Global laws for a global market - G20 derivatives reform in context.

Transformation beyond trading
Standards beyond sovereignty
Primacy beyond precedent.

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"All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end - 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."[1]

This statement of the leaders of the G20 nations in September 2009 sets out the authoritative goals for the reform of international derivative markets following the global financial crisis. It was a public declaration of international policy - an international manifesto for the global reform of the financial markets and the laws which govern them. It recorded a commitment of each of those G20 countries to that reform.

The commercial impact on the derivatives markets is astonishing. New waves of international regulation have been, and are to be, implemented at a scale which would have been thought impossible before the global financial crisis. This regulation has driven an increased use of financial market infrastructure which changes the form and life cycle of derivative transactions. There has been a significant shift in cost, liquidity and risk structures. Although the impact has been most keenly felt by the banks and other intermediaries which engage in the majority of derivatives trading, it has also started to affect others who use derivatives transactions including participants in other finance markets, such as the markets for debt and securities.

However, the regulatory impact has been more surprising than the commercial impact. From a regulatory perspective, the international resonance, and local relevance, of the G20 Leaders' statement has tolled far deeper than most would have expected. An international federation of national financial market laws has emerged in pursuit of the global reform objectives. However, this federation has proven imperfect as many of the national laws have overlapped instead of interlocked. In order to avoid perceived gaps in the regulation of a global and interconnected market, the new national laws have contested the regulatory landscape, rather than complemented one another to cover it. This has resulted in foreign laws intervening directly in domestic markets in an unprecedented way. As a smaller G20 country with a globally interconnected derivatives market, Australia has suffered from this loss of regulatory sovereignty.

Additionally, the legal impact has not been insignificant. In order to implement the changes needed to meet the new regulatory requirements (such as the introduction of financial market infrastructure), there has needed to be, and there will need to be, new laws which take primacy over fundamental laws relating to finance transactions and the financial system.

The laws which operate in Australia's financial markets have changed and, as a result, so has the practice of financial markets law in Australia.

This paper does not seek to articulate detail of global derivatives reform. Instead, this paper seeks to provide some context to these reforms from a commercial, regulatory and legal perspective so that their relevance to participants in the finance markets, and their advisers, can be better understood.

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1 G20, *G20 Leaders Statement: The Pittsburgh Summit* (23-25 September 2009) <http://www.g20.utoronto.ca/2009/2009communique0925.html>.

1 A snapshot of change

A brief outline of the G20 derivatives reforms

The G20 Leaders' statement set out at the start of this paper was concise in its description of the G20 derivatives reforms. An expanded outline is provided here.

Trade reporting. Over-the-counter (OTC) derivatives are to be reported to a trade repository. The information is to be available to regulators and, in certain cases, the public. This reform is intended to provide for greater transparency of the positions which are being taken in OTC derivatives, hopefully to better inform future regulatory decisions and interventions if future financial crises arise. A key legal issue which has arisen with implementing this reform has been the effect of national secrecy and privacy laws. Implementation of this reform is the most advanced.

Trade execution. OTC derivatives are, where appropriate, to be entered into through trade execution facilities (also called "swap execution facilities" or "SEFs") or exchanges. This is intended to provide greater transparency on the prices at which OTC derivatives are being entered into and is intended to reduce anomalies developing in the market. Issues have arisen with the implementation of this reform as the OTC market is not the same as the exchange-traded market which offers standardised and liquid contracts. For example, the transmission of information on prospective transactions by derivative dealers is argued to potentially have a significant effect on liquidity in the derivatives market as it would materially affect the ability of those dealers to enter into hedging positions. This reform is not as advanced globally as trade reporting and central clearing.

Central clearing. Standardised OTC derivatives are to be cleared through central clearing facilities. This central clearing process inserts (usually through novation) a central counterparty into each bilateral derivative contract between the two original parties, with the intention of insulating each of them from the default of the other. In order to protect the clearing house from the default of the participants, each participant is required to provide the clearing house with initial margin and variation margin with respect to that participant's positions on at least a daily basis. Further, each participant is required to provide financial support to the clearing house if needed to cover losses suffered by the clearing house if a participant fails. For derivative counterparties who do not (or are unable to) join a clearing house, indirect access to clearing is facilitated through 'client clearing' arrangements with the participants who have joined the clearing house (this is explained further later in this paper).

Capital. OTC derivatives which are not centrally cleared are to be subject to higher capital requirements when entered into by entities which are subject to capital regulation. This is to be implemented through the Basel III capital accord and its adoption by national regulation. It is intended to provide an economic incentive for those derivative users who are subject to these capital requirements to use central clearing. Although these reforms have already been adopted in Australia,[2] a key issue is consistency in the timing and manner of adoption of these capital requirements across countries.

Margining. In addition to the reforms set out above, the G20 Leaders further agreed in 2011[3] that international standards on margining for non-centrally cleared OTC derivatives should be developed. These requirements are intended to further mitigate systemic risk in the derivatives markets. In addition, they are aimed at encouraging standardisation and promoting central clearing of derivatives. Although the detail of these margining arrangements has not been settled internationally, there has been considerable concern with the commercial and legal impacts of this reform. These are discussed in further detail later in this paper.

[2] Prudential Standard APS 112, Attachment C <http://www.apra.gov.au/adi/PrudentialFramework/Documents/Basel-III-Prudential-Standard-APS-112-(January-2013).pdf>.

[3] G20, *Cannes Summit Final Declaration – Building Our Common Future* (4 November 2011) <http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html>.

There is a further category of reform which has been included in some countries' national derivatives reform regulations (primarily those of the United States and the European Union). These are the ***bilateral risk management*** reforms applicable to non-cleared derivatives. Examples of these include requirements for portfolio reconciliation (to ensure there is a mutual understanding between the parties of the transactions which they have entered into), portfolio compression (to eliminate transactions which offset each other) and trade valuation (to ensure agreement on the value of transactions). These reforms are not specifically part of the G20 derivatives reforms, except to the extent that their implementation on non-cleared derivatives encourages the clearing of those derivatives.

The transformation which these reforms have wrought on trading in the derivative markets is extraordinary. However, the following sections of this paper provide context in which the broader importance of these reforms can be understood - the impact on other financing arrangements, the impact on Australia's regulatory sovereignty and the impact on Australia's finance laws.

2 No market is an island

The relevance of the derivatives market

The global derivatives market is significant. The Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulatory Authority (APRA) and the Reserve Bank of Australia (RBA) noted in their 2012 Report on the Australian OTC Derivatives Market[4] that the total gross notional value of OTC derivatives outstanding at the end of 2011 was US$650 trillion. However, once adjustments are made for legally enforceable bilateral netting, this number is reduced to US$30 trillion (still significant, but 4% of the total gross notional amount). Not surprisingly, the Australian derivatives market is much smaller. Outstanding positions denominated in Australian dollars amount to approximately 2% of the global market. The daily average turnover of OTC derivatives in Australia is around A$180 billion, which is Australian dollar-focussed – for example 80% of OTC derivatives were in Australian dollar denominated products, mainly interest rate derivatives, cross currency swaps and foreign exchange derivatives.[5]

Despite the comparatively small size of the Australian derivatives market, derivatives are relevant to many financing arrangements which incorporate them to manage risks and returns. If the G20 derivatives reforms have a commercial effect on trading in the derivatives market, then they are also likely to affect the markets for other financing arrangements too.

