13 April 2015

Manager
Banking and Capital Markets Regulation Unit
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The Treasury
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By email: financialmarkets@treasury.gov.au

Dear Mr Bell

AFMA has previously advised the Government that industry is concerned about the effect of temporary stays on netting certainty and that they should be as short as possible and no longer at the maximum than 48 hours and not subject to discretionary extensions.

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Resolution Regime for Financial Market Infrastructures Consultation Paper.

Summary

Overall AFMA supports the objective of this consultation to establish a robust statutory framework for the resolution of Financial Market Infrastructure (FMI) to enable the regulators to either return an FMI to viability or facilitate its orderly wind-down in a manner that is consistent with the Key Attributes of Effective Resolution Regimes for Financial Institutions (KAs) adopted by the Financial Stability Board.

The term FMI used for the purposes of this consultation covers Clearing and Settlement facilities (CS facilities), trade repositories (TRs) and market operators as the terms are understood under Australian law. In relation to CS facilities the establishment of a resolution regime is an important step for increasing market confidence and legal certainty in the event of a failure of such infrastructure where systemic stability is threatened. Well defined arrangements for the authorities to assist in dealing with the consequences of the failure of systemically important infrastructure are an important

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component for a well regulated market and allowing market participants to continue activities which are vital to the economic well-being of the country.

In large part we agree with the proposed powers and structures proposed in the consultation paper for CS facilities.

While the policy case for introducing a special resolution regime for CS facilities has been established, the same cannot be said for market operators or TRs. The working presumption is that a special resolution regime is extraordinary. As far as possible normal insolvency law arrangements should be allowed to prevail without the need for intervention by the authorities. While the failure of a market operator may be disruptive the contestability of services in this area means there is considerably less dependence on a single market operator and consequently greater system resilience. Market participants are not dependent at all on TRs. While the failure of a TR may be inconvenient to the authorities trading and related economic activity can continue uninterrupted.

AFMA has previously advised the Government that industry is concerned about the effect of temporary stays on netting certainty and that they should be as short as possible and no longer at the maximum than 48 hours and not subject to discretionary extensions.

Certain proposals with regard to proposed directions powers go beyond the scope of the reasoning supporting the special resolution regime and would extend statutory powers to situations such as external administration or to non-regulated entities. AFMA considers that the powers should be restricted narrowly to the extraordinary situation which would justify invoking a special resolution and its immediate demands and no further.

Institutional Scope and Resolution Authority

1. *Do you agree with the proposal that all CS facilities that are incorporated in Australia and hold a domestic CS facility licence should be potentially within the scope of the resolution regime and that a judgement would be made at the point intervention was being considered as to whether to exercise resolution tools or to leave the distressed CS facility licensee to be dealt with under the general insolvency regime?*

Agree.

2. *Do you agree with the proposal to introduce enforceable commitments and a new category of licence conditions to support the influence of Australian regulators and resolution authorities over cross border CS facilities?*

Agree. This response should be read in conjunction with the questioning of the need for local incorporation for domestic CS facilities. These powers would enable a significant

additional degree of control and influence. The powers are considered to grant the resolution authorities considerably increased discretionary powers the exercise of which would only be justified in extraordinary circumstances.

3. *Do you have any comment on the proposed power for the Minister to require a licensed overseas CS facility that is systemically important with a strong domestic connection to transition to a domestic licence?*

There needs to be more critical thinking to how Australia should approach overseas FMI providers beyond just control in a crisis. We have come to a national policy consensus since 2009 that would should seeks as far as possible to promote the use of CCPs for financial instruments traded in OTC markets. Much has already been achieved in relation to OTC derivatives and we are now turning our minds to the desirability of centralised clearing of repos. The reasons for this are well understood by the Government and do not need repeating here. However, a major practical challenge that has emerged to continued progress to increasing the level of central clearing is how can such services being provided to markets which are relatively small.

