Parliamentary Joint Committee on Corporations and Financial Services

ANSWERS TO QUESTIONS ON NOTICE

Treasury

Corporations and Financial Sector Legislation Amendment Bill 2013

22 April 2013

General questions

1. Please provide a list of bodies consulted during preparation of the bill.
2. Please provide a list of the licensed domestic financial markets operating in Australia.
3. How do Australia's efforts to implement OTC derivatives reforms compare to those of other jurisdictions? (See for reference: Table 1: Financial Stability Board, OTC Derivatives Market Reforms: Fifth Progress Report on Implementation, 15 April 2013, p. 9, http://www.financialstabilityboard.org/publications/r_130415.pdf)

Answers:

Question 1: List of bodies consulted

The Australian Securities Exchange (the ASX) was consulted on an ongoing basis in preparing the amendments to the Payment Systems and Netting Act facilitating portability of client positions of a failing clearing participant. The extensive involvement of the ASX (including their legal advisor who is a leading commercial lawyer in this area) was judged to be necessary to benefit from their technical expertise to ensure that these amendments are appropriate in achieving the intended outcome. The ASX and their legal advisor for this purpose participated in some meetings with the drafter, and were given the opportunity to comment on drafts of the relevant part of the bill.

Once an advanced draft of the bill had been prepared it was sent to the following parties for review and comment:

- The Australian Financial Markets Association;
- The Australian Bankers' Association;
- Ashurst (a major international law firm incorporating the previous well-known Australian law firm Blake Dawson) - a partner was consulted who is known to have an interest and expertise in the area of portability; and
- Professor John Stumbles, Professor of Finance Law, University of Sydney – Professor Stumbles is a leading academic expert with respect to the law on netting and portability. He was involved in the drafting of the original Payment Systems and Netting Act in the 1990s.

ASIC and the Reserve Bank were also involved in the drafting process.

Question 2: List of licensed financial markets in Australia

<u>Licensed domestic financial markets operating in Australia</u>

- Chi-X Australia Pty Ltd [retail market]
- ASX Limited [retail market]
- Australian Securities Exchange Limited (also known as the SFE) [retail market]

- National Stock Exchange of Australia Limited [retail market]
- SIM Venture Securities Exchange Ltd [retail market]
- IMB Ltd [retail market]
- Asia Pacific Exchange Limited [retail market]
- FEX Global Pty Ltd [retail market]
- Yieldbroker Pty Limited [professional investors only]
- Mercari Pty Limited [professional investors only]
- BGC Partners (Australia) Pty Limited [professional investors only]
- Bloomberg Tradebook Australia Pty Ltd [professional investors only]

<u>Licensed overseas financial markets operating in Australia</u>

- ICE Futures Europe [primary regulator is UK FSA]
- London Metal Exchange [primary regulator is UK FSA]
- Eurex Frankfurt AG [primary regulator is German authority]
- Chicago Mercantile Exchange Inc [primary regulator is US Commodity Futures Trading Commission]
- Reuters Transaction Services Limited [primary regulator is UK FSA]
- Board of Trade of the City of Chicago [primary regulator is US Commodity Futures Trading Commission]

Question 3: Comparison of Australia's implementation of OTC derivatives reforms

Implementing the OTC-related commitments in a globally consistent manner is crucial given the international nature of the OTC derivatives market and the importance of ensuring potential regulatory arbitrage and unnecessary duplication or conflicting requirements are avoided. In meeting its commitments, Australia must necessarily consider the implementation of the major jurisdictions (the US and EU) and tailor its regime to operate harmoniously with the reforms implemented in those jurisdictions. For this purpose, Australia introduced a legislative framework in January 2013 to ensure the Australian authorities have the ability to introduce mandates in relation to trade reporting, central clearing and trade execution in a form flexible enough to allow Australia to adapt to international and domestic developments.

