**ASIC DERIVATIVE TRANSACTION RULES (CLEARING) 2015**

**EXPLANATORY STATEMENT**

Prepared by the Australian Securities and Investments Commission

*Corporations Act 2001*

## Enabling legislation and legislative framework

The Australian Securities and Investments Commission (***ASIC***), acting with the consent of the Minister under section 901K of the *Corporations Act 2001* (the ***Act***), makes the *ASIC Derivative Transaction Rules (Clearing) 2015* (the ***Rules***) under section 901A of the Act.

Subsection 901A(1) of the Act provides that, subject to Division 2 of Part 7.5A of the Act, ASIC may, by legislative instrument, make rules (referred to in the Act as 'derivative transaction rules') dealing with matters as permitted by that section.

*Matters that may be dealt with in the derivative transaction rules – clearing requirements*

Under paragraphs 901A(2)(c) and (d) of the Act, the derivative transaction rules may, subject to Division 2 of Part 7.5A of the Act, impose clearing requirements, and requirements that are incidental or related to clearing requirements. 'Clearing requirements' is defined in subsection 901A(7) as requirements for derivative transactions to be cleared through:

(a) a licensed CS facility, the licence for which authorises the facility to provide services in respect of a class of financial products that includes the derivatives to which the transactions relate (see paragraph 901A(7)(a)); or

(b) a facility that is (or that is in a class of facilities that is) prescribed by the regulations for the purpose of this paragraph in relation to a class of derivatives that includes the derivatives to which the transaction relate (see paragraph 901A(7)(b)).

On 3 September 2015 the *Corporations Amendment (Central Clearing and Single-Sided Reporting) Regulation 2015* was made for paragraph 901A(7)(b) of the Act prescribing:

(a) each facility listed in the regulation in relation to all derivatives (see Reg 7.5A.63); and

(b) a facility determined by ASIC in relation to the class of derivatives specified in the determination (see Reg 7.5A.63).

Under subsection 901A(3) of the Act, the derivative transaction rules may also, subject to Division 2 of Part 7.5A of the Act, deal with matters incidental to or related to requirements referred to in subsection 901A(2) of the Act, including any of the following:

(a) specifying the classes of derivative transactions in relation to which particular requirements apply (see paragraph 901A(3)(a) of the Act);

(b) for clearing requirements:

  (i) specifying the licensed CS facility or prescribed facility (or the class of licensed CS facility or prescribed facility) through which derivative transactions in a particular class must be cleared; and

  (ii) specifying a period within which transactions must be cleared(see paragraph 901A(3)(d) of the Act);

(c) specifying the persons who are required to comply with requirements imposed by the rules (see paragraph 901A(3)(e) of the Act);

(d) the manner and form in which persons must comply with requirements imposed by the rules (see paragraph 901A(3)(f) of the Act);

(e) the circumstances in which persons are, or may be, relieved from complying with requirements in the rules that would otherwise apply to them (see paragraph 901A(3)(g) of the Act);

(f) the keeping of records, or the provision of records or other information, relating to compliance with (or determining whether there has been compliance with) the rules (see paragraph 901A(3)(h) of the Act);

(g) any other matters that the provisions of the Act provide may be dealt with in the derivative transaction rules (see paragraph 901A(3)(i) of the Act).

*Limitations on rule-making power*

ASIC's power to make derivative transaction rules imposing clearing requirements is subject to a number of limitations.

*Ministerial determination*

Subsection 901B(1) of the Act provides that the derivative transaction rules cannot impose clearing requirements in relation to derivative transactions unless the derivatives to which the transactions relate are covered by a determination under section 901B of the Act that relates to requirements of that kind.

On 22 August 2015 the Treasurer made the *Corporations (Derivatives) Amendment Determination 2015 (No. 1)* (***Ministerial Determination***) under subsection 901B(2) of the Act, determining the class of derivatives in relation to which clearing requirements may be imposed. Under the Ministerial Determination, the classes of derivatives determined are interest rate derivatives denominated in any of the following currencies:

(a) Australian dollars;

(b) US dollars;

(c) euros;

(d) British pounds;

(e) Japanese yen.

The Rules apply only to derivative transactions in derivatives in the prescribed class.

*Transactions and positions to which the Rules apply*

Paragraph 901A(8)(c) of the Act provides that the derivative transaction rules cannot impose a clearing requirement on a person in relation to a derivative transaction entered into before the requirement started to apply to the person, unless the transaction has not been cleared by the time the requirement starts to apply to the person.

Therefore the Rules apply only to derivative transactions entered into after, or have not been cleared by the time, the clearing requirements start to apply to a person.

*Regulations*

Under section 901C of the Act, the regulations may provide that the derivative transaction rules:

(a) cannot impose requirements (or certain kinds of requirements) in relation to certain classes of derivative transactions; or

(b) can only impose requirements (or certain kinds of requirements) in relation to certain classes of derivative transactions in certain circumstances.

As at the date of making the Rules, there are no relevant regulations made under section 901C of the Act.

Under section 901D of the Act, the regulations may provide that the derivative transaction rules:

(a) cannot impose requirements (or certain kinds of requirements) on certain classes of persons; or

(b) can only impose requirements (or certain kinds of requirements) on certain classes of persons in certain circumstances.

Regulation 7.5A.50, made for paragraph 901D(a) of the Act, provides that the class of persons on whom the derivative transaction rules cannot impose requirements consists of certain 'end users'. However, the regulation does not apply to a provision of derivative transaction rules to the extent that the provision imposes clearing requirements or requirements that are incidental or related to clearing requirements: subregulation 7.5A.50(4). As at the date of making the Rules, there are no relevant regulations made under section 901D of the Act that would apply to the Rules.

*Consultation*

Except in certain emergency situations (see section 901L), under section 901J of the Act, ASIC must not make a derivative transaction rule unless ASIC:

(a) has consulted the public about the proposed rule; and

(b) has also consulted APRA, the RBA and any other person or body as required by regulations made for the purpose of subparagraph 901J(1)(b)(iii)).

To date no regulations have been made under subparagraph 901J(1)(b)(iii).

For further information relating to consultation on the Rules and satisfaction of the above consultation requirements, see further details under the heading 'Consultation' below.

*Ministerial consent*

Except in certain emergency situations (see section 901L), under section 901K of the Act, ASIC must not make a derivative transaction rule unless the Minister has consented, in writing, to the making of the rule. ASIC makes the Rules with the written consent of the Minister.

*Relevant considerations in making derivative transaction rules*

In considering whether to make a derivative transaction rule, ASIC:

(a) must have regard to:

(i) the likely effect of the proposed rule on the Australian economy, and on the efficiency, integrity and stability of the Australian financial system; and

(ii) the likely regulatory impact of the proposed rule; and

(iii) if the transactions to which the proposed rule would relate would be or include transactions relating to commodity derivatives—the likely impact of the proposed rule on any Australian market or markets on which the commodities concerned may be traded; and

(b) may have regard to any other matters that ASIC considers relevant, for example, relevant international standards and international commitments and matters raised in consultations (if any) under section 901J (see section 901H of the Act).

See below under the heading 'Regulation Impact Statement and section 901H matters', for further information on these matters.

**Compliance and penalties**

Under section 901E of the Act, a person must comply with provisions of the derivative transaction rules that apply to the person. Section 901E is a civil penalty provision (see section 1317E of the Act).

Under subsection 901A(4) of the Act, the derivative transaction rules may specify a penalty amount for a rule. A penalty amount must not exceed 1,000 penalty units (currently, $180,000: see section 4AA of the *Crimes Act 1914*).

**Background and Rationale**

*G20 commitment*

At the Group of Twenty (***G20***) summit in Pittsburgh in 2009, the Australian Government joined other jurisdictions in committing to substantial reforms to practices in over-the counter (***OTC***) derivatives[1] markets. Three of the key G20 commitments in relation to OTC derivatives were:

- the reporting (referred to as '*trade reporting*') of transaction information (such as price, maturity, reference entity and counterparties) on all OTC derivatives to trade repositories which are centralised registries that maintain an electronic database of records of transactions;
- the clearing (referred to as '*central clearing*') of all standardised OTC derivatives through central counterparties; and
- the execution (referred to as '*trade execution*') of all standardised OTC derivatives on exchanges or electronic trading platforms, where appropriate.

Global commitment to OTC derivatives reform arose out of the global financial crisis (***GFC***) in 2008. The GFC highlighted structural deficiencies in the global OTC derivatives markets and the systemic risk that those deficiencies posed to wider financial markets and the real economy. In the lead-up to the GFC, those structural deficiencies contributed to the build-up of large counterparty exposures for which the risks were not appropriately managed. With details of OTC derivative

[1] An OTC derivative may broadly be described as a derivative (i.e. a financial arrangement whose value is derived from an underlying asset, commodity, exchange rate, index or interest rate) that is not traded on an exchange but entered into through bilateral or private negotiation between the counterparties. Examples of OTC derivatives include credit default swaps.

transactions generally held only between the counterparties, in many cases those exposures were not transparent to other market participants and regulators.

The overarching objectives of the OTC derivatives reforms are:

- to enhance the transparency of transaction information available to relevant authorities and the public;
- to promote financial stability; and
- to support the detection and prevention of market abuse.[2]

Implementation of the G20 commitments is being coordinated and monitored by the Financial Stability Board (***FSB***). The FSB membership includes the major financial centres around the world including: China, Hong Kong, India, Indonesia, Japan, the Republic of Korea, Singapore and Australia.

*Australian response*

Part 7.5A establishes a mechanism whereby central clearing requirements, as well as trade reporting and trade execution may be implemented in a proportional and gradual way, through supporting regulations and ASIC rules. The Explanatory Memorandum to the *Corporations Legislation Amendment (Derivative Transactions) Bill 2012* notes, at paragraph 1.7 that "Clearing of standardised OTC derivatives will reduce counterparty risk associated with OTC derivative transactions".

In May 2013, ASIC, the Reserve Bank of Australia and the Australian Prudential Regulation Authority (the ***CoFR***) released a report entitled *Australian regulators' statement on assessing the case for mandatory clearing* that outlined a framework that the regulators would apply when assessing the case for implementing mandatory central clearing requirements.

In July 2013, the CoFR released a report entitled *Report on the Australian OTC derivatives market*, recommending, on the grounds of international consistency, that the Australian Government consider imposing a mandatory central clearing mandate for US dollar, euro, British pound and Japanese yen-denominated interest rate derivatives. The CoFR recommended that the initial focus of the mandate should be on dealers with significant cross-border activity in OTC derivatives.

In April 2014, the CoFR published another report entitled *Report on the Australian OTC derivatives market*, recommending that the Australian Government also consider imposing a mandatory central clearing mandate for Australian dollar-denominated interest rate derivatives.

Australia is implementing the G20 commitments to OTC derivative reforms in close coordination with peer jurisdictions. Mandatory clearing regimes are being developed concurrently by regulators overseas, including the US Commodity Futures Trading Commission, the US Securities and Exchange Commission, the European Securities and Markets Authority, the Monetary Authority of Singapore, for their respective jurisdictions.

**Purpose of these rules**

The Rules aim to:

[2] See CPSS–IOSCO *Principles for financial market infrastructures*, April 2012, p. 9.

- give effect to the Australian Government's G20 commitments in relation to mandatory clearing;
- implement an Australian mandatory central clearing regime that achieves the stated objectives of the OTC derivatives reforms, in particular by enhancing the transparency of OTC derivative markets, both to regulators and the public, leading to an increased capacity for the oversight and monitoring of systemic risk and the prevention and detection of market abuse; and
- ensure the Australian mandatory central clearing regime is likely to be consistent with the regimes (both in place and proposed) in other jurisdictions, including in the European Union (***EU***), the United States (***US***) and Singapore for mutual recognition or substituted compliance purposes.

The Rules are described in more detail in Attachment A.

**Commencement of Rules**

The Rules commence on the day after they are registered on the Federal Register of Legislative Instruments.

**Consultation**

CP 231

On 28 May 2015, ASIC released Consultation Paper 231 *Mandatory central clearing of OTC interest rate derivative transactions* (CP 231)[3] proposing draft derivative transaction rules addressing mandatory central clearing requirements for OTC derivatives. The consultation period ended 10 July 2015. ASIC received 11 written submissions (including three confidential submissions) from a broad range of stakeholders including from domestic and overseas-based clearing and settlement facility operators, market participants and fund managers. Non-confidential submissions are available on ASIC's website.

ASIC also held a series of meetings with stakeholders, including the Australian Financial Markets Association (AFMA) and the International Swaps and Derivatives Association (ISDA). ASIC has also worked closely with the CoFR agencies, particularly the RBA and APRA, in the overall design of the Rules.

A summary of the key issues raised in consultation and ASIC's response to those issues is set out in ASIC Report *Response to submissions on Consultation Paper 231 Mandatory central clearing of OTC interest rate derivative transactions*. ASIC took the submissions into account in making the Rules.

Other consultation

*Treasury consultation*

Treasury has also conducted the following consultations in relation to the framework for central clearing:

- In April 2012 Treasury released a consultation paper entitled Implementation of a framework for Australia's G20 over-the-counter derivatives commitments, seeking stakeholder views on the detailed design of a framework to implement Australia's G20 commitments in relation to OTC derivatives.
- In July 2012 an exposure draft of legislation designed to implement the legislative framework was released for public consultation.
- In December 2012 Treasury released a proposals paper entitled Implementation of Australia's G-20 Over-The-Counter Derivatives Commitments, seeking stakeholder views on a proposed approach for implementing the G20 commitments, including the proposed timetable for implementation. This paper was based on recommendations by APRA, ASIC and the RBA in their report published in October 2012.
- In February 2014 Treasury released a proposals paper entitled Implementation of Australia's G-20 Over-The-Counter Derivatives Commitments: G4-IRD Central Clearing Mandate, seeking stakeholder views on a proposed approach for a first step in implementing its G-20 commitments in relation to central clearing of OTC derivatives.
- In July 2014 Treasury released a further proposals paper entitled Implementation of Australia's G-20 Over-The-Counter Derivatives Commitments: AUD-IRD central clearing mandate, seeking stakeholder views on a proposal to combine the requirements to centrally clear interest rate derivatives denominated in four global currencies and in Australian dollars. This paper was based on a recommendation by APRA, ASIC and the RBA that the Government consider a central clearing mandate for trades between internationally active dealers in interest rate derivatives denominated in Australian dollars.
- In May 2015 Treasury released consultation drafts of a Ministerial determination and a set of amendments to the Corporations Regulations 2001 implementing the proposed central clearing mandate.

**Regulation Impact Statement and section 901H matters**

In making the Rules, ASIC has consulted on, and has had regard to:

- the likely effect of the proposed rule on the Australian economy, and on the efficiency, integrity and stability of the Australian financial system;
- the likely regulatory impact of the proposed rule; and
- the likely impact of the proposed rule on any Australian market or markets on which the commodities concerned may be traded, as required by section 901H of the Act.

ASIC has also had regard to other matters that ASIC considers relevant, including relevant international standards, international commitments and matters raised in consultation under section 901J of the Act.

