5 December 2011

The Manager
Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: CFR-Review-FMI@treasury.gov.au

Dear Mr White

Review of Financial Market Infrastructure Regulation

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Council of Financial Regulators' Consultation Paper on the 'Review of Financial Market Infrastructure Regulation' (Consultation Paper).

The Consultation Paper raises important issues for consideration and AFMA understands why the regulatory concerns are being raised. We see the proposals in the Consultation Paper as preliminary in nature, providing useful starting points for consideration of how to approach the Council's policy concerns. The implications of some of the proposed changes could have great impact on the operation of the markets in Australia and need to be carefully thought through. Change in this area needs to be measured and fully developed to avoid damaging confusion and uncertainty for both regulators and market stakeholders.

The Consultation Paper provides the starting point for an analytical journey the intended destination for which should be genuine enhancement of the regulatory system. AFMA stands ready to be an active participant making a positive contribution to the success of the journey.

AFMA's comments on the Consultation Paper are set out in the attached paper.

Australian Financial Markets Association
ABN 69 793 968 987
Level 3, Plaza Building, 95 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

Please do not hesitate to contact me at dlove@afma.com.au or (02) 9776 7995 for further clarification or elaboration as required.

Yours sincerely

David Love
Director, Policy & International Affairs

REVIEW OF

FINANCIAL MARKET INFRASTRUCTURE REGULATION

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1. Executive Summary

The Consultation Paper raises important issues for consideration but does not provide a complete analysis of them. Thus, we view the Paper as an expression of regulatory concerns on which considerably more policy development work needs to be done. In character the proposals in the Paper are preliminary in nature, providing useful starting points for consideration of how to approach the Council's policy concerns.

While the term financial market infrastructure (FMI) is a useful general rubric, there are quite distinct issues raised in the paper that are not common across trading, clearing and settlement and guarantee fund infrastructure. Accordingly, our responses do not follow the format of the Consultation Paper but are arranged in a way which is consistent with the framework and language of the Parts 7.2 and 7.3 of the Corporations Act.

This response to the Consultation Paper provides a, by no means exhaustive or final, set of views on where more work needs to be done after the short consultation period. In summary these are:

Framework

- Clearly distinguish issues and proposals in relation to their either Clearing and Settlement facilities (CS facilities) or Markets.
- Systemic risk concerns only apply to CS facilities.
- Further policy work needs to be undertaken and proposals need to be developed to clearly outline to the regulators what their responsibilities would be with regard to the supervision and assessment of the solvency of CS facilities.
- If CS facilities are to be made subject to aspects of prudential supervision, consideration will need to be given to how responsibilities are to be allocated among regulators.
- Consideration in this policy analysis needs to be directed to administrative efficiency.

Statutory Manager - Orderly Resolution Arrangements

- AFMA supports the general proposition that Australia should have regulatory arrangements for the orderly resolution of a failed CS facility that is compatible with a yet to be developed international resolution framework for central counterparties (CCPs).
- The statutory manager regime is not relevant to markets.
- A statutory manager arrangement is suitable to an insolvency under the normal Corporations Act, as it would give a more orderly wind-down of business.

- The creation of a new statutory manager regime for CS facilities would have implications that need to be thought through in much greater depth than is permitted by the current consultation, such as with contract cancellation/suspension and close-out netting. AFMA members have not had the time to explore what all the implications may be.
- Regarding the allocation of losses, a statutory manager regime must not allow for uncapped liabilities in a way which is incompatible for Authorised Deposit-taking Institutions (ADIs) under prudential standards.

Client Account Segregation and Portability

- Ensuring the effectiveness of segregation and portability provisions and mechanisms is a substantial challenge and Australian policy work on this issue should be progressed taking into account the work on this area in the United States and Europe in pursuit of the goal of achieving a reasonable level of global consistency.

Location Requirement

- Regulation should strive to ensure that the risk-management design of a CS facility is robust, but should otherwise refrain from inhibiting market forces determining where and which CS facilities prevail in the market place.
- Regulation around use of infrastructure needs to be directed at problem-solving and avoidance of conflicts and unnecessary burdens. The G-20's goal of addressing key systemic risk issues cannot be met without effective international coordination on FMI.

Identifying Systemic Importance

- A robust set of criteria should be developed for identifying systemically important CS facilities to provide clear guidance to regulators, CS facility providers and market participants so as to promote certainty. This requires further policy work and consultation with stakeholders to be carried out to develop appropriate criteria and arrangements.

National Guarantee Fund

- In an environment of market competition the administration of the National Guarantee Fund (NGF) should be demonstrably separated from close ties to one market operator, with all market operators being put on an equal footing in respect of their relationship to the Securities Exchanges Guarantee Corporation (SEGC).

- Changes to the law affecting the administration of the NGF by the SEGC are warranted to recognise the evolution of the NGF as a compensation fund available to the equity market as a whole.

Consideration of the Competition Aspects of Clearing and Settlement

- AFMA welcomes the invitation of the Working Group to the Australian Competition and Consumer Commission (ACCC) to develop analysis on competition aspects of clearing and settlement.