The commercial impact of the G20 derivative reforms

The cost of implementing the G20 derivatives reforms to entities regularly trading in the derivatives is extraordinary. For the interdealer market, massive new investments have had to be made. For example, it has been estimated that the aggregate annual impact on the eight large US banks will be between four and five billion US dollars.[6]

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4 RBA, APRA and ASIC, *Report on the Australian OTC Derivatives Market* (October 2012) <http://www.rba.gov.au/payments-system/clearing-settlement/otc-derivatives/201210-otc-der-mkt-rep-au/pdf/201210-otc-der-mkt-rep-au.pdf>.

5 Ibid at 33. At 30, the Australian derivatives market was summarised as follows: *"The Australian OTC derivatives market is a relatively small share of the global market, with activity mostly focused on Australian dollar-denominated contracts. The vast bulk of this activity in most product classes is intermediated by a small group of domestic and offshore dealers. The most widely used product classes in Australia are single-currency interest rate derivatives, cross-currency swaps and FX derivatives – particularly those with an Australian dollar component. There is also some activity in other types of derivatives, though on a much smaller scale".*

6 Matthew Albrecht and Carmen Manoyan, 'Two Years On, Reassessing the Cost of Dodd-Frank for the Largest U.S. Banks' (9 August 2012) Standard and Poor's Ratings Direct <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245338539029>.

However, many of the G20 derivatives reforms are not limited in their application to derivatives traded in the 'interdealer' market. They can apply to derivative transactions entered into in connection with other finance arrangements such as project finance, securitisation, debt securities, leveraged finance, property finance, corporate finance and asset finance. Derivative transactions have become a regular feature in all of these financing methods and the impact of some of the G20 derivatives reforms on these other financing arrangements will be significant. This is discussed below.

Trade reporting requires a particularly operational response. Derivative counterparties which are subject to it will need to have in place processes for ensuring that the required information is reported and that all necessary consents to do so have been obtained. This requirement will add cost and operational complexity to the institutions affected. Also, there is likely to be a need for some consideration as to whether and how transactions in particular financing structures are to be reported. However, trade reporting does not change the parties to, or interfere in the normal life cycle of, a derivative transaction. In addition, financial institutions are likely to have operational processes in place to meet trade reporting obligations before it becomes relevant to a particular financing transaction. For these reasons, its incremental impact on particular financing transactions may be less than other reforms.

The impact of the ***trade execution*** reform is difficult to predict as there is some doubt as to exactly how it may be implemented. However, if its effect is that all standardised derivatives must be entered into through a 'market-based' facility through which more than one counterparty is able to bid, then it could interfere with the commercial aspects of financing arrangements which have incorporated derivatives. For example, if a financing package is being offered on the basis that financier will also provide the hedging then this may not sit comfortably with a legal requirement that two or three bids be obtained from different entities before a derivative transaction is entered into. As a result, this reform may cause the pricing and structure of some financing arrangements to change.

Central clearing is the reform which intervenes most in the legal life cycle of a derivative transaction by changing its parties and its terms. In essence, if a derivative which forms part of a financing arrangement is required to be cleared then it effectively ceases to be part of the financing arrangement and ceases to be subject to its terms. Instead, it is governed by the rules and regulations of the relevant clearing house. If it is entered into between a member of a clearing house and its client then, under some client clearing structures, it is possible that the transaction may retain some non-standard terms.[7] However, even in this circumstance the ability to customise the legal terms is severely limited. As a result, if a derivative relevant to a financing arrangement is subject to central clearing then the impact on that financing arrangement could be substantial.

If a transaction relating to a financing arrangement is not cleared, then the impact of the imposition of ***margining*** requirements could very well be critical. For example, it may not be part of the commercial structure of a financing arrangement that each party provides to each other both initial and variation margin. [8] Further, a requirement that the initial margin be provided on a gross and not a net basis by each party and that it be kept separate for the provider and not used by the receiver, may also give rise to a need to restructure transactions. In addition, the setting of margin amounts by regulators, instead of the parties themselves, may reduce transaction flexibility. All of this could have a considerable impact on a particular financing arrangement which incorporates derivatives.

In addition, of considerable concern for Australian institutions and cross-border financings will be the potential for the application of the margin requirements to cross-currency swaps.

7 This is more likely to occur in client clearing arrangements based on the "principal model" rather than the "agency model". See "The safety of central clearing" below.

8 Variation margin is collateral which is regularly provided after the derivative has been entered into against movement in the value of a derivative position. Initial margin is collateral provided at the commencement of a derivative transaction, effectively against the potential for variation margin to not be sufficient to cover the losses which could be incurred on default (due to movements in value of the derivative position which occur between the time at which the last variation margin was provided and close-out of the position, for example).

These transactions, which are used to hedge the foreign currency exposure which arises out of offshore capital raisings, form a disproportionately large share (in comparison to other countries) of the derivatives positions of Australian institutions. No clearing house currently offers central clearing of cross-currency swaps. This is for a number of reasons, including that they involve an exchange of different currencies potentially in different time zones, that there is insufficient standardisation and pricing data and because FX forwards and swaps are exempt from central clearing and margining requirements in the United States.[9] Accordingly, it would not be possible to avoid the application of margining regulation by clearing these transactions. However, if compulsory margining were imposed, the amount of margin is likely to be significant, which would place large liquidity pressures on those institutions which are required to comply.[10]

Uncleared transactions entered into with banks also give rise to the potential for the increased ***capital*** requirements to apply. These may increase the costs of a derivative transaction significantly, particularly if the transaction is not collateralised. This increase in cost is likely to have a commercial impact on financing arrangements which incorporate uncleared derivatives.

As many of the ***bilateral risk management*** reforms are to apply at an entity level rather than a transaction level (in terms of compliance), they are less likely to directly affect particular financing arrangements specifically. However, to the extent that these require particular provisions be included in transaction documents, they may complicate the process for entry into financing arrangements.

Transformation beyond trading

Fortunately, not all of these requirements will apply beyond trading on the interdealer market and so to derivatives relating to financing arrangements. Some entities in financings will benefit from so-called “end-user” exemptions contained in national regulation. Also, it is not certain when some of these reforms will commence. Even so, some care should be taken with reforms which are yet to apply. In cases where financing arrangements are now being established on the assumption that the derivatives used by them can be easily replaced in the future if they need to be, the potential for the G20 derivatives reforms to contribute to the costs and complexity of any replacement transaction is worth understanding. All in all, with the complexity of the reforms and the lack of certainty as to what will be exempted from them, caution is needed before discounting the application of the G20 derivative reforms to any particular financing arrangement.