While the *Financial Stability Board, OTC Derivatives Market Reforms: Fifth Progress Report on Implementation*, 15 April 2013 has assessed Australia as only at the consultation stage for implementing supporting regulations/rules for the trade reporting requirement, Australia is aiming to have in place the trade reporting regime by July 2013, with obligations coming into effect in a phased manner commencing in July 2013.

At this stage, Australia is allowing market forces (and other regulatory incentives such as the more favourable treatments of cleared transactions under BASEL III capital requirements) to drive the migration to central clearing. Initial indications are that this approach is working; however the regulators will reassess this approach in their second market assessment report, expected to be released in mid-2013. The legislative framework is in place to enable clearing mandates to be imposed if required to ensure that Australia implements its G20 commitments on a timetable consistent with other jurisdictions. Few jurisdictions other than the leading major jurisdictions have implemented clearing mandates at this time.

Regulators will conduct further analysis on the volume and liquidity characteristics of the market, prior to a trade execution mandate being imposed. At this time the imposition of any mandatory requirement to trade on a platform is not imminent. Few jurisdictions other than the leading major jurisdictions have implemented trading mandates at this time. The relevant G20 commitment supports the introduction of such mandates ‘where appropriate’.

The Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) Working Group on Margining Requirements is continuing its work on settling international standards for imposing margining requirements. Australia is heavily engaged with this process through BCBS and IOSCO. The implementation of any margining requirements would occur following the conclusion of this process. Few jurisdictions other than the leading major jurisdictions have implemented margining requirements in advance of the settlement of international standards.

Going forward the focus will be to maintain Australia’s progress in implementing the commitments, and work with international regulators to address any cross-border regulatory issues that arise.

Part 1 - Payment Systems and Netting

1. Please provide an example of when a porting arrangement may need to be put into place.
2. To what extent have insolvency issues in relation to porting arrangements arisen in the past? Is this a new concern post-global financial crisis?
3. How have other jurisdictions addressed protecting porting arrangements from insolvency laws? How are the proposed reforms in keeping with international developments?

Answers:

Question 1: Example of a porting arrangement

Scenario

Client has entered into a number of exchange-traded futures transactions (the “Portfolio”) via Broker 1 on the ASX24 futures market, cleared by ASX. These transactions hedge the

Client's exposure to commodity or interest rate risk (e.g. a farmer may trade futures on ASX24 to lock in the price of grain to be harvested in the future). Broker 1 becomes insolvent and an administrator (the "**Administrator**") is appointed.

Resolution

As the clearing house for the futures market, ASX must manage its exposure to Broker 1's default as follows:

1. ASX may "close out" the Portfolio by executing transactions in the market that are equal and opposite to those comprising the portfolio. This extinguishes the transactions entered into by Broker 1 on behalf of the Client; OR

2. ASX may "port" the Portfolio to a new clearing broker ("Broker 2") on behalf of Client.

Porting requires the agreement of Broker 2 and Client. It preserves the transactions entered into by Broker 1 on behalf of Client but moves them to Broker 2.

Impact of porting on the Client

For the Client, the preferred and least disruptive solution in the broker default scenario is (2) above, or "porting" of the Portfolio. This solution also removes the credit exposure the Client has in respect of the insolvent Broker 1. Porting preserves transactions entered into in order to hedge market risks to which the Client is exposed in the course of its business (for example, commodity price fluctuations). Contrast with the situation where the Portfolio is not ported and therefore must be closed out: any loss on the positions will be crystallised and may impact Client's business.

A further advantage of the porting arrangement is that the Client retains the benefit of the value of the margin held by the ASX in respect of the portfolio. Where the Client's position is not ported, it would have to wait until the Administrator is in a position to release funds held as margin on trust by Broker 1; in the meantime Client would have to find new funds to submit as margin in respect of replacement transactions for its original Portfolio.

Impact of porting on the insolvent Broker 1

The Client's Portfolio is client (i.e. trust) property and accordingly the transfer (porting) of the Portfolio will not disadvantage Broker 1's creditors.