The clearing and settlement business is one dependent upon economies of scale. A central premise of this consultation is that offering FMI is a complex business which demands a high level of resources and expertise. It represents a large long term investment which needs to be prudently managed. High volume, high speed liquid markets like those for cash equities in Australia provide sufficient business to keep at least one CS facility viable solely on domestic business. Nevertheless, as has been discussed in the recent consultation on completion in the clearing of Australian cash equities the economics of the business make the entry of a competitor unlikely for the foreseeable future. Other markets which have traditionally been traded OTC in much smaller volumes because the transactions involve high value, complex longer term financial instruments such as interest rate swaps where counterparty credit risk management is a major factor make it a costly business service to offer. For this reason market participants favour those clearers who can offer economies of scale resulting in lower fees as well as broad netting benefits that flow from being in a large pool of transactions with a larger number of counterparties. In relation to the clearing of some Australian traded financial instruments it may only make commercial sense to extend a global operation into Australia in order to offer a viable and realistically priced service.

There is a need to balance competing policy objectives in this area. On the one hand, crisis resolution encourages the seeking of more domestic control by our regulators. In relation to this a considerable degree of administrative discretion and flexibility is proposed resulting in language which suggests a vaguely defined boundary with a difficult to judge tipping point at which it is deemed that a CS facility might be required to locally incorporate. On the other hand it is desirable to provide an environment in which well resourced, competent and experienced CS facility providers are attracted to provide their services in Australia so that more financial instruments may be centrally cleared and competitive discipline may apply. Too much administrative discretion and vagueness

around what point a CS facility is "systemically important" makes it difficult to a service provider to accurately evaluate their business case for entering the market.

The concept of a "systemically important" is widely used throughout the CPSS-IOSCO Principles for financial market infrastructures without further precision. As we have seen with the process surrounding the identification of 'Global Systemically Important Banks' G-SIBs a degree of judgment is involved in making a designation. The BCBS methodology uses indicators of banks' size, interconnectedness, substitutability, complexity and global activity to rank their global systemic importance. In relation to FMI interconnectedness and substitutability are key determinants.

The US Federal Reserve has given thought to defining systemically important FMI through the term 'Financial Market Utilities' (FMUs) that it has the power to designate as multilateral systems that provide the infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions among financial institutions or between financial institutions and the system. In this it has allowed itself a considerable degree of discretion which relies to a large degree on the idea of interconnectedness. In cases where, among other things, a failure or a disruption to the functioning of an FMU could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threatening the stability of the US financial system.

We suggest that substitutability is also an important determinant relevant to the Australian situation. The assessment of the criticality of a function is always driven by the impact of a failure on external parties, i.e., the reliance of third parties on the continuing provision of a function. In the case of FMI, if its function can be performed in another way so that market activity does not need to stop then it would not be systemically important. For example, if the FMI were a CS facility for financial products that could be bilaterally cleared the market could continue to operate. While this may be disruptive, inefficient and raise operational risk for counterparties it could be used to bridge a period while a longer term solution is found.

Additionally, if there is an alternative FMI provider in the market there is greater resilience in the system because there is a substitute available.

4. *Do you have any comment on the proposal to restrict the availability of a domestic CS facility licence to domestically-incorporated entities?*

It was noted in the response to Question 3 that thought needs to be given to how the regime might affect the viability of overseas providers offering their services here and willingness to enter the market. Flexibility is a keynote of the design of this regime elsewhere which will allow judgments to be made on particular circumstances. Domestic incorporation should not be a condition precedent to obtaining a domestic CS facility licence.

5. *Do you agree that there is less of a presumption of systemic importance for TRs than for CS facilities?*

Agree.

To market participants TRs are not critical to the continuance of their business or the functioning of the market in general. From an industry point of view the failure of a monopoly TR service would only result in regulatory risk from the impossibility of being to meet a statutory obligation to report. In such circumstances the regulators would be expected to act with common sense and give relief to reporting entities while the situation was sorted out.