Overall, AFMA considers the range of issues and regulatory concerns in relation to FMI merit significantly more policy work. The implications of some of the proposed changes could have great impact on the operation of the markets in Australia and need to be carefully thought through. Change in this area needs to be measured and fully developed to avoid damaging confusion and uncertainty for both regulators and market stakeholders. The Consultation Paper provides the starting point for an analytical journey, the intended destination for which should be genuine enhancement of the regulatory system, not adversely disruptive change. AFMA stands ready to be an active participant making a positive contribution to the success of the journey.

2. Clearing and Settlement Facilities

2.1. Regulatory Framework Issues

The paper seeks to address issues that include the adequacy of oversight, powers of direction and crisis management arrangements for markets and CS facilities. Particular reference is made to the adequacy of regulatory powers to ensure the smooth operations of Australian financial markets and CS facilities in all market conditions.

The ministerial referral sought advice on issues of fundamental importance to the financial system. In response, the paper makes out an implicit case for treating CS facilities of systemic importance as if they were prudentially regulated entities by introducing a statutory management regime.

In terms of our current regulatory framework, ASIC does not have the authority to act as a prudential regulator, as the specialist skills, regulatory tools and powers are provided with APRA and the RBA has the skills and knowledge to deal with issues relating to systemic stability.

In considering changes to the level of regulation required, heed should be paid to the structural framework in which these proposals will be operating and how and which regulators should be equipped with the appropriate regulatory tool kits.

The case for prudential regulation is based on the pursuit of financial system safety articulated under the Wallis framework which is that the consequences of financial contracts not being honoured can be particularly severe if the contagion of financial failure becomes systemic.

A key theme of the Wallis Report was that the extent of regulatory intervention to address a particular concern should be proportional to the risks and costs of intervening. This is reflected, for example, in the Report's approach to regulating for financial safety:

> '… the Inquiry considers that the intensity of financial safety regulation should be proportional to the intensity of financial promises'.[1]

Prudential regulation aims to ensure that, under all reasonable circumstances, financial promises made by regulated entities are met within stable, efficient and competitive financial markets. It also aims at ensuring that the quality of a financial institution's systems for identifying, measuring and managing the various risks in its business act to reduce the risk of failure and that, where failure does occur, public confidence in the financial system is maintained while the failure is appropriately managed.

The proposals in their current form create a high level of administrative ambiguity which needs to be resolved. A failure to create such a framework will create an environment ripe for administrative confusion and delay at a time of crisis. A statutory manager regime requires prudential regulation capability. At present, ASIC is not designed and equipped to act as prudential regulator and the RBA has a restricted role in the oversight of CS facilities.

AFMA View

- Further policy work needs to be undertaken and proposals need to be developed to clearly outline to the regulators what their responsibilities would be with regard to the supervision and assessment of the solvency of CS facilities.
- If CS facilities are to be made subject to aspects of prudential supervision, consideration will need to be given to how responsibilities are to be allocated among regulators. For example, would the RBA be better equipped to make a judgment about the installation of a statutory manager than ASIC for CS facilities, or should APRA be involved in the oversight of CS facilities.
- Consideration in this policy analysis needs to be directed to administrative efficiency. An increase in the cost of regulation flowing from these changes is unacceptable.

[1] Financial System Inquiry (Wallis Committee) (1997).

2.2. Step-in-Powers

11. Do you have comments on the proposal that either ASIC (in the case of an AML) or RBA (in the case of a CSFL) in consultation with the Treasurer could make the appointment of a statutory manager?

12. Do you have comments on the proposal that the relevant appointing agency should be able to appoint itself or a third party entity such as an individual, a professional services firm, or a company, to step in and take over the operators of a systemically important FMI?

13. Do you have comments on the proposal that criteria identified in 8.1.3 are appropriate triggers for appointment of a statutory manager? Are there other criteria that should be considered? If so why?

AFMA View

AFMA supports the general proposition that Australia should have regulatory arrangements for the orderly resolution of a failed CS facility that is compatible with a yet to be developed international resolution framework for CCPs.

The creation of a new statutory manager regime for CS facilities would have implications that need to be thought through in much greater depth than is permitted by the current consultation. AFMA members have not had the time to explore what all these implications may be.

2.2.1. Contract Cancellation/Suspension & Close-out Netting

14. Do you have comments on the proposed powers to be exercised by a statutory manager of an FMI and the proposed powers of the appointing regulator in relation to the statutory manager that are set out in Section 8.1.4?

Among the proposed powers of the statutory manager is the ability to suspend or cancel obligations and cancel securities and other financial products. Such a power goes beyond the ability of a statutory manager appointed under the Banking Act, who cannot cancel contracts to which an ADI is a party. A statutory manager cannot be permitted to pick and choose which close-out contracts to cancel or suspend depending on whether they would result in a loss to the CS facility.

It is important that a statutory manager must give a notice in respect of all close-out netting contracts. Allowing the statutory manager to choose which contracts are to be closed out runs contrary to the fundamental concept of close-out netting.

