) relating to specific circumstances could then be appropriately dealt with through rules.

3. Section 900A Extraterritoriality

Paragraph 900A(c) extends the theoretical scope of legislation to 'a place outside Australia'. In other words this legislation has no bounded jurisdiction whatsoever. The Explanatory Memorandum at paragraph 1.93 comments that the broad territorial reach of the provision is required to ensure that ASIC is able to coordinate its rule-making with foreign jurisdictions to aid in consistency of regulatory approaches and to assist in ensuring that international capital markets remain open to cross-border participation.

While jurisdiction can readily be exercised over those entities having a presence in Australia through being incorporated in or having a branch in Australia, a law that attempts to impose jurisdiction on offshore parties is likely to fail where the entity does not carry out the activity in Australia and has no presence here. Dealings between counterparties both located offshore are in a practical sense very difficult to capture. Extraterritorial laws normally rely on the party having some physical connection with the jurisdiction, such as through the location of assets or personnel, even if they are not directly connected with the dealing in question.

AFMA considers that this unbounded jurisdictional reach may prove problematic in practice with the risk that market participants will be faced with complex conflicts of laws problems. A more precise extension of jurisdiction beyond Australia to persons with some connection to it would be desirable.

4. Definition of 'Class'

The legislation enables the use of the concept of 'class' as a means to create a category of derivatives that may be either brought under the requirements under paragraph 901B(2) or exempted by ASIC for different purposes under sections 905A and 907D. While it is desirable to control coverage by a category of derivatives this should be done in a way which is comprehensible and usable by the market. Currently, Note 2 says that a class of derivatives can be described by reference to any matter, including (for example):

- the kind of asset, rate, index or commodity to which the derivatives relate; or
- the time when the derivatives were issued, or their date of maturity.

Market participants consider this language to be vague and uncertain. Greater precision could be achieve if the note were to describe a 'class' as based on a product classification system that is aligned with international financial standards.

5. Consequential Amendments

The Bill also provides for consequential amendments to related legislation. AFMA in its earlier submissions to the Government commented that there should be a government commitment to ensure that other laws, such as tax and insolvency laws, do not have adverse consequences for entities complying with the new regime, which would otherwise impede the systemic stability objectives of the OTC derivatives reforms.

Tax issues are an area that needs particular attention to ensure that no adverse outcomes arise from meeting clearing requirements. Many market participants will be located in jurisdictions that either do not impose withholding tax on interest payments, provide specific withholding exemptions in respect of cleared trades or will otherwise not be required to withhold on payments to Australian participants. In this regard, AFMA is bringing to the Government's attention taxation concerns and a proposal to alleviate the competitive disadvantage created by the Australian withholding tax system. This may require additional consequential amendments.

Yours sincerely

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