6. *Do you have any comments on the proposal that a domestically incorporated TR may be identified as being systemically important where it holds a material volume of information on transactions involving systemically important Australian financial institutions, bringing it within the scope of the domestic resolution regime?*

As was noted in response to Question 5, the notion of a TR being systemically important is not a circumstance we envisage arising. The arrangements for salvaging data from a failed TR can fit within the scope of current TR licensing powers and obligations. With regard to other aspects of an insolvent administration of a TR there appears to be no policy justification for applying an extraordinary administration regime to such an entity.

The introduction of special legal framework to handle the failure of a CS facility is justified by the need for legal certainty and predictability in the event of a failure in the context of the economic impact on the community as a whole that might flow from uncertainty and confusion. Industry would look to the assistance of the authorities to manage the situation in a way which is predictable and can be planned for from a risk management point of view.

7. *Do you have any comments on the proposal to exclude licensed TRs that are not incorporated in Australia from the scope of the domestic resolution regime?*

Consistent with the view given above a special resolution regime for TRs is not deemed necessary even for a domestic TR then no importance is placed on excluding a non-locally incorporated TR from the regime.

8. *Do you have any comments on the application of the domestic resolution regime proposed in this paper to covered TRs, having regard to the existing regulatory provisions relating to recovery and resolution of licensed TRs?*

We reiterate the view that there is not a policy justification to apply a special resolution regime to TRs. Existing Corporations Act licensing and insolvency rules are appropriate and adequate.

9. *Do you have any comments on the proposal that the Corporations Act be amended to provide for any liquidator or receiver appointed over a related body corporate of a covered FMI to comply with any directions given by the FMI's resolution authority?*

Our approach to the questions in this section is a cautious one. A special resolution regime should be treated as extraordinary. The justification for special rules is related to the peculiar reliance that is placed on certain organisations for the maintenance of essential economic activity. A solid case can be made out for ADIs and CS facilities in this regard. The extension of a directions powers beyond the licenced entity needs more justification beyond being a 'nice to have' reserve power. FMI in a number of cases belong to large complex corporate groups. While it is assumed that such a directions power would only be used sensibly and with caution its potential to extend to related body corporates which are in different lines of business could have undesirable consequences.

Our comments made under Question 38 in relation to non-regulated entities should also be taken into account here.

10. *Do you have any comments on the proposal to extend these powers to all service providers for key outsourced functions, even if those service providers are not related bodies corporate?*

Following on from the response to Question 9, it is questionable whether the case is made out for a directions power to be extended to related bodies corporate. The extension to outsourced function providers is not justified. Licensing conditions already are capable of dealing with outsourced functions and with normal administrator authority under existing contractual arrangements without a directions power being added.

11. *Do you have any comments on whether the resolution regime for market operators should be different to that for FMIs as defined in Section 1?*

Market operators should be distinguished from CS facility providers by looking to the utility character of systemically important CS facilities. Market operator services are subject to a greater degree of contestability and do not have the high degree of legal and credit risk that is found in CS facilities. Market resilience is served by having several competing market operators serving a market allowing for ready substitution in the event of a failure of one operator.

12. *Do you have any comments on whether, given the different risk profile of market operators, it would be appropriate for a regulator to have statutory management powers in relation to market operators?*

The statutory management powers are not necessary in relation to market operators. The existing licensing powers give ASIC sufficient authority to influence and control outcomes.

13. *Do you have any comments on an appropriate alternative regime for market operators, and how market disruption in the event of failure of such entities could be mitigated?*

As noted above resilience achieved through having multiple market operators so that there can be ready substitution in the event of failure provides a desirable environment to deal with a failure.

Resolution Regime

14. *Do you have any comments on the proposed objectives of the resolution regime? Are there other relevant objectives or considerations that should be included?*

Consistent with previous comments in relation to TRs we do not agree that maintaining the continuity of TR services is critical to the smooth functioning of the financial system meriting special resolution, and should not therefore be included in the statutory objectives.