The *Payments System and Netting Act 1998* (PS&N Act) is a critical component of the financial system framework. It was decided in 1998 that enactment of legislation to

clarify a number of issues arising in netting financial market transactions was necessary to put them beyond legal doubt. This is important because of the often high value of transactions cleared and settled through CS facilities which are subject to netting arrangements, and the potentially disruptive consequences of adverse rulings by the courts. The PS&N Act minimises risks associated with participating in multilateral netting in the payments system and the performance of certain large financial transactions involving netting systems.

Section 14 of the PS&N Act generally preserves the validity of the netting provisions in a contract. Subsection 14(2) preserves the validity of close-out netting contracts on the external administration of a party to a contract where Australian law governs either the external administration or the contract. The exclusion of an obligation acquired from another person with notice that the other person was insolvent is intended to prevent a party to a close-out netting contract from buying in debts with a view to setting them off against its obligations under the netting contract where the counterparty is insolvent (subsection 14(3)). Subsection 14(4) ensures that subsections 14(1) (2) and (3), as described above, apply 'despite any law'.

It is important that the introduction of a statutory manager does no harm to the validity of netting provisions. This is an issue of particular importance to CS facility resolution arrangements.

It is noted that the Government has been consulting on remedial legislation through the Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011 to deal with the problems caused by the passage of the *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008*. In this regard we have commented that AFMA does not support the ability of a statutory manager to extend the stay period beyond 48 hours. The only circumstance where a statutory manager should have the ability to do this is where a reputable entity agrees to stand behind the obligations of an FMI if the period is extended.

The unfettered discretion of the statutory manager to extend the period leaves too much uncertainty in the outcome which may well make it less desirable to do business with Australian banks and insurance companies. Other key jurisdictions do not leave this degree of uncertainty in their bank failure resolution schemes.

2.2.2. Allocation of Losses

15. Do you have comments on the proposal that the Banking Act model of interaction with insolvency law, as set out in Section 8.1.5, be applied to FMIs?

Application of the normal insolvency provisions of the Corporations Act in a liquidation process is problematic when it is applied to a CS facility because it leads to a rapid sale

of assets. Any resolution involves the distribution of losses but these losses are generally much smaller under orderly resolution than under disorderly liquidation.

Consideration of resolution arrangements also needs to take into account the interaction that could occur between a CS facility and a failed clearing participant.

The Financial Stability Board (FSB) has noted that a resolution authority should have the powers and tools to meet the following key objectives:

- to preserve those of the SIFI's operations that provide vital services to the financial system and the wider economy, which would cause system-wide damage if lost;
- to avoid unnecessary loss in value of financial assets and contagion (direct and indirect) to other parts of the financial system; and
- to ensure that losses are borne by those with whom the risks properly reside – first shareholders, and unsecured and uninsured creditors – rather than taxpayers.

The resolution regime needs to credibly be able to achieve these objectives if financial stability is to be protected and market discipline and incentives are to operate effectively.

The interaction of the APRA ADI prudential standards with resolution arrangements needs to be developed to deal with circumstances where a bank is a clearing house member. CS facility default waterfalls that would allow for uncapped liability are not compatible with prudential standards.

Consideration needs to be given to providing for a capped liability structure so that clearing house members can measure and manage their risks to the CS facility. Only a capped liability structure can provide each member with the ability and incentives to manage its counterparty exposure to other members of the CS facility and the CS facility itself. In the event that a CS facility's total financial resources are depleted, clearing members should not be subject to a legal obligation to finance the CS facility with unlimited liability.

A capped liability default management structure that limits potential clearing members' losses in a way that can be measured and managed is desirable. Non-defaulting clearing members should only be exposed to losses which they can anticipate and for which they have the means and incentive to control. The tools to manage the risk that a CS facility in particular, has to its members should be under the control of the CS facility.

Uncapped liability of clearing members introduces systemic risk and potential moral hazard, as the CS facility resources are only limited by the total capital and resources of

all the members. Uncapped liability across a member group of large financial institutions in a crisis scenario would result in systemic risk by increasing the likelihood of a cascading series of defaults across multiple members.

In the case of a CS facility, exposure of non-defaulting clearing members to guarantee fund assessments by the CS facility should be capped for both a single default and a series of defaults that occur during a pre-defined number of days, with the day count rolling from the day of the most recent default, until a full period expires without the occurrence of a default. This aims at capturing all defaults related to one systemic crisis and subjects the sequential defaults to the same overall cap.

16. Do you have comments on the proposal that the statutory manager should be obliged to operate in the best interest of overall financial system stability and/or market integrity?

While as a general principle this is a reasonable idea, further thought needs to be given to the kinds of conflicts of duties this may create for a statutory manager and how they might be resolved.

2.3. Client Account Segregation and Portability in a CS Failure

19. Do you agree that the insolvency provisions of the Corporations Act should be amended to allow for timely portability of segregated client accounts in the best interests of financial system stability and market integrity?

The consultations of the CPSS-IOSCO on principles for FMI include new principles on segregation and portability, tiered participation and general business risk. In the consultation the proposed Principle 14 on segregation and portability is applicable. The substantially new principle recommends that CCPs should have segregation and portability arrangements that protect customer positions and collateral, to the extent practicable and where feasible and supported by the legal framework. This qualifying language recognises that there may be market structure or legal impediments to a CS facility facilitating segregation and portability in the cash markets.

