Council of Financial Regulators: Review of Financial Market Infrastructure Regulation

ASX Submission

23 November 2011

Introduction

This submission outlines the ASX Group's formal response to the Council of Financial Regulators (CoFR) Consultation Paper: *Review of Financial Market Infrastructure Regulation*. ASX appreciates the opportunity to comment on the CoFR proposals and looks forward to working closely with CoFR as the proposals are refined and eventually finalised.

ASX Group notes that the scope of the term "FMI" is taken to be limited to market licensees and clearing and settlement facility licensees.

About ASX Group

ASX Group is a provider of multi-asset class exchange services providing trading, clearing and settlement services. It operates Australia's main equities and derivatives exchange markets and the post-trade processing services in which transactions executed on these markets and alternative market operators trading ASX-listed equities are cleared and settled.

ASX currently operates two CCPs – ASX Clear and ASX Clear (Futures). ASX Clear provides CCP services for a range of financial products traded on the ASX market, including cash equities, pooled investment products, warrants, certain interest rate products and equity and commodity-related derivatives. ASX Clear (Futures) provides CCP services for derivatives traded on the ASX24 market (formerly the Sydney Futures Exchange), including futures and options on interest rate, equity, energy and commodity products.

The ASX Group also has two wholly owned settlement subsidiaries, ASX Settlement and Austraclear. These two settlement facilities provide a delivery versus payment (DvP) settlement service, secure asset holding services as well as a wide network that enables 'straight through processing' to both exchange traded markets (ASX Settlement) and over the counter markets (Austraclear).

ASX Settlement operates the Clearing House Electronic Subregister System (CHESS) which effects the trade settlement for ASX Clear. It does this by transferring the title or legal ownership of the shares while simultaneously facilitating the transfer of money for those shares between participants via their respective banks. CHESS is a Model 3 batch settlement system which reduces settlement exposure and improves operating efficiency by providing multi-lateral netting of settlement positions across all ASX Settlement Participants.

Austraclear is Australia's settlement system and central securities depository (CSD) for the wholesale debt market. Austraclear is a Model 1 Real Time Gross Settlement system which offers a line-by-line, DvP model providing, in real-time, the irrevocable exchange of cash for securities.

ASX is actively looking at extending its CCP services into OTC markets such as equity options and Australian dollar interest rate swaps consistent with the Australian Council of Financial Regulator's discussion paper on Central Clearing of OTC Derivatives in Australia and overseas regulatory changes such as those arising from Dodd-Frank.

Summary

ASX supports the recent review by CoFR and believes that Australia needs a robust regulatory framework which addresses the competing obligations that can arise when FMIs operate, or are part of a group structure operating, across multiple jurisdictions. We also support CoFR's efforts to obtain clearer codification of the powers of Australia's regulators to ensure that:

- FMIs remain adequately resourced; and
- Australian regulators have clearly defined powers in connection with FMIs engaged in markets in financial products or instruments that are systemically important to the Australian economy.

The key comments that ASX has articulated more fully in its response are:

- ASX is largely supportive of the Council's proposals.
- Australian regulatory controls (including domestic location requirements and step-in powers) should extend to all FMI entities, irrespective of size, that are part of a market in financial products or instruments (exchange traded or OTC) deemed systemically important to the Australian economy.
- There should not be a graduated location requirement for FMI entities operating in Australian systemically important markets. Provision though should be made for outsourcing and offshoring arrangements that would be available equally to all FMIs.
- The Corporations Act should clearly set out the circumstances when Australia regulators would intervene with regard to listing rule content.
- Any extension of the power to impose directions and conditions needs to be specific and should set out the circumstances when directions or conditions can be imposed. The Banking Act provides a model for when these types of powers should apply and when directors and officers are liable to penalties and sanctions for non-compliance.
- To give full effect to portability proposals, regulators should consider requiring individual client positions and associated collateral to be segregated and held by a clearing house for systemically important markets (other than cash equity markets because of the high retail client composition and short three day settlement cycle making it impractical).
- If changes are made to the SEGC and NGF governance arrangements, the current ASX collection agency role, in the event that that NGF needs replenishment, should be removed.

