

Implementation of Australia's G-20 over-the-counter derivatives commitments

Proposals Paper

December 2012

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CONSULTATION PROCESS

Request for feedback and comments

This paper seeks stakeholder views on a proposed approach for implementing the Australian Government's G-20 Commitments in relation to over the counter (OTC) derivatives.

For this consultation Treasury has published a consultation website that will allow you to post comments for each section of the paper. These comments will be added to the website and made publicly available immediately. Treasury will moderate the comments after they are submitted on the website. Please refer to the moderation policy on the website for more information. The consultation website is available at financialmarkets.tspace.gov.au.

The Paper is also available for you to download from the Treasury website and you can still provide your submission via the Treasury website online form or by post.

Submissions should include the name of your organisation (or your name if the submission is made as an individual) and contact details for the submission, including an email address and contact telephone number where available.

While submissions may be lodged electronically or by post, electronic lodgement is strongly preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 15 February 2013.

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GLOSSARY

The Act	Corporations Act 2001
ADI	Authorised Deposit-taking Institution
AEMC	Australian Energy Market Commission
AFMA	Australian Financial Markets Association
AFSL	Australian financial services licence
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASX	ASX Limited
AUD	Australian dollar
CCP	Central counterparty
CFTC	US Commodity Futures Trading Commission
The Council	The Council of Financial Regulators
CSV	Comma-separated values
DTCC	Depository Trust & Clearing Corporation
EMIR	European Market Infrastructure Regulation
ESAA	Energy Supply Association of Australia
EU	European Union
FSB	Financial Stability Board
FX	Foreign exchange
G-20	Group of Twenty
IRS	Interest rate swap
NEM	National Electricity Market
OTC	Over-the-counter
The Reserve Bank	Reserve Bank of Australia
SCER	Standing Council on Energy and Resources
US	United States of America

1. EXECUTIVE SUMMARY

This paper seeks stakeholder views on a proposed approach for implementing the Australian Government's G-20 commitments in relation to over-the-counter (OTC) derivatives. This consultation is conducted specifically in relation to the requirements in section 901B(3) of the *Corporations Act 2001* (Act) and related obligations under the Act, and the *Legislative Instruments Act 2003*.

The proposals are based on recommendations provided by the Australian Prudential Regulatory Authority (APRA), the Australian Securities and Investment Commission (ASIC) and the Reserve Bank of Australia (Reserve Bank) contained in the *Report on the Australian OTC Derivatives Market* (the Report), published in October 2012.¹ It is recommended that these proposals be read in conjunction with the Report.

In summary the proposed approach contains the following:

- For trade reporting it is proposed that a broad-ranging determination be made in the first quarter of 2013 that will require the reporting of all five derivative classes (that is interest rate, foreign exchange (FX), credit, equity and commodity) to a licensed trade repository where one is available.
 - It is expected that the trade reporting regime will be in place by mid-2013.
 - The trade reporting obligation would be phased in over two years with the obligation commencing by the end of 2013 for major financial institutions following the establishment of a licensed trade repository.
 - In line with the Government's earlier commitments, no decision on any mandate relating to electricity derivatives will be taken until after the completion of the reviews of the sector currently underway.
- For central clearing it is proposed that no decision be taken on any mandatory clearing obligation until the regulators have conducted further review or otherwise provided further advice.
 - However, should substantial industry progress towards central not be evident in the near future, the regulators would revisit this recommendation.
- For trade execution it is also proposed that no decision be taken on any mandatory trade execution requirements until subsequent reviews by the regulators. Future recommendations for trade execution will be developed separately from recommendations in relation to central clearing.

The Australian Government seeks feedback on these proposals and, following assessment of stakeholder views, the approach may be modified.

¹ Available at: <http://www.rba.gov.au/payments-system/clearing-settlement/otc-derivatives/201210-otc-der-mkt-rep-au/index.html>.

Following this consultation, and subject to stakeholder feedback, the Minister will make an initial determination identifying classes of derivatives that will be subject to the reporting mandate. The Minister will also expose for comment draft regulations limiting the scope of ASIC rule making under the framework as appropriate.

ASIC will separately consult on draft rules and requirements for trade repository licensing in the first half of 2013.

2. BACKGROUND

INTERNATIONAL COMMITMENTS

At the G-20 summit in Pittsburgh in 2009, following the global financial crisis, the Australian Government joined other jurisdictions in committing to substantial reforms to practices in OTC derivatives markets.

Three of the key G-20 commitments² in this area related to:

- the reporting of OTC derivatives to trade repositories;
- the clearing of standardised OTC derivatives through central counterparties; and
- the execution of standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

These commitments aim to bring transparency to OTC derivative markets and improve risk management practices.