ASIC notes in this regard:

- ASIC has carefully considered stakeholder feedback gathered from the consultation.
- In order to reduce the regulatory impact of the implementation of the clearing obligation, ASIC has included a number of exemptions that will reduce the impact on entities subject to the Rules, including:

- removing the requirement to clear a derivative transaction between two foreign entities if neither books the transaction into Australia;
- the availability of 'alternative' clearing;
- the ability to conduct multilateral portfolio compression trades without needing to clear trades conducted for that purpose;
- the ability to conduct intra-group derivative transactions without needing to clear trades conducted for that purpose;
- a delay of 24 months for the commencement of mandatory clearing of AUD forward rate agreements; and
- a delay of 6 months for the commencement of mandatory clearing of AUD denominated overnight index swaps.

A Regulation Impact Statement (RIS), *Mandatory central clearing of OTC interest rate derivative transactions*, has been prepared in relation to the Rules and is included as Attachment B. The Office of Best Practice Regulation has determined that ASIC is compliant with the Government's RIS requirements and the RIS is consistent with best practice.

**Statement of Compatibility with Human Rights**

A Statement of Compatibility with Human Rights is included in this Explanatory Statement at Attachment C.

## ATTACHMENT A – Provision-by-provision description of the instrument

Capitalised terms used in this Attachment have the same meaning as in the Rules.

## CHAPTER 1: INTRODUCTION

### Part 1.1 Preliminary

#### Rule 1.1.1 Enabling legislation

Rule 1.1.1 provides that ASIC makes the instrument under section 901A of the Act. Section 901A of the Act empowers ASIC to make derivative transaction rules imposing clearing requirements.

#### Rule 1.1.2 Title

Rule 1.1.2 provides that the instrument is the *ASIC Derivative Transaction Rules (Clearing) 2015*.

#### Rule 1.1.3 Commencement

Rule 1.1.3 provides that this instrument commences on the day after the instrument is registered on the Federal Register of Legislative Instruments.

#### Rule 1.1.4 Penalties

Subrule 1.1.4(1) provides that, for subsection 901A(4) of the Act, the penalty amount specified under a Rule is the penalty amount for that Rule. Subsection 901A(4) of the Act provides: 'The derivative transaction rules may specify a penalty amount for a rule. A penalty amount must not exceed 1,000 penalty units'. At the time of making the rules, a penalty unit for the purposes of subsection 901A(4) is $180 (see section 4AA of the *Crimes Act 1914*).

Subrule 1.1.4(2) provides that, if no penalty amount is specified under a Rule, there is no penalty for that Rule.

### Part 1.2 Interpretation

#### Rule 1.2.1 Definitions

Rule 1.2.1 provides definitions for the following terms used in the Rules:

- Act;
- Australian ADI;
- Australian Clearing Entity;
- Basis Swap;
- Calculation Date;
- Central Clearing Transaction;
- Cleared Through;
- Clearing Derivative;
- Clearing Entity;
- Clearing Facility;
- Clearing Requirements;

- Clearing Threshold;
- Clearing Transaction;
- Derivative;
- Derivative Transaction;
- Designated Business Identifier;
- Determined Clearing Class;
- Exempt Financial Market;
- Exempt Foreign Licensee;
- Financial Entity;
- Fixed-to-Floating Swap;
- Foreign Clearing Entity;
- Foreign Internationally Active Dealer;
- Forward Rate Agreement;
- IRD Class Specifications;
- LEI;
- Licensed CS Facility;
- meets the Clearing Threshold;
- meets the IRD Class Specifications;
- Multilateral Portfolio Compression Cycle;
- Opt-In Australian Clearing Entity;
- Opt-In Clearing Entity;
- Opt-In Foreign Clearing Entity;
- Overnight Index Swap;
- Part 7.2A Market;
- Personal Capacity;
- Prescribed CS Facility;
- Regulated Foreign Market;
- Regulations;
- Reporting Rules;
- Representative Capacity;
- Rules;
- Swap; and
- total gross notional outstanding positions.

**Rule 1.2.2 References to entity acting in a capacity**

Rule 1.2.2 provides that in the Rules, unless the contrary intention appears, a reference to an entity 'acting in a capacity' or 'acting in a particular capacity' where the capacity is not specified is a reference to the entity acting in its Personal Capacity or in a Representative Capacity.

**Rule 1.2.3 Meaning of Clearing Derivative**

Rule 1.2.3 provides a definition of 'Clearing Derivative' for the purposes of the Rules. Under the Rules, Clearing Entities are required to ensure their Clearing Transactions are Cleared Through a Clearing Facility (see Rule 2.1.1). 'Clearing Transactions' are defined by reference to the entry into a Clearing Derivative (among other things) (see Rule 1.2.5).

Subrule 1.2.3(1) provides that, subject to subrules 1.2.3(6) to (8), a Derivative is a Clearing Derivative if the Derivative:

- is in a Determined Clearing Class; and
- is a Basis Swap, Fixed-to-Floating Swap, Forward Rate Agreement or Overnight Index Swap; and
- meets the IRD Class Specifications.

Subrules 1.2.3(2), (3) and (4) set out when a Derivative that is a Basis Swap, Fixed-to-Floating Swap, Forward Rate Agreement or Overnight Index Swap 'meets the IRD Class Specifications'. Under those subrules, a Derivative that is a Basis Swap, Fixed-to-Floating Swap, Forward Rate Agreement or Overnight Index Swap 'meets the IRD Class Specifications' if a row in the following tables (as applicable) contains:

- the currency (Currency) in which the notional principal amount and payments under the Derivative are denominated; and
- the benchmark, index or rate (Floating Rate Index) on which each floating rate for the Derivative is based; and
- a period of time (Termination Date Range) which includes the period from entry into the Derivative until the termination date for the Derivative.

| **IRD Class Specifications for Basis Swaps and Fixed-to-Floating Swaps** | | | |
|---|---|---|---|
| **Item** | **Currency** | **Floating Rate Index** | **Termination Date Range** |
| 1 | US dollar | London Interbank Offered Rate (LIBOR) | 28 days to 50 years |
| 2 | euro | Euro Interbank Offered Rate (EURIBOR) | 28 days to 50 years |
| 3 | British pound | London Interbank Offered Rate (LIBOR) | 28 days to 50 years |
| 4 | Japanese Yen | London Interbank Offered Rate (LIBOR) | 28 days to 30 years |
| 5 | Australian dollar | Australian Bank Bill Swap Rate (BBSW) | 28 days to 30 years |

| **IRD Class Specifications for Forward Rate Agreements** | | | |
|---|---|---|---|
| **Item** | **Currency** | **Floating Rate Index** | **Termination Date Range** |
| 1 | US dollar | London Interbank Offered Rate (LIBOR) | 3 days to 3 years |
| 2 | euro | Euro Interbank Offered Rate (EURIBOR) | 3 days to 3 years |
| 3 | British pound | London Interbank Offered Rate (LIBOR) | 3 days to 3 years |
| 4 | Japanese Yen | London Interbank Offered Rate (LIBOR) | 3 days to 3 years |
| 5 | Australian dollar | Australian Bank Bill Swap Rate (BBSW) | 3 days to 3 years |

| **IRD Class Specifications for Overnight Index Swaps** | | | |
|---|---|---|---|
| **Item** | **Currency** | **Floating Rate Index** | **Termination Date Range** |
| 1 | US dollar | Effective Federal Funds Rate (FedFunds) | 7 days to 2 years |
| 2 | euro | Euro Overnight Index Average (EONIA) | 7 days to 2 years |

| | | | |
|---|---|---|---|
| 3 | British pound | Sterling Overnight Interbank Average Rate (SONIA) | 7 days to 2 years |
| 4 | Australian dollar | RBA Interbank Overnight Cash Rate (IBOC) | 7 days to 2 years |

Subrule 1.2.3(5) provides that a reference to a type of Floating Rate Index in a table in the Rule 1.2.3 includes a reference to any successor to that Floating Rate Index.

Subrule 1.2.3(6) provides that a Derivative is not a Clearing Derivative if under the Derivative:

- **Optionality**: either party is granted an option which, if exercised, would or might affect the amount, timing or form of the consideration that would otherwise be provided under the Derivative by a party to the Derivative. It is noted that a Derivative that gave a party the ability to change the notional principal amount at its election would be an example of optionality. This type of optionality would also fall within paragraph 1.2.3(6)(a); or
- **Multi-currency**: the notional principal amount and payments under the Derivative are not all denominated in the same currency. It is noted that such a Derivative would also not be a Clearing Derivative because it would not meet the IRD Class Specifications: see paragraphs 1.2.3(2)(a), (3)(a) and (4)(a); or
- **Conditional notional principal amount:** the notional principal amount will or may change upon the occurrence of a specified future event where, at the time of entry into the Derivative, at least one of the following is uncertain: (i) when the future event will occur; (ii) whether the future event will occur.

Subrule 1.2.3(7) carves out certain Derivatives from the definition of 'Clearing Derivative' for the purposes of the Rules. Under that subrule, a Derivative is not a Clearing Derivative if:

- the Derivative is able to be traded (within the meaning of section 761A of the Act) on a Part 7.2A Market, a Regulated Foreign Market or an Exempt Financial Market; and
- in the case of a Part 7.2A Market, the entry into of the arrangement that is the Derivative:
    - takes place on the Part 7.2A Market in accordance with the operating rules of the Part 7.2A Market; or
    - is reported to the operator of the Part 7.2A Market in its capacity as operator of the Part 7.2A Market, in accordance with the operating rules of the Part 7.2A Market; and
- in the case of a Regulated Foreign Market or an Exempt Financial Market, the entry into of the arrangement that is the Derivative takes place on the Regulated Foreign Market or an Exempt Financial Market.

Subrule 1.2.3(8) carves out a Derivative from the definition of a 'Clearing Derivative" if both the following are satisfied:

- the notional principal amount and payments under the Derivative are denominated in Australian dollars; and
- the Derivative is either: (a) an Overnight Index Swap that was entered into before 3 October 2016, or (b) a Forward Rate Agreement that was entered into before 2 April 2018.

**Rule 1.2.4 Meaning of Clearing Entity**

Rule 1.2.4 provides a definition of 'Clearing Entity for the purposes of the Rules. Under the Rules, Clearing Entities are required to ensure their Clearing Transactions are Cleared Through a Clearing Facility (see Rule 2.1.1).

Subrule 1.2.4(1) provides that an entity is a Clearing Entity in relation to a Derivative Transaction if it is an Australian Clearing Entity or a Foreign Clearing Entity in relation to the Derivative Transaction.

**Australian Clearing Entity**

Subrules 1.2.4(2) and (3) provide when an entity is an Australian Clearing Entity in relation to a Derivative Transaction.

Subrule 1.2.4(2) provides that an entity is an Australian Clearing Entity in relation to a Derivative Transaction to which it is party in its Personal Capacity if the entity is:

- an Australian ADI or a financial services licensee that is incorporated or formed in Australia and meets the Clearing Threshold in its Personal Capacity; or
- an Opt-In Australian Clearing Entity in its Personal Capacity.

Subrule 1.2.4(3) provides that an entity is an Australian Clearing Entity in relation to a Derivative Transaction to which it is a party in a Representative Capacity if:

- the scheme or trust to which the Representative Capacity relates is incorporated or formed in Australia; and
- the entity is:
    - a Financial Entity that is incorporated or formed in Australia or is a foreign company; and meets the Clearing Threshold in that Representative Capacity; or
    - an Opt-In Australian Clearing Entity in that Representative Capacity.

**Foreign Clearing Entity**

Subrules 1.2.4(4) and (5) provide when an entity is a Foreign Clearing Entity in relation to a Derivative Transaction.

Subrule 1.2.4(4) provides that an entity is a Foreign Clearing Entity in relation to a Derivative Transaction to which it is party in its Personal Capacity if the entity is:

- a Financial Entity that is a foreign company and meets the Clearing Threshold in its Personal Capacity; or
- an Opt-In Foreign Clearing Entity in its Personal Capacity.

Subrule 1.2.4(5) provides that an entity is a Foreign Clearing Entity in relation to a Derivative Transaction to which it is a party in a Representative Capacity if:

- the scheme or trust to which the Representative Capacity relates is incorporated or formed outside Australia; and
- the entity is either:
    - a Financial Entity that is incorporated or formed in Australia or is a foreign company, and meets the Clearing Threshold in that Representative Capacity; or
    - an Opt-In Foreign Clearing Entity in that Representative Capacity.

**Definitions of *Australian clearing entity* and *foreign clearing entity* in the Regulations**

Subregulations 7.5A.61(2) and 7.5A.62(2) of the Corporations Regulations provide that an entity is an 'Australian clearing entity' or a 'foreign clearing entity' in relation to a derivative transaction to which it is a party in a representative capacity in the circumstances set out in derivative transaction rules.

Subrule 1.2.4(6) provides that for the purposes of subregulations 7.5A.61(2) and 7.5A.62(2) of the Corporations Regulations, an entity that is:

- an Australian Clearing Entity in relation to a Derivative Transaction to which it is party in a Representative Capacity is an 'Australian clearing entity' (as defined in subregulation 7.5A.61(2)) in relation to the Derivative Transaction; and
- a Foreign Clearing Entity in relation to a Derivative Transaction to which it is party in a Representative Capacity is a 'foreign clearing entity' (as defined in subregulation 7.5A.62(2)) in relation to the Derivative Transaction.

**Rule 1.2.5 Meaning of Clearing Transaction**

Under the Rules, Clearing Entities are required to ensure their Clearing Transactions are Cleared Through a Clearing Facility (see Rule 2.1.1).

Subrule 1.2.5(1) provides that Rule 1.2.5 defines when a Derivative Transaction is a Clearing Transaction for a Clearing Entity in relation to the Derivative Transaction.

**Entry into a Clearing Derivative by an Australian Clearing Entity**

Subrule 1.2.5(2) provides that entry into a Clearing Derivative by an Australian Clearing Entity is a Clearing Transaction for the Australian Clearing Entity if the other party to the Clearing Derivative is:

- an Australian Clearing Entity; or
- a Foreign Clearing Entity; or
- a Foreign Internationally Active Dealer.

'Foreign Internationally Active Dealer' is defined in Rule 1.2.1 as having the meaning given by regulation 7.5A.65 of the Corporations Regulations. At the date of making the rule, regulation 7.5A.65 provides that a Foreign Internationally Active Dealer is a foreign entity, other than a Foreign Clearing Entity, that is registered or provisionally registered as a swap dealer with the US Commodity Futures Trading Commission; or a securities-based swap dealer with the US Securities Exchange Commission.

**Entry into a Clearing Derivative by a Foreign Clearing Entity**

Subrule 1.2.5(3) provides that entry into a Clearing Derivative by a Foreign Clearing Entity is a 'Clearing Transaction' for the Foreign Clearing Entity if:

- the other party to the Clearing Derivative is:
    - an Australian Clearing Entity; or
    - a Foreign Clearing Entity; or
    - a Foreign Internationally Active Dealer; and
- where the other party is a Foreign Clearing Entity or a Foreign Internationally Active Dealer - at least one Foreign Clearing Entity that is party to the Clearing Derivative books

the Clearing Derivative to the profit or loss account of a branch of the Foreign Clearing Entity located in Australia.

