

# Chapter 1

## Introduction

### The referral

1.1 On 13 September 2012, the House of Representatives Selection Committee referred the Corporations Legislation Amendment (Derivative Transactions) Bill 2012 to the Parliamentary Joint Committee on Corporations and Financial Services ('the committee') for inquiry and report.

### Conduct of the inquiry

1.2 The inquiry was advertised in *The Australian* newspaper on 26 September 2012. Details of the inquiry, the bill and associated documents were placed on the committee's website.

1.3 The committee invited submissions by 3 October 2012. Submissions were received from eleven individuals and organisations, as listed in Appendix 1.

### Acknowledgement

1.4 The committee thanks the organisations and individuals who made submissions to the inquiry, and those who gave evidence at the public hearing.

### Notes on references

1.5 References to submissions are to individual submissions as received by the committee rather than to a bound volume. References to *Committee Hansard* are to the *Proof Hansard* transcripts available on the Parliamentary website. Please note that page numbers may vary between the proof and official *Hansard*. Copies of the submissions received and the *Committee Hansard* are available on the Parliamentary website.<sup>1</sup>

### Background

1.6 Following the collapse of the sub-prime mortgage market in the United States in August 2007, the International Monetary Fund reported that the 'world economy is now entering a major downturn in the face of the most dangerous shock to mature financial markets since the 1930s'.<sup>2</sup> The 'global financial crisis' (GFC) prompted calls

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1 Parliamentary Joint Committee on Corporations and Financial Services, *Current inquiries*, [http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate\\_Committees?url=corporations\\_cte/derivatives/index.htm](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_cte/derivatives/index.htm) (accessed 21 September 2012).

2 International Monetary Fund, *World Economic Outlook*, October 2008, p. 1.

for financial regulators to review the regulatory framework underpinning domestic and global economies.

1.7 One of the main culprits for the GFC was the rapid growth of a largely unregulated derivatives market.<sup>3</sup> This market was conducted on both public stock exchanges and in private through over-the-counter (OTC) derivative transactions.<sup>4</sup> As the Chairman of the US Commodity Futures Trading Commission noted:

[W]hile the crisis had many causes, it is evident that unregulated derivatives, called swaps, played a central role...[O]ver the last 30 years, the unregulated swaps market grew by orders of magnitude and is now seven times the size of the futures market. During its growth, the market lacked the transparency of the futures and securities markets, and risk accumulated. Swaps, which were developed to mitigate and spread risk, actually added leverage to the financial system – with more risk backed by less capital.<sup>5</sup>

1.8 The International Organization of Securities Commissions noted that the GFC 'highlighted a severe lack of transparency in the OTC derivatives markets'. Improving this lack of transparency has been the focus of the OTC derivatives reforms. Measures to increase transparency include the creation of trade repositories to act as centralised electronic registries of OTC derivatives transactions. Trade repositories are a departure from traditional forms of recording OTC derivative transactions, in which data is maintained by individual counterparties or institutions that provide services to market participants, such as central counterparties (CCP). Trade repositories are designed to improve market transparency through providing regulators and the public an accessible database of reliable information on the OTC derivatives market.<sup>6</sup>

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3 A derivative is a security, in the form of a contract between two or more parties, based on an arrangement to buy one or more underlying assets for future delivery at a specified date or at a specified point in time. Common underlying assets are stocks, bonds, commodities, currencies, interest rates and market indexes. A derivative is a way for those parties to the contract to hedge their risk: their profit or loss will be determined by the value of the asset at the specified point in time.

4 Over-the-counter derivatives operate through a dealer network where dealer-brokers negotiate directly with each other. A dealer network is often used by small companies that are unable to meet exchange listing requirements.

5 Mr Gary Gensler, Chairman, Commodity Futures Trading Commission, 2 December 2011, as cited in Corporations and Markets Advisory Committee, *Derivatives: Report*, December 2011, p. 15. An option is a form of derivative whereby an investor purchases the right to buy a stock or a bond at a specified future date for a specified price. A swap is a form of derivative whereby two parties agree to exchange financial instruments—such as foreign exchange—at a specified future time at a pre-specified exchange rate

6 Committee on Payment and Settlement Systems–Technical Committee of the International Organisation of Securities Commissions, *Considerations for trade repositories in OTC derivatives markets: Consultative report*, May 2010, p. 1.

1.9 In its response to the GFC, the G20 noted the potential for trade repositories to reduce the opacity of the OTC derivatives market. In 2009, the G20 agreed to progress measures to strengthen the international financial regulatory system.<sup>7</sup> The measures included reforms intended to increase the transparency of, and reduce the risks attached to, the OTC derivatives market.