The implementation of the G-20 commitments is being coordinated and monitored by the Financial Stability Board (FSB). The FSB membership includes the major financial centres around the world and in our region, including: China, Hong Kong, India, Indonesia, Japan, the Republic of Korea, Singapore and Australia.

The FSB recently called on all jurisdictions to put legislation and regulations in place promptly, and in a form flexible enough to ensure that reforms are implemented consistently.³ The FSB also noted that most progress on implementation has been made in the major jurisdictions of the United States of America (US), European Union (EU) and Japan, it acknowledged that no single jurisdiction has fully met the G-20 commitments.

The international regulatory community is working toward improving clarity and reducing conflict but these remain significant concerns. Global regulators recently met to identify various potential conflicts, inconsistencies, and duplicative requirements within respective contemplated rules related to OTC derivatives. Following the meeting a statement of understandings as well as areas for further consideration was published in December 2012.⁴

2 The G-20 also committed to subjecting non-centrally cleared derivatives to higher capital requirements. There is separately work underway by international standard-setters on proposals to strengthen risk management practices for non-centrally cleared OTC derivatives by introducing global minimum standards for margin requirements.

3 OTC Derivatives Market Reforms - Fourth Progress Report on Implementation, Financial Stability Board, 31 October 2012, http://www.financialstabilityboard.org/publications/r_121031a.pdf.

4 Joint Press Statement of Leaders on Operating Principles and Areas of Exploration in the Regulation of the Cross-border OTC Derivatives Market, December 4, 2012 available at <http://www.cftc.gov/PressRoom/PressReleases/pr6439-12>.

AUSTRALIAN APPROACH

In light of the uncertainty around the international framework for regulation of OTC derivatives, the Australian legislation does not pre-empt international developments; it instead allows for mandates to be determined based on regular consideration of domestic market developments and in coordination with other economies.

With regard to international developments, the Australian Government proposes to implement the G-20 commitments in a way that:

- ensures that Australian businesses can continue to participate in international markets while remaining primarily regulated in Australia; and
- ensures that Australia does its part to maintain a consistent global framework and remove opportunities for regulatory arbitrage.

LEGISLATIVE FRAMEWORK

The Australian legislative framework passed the Parliament in November 2012 and will have effect by year end.

Under the legislation, the Minister has the power to prescribe certain classes of derivatives as subject to mandatory reporting to a derivative trade repository, mandatory clearing by a central counterparty, or mandatory execution on a trading platform based on regular market assessments. Regulators may also make urgent recommendations in response to unexpected international or domestic developments that occur in between regular assessments, for example to deal with foreign rulemaking with extraterritorial application to Australia.

To give effect to any mandate, ASIC will be tasked with developing 'derivative transaction rules'. These rules will clarify matters such as the institutional and product scope of the obligation, as well as details of how any relevant mandatory obligations can be complied with.

The legislation also establishes a licensing regime for derivative trade repositories, largely modelled on the existing licensing regimes for market operators and clearing and settlement facilities under the Act. ASIC will have primary responsibility for administering this regime and overseeing any trade repositories licensed under the regime, as well as making 'derivative trade repository rules' under section 903A to govern the conduct of those repositories.

A decision by the Minister prescribing a class of derivatives under the framework will be based on advice from APRA, ASIC and the Reserve Bank. ASIC is also required to consult with both APRA and the Reserve Bank before issuing any derivative transaction rules.

RECOMMENDATIONS FROM AUSTRALIAN REGULATORS

Consistent with this advisory role, APRA, ASIC and the Reserve Bank released the *Report on the Australian OTC Derivatives Market* in October 2012 (the Report).⁵ The Report examined the risk

⁵ *Report on the Australian OTC Derivatives Market*, published in October 2012 and available at this web address: <http://www.rba.gov.au/payments-system/clearing-settlement/otc-derivatives/201210-otc-der-mkt-rep-au/index.html>.

management practices of market participants, with a particular focus on how market participants are using centralised infrastructure, and the prospects for increased usage.

In preparing the Report, a wide-ranging survey of key participants in the Australian OTC derivatives market was undertaken during July 2012. The survey covered large domestic and international banking groups, smaller authorised deposit-taking institutions, fund managers, government borrowing authorities, corporate treasuries and electricity companies.

The Report reiterated the Council of Financial Regulators (Council) recommendation to the Deputy Prime Minister and Treasurer in March 2012. That is, that there are strong in-principle benefits from participants in the domestic OTC derivatives market making greater use of centralised infrastructure, such as trade repositories, central counterparties and trading platforms.

In promoting this outcome, the Report recognised the importance of retaining the benefits of OTC derivatives markets wherever possible. Accordingly, the Report favoured an industry-led transition to use of centralised clearing infrastructure, where possible. The Report also recognised that not all products and participants are amenable to a transition to centralised infrastructure; in such cases, it is important to ensure other risk management measures are rigorously applied.