The principle is designed to offer CS facilities flexibility in achieving segregation of customer collateral and identifies the advantages and disadvantages associated with the use of omnibus and individual accounts. The principle also provides expanded guidance on the way that margin is collected (gross or net basis) by the CS facility and explains how different levels of customer protection can be achieved. While the principle presents options, the overall objective is to protect customer positions and collateral, particularly in the case of insolvency of a participant.

It is recognised that the segregation of clients' positions and collateral can play an important part in the safe and effective holding and transfer of their assets. Effective

segregation arrangements can reduce the impact of a clearing participant's insolvency on its customers.

There are a number of ways that margin can be segregated depending on how the margin is posted and held and the segregation in place in a given situation. There are variables in margin posting that need to be taken into account, such as whether a CS facility collects margin from clearing participants on a gross basis or on a net basis. An important consideration in how margin is held is the degree to which the margin is commingled with other assets and where the margin is held. Customer assets may be segregated from the clearing participant's proprietary assets in an omnibus or on an individual client basis. Margin may be held at the CS facility (in the client's name or in the clearing participant's name), with the clearing participant, or at a third-party custodian. In a situation where margin is posted by the client on a gross basis, but collected by the CS facility on a net basis, it is possible that client margin is held at both the CS facility and the clearing participant. The choice of arrangements can be critical in relation to whether customer positions and related margin are likely to be successfully ported. The prevailing view has been that market participants should have freedom to contract on segregation and portability, as opposed to this being rigidly prescribed through regulation.

It is noted that the Basel Committee in its consultative document on "Capitalization of bank exposures to central counterparties", proposed a favourable treatment for "bankruptcy-remote" collateral for direct participants as well as a favourable qualifying CS facility risk weight for non-member banks' exposures, provided their assets were segregated and bankruptcy-remote from the direct participants. Accordingly, in respect of a particular CS facility the need for rules would depend upon how bankruptcy-remote the CS facility is.

The model selected for segregation of assets and margins should be judged from the standpoint of how well it protects the positions of indirect clearing participants on their request, allows an expedite portability, and provides full transparency to the participants on their exposures. It is a common requirement of CS facilities for the clearing participant to guarantee performance by the client to the clearing house. The clearing participant takes on credit risk towards the client, and for that reason the clearing participant must apply credit limits to manage the extent of their exposure to clients. Clearing participants do not guarantee performance by the CS facility to the client. The rationale for this approach is that the client should look to the legal segregation framework and the financial guarantees package of the CS facility rather than to the clearing participant in conducting their counterparty risk assessment.

Typically clearing provides clients with the ability to port or transfer positions without consent to transfer being required of the outgoing clearing participant, which will enable a client to address possible concerns with the financial stability of their clearing

participant, provided that they are able to find a suitable substitute clearing participant. If a client leaves any residual positions with the outgoing clearing participant they may be required to provide adequate collateral because the outgoing clearing participant continues to be exposed to the CS facility for performance by the client for those positions.

Ensuring the effectiveness of segregation and portability provisions and mechanisms is a substantial challenge and work in these areas continues in the United States and the European Union. Consideration should be paid to ensuring that Australian rules are consistent with those in other major jurisdictions.

AFMA View

AFMA considers that the examination of segregation as it relates to portability of accounts with a CS facility should be treated as a distinct issue to the parallel consultations being conducted by the Treasury through the discussion paper on the handling and use of client money in relation to retail over-the-counter derivatives transactions.

Ensuring the effectiveness of segregation and portability provisions and mechanisms is a substantial challenge and Australian policy work on this issue should be progressed taking into account the work on this area in the United States and Europe in pursuit of the goal of achieving a reasonable level of global consistency.

2.4. Location Requirements for CS Facilities

3. Do you have comments on the proposed mechanism to allow for the power to impose location requirements?

It is important to ensure that a CS facility is independently managed and there is no conflict of interest or exposure to these activities from a broader based FMI business of which it forms a part and that the CS facility has dedicated resources to manage its clearing activities, which is particularly important in the event of a default.

There is increasing apprehension that regulation in different G-20 jurisdictions may be creating conditions which will lead to fragmentation of markets, protectionism, and regulatory arbitrage, ultimately decreasing the ability of global regulators to effectively regulate an increasingly global capital marketplace. Different jurisdictions are enacting changes in a way that creates an uneven playing field and whether differences in approaches to regulation could give rise to competitive imbalances and/or regulatory arbitrage opportunities between different jurisdictions is becoming a real concern. Even differences that may appear relatively minor can in practice give rise to major problems and therefore be a significant hurdle to meeting the G-20 objectives.

This issue is currently especially acute in relation to derivatives FMI. Major jurisdictions are creating rules which are ambiguous and which create problematic extra-territorial challenges and issues of legal uncertainty and misunderstanding which might give rise to material risk. Key jurisdictions seek to have at least some extraterritorial effect in relation to their regulations relating to derivatives.

