Strengthening APRA's Crisis Management Powers

ASX Submission

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Executive Summary

ASX supports Australia's regulators having clear statutory powers to protect the interests of Australian investors and financial market participants, and Australian financial system stability, in the event of a clearing house's failure. Clearing houses play a systemically important function supported by substantial amounts of collateral and capital.

Australian investors who have their transactions processed through a clearing house should have the assurance of knowing that the powers of the Australian regulators are supported by the same statutory management scheme and directions powers that is put in place for APRA in relation to ADIs. This means that any clearing house operating in Australia, whether its principal place of business is in Australia or overseas, should be directly subject to the statutory powers conferred on Australia's regulators and that the collateral and capital that supports the clearing house should be held in Australia and regulated by Australian law including insolvency laws.

The Treasury's Consultation Paper on *Strengthening APRA's Crisis Management Powers* is part of an ongoing review process to ensure Australia's financial regulation remains ready to meet the needs of Australians. ASX strongly supports this policy objective. ASX believes that "Financial Market Infrastructure" – the market operators and clearing and settlement facilities ("FMIs") that are a critical part of the proper functioning of Australia's financial markets – should be subject to the same system of local regulation, including specialised recovery and resolution regimes, that applies to the broader financial sector, irrespective of whether FMIs are based in Australia or overseas. There would be a clear inconsistency in regulatory approach if the recovery and resolution of a foreign FMI that may be licensed to operate in Australia is effectively outsourced to overseas regulators while at the same time APRA is given strengthened crisis management powers over foreign ADIs and insurance companies.

ASX's response to the technical matters raised by the Consultation Paper is based on the principle that Australia's financial regulation must meet the needs of Australians. ASX's submission is that the role of a statutory manager appointed to an FMI servicing the Australian market should be: first, to protect the interests of Australian investors and financial market participants, and Australian financial system stability, and second – only where it is consistent with the first objective – to use its powers to support a resolution carried out by a foreign home authority. The only satisfactory way in which to provide for recovery and resolution of the Australian operations of domestic and overseas FMIs is pursuant to a specialised FMI statutory management regime administered by Australian regulators and operated under Australian law. Accordingly, ASX also submits that FMIs operating in Australia, under an Australian overseas or domestic licence, should be carved out from the operation of the UNCITRAL Model Law on Cross Border Insolvency, in the same way as for ADIs and insurance companies.

Consideration of these matters is timely as the Council of Financial Regulators and the Treasurer consider the structure of clearing and settlement for the cash equities market and licence applications for new clearing facilities, whether overseas or domestic, to operate in Australia. ASX's strong view is that a licence cannot be granted to an overseas operator of a clearing and settlement facility until a proper FMI recovery and resolution framework is in place.

Sections 1 and 2 of this submission set out ASX's detailed responses to the questions in Chapter 7 of the Paper.

The Consultation Paper also addresses suspending continuous disclosure obligations of listed ADIs, insurance companies, and potentially FMIs.

ASX is aware that the IMF has recently recommended that legislative changes should be made to forestall "premature" disclosure of information to investors as a result of continuous disclosure obligations in a crisis resolution involving a publicly listed ADI.

Australia's continuous disclosure regime is an important feature of Australia's capital market and promotes ongoing investor confidence. If a policy decision is made to implement legislative change to support the IMF's recommendations, these powers need to be designed so that they do not cause doubts to be raised about the application of the continuous disclosure regime and the underlying objective of fair and efficient markets that it seeks to support. Clear guidance will need to be communicated to the market about the narrow circumstances in which such a suspension would be applied, the entities to which it would extend (presumably only those that are prudentially regulated) and the likely time frame that would apply to any such suspension. Policy makers should satisfy themselves that the policy objective that they seek to achieve will, at a practical level, be supported by use of such a suspension power given the circumstances at the time and whether there may be other mechanisms that might also support those objectives. ASX would like to directly engage with policy makers and the regulators in the development of the principles and guidance that would apply to the development of any regulatory powers for APRA or ASIC to suspend compliance with these obligations.

1. ASX supports a statutory management regime for FMIs which applies to overseas and domestic licensees

ASX supports the establishment of a FMI statutory management regime and extending related directions powers for FMIs. Those reforms would represent an incremental improvement in the existing Australian regulatory regime for FMIs, by providing all stakeholders with greater certainty about the rules that apply in the event of a FMI's failure and by promoting financial system stability in a crisis.

Any steps taken by resolution authorities – in Australia or overseas – to effect the recovery or resolution of a financially distressed overseas FMI that is licensed to operate in Australia will have significant implications for Australian investors and financial market participants.

The processes of FMI recovery and resolution involve the adjustment of rights and obligations of third parties (i.e. loss allocation) to enable a financially-distressed FMI to continue operating, or to be wound down in a manner that imposes least disruption to the financial system. If an overseas FMI were licensed to operate in Australia and subsequently experienced a financial crisis, Australian financial market participants who participate in the FMI, and Australian investors who have their transactions processed through the FMI, will be subject to the adjustment of their rights and obligations as part of FMI recovery and resolution processes. Australian investors would expect Australian law to apply in these circumstances. This was ASX's experience in MF Global even though disclosures were made indicating that this was not the case.