Impact of porting on ASX and the market

Investor confidence will be strengthened by the introduction of arrangements that increase clients' ability to preserve positions notwithstanding broker default.

Impact of porting on the new Broker 2

Broker 2 takes the Client and its positions on by agreement – and suffers no detriment.

Question 2: Insolvency issues in the past

Under the existing legal framework, consent must be sought from the Administrator before the Portfolio may be ported. The Administrator's duties towards creditors, shareholders and other stakeholders mean that it would be unlikely to be able to provide consent in a timely fashion. Therefore as the law in Australia currently stands, "porting" lacks legal certainty and is not practicable.

Should the Bill be enacted, the Administrator will no longer need to provide permission for "porting". This would ensure that the option to port would be available going forward, to the benefit of the end user market participants.

As a consequence of the existing legal structure, there are no examples of porting having taken place within Australia. However there have been some recent examples of overseas clearing houses offering portability arrangements in respect of participant defaults.

In particular in the U.S. the legislative environment specifically supports portability. The critical nature of the porting process in bankruptcy can be seen with respect to the MF Global default. Arrangements for porting client positions were made by many U.S. clearing houses following the default of MF Global; these included CME Group, ICE Futures US, ICE Clear US, NYSE Liffe US and others. A number of notices and press releases issued by some of these clearing houses in respect of their porting arrangements are provided in Annex 1 as examples of actual cases where porting was implemented.

Portability is not a new concern, but has been a focus of post crisis CPSS-IOSCO work on strengthening international principles so as to avoid financial market disruption that might arise from loss of client hedges (noting that clients may be banks or other ADIs that are of systemic importance).

Question 3: Action by other jurisdictions and relationship with international developments

U.S. legislation and insolvency provisions

The United States Bankruptcy Code expressly contemplates and protects porting under the "Commodity Broker Liquidation" provisions.[1] These provisions provide that a bankruptcy trustee may not avoid a transfer of a client's positions, provided that transfer occurs within seven days of the start of bankruptcy proceedings.

[1] Subchapter IV of 11 USC 7

United Kingdom legislation and insolvency provisions

English insolvency law provides statutory protection in respect of contracts with clearing houses in the event of insolvency of clearing members[2], and more recently has been amended to give explicit protection to porting[3].

Relationship with international developments

The CPSS-IOSCO Principles for Financial Market Infrastructure includes a Principle on Segregation and Portability. This directs central counterparties to structure their arrangements so that it makes it highly likely that the positions and collateral of a defaulting participant's customers will be transferred to one or more other participants. The effectiveness of a central counterparty's arrangements may be constrained by the limitations of legislation in the jurisdiction in which it operates. The explanatory text to this Principle states that in order to receive the full benefit of segregation and portability, the legal framework applicable to the central counterparty should support its arrangements to protect and transfer the positions and collateral of a participant's customers. The Principles recognise that differences in the detail of legal frameworks across jurisdictions preclude a single model for achieving portability. However, to the best of our knowledge, arrangements in place, or being developed, elsewhere are consistent with the portability arrangements proposed in the Bill.

Part 2 - Review of Licences

1. What criteria should the Government use to determine which licence holders should be prescribed for annual review by ASIC and the RBA?

2. Can you please explain the new Financial Stability Standards (FSS) that came into effect on 29 March 2013?

3. How do the new FSS differ from previous standards and what was the intent of the change?

Answers:

Question 1: Criteria with respect to annual reviews

The Government decided to include a regulation-making power to prescribe annual reviews for specified markets, with a view to ensure that the frequency of reviews appropriately reflected factors such as the importance of licensees with respect to financial system stability; the number of retail investors they serve and the risk of harm to those investors;

[2] Part VII, Companies Act 1989

[3] See Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013. Regulation: http://www.legislation.gov.uk/uksi/2013/504/contents/made

Explanatory memo: http://hb.betterregulation.com/external/SI%202013_504%20UkF%20EM.pdf and the efficient use of regulators' resources. A regulation-making power also provides flexibility in adapting the annual review requirements as and when circumstances change.