Banks and other financial institutions that undertake significant cross-border activities are particularly concerned that they may be subject to overlapping regulatory requirements in different jurisdictions and may need to comply with two or more different regimes. Areas of concern include duplication of registration and licensing requirements, clearing obligations, transaction and position reporting, collateral and margining requirements, and prudential obligations. There is also the possibility that it may be impossible for an institution to comply with conflicting requirements in different jurisdictions. Even where compliance with two or more overlapping requirements is possible, this is likely to lead to additional administrative and compliance costs.

The effect of such regulation is to cause competitive imbalances in the international markets with market participants structuring their businesses and making decisions in relation to dealings in particular jurisdictions or with particular counterparties based on regulatory considerations rather than normal commercial grounds. The effect of such imbalances is also likely to have an impact on counterparty and ultimately client choice and lead to increased costs. If differences are material, many firms are likely to gravitate away from an integrated global approach to business and structure their businesses around specific products with local counterparties in the relevant jurisdiction.

Regulation around use of infrastructure needs to be directed at problem-solving and avoidance of conflicts and unnecessary burdens. The G-20's goal of addressing key systemic risk issues cannot be met without effective international coordination on FMI. The push by multiple jurisdictions to require certain types of CS facility FMIs to be located in their jurisdiction could result in multiple, under-scaled or under-diversified CS facilities. Several major jurisdictions have already made it clear that they will require products traded in them, or by firms located in them, to be cleared there. Jurisdictional fragmentation will inhibit the full realisation of scale and scope economies. The existence of multiple CS facilities domiciled in various jurisdictions has several adverse consequences, and measures to address them can pose systemic risks and regulatory challenges. If the same product is cleared in CS facilities in multiple jurisdictions, position netting opportunities will be foregone, thereby reducing the efficiency of capital utilisation and increasing the costs and risks of position replacement in the event of default.

Importantly, consideration needs to be given to the views of the FSB which has pointed out that cross-border resolution is impeded by major differences in national resolution regimes, absence of mutual recognition to give effect to resolution measures across

borders, and lack of planning for handling stress and resolution. The complexity and integrated nature of many firms' group structures and operations, with multiple legal entities spanning national borders and business lines, make rapid and orderly resolutions of these institutions under current regimes virtually impossible. Legislative changes are likely to be needed in many jurisdictions to ensure that resolution authorities have resolution powers with regard to all financial institutions operating in their jurisdictions, including the local branch operations of foreign institutions. Cross-border cooperation and effective pre-planning of resolutions will be difficult if not impossible if the authority over failed institutions resides with the courts. As part of its statutory objectives, the resolution authority should duly consider the potential impact of its resolution actions on financial stability in other jurisdictions. It should have the legal capacity to cooperate and coordinate effectively with foreign resolution authorities, to exchange information in normal times and in crisis, and to draw up and implement recovery and resolution plans and cooperation agreements on an institution specific basis.

AFMA View

In broad terms, regulation should strive to ensure that the risk-management design of a CS facility is robust, but should otherwise refrain from inhibiting market forces determining where and which CS facilities prevail in the market place.

Regulation around use of infrastructure needs to be directed at problem-solving and avoidance of conflicts and unnecessary burdens. The G-20's goal of addressing key systemic risk issues cannot be met without effective international coordination on FMI.

2.5. Identifying Systemic Importance

2. Do you have comments on the flexible graduated approach for systemically important FMIs?

FMI providers and market participants require a level of certainty for their long term business planning. The current proposal may encourage an exodus of business from Australia by market participants as long term decision making about which FMI to use is simpler and more certain if default and margin fund location requirements are predictable. The proposed flexible arrangements have the potential to detrimentally disrupt business arrangements and plans.

This is an area where regulator discretion needs to be strictly managed to avoid the dangers of uncontrolled regulatory creep, excessive rule making and arbitrary decision making.

18. Do you have comments on the proposed criteria for designation of systemically

important FMIs in Section 9.1.2? Are there other criteria you consider important. If so why

The Consultation Paper's lack of clear streams of analysis for FMI which are either markets or CS facilities is particularly problematic when it comes to a discussion over systemic significance and how it is to be identified.

The Australian regulatory framework has clear delineation between market integrity, prudential and systemic oversight. The regulatory framework recognises that systemic risk can arise from an event that leads to the breakdown of a payment, settlement, or clearing system. This type of regulation focuses on the robustness of the system as a whole when something goes wrong. There is a broad recognition that CS facility FMI may be systemically important as reflected by the global discussion on CCP regulation. Adverse events could potentially include the failure of a major counterparty, clearinghouse, technological disruptions, or fraud, any of which might disrupt timely payments to a large number of financial market participants. On the other hand, it is a highly debateable proposition that market FMI can really pose systemic risk to the financial system. Markets which in essence as we understand them in the terms of Chapter 7.2 of the Corporations Act are not systemically important as disruptions to their activities or their failure may affect market integrity and adversely curtail activity by participants to their commercial disadvantage in the short term are not in and of themselves a source of systemic risk.