ASX would once again like to thank CoFR for the opportunity to comment on this Consultation Paper. We would be happy to discuss any of these issues further and are keen to maintain ongoing contact to assist in any way to explain the impact of the Committee proposals on our markets. If you have any comments or questions, please contact:

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Responses to COFR questions

Section 6: Proposals for strengthening general compliance

6.1. Location requirements

1. Do you have comments on the location requirement proposal?

ASX supports the view that the Australian regulatory regime should, in circumstances which threaten to disrupt systemically important activities in the financial system, be able to resolve distress or adverse events quickly and effectively. Default situations demonstrate the practical challenges in managing events across different jurisdictions.

ASX is of the view that Australian regulatory controls and location requirements should extend to all FMIs that are part of a market in financial products or instruments that are systemically important to the Australian economy. If an FMI services or participates in a systemically important market it has the potential – irrespective of the size of an FMI's operations – to disrupt that market and consequently have systemic risk implications for the Australian economy. For example, a new entrant FMI with a small market share would have the potential to disrupt a systemically important market because of the interconnectedness of trading, clearing and settlement activities. The application of a "graduated approach to the application of the location requirement" will inevitably present challenging judgement calls and implementation issues for Australia's regulators. These challenges are most acute at times of default. Legislative provisions relating to approval processes for a change of operational control for systemically important FMIs (currently only ASX) will also need to be adjusted accordingly.

ASX is supportive of a regulatory level playing field being established between locally based and foreign domiciled FMIs and considers that CoFR should release guidelines for consultation on their approach to exercising their location requirement powers. However, ASX believes that foreign FMIs that seek to service or participate in systemically important Australian markets should be licensed as domestic facilities and subject to direct oversight and regulatory requirements under the Australian regulatory framework.[1]

Location requirements relating to an FMI's operations and infrastructure need to recognise that offshore or outsourcing arrangements can be put in place in a manner that enables regulatory objectives to be met. It is important that Australian location requirements imposed for infrastructure and operations do not cause Australia's domestic licensed FMIs to be uncompetitive either in the Asia-Pacific region or globally. The proposal to extend sanctions to apply to outsourced service providers addresses these matters.

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

ASX considers that the "flexible graduated approach" creates a number of important regulatory issues. Primarily, ASX believes that all FMIs operating in an Australian systemically important market should be subject to the same Australian regulatory controls irrespective of the FMI's size. All such FMI's should have the same location requirements. A "flexible graduated approach" to location requirements also has a number of practical issues:

- What are the actual triggers for a change in systemically important status and how will a decision on this status be made and communicated to financial markets?
- Is it appropriate that multiple FMI's that are individually not deemed systemically important but would be in aggregate are permitted a graduated location requirement?

[1] This is supported by the RBA's comments in its 2010-11 Annual Assessment of CS Facility Licensees (page 11): "However, the Minister may decide that licensing under the alternate regime for overseas facilities is not appropriate – irrespective of sufficient equivalence – and that the facility will require a domestic licence and so be under the direct oversight of the Australian Securities and Investment Commission and the Reserve Bank. For example, where a prospective overseas CS facility is considered to be serving a particularly large or systemically important market in Australia, the Reserve Bank expects to assess the facility in full against the FSS." (emphasis added).

- What are the systemic risk implications of an FMI located offshore becoming systemically important and then deciding not to meet an Australian location requirement?
- What would be the transition period for an offshore FMI locating in Australia once it becomes systemically important. How would the systemic risk in that transition period be managed?
- How would conflicts be resolved where an offshore FMI becomes systemically important in multiple jurisdictions?
- How would the application of different legal regimes be resolved, particularly in default situations?

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

No further comments.

6.2. Pre approval of directors of FMIs and their parents

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?

ASX agrees with the CoFR proposal.

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

ASX agrees with the CoFR proposal.

6.3. Responsibility for making 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?

It is not clear that this proposal is limited to the situation where an important Australian market operator is acquired by a foreign entity.

ASX's listing rules balance the needs of the businesses listed to raise capital to develop their business and the need for investors to have the information to assess their investment decisions with confidence. As a listing venue ASX competes globally and regionally to attract businesses to list and investors to invest.

If ASIC is to be given the power to direct a listing market to alter the content of its listing rules, beyond the powers that are in place today, ASX's view is that, given the potential economic consequences, the circumstances in which this power may be exercised should be clearly set out in the Corporations Act. These circumstances and matters relating to how this power could be exercised should be well articulated. This is important given the impact which these powers could have on the competitive position of Australian licensed listing venues and the commercial interests of entities listed on Australian markets. Any such power should apply to all Australian listing markets and should not be used in a discriminatory manner.