Questions 2 and 3: The new Financial Stability Standards (FSS)

The new Financial Stability Standards (FSSs) for clearing and settlement (CS) facilities replace previously determined FSSs in light of the April 2012 release of new international standards for CS facilities and other financial market infrastructures, the *Principles for Financial Market Infrastructures* (the PFMIs).[4] The new FSSs are aligned with those parts of the PFMIs relevant to financial stability and the types of CS facility to which they apply – central counterparties (CCPs) and securities settlement facilities. In addition, they include provisions designed to ensure that Australian regulators have appropriate influence over cross-border CS facilities.[5]

Most requirements of the new FSSs are consistent with those of the previous FSSs. The new FSSs do, however, adopt a different structure designed to assist the legal enforceability of requirements at a more granular level. Other key changes from the previous FSSs include:

- enhanced requirements for the level and nature of financial resources held by CCPs;
- new requirements regarding the protection of client positions and related collateral;
- additional requirements for CS facilities to plan for recovery from losses that threaten their viability;
- enhanced requirements regarding CS facilities' investment and collateral policies; and
- provisions to support regulatory influence over cross-border facilities, including governance and operational arrangements that support Australian financial stability, and greater scrutiny of outsourcing arrangements.

The standards are designed to ensure that licensed CS facilities act in a way that promotes financial stability, as required under section 827D of the *Corporations Act 2001*. The use of international standards is intended to ensure that CS facilities manage their risks in accordance with international best practice, and facilitates the cross-border use of financial market infrastructures.

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[4] The PFMIs can be found at http://www.bis.org/publ/cpss101a.pdf.

[5] See Council of Financial Regulators (2012), *Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities*, Supplementary Paper to the Review of Financial Market Infrastructure Regulation, July, available at http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/cross%20border%20clearing/key%20documents/pdf/cross-border-provision.ashx.

Part 3 - International Business Regulators

1. What is meant by 'protected' information?

2. What are some of the concerns around dissemination of this information?

3. Re: the proposed amendment to subparagraph 234(a)(ii) of the *Australian Securities and Investments Commission Act 2001*, can you please:

    a) explain what 'affect significantly' means; and

    b) provide an example of a foreign business law or any other law of a foreign country, which could 'affect significantly the operation of the corporations legislation'. For example, could the 2010 US Dodd-Frank Act 'affect significantly' the operation of Australia's corporations legislation and therefore warrant the attention of the Parliamentary Joint Committee?

Answers:

[to be provided]

Part 4 - Reporting on ASIC's Information Gathering Powers

1. Why is it necessary to formalise ASIC's annual reporting requirements in relation to ASIC's use of information gathering powers?
2. What kind of information will ASIC include in its annual report as a result of the proposed reporting requirements?
3. Will the categories of powers reported against be the same as those listed in the 2010–11 annual report or will they be more extensive?

    At a hearing of the Senate Economics Legislation Committee in November 2010, Mr Malcolm Stewart, Vice President of the Rule of Law Institute, criticised ASIC for a lack of accountability in relation to reporting on its use of information gathering powers. Mr Stewart pointed to the omission of search warrants, wire taps, telephone logs and bank records obtained by ASIC in the preceding three years, from the figures provided by ASIC to the committee.
4. Will the proposed formalised reporting requirements mean that this information will be included in ASIC's annual reports?
5. How do these requirements address concerns about ASIC's accountability in relation to its use of information gathering powers?

Answers:

[to be provided]

Part 5 - Disclosure of Information by the Reserve Bank

1. How do the RBA and APRA's information sharing powers currently differ?
2. Why are amendments to the RBA's information sharing powers required?
3. How will the proposed amendments to the *Reserve Bank Act 1959* (the RB Act) assist the RBA to promote the stability of financial markets?

