Financial System Inquiry Submission

Financial System Inquiry
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Dear Sir/Madam,

Strengthening Australia's Legal Framework for Client Clearing: Default Management, Portability and Indirect Clearing

I am a lawyer with over 10 years of experience in the area of derivatives law and practice and am pleased to take this opportunity to contribute to the Financial System Inquiry. I would like to contribute by drawing the attention of the Inquiry to several areas of Australian law where I feel reform could be beneficial to promote a stable financial system and foster the integration of international financial regulation, specifically in the context of OTC derivatives.

As the Inquiry will be aware, the global OTC derivatives market has $600+ trillion in outstanding notional amounts. The financial crisis highlighted the immense systemic risk that this market can pose to the global financial system. The ensuing and ongoing OTC derivatives reforms process arising from the "G20 commitments" – of which Australia is part - is unprecedented in financial market history. Never before has an attempt been made to more or less simultaneously reform a global market in so many jurisdictions based on a "commitment" rather than a public international law instrument such as a treaty. These regulatory reforms have resulted in fundamental changes to the structure of the derivatives markets and the trading of derivatives, as the four pillars of reform - central clearing, trade reporting, electronic execution and risk mitigation for uncleared derivatives – have been implemented.

A consequence of this reform effort is that the legal frameworks of the derivatives markets in many jurisdictions have undergone significant development. Australia is no exception and there have been major amendments to date, for example in the *Corporations Legislation Amendment (Derivative Transactions) Act 2012* and the *Corporations and Financial Sector Legislation Amendment Act 2013*. No doubt these developments will continue as Australia continues implementation of its G20 commitments.

In light of the enormous impact this regulatory reform continues to have on Australian market participants it is to be expected that derivatives will be the subject of comments to, and perhaps recommendations by, the Inquiry. With this in mind I would like to comment on three key areas of Australian law where additional reforms could be beneficial in the context of central clearing of derivatives. Central clearing is arguably the most significant of the regulatory reforms, and mandatory central clearing of certain OTC derivatives in Australia is now firmly on the horizon. I will restrict my comments specifically to client clearing. That is, the clearing of the leg of an OTC derivative executed by an entity which is not a clearing member of a clearing house ("**CCP**"). Client clearing is a developing area internationally. There are currently at least two OTC derivative clearing houses gearing up to offer this service in Australia in the near future.

I would like to suggest that in the context of client clearing there are three areas where law reform ought to be given further consideration in order to keep pace with the latest developments in the OTC derivatives space:

1. Amendments to client money rules to facilitate portability and indirect clearing;

2. Amendments to the *Payment Systems and Netting Act 1998* (the "**Netting Act**") to further facilitate CCP default management, including porting and compression as well as to facilitate indirect clearing;

3. Enhancements to the *Personal Property Securities Act 2009* (the "**PPSA**") to facilitate portability through permitting perfection by control and super priority in relation to cash collateral.

Client Money and Client Property Rules

The collapse of MF Global in 2011 drew attention to the permissive regime in Australia that allows client's money to be withdrawn and used for hedging by an AFS licensee dealing in derivatives. Responses to the 2011 Treasury discussion paper "*Handling and use of client money in relation to over-the-counter derivatives transactions*" showed a clear market consensus in favour of tightening client money protection. However no change has yet been implemented in this area.

The implementation of client clearing of OTC derivatives has prompted a renewed need to examine client money rules for two reasons. First, to facilitate porting[1] upon the insolvency of a clearing member. Secondly, to facilitate indirect clearing.[2] Other G20 jurisdictions have undertaken or are undertaking a similar exercise currently in relation to client money and client property rules, for example in the United States,[3] United Kingdom[4] and Canada[5].

Much of the work on portability to date in Australia has focussed on porting at the clearing house level. The *Corporations and Financial Sector Legislation Amendment Act 2013* amended section 16 of the Netting Act to grant statutory protection to porting in accordance with a "market netting contract". This protection is likely to be effective in relation to porting by a CCP of client positions and collateral held at the CCP from a defaulting clearing member to a back-up clearing member. However it must be recognised that porting is often not solely an action taken by a CCP. The back-up clearing member may require additional collateral to be posted by a client to cover the ported positions. This may be due to more onerous collateral requirements of the back-up clearing member owing to the different netting set of the back-up clearing member vis-à-vis the CCP if the CCP takes margin on a net basis. If the client does not provide the additional collateral required by the back-up clearing member then the back-up clearing member may reject the porting request. Some clients may have sufficient additional collateral available to transfer in this situation. However in some cases the client's excess collateral may be held at the insolvent clearing member and therefore unavailable for immediate transfer by the insolvency official. In this situation portability may not be able to be said to be "highly likely" at all. This is an issue because under Prudential Standard APS 112 authorised deposit-taking institutions ("**ADIs**") may only obtain favourable capital treatment in respect to trade exposures for clients of qualified central counterparty clearing members if portability is considered "highly likely".

