Ashurst Australia
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Financial Services Update

Recent developments on OTC derivatives clearing

WHAT YOU NEED TO KNOW

- The *Corporations Legislation Amendment (Derivatives Transactions) Act 2012* commenced on 3 January 2013. The Act provides a legislative framework from implementation of Australia's G-20 commitments regarding the mandatory clearing and trade reporting of OTC derivatives.
- Notwithstanding the new framework, the Commonwealth Treasury has indicated that mandatory clearing (and trade reporting) will not be imposed at this time, leaving the way open for industry led solutions to develop.
- Each of ASX and LCH have announced their intention to provide a clearing service for certain OTC derivatives in Australia.

WHAT YOU NEED TO DO

- Banks and other participants in Australia's OTC derivative markets will need to familiarise themselves with the proposed clearing services and consider the implications for their capital, risk management and documentation requirements.

Background

In 2009 Australia and other jurisdictions committed to substantial reforms to practices in the over-the-counter ("OTC") derivatives markets at the G-20 summit in Pittsburg. This included commitments to implement reforms to provide for the clearing of standardised OTC derivatives through central counterparties ("CCP"), the greater use of trade repositories, and the execution of standardised OTC derivatives on exchanges or electronic trading platforms. The reform initiative sought to achieve greater transparency in the OTC derivatives market, and a reduction of risk through the use of CCPs.

In response to these commitments, we have seen extensive changes to the regulation of OTC derivatives. For example, the US has implemented the Dodd-Frank reforms, and Europe the "EMIR" reforms.

In Australia, there has also been extensive consultation, which began with the Council of Financial Regulators (comprising APRA, ASIC, the Treasury and the Reserve Bank) (the "Council") issuing a discussion paper in June 2011. This was followed by a report entitled *OTC Derivatives Market Reform Considerations* in March 2012.

The new legislative framework

On 6 December 2012, the *Corporations Legislation Amendment (Derivatives Transactions) Act 2012* (the "Act") received Royal Assent and commenced on 3 January 2013. The Act amended, among other legislation, the *Corporations Act 2001*, the *Australia Prudential Regulation Authority Act 1998* and the *Reserve Bank Act 1959*. The Act provides a legislative framework for the implementation of Australia's G-20 commitments.

The Act does not itself introduce any trade reporting, central clearing or trade execution obligations for OTC derivatives. It merely provides the framework by which such obligations may be implemented in the future through supporting regulations and rules. In particular, the Act empowers the Minister to prescribe a certain class of derivatives as being subject to mandatory requirements and also provides for ASIC to make rules, to be known as "derivatives transaction rules", to impose mandatory obligations. The Act also

provides a basic framework for the licensing of trade repositories.

On 12 December 2012, the Treasury released a proposals paper entitled *Implementation of Australia's G-20 over-the-counter derivatives commitments* which proposed that no decision be taken on any mandatory clearing obligation until the regulators have conducted further review or otherwise provided further advice. To date, no such rules or regulations for mandatory clearing have yet been implemented.

This approach is consistent with the Council's report of March 2012 in which it expressed a preference for market forces to deliver effective regulatory outcomes. In particular, the Council anticipated that the Australian industry would itself move to the mandatory reporting and clearing of Australian dollar interest rate swaps, without regulatory intervention. However, the Council added that if this did not occur, then there should be regulatory intervention to achieve it.

On 18 December 2012, ASIC updated Regulatory Guide 211 *Clearing and settlement facilities: Australian and overseas operators* to reflect recent developments in the policy regarding the granting of clearing and settlement facility licences.

Industry developments – LCH and ASX initiatives

There have since been two significant industry developments.

First, in its press release on 14 February 2013, LCH.Clearnet indicated that it intended to apply for an Australian CS facility licence to support the provision of its SwapClear service to the Australian market. SwapClear is a significant OTC interest rate swap clearing service in Europe and the US.

On 19 February, ASX released for public comment draft operating rules for ASX's OTC Interest Rate Derivatives Clearing Service, which it plans to implement in two phases.

Phase 1 (scheduled for implementation from 1 July 2013, but subject to regulatory approvals) involves the clearing of A$ denominated interest rate swaps and overnight index swaps and A$ denominated forward rate agreements, with NZ$ denominated swaps and forward rate agreements to follow in Phase 2 (scheduled for implementation from the end of 2013).

Initially, only dealer-to-dealer principal trades will be cleared as part of Phase 1, with client clearing scheduled for Phase 2.

The clearing service will be provided by ASX Clear (Futures) Limited, the current clearing house for the ASX24 futures market. The proposals involve a new ASX rule book (to be known as the OTC Derivatives Clearing Rules), as well as amendments to the current Futures Clearing Rules. Key matters covered by the rules include participation requirements, default management arrangements and the provision of financial default commitments by participants.

The ASX proposals are subject to non-disallowance by the Minister under section 822E of the *Corporations Act 2001* and will be scrutinised by ASIC and the Reserve Bank as part of this process.

ASX has also indicated in its consultation package that it is considering the relevant approvals in Europe and the US in order to extend the service to clearing participants incorporated in Europe and to US persons under US regulations. It is also engaging with the Reserve Bank of New Zealand in relation to its requirements for clearing NZ$ denominated products.

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