The main recommendations of the Report were that:

- the Government consider a broad-ranging mandatory trade reporting obligation for OTC derivatives; and
- a mandatory clearing obligation is not necessary for any derivative at this time, but may become necessary in the future.

REGULAR MARKET ASSESSMENTS

Regulators will continue to keep the OTC derivatives market under review, and future market assessments will examine whether the policy case is satisfied for mandatory central clearing and execution on trading platforms.

It is also anticipated that future market assessments will consider Australia's position in relation to any decision to mandate derivatives in other jurisdictions. This analysis would consider whether there would be benefits to the Australian economy and/or the efficiency, integrity and stability of the Australian financial system from eliminating potential regulatory gaps by also mandating those derivatives in Australia.

3. LEGISLATIVE BASIS

3.1 MINISTERIAL DETERMINATIONS IDENTIFYING PARTICULAR DERIVATIVES FOR ONE OR MORE OF THE MANDATES

Under section 901B of the Act the Minister may determine the classes of derivatives that will be subject to ASIC rule-making; this would also specify whether the rules relate to either trade reporting, central clearing or use of trading platforms. Determinations are legislative instruments and are therefore subject to review by Parliament and, potentially, disallowance. Classes of derivatives may be defined with reference to any matter, including the underlying asset, or the time when the derivatives were issued. In making determinations, the Minister must consider certain matters (such as the impact on the stability, integrity and efficiency of the Australian financial system) and consult certain bodies (such as APRA, ASIC and Reserve Bank). The Minister may amend or revoke a determination.

Prior to making a determination mandating any obligations with respect to a commodity derivative the Minister is required in subparagraph 901B(3)(a)(iii) of the Act to consider the likely impact on any Australian market or markets on which the commodities concerned may be traded. As part of the process of fulfilling the requirement, the Minister will seek the written agreement of the Minister for Resources, Energy and Tourism in relation to any decision mandating electricity derivatives.

3.2 REGULATION LIMITING ASIC'S RULEMAKING

Under section 901C of the Act regulations can be made that limit the scope of ASIC rulemaking with respect to certain classes of derivative transactions. Regulations may also provide that requirements may only be imposed on certain classes of derivative transactions in certain circumstances.

There is an additional provision in section 901D that allows for regulations to be made limiting requirements which can be imposed on certain classes of persons. Regulations may also provide that requirements may only be imposed on certain classes of persons in certain circumstances.

These regulations provide a mechanism by which certain persons and transactions can be carved out of the potential reach of the derivative transaction rules. For example, they may specify thresholds of activity that must be met before a person might become subject to one or other requirements. Likewise, they may provide that certain transactions for certain purposes cannot be made subject to a certain requirement.

The regulations (in conjunction with the ability to prescribe non-licensed trade repositories) also provide the means by which the regulator may be given constrained derivative transaction rule making powers, for example, in connection with compliance with foreign trade reporting, clearing or execution requirements.

The scope of these obligations could also be limited by ASIC as it phases in the application of the rules, as discussed in section 4 of this paper.

3.3 REGULATION REQUIRING ADDITIONAL CONSULTATION IN CERTAIN CIRCUMSTANCES

Under section 901J of the Act regulations may require that ASIC consult with particular bodies prior to making rules.

4. PROPOSALS

This proposals paper seeks stakeholder views on the first Ministerial determination under the legislative framework and related regulations. It is proposed that the initial Ministerial determination will only relate to trade reporting, although stakeholders are invited to suggest alternatives.

4.1 TRADE REPORTING

The Report noted that trade reporting is not well entrenched in the Australian OTC derivatives market. There is some evidence of an increased uptake in trade reporting by larger market participants. In the near term some of the domestic and foreign participants in the Australian OTC derivatives market are expected to be required to report OTC transactions executed in US and EU markets (or undertaken with US and EU counterparties) in compliance with regulatory regimes being developed in those jurisdictions. Outside of these requirements, however, an industry-led transition to trade reporting in the Australian market would not seem likely in the near term.

Economy-wide benefits from trade reporting

Derivative contracts are financial instruments that grant rights to some future payment or other consideration that is defined with reference to the value or amount of some underlying asset, rate or index.

Derivatives allow banks and other financial and non-financial institutions to mitigate risk and generate tailored exposures to variables, such as interest rates, or events, such as the credit default of a corporation.

While derivatives are a valuable tool in managing or hedging against risk, they are also a source of counterparty credit risk. Derivative contracts bind counterparties together for the duration of the contract. Throughout the lifetime of a contract, counterparties build up claims against each other, as the rights and obligations contained in the contract evolve as a function of changing circumstances.

The management of derivatives contracts may also be a source of operational risk.

Importantly, derivatives may also be a channel for financial contagion between market participants.