If there is to be a power vested in ASIC to impose obligations directly on listed entities as an overlay to the contractually based listing rules of listing market operators, there should be a comprehensive explanation provided to Australia's corporate sector as to how and when this complementary power will be exercised. Such a framework should also ensure that any regulations flowing from this new power are subject to the Government's best-practice regulatory requirements as well as the disallowance powers of the Parliament. It is not clear that such transparent oversight would apply in the case where the result is achieved through a direction to a market operator to amend its listing rules.

There are a number of areas where public policy considerations have determined that the Corporations Act should impose requirements that go beyond the Listing Rules – eg. executive remuneration, related party transactions and continuous disclosure requirements. ASX considers that ASIC should have the responsibility for monitoring and enforcing compliance with the Corporations Act or rules which it creates pursuant to any such new powers.

Section 7: Proposals for strengthening powers of direction and sanctions

7.3. Applying sanctions to directors and officers

7. Do you have comments on the proposal to extend the power of directions to directors and officers of relevant licensees?

The directions and conditions which invoke these provisions need to be clearly distinguished from general licence obligations.

ASX agrees that the usual protections should be provided for directors when complying with a direction or condition, including that any direction or condition does not conflict with any other obligation or law. Specific direction or condition powers need to be set out so that the circumstances in which they can be given or imposed and the nature of the directions or conditions is clear. The Banking Act sets out specific direction powers which are limited.

Sanctions should only apply, as under the Banking Act, when there is a failure to take reasonable steps to ensure compliance with directions or conditions and when a director's or officer's duties include ensuring compliance with the directions or conditions.

7.4. Applying sanctions to related bodies corporate

8. Do you have comments on the proposal to extend sanctions for failure to take reasonable steps to ensure compliance by the licensed FMI with a direction or condition onto an outsourced service provider, where the service provider is ordinarily (absent the direction) under an obligation to provide critical services to the FMI?

ASX agrees with the CoFR proposal.

7.5. Broadening sanctions for breach of conditions and directions

9. Do you have comments on the proposal that penalties for breach of directions or licence conditions be extended to all directions and conditions imposed by ASIC and the Minister on FMI licensees?

ASX's response to questions 9 and 10 is set out below (Question 10).*10. Do you have comments on the proposal that further sanctions be provided for in the Corporations Act for breach of directions and licence conditions?*

The reference to licence conditions in this context could be confused with general licence obligations. ASX does not believe that this is the CoFR proposal. Our expectation is that the reference is to specific directions or conditions referred to in 7.3.

Penalties and sanctions need to recognise that only reasonable steps can be taken to achieve outcomes and should not be imposed where they would involve a conflict with other duties or laws. The circumstances in which criminal liability can be imposed need, as recognised in the CoFR proposal, to be properly justified.

It is not appropriate for penalties and sanctions to apply in relation to directions or conditions which go to matters which are the subject of the powers of a statutory manager to act.[2] If a CS facility licensee does not comply with such directions or conditions then an appropriate remedy for the regulator is to exercise the step in powers by

[2] Refer page 35, for example the power to recapitalise or alter the capital/ownership structure of an FMI. These are matters that go to a decision as to whether the FMI continues to operate under the governance of those directors and officers.

appointing a statutory manager who will carry out the required actions. This power cannot require an FMI to effect a recapitalisation but can be used to specify the level and timing of recapitalisation required for continued operations under its licence. The same principle applies to the holding company of an FMI.

Section 8: Proposals for step in powers

8.1. Mechanics of step in

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?

ASX agrees with the outlined proposal. However, it is important to note that clearing participants and other external stakeholders (e.g. providers of finance to the clearing companies) may be concerned about the prospect of action being taken by a statutory manager which is contrary to the operating rules. Consideration should be given to whether there may be pre-defined "quarantined matters". This could include, for example, the order of application of clearing default resources or the basis on which contingent default resources may be called up, which a statutory manager cannot change without the requisite level of stakeholder approval.

There is therefore a need to balance between:

- minimisation of disruption and value destruction;
- FMI service continuity[3]; and
- commercial certainty.