**Clearing Entity that is party to a Clearing Derivative in different capacities**

Subrule 1.2.5(4) provides that for the avoidance of doubt, if:

- an entity is party, in different capacities, to both sides of a Clearing Derivative; and
- the entity is a Clearing Entity in relation to the Clearing Derivative in each of those capacities;

subrules 1.2.5(2) to (3) apply as if the Clearing Derivative had two distinct parties, being the entity acting in each of those capacities. It is noted that this may result in entry into such a Clearing Derivative being a Clearing Transaction for the entity.

**Rule 1.2.6 References to total gross notional outstanding positions**

Subrule 1.2.6(1) provides that a reference in these Rules to the total gross notional outstanding positions held by an entity in a particular capacity is a reference to the entity's total gross notional outstanding positions aggregated across all Derivatives to which the entity is a party in that capacity, but does not include the following:

- a position in a Derivative that is not a Clearing Derivative because of subrule 1.2.3(7) (whether or not it is also not a Clearing Derivative for other reasons); or
- a position in a Derivative entered into with a related body corporate of the entity; or
- for an entity:
    - that is acting in its Personal Capacity and is incorporated or formed outside Australia; or
    - that is acting in a Representative Capacity in relation to a scheme or trust that is incorporated or formed outside Australia;

  a position in a Derivative:
    - that was not booked to the profit or loss account of a branch of the entity located in Australia; and
    - that either was not entered into in Australia, or was entered into in Australia before 25 February 2015.

The term 'total gross notional outstanding positions' is used to determine whether an entity is an 'Australian clearing entity' (for the purposes of subregulation 7.5A.61(1) of the Corporations Regulations), or 'foreign clearing entity' (for the purposes of subregulation 7.5A.62(1)). It is also used to calculate whether an entity 'meets the Clearing Threshold' to determine whether an entity is an 'Australian Clearing Entity' or a 'Foreign Clearing Entity' for the purposes of these Rules.

Subrule 1.2.6(2) provides that Rule 1.2.6 applies for the purposes of these Rules and paragraph 7.5A.60(2)(a) of the Corporations Regulations.

**Rule 1.2.7 Clearing Threshold**

Rule 1.2.7 defines the term 'meets the Clearing Threshold'. An entity is a Clearing Entity (i.e. an Australian Clearing Entity or a Foreign Clearing Entity) if the entity 'meets the Clearing Threshold' (among other things) (see Rule 1.2.4).

**Financial Entity acting in its Personal Capacity**

Subrule 1.2.7(1) provides that if a Financial Entity holds total gross notional outstanding positions of AUD $100 billion or more in its Personal Capacity on each of two consecutive Calculation Dates, the entity meets the Clearing Threshold in its Personal Capacity from the date (Clearing Start Date) that is the first Monday after the immediately following Calculation Date.

Subrule 1.2.7(2) provides that if the Financial Entity meets the Clearing Threshold in its Personal Capacity, but does not hold total gross notional outstanding positions of AUD $100 billion or more in its Personal Capacity on each of two consecutive Calculation Dates, the Financial Entity ceases to meet the Clearing Threshold in its Personal Capacity on the day (Clearing End Date) after the second of those Calculation Dates.

**Financial Entity acting in a Representative Capacity**

Subrule 1.2.7(3) provides that if a Financial Entity holds total gross notional outstanding positions of AUD $100 billion or more in a Representative Capacity on each of two consecutive Calculation Dates, the Financial Entity 'meets the Clearing Threshold' in that Representative Capacity from the date (Clearing Start Date) that is the first Monday after the immediately following Calculation Date.

Subrule 1.2.7(4) provides that if a Financial Entity meets the Clearing Threshold in a Representative Capacity, but does not hold total gross notional outstanding positions of AUD $100 billion or more in that Representative Capacity on each of two consecutive Calculation Dates, the Financial Entity ceases to meet the Clearing Threshold in that Representative Capacity on the day (Clearing End Date) after the second of those Calculation Dates.

Subrule 1.2.7(5) provides that nothing in this Rule 1.2.7 prevents a Financial Entity that has ceased to meet the Clearing Threshold in its Personal Capacity under subrule 1.2.7(2) or in a Representative Capacity under subrule (4) from meeting the Clearing Threshold in that capacity again under subrule 1.2.7(1) or 1.2.7(3).

Subrule 1.2.7(6) provides that this Rule 1.2.7 applies for the purposes of these Rules and paragraph 7.5A.60(2)(b) of the Regulations. For example, a Financial Entity that holds total gross notional outstanding positions of AUD $100 billion or more in a particular capacity as at both 30 September 2015 and 31 December 2015 meets the Clearing Threshold in that capacity from 4 April 2016. If the Financial Entity subsequently holds total gross notional outstanding positions of less than AUD $100 billion in that capacity on both 30 September 2016 and 31 December 2016, the Financial Entity will cease to meet the Clearing Threshold in that capacity on 1 January 2017.

**Rule 1.2.8 Opt In to become a Clearing Entity**

Rule 1.2.8 sets out how an entity may become an 'Opt-In Clearing Entity'. The term is defined as "an Opt-In Australian Clearing Entity or an Opt-In Foreign Clearing Entity" (see Rule 1.2.1). 'Opt-In Australian Clearing Entity' has the meaning given by paragraphs 1.2.8(4)(a) and

1.2.8(5)(a) (see Rule 1.2.1). 'Opt-In Foreign Clearing Entity' has the meaning given by paragraphs 1.2.8(4)(b) and 1.2.8(5)(b) (see Rule 1.2.1).

Subrule 1.2.8(1) provides that an entity may lodge a written notice (an Opt-In Notice) with ASIC setting out the following:

- the name of the entity;
- the entity's LEI or interim entity identifier or, if no LEI or interim entity identifier is available for the entity, a Designated Business Identifier or, if no Designated Business Identifier is available for the entity, a Business Identifier Code (BIC code);
- which of the following capacities the entity is lodging the notice in: (i) its Personal Capacity; (ii) a Representative Capacity;
- if the entity is lodging the notice in a Representative Capacity – the name of each scheme or trust to which the Representative Capacity relates and whether the scheme or trust was incorporated or formed in Australia or outside Australia;
- the date (Clearing Start Date) on which the entity will commence being an Opt-In Clearing Entity in relation to each capacity in which it is lodging the notice, being a date not less than 30 days from the date the Opt-In Notice is lodged.

Subrule 1.2.8(2) provides that an entity that has lodged an Opt-In Notice under subrule (1) may withdraw the Opt-In Notice by lodging a written notice (Withdrawal Notice) with ASIC setting out the following:

- the name of the entity;
- the entity's LEI or interim entity identifier or, if no LEI or interim entity identifier is available for the entity, a Designated Business Identifier or, if no Designated Business Identifier is available for the entity, a Business Identifier Code (BIC code);
- which of the following capacities the entity is lodging the notice in: (i) its Personal Capacity; (ii) a Representative Capacity;
- if the entity is lodging the notice in a Representative Capacity – the name of each scheme or trust to which the Representative Capacity relates;
- the date (Clearing End Date) on which the entity will cease being an Opt-In Clearing Entity in relation to each capacity in which it is lodging the notice, being a date not less than 30 days from the date the Withdrawal Notice is lodged.

Subrule 1.2.8(3) provides that ASIC may publish on its website any Opt-In Notice or a Withdrawal Notice given to it by an entity under this Rule.

Subrule 1.2.8(4) provides that if an entity lodges an Opt-In Notice with ASIC under subrule (1) in its Personal Capacity:

- if the entity is incorporated or formed in Australia – it will be an 'Opt-In Australian Clearing Entity' in its Personal Capacity from the Clearing Start Date; and
- if the entity is incorporated or formed outside Australia – it will be an 'Opt-In Foreign Clearing Entity' in its Personal Capacity from the Clearing Start Date.

It is noted that for the purposes of the Corporations Regulations:

- the entity will be an 'Australian clearing entity' (as defined in subregulation 7.5A.61(1) of the Regulations) in relation to a Derivative Transaction to which it is party in its Personal Capacity: see paragraph 7.5A.61(1)(b) of the Regulations.
- the entity will be a 'foreign clearing entity' (as defined in subregulation 7.5A.62(1) of the Regulations) in relation to a Derivative Transaction to which it is party in its Personal Capacity: see paragraph 7.5A.62(1)(c) of the Regulations.

Subrule 1.2.8(5) provides that if an entity lodges an Opt-In Notice with ASIC under subrule (1) in a Representative Capacity:

- if the scheme or trust to which the Representative Capacity relates is incorporated or formed in Australia – the entity will be an 'Opt-In Australian Clearing Entity' in that Representative Capacity from the Clearing Start Date; and
- if the scheme or trust is incorporated or formed outside Australia – the entity will be an 'Opt-In Foreign Clearing Entity' in that Representative Capacity from the Clearing Start Date.

Subrule 1.2.8(6) provides that if an entity lodges a Withdrawal Notice under subrule (2), the entity ceases to be an Opt-In Australian Clearing Entity or an Opt-In Foreign Clearing Entity (as the case may be) in relation to each capacity in which it lodges the notice from the Clearing End Date.

Subrule 1.2.8(7) provides that nothing in this Rule affects whether an entity is a Clearing Entity under any other Rule. It is noted that an entity that has lodged an Opt-In Notice in accordance with this Rule will be required to comply with the applicable Clearing Requirements from the Clearing Start Date until the Clearing End Date.

## CHAPTER 2: CLEARING REQUIREMENTS

Chapter 2 of the Rules:

- imposes clearing requirements as permitted by paragraph 901A(2)(c) and subsection 901A(7) of the Act;
- specifies the persons who are required to comply with the clearing requirements imposed by the Rules as permitted by paragraph 901A(3)(e) of the Act;
- deals with the manner in which persons are required to comply with the clearing requirements imposed by the Rules as permitted by paragraph 901A(3)(f) of the Act; and
- deals with the circumstances in which persons are relieved from complying with the clearing requirements in the Rules that would otherwise apply to them as permitted by paragraph 901A(3)(g) of the Act.

### Rule 2.1.1 Clearing Requirement

Subrule 2.1.1(1) provides that a Clearing Entity must ensure that each of its Clearing Transactions is Cleared Through a Clearing Facility as soon as practicable after the Clearing Transaction is entered into.

Subrule 2.1.1(2) provides that a Clearing Transaction is Cleared Through a Clearing Facility if:

- for each party to the Clearing Transaction that is a participant in the Clearing Facility, the Clearing Facility operator enters into a Central Clearing Transaction with that party or another participant acting on behalf of that party; and
- for each party to the Clearing Transaction that is not a participant in the Clearing Facility, the Clearing Facility operator enters into a Central Clearing Transaction with a participant acting on behalf of that party; or acting on behalf of a person who is acting on behalf of that party; and
- following entry into the Central Clearing Transactions, each party to the Clearing Transaction has no, or substantially no, further rights against, or obligations to, the other party under the Clearing Derivative to which the Clearing Transaction relates.

It is noted that a participant may be acting on behalf of a person even if it enters into a Central Clearing Transaction as principal.

Subrules 2.1.1(3) and 2.1.1(4) set out when an operator of a Clearing Facility enters into a Central Clearing Transaction for the purposes of Rule 2.1.1.

Subrules 2.1.1(3) and 2.1.1(4) provides that in Rule 2.1.1, a Clearing Facility operator enters into a Central Clearing Transaction with:

- a party to a Clearing Transaction who is a participant in the Clearing Facility if the operator is substituted, by novation, as the counterparty to the participant under the Clearing Derivative to which the Clearing Transaction relates; and
- a participant who is acting on behalf of a party ('first party') to a Clearing Transaction if:
    - the participant is substituted, by novation, as the first party under the Clearing Derivative to which the Clearing Transaction relates; and
    - the operator is substituted, by novation, as the counterparty to the first party under the Clearing Derivative; and
- a participant who is acting on behalf of a person who is acting on behalf of a party ('first party') to a Clearing Transaction if:
    - the participant is substituted, by novation, as the first party under the Clearing Derivative to which the Clearing Transaction relates; and
    - the operator is substituted, by novation, as the counterparty to the first party under the Clearing Derivative; and
- a person in relation to a Clearing Transaction if the operator and the person enter into a transaction which has an equivalent, or a substantially equivalent, legal and economic effect as between the operator and the person as a novation referred to in paragraph 2.1.1(3)(a), (b) or (c).

Rules 2.1.2 to 2.1.5 provide exceptions to the clearing requirement in this Rule 2.1.1, including where there is no licensed CS facility or prescribed CS facility; for intra-group trades; and for multilateral portfolio compression.

**Rule 2.1.2 Exception where Clearing Derivative terminated**

Rule 2.1.2 provides that a Clearing Entity is not required to comply with Rule 2.1.1 (i.e. to ensure each of its Clearing Transactions is Cleared Through a Clearing Facility) in relation to a Clearing Transaction if the Clearing Derivative to which the Clearing Transaction relates is terminated before the time by which the Clearing Transaction must be cleared in accordance with Rule 2.1.1.

**Rule 2.1.3 Exception where no Licensed CS Facility or Prescribed CS facility**

Rule 2.1.3 provides that a Clearing Entity is not required to comply with Rule 2.1.1 (i.e. to ensure each of its Clearing Transactions is Cleared Through a Clearing Facility) in relation to a Clearing Transaction if:

- there is no Licensed CS Facility that: (a) is authorised to provide clearing services in respect of the class of Derivatives that includes the Clearing Derivative to which the Clearing Transaction relates; and (b) provides clearing services in respect of the Clearing Derivative to which the Clearing Transaction relates; and
- there is no Prescribed CS Facility that: (a) is prescribed in relation to the class of Derivatives that includes the Clearing Derivative to which the Clearing Transaction relates; and (b) provides clearing services in respect of the Clearing Derivative to which the Clearing Transaction relates.

**Rule 2.1.4 Exception to Clearing Requirement – Intra-group trades**

Subrule 2.1.4(1) provides that a Clearing Entity is not required to comply with Rule 2.1.1 (i.e. to ensure each of its Clearing Transactions is Cleared Through a Clearing Facility) in relation to a Clearing Transaction if at the time the Clearing Transaction is entered into, the counterparty to the Clearing Transaction is a related body corporate of the Clearing Entity.

**Rule 2.1.5 Exception to Clearing Requirement – Multilateral portfolio compression**

Subrule 2.1.5(1) provides that a Clearing Entity is not required to comply with Rule 2.1.1 (i.e. to ensure each of its Clearing Transactions is Cleared Through a Clearing Facility) in relation to a Clearing Transaction if:

- the Clearing Transaction is entered into by the Clearing Entity as a result of the Clearing Entity modifying or terminating and replacing Derivatives under a Multilateral Portfolio Compression Cycle; and
- for each of the Derivatives that was modified, or terminated and replaced—entry into the Derivative was not a Clearing Transaction that was required to be Cleared Through a Clearing Facility in accordance with Rule 2.1.1 or subrule 2.1.6(2);
- the Clearing Transactions entered into by the Clearing Entity as a result of the Multilateral Portfolio Compression Cycle are only entered into with persons who were counterparties to those Derivatives; and
- the Multilateral Portfolio Compression Cycle was conducted in accordance with the rules of a third-party operator of Multilateral Portfolio Compression Cycles and involved more than two participants, none of which was the operator; and
- the Multilateral Portfolio Compression Cycle was conducted in compliance with the counterparty credit risk tolerance levels set by the participants in the Multilateral Portfolio Compression Cycle.