While many derivatives are traded on exchanges, such as the ASX 24 market, others are negotiated bilaterally 'over-the-counter' (OTC) between the buyer and the seller.

OTC derivatives often incorporate bespoke terms to allow the contracting parties to manage specific risks. This is in contrast to exchange traded derivatives that are typically highly standardised. OTC derivatives markets have traditionally been subject to less direct regulation than exchange-based markets.

The global OTC derivatives market is of a significant size — the total notional amount outstanding for OTC derivatives worldwide was \$639 trillion at end of June 2012.⁶ The Australian market is small by comparison, comprising less than 5 per cent of the global market. But as is the case in most countries, Australian-located OTC derivatives market participants are extensively involved in overseas markets.

The technology supporting financial markets and the nature of derivatives means that a participant located in Australia can very easily transact with a participant located offshore. The ability of locally-based market participants to participate in global markets reduces transaction costs and increases the range of available counterparties and products, in turn enhancing the depth and breadth of the Australian market. Australian banks are also active in foreign marketplaces through their overseas branches.

However the financial crisis in 2008 highlighted structural deficiencies in the global OTC derivatives market and the systemic risks that those deficiencies can pose for wider financial markets and the real economy.

In many countries, these structural deficiencies contributed to the build-up of large, insufficiently risk-managed, counterparty exposures between some market participants in advance of the global financial crisis; and to the lack of transparency about those exposures for market participants and regulators.

The deficiencies may also contribute to market inefficiency, uncertainty, loss of confidence and loss of market liquidity, particularly when the market comes under stress.

The G-20 commitments aim to bring transparency to OTC derivative markets and improve risk management practices. Reducing risk and increasing transparency brings significant benefits to the economy as a whole by making derivatives markets more stable and efficient, especially in times of crisis.

Fulfilling Australia's obligations in a globally coordinated way will also help to ensure that global markets remain open to Australian business. Companies wishing to purchase or sell a derivative contract will benefit from reduced market impact costs to trading⁷ and extra liquidity, which allows them to trade when they wish to trade. This benefits the economy as a whole.

Participating in global derivatives markets also allows companies to better tailor their derivatives to their risks. This is of value to Australian companies and the economy as a whole.

Global implementation of the G-20 commitments also ensures that Australian businesses, investors and corporations have the benefit of improved risk management practices and transparency when they participate in international markets.

6 Statistical release: OTC derivatives statistics at end-June 2012, November 2012, Bank for International Settlements, http://www.bis.org/publ/otc_hy1211.pdf.

7 Market impact is the adverse price movement that can occur when a trade is executed; larger, more liquid markets have lower market impact costs.

Benefits to the efficiency, integrity and stability of the Australian financial system

The Report found that there would be substantial benefits to the efficiency, integrity and stability of the financial system if market participants were to use centralised trade repositories, including:

- increased capacity for market oversight and monitoring of risk concentration and other systemic risk indicators;
- improved risk management for market participants;
- enhanced market transparency; and
- greater operational standardisation.

Comprehensive trade reporting would also provide regulators with detailed information to inform recommendations around potential future product class prescriptions and rule design.

In principle, all product classes and participants might directly or indirectly benefit from these enhancements. However, it is likely that the most immediate benefit would be in higher turnover markets and for larger participants. Markets in interest rate derivatives and FX derivatives are the most actively used in Australia; the credit derivatives market is also widely used. Within these, the bulk of turnover involves financial institutions, of which the vast majority of activity is facilitated by a relatively small number of dealers.

Costs to business from complying with trade reporting obligations as well as benefits to business from applying a consistent international approach

In submissions and in meetings many stakeholders have noted that there would be benefits to their business from Australia implementing a comprehensive trade reporting obligation, especially as it clarifies confidentiality restrictions that are currently in place. Implementing a reporting mandate in Australia would also assist relevant Australian market participants to seek mutual recognition or substituted compliance with regulatory requirements in other jurisdictions.

Assisting Australian businesses to meet international requirements and improve their risk management practices

The Report notes that an impediment to the larger firms reporting trades on a voluntary basis could be the duty of confidentiality that banks and other larger market participants owe to clients under Australian law and under contract. Without the express consent of clients, banks may be unable to report the details of client trades to trade repositories in the absence of a regulatory provision that would allow the banks or market participants to report data without breaching such duties. This 'opt in' requirement could substantially slow the uptake in trade reporting in Australia, delaying the system-wide benefits discussed previously.

The issue of confidentiality is also relevant with respect to the reporting obligations that are being implemented in other jurisdictions. Many Australian and foreign participants active in the domestic market are also active in major overseas markets. There is a strong likelihood that, depending on the counterparties involved, some transactions undertaken in the Australian OTC derivatives market will have to be reported to trade repositories in accordance with offshore reporting obligations. In this regard, the legislative framework provides legal protections to entities that report to trade

repositories in accordance with a mandatory obligation imposed under Australian law. However this would require that the Minister make a Determination mandating a derivative. ASIC rule making or regulations could limit the effect of the mandate to those seeking compliance with international regimes.