On a broader basis, the reforms will also challenge part of the business model of banking. Part of the service provided by the banking sector is the acceptance of credit risk on clients on the basis of the risk assessment conducted by the bank. As clearing and margining seek to isolate counterparties from credit risk on each other, the role of this credit assessment falls in relevance.[11] Credit risk is sought to be managed by the provision of liquidity rather than assessment of counterparty credit risk. This is likely to change the nature of the commercial issues (and costs) relevant to a bank’s transactions.

Further, the commercial impact of the G20 derivative reforms may change the risk management strategies of end-users of derivatives. For example, one of the impacts of the

[9] See also Ivailo Arsov et al ‘OTC Derivatives Reforms and the Australian Cross-currency Swap Market’ (June 2013) Reserve Bank of Australia < http://www.rba.gov.au/publications/bulletin/2013/jun/7.html>. As noted in this paper, because of the exemption of FX swaps and FX forwards: “*there is a risk that banks may respond to an increased cost of using cross-currency swaps by engaging in less effective and more complex hedges, possibly involving a combination of FX swaps or forwards and single currency interest rate swaps*”.

[10] The additional cost to Australian banks of margining cross-currency swaps on this basis has been estimated at $21 billion: Viren Vaghela, ‘Australian Banks Lobby for Reduced Margin on Cross-Currency Swaps’ *Asia Risk,* 29 May 2013 < http://www.risk.net/asia-risk/news/2271187/australian-banks-lobby-for-reduced-margin-on-crosscurrency-swaps>.

[11] However, some credit analysis should take place with respect to the central counterparties which become the banks’ counterparties.

reforms is that standardised and cleared derivatives will be less expensive than those which are customised, due to the higher capital and margin costs of uncleared trades. This should create an economic incentive to use standardised derivatives. However, standardised derivatives are not customised to the risks which arise with particular transactions or with particular counterparties. Accordingly, the effect of the reforms is likely to create an incentive for end-user's to use 'imperfect' hedges of risk, rather than those which are tailored to the end-user's risk profile.

On this basis it is fair to assume that the transformation caused by the G20 derivatives reforms will take effect beyond the derivatives trading market. Even those who do not consider themselves "trading" in the derivatives market will need to have some understanding of the reforms. However, it is not a simple task to obtain that understanding. This is because it is no longer an issue of local law and regulation, but international standards and the laws of other countries as well. This is discussed in the next section of this paper.

3 We are not alone

The imperfect federation of financial market laws

The reforms required by the G20 Leaders' statement had to be separately and individually implemented at a country, or jurisdictional, level. The individuality of the legal system and regulatory landscape of each of the G20 countries meant that separate law reform processes were needed.

The need for the separate law reforms in each country has had the effect of creating a loose *federation* between the G20 countries in relation to their financial market laws – aimed at achieving a common goal through the combination of their national laws. However, this federation has proven imperfect. International pressure has driven national laws to meet global standards and, in some cases, those national laws have extended internationally to apply domestically in other countries. This has resulted in a loss of regulatory sovereignty in some G20 nations, particularly those with small but interconnected derivative markets – like Australia. Key causes of this loss, being the imperative for laws to conform to international standards and the local application of foreign derivatives laws, are considered below.

The imperative for Australian law to conform to international standards

Australia has had a comprehensive derivatives regulation regime since its *Financial Services Reform Act* in 2001. This introduced derivatives into the new financial regulation included in the Australian *Corporations Act*. As a result, the licensing and conduct of participants with respect to derivatives has been regulated in Australia for more than a decade. This regulation was imposed in a manner which is consistent with the regulation of other financial products in Australia. A broad functional approach was taken in introducing this regulation which, to the extent possible, avoided regulation which is specific only to a particular type of financial product.[12] However, the *Corporations Act's* 'functional approach' to the regulation of financial products meant that the new reforms specific to derivatives which are required by the G20 Leaders' commitment were not addressed (or even contemplated) under Australian law. Accordingly, a new Australian approach to the G20 derivatives reforms was required.

The 'Australian approach' to the G20 derivatives reforms

Despite the early regulation of derivatives in Australia, Australia's financial regulators have

[12] The breadth, and functional nature, of financial product regulation in Australia has been recognised by Australia's High Court in *International Litigation Partners v Chameleon Mining* [2012] HCA 45: "*The legislative scheme implemented by the Reform Act has two significant characteristics. One is over-inclusiveness. Rights and liabilities are drawn in overtly broad terms, on the footing that instances of overreach which become apparent in the administration of the legislation may be remedied by adjustments to the Act made not by remedial legislation but by exercise of powers conferred upon the executive government or bodies such as the Australian Securities and Investments Commission. The second characteristic is the creation by the legislation of rights and liabilities by means of criteria which reflect fluid market and economic usage rather than any ascertainable and stable meaning in the law.*"

not sought to lead the international market in the adoption of the G20 derivatives reforms. The approach of the Australian regulators (referred to in this paper as the "Australian approach") has been based on a principle of allowing combination of international direct and indirect regulation to develop and to take its effect to achieve G20 derivatives reform outcomes and limiting the additional Australian regulation imposed on market participants. As has been noted by the Council of the Financial Regulators:[13]

> *"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."*[14]

For a country like Australia, with its comparatively small but internationally interconnected derivatives market, this is a sensible and pragmatic approach. Nevertheless, it does contain an implied recognition and acceptance that regulatory sovereignty has diminished. However, even though the intention of the Australian approach was the effective achievement of the G20 derivatives reform *outcomes* in Australia with minimal change to domestic laws, Australia has needed to respond to international pressure to change its laws, in order to make them equivalent to international standards. The delicate balance can be seen in Australia's "G20 law".

Australia's "G20 law"

Australia's response to the international pressure to implement changes in local law to implement the G20 reforms can be seen in the *Corporations Legislation Amendment (Derivatives Transaction) Act 2012* which was passed in December 2012. This international context of the Act is expressly recognised in the initial paragraphs of the explanatory document to the consultation draft of its Bill:

> *"1.1 At the G-20 summit in Pittsburgh in 2009, the Australian Government joined other jurisdictions in committing to substantial reforms to practices in over-the-counter (OTC) derivatives markets.*
>
> *1.2 The Australian Government is now releasing for comment draft legislation that will provide a legislative framework to ensure that Australia can meet its commitments in this area by prescribing the following requirements as each becomes appropriate:*
>
> - *the reporting of all OTC derivatives to trade repositories;*
> - *the clearing of all standardised OTC derivatives through central counterparties; and*
> - *the execution of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate."*[15]

It is clear that a key purpose of the legislation is to demonstrate compliance with the G20 Leaders' commitment. However, the Act preserves flexibility in the implementation of reforms in Australia (and in doing so preserves the "Australian approach"). It does this by creating a platform for implementing G20 derivative reforms in Australia which can be activated as and when needed by the Australian Government. As is noted in the Explanatory Memorandum for its Bill:

> *"The establishment of the framework will not in itself introduce any trade reporting, central clearing or trade execution obligations for OTC derivatives transactions. Rather,*

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13 The Australian Council of Financial Regulators is comprised of ASIC, APRA, the RBA and the Commonwealth Treasury.

14 ASIC, "Implementation of Australia's G-20 over-the-counter derivatives commitments: Proposals Paper", December 2012, <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/G20%20OTC%20derivatives%20commitments/Key%20Documents/PDF/Proposal_Paper.ashx>, page 2.