The RB Act was amended last year as a result of the DT Act.

4. Why were the proposed amendments not included in 2012?

Answers:

Question 1: Differences between RBA and APRA's information-sharing powers

Section 79A(2) of the *Reserve Bank Act 1959* (RB Act) contains a prohibition on disclosure of 'protected information' and 'protected documents' in terms which has a substantially similar effect to the equivalent prohibition in section 56(2) of the *Australian Prudential Regulation Authority Act 1998* (the APRA Act). However the exceptions to the prohibitions in the two Acts are not the same. In some cases the differences reflect the different functions of the RBA and APRA. However in other respects the differences are not related to, or required because of, different functions and powers and so in those respects there is no legitimate reason for the exceptions to the prohibition on disclosure not to be the same, or substantially the same. The three differences outlined in a. to c. below fall into this category. In these three respects consistency between the secrecy provisions in the RB Act and the APRA Act is important given that the RBA and APRA are both members of the Council of Financial Regulators (CFR) and co-operate closely with each other in the performance of their respective financial stability mandates.

The following exceptions to the prohibition in the APRA Act are not currently replicated in s.79A of the RB Act:

a. **s56(5)(a) of the APRA Act to the extent that it permits disclosure to 'any other agency (including foreign agencies) specified in the regulations'** – such a provision provides flexibility to permit disclosure on an ongoing basis to other persons, organisations or agencies (whether in or outside Australia) by regulation[6]. Under s.79A as it stands there are potential issues for the RBA seeking to share in some contexts with Treasury as a CFR member and with New Zealand Treasury. There is also the potential need to share with other international organisations such as the Bank for International Settlements (BIS), the FSB and the International Monetary Fund (IMF). These entities are not 'financial sector supervisory agencies' as defined in section 79A(1) or 'foreign central banks', and so subsection 79A(4) (which

[6] Regulation 5 under the APRA Act permits APRA to share information with agencies in Australia and overseas. The Regulation was amended in 2011 to permit APRA to share protected information and data with New Zealand Treasury given the need for information exchange in the Trans Tasman Banking Council and again in 2012 to permit APRA to share protected information with the BIS, the Basel Committee on Banking Supervision, the FSB, the IMF and the World Bank.

permits sharing with financial sector supervisory agencies and foreign central banks) does not currently permit sharing with them. As sharing with such entities is likely to be necessary on an ongoing basis, expressly permitting it by Regulation is more practicable (and more transparent) than having the Governor approve the disclosure under the provision referred to in b. below. Accordingly the proposed s.79A(4)(c) provides for disclosure to 'any other person or body (including a foreign person or body) prescribed by the regulations'.

b. **s56(5)(b) of the APRA Act which permits disclosure to a person 'approved by APRA by instrument in writing' –** the proposed s.79A(5) provides for disclosure to a person or body (including a foreign person or body) if the disclosure to that person or body is approved in writing by the Governor of the RBA. Such a provision was previously in s79A of the RB Act but was automatically repealed under a 'sunset' provision. The other provision automatically repealed under the same sunset provision (permitting disclosure to a financial sector supervisory agency if the person making the disclosure is satisfied that the information or document will assist the financial sector supervisory agency to perform its functions or excise its powers) was inserted in s79A under the *Corporations Legislation Amendment (Derivatives Transaction) Act 2012* (the DT Act). Re-instating an exception permitting disclosure to any other person approved by the Governor or his delegate in writing will fully reinstate the exceptions existing prior to repeal, and will also bring s79A into line with s56 (5)(b) of the APRA Act.