Cost of reporting

Concerns have been raised about the burden of reporting, especially where international standards are not settled. For instance the Australian Financial Markets Association (AFMA) submitted earlier this year:

While industry understands and accepts the importance of trade reporting and the need to take on the responsibility for catalysing this, it will require a major commitment of time, resources and money to achieve. There is a broad universe of derivatives data on which the authorities here and overseas want to capture through trade reporting. Combined with the nascent state of development for trade repositories, or complete lack of existing infrastructure for many classes of asset, it would not be practicable to prescribe at this time a broad range of derivatives classes to be subject to the mandate for trade reporting.⁸

The energy sector in particular has raised concerns about the costs of trade reporting of electricity derivatives. For instance the Energy Supply Association of Australia (ESAA) submitted earlier this year:

Even the lightest approach suggested in the consultation paper — reporting all OTC derivatives to trade repositories — could result in a substantial cost to the industry for little benefit. While standardised contracts are relatively easy to report, OTC contracts are more flexible and can be more complex. Treasury should not underestimate the difficulties associated with the design and implementation of the systems necessary to monitor and analyse all OTC market transactions between participants...

The compliance cost will be significant and will ultimately need to be borne by the consumer.⁹

The Report noted that provision of data to a trade repository requires that a market participant either has some direct connectivity to the trade repository, or can use an agent or other intermediary arrangement to transmit and access necessary information. Once a connection is made, it is likely that the ongoing marginal cost of utilising this connection will be low.

However, there may be some costs associated with establishing systems that can efficiently capture the necessary information and transmit this to and from trade repositories. A market participant's unit cost of reporting trades is therefore likely to be a function of its overall scale and level of activity. To address this concern some global trade repositories have offered flexible reporting methods, for example the Depository Trust & Clearing Corporation (DTCC) offers web-based uploads in the

8 Implementation of a Framework for Australia's G-20 Over-the-Counter Derivatives Commitments, Australian Financial Markets Association, June 2012.

9 Implementation of a framework for Australia's G-20 over-the-counter derivatives commitments, Energy Supply Association of Australia, June 2012.

comma-separated values (CSV) format¹⁰, which is supported by almost all spreadsheets and database management systems.

Globally, trade repositories exist for interest rate, FX, credit, equity and commodity derivatives, with trade repositories currently in operation across a number of jurisdictions including Brazil, the EU, India, Korea and the US. The preferred business model of many of these trade repositories would appear to be to broaden the product classes for reporting and the markets in which they operate, while remaining physically located in just one jurisdiction.

It is likely that a number of trade repositories will apply for Australian trade repository licences in the next calendar year.

For most OTC derivatives product classes, the vast bulk of transactions will typically involve at least one counterparty from the group of larger market participants. These larger firms may therefore be well positioned, operationally, to act as agents for counterparties in using trade repositories.

Feedback sought

1. Do you have comments on the costs and benefits of complying with the trade reporting obligation, as outlined above, from the point of view of your business and/or that of your customers?

Ministerial Determination

For trade reporting it is proposed that a broad-ranging determination will be made in the first quarter of 2013 that will require the reporting of all five derivative classes (that is interest rate, FX, credit, equity and commodity) to a licensed trade repository where it is available. There would be no obligation to report where a licensed trade repository is not available.

The obligations will be phased in and exceptions will be provided as outlined below.

Feedback sought

2. Do you have comments on the proposal to mandate a broad range of derivatives subject to the phase-in and exceptions outlined below? Or is there another option you prefer? If so why?

Timetable for implementation

While it is proposed that there be a broad-ranging determination requiring reporting of derivatives trades in the first quarter of 2013, the obligations would be phased in.

There are two possible approaches for phasing in the requirements:

1. the Government could make a regulation that restricts the timing of ASIC's rule-making; or

¹⁰ DTCC's Global Trade Repository for OTC Derivatives, Frequently Asked Questions (FAQs), Deposit Trust Clearing Corporation, March 2012, <https://www.dtcc.com/customer/faq/services/derivserv/GlobalTradeReposFAQ.pdf>.

2. the Government could leave the timing of implementation to ASIC to determine in consultation with stakeholders and with regard to the technical challenges that emerge.

Feedback sought

3. Do you have a preference for the timetable being prescribed in regulation or implemented by a phased approach to ASIC rule-making?

The proposed timetable on which feedback is sought would separate commencement into a number of phases.

Phase 1: major financial institutions: these would be required to commence reporting of trades in the first phase.