15 Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012 (Cth) <www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Derivative-Transactions > at 1.3.

the framework creates a mechanism by which such obligations may be implemented by supporting regulations and rules."[16]

The process established under the Act (which introduced its provisions into the Australian *Corporations Act 2001 (Cth)*) relies on further ministerial determinations and government regulations as well as new "Derivatives Transaction Rules" being created by ASIC. The Act allows for this process to be initiated separately in relation to trade reporting, clearing and trade execution - providing the flexibility to adapt to the Australian and international market. This flexibility was intended to permit Australia to step through the delicate path of implementing reform where it may not be otherwise needed because its effect would already be achieved by economic incentives and foreign regulation.

The only reform which has been implemented using the platform to date is in relation to trade reporting, in respect of which there has been a ministerial determination and Derivative Transaction Rules.[17] Implementation of these trade reporting obligations commences for some entities in October 2013. However, in addition, there has also been a recommendation given by the Australian financial regulators to the Australian Government that the framework be used to implement a requirement to clear certain transactions. The manner in which this clearing recommendation has emerged further demonstrates the international influence on domestic Australian law. This is described in the next section of this paper.

The extraordinary influence of the FSB on the Australian clearing mandate

The terms of the G20 Leaders' statement make it clear that the Financial Stability Board (FSB)[18] is tasked with reporting on the progress which each G20 country makes in implementing the G20 commitments. This enhanced role of the FSB in monitoring and reporting on the progress of countries in implementing derivatives law reforms is influential. It sets the standards with which national lawmakers must comply. It has established itself as the key international body for global derivatives regulation, in a role which is not dissimilar to that which the Bank of International Settlements performs with respect to the Basel capital accords. This role and has been expressly supported by the G20 nations.[19]

The FSB has published five implementation reports on the progress which each G20 country has made. As part of its reports, the FSB includes a 'scorecard' for how each country is progressing with implementing the G20 derivatives reforms, in comparison with the others. For example, there are 45 references to aspects of Australia's performance in the FSB's fifth implementation report.[20] These include, in relation to trade reporting:

"By end-Q1 2013, 14 jurisdictions had legislation in place to require reporting OTC derivatives contracts. More specifically, Australia, Brazil, some Canadian provinces, China, the EU, India, Indonesia, Japan, Korea, Russia, Singapore, South Africa, Turkey and the US had all adopted legislation on regulatory reporting to TRs."[21]

and in relation to trade execution facilities:

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16 Ibid at 1.24.

17 *ASIC Derivative Transaction Rules (Reporting) 2013* (Cth). *Corporations (Derivatives) Determination 2013*, 2 May 2013.

18 The Financial Services Board is an international body established to coordinate countries' financial regulatory bodies in developing and promoting financial stability through regulatory and supervisory policies, <http://www.financialstabilityboard.org/>.

19 *"Building on its achievements, we have agreed to reform the FSB to improve its capacity to coordinate and monitor our financial regulation agenda. This reform includes giving it legal personality and greater financial autonomy."* - G20 Leaders' Summit in Cannes. "Final Communiqué", 4 November 2011, <http://www.g20.utoronto.ca/2011/2011-cannes-communique-111104-en.html>.

20 Financial Stability Board, "Fifth progress report on OTC derivatives", 15 April 2013, <http://www.financialstabilityboard.org/publications/r_130415.htm>.

21 Financial Stability Board, *OTC Derivatives Market Reforms 5th Progress Report on Implementation* (15 April 2013) <www.financialstabilityboard.org/publications/r_130415.pdf> at 19.

"In the case of Australia and some Canadian provinces, authorities have indicated they are waiting for comprehensive trade repository information before requiring any specific products to be traded on organised trading platforms, due to concerns as to when trading requirements might be appropriate; these jurisdictions are therefore focusing on operationalizing trade reporting obligations."[22]

The report indicates that Australia's progress on these is acceptable, and notes that it is consistent with Canada, a country with which Australia shares financial regulation similarities (and comparatively successful survival of the global financial crisis). However, the report was a little different in tone in relation to Australia's approach to central clearing:

"Several jurisdictions indicated that, at least initially, they anticipate implementing the commitment to centrally clearing all standardised OTC derivatives through incentives alone."[23]

These jurisdictions were referred to in a footnote to the report as being Argentina, Australia, Brazil, Russia, Indonesia, Saudi Arabia, and South Africa. The report followed with:

"There is a risk, however, that incentives alone may not be sufficient to meet the commitment, particularly in light of extended implementation periods provided for under the proposed standards (until 2019). Jurisdictions should set a timetable, criteria and thresholds for deciding in which cases mandatory obligations would be adopted in order to ensure the G20 commitment is met."[24]

In the diplomatic world of international regulatory relations, this does appear to be a less than satisfactory 'grade' from the new international 'standard-setter'.

Before considering Australia's response to this assessment of the FSB, it is worth considering Australia's previous policy in relation to the central clearing mandate. An earlier report of Australia's financial regulators indicated that the Australian dollar interest rate swap market was the most appropriate Australian market to be subject to central clearing but that any Australian legal requirement to do so would be premature.[25] This approach was considered the best for the Australian market:

"Reliance in the first instance on market incentives is particularly relevant in the case of central clearing. Premature regulatory intervention could interfere with the competitive and commercial responses of central counterparties, clearing participants and other service providers. A flexible approach should allow for the transition to occur with maximum choice available to participants on issues such as the commercial terms of agreements, the choice of counterparties and central counterparties, and operational changes that might be needed."[26]

and:

"… at this stage it remains appropriate for industry led migration to central clearing of AUD denominated IRS to continue for the time being."[27]

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22 Ibid at 28.

23 Ibid at 29.

24 Ibid.

25 Council of Financial Regulators, "Survey of the OTC Derivatives Market in Australia", May 2009, <http://www.rba.gov.au/payments-system/clearing-settlement/survey-otc-deriv-mkts/sotcdma-052009.pdf>.

26 Assistant Governor (Financial System) Reserve Bank of Australia, Malcolm Eady, 'OTC Derivatives Regulation' (Keynote Address delivered to the International Swaps and Derivatives Association (ISDA) Conference, 18 October 2012).

27 The Treasury, *Implementation of Australia's G20 Over-The-Counter Derivatives Commitments* (December 2012) <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/G20%20OTC%20derivatives%20commitments/Key%20Documents/PDF/Proposal_Paper.ashx> at 16.

The intention was that higher capital requirements for non-centrally cleared transactions and the implementation of emerging international standards for margin requirements on non-centrally cleared derivatives should create a sufficiently strong economic incentive for transactions to be centrally cleared. This was a clear demonstration of the 'Australian approach' referred to earlier in this paper.

