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Central Clearing of OTC Derivatives in Australia

We refer to the request by the Council of Financial Regulators ("**Council**") for written submissions on its discussion paper on the central clearing of OTC derivatives in Australia. We appreciate the opportunity to make this submission.

We have limited our submission to those aspects of the discussion paper that relate directly to law or issues relating to law reform. Accordingly, we make comments on questions 10, 11, 12, 15, 16 and 17 raised in the paper. Our responses to these questions are set out in turn below, after some short initial comments.

Initial comments

We appreciate the Council's work on the discussion paper. A number of Australian and international entities and organisations have commented to us that it is a thorough and thoughtful paper which reflects well on the sophistication of the Australian financial regulators. We echo these remarks and we are grateful for the efforts made by the Council.

Clearly, there is more which needs to be done in relation to the issue of central clearing of derivatives in Australia, whatever the path taken by the Council following this discussion period. The path taken will give rise to further issues for consideration as the detail of the consequences emerge. For example, the responses to a number of questions in relation to our legal and regulatory system depends on the structure and form of any Australian clearing house which is established. Accordingly, we have left our comments below at a high level. We would be happy to respond with more detailed comments if a more detailed structure is developed.

Question 10: *Do you consider any changes need to be made to Australian law or regulation to improve a CCP's arrangements for the segregation and portability of client accounts?*

As noted above, a detailed response to this would depend on the precise structure of the proposed CCP arrangements. However, it is possible to make the following general observations:

- the *Payment Systems and Netting Act 1998* (Cth) ("***Netting Act**")* does provide a significant level of protection to "market netting contracts" which are approved for the purposes of that Act. Due to this protection, we would expect that an Australian CCP would seek to obtain such approval. Also, as the protection granted by the *Netting Act* to market netting contracts

is more comprehensive if they are governed by Australian law, we expect that there is some an incentive for Australian law to govern the relevant rules of a CCP, particularly from a legal certainty perspective.

- the protection granted by the *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 ("**clearing member**") and its customers (of course, with appropriate structuring, these bilateral contracts could obtain protections provided by other parts of the Netting Act).

- accordingly, further clarity of protection would be provided if the statutory protection granted by the *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]

- in fact, 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 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.

[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.

Question 11: *Do you consider any other changes need to be made to Australian law or regulation to improve the handling of collateral posted by market participants for positions cleared offshore?*

The rules of offshore CCPs provide varying degrees of protection to collateral posted by participants in the system and their customers. For example, the rules of some offshore CCPs do not regulate the relationship between the clearing member and its customers, nor require the segregation of customer collateral at the clearing member level. This may mean that, in the event of a clearing member insolvency, the ability of an Australian customer to recover collateral posted with the participant may depend on the laws of the home jurisdiction of the clearing member and the laws governing the proprietary aspects of the collateral (or any security interest in it). If this is of a concern to the Council, there are a number of ways in which this could be addressed. For example, it might be possible to require that the contracts between Australian customers and clearing members be governed by Australian law, that collateral posted by Australian customers and Australian clearing members be located in Australia and that any proprietary interest of the customer and clearing member in such collateral be governed by Australian law.

Although the primary legal system which is relevant to the proper functioning of an offshore CCP is the laws of the jurisdiction where is it is based, Australian laws and regulations can still impact the ability of Australian institutions to join, and use, offshore clearing systems. This can occur in at least two ways:

- recognition by the regulators of the CCP's jurisdiction of Australian regulatory arrangements which apply to Australian participants may be fundamental to those Australian participants being able to join the system efficiently. For example, if the Australian regulatory regime to which Australian market participants are subject is not recognised by the jurisdiction where the CCP is located (such that the Australian market participants needed to subject themselves to separate regulation in each jurisdiction in which they clear derivatives) then significant additional costs and incremental inefficiencies are likely to be incurred.

