



3 September 2012

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

The Treasury

Henry Davis York submissions

### 1 Introduction

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We welcome this opportunity to make submissions on the Exposure Draft of the Corporations Legislation Amendment (Derivative Transactions) Bill 2012 (**Bill**).

Henry Davis York (**HDY**) is a major law firm practising extensively in Australia, with a recognised expertise in financial markets, financial services and banking law. We have over many years advised and represented Australian and overseas derivatives exchanges and clearing houses, as well as major Australian and offshore banks, funds and other institutional and business users of the derivatives markets.

We commend the approach taken by the Treasury in relation to the preparation of this important piece of framework legislation that will help Australia meet its G20 obligations regarding central clearing and trade reporting of OTC derivative transactions.

These submissions are in addition to the comments on the Bill which we emailed to Treasury on 23rd August 2012.

### 2 Our approach

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Our approach has been to review the Exposure Draft and prepare our comments on what we see as important issues, based on:

- (a) regulatory issues which we have experienced in practice, including those encountered by our overseas clients; and
- (b) our initial perception of how this legislation will operate within the regulatory context of Chapter 7 of the Corporations Act.

### 3 The "framework" nature of the Bill

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We appreciate that it is consistent with Australia's current commitment to the G20 process that the Bill is of a "framework" nature. However we believe that it is important that the Bill be examined carefully and that potential practical problems or areas of regulatory inconsistency or ambiguity are raised for discussion at this early stage.

## 4 Particular definitions

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We appreciate that to some extent it is inevitable that definitions in any "framework" document will be largely mechanical and enabling in nature. However we do apprehend that there may be ambiguities and uncertainty as to the operation and reach of the legislation in practice because of the general nature of some of the definitions. We suggest that these be reviewed, perhaps after consultation with appropriate industry groups.

We believe that problems may arise in particular in applying the following concepts:

### 4.1 "Class"

We have had the opportunity to consider the submissions made by ISDA and we support its contention that the Bill should include a definition of "class".<sup>1</sup>

This is an important term which needs a definition. The term is used to qualify obligations and powers in relation to various key components of the legislation, for example:

- (a) the concept of a class of derivative transactions is central to understanding the scope of the legislation, the derivative transaction rules (DTR) and the powers of ASIC;<sup>2</sup>
- (b) the Minister's power to determine the scope of execution, reporting and clearing requirements depends on an understanding of what constitutes a "class of derivatives",<sup>3</sup> and
- (c) the scope of the proposed regulations covering trade repositories is based on understanding what constitutes a "class of derivative trade repositories".<sup>4</sup>

### 4.2 "Derivative trade data"

We understand the need for a broad definition of the term, and indeed that is important for participants dealing with ASIC by virtue of s903A. However the "2-part" definition is somewhat cumbersome. We see that it precludes use of the defined term, for example in the definition of "derivative trade repository" and at s901A (3)(c)(i). We believe that a simpler definition is desirable. The term "positions" within the definition needs clarification.

### 4.3 "Derivatives transaction" and "derivative"

We assume that "derivative" bears the same meaning as for Chapter 7 generally but we think that the concept of "derivatives transaction" as currently drafted in the amendment to s 761A leaves open important questions as to whether both traded and cleared transactions are intended to be covered and also leaves unclear the point at which a cleared transaction will cease to be subject to the "derivatives transaction" requirements.

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<sup>1</sup> ISDA submission, paragraph 4(a).

<sup>2</sup> See, for example, section 901A(3) of the Bill.

<sup>3</sup> We accept that some guidance is given in Note 2 to section 901B(2), but ask that such explanations be reflected in a formal definition.

<sup>4</sup> See section 905A(1) of the Bill.

In short, if a transaction has been cleared and then replaced or terminated, is it intended that it be treated as a derivatives transaction for particular purposes of these proposed provisions?

We also believe that paragraph (c) of the definition is far too general in speaking of a "transaction relating to a derivative". The boundaries of such a phrase would seem to encompass many transactions which are beyond the intended scope of the legislation. We assume the intended limit of the legislation is traded derivatives transactions, cleared derivatives transactions and (perhaps) derivatives transactions which have been replaced or replicated (as opposed to closed out and thereby terminated). We have difficulty in seeing the justification for any broader coverage. We believe the definition needs substantial revision.

#### 4.4 "Derivatives trade repository"

This term is also unclear. Please see our submissions below at section 10.

### 5 The hierarchy of operation of various types of rules

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In general, we agree with the approach taken in the Bill in relation to the hierarchical operation of the various types of rules.

However, we do not consider that the amendments to section 822B of the Corporations Act<sup>5</sup> reflect a sensible approach to establishing a functioning hierarchy. It appears that the intention of this amendment is to make the DTRs and the derivative trade repository rules (DTRR) prevail over the existing operating rules of a licensed CS facility to the extent of any inconsistency.

We do not believe that this will in every instance produce a sensible result. For example operating rules may make a provision for emergency trading, including say execution through an emergency facility, which might conflict with a DTR provision requiring a specific facility, as contemplated by section 901A(3)(b). However we concede that much will depend on the content of the individual DTRs and DTRRs.

### 6 Extraterritoriality

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As stated above, we have had the benefit of considering the submissions made by ISDA in relation to the Bill. We note that in its submissions, ISDA, put forward the view that any potential extraterritorial application of the Bill could compromise the achievement of cross-border harmonization of regulatory regimes around the world and have significant consequences for compliance by market participants.<sup>6</sup>

We respectfully disagree with ISDA's position.

It is our view that the drafting of section 900A of the Bill does provide a satisfactory approach as it will be necessary for the provisions of the Bill to have extraterritorial effect, particularly as there are currently no trade repositories in Australia and it is doubtful whether there will be any in the near future.