Subrule (2) provides that in subrule 2.1.5(1), 'Multilateral Portfolio Compression Cycle' means a process under which portfolios of Derivatives between participants in the process are modified to reduce their notional value or terminated and replaced with new Derivatives providing for reduced notional exposures between the participants, conducted for the purposes of reducing operational risk or counterparty credit risk for the participants.

**Rule 2.1.6 T+3 clearing if foreign clearing requirements apply**

Subrule 2.1.6(1) provides that a Clearing Entity is not required to comply with Rule 2.1.1 in relation to a Clearing Transaction if the Clearing Entity or its counterparty to the Clearing Transaction is subject to a requirement in a foreign jurisdiction ('relevant foreign jurisdiction') which requires the Clearing Transaction to be Cleared Through a Clearing Facility by no later than three Business Days after the date on which the Clearing Transaction was entered into.

Subrule 2.1.6(2) provides that a Clearing Entity that relies on the exemption in subrule 2.1.6(1) must ensure that the Clearing Transaction is cleared in accordance with the requirements of the relevant foreign jurisdiction by no later than three Business Days after the date on which the Clearing Transaction was entered into.

Subrule 2.1.6(3) provides that for the purposes of Rule 2.1.6, 'Business Day' means a day that is a business day as that term is commonly understood in the relevant foreign jurisdiction.

## CHAPTER 3: NOTIFICATIONS AND RECORD KEEPING

Chapter 3 of the Rules:

- imposes requirements to provide notifications before they come, or cease to be, a Clearing Entity; and
- deals with the keeping of records, or the provision of records or other information, relating to compliance with or determining whether there has been compliance with the Rules as permitted by paragraph 901A(3)(h) of the Act.

### Part 3.1 Notifications

**Rule 3.1.1 Notification of Clearing Start Dates and Clearing End Dates**

Subrule 3.1.1(1) provides that a Financial Entity that is incorporated or formed in Australia or outside Australia must notify ASIC of each Clearing Start Date and each Clearing End Date that applies to the entity under Rule 1.2.7. "Financial Entity" is defined in Rule 1.2.1. "Clearing Start Date" and "Clearing End Date" are defined in Rule 1.2.7.

Subrule 3.1.1(2) provides that a notification under subrule 3.1.1(1), of each Clearing Start Date and each Clearing End Date, must be in writing and must set out:

- the name of the entity;
- the entity's Legal Entity Identifier (LEI) or interim entity identifier or, if no LEI or interim entity identifier is available for the entity, a Designated Business Identifier, or if no Designated Business Identifier is available for the entity, a Business Identifier Code (BIC code);

- whether the entity is giving the notification in its Personal Capacity or in a Representative Capacity;
- if the entity is giving the notification in relation to a Representative Capacity – the name of each scheme or trust to which the Representative Capacity relates;
- if the notification is of a Clearing Start Date – the Clearing Start Date and whether the entity will become an Australian Clearing Entity or a Foreign Clearing Entity on the Clearing Start Date;
- if the notification is of a Clearing End Date – the Clearing End Date and whether the entity will cease to be an Australian Clearing Entity or a Foreign Clearing Entity on the Clearing End Date.

Subrule 3.1.1(3)(a) provides that a notification under subrule 3.1.1(1) of a Clearing Start Date must be given to ASIC no later than 30 days before the Clearing Start Date. Subrule 3.1.1(3)(b) provides that a notification under subrule 3.1.1(1) of a Clearing End Date must be given to ASIC no later than 30 days after the Clearing End Date.

Subrule 3.1.1(4) provides that ASIC may publish on its website any notification given to ASIC under Rule 3.1.1.

**Rule 3.1.2 Notification of Clearing Entity status to counterparty**

Rule 3.1.2 requires a Clearing Entity, or an entity that will become a Clearing Entity, to disclose to a counterparty or prospective counterparty, on request, information set out in Rule 3.1.2 relating to its status as a Clearing Entity.

Subrule 3.1.2(1) provides this Rule 3.1.2 applies to an entity that: (a) is a Clearing Entity; or (b) has given, or is required to give, a notice to ASIC under Rule 1.2.8 or subrule 3.1.1(1).

Subrule 3.1.2(2) provides that an entity to which this Rule 3.1.2 applies must, on request by a person that has entered into or proposes to enter into a Derivative Transaction with the entity, disclose in writing to the person the following within a reasonable time after the request:

- whether the entity is an Australian Clearing Entity or a Foreign Clearing Entity; and
- if the entity will become or cease to be a Clearing Entity on an identifiable future date – that date and whether the entity will become or cease to be an Australian Clearing Entity or a Foreign Clearing Entity on that date.

Subrule 3.1.2(3) provides that an entity must disclose information under Rule 3.1.2 in relation to each capacity in which the entity is a Clearing Entity or has given, or is required to give, a notice to ASIC under Rule 1.2.8 or subrule 3.1.1(1).

**Part 3.2 Records**

**Rule 3.2.1 Keeping of records**

Subrule 3.2.1(1) provides that a Clearing Entity must keep records that enable it to demonstrate it has complied with the requirements of the Rules. Subrule 3.2.1(2) provides that a Clearing Entity must keep each record referred to in subrule 3.2.1(1) for at least five years from the date the record is made or amended.

Subrule 3.2.1(3) provides that a Clearing Entity is not required to keep the records referred to in subrule 3.2.1(1) where it has arrangements in place to access those records in a Clearing Facility, either directly or through another person, for the period set out in subrule 3.2.1(2), i.e. at least five years from the date the record is made or amended.

**Rule 3.2.2 Provision of records or other information**

Subrule 3.2.2(1) provides that a Clearing Entity must, on written request by ASIC, provide ASIC with records or other information relating to compliance with or determining whether there has been compliance with the Rules.

Subrule 3.2.2(2) provides that a Clearing Entity must comply with a request under subrule 3.2.2(1) within the time specified in the request.

**ATTACHMENT B – Regulation Impact Statement**

ASIC
Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

# Mandatory central clearing of OTC interest rate derivative transactions

Issue date

## About this Regulation Impact Statement

This Regulation Impact Statement addresses ASIC's proposals to implement mandatory central clearing under Pt 7.5A of the *Corporations Act 2001*.

# What this Regulation Impact Statement is about

1 This Regulation Impact Statement (RIS) addresses ASIC's proposals to implement mandatory central clearing under Pt 7.5A of the *Corporations Act 2001* (Corporations Act).

2 In developing our final position, we have considered the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:

(a) ensuring fair and efficient capital markets, in-line with ASIC's key priorities;

(b) maintaining, facilitating and improving the performance of the financial system and entities in it;

(c) promoting confident and informed participation by investors and consumers in the financial system;

(d) administering the law effectively and with minimal procedural requirements;

(e) improving risk management and reducing systemic risk in the financial industry to promote financial stability;

(f) supporting the detection and prevention of market abuse and promoting market integrity;

(g) facilitating market participants and market infrastructures to obtain equivalence and substituted compliance determinations from overseas regulators—to reduce the compliance burden associated with duplicative or conflicting regulation; and

(h) reinforcing international cooperation.

3 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:

(a) the likely compliance costs and savings;

(b) our consideration of industry feedback on our proposals;

(c) the likely effect on competition; and

(d) other impacts, costs and benefits.

# Contents

# Executive summary

## What is the problem ASIC is trying to solve?

4 The proposal to implement mandatory central clearing of certain interest rate derivatives seeks to address two significant problems:

(a) the need for Australian participants in foreign over-the-counter (OTC) derivatives markets to comply with multiple clearing requirements, which increases their compliance costs; and

(b) financial stability concerns around the lack of transparency in OTC derivatives markets.

### Increased compliance costs

5 As a result of international regulatory developments to implement mandatory central clearing, Australian entities that participate in foreign OTC derivatives markets need to comply with foreign clearing requirements, which is costly.

6 The central clearing regulatory frameworks of the United States and European Union provide a mechanism for substituted compliance assessments—allowing entities subject to jurisdictions with positive assessments based on substantially-equivalent regulatory requirements to meet the requirements in the United States and European Union for central clearing by complying with their local laws.

7 Allowing equivalence minimises costs for market participants by reducing the need to comply with duplicate and potentially conflicting regulations.

### Financial stability concerns

8 There is a lack of transparency in OTC derivatives markets without central clearing. These markets operate on a bilateral basis outside of organised exchanges or trading platforms. While each participant holds complete information about their own exposures, no one knows the creditworthiness of their counterparty, or that counterparty's obligations to other participants.

9 During the global financial crisis (GFC) this lack of transparency made it difficult for market participants to assess the impact of institutional collapses or near-collapses. By reducing their ability to assess real-time counterparty risk there was an increase in mutual distrust, which was reflected in a sharp increase in the cost of funding.

10 In such opaque and uncertain environments, withdrawing from the market is rational. This is the mechanism that froze lending capacities in capital markets in a number of developed countries, the flow-on effects of which

served to significantly exacerbate the effect of the GFC. Had markets, regulators and governments been better able to assess the effect of institutional collapses or near-collapses, the broader consequences for the financial system could have been better anticipated and safeguarded against.

11 Requiring central clearing of OTC derivatives will enable regulators to better manage systemic risk in the system by facilitating a reduction in counterparty credit exposures among participants and allowing regulators to focus their supervisory efforts on central counterparty (CCPs). The introduction of a mandatory clearing requirement will also help to address concerns around a lack of transparency in OTC derivatives markets by providing regulators and participants with a better understanding of counterparty risk exposure and creditworthiness.

## Why is ASIC action needed?

12 The Minister has made a decision to implement a mandatory central clearing requirement in Australia to help address the problems of increased compliance costs for Australian participants in foreign OTC derivatives markets, and financial stability concerns surrounding a lack of transparency in OTC derivatives markets.

13 In order for Australian participants in foreign OTC derivatives markets to qualify for substituted compliance arrangements for central clearing (and thereby reduce their overall compliance costs) they will need to be subject to similar legally-binding central clearing obligations in Australia.

14 Previous market assessment reports published by the Council of Financial Regulators (CFR) have shown that the OTC derivatives markets in Australia are largely dominated by the banks, especially the major Australian banks, as well as a small number of global financial institutions. It is our view that requiring these entities to centrally clear their OTC derivatives transactions would help to substantially address the lack of transparency in OTC derivatives markets and ensure financial system stability.

Note 1: The CFR comprises ASIC, the Reserve Bank of Australia (RBA), Treasury and the Australian Prudential Regulation Authority (APRA) (together, 'the regulators').

Note 2: CFR, *Report on the Australian OTC derivatives market*, July 2013, p.23.

15 To realise the deregulatory benefit of a mandatory requirement and to help achieve the financial system stability benefits of central clearing it is necessary for ASIC to make ASIC Derivative Transactions Rules (Clearing) 2015 (derivative transaction rules (clearing)) to give effect to the Government's mandate.

## What policy options is ASIC considering?

16 To address the issues that we identified in our engagement with industry we have considered three regulatory options to implement the derivative transaction rules (clearing) in Australia.

### Option 1

17 Under Option 1 we proposed to implement a rule framework that has been drafted in accordance with the Corporations Amendment (Central Clearing and Single-Sided Reporting) Regulation 2015 (Central Clearing Regulation). The rule framework proposed under this option does not provide for exemptions from the requirements.

18 We do not recommend Option 1 because it imposes high compliance costs on industry stakeholders.

### Option 2

19 Under Option 2 we proposed to implement a rule framework in accordance with the Central Clearing Regulation (set out in Option 1, see paragraph 17) with additional allowances and exemptions. These allowances and exemptions aim to reduce the compliance burden on industry while achieving the targeted substituted compliance and systemic risk benefits.

20 We recommend Option 2 because it imposes minimal costs on market participants while preserving the substituted compliance benefits granted to Australian entities and possibly leading to further relief.

### Option 3

21 Under Option 3 we proposed not to impose any direct regulatory requirements on stakeholders.

22 We do not recommend Option 3 because it does not address increased costs to Australian participants in foreign markets as a result of compliance with foreign clearing requirements.

23 Under Option 3, it is likely the United States would withdraw the substituted compliance benefits already provided to Australian businesses active in OTC derivatives markets in the United States. It would also not be helpful to obtaining substituted compliance benefits in other important overseas jurisdictions such as the European Union.

### What is the likely net benefit of each option?

24 Option 1 proposes to implement a rules framework drafted in accordance with the parameters established by the Central Clearing Regulation. We have calculated the cost savings to industry of implementing Option 1 as $5,000,000.

25 Option 2 proposes to implement a rule framework in accordance with the Central Clearing Regulation (set out in Option 1), with some additional allowances and exemptions. We have calculated the cost savings to industry of implementing Option 2 as $8,200,000. We believe that Option 2 minimises the compliance burden on clearing entities, while also realising the improved system stability benefits of central clearing.

26 Option 3 proposes to maintain the status quo (i.e. not impose a central clearing mandate for any class of persons). This approach would address the financial stability concerns around transparency because the rates of voluntary central clearing would rise given the existing prudential obligations and foreign central clearing requirements. However, a decision to not implement a domestic mandatory clearing regime means Australian participants in foreign markets would not benefit from substituted compliance benefits under this option, and the estimated $5 million cost savings (based on our updated analysis of Treasury's initial RIS) would not be realised. We therefore believe that Option 3 would result in an overall cost increase to industry.

## Consultation process

27 On 28 May 2015, we released Consultation Paper 231 *Mandatory central clearing of OTC interest rate derivative transactions* (CP 231) which outlined the proposed scope of the new derivatives transaction rules (clearing). CP 231 was open for submissions from 28 May 2015 to 10 July 2015. We received 11 submissions in response to CP 231 (including three confidential submissions).

28 We have engaged with stakeholders following the formal consultation period, particularly in relation to the types of Australian dollar (AUD)-denominated interest rate derivatives subject to the proposed mandate— and we took on board industry concern about the current lack of CCP's offering central clearing for a number of these products.

29 We also held meetings with stakeholders to discuss a range of issues, including the proposed requirement for foreign clearing entities (as defined in the Central Clearing Regulation) to clear 'nexus' and 'entered into' trades, and a proposed exemption for 'offset' trades that are created during multilateral compression exercises.

## Recommendation

30 We recommend Option 2 because it provides a substantial deregulatory benefit to industry while addressing the issues of increased compliance costs to Australian participants in OTC derivatives markets and financial stability concerns surrounding a lack of transparency in OTC derivatives markets.

31 The changes introduced under Option 2 will also provide certainty to industry as to their obligations under the derivatives transaction rules (clearing) on an ongoing basis.