- This phase would commence by the end of 2013 after:
 - the trade reporting regime is in place, expected by mid-2013; and
 - one or more relevant trade repositories have been licensed.
- The commencement date is considered further in the next section.
- Major financial institutions could be determined by reference to:
 - legal status, such as being subject to mandatory reporting registration in other jurisdictions, for example, registration as a swaps dealer with the Commodity Futures Trading Commission (CFTC) or being under a mandatory obligation to report transactions under the European Market Infrastructure Regulation (EMIR) in the EU; or
 - thresholds of activity, for example, based on gross notional outstanding across asset classes, if implemented through rulemaking, these thresholds could be developed by ASIC; or
 - some other size proxy for the entity's importance in the financial sector, such as a revenue proxy, balance sheet proxy or employee proxy.

Phase 2: domestically-focused financial institutions: Australian deposit taking institutions (ADIs) and larger AFSL holders (and those exempt from holding AFSLs under relevant ASIC class orders for foreign financial services providers) which are not within phase 1, would be required to report starting in Phase 2.

- It is proposed this phase would commence 6 months after Phase 1. It is expected that this would be the end Q2 2014.
- Larger AFSL holders and exempts could be identified by reference to thresholds of derivatives activity, or to other size proxies, as mentioned above. These thresholds or proxies would logically be lower than in phase 1.

Phase 3: end users: end users (including corporates), and other financial institutions not commencing reporting in Phase 2, would be subject to reporting in phase 3.

- Phase 3 would commence 6 months after Phase 2. It is expected that this would be the end of 2014.
- End users would be either subject to an overall activity threshold or size proxy.
- The threshold or proxy could be reduced over time, however there would also be an additional de minimis threshold or size proxy where there would be no obligation to report end-user to end-user transactions.

Within each phase, there would be scope for further differentiating between instrument classes, according, for example, to the availability of relevant licensed trade repositories.

Feedback sought

4. Do you have comments on the proposal timetable for implementing the trade reporting obligation? Or is there another option you prefer? If so, why?

5. For Phase 1, do you have a preference for referencing legal status, thresholds of activity, or size proxies? For Phases 2 and 3, do you prefer activity thresholds or size proxies?

Treatment of electricity derivatives

In line with the Government's earlier commitments, any decision taken by the Minister in relation to either the making of regulation or consent to an ASIC rule will also involve the Minister for Resources and Energy where that decision relates to the energy sector.

The Australian Government has also committed to considering whether ASIC may be required by regulation, made under the new section 901J, to consult with energy regulators and relevant bodies prior to making any derivative transaction rule.

This paper seeks comment on a draft regulation at [Attachment A](#) that would require ASIC to seek the views of the Australian Energy Markets Commission (AEMC) prior to making a derivative transaction rule relating to an electricity derivative, if the rule is about a matter connected with the AEMC's functions.

Feedback sought

6. Do you have comments on the proposed regulations at [Attachment A](#)? Or is there another option you prefer? If so why?

Several processes are currently under way that are directly relevant to the use of OTC derivatives in the energy market. The AEMC has been asked to provide advice to the Standing Council on Energy and Resources (SCER) on the resilience of the financial relationships and markets that underpin the operation of the National Electricity Market (NEM). It is expected that this advice will be developed in the first half of 2013.

The Government will consider whether it is appropriate to impose mandatory requirements in relation to electricity derivatives after the AEMC's financial resilience review has been completed.

Feedback sought

7. Do you have comments on the proposal to wait until after review processes before making a decision on mandating trade reporting of electricity derivatives? Or is there another option you prefer? If so, why?

Consultation with other specified bodies

It is expected that the regulations may prescribe consultation with other specified bodies where the underlying assets upon which a derivative is based fall with the regulatory responsibilities of that body.

Feedback sought

8. Are there other bodies with responsibility for underlying assets upon which a derivative is based that should be also be specified under section 901J?

Relationship between domestic obligations and foreign regulatory requirements

Stakeholders have raised concerns that Australian privacy laws (in particular the *Privacy Act 1998*) and confidentiality provisions in contract or under equitable banker-client or fiduciary-client obligations could restrict data reporting in some circumstances, including mandatory data reporting required under foreign laws.

This concern could also arise with respect to electricity derivatives, where it is proposed that no decision be taken until after review processes are completed, if active financial entities are required under foreign laws to report data relating to cross-border transactions in electricity derivatives. Such transactions may occur in respect of the NEM or foreign electricity markets.

Status quo

Some stakeholders have reported that they are working to address these concerns by obtaining client consent and/or to seeking relief under foreign regulatory requirements (for instance, allowing masking of counterparty identities pending consent being obtained). However, the extent of any relief necessary would depend upon the extent of any duties of confidence; for example, some contractual obligations may preclude disclosure of even anonymous data.