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.<sup>8</sup>

1.10 The G20 continues to reaffirm, and refine, its commitment to OTC market reforms. The G20 has subsequently stated its expectation that the reforms will be 'internationally consistent', to effectively avoid loopholes, overlapping regulations, and discrimination between markets.<sup>9</sup> It has maintained its expectation that jurisdictions will implement the reforms by the end of 2012, instructing jurisdictions to 'rapidly finalise their decision-making and put in place the needed legislation and regulations to meet the G20 commitment to central clearing'.<sup>10</sup>

1.11 In accordance with G20 directives,<sup>11</sup> the Financial Stability Board (FSB) has monitored the implementation of the OTC market reforms.<sup>12</sup> As part of this monitoring process, in October 2010 the FSB issued 21 recommendations to guide jurisdictions in implementing the reforms. The recommendations were designed to

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7 The Group of 20, or G20, is a forum for international collaboration and coordination on matters affecting international financial stability. The G20 includes 19 member countries and the European Union. For further information, see G2012 Mexico, *What is the G20*, <http://www.g20.org/index.php/en/what-is-the-g20> (accessed 21 September 2012).

8 G20 Information Centre, *G20 Leaders Statement: The Pittsburgh Summit*, 24 – 25 September 2009, <http://www.g20.utoronto.ca/2009/2009communiqu0925.html> (accessed 17 September 2012).

9 G20 Information Centre, *Cannes Summit Final Declaration – Building our common future: Renewed collective action For the benefit of all*, 4 November 2011, paragraph 24, <http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html> (accessed 17 September 2012); G20 Information Centre, *G20 Toronto Summit Declaration*, 27 June 2010, paragraphs 24 – 26, <http://www.g20.utoronto.ca/2010/to-communique.html> (accessed 17 September 2012).

10 G20 Information Centre, *G20 Leaders Declaration*, 19 June 2012, paragraph 39, <http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html> (accessed 17 September 2012).

11 G20 Information Centre, *G20 Leaders Statement: The Pittsburgh Summit*, 24 – 25 September 2009, <http://www.g20.utoronto.ca/2009/2009communiqu0925.html> (accessed 17 September 2012).

12 The Financial Stability Board is an international body that coordinates the activities of domestic financial authorities undertaken in response to international policies and standards. For further information, see, Financial Stability Board, *Overview*, <http://www.financialstabilityboard.org/about/overview.htm> (accessed 21 September 2012).

promote consistency across jurisdictions, minimise the potential for regulatory arbitrage,<sup>13</sup> and increase the use of OTC derivatives in standardised form.<sup>14</sup>

1.12 Together with the G20 commitments, the recommendations form part of the international approach to reforming the OTC derivatives market. The FSB distilled the reforms into four core areas, issuing guidance on the scope of the application of the reforms, clearing arrangements, trade execution, and trade reporting requirements:

- **Application:** the proportion of the OTC market to be standardised;
- **Clearing arrangements:** including the factors for jurisdictions to consider when determining whether an OTC derivative is suitable for standardisation, and therefore central clearing; risk management requirements for the remaining non-centrally cleared markets; and supervision, oversight and regulation of CCP;
- **Trade execution:** recommendations regarding exchange or electronic platform trading for standardised OTC derivatives; and
- **Trade reporting:** guidance on reporting to trade repositories; including requirements for trade repository data to be comprehensive, uniform and reliable.<sup>15</sup>

### *Australia's implementation of the G20 OTC derivatives market reforms*

1.13 Analysis undertaken by the Council of Financial Regulators, comprised of representatives of the Treasury, the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (the RBA), indicates that Australia's current OTC derivatives market is small compared with international markets.<sup>16</sup> The FSB also considers Australia's OTC market to be relatively small, with the largest markets in OTC derivatives operated by the European Union, Japan and the United States.<sup>17</sup> The

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13 In relation to financial markets, the Australian Securities and Investments Commission has defined 'arbitrage' as 'the process of seeking to capture pricing inefficiencies between related products or markets'. For further information, see, for example, Australian Securities and Investments Commission, *Report 125: Australian equity market structure*, November 2010, p. 103.

14 Financial Stability Board, *Implementing OTC derivatives market reforms*, 25 October 2010, p. iv.

15 Financial Stability Board, *Implementing OTC derivatives market reforms*, pp 12.

16 Council of Financial Regulators, *OTC derivatives market reform considerations*, March 2012, pp 18-19.

17 Financial Stability Board, *OTC derivatives market reforms: Third progress report on implementation*, 15 June 2012, p. 1.

