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Briefing note July 2015

Proposed mandatory central clearing rules for Australia

The Australian Securities & Investments Commission (**ASIC**) has proposed draft rules to implement mandatory central clearing requirements for Australia. ASIC's draft rules will implement the Australian Government's proposed central clearing mandate, which was also released for comment at the same time.

Under the draft ASIC Derivative Transaction Rules (Clearing) 2015 (**Draft Clearing Rules**), 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, but in any event by no later than the end of the first business day after the day on which the clearing transaction is entered into.

Who will qualify as a clearing entity?

The Draft Clearing Rules differentiate between Australian clearing entities and foreign clearing entities. It further differentiates between a clearing entity acting in its own capacity or acting in its capacity as the responsible entity for a registered scheme or as a trustee of a trust.

Australian clearing entity

An Australian authorised deposit taking institution (**ADI**) or an Australian financial services licensee (**AFS Licensee**):

- that is incorporated or formed in Australia; and
- who holds total gross notional outstanding positions of A$100 billion or more in its personal capacity (ie not in its capacity as the responsible entity for a registered scheme, or as the trustee of a trust) on each of two consecutive calculation dates (these dates being each of 31 March, 30 June, 30 September and 31 December in each calendar year, the first of such dates not be before 30 September 2015 (**Calculation Dates**)),

will qualify as an Australian clearing entity.

In addition where an entity (whether foreign or Australian) acts as the responsible entity for a registered scheme or as the trustee of a trust, it will also be an Australian clearing entity, if:

- the scheme or trust for which it is acting is incorporated or formed in Australia; and

Key issues

- A clearing entity is a financial entity with A$100 billion or more gross notional outstanding in OTC derivatives measured on a rolling basis.
- Only certain interest rate derivatives in certain currencies are clearing derivatives.
- Only those clearing derivatives of a clearing entity that are clearing transactions must be cleared through a clearing facility.
- A clearing derivative is only a clearing transaction when entered into with another clearing entity or swap dealer regulated by the CFTC or SEC.

- the entity is an Australian ADI, an AFS Licensee or is an exempt foreign licensee and:
  - is incorporated or formed in Australia, or is a foreign company that is registered or required to be registered as a foreign company under Part 5B.2 of the Corporations Act; and
  - who holds total gross notional outstanding positions of A$100 billion or more in its representative capacity (ie in its capacity as the responsible entity for a registered scheme, or as the trustee of a trust) on each of two consecutive Calculation Dates.

Foreign clearing entity

A foreign entity will be a foreign clearing entity for the purposes of the Draft Clearing Rules if the foreign entity is an Australian ADI or an AFS Licensee or an exempt foreign licensee:

- that is a foreign company that is registered or required to be registered as a foreign company under Part 5B.2 of the Corporations Act; and
- who holds total gross notional outstanding positions of A$100 billion or more in its personal capacity (i.e. not in its capacity as the responsible entity for a registered scheme, or as the trustee of a trust) on each of two consecutive Calculation Dates.

In addition, a foreign entity could also qualify as a foreign clearing entity if it acts as the responsible entity for a registered scheme or as the trustee of a trust, where:

- the scheme or trust for which it is acting is incorporated or formed outside Australia; and
- the entity is a an Australian ADI, an AFS Licensee or an exempt foreign licensee:
  - that is incorporated or formed in Australia, or is a foreign company that is registered or required to be registered as a foreign company under Part 5B.2 of the Corporations Act; and
  - who holds total gross notional outstanding positions of A$100 billion or more in its representative capacity (ie in its capacity as the responsible entity for a registered scheme, or as the trustee of a trust) on each of two consecutive Calculation Dates.

Opt-in clearing entity

In addition, any entity may opt-in by way of a notice to ASIC to become a clearing entity. The notice must amongst others set out in which capacity it opts-in (ie personal or representative capacity) and the date on which it will commence being an opt-in clearing entity.