So, Australian policy on central clearing was clear, that is, until the FSB published its fifth implementation report in March 2013 with those statements on central clearing. It took only three weeks for the Council of Financial Regulators[28] to publish a media release after the FSB report which included the following paragraph:

> *"To date, the regulators have favoured an approach whereby central clearing arrangements are given time to evolve in response to economic and regulatory incentives the commercial considerations of market participants and clearing providers. Internationally, however, there is increasing interest - including from the Financial Stability Board - in understanding how those jurisdictions which have not yet adopted mandatory requirements would decide whether and when to do so."*[29]

The media release clarified how the products which would be mandated for clearing would be determined. This was followed in July 2013 with a recommendation from the Australian financial regulators to the Australian government that a requirement for central clearing of OTC interest rate swaps be implemented in Australia. However, despite the earlier determination that AUD denominated interest rate swaps (IRS) were the most appropriate transaction type to be mandated for clearing in Australia, AUD IRS were not included in this new clearing recommendation. Instead only interest rate swaps denominated in the currencies of the United States, Great Britain, Japan and Europe were. This was explained by these being the currencies of denomination of interest rate swaps which foreign derivatives laws require to be cleared.[30] The report states that this need for international consistency is driven by a desire to avoid regulatory arbitrage, to facilitate the equivalence assessments being made by foreign regulators on Australian banks and to facilitate tailoring of the requirements to clear these products to the Australian market if possible.

Again, this seems to be a logical and pragmatic approach to be taken by the regulators of a small and interconnected market. However, the result is startling. Due to the international pressure created from the G20 Leaders' statement, the reports of the FSB and the assessments of foreign regulators of Australia's regulatory system, Australia is likely to implement a requirement under its own law that interest rate swaps denominated in four foreign currencies are required to be cleared. And this is in circumstances where clearing of derivatives in these currencies cannot currently take place in Australia. Also, this is despite the initial regulatory assessment that from an Australian marketplace perspective there may be no need to implement any Australian legal obligation to clear transactions and, if one were needed, then it should apply to AUD denominated interest rate swaps (and not those denominated in the currencies of other countries). That this result evidences some loss of regulatory sovereignty seems irrefutable.

This decision was, in part, based on a need to not only fit in with the international standards but also to fit in with foreign laws which are applying to Australian entities. This domestic application of foreign laws is explored next in this paper.

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[28] Comprised of the RBA, ASIC, APRA and the Australian Commonwealth Treasury.

[29] Australian Council of Financial Regulators, "Australian Regulators' Statement on Assessing the Case for Mandatory Clearing Obligations" (Media Release, 8 May 2013) <http://www.cfr.gov.au/media-releases/2013/mr-13-02.html>.

[30] The regulators' recommendation notes that: *"International consistency is a key consideration in assessing the case for implementing a domestic clearing mandate for these products. US dollar-, euro-, British pound- and yen-denominated interest rate derivatives are subject to the CFTC's mandate, and yen-denominated interest rate derivatives are also subject to a Japanese clearing mandate. It is also expected that at least some of these products will be considered for mandatory clearing by ESMA and the EC."*

The application of foreign derivatives law in Australia

As a general matter, the national law reforms which have implemented the G20 derivatives reforms have not been limited to locally established entities. They have reached further, to apply to foreign participants in the local markets and, in some cases, foreign entities which deal with local entities from offshore. Whilst this is understandable, it results in nearly every participant in the derivatives market coming into contact with multiple waves of regulation at different times from different countries and sometimes requiring different (and conflicting) regulatory responses. Instead of each country's regulatory response working in harmony with those of others to create a single global wave of consistent financial markets law reform, there are multiple waves interfering with each other and creating a very stormy sea.

The issues are clearly demonstrated by the experience of many involved in the Australian financial market (participants, regulators and advisers) with the implementation of the Dodd-Frank Act[31] of the United States of America.

The Australian experience of Dodd-Frank

The implementation of Title VII of Dodd-Frank by the United States government and its regulators has transformed the Australian derivatives marketplace, Australian financial law and Australian regulation. It is difficult to identify another piece of foreign law which has had such an impact on the Australian businesses of so many entities without the need for any enabling legislation being passed in Australia.[32]

Although its implementation is not complete, the inroads which the laws of the United States have made through the implementation of the Dodd-Frank Act into the Australian legal fabric are so extensive that a broad practice of derivatives law *in Australia* cannot be effectively conducted without some understanding of the US legislation, its regulations and its regulators (being the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC)). This intrusion of US regulation into Australia has been effected both *directly* through its impact on entities participating in the Australian market which are subject to it and *indirectly* through its impact on those which deal with them.

The ***direct*** impact has fallen on those participants in the Australian market who are subject to the US regulation. These are the financial institutions which conduct significant derivatives business both in Australia and in the United States: the "Swap Dealers" registered in accordance with the Dodd-Frank Act. These entities may be US entities or they could be established outside of the United States (including in Australia). For example, five Australian banks have registered as "Swap Dealers" with the CFTC.[33] By this registration, those banks have subjected themselves to direct and, in some cases, intrusive regulation by a foreign regulator under foreign laws - even with respect to conduct which occurs outside of the United States, including in Australia. Due to the concentration of participants in the Australian derivatives markets, the registration of major US and non-US banks as Swap Dealers means that at least one party to most derivatives transactions conducted in Australia will be subject to direct US regulation.

However, the most extensive incursion of the US laws into Australia may not be through its direct regulation of the Australian and foreign Swap Dealers which operate in the Australian market. Instead it may be through the ***indirect*** regulation of those other Australian entities which deal with these Swap Dealers. This occurs because the US regulation is not limited to the Swap Dealers' internal affairs. It also relates to the relationships those Swap Dealers have with other entities, or to derivative transactions more generally. This means that the

31 *Dodd-Frank Wall Street Reform and Consumer Protection Act,* H.R. 4173.

32 Since perhaps the enactment of the Australian Constitution by the Parliament of the United Kingdom, pursuant to the *Commonwealth of Australia Constitution Act 1900* (Imp).

33 CFTC, *Provisionally Registered Swap Dealers* (5 July 2013) <http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer>. The Australian banks registered as swap dealers are: Australian and New Zealand Banking Group Ltd, Commonwealth Bank of Australia, Macquarie Bank Limited, National Australia Bank Limited, Westpac Banking Corporation.

impact of the US regulation cannot be seen to be 'internalised' to the entities directly regulated by US law.[34] Two practical examples of this are:

- *indirect regulation of contracts*. The regulations under the Dodd-Frank Act require that Swap Dealers provide to, and obtain from, their counterparties certain undertakings and representations as part of business conduct requirements. This can apply whether or not those counterparties are themselves subject to the Dodd-Frank Act or are even in the United States.[35] Where the regulation applies, Swap Dealers need to ensure that the terms which are agreed with their counterparties include these provisions. If not, then the Swap Dealer may not be able to continue dealing with that counterparty, even though the counterparty has not breached any US law or regulation (or is even subject to it). This has meant that the already complex documentation used for international derivative transactions has become more complex. Australian entities which are not directly subject to US regulation are having to review, consider and enter into protocols, questionnaires, representations and legal provisions based on US legal requirements which do not directly apply to them.