ASX also believes that step in powers should exist for both domestic and foreign FMIs operating in Australia in order to create a level FMI regulatory playing field. ASX considers that Australian regulators' ability to enforce this step in power should be agreed to by the foreign FMI applicant and their home regulator as part of their application to operate a clearing or settlement facility in Australia. In the event that a foreign FMI or their home regulator is unwilling to agree to such powers then ASX considers that it is appropriate that as part of the regulatory licence conditions all relevant collateral pools, default funds and operations must be physically located in Australia in order to reduce Australian systemic risk (ASX believes that domestic licensing and location requirements should apply in any case where an FMI is seeking to service a systemically important market given the disruptive effect that failure of any FMI can have if it is connected to any such market.)

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?

ASX agrees with the CoFR proposal.

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?

ASX agrees with the CoFR proposal.

[3] Please see speech by Paul Tucker, Deputy Governor Financial Stability, Bank of England (24 October 2011): "Orderly resolution is what is needed when a CCP is bankrupt, when we all need somehow to avoid the chaos that follows a standard liquidation of assets and closing out of positions. The issue, always, is where do the losses go? The answer cannot be the taxpayer. In the banking sphere, the answer, broadly, is bond holders and other unsecured, uninsured creditors. In the CCP sphere, it is probably the clearing members, as they would be the principal creditors in an insolvent liquidation. The technical issue is how to achieve that in a way that minimises disruption and value destruction and enables essential CCP services to be maintained. This is a key agenda item going forward. It will involve achieving greater clarity in the related area of the optimal 'waterfall' of margin, default fund and CCP own-capital resources in absorbing losses." (emphasis added)

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?

ASX agrees with the CoFR proposal. See comments on question 11 above.

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?

ASX agrees with the CoFR proposal.

8.3 In whose interests should the statutory manager act?

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?

ASX agrees with the CoFR proposal.

8.5 Scope of the step in provisions

17. Do you have comments on the proposal that all FMIs should be subject to step in unless exempted by regulators?

ASX agrees with the CoFR proposal.

Section 9: Identifying systemically important FMIs

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?

If an FMI participates in any systemically important markets then ASX considers that, irrespective of a FMI's size or degree of interconnectedness, it should be considered to be systemically important. ASX believes this is an appropriate position because where a FMI participates in a systemically important market it has the potential – irrespective of the size of its operations – to disrupt that market and therefore to have systemic risk implications for the Australian economy.

ASX considers that CoFR should formulate a list of systemically important markets which is based on the size and economic importance of such markets. ASX considers that the cash equity market in ASX listed securities, the exchange-traded market in options and index derivatives over ASX listed equity securities, the exchange-traded market in A$ interest rate derivatives and the A$ OTC interest rate swap markets should all be considered to be systemically important. There may be smaller specialised markets where, notwithstanding the smaller size of the market, disruption to market operations may have wider implications for the national economy.

Section 10: Client protection through account segregation and portability

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?

ASX supports CoFR's efforts to increase the portability of client positions in the event of a participant default. The recent experience of the MF Global default has highlighted the importance of transfer of positions as a potential means, where practicable, of enabling a clearing house to manage its exposure to a failing or failed participant without crystallising market risk of underlying clients and, where positions are held by clients as hedges, causing the loss of those hedges. ASX strongly supports Council agencies giving further consideration to amending the

Corporations Act to improve the portability of client positions. It does need to be recognised that the insolvency provisions of the Corporations Act are only one element of the framework needed to implement portability.

While ASX would like to see improved client portability, timely portability in the cash market would be difficult to achieve as it would be administratively difficult given the large number of retail clients held by most clearing participants and the short three day settlement cycle.

The recent experience of the MF Global default has reinforced ASX's view that administrators of failing or failed participants cannot be expected in real-world crisis situations to react within required timeframes to clearing house requests for consent or assistance to facilitate the transfer of positions and collateral, where this is considered practicable, to a surviving participant or participants. However, as noted above, reform to the legislative framework is a necessary but not sufficient condition for ensuring portability. Even under the UK's Special Administration Regime, under which it is part of the statutory objectives of a Special Administrator to ensure the return of client assets as soon as practicable and to ensure timely engagement with market infrastructure bodies, delays have been experienced in effecting the transfer of positions and collateral.