## Implementation and evaluation

32 We will seek the Minister's consent to make the derivative transaction rules (clearing). Should we obtain the Minister's consent to make the rules, we will do so. We will then communicate the rules to stakeholders by publishing the derivative transaction rules (clearing) and organising events with stakeholders to inform them of the impact of the rules.

33 We will keep the derivative transaction rules (clearing) under review and evaluate their effectiveness on an ongoing basis through constant communications and dialogue with stakeholders in the market.

34 The CFR also periodically examines trends in OTC derivative markets and publishes their assessments of market developments in a market assessment report.

# A Introduction

## Background

35 Over the past decade, rapid growth in OTC derivatives markets has been accompanied by an increasing awareness of both the systemic importance of, and risks inherent in, these markets.

36 The magnitude of these risks was demonstrated during the GFC in 2008, particularly at the time of the collapse of Lehman Brothers investment banking group and the threatened collapse of AIG insurance group.

37 This episode highlighted a number of structural deficiencies in OTC derivatives markets and the associated systemic risks they posed for both financial markets and the real economy.

38 These structural deficiencies stemmed largely from the way that OTC derivatives transactions were concluded. At the time, OTC derivatives contracts were mainly executed directly between two parties over the telephone (i.e. not through an organised exchange or trading platform). This had two important consequences:

(a) the market was not transparent for both participants and regulators because transactions, prices and exposures were not reported or published; and

(b) participants were not only exposed to the direct risk of default by their counterparty, but also to the indirect risk of default by every other market participant due to the potential effect of a default on the solvency of other participants (the contagion effect).

39 The inherent lack of transparency, and the interconnectedness among participants in OTC derivatives markets, meant that when the GFC occurred in the second half of 2008 participants were unable to understand and assess the effect of the defaults or potential defaults of major market participants such as Lehman Brothers, AIG and Bear Stearns, as transmitted through OTC derivatives markets.

40 This led to an unprecedented freeze in financial markets where major market participants stopped most trading activities involving credit risk, even with the most highly-rated counterparties. The inability to assess counterparty risk during the height of the GFC contributed to the rise of mutual distrust, reflected in a sharp increase in the cost of funding, and led to a halt in most trading and lending activities—which had devastating consequences for both global financial markets and the real economy.

41 As a result of issues identified during the GFC, the Leaders of the Group of 20 (G20) nations (including Australia) agreed at the 2009 Pittsburgh

Summit to commit to substantial reforms to practices in OTC derivatives markets. These commitments aim to bring transparency to OTC derivatives markets and improve risk management practices. Specifically, the Leaders of the G20 committed to three key mandates:

(a) *Transaction reporting:* All OTC derivatives transactions should be reported to trade repositories.

Note*:* Trade repositories are facilities to which information about derivative transactions, or about positions relating to derivative transactions, can be reported. A derivative trade repository acts as a centralised registry that maintains a database of records of transactions and disseminates the information, including to regulators and the public.

(b) *Clearing:* All standardised OTC derivatives transactions should be centrally cleared.

(c) *Trading:* All standardised OTC derivatives transactions should be traded on exchanges or trading platforms, where appropriate.

42 This RIS relates to the making of derivative transaction rules (clearing) by ASIC to prescribe central clearing of certain OTC derivatives and implement the mandate in paragraph 41(b) in Australia. The classes of OTC derivatives covered by the rules are proposed to include interest rate derivatives denominated in Australian dollars (AUD interest rate derivatives) and US dollars, euros, Japanese yen and British pounds (G4 interest derivatives).

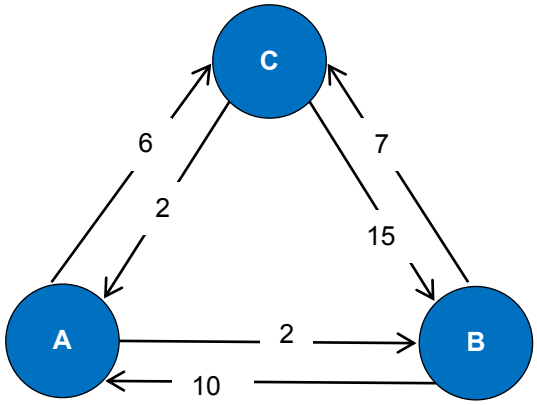
## Central clearing

43 In an OTC derivatives market without central clearing, when two parties enter into an OTC contract they commit to make a series of payments to each other over the life of the contract. Under this bilateral arrangement each counterparty is exposed to the risk that the other party may default.

44 In a centrally-cleared market, the contract between the two counterparties is replaced by two back-to-back contracts with a CCP through a legal process known as novation—with the CCP becoming the buyer to every seller and the seller to every buyer.

45 Figure 1 provides an illustration of the payment obligations between counterparties in a non-centrally cleared market. The numbers in the figure represent the hypothetical payments due between counterparties. The total payments due at any point in time may be seen as a measure of total counterparty risk in the system. In this example the total amount of payments due among the three counterparties is 42.

**Figure 1: Payment obligations between counterparties in a non-centrally market**

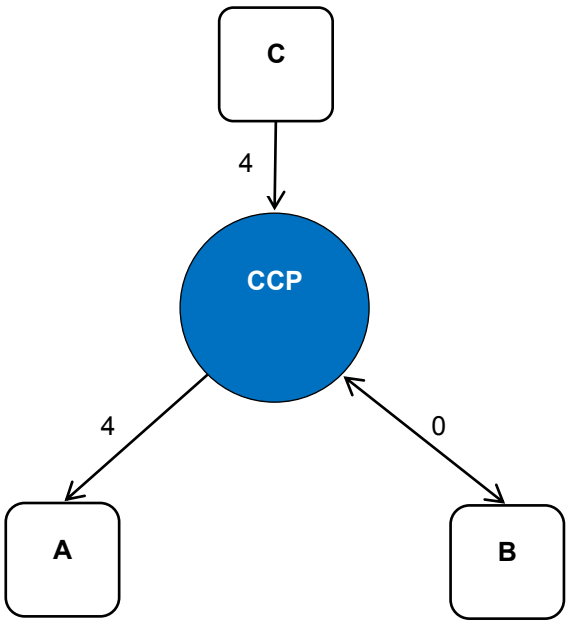



46 Figure 2 shows how the total amount of payments due among counterparties can be reduced in a market where trades are centrally cleared. After two counterparties agree to enter into a derivative transaction, their bilateral contract is replaced by two mirror-image contracts novated through the CCP.

47 The CCP assumes responsibility for making the payments that each party would have received from their counterparty under the bilateral arrangement. The CCP should theoretically have a net risk of zero, because the total payments it needs to make on contracts should be equal to the total payments it is owed.

48 With all of the contracts running through a CCP, the CCP can net out the payments owed to each counterparty, reducing the total payments owed to counterparties to eight, down from 42 in Figure 1.

**Figure 2: Payment obligations between counterparties in a centrally cleared market**



49 A central clearing mandate has the effect of making CCP's the focal points of all transactions in centrally-cleared markets which, in turn, would:

(a) reduce overall risk in the system by minimising counterparty credit risk exposures—because each counterparty would only deal with the CCP rather than multiple counterparties with hidden exposures;

(b) concentrate default risk management in the hands of the CCP, in order to limit the contagion effect of the default or potential default of a market participant;

(c) minimise total bilateral exposures by netting offsetting positions, creating efficiencies in risk management processes such as holding collateral against potential losses from derivatives contracts;

(d) increase transparency, with regulators and participants alike having knowledge of the CCPs overall exposure; and

(e) allow regulators to focus supervisory efforts on CCPs—who are already subject to extensive regulatory requirements—rather than having to monitor widely-dispersed default risks across a large range of participants.

## International developments

50 Australia is implementing the G20 commitments to OTC derivative reforms in close coordination with peer jurisdictions. Similar rules are concurrently being put in place in other G20 jurisdictions in-line with G20 commitments—reflecting the fact that OTC derivative transactions often occur between counterparties in different jurisdictions and the underlying reference asset may be in a third jurisdiction.

51 The cross-border nature of OTC derivative trading means that it is possible for clearing requirements to overlap in different jurisdictions. To address this, jurisdictions may allow for a system of recognition, or substituted compliance. ASIC is in discussions with a number of foreign regulators assessing whether the Australian clearing regime is comparable to their own.

52 If it is, Australian clearing entities will be able to clear their trades under the Australian requirements and be deemed to satisfy the requirements of the overseas regimes—reducing the compliance burden on Australian clearing entities.

## Australian legislative framework

53 The Minister has the power to prescribe certain classes of derivatives as being subject to ASIC's rule-making power for each of the G20 mandates: see paragraph 41. This should be based on advice from ASIC, APRA and the RBA.

54 In July 2013, the CFR released the *Report on the Australian OTC derivatives market* (the 2013 Report) which recommended Government mandate central

clearing of OTC transactions among dealers with significant cross-border activity in G4 interest rate derivatives.

55 In April 2014, the CFR released the *Report on the Australian OTC derivatives market* (the 2014 Report) which recommended implementing a mandatory clearing obligation for OTC transactions in AUD interest rate derivatives for internationally-active dealers.

56 On 8 July 2014, in-line with a recommendation made by the CFR, Treasury published a consultation paper which proposed to combine the recommended mandatory central clearing of AUD and G4 interest rate derivatives into a single determination to be issued by the Minister.

57 In May 2015, Treasury released consultation on a draft determination which mandates the clearing of AUD and G4 interest rate derivatives and draft regulations setting out the scope of the clearing mandate.

58 On 2 September 2015, a Ministerial determination was made setting out the product scope of the Mandatory clearing regime. On 8 September 2015, the Corporations Regulations 2001 were amended to implement central clearing of prescribed classes of OTC interest rate derivatives among a small number of major domestic and foreign banks that act as dealers in the Australian OTC derivatives market—thereby setting ASIC's rulemaking power.

## The derivative transaction rules (clearing)

59 While the Minister's determination sets out the high level features of the mandatory clearing regime, ASIC must issue derivative transaction rules (clearing) that set out the remaining details, such as:

(a) the types of entities that must comply with the clearing mandate;

(b) what entities must do to comply with the mandate; and

(c) whether there are any exemptions from the requirement to comply with the mandate.

60 Derivative transaction rules (clearing) do not need to be made for all derivatives covered by a determination. The rules may also provide exceptions to the application of any requirement. Subject to urgency provisions, ASIC is required to engage in public consultation and consult with both APRA and the RBA before issuing any derivative transaction rules (clearing).

## Complementary regulatory impact statements

61 The subject of this RIS is the regulatory impact of the derivative transaction rules (clearing) on industry participants, and the associated costs and benefits.

62 The Ministerial determination specifies that AUD and G4 interest rate derivatives will be within scope of the mandate and the derivative transaction

rules (clearing). This RIS assesses whether all these derivatives, or only certain sub-sets of such derivatives, should be covered by the mandate. In doing so, this RIS looks at whether the options would realise the cost savings quantified in the Treasury RIS.

63 Treasury separately submitted a RIS in relation to the Ministerial determination and draft a Central Clearing Regulation to the Office of Best Practice Regulation (OBPR). The draft Ministerial determination and draft regulation, and ASIC's rule-making, are two necessary and complementary measures. For this reason, a certain degree of overlap exists between the Treasury RIS and this RIS.

## Assessing the problem

64 The proposal to implement mandatory central clearing of certain interest rate derivatives seeks to address two significant problems:

(a) increased costs for Australian participants in foreign OTC derivative markets as a result of compliance with foreign clearing requirements; and

(b) financial stability concerns around the lack of transparency in OTC derivatives markets.

### Increased compliance costs for Australian participants in foreign OTC derivatives markets

#### Substituted compliance

65 International consistency was a key consideration when assessing the case for a domestic clearing mandate for interest rate derivatives.

66 Since the G20 commitments to reform OTC markets were announced, a number of key jurisdictions have made significant progress with respect to mandated central clearing.

67 As a result of these international regulatory developments to implement mandatory central clearing, Australian entities that participate in these foreign OTC derivatives markets need to comply with those clearing requirements.

68 Relevantly, the regulatory frameworks in the United States and the European Union provide a mechanism for substituted compliance assessments that will allow entities subject to jurisdictions with positive assessments based on substantially equivalent regulatory requirements to meet their central clearing requirements in the United States and the European Union by complying with local laws.

**Table 1: Progress in overseas jurisdictions towards mandated central clearing**

| Country | Date | Steps taken towards implementing central clearing |
|---|---|---|
| United States | 2012 | The Commodity Futures Trading Commission (CFTC) and Securities Exchange Commission (SEC) were given powers to write rules and regulations for central clearing. The CFTC guidance on the cross-border application of OTC derivatives provisions establishes that Australian entities provisionally registered with the CFTC as swap dealers are currently subject to US clearing requirements. |
| European Union | 6 August 2015 | The European Commission adopted a delegated regulation that will make it mandatory for interest rate derivative contracts to be cleared through central counterparties from early-2016 for interest rate derivatives denominated in US dollars, euros, and British pounds, as well as credit index derivatives that reference European indices.<br>This is broadly in-line with the clearing mandate set by the CFTC. |
| Japan | 2012 | The Japan Financial Services Agency imposed a central clearing mandate on yen-denominated interest rate swaps and Japan-referenced credit derivatives. |
| Singapore | July 2015 | Consulted on draft regulations mandating the central clearing of interest rate swaps denominated in Singapore dollars and US dollars. |
| China | 2014 | The People's Bank of China imposed a central clearing mandate on yuan-denominated interest rate derivatives from 1 July 2014. |
| Korea | 2014 | The Korean government introduced a clearing mandate on Korean won-denominated interest rate derivatives from 1 July 2014. |
| India | 2014 | The Indian Implementation Group on OTC Derivatives Market Reforms introduced a clearing mandate on Indian rupee–US dollar foreign exchange forwards from March 2014. |

69 Positive assessments will therefore, under certain conditions, allow the European Securities and Markets Authority (ESMA) and the CFTC to place reliance on Australian regulation and regulators. This should minimise costs for Australian market participants and infrastructures arising from duplicate and potentially conflicting regulations.

70 In the United States, foreign participants can apply for the CFTC to assess whether their home regime is comparable. If it is, the CFTC's cross-border guidance permits them to rely on meeting certain requirements of their home jurisdiction to fulfil the CFTC requirements. Under CFTC guidance, Australian entities that are captured by US clearing requirements may comply with comparable Australian regulation instead of CFTC regulation.

> Note: The CFTC guidance on the cross-border application of swap provisions establishes that Australian entities provisionally registered with the CFTC as swap dealers are currently subject to US clearing requirements.

71 Currently, with no comparable domestic mandate, the CFTC requires Australian participants to comply with US mandatory clearing requirements when trading with US persons or guaranteed affiliates of US firms.

72 Australian market participants currently benefit from relief granted by the CFTC from a number of its so-called 'entity-level' requirements. This relief is time limited and subject to renewal. Failure on the part of Australia to implement a central clearing mandate is likely to put the renewal of such existing relief at risk. It will also make it unlikely that the United States will agree to extend other kinds of substituted compliance relief to Australian entities.