- extension to foreign CCPs of the protection afforded to Australian clearing systems from the insolvency laws applying to Australian market participants is likely to assist in ensuring that those Australian market participants do not suffer a disadvantage because of so-called "safe-harbours" of protection extended by the jurisdiction of the CCP to its own local participants. For example, an Australian institution which joins a foreign CCP may find that although the rules of the CCP are protected from the operation of the insolvency laws in the jurisdiction in which the CCP is based, those rules are not protected from Australian insolvency laws (this could arise because the market netting contract protection in our *Netting Act* applies only to approved market netting contracts). This may result in the effectiveness of those rules in the insolvency of the Australian market participant being qualified, potentially such that full membership is not available to that Australian market participant. In other words, recognition of foreign clearing systems for the purpose of the protection which our laws can give to CCPs may be important in facilitating access of Australian financial market institutions to membership of foreign CCPs.

Also, the Council may wish to consider whether clarity as to the application of the *Personal Property Securities Act 2009* (Cth) to rights and interests under the rules of a CCP should be provided. The *Personal Property Securities Act* provides that it does not apply to any right or

interest held by a person, or any interest provided for by any transaction, under a market netting contract (as defined in the *Netting Act*). However, as noted in the bullet point immediately above, the rules of offshore CCPs may not constitute market netting contracts for the purposes of the *Netting Act* and, accordingly, the exclusion for market netting contracts in the *Personal Property Securities Act* may not apply. Given the complexity involved in applying the jurisdictional and governing law provisions in the Act to collateral posted with entities offshore (particularly where the collateral is an intermediated security), it would be likely to be preferable if the application of the Act to rights and interests under the rules of a CCP were clarified.

Please also see our comments in our response to question 15 below regarding legal considerations that may be relevant in considering the extent to which foreign CCPs should be recognised by Australian regulators.

Question 12: *Are there any other changes to the regulation of CCPs that should be considered that are particular to the clearing of OTC derivatives?*

There does not appear to be particular rules in our legislative system expressly dealing with the failure of a CCP (as opposed to its participants). For example, if an Australian CCP were to become insolvent, it is not clear that the ordinary operation of our insolvency laws produce the policy outcomes which would be expected by the Council. Also, the Council may wish to consider whether it would be desirable to protect customers against the risk of a failure by a CCP or a participant to segregate money and assets, and to facilitate the timely access by customers to their collateral after the insolvency of a CCP or a participant. The laws dealing with the failure of a CCP do not appear to be receiving that much attention internationally, but appear to be an important issue for overall systemic stability.

A related issue is the extent to which the CCP is subject to prudential supervision, including capital requirements.

Question 15: *Are there any legal impediments to mandating the clearing of OTC derivatives and the use of CCPs? Are there any legal impediments to mandating the use of a CCP where that CCP is domiciled in a foreign jurisdiction?*

We expect that the Australian government will take its own advice in relation to the constitutionality of any compulsory requirement to submit OTC derivatives to central clearing in Australia. However, we expect that this issue, and the operational rules involved in tracking the relevant derivatives, formed the basis of the Council's suggestion that the clearing mandate operate by reference to the existing authorisation regime for ADIs and AFSL holders. We do note in this regard that it is important to clarify whether it is to be limited to holders of AFSL's with a derivatives authorisation.

A separate issue is the nature of the mandate, if it is imposed. We suggest that careful thought be given to this, so that the scope of the operation of the mandate is very clear. For example, we consider that if the same general definitional approach taken with the definition of "derivative" in the *Corporations Act* was adopted, this would not result in an efficient outcome when applied to interest rate derivatives for the purposes of mandating their central clearing. Instead, it would be critical that the exact types of derivatives which need to be subject to central clearing were specified. Otherwise, derivatives may be caught which, as a practical matter, may not be able to be cleared.

Also, clearing of transactions may be more likely to occur through an offshore CCP rather than a CCP in Australia if an Australian CCP is not recognised by offshore regulators as being an eligible CCP. Clearing through an unrecognised Australian CCP may fail to meet the mandatory requirements of the foreign regulator.