The focus on how to effectively assess in more rigorous quantitative terms the systemic risk that a CS facility poses is a recent development and starts with the work in this area with banking institutions. The FSB released for consultation recommendations for an "effective resolution of systemically important financial institutions". Although the document primarily discusses how resolution regimes can be made more effective, it also contains some valuable thoughts on resolvability assessment. To this end it said that including resolvability as an overriding criterion in the assessment methodology would minimise competitive and other distortions and help align incentives with the aim of reducing moral hazard and increasing systemic stability overall. To this end, qualitative and quantitative factors should be considered which determine the likelihood that the institution would be resolved or restructured in an orderly procedure if it were to fail. Based on the FSB's proposed "resolvability assessment", the firm's structure and operations, its management information systems as well as national resolution regimes and tools should be considered.

It is important for the law to lay down a clear framework and AFMA considers that assessment procedure should have clear criteria for identifying systemically important CS facility FMI that relies more heavily on objective quantitative measures than qualitative indicators. A systemically significant CS facility derives its importance first

and foremost from the essential and irreplaceable functions it fulfils for a significant number of other agents.

Various types of financial exposures are being quantified and differing methodologies form part of the factors involved in the identification of a systemically important CS facility:

- Loss sharing formulas and worst case scenarios can be reviewed, assessed and estimated.
- Current exposure and potential exposure based on open transactions as calculated and reported.
- Membership related exposures for all businesses sponsoring the CS facility can be calculated. The types of financial exposures quantified include margin (customer and house), collateral, guarantee fund deposits, pre-funding, loss sharing obligations, pre-settlement exposure (when the CS facility is the counterparty) and certain forced credit extensions associated with clearing participant membership. The methodology is to reflect actual outstandings for all categories except for loss sharing, where participant default scenarios are used to estimate exposures to loss sharing in extreme events.
- Risk mitigation controls are based on close monitoring of net settlement exposure to counterparties taking into account the short-term funding position, collateral amount, marketable securities, unused balances of borrowing limits, and other factors.
- Measurement of the potential for loss with respect to margin or capital at risk. This can also take into account loss sharing among members and back up credit facilities.

Beyond these indicators it is recognised that there is no consistent globally accepted theory for the identification of systemically important FMI. Instead there are a number of methodological and empirical concepts that coexist in a loose manner. The question which arises in this context is to what extent are methodologies and tools developed for banking relevant to assessing the systemic risk of CS facilities.

The dividing line between prudential and systemic regulation commonly distinguishes between whether there are idiosyncratic or systematic triggering events. An idiosyncratic shock occurs when the initial shock affects only the health of a single element of the financial system. Systematic shocks simultaneously affect a greater number of players at the same time or the entire financial system, in an extreme case. The triggering shock may cause second-round effects, which in extreme cases may cause institutions that were solvent before the shock to fail. The shock may spill over to the real economy. Systemic risk usually refers to financial shocks which are likely to be serious enough to damage the real economy as the shock causes a contraction of credit

or when the shock is associated with significant loss of financial wealth both to businesses and households. Contagion goes to the core of identifying systemic risk.

A distinction should be made between real and information contagion channels. Contagion through the real channel refers to the direct flow through effects on other parts of the financial system through direct exposures (such as counterparty exposures) and interconnections (such as through payment systems). In addition to contagion through direct exposures, contagion may spread through the information channel. Contagion through the information channel occurs when economic agents (including counterparties, investors, and depositors) change their behaviour in response to a particular event. While the intensity and direction of contagion effects as a result of direct exposures and interconnections can in principle be assessed beforehand, contagion through the information channel is much more difficult to predict. The possibility of real contagion is crucial to making assessments about the systemic significance of CS facilities.

Some of the indicators on which real contagion risk can be assessed are:

- Volume and value of pending transactions. A key factor in assessing the potential for a CS facility to trigger or transmit systemic disruptions is the volume and value of transactions that the particular system processes - either in aggregate or individually - relative to the resources of the system's participants and in the context of the financial system more generally. The extent of potential damage may be aggravated by long expected recovery times and lack of back-up systems.
- Critical dependency of other systems and/or markets. In assessing the extent to which the proper functioning of the financial system is impaired consideration can be given to whether the CS facility is used to settle other financial market transactions or payments.
- Risk mitigants - These include the presence of readily available back-up systems, the use of collateral, guarantees, netting and default waterfalls.

A real contagion risk assessment draws heavily on microprudential assessment techniques for which APRA is equipped to deal with. This approach tends to see widespread financial distress as arising primarily from the failure of individual institutions. The failure then spreads, through a variety of contagion mechanisms, to the financial system more generally. The assessment examines the possible fallout for the rest of the system. This microprudential approach tends to treat risk as endogenous in terms of the amplification mechanisms, but not with respect to the original shock, which is seen as exogenous.

This often goes hand in hand with a rather static view of instability. In other words, for a variety of reasons, the financial system is seen as initially vulnerable; suddenly, a shock

occurs, which is then amplified by the endogenous response of market participants. If losses to a particular institution are large – relative to overall losses – such an institution will be viewed as systemically relevant. Participation in a systemic event is determined by the expected loss the institution is likely to cause to traders. The logic behind this approach runs that when a financial institution fails, it defaults on its liabilities and/or triggers asset fire sales. The ensuing losses to the rest of the financial system through first, second or third round effects will be regarded as the institution's contribution to systemic risk. Third round effects relate to spill-over stemming from uncertainty or reassessment of financial risk; whereas first and second round effects arise from direct and indirect exposure to the failing institution. A financial institution's contribution to systemic risk is generally reflected in its liabilities to the rest of the system, i.e. to other financial institutions, and in its possible impact on asset and credit markets.