- *indirect regulation of transactions*. A number of the requirements in the Dodd-Frank Act apply to transactions as much as they do to market participants. This includes the requirements relating to trade reporting, trade execution and central clearing. These can apply because one party is from the United States, even if the other is not. In fact, whether the other party is even subject to US law may become irrelevant once the transaction is. Take central clearing as an example. This can only occur if both parties engage in the clearing process. If only one of the parties is directly subject to the requirement under US law to clear a transaction then the other party will need to co-operate. Otherwise the entity which is subject to US law will not be able to enter the transaction. The result is that both parties effectively comply with US law if the transaction is to be entered into, one due to its direct application and the other due to the commercial reality of its position.

Effective compliance with the regulation of the United States is required in order to contract and transact with entities which are subject to US regulation. As a result, the number of entities who *effectively* comply with this US regulation far exceeds the number which are *directly* required to comply. The commercial strength of US financial institutions and the interconnectedness of the global financial marketplace has meant that this has been extremely effective at extending extra-territorial reach of the US Dodd-Frank legislation into the Australian market, far beyond what was expected (by those in the Australian market at least).

However, the local intrusion of US law does not end here. Through US regulatory requirements for "super equivalence", US law is reaching further and shaping Australian regulation itself.

The requirement for Australian super-equivalence

Super-equivalence is used in this paper to refer to reforming legislation to not only be equivalent to international standards but to match the manner in which another country reformed its own laws to meet those same standards. A need for super-equivalence in this context reaches further into the regulatory sovereignty of a country, as it requires a comparison against a foreign country's laws, rather than the standards set by the G20 countries and the FSB. The clearest example which has arisen for Australia has been in relation to so called "substituted compliance" for Australian Swap Dealers, meaning relief from certain requirements of the CFTC on the basis of compliance with equivalent Australian

[34] A contrast here might be drawn with the regulation of the credit risk which a bank undertakes through capital requirements imposed on the bank rather than express limitation on the dealings which the banks have with other parties.

[35] Commodity Futures Trading Commission, "Interpretive Guidance and Policy Statement regarding Compliance with Certain Swap Regulations", Vol 78 *Federal Register* No 144, 26 July 2013.

laws. It is understood that this question of the extent of similarity needed by the CFTC to agree to substituted compliance is still being considered.[36] However, it seems at this stage possible that the approach taken will be a detailed and mechanical 'gap analysis' between Australian and US law to determine whether Australian laws have the same requirements as those of the US - whether or not Australia's laws are already sufficient to achieve the outcomes of the G20 Leaders' commitment in Australia. In other words, if this approach is taken then it means that not only must Australia's laws conform to internationally set outcomes, but they must do so in the same way as was chosen by the United States of America.

The influence that this has had on Australian law can be seen from the recently published Derivatives Transaction Rules in Trade Reporting. These provide the detail as to what ASIC requires to be reported, when, and by whom. The Explanatory Statement to the Rules include a statement that one of the aims is to:

> *"ensure the Australian trade reporting regime is consistent with other international regimes, including those in the European Union (EU), the United States (US), Canada, Hong Kong and Singapore for mutual recognition or substituted compliance purposes;"*[37]

Also, Australian regulators have made similar statements in recommending foreign currency denominated clearing be mandated in Australia (as referred to earlier in this paper). Australian regulation is being tailored match foreign law so as to simplify Australian entities' compliance with that foreign law.

Standards beyond sovereignty

Australia's new derivatives regulation is being designed to meet the standards set by the G20 and the FSB as well as those set by foreign lawmakers.

This is a realistic and pragmatic solution for a country with a small but interconnected derivatives market. Australian regulatory policy has become as bound to the global regulatory framework as the Australian derivatives market is to the global derivatives marketplace. As logical as this may seem, it means that Australia's laws are being to set to standards which surpass Australian sovereignty.

The impact of the G20 derivatives reforms on the fabric of Australian law goes further still. Other significant changes in Australia's laws have been made, and will be made, in order to facilitate the effectiveness of the G20 derivatives reforms. These affect substantive Australian finance law. They are considered in the next section of this paper.

4 Despite any other law

The submission of finance laws to systemic certainty

The changes wrought on Australian law by the G20 derivatives reforms are not limited to regulatory laws. Other reform is needed to give effect to the change in regulation. One example of this is in relation to the financial market infrastructure needed for central clearing, in respect of which there has already been extraordinary changes in Australian law. Even more far-reaching changes are likely to be required in order to implement the G20 derivatives margining reforms.

[36] The need for time to consider substituted compliance for non-US Swap Dealers was one of the reasons given by the CFTC for the extension of time in its report, "Commodity Futures Trading Commission, "Exemptive Order Regarding Compliance With Certain Swap Regulations", Vol 78 *Federal Register* No 140, 22 July 2013.

[37] Australian Securities and Investments Commission, "ASIC Derivative Transaction Rules (Reporting) 2013: Explanatory Statement".

The changes made to law for financial market infrastructure

The majority of the G20 derivatives reforms concern the use of financial market infrastructure: the entry of transactions through trade execution facilities, the reporting of transactions to trade repositories and the clearing of transactions through central clearing facilities.[38] Although this infrastructure existed before the financial crisis, its use was not extensive, particularly in Australia. Now, it is becoming a fundamental feature of derivatives transactions globally.

Each of these pieces of financial market infrastructure is intrusive in the life cycle of an OTC derivative. Each requires new connections with third parties, either to a financial marketplace which facilitates the entry into transactions, a trade repository which facilitates the collection and reporting of information about those transactions or a clearing house which interposes itself as counterparty to each transaction. The most intrusive of these in a legal sense is central clearing. It has the effect of replacing a single bilateral contract with two similar contracts between each one of those original counterparties and a common 'central' counterparty (usually by novation). However, as these contracts are subject to the rules of the clearing house and its standard terms, the rights and obligations of the parties with respect to the clearing house are different to those which they held between each other under the original bilateral contract. The most significant difference to that of uncleared transactions is the extent of the rights which the clearing house is given to manage the default of a participant. These rights provide part of the safety which central clearing is intended to provide.

The safety of central clearing

The default management rights granted to a central counterparty of a clearing house are far more extensive than those enjoyed by the parties to a bilateral, uncleared, derivatives transaction. This is because it is of critical importance that if a participant in a clearing house defaults then the clearing house, the other participants and the clients of the failed participant can survive. Otherwise, one of the fundamental reasons for central clearing - being the isolation of credit risk and reduction of contagion risk - would not be met.

These default management rights can differ between clearing houses but they should include:

- the right to terminate the obligations relating to the failed participant's positions (including with respect to collateral) and the netting of the values of those obligations;

- the right to enforce any security held by the clearing house against the obligations of the failed participant; and

- the right to transfer positions and margin from the failed participant to another participant (this is often referred to as 'porting').

Of these, the first two also exist in uncleared bilateral derivatives. However, porting is a process only applicable to cleared transactions.