In relation to mandating the use of an offshore CCP, some conflict of law and policy issues should be considered. These issues vary, but they should include issues such as confirming that the clearing of Australian market participants' contracts is actually possible under the foreign legal and regulatory regime and also that clearing through the offshore CCP would not compel an Australian market participant to engage in activity which would be contrary to Australian law, regulation or policy. Other legal issues which may need to be considered include the finality of settlements by the CCP (including against participants in the CCP that are not incorporated in Australia); the ranking of creditors in insolvency of the CCP; the local law effect of any loss sharing obligations; and the impact of competition, anti-money laundering and counter-terrorism financing, financial transactions reporting requirements, privacy and confidentiality laws. A further issue may be the extent to which the use of an offshore CCP causes unintended taxation consequences for Australian market participants.

A related issue may arise if the rules of an offshore CCP will not be governed by Australian law and an Australian participant submits to the courts of a foreign jurisdiction in respect of those rules and any claims in connection with them. The ability of Australian legislation or the Australian regulators to stay action under those rules may be more limited than would be the case if clearance were conducted by a CCP in Australia under Australian law. For example, the *Banking Act 1959 (Cwth)* and the *Financial Sector (Business Transfer and Group Restructure) Act 1999 (Cwth)* provide that certain events such as the appointment of a statutory manager to an Australian ADI or the compulsory transfer of business do not allow the contract or any other party to the contract to deny any obligations, accelerate any debt or close out any transaction under the contract. The ability of Australian regulators to enforce this in relation to Australian participants in offshore clearing systems and clearing members may be limited if the rules of the system are not governed by Australian law and the CCP or clearing member has not submitted to the jurisdiction of the Australian courts. If this issue is of concern to the Council then this issue could potentially be addressed by, for example, requiring that Australian participants only become members of offshore CCPs that meet certain criteria set by the Australian regulations, including for example, that they agree to comply with certain Australian laws and submit to the jurisdiction of Australian courts (please also see our response in relation to question 11).

Question 16: *Are there any extraterritorial effects of regulatory reform underway in foreign jurisdictions that should be considered in developing a clearing regime for Australia?*

The development of an Australian central clearing requirement needs to be considered in the context of international OTC derivative reforms, particularly those in the United States, Europe and Asia. Laws and regulations relating to OTC derivatives are just as internationally interconnected as the market participants. A conflict in regulatory requirements between different jurisdictions would not appear to achieve a better regulatory outcome for anyone, and would certainly increase costs and confusion in a market where clarity and certainty are critical. For this reason, it is fundamental to the efficient operation of a global regime that any Australian CCP is recognised by United States and European laws which require the clearing of OTC derivatives.

This issue is not limited to central clearing requirements. It also applies to related regulatory requirements in offshore jurisdictions, such as requirements to use "swap execution facilities" and to provide certain amounts of collateral or hold capital. The impact of these offshore requirements on the Australian market should be considered in developing any Australian response.

Question 17: *Are there any other changes to the existing regulatory framework for the Australian financial system that would be desirable to accommodate a move to central clearing of OTC derivatives?*

A number of changes should be considered.

For example, clarity around the capital treatment of cleared and non-cleared transactions is important and should be addressed by the Australian Prudential Regulatory Authority as part of the implementation of Basel III.

Also, as noted in our response to question 10 above, clarification of the *Netting Act* and the client money rules in the *Corporations Act* should also be considered. Further, as noted in our response to question 11 above, some clarity as to the operation of the *Personal Property Securities Act* on the proposed CCP arrangements would also be of assistance. The establishment of an onshore CCP may also involve competition law issues, for example, in relation to membership criteria, which may need to be considered.

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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@mallesons.com) of our offices if we may be of further assistance.

Thank you for your consideration.

Yours faithfully