73 Similarly to the US, the EU regime allows transactions that are subject to both the EU and Australian mandate to qualify for substituted compliance recognition where:

(a) the clearing obligations in the European Union and Australia both apply to the product; and

(b) the counterparty in Australia is a non-exempted entity or, if exempted, would get an equivalent exemption if established in the European Union.

74 While the European Union has yet to implement mandatory clearing requirements, ESMA has advised the European Commission to only recognise the equivalence of Australian mandatory clearing obligations if a trade that will be subject to the EU's clearing obligation is also subject to a clearing obligation in Australia. Otherwise, the EU rules will apply to trades with EU entities.

75 The compliance cost of duplicate, or in the majority of cases multiple, foreign jurisdiction requirements affects an increasing number of Australian participants. Introducing an Australian central clearing mandate equivalent to the clearing requirements in the United States and the European Union would relieve Australian entities of this compliance burden.

#### Regulatory arbitrage

76 International consistency considerations are also an issue. In the absence of broadly-harmonised requirements, regulatory arbitrage or other distortions can occur where market participants choose where to conduct business or book trades depending on which regulatory framework they prefer.

77 Even where Australian participants will not be directly subject to overseas mandates, if they wish to continue trading with many of their international counterparties the only option will be to centrally clear such trades.

#### Unintended consequences of overseas requirements

78 Unintended consequences could arise due to differences in market structure and market practices. A domestic mandate could permit the CFR to take account of such differences in the derivative transaction rules (clearing).

79 There is a lack of transparency in OTC derivatives markets without central clearing. These markets operate on a bilateral basis outside of organised

exchanges or trading platforms. While each participant holds full information about their own exposures, no one knows the creditworthiness of their counterparty, or that counterparty's obligations to other participants.

80 As such, each participant is not only directly exposed to the default risk of its counterparty, but also indirectly to the default risk of all other market participants. This lack of mandated understanding means it is impossible to know which counterparties will be affected by the failure of a significant participant.

81 This lack of transparency during the GFC made it difficult for market participants to assess the impact of institutional collapses or near-collapses, affecting their ability to assess real-time counterparty risk. Consequently, markets, regulators and governments did not have a clear picture of which institutions were exposed (and the extent of that exposure) to troubled financial firms such as Lehman Brothers and AIG.

82 By reducing the ability to assess real-time counterparty risk, mutual distrust rose and was reflected in a sharp increase in the cost of funding. In such opaque and uncertain environments, withdrawing from the market is rational. This is the mechanism that froze lending capacities in capital markets in a number of developed countries, the flow-on effects of which served to significantly exacerbate the impact of the GFC.

83 Had markets, regulators and governments been better able to assess the impact of institutional collapses or near-collapses, the broader consequences for the financial system could have been better anticipated and safeguarded against. Efforts to improve transparency in OTC markets by requiring participants to centrally clear their transactions would serve to better enable such assessments by:

(a) enhancing systemic risk management by regulators and counterparties; and

(b) improving market participant understanding of counterparty creditworthiness.

## Why is ASIC action needed?

84 The Minister has decided to implement a mandatory central clearing requirement in Australia. This should help address the problems of increased compliance costs for Australian participants in foreign OTC markets, and financial stability concerns surrounding a lack of transparency in OTC markets. The Minister has also set some key parameters of the mandate under the Ministerial determination and regulations.

85 For Australian participants to qualify for substituted compliance arrangements in foreign OTC markets with regard to central clearing, Australia will need

similar legally-binding clearing obligations. Foreign regulators will not consider it material that most OTC derivatives transactions in the Australian market are already being centrally cleared on a voluntary basis.

86 For example, ESMA found that while the Australian legal framework provides for the imposition of a clearing mandate, actual equivalence with the EU framework would only be achieved through a Ministerial determination mandating central clearing. ESMA also noted that equivalence would be limited to the specific types of OTC derivatives covered by the Ministerial determination, and to transactions involving counterparties covered by the clearing obligation as set out in the Central Clearing Regulation and derivative transaction rules (clearing).

Note: ESMA, Technical Advice on third country regulatory equivalence under EMIR Australia, final report, September 2013.

87 Previous market assessment reports published by the CFR have shown that OTC derivatives markets in Australia are largely dominated by the banks, especially the major Australian banks as well as a small number of global financial institutions. It is ASIC's view that mandating central clearing for these entities with their OTC derivatives transactions would help improve the level of transparency in OTC markets, and achieve the financial system stability benefits inherent in central clearing.

Note: CFR, *Report on the Australian OTC Derivatives Market,* July 2013, p.23

88 Foreign regulatory developments, capital requirements and liquidity concerns have driven the uptake of voluntary central clearing of OTC derivatives in Australia. In light of these developments, we consider that a mandatory central clearing requirement is the most appropriate way to help ensure that there is certainty for industry as to their obligations on an ongoing basis.

89 Importantly, to realise the expected overall deregulatory benefit of a mandatory requirement, ASIC must make derivative transactions rules (clearing) to give effect to the mandate.

# B Options and impact analysis

90 We have considered three regulatory options to implement the derivative transaction rules (clearing) in Australia:

(a) *Option 1*: Implement central clearing mandate;

(b) *Option 2*: Implement central clearing mandate with additional allowances and exemptions (preferred option); or

(c) *Option 3*: Maintain the status quo (i.e. do not impose a central clearing mandate for any class of persons).

## Option 1: Implement central clearing mandate

91 Under Option 1 the derivative transaction rules (clearing) will be drafted in accordance with the parameters established by the Central Clearing Regulation. The rules proposed under this option do not provide for exemptions from the requirements.

### Entity scope

#### Background

92 The government has implemented a regulation which specifies that clearing requirements in relation to derivative transactions can only be imposed on a person who is either an Australian clearing entity or foreign clearing entity in relation to the transaction.

> Note 1: The term Australian clearing entity means any Australian financial entity, defined as any Australian authorised deposit-taking institution (ADI) or Australian financial services (AFS) licence holder that is incorporated in Australia and whose derivative activities meet or exceed a mandatory clearing threshold of $100 billion.
>
> Note 2: The term foreign clearing entity means a foreign financial entity that is an ADI or AFS licence holder that is incorporated outside of Australia whose derivatives activities meet or exceed a mandatory clearing threshold of $100 billion.

93 The Central Clearing Regulation imposes a clearing obligation on trades where one party to the transaction is either an Australian clearing entity or foreign clearing entity and the other party is either an Australian clearing entity, foreign clearing entity or a foreign internationally-active dealer.

> Note: The term foreign internationally-active dealer means a foreign entity, other than a foreign clearing entity, that is registered or provisionally registered with the CFTC as a derivatives trader (known in the United States as a swaps dealer).

94 Under s901A(3)(e) ASIC may make rules that deal with matters incidental or related to requirements referred to in s901A(2), including specifying the persons who are required to comply with requirements imposed by the rules.

### ASIC's proposal

95 Under this option, ASIC would impose clearing obligations on trades involving Australian clearing entities, foreign clearing entities and foreign internationally-active dealers within the scope set out by the Central Clearing Regulation.

96 This would see clearing requirements apply to derivative transactions entered into between:

(a) two Australian clearing entities;

(b) an Australian clearing entity and a foreign clearing entity;

(c) an Australian clearing entity and a foreign internationally-active dealer;

(d) two foreign clearing entities, where a branch of a foreign clearing entity has booked the trade to the profit-and-loss account of a branch in Australia ('booked-in trades'), entered into the trade under contract law in Australia ('entered-into trades') or, if it has opted-in to the nexus test, conducted a nexus derivative ('nexus trades'); and

Note: A 'nexus derivative' is an OTC derivative to which a clearing entity is a counterparty that meets the nexus test. The 'nexus test' is the test in ASIC Instrument [15/0067] *ASIC Derivative Transaction Rules (Nexus Derivatives) Class Exemption 2015*, and is based on the location of salespersons or traders performing particular functions in relation to an OTC derivative.

(e) a foreign clearing entity and a foreign internationally-active dealer, where the foreign clearing entity has booked the trade in Australia, entered into the trade in Australia or, if it has opted-in to the nexus test, conducted a nexus derivative.

97 Based on our analysis, this option would bring 15 Australian financial institutions (including the local operations of major overseas banks) within the scope of ASIC's derivative transaction rules (clearing). As the majority of these institutions have already established the infrastructure required for central clearing (i.e. technology systems to facilitate clearing, compliance and monitoring systems, associated compliance staff) and are already clearing most of their new OTC interest rate derivative transactions, the additional compliance costs associated with the mandate would be minimal.

98 The derivative transaction rules (clearing) would also allow other entities to 'opt-in' to clearing obligations (becoming 'opt-in Australian clearing entities' or 'opt-in foreign clearing entities') if they could gain substituted compliance benefits from being subject to a mandatory central clearing requirement in Australia.

## Product classes

### Background

99 Treasury has issued a Ministerial determination that specifies that AUD and G4 interest rate derivatives would be covered by the clearing mandate. Under s901A(3), ASIC may make rules that further limit the classes of AUD and G4 interest rate derivatives that are subject to the clearing requirement.

### ASIC's proposal

100 Under this option, ASIC would mandate clearing requirements for AUD and G4 interest rate derivative product classes that are broadly consistent with overseas mandates. These are:

(a) fixed-to-floating swaps (where one counterparty swaps its fixed interest rate for the other's 'floating' or variable rate);

(b) basis swaps (where two parties swap variable interest rates that are based on different money markets);

(c) forward rate agreements (contracts between parties to determine the interest rate of a future obligation); and

(d) overnight index swaps (where parties swap the overnight rate for a fixed interest rate).

101 This approach would harmonise Australia's clearing mandate with overseas clearing requirements for G4 interest rate derivatives.

## Approved CCPs

### Background

102 Under s901A(7) of the Corporations Act, where a mandatory clearing requirement is in place, the clearing entity subject to the requirements must ensure that the derivative transaction is cleared through either a:

(a) licensed clearing and settlement (CS) facility (licensed CCP); or

(b) CS facility prescribed by the Corporations Regulations (prescribed CCP).

103 Under s901A(3)(d)(i), ASIC may make rules that specify the licensed CCP or prescribed CCP through which derivative transactions in a particular product class must be cleared.

104 The Central Clearing Regulation states that only CS facilities that meet the criteria set out under the regulation would be able to be prescribed. The Central Clearing Regulation also includes an initial list of overseas CS facilities that have been assessed as meeting the stated criteria.

### ASIC's proposal

105 Under this option, an entity subject to central clearing obligations will be able to use a licensed or prescribed CCP to comply with their obligations.

106 This option causes minimal disruption to the current clearing arrangements of Australian participants in OTC derivatives markets. Those Australian participants that already clear OTC derivatives transactions have existing working relationships in place with the majority of the proposed licensed and prescribed CCPs. Entities can continue to clear as they currently do where this is consistent with the existing licensing regime for CS facilities, without imposing additional compliance costs. This option also leaves open the possibility for ASIC and the RBA to prescribe additional CS facilities in the future, where the regulatory requirements are met.

## Calculation of the threshold

### Background

107 The Central Clearing Regulation specifies that an Australian clearing entity or foreign clearing entity is an entity that has more than $100 billion in gross total notional outstanding positions (the clearing threshold). The regulation gives ASIC the ability to specify how entities subject to the clearing obligations must calculate this clearing threshold.

### ASIC's proposal

108 Under this option, the clearing threshold calculation will include all derivatives that are subject to the clearing requirements, and all other derivatives that are not traded on a financial market (as defined under Pt 7.2A of the Corporations Act) or a regulated foreign market.

109 An entity will become a clearing entity if it is above the clearing threshold as at the end of the last day of the quarter for two consecutive quarters. For Australian clearing entities the clearing threshold will be based on the gross notional outstanding of OTC derivatives positions as at the last day of the last quarter. For foreign clearing entities, the clearing threshold will be based on the total gross notional outstanding of OTC derivatives positions that are 'entered into' in Australia, or booked to the profit-and-loss account of a branch in Australia as at the last day of the last quarter.

> Note: The last day of the quarter, for the purposes of calculating the clearing threshold, is 31 March, 30 June, 30 September and 31 December of each year. The entity will become a clearing entity on the first Monday three months on or after the last day of the second consecutive quarter (second calculation date) (i.e. at least 90 days).

110 The derivative transaction rules (clearing) would also require fund managers (both domestic and foreign) that deal in the relevant product classes to calculate the clearing threshold for each fund under their management.

111 This option captures entities that have significant OTC derivatives activities and pose risk from a transparency perspective, without imposing unreasonable compliance burdens on foreign clearing entities. Foreign clearing entities caught by the clearing requirement are anticipated to enjoy substituted compliance benefits, which are expected to offset associated compliance costs. This arrangement would not impose disproportionate compliance requirements or costs on fund managers (including superannuation trustees).

## Overall cost savings

### Substituted compliance benefits

112 The costs of complying with the requirement to centrally-clear OTC interest rate derivatives are offset by a number of related regulatory measures that already incentivise Australian entities to centrally clear trades voluntarily, including:

(a) the International regulatory framework for banks (Basel III), a comprehensive set of reform measures to strengthen the regulation, supervision and risk management of the banking sector;

(b) market forces providing greater liquidity in centrally cleared markets as more participants begin to clear through CCPs; and

(c) international standards on margin requirements, which make centrally cleared transactions more economically attractive relative to non-centrally cleared transactions.

113 However, the market-based adoption of central clearing is not recognised by foreign regulators under their mandatory central clearing regimes. In the absence of an Australian mandate, Australian entities will incur the cost of clearing without benefiting from equivalence recognitions from foreign regulators. Consequently, government action to introduce a central clearing mandate is required to achieve the costs savings available through equivalence recognitions.

### Treasury analysis of costs

114 An analysis of the likely cost savings was undertaken by Treasury in 2014 and was based on the features and elements that are set out in the final regulations released by the Government on 8 September 2015. Based on the available data at the time, the analysis estimated that there would be approximately 20 Australian entities that would fall under the scope of an Australian clearing mandate and benefit from substituted compliance arrangements.

115 The analysis examined the existing entity-level relief measures that were granted by the CFTC in December 2013 in relation to the US central clearing mandate, including costs relating to:

(a) one support staff member for chief compliance officer (salary costs);

(b) risk management requirements, including establishment of a comprehensive risk management program and a compliance monitoring system in-line with *Dodd–Frank Wall Street Reform and Consumer Protection Act* (US) and US CFTC requirements (legal, IT and personnel costs); and

(c) swap data record-keeping and reporting requirements (mainly personnel costs).

116 The calculation per entity is set out in Table 2.

**Table 2: Costs of complying with the US CFTC regime***

| Item | One-off costs | Annual costs |
|---|---|---|
| Support compliance staff | N/A | $100,000 |
| Risk management set-up costs (legal) | $50,000 | N/A |
| Risk management set-up costs (IT) | $50,000 | N/A |
| Compliance monitoring system (set-up and ongoing monitoring) | $15,000 | $200,000 |
| Record keeping | $50,000 | $20,000 |
| **Total costs per dealer** | **$165,000** | **$320,000** |

* Estimates provided by industry stakeholders

117 The Treasury analysis found that if a central clearing mandate were introduced in Australia, the Australian entities covered under the scope of such a mandate would achieve a combined total annual cost saving of approximately $6.7 million in substituted compliance benefits in relation to the US CFTC regime.