   The proposed subsection (5B) allows for delegation by the Governor of the power to approve a disclosure to the Deputy Governor or an Assistant Governor. This has been done because the new subsection (5) specifies approval by the Governor (unlike the current APRA Act equivalent which is silent as to who must sign an approval on behalf of APRA) and there needs to be some provision for approval to be given in the absence of the Governor. The original provision which was automatically repealed under a 'sunset' provision included power for the Governor to delegate to the Deputy Governor or another officer of the RBA.

c. **s56(9) and s56(10) which provide for APRA to impose conditions to be complied with in relation to information disclosed under a permitted exception and provide for a penalty for breach of any such condition** – the proposed new subsections (7A) and (7C) replicate these provisions so as to permit a person disclosing protected information or protected documents under s79A to impose confidentiality restrictions on recipients of such information/documents, breach of which will constitute an offence. This will strengthen protection in line with s56(9) and s56(10) in the APRA Act and is a prudent protection given the expansion of the classes of potential recipients of protected information. The proposed new subsection (7B) clarifies that a notice imposing conditions is not a legislative instrument.

Question 2: Reasons for amendments

The proposed amendments are consistent with international best practice as set out by the Financial Stability Board (FSB) in its Key Attributes for Effective Resolution Regimes (October 2011), which notes that jurisdictions should ensure that no legal, regulatory or policy impediments exist that hinder the appropriate exchange of information, including firm-specific information, between supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes[7]. Sharing of information needs to be possible in normal times, and during a crisis, at a domestic and a cross-border level.

The reasons for:

- the changes in sections 28, 29 and 30 of the Bill are set out in above (under response a. to Question 1) and in paragraph 1.37 of the Explanatory Memorandum (EM) (the changes in each of section 28 and 30 are drafting changes necessary to accommodate the inclusion of the new paragraph (c) provided for in section 29);
- the changes in section 31 of the Bill are set out under answer b. to Question 1 above and in paragraph 1.36 of the EM;
- the changes in section 32 of the Bill are set out under answer c. to Question 1 above and in paragraphs 1.38, 1.39 and 1.40 of the EM; and
- the change in section 27 of the Bill is to strengthen the protections offered by section 79A. Currently persons employed by authorised recipients of 'protected information' and 'protected documents' (including entities providing services to the RBA) are 'officers', and so bound by the secrecy provisions in s.79A. This amendment will ensure that all persons engaged in any capacity by authorised recipients (including as contractors) will be 'officers', and so bound by the secrecy provisions in s.79A. This change is addressed in paragraph 1.41 of the EM.

Question 3: Financial stability promotion

The Reserve Bank of Australia's mandate, as expressed in the Financial Stability section of the 2010 Statement on the Conduct of Monetary Policy agreed with the government[8], is to promote stability of the (overall) financial system, not specifically that of financial markets, which represent just one part of the financial system.

The proposed amendments will assist the RBA fulfil its mandate by ensuring that protected information may be shared with all other agencies involved with detecting and responding to threats to financial stability. As noted in the answer to Question 1 in this section, international financial agencies such as the IMF and FSB are not 'financial sector supervisory agencies' but they are heavily involved in the detection and analysis of risks to global financial stability, and thus the stability of the Australian financial system. It is essential that these agencies have access to the data and information needed to carry out this work; this includes institution-specific information, which can reveal concerns such as concentrations of exposures in one or a few institutions. Likewise, departments of Treasury both in

[7] http://www.financialstabilityboard.org/publications/r_111104cc.pdf S12, page 18; see also S6 page 24
[8] http://www.rba.gov.au/monetary-policy/framework/stmt-conduct-mp-5-30092010.html

Australia and abroad are deeply involved in financial crisis management and other responses to financial sector distress. It could harm effective decision-making if these agencies did not have access to the necessary institution-specific (and hence protected) information.

Question 4: DT Act

The DT Act included a number of measures amending the information-sharing provisions in the RB Act. The additional measures contained in the current bill were intended to form part of the DT Act, but could not be included due to delays in finalising the scope of the measures. As there were a number of other measures that were in a similar situation it was decided to group them together in a subsequent miscellaneous measures bill, which is the bill currently being considered by the Committee.