Clearing requirements cannot be imposed on entities that do not fall within these categories – these categories exclude a wide range of international bodies not meeting these requirements, such as central banks, multilateral development banks, the Bank for International Settlements and other similar organisations. The explanatory guide further explains that it is the intention that only major domestic and foreign banks active in the Australian OTC derivatives market are captured. Smaller financial entities would not be affected by the mandate as they would not be expected to reach the level of the A$100 billion threshold. Furthermore corporate end users are carved out to the extent that they are not the financial entities referred to.

What is a clearing derivative and a clearing transaction?

Only a clearing derivative can potentially constitute a clearing transaction which must be cleared as per the Draft Clearing Rules.

Clearing derivative

A derivative is only a clearing derivative if:

- it is an interest rate derivative denominated in Australian dollar, United States dollar, Euros, British pounds or Japanese yen;
- it is a basis swap, fixed-to-floating swap, forward rate agreement or overnight index swap (all as defined in the Draft Clearing Rules); and
- meets certain specifications (known as IRD Class Specifications) set out in the Draft Clearing Rules.

Are any other derivatives excluded from being a clearing derivative?

Yes, despite the above, a derivative will not be a clearing derivative if:

- either party has an option, which if they exercised it, would affect the amount, timing or form of the consideration payable under the derivative;
- the notional principal amount and payments are not in the same currency;
- the notional principal amount will or may change upon the occurrence of a specified future event, and at the time of the entry into of the derivative, it is

uncertain whether or when the future event will occur;

- a derivative is able to be traded on a financial market, the operator of which holds an Australian market licence, and the entry of the derivative takes place on that market and is reported to the operator of that market, both in accordance with the operating rules of that market; or
- a derivative is entered into on certain regulated foreign markets.

Clearing transaction

Not all clearing derivatives are clearing transactions. Only clearing transactions must be centrally cleared.

The Draft Clearing Rules distinguishes between clearing transactions for Australian clearing entities and for foreign clearing entities.

A clearing derivative entered into by an Australian clearing entity, will only be a clearing transaction if the other party to the clearing derivative is:

- another Australian clearing entity;
- a foreign clearing entity; or
- a foreign entity that is registered or provisionally registered as a swap dealer with the Commodity Futures Trading Commission under the Commodity Exchange Act 1936 (US) or a securities-based swap dealer with the Securities Exchange Commission under the Securities Exchange Act 1934 (US) (both of these defined as **Foreign Internationally Active Dealers** under the Draft Clearing Rules and so referred to herein).

Similarly, a clearing derivative for a foreign clearing entity will only be a clearing transaction if the other party is:

- an Australian clearing entity;
- another foreign clearing entity; or
- a Foreign Internationally Active Dealer.

Where the other party is another foreign clearing entity or a Foreign Internationally Active Dealer, there must be a link to Australia before it would classify as a clearing transaction. There would be a link to Australia where:

- at least one of the foreign clearing entities books the clearing derivative to the profit or loss account of a branch of the foreign clearing entity located in Australia; or
- in relation to at least one of the foreign clearing entities, the clearing derivative:
  - qualifies as a *nexus derivative* (see below); or
  - otherwise was entered into in Australia.

What is a nexus derivative?

A clearing derivative can only be a nexus derivative where the foreign clearing entity lodged a written notice with ASIC that it opts-in to be an opt-in nexus entity.

If a clearing entity lodged such an opt-in notice with ASIC and became an opt-in nexus entity, then the test to determine if the clearing derivative is a nexus derivative will be similar to the nexus test set out in *ASIC Derivative Transaction Rules (Nexus Derivatives) Class Exemption 2015*, which test focuses on the location of persons performing particular functions in an OTC derivative, as opposed to where the derivative was entered into.

Applied to a clearing derivative, this means that a clearing derivative will be a nexus derivative if certain sales and trader functions are or will be performed on behalf of the foreign clearing entity by a person who is:

- ordinarily resident or employed in Australia; or
- acting as part of a desk, office or branch of:
  - the foreign clearing entity; or
  - an entity that is an associate of the foreign clearing entity,

  where that desk, office or branch is located in Australia.

Once it has been established that a clearing entity has entered into a clearing transaction, then it must be cleared on a clearing facility.