### Further ASIC analysis of costs

118 Further analysis of the number of potential entities that would be subject to the proposed Australian clearing mandate was undertaken by ASIC in 2015. Using more recent data, our analysis showed that there were likely to be approximately 15 Australian entities that would be subject to the proposed mandate, rather than 20.

### Summary of costs

119 Taking into account the reduced number of entities that would likely be subject to a central clearing mandate, we estimate that these entities would receive a combined total annual cost saving of approximately $5,000,000 in substituted compliance benefits in relation to the US CFTC regime. This figure is based on Treasury's initial $6.7 million assessment of annual substituted compliance savings (based on their original estimate of 20 entities),

adjusted for our updated estimate of 15 entities subject to the proposed mandate.

120 In addition to the annual cost savings these entities would receive through substituted compliance with the CFTC regime, we believe they are likely to accrue additional substituted compliance savings in the future as other international jurisdictions such as Singapore, the European Union and Hong Kong introduce mandatory central clearing obligations for OTC derivatives transactions.

## Impact on industry

121 The imposition of a central clearing mandate would provide a number of benefits to industry participants including improving market transparency and reducing counterparty credit risk. In addition to the associated systemic risk benefits, a clearing mandate would also provide substituted compliance benefits for Australian entities that participate in foreign OTC markets.

122 The scope of the mandate captures the systemically-significant participants in the Australian market which, in aggregate, hold the majority of total gross notional OTC derivatives outstanding in Australia.

123 From a risk mitigation perspective, the imposition of a central clearing mandate will help firms to minimise counterparty credit risk exposures by only having to deal with the CCP rather than multiple counterparties, and also to create efficiencies in risk management processes such as margining and capital provisioning (through the netting of offsetting positons).

124 This option will also protect the existing substituted compliance benefits provided by the CFTC to Australian entities and may in time lead to further relief being provided by the CFTC and ESMA. Following the publication of the Ministerial determination and Central Clearing Regulations by the Government in September 2015, once ASIC's derivative transaction rules (clearing) have been made, it will be possible for Australian financial institutions active in US markets to apply to the CFTC for further, clearing-related relief. The European Union has adopted regulations implementing a central clearing regime which is expected to commence in the first half of 2016. It may, therefore, also be possible to apply for substituted compliance relief under the EU regime.

## Impact on consumers

125 Consumers will not be subject to the clearing obligation. Only entities that hold an ADI or an AFS licence, or are a foreign entity exempt from holding an AFS licence, can be subject to a clearing mandate. Also, because of the substantial threshold of $100 billion gross notional value of OTC derivatives outstanding, these obligations will only apply to large entities. Because the transactions that

are expected to be subject to the clearing mandate are not directly related to the banks' retail banking businesses, this mandate is not expected to have a direct impact on the cost of retail financial products or services.

## Option 2: Implement central clearing mandate with additional allowances and exemptions

126 Under Option 2 the derivative transaction rules (clearing) will be drafted in accordance with the Central Clearing Regulation (set out in Option 1, see paragraph 91) with a number of allowances and exemptions. These allowances and exemptions aim to further reduce the compliance burden on industry while still achieving the targeted substituted compliance and systemic risk benefits.

127 The proposed allowances include:

(a) delaying the mandatory clearing requirement for both AUD-denominated forward rate agreements (AUD forward rate agreements) and AUD-denominated overnight index swaps (AUD overnight index swaps);

(b) removing the requirement for foreign clearing entities to clear 'entered-into' or 'nexus' trades; and

(c) enabling trades to be 'de-cleared' if necessary.

128 The proposed exemptions are for trades:

(a) cleared in accordance with equivalent clearing requirements in a foreign jurisdiction (alternative clearing exemption);

(b) conducted for the purposes of reducing or eliminating OTC derivative contracts by way of multilateral trade compression (multilateral compression exemption); and

(c) conducted between two entities in the same corporate group (intra-group exemption).

129 This option is the preferred option put forward because it imposes minimal costs on market participants while preserving the substituted compliance benefits granted to Australian entities—it also best reflects the stakeholder feedback we received during consultation.

### Allowances

#### Delaying clearing obligations for some product classes

130 During consultation, we received a number of submissions that noted there are currently no CCPs in Australia that are currently licensed to clear AUD forward rate agreements.

131 Without any market infrastructure in place to clear AUD forward rate agreements we proposed in Option 2 to delay the commencement of the mandatory clearing of AUD forward rate agreements for a period of two years from the commencement date.

132 Substantial work is required to establish CCP infrastructure that could accommodate the clearing of AUD forward rate agreements. It will also require entities to build new technology systems, develop new compliance and monitoring systems and hire additional staff—because there are no existing practices to clear this product class. However, we do not believe the regulatory burden outweighs the benefit of clearing AUD forward rate agreements.

133 We also received submissions during the consultation period, noting that there is only one CCP currently licensed in Australia to clear AUD overnight index swaps.

134 Due to the current lack of market competition for the clearing of this product, we proposed in Option 2 to delay the commencement of mandatory clearing of AUD overnight index swaps for a period of six months from the commencement date.

135 Should no additional CCPs enter the market to clear forward rate agreements or overnight index swaps, ASIC will consider further delaying the start dates to ensure the preconditions for mandatory clearing expressed by the CFR in a joint policy statement have been met.

> Note: CFR, *Australian regulators' statement on assessing the case for mandatory clearing obligations*, May 2013.

136 If these delays are not introduced, we believe that all 15 entities would need to build new IT, compliance and record-keeping systems to begin clearing AUD forward rate agreements from the original commencement date. Option 2 will prevent entities incurring these costs for another two years.

### Removing the requirement for foreign clearing entities to clear 'entered-into' or 'nexus' trades

137 During consultation, we received a number of submissions that 'entered-into' or 'nexus' trades should be excluded from the clearing mandate because, to comply with this requirement, foreign clearing entities would be required to build additional systems and incur material compliance costs.

138 A number of submissions also noted that a requirement to clear 'entered-into' or 'nexus' trades would be inconsistent with the clearing requirements in overseas regimes.

139 After further analysis of this issue we believe there is little risk-reduction benefit gained from requiring 'entered-into' or 'nexus' transactions to be subject to the clearing requirements and that the overall regulatory benefits

do not outweigh the compliance cost that would be imposed. The potential reduction in systemic risk in Australia from requiring 'entered-into' or 'nexus' trades to be cleared would be relatively small because the only trades that would be captured under this requirement would be those between non-Australian entities (of which a large proportion would be picked up by foreign clearing regimes).

140 As a result, under Option 2 we propose to remove the requirement for foreign clearing entities to centrally clear 'entered-into' or 'nexus' trades.

#### No express prohibition on de-clearing

141 In CP 231, we sought feedback on whether the derivative transaction rules (clearing) should impose any prohibitions on derivative transactions being de-cleared after they have been centrally cleared.

142 De-clearing (or re-bilateralisation) is the process of removing a trade from clearing so the CCP no longer interposes itself between the two original parties to the trade (as was the case when it was a cleared trade). The requirement to de-clear a trade can arise when CCPs are conducting multilateral compression cycles amongst a number of different counterparties, and need to match-up counterparties with equal and offsetting exposures to carry out the compression. The ability to de-clear a trade and return it to its original bilateral status can help align counterparty exposures.

143 A number of submissions stated that the derivative transaction rules (clearing) should not prohibit derivatives transactions being de-cleared because it may impede the ability of CCPs to run regular compression cycles as part of their risk-mitigation practices. As a result, under Option 2 we would not seek to impose any prohibition on derivatives transactions being de-cleared after they have been centrally cleared.

### Exemptions

144 Most overseas jurisdictions that have implemented mandatory central clearing have included an exemption for alternative clearing and intra-group derivative transactions, including the United States, the European Union, Japan and (the proposed rules in) Canada.

145 As a result, we proposed under Option 2 to provide an exemption from the central clearing requirement for alternative clearing, intra-group trades and for new or amended derivatives where the transaction occurs as part of a multilateral compression cycle.

### Alternative clearing exemption

146 Alternative clearing is the practice of allowing entities subject to the Australian clearing mandate to comply with their clearing requirements by clearing in accordance with clearing requirements in a foreign jurisdiction.

147 We believe that allowing alternative clearing offers significant cost-reduction benefits to clearing entities with derivative transactions already subject to mandatory central clearing in another jurisdiction. We expect that alternative clearing will be beneficial for both foreign clearing entities that are subject to mandatory central clearing in the jurisdiction in which they are located, as well as to Australian clearing entities that must comply with clearing requirements in another jurisdiction.

148 Industry feedback was strongly supportive of providing access to alternative clearing arrangements.

### Multilateral compression exemption

149 Multilateral trade (or portfolio) compression is the practice of reducing or eliminating OTC derivative contracts by simultaneously terminating or replacing them with a smaller, more compact set of contracts, giving rise to economically-equivalent exposures or for a compensating payment.

150 Multilateral compression cycles can result in the amendment of existing OTC derivatives or the creation of new OTC derivatives. If amended or new OTC derivatives fell within scope of the proposed clearing requirements and were required to be cleared, the clearing requirements could reduce the effectiveness of multilateral compression. This is because mandatory central clearing would change the counterparties to the amended or new derivatives, so that the counterparties would face a CCP instead of the original counterparty. This would change the credit risk profile of the new or amended derivatives, and may make multilateral compression less economically attractive or viable.

151 Multilateral portfolio compression is an effective method for dealers with a large number of trades to reduce operational risk. We received industry feedback strongly in support of providing a multilateral compression exemption.

### Intra-group exemption

152 An intra-group derivative transaction is a derivative transaction that occurs between two clearing entities in the same corporate group at the time the transaction is entered into.

153 We believe there is little risk-reduction benefit from requiring intra-day group derivative transactions to be subject to the clearing requirements, and that the overall regulatory benefits do not outweigh the compliance cost that would be imposed. The reduction in systemic risk that occurs when derivative transactions are entered into between different corporate groups

does not apply to the same extent where derivative transactions are entered into within the same corporate group.

154 As such, under Option 2 we propose to provide an exemption for intra-group derivative transactions.

## Overall deregulatory benefits

155 In addition to the annual cost savings that the 15 clearing entities would achieve through substituted compliance arrangements (as discussed in Option 1 see paragraphs 91–125) we believe a number of additional deregulatory benefits would be achieved under Option 2: see paragraphs 156–163. The costings for these additional savings were determined by analysing the savings that would be achieved in relation to the initial analysis undertaken by Treasury.

### Delaying mandatory clearing of AUD forward rate agreements and AUD overnight index swaps

156 We believe that without a delay in the requirement to centrally clear AUD forward rate agreements and AUD overnight index swaps all 15 clearing entities would be required to incur large one-off costs in order to connect to an additional clearing facility in order to begin clearing these products.

157 Based on the costs of complying with the CFTC regime in the United States, we estimate that delaying the commencement of mandatory clearing of AUD forward rate agreements and AUD overnight index swaps will lead to annual savings of $20,000 per entity.

**Table 3: Cost savings from delaying central clearing of AUD forward rate agreements and AUD overnight index swaps**

| Cost item | One-off costs | Annual costs |
|---|---|---|
| IT system build | $175,000 | $N/A |
| IT staff | $25,000 | $N/A |
| Legal | $13,000 | $N/A |
| **Total costs per clearing entity** | **$213,000** | **$N/A** |

### Allowing alternative clearing

158 We believe that without access to alternative clearing arrangements, all 10 foreign clearing entities would be required to build new compliance and record-keeping systems in order to ensure that they are fully complying with the Australian clearing mandate.

159 We estimate that allowing foreign clearing entities to use alternative clearing arrangements will lead to annual cost savings of $75,000 per foreign clearing entity.

**Table 4: Cost savings from allowing foreign clearing entities to use alternative clearing**

| Cost item | One-off costs | Annual costs |
|---|---|---|
| Compliance monitoring system (set-up and ongoing monitoring) | $15,000 | $50,000 |
| Record keeping | $20,000 | $20,000 |
| **Total costs per foreign clearing entity** | **$35,000** | **$70,000** |

**Removing the requirement to clear 'entered-into' and 'nexus' trades**

160 We believe that without an exemption from clearing 'entered-into' and 'nexus trades' all 10 foreign clearing entities would be required to build additional IT, compliance and record-keeping systems to identify 'entered into' and 'nexus' trades before the trade has been executed, in order to ensure that they are fully complying with the Australian clearing mandate.

161 We estimate that removing the requirement for foreign clearing entities to clear 'entered into' and 'nexus' trades will lead to annual cost savings of $95,000 per foreign clearing entity

**Table 5: Costs savings from removing the requirement for foreign clearing entities to clear 'entered-into' and 'nexus' trades**

| Item cost | One-off costs | Annual costs |
|---|---|---|
| IT | $200,000 | N/A |
| Compliance monitoring system (set-up and ongoing monitoring) | $15,000 | $50,000 |
| Record keeping | $50,000 | $20,000 |
| **Total costs per foreign clearing entity** | **$265,000** | **$70,000** |

**Exempting intra-group trades and multilateral compression exercises**

162 We believe that without an exemption from clearing intra-group trades and trades conducted as part of multilateral portfolio compression exercises, all 15 clearing entities would be required to build additional compliance and record-keeping systems in order to ensure that they are fully complying with the Australian clearing mandate.

163 We estimate that providing exemptions for intra-group trades and trades that form part of multilateral compression exercises will lead to annual cost savings of $75,000 per clearing entity.

**Table 6: Cost savings from exemptions for intra-group trades and multilateral compression**

| Cost item | One-off costs | Annual costs |
|---|---|---|
| Compliance monitoring system (set-up and ongoing monitoring) | $15,000 | $50,000 |
| Record keeping | $20,000 | $20,000 |
| **Total costs per clearing entity** | **$35,000** | **$70,000** |

### Impact on industry

164 To the extent that the requirements under Option 1 and Option 2 differ, Option 2 would have a smaller cumulative impact on industry. Specifically, the proposals to provide exemptions for intra-group trades and multilateral compression exercises would help to reduce the concentration of operational risk by making it easier for entities to conduct intra-group hedging exercises, and allow dealers with a large number of trades to reduce operational risk through trade compression.

165 Option 2 is the preferred option because it achieves the inherent benefits of central clearing for market participants (by allowing them to minimise counterparty credit risk exposures and to create efficiencies in risk management processes), imposes minimal costs on market participants, and preserves the substituted compliance benefits granted to Australian entities (with the possibility of further future relief).

### Impact on consumers

166 ASIC does not expect consumers to be caught by central clearing obligations because OTC derivatives are typically only traded by, and accessible to, financial institutions and corporations. It is also extremely unlikely that an individual would hold a portfolio of OTC derivatives in excess of $100 billion gross notional value to meet the clearing threshold.