In the absence of any statutory override of clients' privacy or confidentiality rights, persons subject to a foreign reporting obligation would appear to need to obtain the consent of each client (or in the case of Australian privacy law, to report data identifying individuals only in an anonymous form). Requiring the obtaining of this consent may be difficult and costly.

In some circumstances such as data relating to former clients, it may be even more difficult, or impossible, to obtain client consent for data to be reported.

Support of foreign trade reporting requirements

The Act enables rules to be made to support compliance with foreign trade reporting requirements. The regulations (in conjunction with the ability to prescribe non-licensed trade repositories) provide a means of tightly constraining ASIC's derivative transaction rule making powers to facilitate such compliance.

However, it may be questioned whether the imposition of any rules overriding clients' privacy or confidentiality rights is appropriate.

Additionally the Act only allows for mandating of future derivative transactions and so this approach could not be used to authorise or require the reporting of transaction or position data prior to the establishment of the rule making power.

If ASIC was provided with a rule making power to support compliance with foreign trade reporting requirements, it would need to assess the appropriateness of the use of this power in light of, amongst other considerations, the alternatives available to industry to achieve compliance with foreign laws.

Regulations would need to prescribe which trade repositories ASIC could require reporting to (in addition to any domestically licensed trade repositories). It would be open for the regulations to prescribe classes of trade repository (for example trade repositories licensed under the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)).

Resolving what trade repositories to prescribe, in circumstances where they are not licensed, could also take considerable time. The trade repository licensing regime is flexible in allowing for the entry of foreign-based licensees with only limited regulation in Australia and in practice considerations for recognising an overseas trade repository would require examination of some, if not all, of the same matters as for licensing.

Proposed approach — Implementing domestic requirements (and, if necessary, obtaining mutual recognition)

Implementing the mandatory reporting regime for internationally active financial institutions as quickly as possible will assist to address these concerns. However, there are necessary steps to be taken prior to the operation of mandatory trade reporting in Australia. If the regulatory framework can be in place by mid-2013 and trade repositories can be licensed in Australia shortly thereafter, a trade reporting mandate to licensed trade repositories would be unlikely to commence until late 2013.

The Australian regime will also need to be recognised for 'substituted compliance' under each relevant foreign regime. This could take further time.

Along with concerns about privacy and confidentiality laws, a number of other concerns are emerging with respect to the extra-territorial application of foreign laws, such as potentially inconsistent data fields and timing for trade reporting. The regulators will monitor the situation closely and make regular recommendations following their market assessments. Urgent recommendation could also be provided in between assessments in response to unexpected market developments.

Feedback sought

9. Do you have comments on the proposal to implement the trade reporting and trade repository licensing regime expeditiously, but not to impose interim reporting obligations ahead of this? Or is there another option you prefer? If so, why?

4.2 CENTRAL CLEARING

In its earlier consultation the Australian Government sought stakeholder views on the option that systemically important derivative classes be identified as priorities for mandating (such as Australian dollar (AUD) denominated interest rate swaps (IRS)). This option would be subject to further assessment of the market and monitoring of the impact of capital incentives and other initiatives to ensure that central clearing becomes standard industry practice in Australia within a timeframe that is consistent with international implementation of the G-20 commitments.

This option was generally supported by stakeholders.

The Report subsequently recommended that a mandatory clearing obligation is not necessary for any derivative at this time, but may become necessary in the future.

The Report recommended that at this stage it remains appropriate for industry-led migration to central clearing of AUD denominated IRS to continue for the time being. There is clear evidence that large Australian banks are establishing central clearing arrangements for this product class.

Industry migration to central clearing is likely to accelerate once a licensed central counterparty that clears these products is available in Australia, particularly given emerging economic incentives including higher capital charges for non-centrally cleared trades.

The Report also found that there are good prospects for adequate arrangements to be put in place for Australian participation in the relevant CCPs. However, should the migration of single-currency interest rate derivatives to central clearing not make sufficient progress in the near future, the regulators would consider recommending that a mandatory central clearing obligation be instituted as a priority.

The regulators and Government will also regularly consider Australia's position in relation to decisions to mandate derivatives for clearing in other jurisdictions. This analysis would consider whether there would be benefits to the Australian economy and/or the efficiency, integrity and stability of the Australian financial system from eliminating potential regulatory gaps by also mandating those derivatives in Australia.

Australian regulators will also provide urgent recommendation in between assessments, if required, in response to unexpected market developments in Australia or overseas.

Feedback sought

10. Do you have comments on the proposal to not impose central clearing obligations at this stage? Or is there another option you prefer? If so, why?

4.3 TRADING PLATFORMS

In its earlier consultation the Australian Government provided the option for stakeholder comment that further analysis be conducted on the volume and liquidity characteristics of markets for particular derivative classes and the emergence of suitable trading platforms. Additionally, there may need to be further consideration of reform to Australia's market licensing regime to better accommodate wholesale professional markets that may emerge to facilitate the execution of derivative transactions on trading platforms.