Client money rules could be enhanced to facilitate the transfer of excess client collateral held by an insolvent clearing member and, in the context of indirect clearing, by the insolvent client of the clearing member. This could be achieved by rules requiring segregation and recordkeeping together with a statutory duty on an insolvency official to promptly transfer excess collateral if requested to facilitate CCP porting of cleared client positions. In addition, the rules could require that excess client collateral relating to clearing client positions be swept up to the CCP rather than held by a clearing member. Transfer of the excess client collateral by the CCP would then be protected under the market netting contract porting protections in the Netting Act.

The exact approach to be taken will require further consultation and consideration by regulators and market participants. My point for present purposes is simply to highlight the need for focus in the client monies

[1] The Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) define portability as "the operational aspects of the transfer of contractual positions, funds, or securities from one party to another party". In the context of central clearing, facilitating portability is one of the fundamental principles for financial market infrastructures. Porting client positions away from an insolvent clearing member to a back-up clearing member may ensure that the client positions "stay on foot" rather than being terminated. This could minimise market disruption arising from the insolvency.

[2] "Indirect clearing" refers to clearing offered by a market participant that is not itself a clearing member of a clearing house. For example, a fund manager may act as a clearing intermediary to a number of funds which it manages. The fund manager itself maintains clearing relationships with one or more clearing brokers which are clearinghouse members.

[3] See eg *Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions,* 76 FR 35141.

[4] See eg Financial Conduct Authority CP13/5 "*Review of the client assets regime for investment business*" (July 2013).

[5] See eg Canadian Securities Administrators Model Rule 91-304 "*Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*" (16 Jan 2014).

area to minimise fellow customer risk, operational risk and investment risk, facilitate portability and indirect clearing and thereby reduce systemic risk.

Netting Act

Section 16 of the Netting Act was amended in 2013 to facilitate portability. The effect of the amendments was to provide that all "transfers" or dealings with property "in accordance with" the operating rules of a CS Facility Licensee are to be enforceable notwithstanding any other law to the contrary. This amendment has gone a long way towards protecting porting by a CCP pursuant to its operating rulebook. However there are some significant issues that remain to be considered.

The Netting Act does not fully address porting at the clearing member level. This means that indirect client clearing is not fully protected. Furthermore, there is a potential uncertainty for cleared "principal model" derivatives. The clearing structure for principal model derivatives involves a transaction between a CCP and clearing member and a mirror transaction between the clearing member and client. The mirror transactions are subject to a contract between the clearing member and client, which is not a "market netting contract" as defined in the Netting Act. This leaves a potential gap in the protection of cleared "principal model" derivatives under the Netting Act. Such derivatives could be close-out netted under section 14 of the Netting Act which is beneficial if collateral has been posted on a title transfer basis. However, the treatment of derivatives collateralised on a security interest basis, and the porting of the mirror trades, could fall outside the protection of the Netting Act. This leaves a lacuna in Australian law in relation to clearing.

Another uncertainty is the scope of CCP actions covered by the Netting Act. A CCP may need to undertake a broad set of activities as part of its default management procedures. For example, it may wish to run a compression cycle prior to porting or auctioning positions. Actions such as compression may result in new transactions being created in relation to the insolvent clearing member. It is not clear that the Netting Act would give effect to these new transactions. In addition, such actions may be undertaken pursuant to contracts which are not the market netting contract. For example the compression contract between a CCP and a service provider such as TriOptima may not be a "market netting contract" for the purpose of the Netting Act. Therefore the Netting Act protection for actions undertaken "in accordance with" a market netting contract may prove to be insufficient. Again, this leaves a potential lacuna in Australian law which results in higher systemic risk than is desirable.

I suggest that there is a need to carefully examine the scope and coverage of the Netting Act to ensure that it adequately protects cleared derivatives from insolvency laws in light of evolving derivative market practices such as indirect clearing, compression, portability and other CCP default management processes.

PPSA

A third area I would like to touch on relates to the treatment of cash collateral under the PPSA. Cash collateral is extremely prevalent in relation to OTC derivatives. Current rules require that cash margin which is client money must be deposited with an ADI. Commonly a client will grant a security interest over its rights to the cash in favour of its clearing member. Such cash margin is not required to be held on trust under current Australian law in all cases.[6]

When it comes to perfecting the security interest in cash collateral the PPSA currently only allows ADIs to perfect by control. All non-ADI clearing members need to register a financing statement on the Personal Property Securities Register (PPSR). Registration perfects the security interest but does not guarantee a first ranking priority.

This situation can limit portability for two reasons. First, an ADI may be unwilling to transfer a client money account without first clarifying whether there are other creditors who may have a prior ranking right to the money. Secondly, a back-up clearing member may be unwilling to accept a transfer of cash margin also due to the uncertainty about its priority position.

[6] ASIC Regulatory Guide 212: *Client money relating to dealing in OTC derivatives*.

Portability would be facilitated if the PPSA were to be amended to permit perfection of cash collateral by control by non-ADI clearing members and to grant super-priority in the clearing context. Such specific protection for the porting of cash collateral would render portability more likely and serve to reduce systemic risk.

I would like to thank the Inquiry for consideration of these points. I look forward to further participation in the Inquiry process going forward.

Yours sincerely,

Carl Baker