## Option 3: Maintain the status quo

167 Under Option 3, ASIC would not impose any direct regulatory requirements on stakeholders.

168 However, the lack of an Australian central clearing mandate would not mean that Australian participants in OTC interest rate derivative markets would be able to avoid having to centrally clear or be subject to clearing mandates in other jurisdictions. Market forces such as prudential requirements and overseas regulations would still ensure that most OTC interest rate derivative transactions in Australia would be centrally cleared. For example, the majority of G4 interest rate derivative transactions entered by Australian

banks have an international bank as the counterparty, many of which are subject to the US clearing requirement.

169 Australian banks would therefore still have to incur the costs to put in place and maintain the necessary arrangements for central clearing if they wished to participate in OTC derivatives markets—without enjoying the substituted compliance benefits that would arise from a central clearing mandate.

170 Pursuing this non-regulatory option, ASIC would not seek to use its rulemaking powers to mandate a central clearing requirement for any class of persons with respect to OTC derivatives. In this instance, the cumulative impact of market forces, prudential obligations arising out of Basel III and foreign central clearing requirements would incentivise Australian entities to move towards central clearing without legislative intervention.

171 This approach would go some way to addressing the financial stability concerns around transparency, given that rates of voluntary central clearing would rise under such incentive structures. However, the decision to not implement a domestic mandatory clearing regime means Australian participants would still have to adhere to foreign central clearing requirements. Participants would not benefit from substituted compliance determinations under this option, and hence the $5 million cost savings based on our updated assessment of the initial estimate put forward in Treasury's initial RIS would not be realised.

## Impact on industry

172 Failure by Australia to put in place a central clearing mandate would mean that Australian participants in OTC derivatives markets would not be able to benefit from substituted compliance rulings and would have to clear in accordance with overseas regulatory frameworks. Relief provided in the past is likely not to be extended or revoked if Australia reneges on its commitment to implement a central clearing mandate.

173 Australian market participants already benefit from relief granted by the CFTC from a number of its so-called 'entity-level' requirements. This relief is time limited and subject to renewal. Failure on the part of Australia to implement central clearing as one of the key agreed reforms of OTC derivatives markets is likely to put the renewal of existing relief at risk. It will also make it very unlikely that the United States will agree to extend other kinds of substituted compliance relief to Australian entities.

> Note: See CFTC, *CFTC's division of market oversight issues time-limited no-action relief from certain requirements of Part 45 and Part 46 of the Commission's Regulations, for certain swap dealers and major swap participants established under the laws of Australia, Canada, the European Union, Japan or Switzerland*, press release, 20 December 2013.

174 The European Commission is currently conducting an equivalence assessment of the Australian regulatory framework for OTC derivatives, with a view to

determining what substituted compliance relief it will provide. Failure to put in place a central clearing mandate would significantly reduce the scope of the relief that would be provided by the European Commission.

175 Similar outcomes would result as mandatory central clearing is adopted by further jurisdictions. Australian participants in global OTC derivatives markets would, as a consequence, face an increasing compliance burden in continuing their activities in these markets.

176 This option would therefore not address the first issue of providing relief to Australian OTC derivatives market participants from the effect of overseas regulation—resulting in increased costs for Australian banks and other institutions accessing global capital markets, especially in the United States and the European Union. These costs would include direct costs of complying with foreign regulations, but could also give rise to indirect costs such as those caused by having to withdraw from certain markets and, as a result, not being able to hedge certain products or currencies.

177 As well as failing to address the main problem, this option does not provide any compensating benefits to Australian participants in OTC derivatives markets because it will not reduce the pressure driving the uptake of central clearing in Australia and globally. Australian banks and businesses will therefore have to maintain the necessary arrangements for central clearing in order to continue participating in OTC derivatives markets.

### Impact on consumers

178 There would be no impact on consumers under this Option 3 because there is currently no obligation in Australia to clear OTC derivatives.

# C Consultation

179 The Australian Government released a consultation paper on a proposed central clearing mandate in February 2014. The paper asked for stakeholder feedback on a number of matters, including a central clearing mandate for G4 interest rate derivatives restricted to internationally-active dealers, and the best methodology for defining these dealers. Initial feedback was also requested for a possible future central clearing mandate for AUD interest rate derivatives, and the timing of such a mandate.

180 Twenty-three submissions were received, mainly from financial industry bodies and the major banks. Other submissions were received from a smaller financial institution, corporate entities, energy and commodity companies, and financial consultants.

181 There was almost universal support for a G4 interest rate derivative mandate limited to transactions between internationally-active domestic and foreign banks. There was also wide support for a similar AUD interest rate derivative mandate, but somewhat less consensus on timing. A number of submissions supported a simultaneous move to impose G4 and AUD interest rate derivative mandates, while others noted that international consistency is a key consideration, and that an AUD interest rate derivative mandate in Australia should be timed to coincide with a similar move in key overseas jurisdictions.

182 There was very firm support to restrict any clearing mandate to internationally-active domestic and foreign banks, but no consensus on how to define these entities. Many submissions, especially from the major domestic banks, called for further detailed consultation on this issue.

183 Following the release of the 2014 report (which recommended the imposition of a central clearing mandate for AUD interest rate derivatives) the Government released a further consultation paper in July 2014 on:

(a) a proposal to proceed with an AUD interest rate derivative central clearing mandate (in combination with the G4 interest rate derivative mandate) limited to internationally-active domestic and foreign banks;

(b) the timing of the commencement of such a mandate; and

(c) an amended definition of internationally-active domestic and foreign banks.

184 On the whole, stakeholders supported combining the AUD and G4 interest rate derivative mandates, and limiting the scope of the mandate to internationally-active domestic and foreign banks. Views on the detailed definition of internationally-active domestic and foreign banks continued to diverge.

185 Following this consultation, Treasury and the CFR have continued to engage with key stakeholders on this definition. It appears that broad support for a reworked definition of internationally-active domestic and foreign banks has been achieved.

186 On 28 May 2015, the Government released a draft of the Ministerial determination and associated regulations for public consultation. Stakeholders were broadly supportive of the Government's approach and agreed with the importance of the commitments being implemented in a globally-coordinated, least-cost manner.

187 Following the consultation process, Treasury published a Ministerial determination on 2 September 2015 which set out the mandatory central clearing product scope.

188 On 8 September 2015, Treasury published amendments to the Corporations Regulations to implement central clearing of prescribed classes of OTC interest rate derivatives.

189 On 28 May 2015, ASIC released CP 231 and draft derivative transaction rules (clearing) for consultation. CP 231 was open for submissions from 28 May 2015 to 10 July 2015, which allowed six weeks for stakeholders to respond. We received 11 written submissions in response to CP 231 (including three confidential submissions) from a broad range of stakeholders.

190 We have engaged with stakeholders following the formal consultation period and, in particular, in relation to the types of AUD interest rate derivatives subject to the proposed mandate—where we took on board industry concern about the current lack of CCP's offering central clearing for a number of these products.

191 We have also held several meetings with stakeholders to discuss a range of issues, including the proposed requirement for foreign clearing entities to clear 'nexus' and 'entered-into' trades, and a proposed exemption for 'offset' trades that are created during multilateral compression exercises: see paragraphs 192–199.

## Key feedback

### Product scope

192 A number of submissions raised concerns regarding the proposal to mandate clearing of AUD forward rate agreements because, at present, there are no licensed clearing facilities clearing these products.

193 A number of submissions also questioned the decision to mandate the clearing of AUD overnight index swaps, because there is currently only one licensed CCP clearing this product. Industry proposed that AUD overnight index swaps should not be subject to the clearing mandate until there are at least two CCPs that may be used to meet the mandate.

### Clearing of 'nexus' and 'entered-into' trades by foreign clearing entities

194 During consultation, we received a number of submissions arguing that 'entered-into' or 'nexus' trades should be excluded from the clearing mandate because, to comply with this requirement, foreign clearing entities would be required to build additional systems and incur material compliance costs.

195 A number of submissions also noted that a requirement to clear 'entered-into' or 'nexus' trades would be inconsistent with the clearing requirements in overseas regimes.

### Multilateral compression exemption

196 A number of submissions expressed support for an exemption from the clearing requirement for 'offset' trades that are created during multilateral trade compression exercises. The industry response was that multilateral compression exercises serve an important purpose in helping to reduce both entity and overall systemic risk.

197 A number of submissions argued that an exemption should also be applied to 'offset' trades that are created during bilateral compression exercises.

### Intra-group exemption

198 Industry response was that the derivative transaction rules (clearing) should allow an exemption for intra-group derivative transactions.

199 A number of submissions argued that the notification requirement regarding intra-group transactions should be amended to require post-trade notification rather than pre-trade notification in order to provide ASIC with certainty that a transaction has been conducted and to allow entities to retain the flexibility to hedge, as required.

# D Conclusion and recommended option

200 OTC derivatives are an important segment in global financial markets. For Australian businesses, OTC derivatives are an essential product for hedging their foreign exchange, interest rate and other market exposure risks. This is particularly important for the major Australian banks, because they depend on global capital markets for raising a substantial proportion of their funding needs. Given the central importance of the major banks in providing financing to Australian consumers and businesses, preserving their access to global financial markets (including OTC derivatives markets) at the lowest possible cost is a key concern for the Government.

201 The reforms to OTC derivatives markets are an important global initiative to improve the stability of financial markets and minimise the risk of future financial crises. The Government is prepared to play its part in implementing the reforms, including with respect to central clearing of OTC derivatives.

202 However, in implementing any reforms the Government is determined to minimise the regulatory impact on Australian banks and businesses operating in OTC derivatives markets. With respect to the OTC derivatives reforms, it is of particular importance to limit the potential impact of extraterritorial regulation. Failure to do so could significantly increase the costs of Australian banks and businesses raising funds and hedging risks in global financial markets.

203 The Government has considered the options examined in this RIS to address the issues set out in paragraphs 4–7 (i.e. maximising substituted compliance relief). Option 3 does not address this problem because it would likely cause the United States to withdraw the substituted compliance benefits already provided to Australian businesses active in OTC derivatives markets in the United States. It would also not be helpful in obtaining substituted compliance benefits in other important overseas markets, such as the European Union, because they implement their own OTC derivatives reforms. Option 1 addresses this problem—as does Option 2. However, Option 1 imposes higher compliance costs on industry stakeholders.

204 Following consideration of these options and their relative impact on Australian banks and businesses it is our recommendation to proceed with Option 2. Option 2 is the preferred option because it imposes minimal costs on market participants, while preserving the substituted compliance benefits granted to Australian entities and possibly leading to further relief.

# E Implementation and review

205 The central clearing mandate will be implemented through the derivative transaction rules (clearing) and evaluation of the impact of the central clearing mandate will occur on several levels.

206 The CFR regularly survey Australian OTC derivatives markets and report on key developments and issues. Based on the results of their work the CFR have, in the past, provided recommendations to Government on developing regulation to implement global reforms to OTC derivatives markets. It is anticipated that the CFR will continue this series of reports, including on any issues or new developments they may identify in relation to central clearing.

207 Regular global surveys of the state of OTC derivatives markets regulation are conducted by the Financial Stability Board (FSB). Nine reports have been produced to date, with the most recent published in July 2015. These reports provide a comparative view of the progress of the reforms to OTC derivatives markets across jurisdictions, including with respect to central clearing. The FSB reports provide a good overview of the state and progress of global reforms to OTC derivatives markets, and a way for individual jurisdictions, including Australia, to benchmark their own progress against that achieved by their peers.

# F Regulatory Burden and Cost Offset (RBCO) Estimate Table

## Option 1

**Table 7: Average annual costs and cost offsets of implementing Option 1**

| Costs/costs offset ($m) | Business | Community organisations | Individuals | Total savings |
|---|---|---|---|---|
| Total by sector (cost) | $5.0 | $ | $ | $5.0 |
| Agency (cost offset) | $ | $ | $ | $ |
| Within portfolio (cost offset) | $ | $ | $ | $ |
| Outside portfolio (cost offset) | $ | $ | $ | $ |
| Total by sector(cost offset) | $ | $ | $ | $ |

**Table 8: Average annual compliance savings of implementing Option 1**

| | |
|---|---|
| **Proposal is cost neutral?** | No |
| **Proposal is deregulatory?** | Yes |
| **Balance of cost offsets $** | |

## Option 2

**Table 9: Average annual costs and cost offsets of implementing Option 2**

| Costs/costs offset ($m) | Business | Community organisations | Individuals | Total savings |
|---|---|---|---|---|
| Total by sector (cost) | $8.2 | $ | $ | $8.2 |
| Agency (cost offset) | $ | $ | $ | $ |
| Within portfolio (cost offset) | $ | $ | $ | $ |
| Outside portfolio (cost offset) | $ | $ | $ | $ |
| Total by sector(cost offset) | $ | $ | $ | $ |

**Table 10: Average annual compliance savings of implementing Option 2**

| | |
|---|---|
| **Proposal is cost neutral?** | No |
| **Proposal is deregulatory?** | Yes |
| **Balance of cost offsets $** | |

## Option 3

**Table 11: Average annual costs and cost offsets of implementing Option 3**

| Costs/costs offset ($m) | Business | Community organisations | Individuals | Total savings |
|---|---|---|---|---|
| Total by sector (cost) | ($5.0) | $ | $ | ($5.0) |
| Agency (cost offset) | $ | $ | $ | $ |
| Within portfolio (cost offset) | $ | $ | $ | $ |
| Outside portfolio (cost offset) | $ | $ | $ | $ |
| Total by sector(cost offset) | $ | $ | $ | $ |

**Table 12: Average annual compliance savings of implementing Option 3**

| | |
|---|---|
| **Proposal is cost neutral?** | No |
| **Proposal is deregulatory?** | No |
| **Balance of cost offsets $** | |

## ATTACHMENT C – Statement of Compatibility with Human Rights

*Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011.*

***ASIC Derivative Transaction Rules (Clearing) 2015***

This legislative instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

### 1. Overview of the Legislative Instrument

The *ASIC Derivative Transaction Rules (Clearing) 2015* (the ***Rules***) are made by ASIC under section 901A of the *Corporations Act 2001* (the ***Act***), acting with the consent of the Minister under section 901K of the Act.

The Rules require certain standardised over-the-counter (***OTC***) derivatives to be cleared through a licensed or prescribed clearing and settlement facility in accordance with the clearing requirements specified in the Rules.

By doing this, the Rules give effect to:

- a commitment made by the Australian Government at the Group of Twenty (***G20***) summit in Pittsburgh in 2009 to implement mandatory central clearing requirements for standardised OTC derivatives as part of substantial reforms to practices in OTC derivatives markets;
- the proposals in Treasury's proposals paper in February 2014 entitled *Implementation of Australia's G-20 Over-The-Counter Derivatives Commitments: G4-IRD Central Clearing Mandate*, and in July 2014 entitled *Implementation of Australia's G-20 Over-The-Counter Derivatives Commitments: AUD-IRD central clearing mandate*; and
- the objectives of the Corporations Legislation Amendment (Derivative Transactions) Act 2012. As noted in the Explanatory Memorandum to the originating Bill, at paragraph 1.7: "Clearing of standardised OTC derivatives will reduce counterparty risk associated with OTC derivative transactions".

### 2. Human rights implications

The Rules do not engage any of the applicable rights or freedoms.

### 3. Conclusion

The Rules are compatible with human rights as they do not raise any human rights issues.