Porting is best understood in the context of client clearing arrangements. These are arrangements entered into between participants in a clearing house and other market participants (referred to as their 'clients') who want their transactions cleared but are not members of the clearing house. These clients are given "indirect" access to the clearing house through arrangements entered into with their participant. The exact nature of these arrangements is dependent on the clearing house and the laws which apply to it. However, there are two primary categories of these arrangements, each named by reference to the

[38] *"There is now an international policy consensus that embedding centralised infrastructure – trade repositories, CCPs and trading platforms – in OTC derivatives markets is the most effective mechanism for addressing many of the concerns of regulators and market participants. Regulatory reform efforts in a number of jurisdictions are now underway to implement a transition to this market structure."* - RBA, APRA and ASIC, *Report on the Australian OTC Derivatives Market,* above n 4 at 5.

legal characterisation of the role of the participant when dealing with the clearing house on behalf of its client:

- under the ***principal model*** the participant acts as principal when dealing with both the clearing house and the client, so that the client does not have direct dealings with, and may not have any direct rights against, the clearing house; and

- under the ***agency model*** the participant acts as agent of its client in dealing with the clearing house on its behalf. However, the participant is still responsible as principal for its client's obligations to the clearing house.[39] This is necessary as a clearing house is ultimately relying on the performance of its surviving participants for its own survival - including with respect to transactions entered into on behalf of clients.

Each of these two models requires different structures and documents in order to operate effectively. However, in each case a fundamental protection is being offered - the ability of the clearing house to 'port' the positions and collateral which a defaulting participant holds on behalf of its clients to another participant which is not in default. For this to operate, particularly in the insolvency of the participant, some protection from "ordinary" laws of finance is required.

The legal protection for central clearing

For there to be confidence in a clearing house, there needs to be certainty that the default management processes will be able to be effected quickly and effectively.[40] This is due to the systemic nature of the risks being managed. In a structure where every participant is 'linked in' to the clearing house and subject to its rules, it is fundamental that the rights needed to preserve the clearing house are enforceable. However, clearing house rules do not operate in a vacuum. Existing finance laws, such as those relating to the enforcement of security and dealing with property on insolvency, can conflict with the default management rights needed by a clearing house. For example, the ability to transfer the positions and collateral given by a participant on its insolvency, even if they are given on behalf of its clients, is likely to be complicated by the insolvency law applicable to the participant. For there to be sufficient certainty, these more 'ordinary' finance laws need to be subordinated to the clearing house default management rights.

In Australia, this has been achieved by the *Payment Systems and Netting Act 1998* (sometimes referred to as the *PSN Act*). This legislation was passed in 1998 to provide legal protection to a number of arrangements in connection with financial market infrastructure including real time gross settlement systems (such as the 'RITS' system operated by the Reserve Bank of Australia), multi-lateral netting arrangements (such as those used by the

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[39] Although this liability relationship is usually created expressly under the rules of the relevant clearing house and the applicable law, it is also available under the common law of agency if it is the parties' intention. As stated by the Privy Council in *Yeung Kai Yung v Hong Kong and Shanghai Banking Corporation* [1981] AC 787 at 795 "*The true principle of the law is that a person is liable for his engagements (as for his torts) even though he is acting for another, unless he can show that by the law of agency he is to be held to have expressly or impliedly negatived his personal liability."*. This was cited in *Austrac Rail v Hunter Premium Funding* [2001] NSWSC 654*, Manasseh and anor v R* [2002] NSWCCA 27 and *Carminco Gold & Resources and anor v Findlay & Co Stockbrokers (Underwriters)* (2007) 243 ALR 472.

[40] This is recognised in the Principles for Financial Market Infrastructure published by CPSS - IOSSCO:*"The rules, procedures, and contracts related to an FMI's operation should be enforceable in all relevant jurisdictions. In particular, the legal basis should support the* enforceability *of the participant-default rules and procedures that an FMI uses to handle a defaulting or insolvent participant, especially any transfers and close-outs of a direct or indirect participant's assets or positions (see also Principle 13 on participant-default rules and procedures). An FMI should have a high degree of certainty that such actions taken under such rules and procedures will not be voided, reversed, or subject to stays, including with respect to the resolution regimes applicable to its participants. Ambiguity about the enforceability of procedures could delay and possibly prevent an FMI from taking actions to fulfil its obligations to non-defaulting participants or to minimise its potential losses. Insolvency law should support isolating risk and retaining and using collateral and cash payments previously paid into an FMI, notwithstanding a participant default or the commencement of an insolvency proceeding against a participant."*

systems which clear cheques and electronic payments) and netting markets (such as central clearing and settlement facilities). It also protects close-out netting under 'close-out netting contracts', such as the master agreements used for uncleared bilateral OTC derivatives.[41]

The protections for central clearing (market netting) are contained in Section 16 of the PSN Act. These provisions have, since 1998, validated the netting, termination and valuation of obligations under contracts entered into under certain, approved, "netting markets". However, those provisions did not, before June 2013, relate to terms of those contracts which concerned the enforcement of security or, as porting will require, the transfer of property.

In order to provide that certainty, the provisions of the PSN Act were amended by the *Corporations and Financial Sector Legislation Amendment Act 2013* to validate dealings with the property (including by way of enforcement of security) of a party to the market netting contracts which is conducted in accordance with the market netting contracts provided that either the market netting contract is governed by Australian law or one of the parties to it is subject to an insolvency proceeding governed by Australian law. These provisions are expressed by the PSN Act to apply "despite any other law". This includes Australia's insolvency laws, banking laws, laws relating to entities such as insurance companies and superannuation funds and includes laws relating to the provision and enforcement of security interests such as the *Personal Property Securities Act*.[42] In short, Australia's 'ordinary' finance laws are subordinated to the protection which the PSN Act gives to these default management rights of the approved netting market. The power given to the relevant rules of the netting market by these amendments is immensely powerful (and quite unprecedented) but it is needed to produce the certainty required for systemic stability. In the Explanatory Memorandum to the Bill, the intention, and reason, for the legislation to have primacy over any other Australian laws was made clear:

> *"The PSN Act contains a range of powerful provisions which may override other laws (such as insolvency laws) or contractual arrangements. In some instances the PSN Act states explicitly that certain provisions have effect despite any other law. The reason for providing this type of powerful authority to the provisions in the PSN Act is that the systems, activities and arrangements it covers are at the heart of the financial system. Ensuring that they have legal validity, including in situations where one of the parties enters insolvency, is considered fundamental to protecting the stability of the financial system."*

and:

> *"Legal certainty is of the utmost importance in relation to portability arrangements, because they would have to be implemented in crisis situations and under extreme time pressure."*[43]

This primacy over ordinary Australian finance laws is needed by financial market infrastructure which is required in order for Australia to meet its G20 derivatives reform commitments. However, as extraordinary as this is, it is limited to netting markets approved by Australia's regulators. The same cannot be said for the new laws needed in relation to margining, which will need to be far more general in nature.

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41 The PSN Act has been applied judicially in this context: *In the Matter of Opes Prime Stock Broking Limited (Administrators appointed) and Leveraged Capital Pty Limited* [2008] FCA 1425.