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Council's review also found that a portion of the Australian market is comprised of cross-border activity.<sup>18</sup>

1.14 As a G20 member, Australia is committed to implementing the G20's OTC derivatives market reforms.<sup>19</sup> Since the G20 announcement in 2009, Australia's implementation of the reforms has been under consideration by Australia's regulators.<sup>20</sup> The Council of Financial Regulators issued its final report in March 2012, recommending Australia adopt the following policy approach:

- **Trade repositories:** The Council recommended the introduction of a legislative framework to enable the imposition of mandatory reporting requirements for certain products. The Council further recommended that reporting entities be authorised to report to offshore trade repositories provided certain conditions are met. Conditions would include that Australian regulators could access relevant data collected by offshore trade repositories.<sup>21</sup> It was also concluded that cross-border activity 'poses significant jurisdictional oversight challenges, which need to be given careful consideration in developing reform proposals'.<sup>22</sup>
- **Clearing arrangements:** The Council noted that moving to central clearing is a significant change for current market participants, and signalled its preference for the transition to CCP to be driven by economic factors rather than mandatory requirements. However, to ensure that the transition occurs within appropriate timeframes, the Council concluded that 'it is appropriate that there be a capacity to mandate central clearing if necessary'.<sup>23</sup> The Council also concluded that 'not all OTC derivatives will be able to be centrally cleared', however, all transactions should be 'robustly risk managed'.<sup>24</sup>
- **Trade execution:** The Council recommended that primary legislation allow for the rules regarding trade execution to be developed through subordinate legislation.<sup>25</sup>

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18 Council of Financial Regulators, *OTC derivatives market reform considerations*, pp 18-19.

19 G20 information Centre, *G20 members*, <http://www.g20.utoronto.ca/members.html> (accessed 17 September 2012).

20 Mr Malcolm Edey, Assistant Governor (Financial Systems), Reserve Bank of Australia, 'Address to the ISDA Annual Australia Conference', 20 October 2011, [http://www.rba.gov.au/or\\_speeches/2011/sp-ag-201011.html](http://www.rba.gov.au/or_speeches/2011/sp-ag-201011.html) (accessed 18 September 2012).

21 Council of Financial Regulators, *OTC derivatives market reform considerations*, pp 25-25.

22 Council of Financial Regulators, *OTC derivatives market reform considerations*, p. 19.

23 Council of Financial Regulators, *OTC derivatives market reform considerations*, pp 26-27.

24 Council of Financial Regulators, *OTC derivatives market reform considerations*, p. 19.

25 Council of Financial Regulators, *OTC derivatives market reform considerations*, p. 28.

1.15 The final report builds on consultations undertaken in 2011 and a survey of the domestic OTC derivatives market published in 2009. The 30 submissions to the 2011 consultations were reportedly broadly supportive of the G20 reforms. However, concerns were raised with aspects of the practical measures required to introduce greater transparency for OTC derivative transactions.<sup>26</sup>

1.16 Following the Council's report, on 18 April 2012 the government released for public comment options for policy and legislative reform to implement Australia's G20 OTC derivatives commitments.<sup>27</sup> The consultation period ran for approximately 2 months and generated 37 submissions.<sup>28</sup> This was followed by the release of exposure draft legislation on 25 July 2012. Sixteen stakeholder organisations provided comment.<sup>29</sup>

1.17 The FSB has monitored Australia's progress with implementing the G20 reforms. Released in June 2012, the FSB's *Third progress report on implementation* notes that at the time of the report jurisdictions with the largest OTC derivatives markets were the most advanced in implementing the reforms. Australia is among the jurisdictions that remain in the initial stages of reform implementation. While noting the government's announcement that Australia will adopt legislation on trade reporting by the end of 2012, the FSB concluded that implementation of requirements relating to central clearing, exchange/platform trading and reporting has not moved beyond the public consultation stage. However, it was also noted that Australia had developed draft legislation for reforms relating to capital requirements and measures to increase the use of standardised products.<sup>30</sup> The FSB's report predates the release of exposure draft legislation and the introduction of the Corporations Legislation Amendment (Derivative Transactions) Bill 2012 to the House of Representatives.

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26 Council of Financial Regulators, *OTC derivatives market reform considerations*, p. 7.

27 The Hon Bill Shorten MP, Minister for Financial Services and Superannuation; the Hon Bernie Ripoll MP, Parliamentary Secretary to the Treasurer, 'Implementing G20 commitment on OTC derivative reforms' Media release 024, 18 April 2012.

28 Treasury, *Consultation and submissions – Implementation of a framework for Australia's G20 over-the-counter derivatives commitments: Consultation paper*, <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Over-the-counter-derivatives-commitments-consultation-paper/Submissions> (accessed 18 September 2012).

29 Treasury, *Consultations and submissions – corporations legislation and (derivative transactions) Bill*, <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Derivative-Transactions> (accessed 18 September 2012).

30 Financial Stability Board, *OTC derivatives market reforms: Third progress report on implementation*, p. 7.