This option was generally supported by stakeholders.

The Report recommended that no obligations to use centralised trade execution of OTC derivatives transactions be put in place at this time. Additional work will be done before recommendations are made.

Feedback sought

11. Do you have comments on the proposal to not impose trading obligations at this stage? Or is there another option you prefer? If so, why?

5. NEXT STEPS

Following this consultation, and subject to stakeholder feedback, the Minister will make an initial determination identifying derivatives that will be subject to the reporting mandate. The Minister will also expose for comment draft regulations clarifying the scope of ASIC rule making under the framework as appropriate.

ASIC will separately consult on draft rules and requirements for trade repository licensing in the first half of 2013.

APRA, ASIC and the Reserve Bank will conduct a second market assessment in 2013. This market assessment will focus on central clearing, particularly of AUD denominated IRS. It will also consider Australia's position in relation to decisions to mandate derivatives in other jurisdictions. This analysis would consider whether there would be benefits to the Australian economy and/or the efficiency, integrity and stability of the Australian financial system from eliminating potential regulatory gaps by also mandating those derivatives in Australia.

Australian regulators will also provide urgent recommendation in between assessments, if required, in response to unexpected market developments in Australia or overseas.

6. FEEDBACK SOUGHT

In commenting on the consultation questions below, you are encouraged to read the proposals in conjunction with the *Report on the Australian OTC Derivatives Market*, by APRA, ASIC and the Reserve Bank, published in October 2012 and available at this web address: <http://www.rba.gov.au/payments-system/clearing-settlement/otc-derivatives/201210-otc-der-mkt-rp-au/index.html>

Feedback questions	Page
1. Do you have comments on the costs and benefits of complying with the trade reporting obligation, as outlined in this document, from the point of view of your business and/or that of your customers?	11
2. Do you have comments on the proposal to mandate a broad range of derivatives subject to the phase-in and exceptions outlined in the document? Or is there another option you prefer? If so why?	11
3. Do you have a preference for the timetable being prescribed in regulation or implemented by a phased approach to ASIC rule-making?	12
4. Do you have comments on the proposal timetable for implementing the trade reporting obligation? Or is there another option you prefer? If so, why?	13
5. For Phase 1, do you have a preference for referencing legal status, thresholds of activity, or size proxies? For Phases 2 and 3, do you prefer activity thresholds or size proxies?	13
6. Do you have comments on the proposed regulations at <u>Attachment A</u> ? Or is there another option you prefer? If so why?	13
7. Do you have comments on the proposal to wait until after review processes before making a decision on mandating trade reporting of electricity derivatives? Or is there another option you prefer? If so, why?	14
8. Are there other bodies with responsibility for underlying assets upon which a derivative is based that should be also be specified under section 901J??	14
9. Do you have comments on the proposal to implement the trade reporting and trade repository licensing regime expeditiously, but not to impose interim reporting obligations ahead of this? Or is there another option you prefer? If so, why?	16
10. Do you have comments on the proposal to not impose central clearing obligations at this stage? Or is there another option you prefer? If so, why?	17

11. Do you have comments on the proposal to not impose trading obligations at this stage? Or is there another option you prefer? If so, why?

ATTACHMENT A



Corporations Amendment Regulation 2012 (No.)¹

Select Legislative Instrument 2012 No.

I, QUENTIN BRYCE, Governor-General of the Commonwealth of Australia, acting with the advice of the Federal Executive Council, make the following regulation under the *Corporations Act 2001*.

Dated 2012

Governor-General

By Her Excellency's Command

[DRAFT ONLY – NOT FOR SIGNATURE]

Assistant Treasurer

DRAFT ONLY

1. 1 Name of regulation

This regulation is the *Corporations Amendment Regulation 2012 (No.)*.

2. 2 Commencement

This regulation commences on the day after it is registered.

3. 3 Amendment of *Corporations Regulations 2001*

Schedule 1 amends the *Corporations Regulations 2001*.

1. Schedule 1 Amendment

(section 3)

[1] After Part 7.5

insert

Part 7.5A Regulation of derivative transactions and derivative trade repositories

Division 2 Derivative transaction rules

7.5A.50 ASIC to consult before making rules

- (1) This regulation is made for subparagraph 901J (1) (b) (iii) of the Act.

(2) ASIC must consult with the Australian Energy Market Commission before making a derivative transaction rule relating to an electricity derivative, if the rule is about a matter connected with the Commission's functions.

(3) In this regulation:

electricity derivative means a derivative whose value is based on the value of electricity.

1. Note

2. 1. All legislative instruments and compilations are registered on the Federal Register of Legislative Instruments kept under the *Legislative Instruments Act 2003*. See www.comlaw.gov.au.

DRAFT ONLY