ASX strongly supports the extension of the FMI statutory management regime and related directions powers to the Australian assets and operations of FMIs holding Australian overseas licenses ("overseas FMIs") as well as domestic licensees.

FMIs concentrate risk. If not properly managed, FMIs "can be sources of financial shocks, such as liquidity dislocations and credit losses, or a major channel through which these shocks are transmitted across domestic and international financial markets"[1]. Given the potential for an overseas FMI to transmit financial shocks to the Australian financial system, Australian regulators must reserve for themselves appropriate powers to protect the interests of Australian investors and financial market participants, and Australian financial system stability, in the event of a FMI's failure. To put the same point another way: there is no possible advantage that would accrue to the Australian financial system or public interest by not extending the statutory management regime to overseas FMIs.

International principles on recovery and resolution of financial institutions dictate that resolution authorities should have resolution powers over local branches of foreign firms. The case for resolution powers over the local operations of overseas FMIs is as strong as it is in relation to Australian branches of foreign banks, and for much the same reasons (as canvased elsewhere in the Consultation Paper).

ASX looks forward to engaging with The Treasury on the detailed design of Australia's FMI statutory management regime. One of the key design issues will be whether a FMI statutory manager should have the power to impose liabilities on clearing participants, or whether ex ante loss allocation rules (potentially set-out in the FMI's multilateral operating rules) should prevail. ASX has previously adverted to the concerns that external stakeholders (clearing participants in particular) may have about the prospect of action being taken by a statutory manager which is contrary to the FMI's operating rules. Such an approach to resolution is likely to cause commercial uncertainty, may provide unintended incentives for clearing participants to exit a distressed FMI, and may have capital and liquidity implications for clearing members that are ADIs. In its consideration of FMI resolution and recovery policy, the UK Government has expressed support for ex ante loss allocation rules in preference to a resolution authority having the power to impose liabilities on members of a failing clearing house.[2]

Robust location requirements are needed for an effective statutory management regime

The lack of any concept of a "branch" in the *Corporations Act* for overseas FMIs is not a reason against extending the FMI statutory management regime to overseas FMIs – it simply reflects the fact that when Chapter 7 was developed, pre-GFC, these issues were not foreseen. Robust location requirements are integral to the efficacy of a statutory management regime for FMIs.

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[1] CPSS-IOSCO Principles for financial market infrastructure, April 2012 – page 5.
[2] HM Treasury, Financial Sector Resolution: Summary of Responses (October 2012), paras 2.24 – 2.25.

In order for the statutory management regime and related directions powers to have any practical utility in a crisis, overseas FMIs that seek to operate in Australia should be required, as a condition of gaining an Australian licence, to comply with basic location requirements in relation to operations, personnel and, in the case of central counterparties, the maintenance in Australia of default funds and collateral. In the absence of such location requirements, a statutory manager will have little or no capacity to protect the interests of Australian investors and financial market participants, or Australian financial system stability, in the event of the overseas FMI's failure.

The Council of Financial Regulators' proposed "graduated approach" to location requirements for overseas FMIs, if implemented, will not provide adequate support for a statutory manager's execution of its functions because the graduated approach fails to deliver the "local leverage" over overseas FMIs (i.e. access to people and property in Australia) that is essential to incentivise FMIs' compliance with directions and support the exercise of resolution powers.

ASX believes that an Australian statutory manager appointed to the domestic operations of an overseas FMI should focus on protecting Australian investor interests

ASX believes that the role of the statutory manager should be: first, to protect the interests of Australian investors and financial market participants, and Australian financial system stability, and second – only where it is consistent with the first objective – to use its powers to support a resolution carried out by a foreign home authority.

ASX has identified two areas of concern with a FMI regime designed so that an Australian statutory manager appointed to the domestic operations of an overseas FMI supports an external administrator appointed over the licence holder in its home jurisdiction:

- It gives insufficient weight to the importance of protecting Australian interests that will be affected if the overseas FMI should experience a crisis. A statutory manager should have all necessary powers – and it should be the first priority of the statutory manager – to prevent or stop actions which might adversely affect the rights of Australian participants or investors for example, an attempt by an overseas clearing house to repatriate default funds or collateral that should be held in Australia;
- It assumes that a foreign resolution scheme that is designed for creditors and financial system stability in the FMI's home jurisdiction will be good for creditors and financial system stability in Australia.