What is a clearing facility?

A clearing facility in relation to a clearing transaction is:

- a licensed clearing facility – being a clearing and settlement facility, the operation of which is authorised by an Australian clearing and settlement facility license (**Australian CS Facility License**), which Australian CS Facility License includes clearing derivatives to which clearing transactions relate; or
- a prescribed clearing facility – being a facility that is prescribed by regulations made under the Corporations Act. It is proposed that the following facilities be prescribed for the purposes of this regulation – CME Clearing Europe Limited, Eurex Clearing AG, Japan Securities Clearing Corporation and NASDAQ QMX Clearing AB. ASIC also has a general power to prescribe additional clearing facilities. The explanatory guide notes that

there are ongoing discussions with a number of further overseas parties to ascertain whether they wish to be prescribed by name in the proposed regulations, if so, their names will be added to the final regulations.

When is a clearing transaction cleared through a clearing facility?

A clearing transaction is cleared through a clearing facility if:

- the operator of the clearing facility enters into the clearing transaction with its participant (or another participant acting on its behalf);
- the operator of the clearing facility enters into the clearing transaction with a participant acting on behalf of a party not a participant to that clearing facility (or a participant acting on behalf of a person who is acting on behalf of the party not a participant to that clearing facility); and
- following entry into of these transactions (centrally cleared transactions), each party to the clearing transaction has no further rights against, or obligations to, the other party under the clearing derivative to which the clearing transaction relates.

Are there any exceptions?

Yes, if any of the following applies, then the clearing transaction does not have to be cleared through a clearing facility.

Clearing derivative terminated

Where a clearing derivative is terminated before the time by which the clearing transaction must be cleared, then a clearing entity is not required to clear such a clearing transaction through a clearing facility.

No licensed clearing facility or no prescribed clearing facility

A clearing entity is not required to clear its clearing transactions where there is no licensed clearing facility authorised, or prescribed clearing facility prescribed, to provide clearing services in respect of that class of derivatives in respect of the clearing derivative to which the clearing transaction relates.

Intra-group trades

If the counterparty to a clearing transaction is a related body corporate of the clearing entity then that clearing transaction does not have to be centrally cleared. This is however subject thereto that at least one business day before the clearing transaction is entered into, the clearing entity has given ASIC written notice advising ASIC amongst others of the name of the clearing entity and that it intends to rely on this exemption.

Multilateral portfolio compression

The Draft Clearing Rules provide that, subject to certain conditions, clearing does not have to take place for clearing transactions taking place as a result of modifying, terminating or replacing derivatives under a multilateral portfolio compression cycle. A multilateral portfolio compression cycle is a process under which portfolios of derivatives between participants are modified to reduce their notional value and replaced with new derivatives providing for reduced notional exposures between participants.

Foreign clearing requirements

Where a clearing entity or the counterparty to the clearing transaction is subject to foreign clearing requirements which require the clearing transaction to be cleared through a clearing facility by no later than 3 business days after the date on which the clearing transaction was entered into, then the clearing entity is not obliged to comply with the requirement to clear the clearing transaction under the Draft Clearing Rules.

It is the obligation of a clearing entity relying on this exception to ensure that the clearing transaction is so cleared in accordance with the requirements of the foreign jurisdiction.

Consultation

In addition to the Draft Clearing Rules, the Australian Government is consulting on a draft determination and regulations to implement the central clearing mandate in Australia. ASIC's draft rules would implement the Government's proposed central clearing mandate, which would cover trades between internationally-active dealers.

Submissions to the Government on the draft Ministerial determination and regulations closed on 26 June 2015, whilst submissions to ASIC close on 10 July 2015.

Australia seems to be ahead of the pack in the Asia Pacific region as far as mandatory clearing is concerned. Closely behind it is Singapore. On 1 July 2015, the Monetary Authority of Singapore (**MAS**) issued a consultation paper on draft regulations for mandatory clearing of derivatives contracts, dealing with the derivative contracts to be cleared, the circumstances under which it should be cleared, the persons subject to the clearing obligations and the exemptions to clearing obligations.

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