In order to achieve effective timely portability ASX also believes that the Australian financial market would need to remove other impediments to portability. In particular, a pre-requisite is a market structure where the clearing house holds segregated individual client accounts and margin (ie no omnibus account structures). Such a move would be a significant change for the Australian financial market and would also carry a number of potential consequences for clients (both retail and institutional), clearing participants and FMIs. ASX believes that CoFR should investigate this issue to determine whether such changes would create a net reduction in the level of systemic risk in Australia's financial markets that would outweigh the loss of position and margin netting benefits.

ASX considers that the enforcement of CCP security interests in non-cash collateral should also be considered as an area for potential legislative change. In particular, security interests arising under market netting contracts are excluded from the ambit of the Personal Property Securities Act 2009 (Cth), section 8(1)(e). This has created potential uncertainty in relation to the perfection and priority of CCP security interests in circumstances where a clearing participant or its client is in external administration. By way of contrast, legislation in the UK and Hong Kong specifically authorises the enforcement of CCP security interests notwithstanding the general insolvency moratorium[4] and gives priority to such security interests against other secured claimants[5]. Clarification of these matters would better equip CCPs to deal with emerging or potential crisis situations.

Section 11: Compensation fund arrangements for securities markets

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

SEGC administers the NGF in accordance with Division 4 of Part 7.5 of the Corporations Act 2001 and the Corporations Regulations 2001 and holds the assets of the NGF in trust for the purposes set out in the legislation. SEGC is a company limited by guarantee which was incorporated in 1987 to be the trustee of the National Guarantee Fund (NGF). While other market operators could apply to become members of SEGC to date none have and the sole member of SEGC is ASX Limited. Accordingly, SEGC is a non-controlled entity of ASX.

The current governance arrangements for SEGC ensure that the NGF is administered independently to meet the objectives in the Corporations Act. The SEGC Board is made up of a majority of independent directors. ASX staff involved in the administration of SEGC are required to act in the interests of SEGC, and prefer those interests over the interests of ASX in the event of any conflict. That is, regardless of the ownership structure of ASX, or for that matter whether any other market operator (which may be controlled by a foreign entity) became a member of SEGC, the directors and officers of SEGC and the staff involved in the administration of SEGC will continue to act in the interests of SEGC and within the scope of the Australian legal framework for SEGC.

However, if changes are made to the governance arrangements for SEGC and the NGF, it follows that ASX's current role as the collection agency for levies on participants in the event that the NGF needs to be replenished, should be removed.

[4] Companies Act 1989 (UK), section 164, Securities and Futures Ordinance (HK), section 45. Section 440JA of the Corporations Act 2001 (Cth) seeks to provide similar protection in relation to operators of CS facilities, but fails to achieve its purpose because, as a result of the exclusion referred to above, CCP security interests are not "PPSA security interests".

[5] Companies Act 1989 (UK), section 177, Securities and Futures Ordinance (HK), section 52.

21. If so, please explain why and how you think improvements can be made?

There are a number of improvements that could be made to the statutory provisions that set out when a claim can be made on the NGF. In particular the CoFR, or another review process, could:

- Consider if claims on the NGF should only be available to retail investors or if there should be capping of claims at a level which maximises the availability of the fund for retail investors – similar to the bank guarantee cap of $250,000. Professional and institutional investors already have a wider range of mechanisms available to address the risks which the NGF was established to address. Other market compensation funds (in Australia and overseas) have caps on claims and there is no policy reason why the NGF should be the exception in this regard – in fact, there is a strong argument for harmonisation of compensation arrangements between licensed markets in Australia.
- Review the heads of claim to determine if they address the circumstances when compensation should be paid. The statutory heads of claim appear out-dated in the context of contemporary broker operations and do not clearly set out what claimants need to provide to prove a claim. This has an impact on the time taken to process and determine claims.
- Consider the potential for harmonisation of the Division 3 and Division 4 heads of claim for compensation particularly in the context of the best execution obligation on brokers and the Division 3 compensation arrangements which Chi-X Australia has put in place for its market. Particularly from the perspective of retail investors, the two very different sets of heads of claim between Division 3 and Division 4 compensation funds can be seen as confusing and serving no apparent policy purpose.
- Assess if there is a need for additional statutory provisions in the event that an investor could make a claim under either Division 3 or Division 4. On one reading there is a risk that in the event of potential coverage under both Divisions the statutory provisions preclude a claim under either Division.