It is acknowledged in the Consultation Paper that:

> *Foreign insolvency administrations may be directed to purposes that do not align with the objects of the domestic specialised regime. Foreign administrations may put creditor protection above system stability, or may focus on the needs of foreign systems or participants in preference to domestic systems or participants*

ASX does not agree with the statement in the Consultation Paper that:

> *… it may be expected that it would be desirable to give domestic effect to home country FMI resolution activities in relation to foreign operators operating under an overseas operators' licence*[3]

Whether it would be desirable depends on the circumstances. No ex ante judgement can be made about the impact of a foreign resolution scheme, or whether it should be given effect locally having regard to its effect on Australian interests.

Australia's statutory management regime for FMIs should require the statutory manager to make an independent judgement about whether a proposed foreign resolution scheme for an overseas FMI in crisis would be:

- fair to Australian creditors and investors, relative to the impact of the resolution scheme on foreign creditors and investors; and
- consistent with the objects of the statutory management regime and, in particular, the maintenance of Australian financial system stability.

[3] Consultation Paper, page 98.

If the statutory manager determines that the resolution scheme proposed in the FMI's home jurisdiction does not satisfy those criteria, the statutory manager should be empowered to take appropriate recovery and resolution actions in relation to the Australian assets and operations of the overseas FMI.

Such an approach to FMI recovery and resolution is consistent with emerging international principles in this arena.[4] The Australian Government can do its part to promote cross-border harmonisation of resolution authorities' recovery and resolution actions in relation to FMI operating in multiple jurisdictions by, for example, requiring the statutory manager to:

- act where possible to achieve a cooperative solution with overseas resolution authorities – but not where this is to the relative disadvantage of Australian financial market participants and investors; and
- consider the impact of its recovery and resolution actions on financial stability in other jurisdictions – but, again, not in a way that promotes the financial system stability of other countries at the expense of Australia's.

2. Cross-border insolvency: the Model Law is not the answer

The Consultation Paper's discussion of cross-border insolvency presumes that the UNCITRAL Model Law on Cross Border Insolvency (Model Law), as enacted by the Cross-Border Insolvency Act 2008, could "enable the effects of [a foreign FMI resolution scheme] to be recognised domestically". That is not necessarily a correct assumption. The UK Supreme Court held[5] recently that provisions of the Model Law relating to the grant of relief at the request of foreign representatives, and co-operation with foreign courts and representatives, are "concerned with procedural matters" and do not provide a basis for the court to grant any type of relief that is available under the law of the relevant foreign state.

Applied in the context of FMI recovery and resolution, this UK Supreme Court decision provides support for the proposition that the Model Law is not an appropriate substitute for a specialised FMI statutory management regime. It is a separate question whether, under such a specialised domestic regime, effect should be given locally to a foreign resolution scheme formulated under the laws of an overseas FMI's home jurisdiction. The important point to arise from this judgement is that the Model Law cannot – and, in ASX's submission, should not as a matter of policy – be used to apply foreign resolution schemes to adjust the rights and obligations of Australian creditors and investors where an overseas FMI has operated in Australia.

The only satisfactory way in which to provide for recovery and resolution of the Australian operations of domestic and overseas FMIs is pursuant to a specialised FMI statutory management regime. It follows that FMIs operating in Australia, under an Australian overseas or domestic licence, should be carved out from the operation of the Model Law, in the same way as for ADIs and insurance companies.

The Consultation Paper also cites a "broader shift in international cross-border insolvency arrangements away from territorialism towards universalism".[6] Universalism is "a trend, but only a trend,"[7] in the administration of insolvency law in certain countries. It is not a legal principle in its own right, but describes an approach that courts in some jurisdictions may take to deciding insolvency cases with multi-jurisdictional elements. Sentiments in favour of "universalism", or "comity" between courts or nations, do not constitute a policy basis for outsourcing to foreign governments or insolvency representatives the resolution of an overseas FMI's Australian operations.

"Universalism" is also no substitute for proper consideration of the impact of a foreign resolution scheme on Australian interests. A universalist approach does not exclude discretionary national action (to use the terminology of the FSB's Key Attributes) to reach a result which protects local interests that would otherwise be disadvantaged by a foreign resolution scheme:

> *… the United States in ancillary bankruptcy cases has embraced an approach to international insolvency which is a modified form of universalism accepting the central premise of universalism, that is, that assets should be collected and distributed on a worldwide basis,* ***but reserving to local courts discretion to evaluate the fairness of home country procedures and to protect the interests of local creditors***.[8]

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[4] The Financial Stability Board's (FSB's) *Key Attributes of Effective Resolution Regimes for Financial Institutions* are being adapted for FMI's by CPSS-IOSCO: refer *Recovery and resolution of financial market infrastructures* (Consultative Report) July 2012.
[5] *Rubin v Eurofinance SA* [2012] UKSC 46 at [143] (decided 24 October 2012).
[6] Consultation Paper, page 96.
[7] *Rubin v Eurofinance SA* [2012] UKSC 46 at [16].
[8] *Re Maxwell Communication Corp*, 170 BR 800 (Bankr SDNY 1994) (emphasis added), cited in *Rubin v Eurofinance SA* [2012] UKSC 46 at [20].