From an analytical perspective, the microprudential approach which looks to the marginal distress caused by the institution failing is well suited to determining systemic relevance of individual institutions. It can be used to identify those institutions that create negative externalities and contribute more strongly to system-wide risk. In practice this approach places little weight on the factors underlying the build-up of the vulnerability in the first place. It assumes that an unexpected large shock hits the financial system and then considers to which extent a particular institution participates in a systemic event that follows suit. However, the global debate around CCP systemic risk assessments which is directly relevant to CS facilities looks to systemic risk that arises primarily through common exposures to macroeconomic risk factors across market participants. It is this type of financial distress that carries the more significant and longer-lasting real costs. And it is this type that underlies the current ongoing crisis.

Performing a systemic risk assessment without clearly articulated analytical foundations makes it difficult for those trying to determine whether intervention is required much more difficult when facing the challenges posed by a financial crisis, including acute time pressure and incomplete information.

AFMA View

A robust set of criteria should be developed for identifying systemically important CS facilities to provide clear guidance to regulators, CS facility providers and market participants so as to promote certainty. This requires further policy work and consultation with stakeholders to be carried out to develop appropriate criteria and arrangements.

2.6. Fit and Proper & Directors' Duties

4. Do you agree with the proposed power of pre approval of directors of FMIs and their parent entities? Are there alternative approaches you consider more appropriate? If so,

why?

5. Do you agree with the adoption of a fit and proper standard similar to that in the Banking Act?

If the Government decides that CS facilities should be subject to prudential regulation it is consistent with this approach to develop a fit and proper standard to minimise the risks that persons who do not have appropriate skills, experience and integrity might hold senior management positions.

If a director is to be subject to removal from their position as director because the regulator is satisfied that the person does not meet one or more of the fit and proper criteria set out in the prudential standards the potentially serious implications for that person's career must be considered. It is important that a prudential standard contains strong natural justice safeguards for individuals whose fitness and propriety is under question. For instance, a person must be protected from mischievous, malicious or unfounded allegations that might be considered as grounds for disqualification by the regulator without being properly tested. One of the most effective ways to achieve this would be to focus on objective tests that limit the element of interpretation.

Fit and proper criteria in a prudential standard need to carefully designed to ensure they are amenable to practical implementation with a high degree of certainty. To achieve the desired policy outcome a fit and proper prudential standard must be couched in terms wide enough to reliably determine a person's fitness and propriety. A principles based approach should be adopted for a fit and proper standard consistent with the approach adopted by APRA under the Banking Act.

Under the Corporations Act the prime responsibility for ensuring that a body corporate's responsible persons are fit and proper remains with the Board of directors or, in the case of a foreign authorised deposit-taking institution as defined under the Banking Act 1959, with the senior officer outside Australia with delegated authority from the Board. Further thought needs to be given to dealing with the idea pre approval of directors of offshore parent entities as it does not appear to be a practical idea.

3. Markets Regulation

It is noted earlier on that markets and CS facilities are quite distinct when it comes to questions of systemic and prudential regulation. The regulatory concerns surrounding systemic risk are not relevant to the discussion of markets as understood under Part 7.2 of the Corporations Act.

AFMA has been of the long standing view that the regulation of markets under Part 7.2 merits policy review for a number of reasons. There are significant problems with the

one size fits all market licensing regime which is being overtaken by rapid technological change and the increasing diversity in trade execution facilities which results in unfair and inappropriate outcomes for different types of markets. We share ASIC's concerns that it needs to be given appropriate regulatory tools and powers to deal with market providers. Such a review of the regulatory framework should go hand in hand with the proposed policy review work on competition and market governance.

3.1. Listing Rules

6. Do you have comments on the proposal that ASIC be given an explicit power to direct a licensed market operator to make listing rules with specified content, with the consent of the Minister, where the making of that rule is appropriate for the enhancement and/or protection of market integrity?

Responding to this question takes us back to the view that more thought needs to be given to the regulatory framework before embarking on reform. The issue raised should be considered, however, the proposal is a curiously isolated one in the context of the paper as a whole and the discussion leading into it is cast in narrow terms. There needs to be a more coherent approach to such reform.

AFMA has consistently argued for a basic policy review of the market licensing provisions over recent years in Part 7.2 of the Corporations Act that should have served as a foundation and guide to market competition reforms of which this forms part and other responses to technological change and global coordination. A more in depth policy discussion could form part of the review work on competition and governance discussed elsewhere in this response.

AFMA View

AFMA considers that further policy work needs to be done on this statutory problem. The discussion on this subject in the paper is only cursory and the analysis of the problem and assessment of the regulatory impact of any changes to current arrangements needs to be developed further. The merits of the current proposal should also be considered in depth against other possible options which only receive passing reference in the paper.