It may well be necessary for the legislation to apply to such bodies in a place outside Australia as is contemplated by section 900A(1)(c).

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<sup>5</sup> Set out at paragraph 22 of the Bill.

<sup>6</sup> ISDA submission, paragraph 3.

## **7 Retrospectivity (s 901A(8))**

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Section 901A(8) of the Bill prevents the DTRs from imposing any execution, reporting or clearing requirements retrospectively. We submit that there should not be an absolute exclusion of retrospectivity in relation to the application of the DTRs.

We question the appropriateness of imposing an absolute prohibition on the imposition of execution, reporting or clearing requirements retrospectively. There may be a situation where there is a delay in clearing or at least reporting, for example, a series of transactions which should be subject to a clearing requirement under the DTRs, but which might involve transactions of the type contemplated by section 901A(8)(c) entered into before the DTR provision had effect.

## **8 Invalidity of transactions (s 901G)**

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Under section 901G of the Bill, a failure to comply with a requirement of the DTRs will not invalidate the transaction or affect any of the rights or obligations arising under or relating to, the transaction.

However there may well be situations where a failure to comply with a particular requirement of the DTRs should invalidate the transaction and affect the rights of the parties involved. For example, where there has been trading in a prohibited or restricted derivative or trading by an unauthorised class of persons.

We consider that it would be a mistake not to allow for a mechanism through which specific derivative transactions that do not comply with the DTRs can be invalidated on the basis that there may be some circumstances where not invalidating such derivative transactions could lead to major financial or systemic risk arising. For example, consider the scenario where a derivatives transaction, or series of derivative transactions could, if not invalidated, undermine the insolvency of a major bank, institution or fund, or a number of them.

## **9 ASIC consultation obligation and the "emergency rule" tests (ss 901J & 901L)**

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We have considered sections 901J and 901L of the Bill together and are of the view that there will be a wider range of circumstances in which ASIC will need to make a DTR urgently than those set out in section 901L(1)(a) and (b) of the Bill, i.e. in order to protect the Australian economy or the efficiency, integrity and stability of the Australian financial system.

It is our view that this triggering standard is too high to be an effective mechanism and as such would lessen the impact of the reforms implemented by this Bill. For example, it may be necessary for ASIC to make a DTR urgently to resolve a situation which is financially threatening to a major bank or institution in circumstances that fall short of the triggering standards set out in section 901L(1)(a) and (b) of the Bill.

Additionally, the drafting of section 901L(1) of the Bill, as it currently stands, is such that we are unsure of the exact measure of ASIC's opinion contemplated in the opening words to sub-section 901L(1), especially the phrase "to do so". Is this intended to mean that the trigger is that it is:

- (i) necessary to make the rule; or
- (ii) necessary to make the rule without consulting?

In short we think that the "bar" for emergency rules under 901L is set too high.

## 10 Trade repository rules (DTRR) (Divisions 3 & 4; ss 902A-903K)

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As noted above at 4.4, we consider that the definition of the term "derivatives trade repository" is unclear. As currently drafted the definition of "derivatives trade repository" reads:

*derivative trade repository* means a facility to which information about derivative transactions, or about positions relating to derivative transactions, can be reported (whether or not other information or data can also be reported to the facility).<sup>7</sup>

With respect, we consider that this definition requires redrafting so as to provide a clearer understanding as to what type of business will be considered to be a trade repository. For example, there is a wide range of businesses that will involve a facility to which information about derivatives or positions can be "reported", for example futures exchanges, stock exchanges, government departments (eg Trade, Treasury) and information media such as wire services.

In addition, the definition of "derivative trade repository" and "derivative trade data" loosely use the term "positions" without further clarification as to its meaning.

*derivative trade data* means:

- (a) information about derivative transactions, or about positions relating to derivative transactions; or
- (b) information (including statistical data) that is created or derived from information referred to in paragraph (a).

Is the use of the term "positions" in the Bill a reference to "open positions" and, if so, if this a reference to positions open as traded or open as cleared, or both? The meaning of "position" should be clarified.

Further to these points, we cannot see the justification for the proposed restricted application of the DTRR as set out in section 903B of the Bill. Section 903B of the Bill currently reads:

The only persons on whom the derivative trade repository rules may impose requirements are:

- (a) operators of licensed derivative trade repositories; and
- (b) officers of licensed derivative trade repositories .

Note: Requirements may also be imposed on these persons by the derivative transaction rules.

We do not understand why the DTRRs would not in certain circumstances need to impose requirements on a party affected by a derivative transaction, which is required to be reported to a repository.

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<sup>7</sup> Set out in paragraph 8 of the Bill.

## 11 ASIC written directions

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Section 904K of the Bill sets out the provisions concerning ASIC's ability to give directions relating to derivative trade data if a derivatives trade repository ceases to be a licensed trade repository.

We question whether a person who ceases to be a licensee can be the subject of a written direction under section 904K(2), particularly given that section 904K(3) provides that:

The direction may be given to:

(a) the operator, or former operator, of the repository; or

(b) an officer or employee, or a former officer or employee, of the operator, or former operator, of the repository.

## 12 Criteria for grant of DT licenses (s 905C(1) & (2))

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We note that the only provision relevant to foreign bodies is in 905C(2), namely that the applicant is registered under Part 5B.2, Division 2. There is no provision for recognition of a foreign body which, for example, is subject to a regulatory regime which is recognised by Treasury or ASIC as equivalent or otherwise adequate in terms of its protection of participants and market users. Some sort of standard along these lines would appear to be most useful given that Treasury and ASIC will need to consider applications by foreign bodies as there are no Australian bodies which currently undertake repository business.

We hope our comments and submissions will be useful. Please contact either of us if you wish to discuss our submissions.



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