42 Section 256 of the *Personal Property Securities Act 2009* (Cth): *"If there is any inconsistency between this Act and one of the following Acts (the **other Act**), the other Act prevails to the extent of the inconsistency:*
*(*a) the Payment Systems and Netting Act 1998…*"*

Further, section 8(1)(e) of the *Personal Property Securities Act 2009* (Cth) states that *"This Act does not apply to any of the following interests:*
(e) any right or interest held by a person, or any interest provided for by any transaction, under any of the following (as defined in section 5 of the Payment Systems and Netting Act *1998):*
(i) an approved netting arrangement;
(ii) a close-out netting contract;
(iii) a market netting contract…"

43 *Corporations and Financial Sector Legislation Amendment Bill 2013*: Explanatory Memorandum, 1.10.

The changes in law needed for margining

The requirements for margining uncleared derivatives are a key challenge for the derivatives industry (including their regulators and advisers) to face. As noted earlier in this paper, the requirement that initial margin be exchanged between counterparties with respect to uncleared derivatives presents considerable commercial problems. These relate to the liquidity issues associated with obtaining high-quality collateral in order to be provided as initial margin as well as the fact that cross-currency swaps, which the Australian market has a disproportionately high reliance on, are both currently unable to be centrally cleared and also are likely to require significantly high amounts of initial margin.

The method of margining

As important as these commercial issues are, there are also significant legal issues with the introduction of compulsory initial margin requirements in Australia. These arise because the provision of initial margin between counterparties which will be required cannot be conducted in the manner which is customary for derivatives collateralisation in Australia.

Collateralisation of over-the-counter derivatives does happen already in Australia.[44] The collateral is usually provided as variation margin, to reflect the change in the value of the outstanding positions between the parties. Initial margin is uncommon and bilateral initial margin is hardly ever provided in the ordinary course of bilateral OTC derivatives business.[45] Part of the reason for this is that collateral is most commonly provided by way of absolute transfer to the receiver rather than by the provision of a security interest (and there is little point in two parties making an absolute transfer of the same amount of initial margin to each other). This absolute transfer approach had been developed due to benefits relating to State stamp duty laws, registration of charges and in connection with its use by counterparties which have restrictions on granting security interests or the effectiveness of interests granted by them.

The absolute transfer method will not be effective to meet the international standards for the margining of uncleared derivatives. As the Bank of International Settlements notes in its second consultative paper on margin requirements:

> *"Initial margin should be exchanged by both parties, without netting of amounts collected by each party (ie on a gross basis), and held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default; and (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law."*[46]

This means that for mutual initial margin obligations to operate effectively the initial margin needs to be provided by way of security rather than by way of absolute transfer.

The laws in the way

Accordingly, the implementation of initial margin arrangements which meet the international standards will require changes to Australian market practice. These changes to practice may be able to be accommodated by the use of documentation and holding structures allowing for a security interest to be provided. However, doing this in a way which is effective will have

[44] The RBA, APRA and ASIC *Report on the Australian OTC Derivatives Market* (above n 4) states the survey of the Australian market indicates that half of the ISDA master agreements include credit support annexes. These are the documents customarily used for collateralisation.

[45] As the RBA, APRA and ASIC *Report on the Australian OTC Derivatives Market* (above n 4) states: *"For larger bank respondents initial margins are not typically posted. Only a very small number of CSAs require that a counterparty post initial margin (or independent amounts); there would appear to be only a small number of these arrangements, which are mainly used to facilitate transactions with smaller or weaker counterparties."*

[46] Bank for International Settlements, *Margin Requirements for Non-Centrally Cleared Derivatives* (February 2013) <http://www.bis.org/publ/bcbs242.pdf>.

some issues under current Australian law. This is because current Australian laws restrict the effectiveness of certain security interests provided by particular types of counterparties. Key amongst these (from the perspective of potential derivative counterparties) are certain statutory bodies, superannuation entities and banks. By way of brief explanation:

- certain government or statutory entities have restrictions on their ability to create security interests or to have them enforced against them,

- superannuation regulations restrict the ability of superannuation entities to create effective security over the assets of a superannuation fund, and

- Australian banking legislation creates a statutory priority of application of the Australian assets of an Australian bank which is in financial distress which renders less effective (in priority) security taken over those Australian assets of the bank.

These restrictions may impair the ability of entities such as these to comply fully with margining requirements. The effect of these restrictions has already been experienced by some of these entities as they have sought to engage clearing participants in the United States for the purpose of obtaining indirect access to offshore clearing arrangements.[47]

In some circumstances it may be possible to manage the consequences without a change in the law. For example, in the case of Australian banks, security might be able to be taken over assets located outside of Australia.[48] However, this would produce an extraordinary policy result in that Australian banks would need to ensure that they located sufficient assets outside of Australia in order to comply with the international obligations of the Australian Government. Given the volume of initial margin which will be required, it is not clear that this would be an acceptable outcome to the Australian regulators (or the Australian banks, for that matter).

In other circumstances, such as in relation to superannuation funds, there may need to be a change in law or regulation to allow the required security to be able to be granted before margining can be effectively implemented.[49]

Primacy beyond precedent

In order for some of the key benefits of clearing derivatives transaction to actually be realisable, new laws have been passed which take primacy over laws which are fundamental to ordinary finance. These new laws do have some limitation, as the primacy is given only to approved netting markets. However, if margining reforms are to be implemented and fully effective in Australia then further new laws will be required, overriding existing laws which relate to the powers and rights of entities which are critical to the financial system, such as banks, superannuation funds and government entities. The extent of the primacy which will need to be given by these new laws is unprecedented as the margining requirements will not be able to be limited to approved financial market infrastructure. Accordingly, the G20 derivatives reforms may lead us further yet, to more extensive changes in our laws than even those which we have seen so far.

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[47] US laws which require that 'Futures Commission Merchants' segregate their client's assets from their own appear to require them to take security interest over them.

[48] The *Australian Banking Act 1959* does not expressly prohibit this. However, the Australian bank will need to ensure that it complies with its own regulatory requirements.

[49] Although there are exemptions in regulations applicable to superannuation entities relating to derivatives these are unlikely to be sufficient to cover the breadth of the margining requirements.

5 Global laws for a global market

The implementation of the G20 derivatives reforms has been ‘game changing’ for the participants who trade in the derivatives markets. It has changed cost structures, liquidity requirements and operational matters to the extent that was never anticipated before the global financial crisis. The extent of this will transform finance beyond trading in the derivatives market and will shape other areas of finance.

The regulatory policy changes have been dramatic. In the interests of achieving a global outcome on derivatives reform, a federation of national financial market laws has been created, although it is an imperfect one. The need to achieve consistency across the G20 has led to a loss of regulatory sovereignty by many G20 nations, including Australia. Local laws have had to change in order to meet an international timetable and to meet the standards set by international bodies. Further, the lack of consistency between nations’ laws has led to overreach by national regulations with the result that in many countries foreign derivatives laws need to be effectively complied with despite the countries’ own domestic laws. Moreover, from a legal perspective, the financial market infrastructure required by the reforms has led to the need for new laws which override ordinary finance law principles, and there should be more to come.

The G20 derivatives reform are transforming finance beyond just trading, aligning laws and regulations to standards beyond Australia’s sovereignty and requiring new laws be given a primacy over existing laws beyond precedent.

Australian financial markets law, and its practice, has changed.

Global laws are emerging for a global market.