4. National Guarantee Fund

4.1. NGF Background

20. Do you see any areas in which the governance of the NGF, or other arrangements under Part 7.5 could be improved?

The States that were parties to the Interstate Corporate Affairs Agreement enacted the Securities Industry Act 1975 (the 1975 Act) which required each stock exchange to establish a fidelity fund. In the case of exchanges that did not have a fund established under the 1970 Act, an amount of $100,000 was required.

The 1975 Act required that:

- a person could only be admitted as a member of a stock exchange if he had made a contribution to the fidelity fund of the stock exchange of not less than $500;
- the fidelity fund of a stock exchange be applied to compensate persons who suffered pecuniary loss by reason of a defalcation, or fraudulent misuse of money, securities or of other property by a member of the exchange (or its employees) where that property had been received in connection with the firm's business of dealing in securities.

In addition, the fidelity fund of a stock exchange could be applied to pay an official receiver or a trustee the amount required to make up or reduce the total deficiency arising because the available assets of a bankrupt member were insufficient to satisfy the debts arising from dealings in securities that have been proved in the bankruptcy.

The Act also provided that the stock exchange could impose a levy on each contributor if the fidelity fund became insufficient.

These provisions were largely replicated in the subsequent Securities Industry Act 1980 (which applied in all States and Territories by virtue of the Co-operative Scheme which existed through the 1980s). They are the antecedents of the provisions in the current Corporations Act.

When the six State stock exchanges merged in 1987 to form the national ASX, the assets of the fidelity funds of those State exchanges were also merged to form the NGF. Up until March 2005, SEGC provided investor compensation and clearing and settlement support. On 31 March 2005, the NGF was split by a payment out of the NGF to ASX Clear which then assumed sole responsibility for clearing counterparty risk. As a result, the NGF now only covers investor compensation in relation to the ASX.

4.2. NGF is a Public Good

The evolution of the NGF illustrates how over time the fund underlying compensation arrangements for equities broking has assumed the character of a public good. It exists for the benefit of investors to protect them for losses caused by participants. In an environment of market competition the administration of the NGF should be demonstrably separated from close ties to one market operator, with all market

operators being put on an equal footing in respect of their relationship to the SEGC. Accordingly, changes to the law affecting the administration of the NGF by the SEGC are warranted to recognise the evolution of the NGF as a compensation fund available to the equity market as a whole.

While agreeing with the importance of perceived independence for the administration of the NGF, AFMA does not agree with the statement in section 11.2 of the paper that "the acquisition of a market which controls the NGF or Div 3 compensation arrangements" as being a correct reading of the operation of Part 7.5 of the Corporations Act. Part 7.5 does not give control of the NGF to a market as a matter of law. It is important to understand this as it affects the amount of amendment to Subdivision D of Part 7.5 that may be considered desirable. In practice it is possible for a market licensee to have too much influence on the corporate governance of the SEGC if it is the only member and we make a proposal to deal with this issue.

4.3. SEGC Reform Proposals

The following changes to the law affecting the SEGC are proposed.

4.3.1. SEGC Board Composition

At present Part 7.5 is silent about the corporate governance arrangements for the SEGC. As a body corporate administrating an open access compensation fund it would be desirable for greater government involvement in deciding upon the composition of the SEGC Board.

Proposal - It is proposed that the Government nominate one member of the SEGC Board and that ministerial approval be required for the appointment of other board members taking into account the desirability for an appropriate mix of stakeholder representation, which includes market licensees and participants.

4.3.2. Equal Treatment of Market Licensees

In an environment of market competition it is inappropriate for particular market licensees to be given special mention in the law, with regard to rules about financial market infrastructure.

Proposal - Subparagraph 890A(3) (a) should be deleted to remove the express reference to the ASX Limited and subparagraph (b) modified consequently to say "each member of the body corporate is a market licensee;"

4.3.3. Oversight of Operating Rules

The current provisions of Part 7.5 provide an effective statutory framework to support the administration by a body corporate nominated to be the SEGC. However, the provisions dealing with the SEGC parallel those for market licencees through a ministerial disallowance mechanism in a way which is no longer necessary in relation to a body that exists purely to serve investor protection needs under statutory rules.

Proposal - It is proposed that sections 890G and 890H be replaced by a simpler oversight process which allows ASIC to approve changes to the SEGC operating rules.

4.3.4. Use of NGF Funds

The NGF also needs to be protected against inappropriate future usage by the Government.

5. Consideration of the Competition Aspects of Clearing and Settlement

If the provision of clearing and settlement services is operating in a competitive market the default starting assumption is that there is no need for regulatory intervention in the governance of market infrastructure institutions to promote efficiency. All forms of regulatory intervention have direct costs which themselves reduce efficiency. The focus here is on the issue of how to ensure clearing and settlement services are provided in a fair and effective way. In situations where the market participants cannot stop a public utility FMI operating as a monopolist, regulatory intervention in the governance of an FMI can be justified. Regulatory intervention in FMI governance arrangements may be used to promote fairness where the FMI services are not contestable and there is threat to the fair and effective operation of the market because of the monopoly position of the FMI.

Accordingly AFMA welcomes the invitation of the Working Group to the ACCC to develop analysis on competition aspects of clearing and settlement.

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