Legislative guidance with regard to the proposed considerations for the resolution authority to take into account when seeking to take resolution actions are reasonable with regard to these considerations:

- maintain confidence in the stability of the financial system;
- maintain the fair and effective provision of FMI services;
- minimise the costs of resolution and losses to creditors and provide for the allocation of losses to creditors in a manner that respects the hierarchy of claims in insolvency and preserves market discipline;
- limit recourse to public funds;

If an FMI service was not critical to the smooth functioning of the financial there is little apparent reason why the resolution authority would need to step and use its special powers. It therefore does not appear to be consistent with the purpose of the regime to include provision for the orderly wind-down of FMI services that are not critical to the smooth functioning of the financial system and which are not financially viable to be included in the statutory objectives.

15. *Do you have any comments on the proposed choice of resolution authority for each FMI type?*

The distribution of responsibilities is appropriate and consistent with overall statutory responsibilities of the regulators.

16. *Do you have any comments on the proposal that the determination of an FMI group resolution authority be governed by a memorandum of understanding between the regulators?*

Memorandum of understanding provide a ready reference point to deal with urgent situations assisting regulator staff to more rapidly and confidently respond to a situation. The failure of an FMI would likely result in a degree of uncertainty and confusion for all involved so pre-planning, established procedures and understandings help promote an atmosphere of calm predictability which is highly desirable in restoring confidence.

Resolution Powers

17. *Do you have any comments on the proposed conditions for entry into resolution and use of resolution powers, and, in particular, the distinction between general and specific conditions? Is there another option you prefer? If so, why?*

Predictability and certainty are key objective in establishing resolution arrangements. As noted elsewhere in these comments the benefit from introducing these reforms will be the putting in place of arrangements that form an integrated plan that can be quickly referred to in the event of a crisis. This involves the integration of individual CS facility recovery plans which are the frontline mechanism for dealing with a failure. The putting in of a statutory manager should be considered to be an extraordinary measure and government management of the resolution process should not be treated as the assumed primary course of action if there is not a serious systemic crisis. The preferred course should be reliance on the CS facilities own recovery plan and the private sector handling of the event.

In the event of a severe systemic disruption and a threat to financial stability where the CS facility recovery plan would appear to be insufficient for dealing with the situation would justification arise for resorting to the resolution regime.

18. *Do you have comments on the proposed powers of a statutory manager? Are there additional powers that should be included? If so, why?*

Part of the planning following on from the establishment of the resolution regime should be an identification of the competencies required of a statutory manager and how suitable candidates could be quickly selected in the event of a crisis. There should be consultation with market participants on this practical issue and transparency with regard to competencies and likely candidates.

19. *Do you have any comments about the proposal that an external administrator cannot be appointed to an FMI during the term of the statutory manager, except with the consent of ASIC or the RBA?*

Thought needs to be given to what would happen in the circumstance that an external administrator was appointed before a statutory manager. As the special resolution regime overrides normal insolvency law arrangements it would be consistent if the appointment of a statutory manager led to the termination of the external administration.

20. *Do you have any comments on whether the appointment of a statutory manager to an FMI should suspend or terminate the rights of shareholders, subject to ex post compensation? Moreover, do you agree that the statutory manager should have the ability to facilitate recapitalisation where an FMI would otherwise be insolvent?*

This is consistent with the nature of a special resolution regime and would need to be taken into account by shareholders as part of their investment decision.

21. *Do you have comments on the proposals related to issuance of directions to a statutory manager? Are there other relevant considerations?*

It is important that a statutory manager should be subject to directions from the resolution authority. The situation here is quite different to the needs of external administration where the administrator enjoys considerable autonomy. A statutory manager is operating in an environment where there are considerable public policy and wider system stability considerations, particularly if the event was being handled during a systemic crisis, which justifies a directions power.

22. *Do you have any comments on the proposal to empower the resolution authorities to impose a limited moratorium on outgoing payments from an FMI? Do you have comments on the proposed limitations applied to the scope of the moratorium? Is there another option you prefer? If so, why?*

Consistent with previous submissions to the Government by AFMA over recent years we consider that the moratorium should not apply to payments made by a CS facility under

market netting contracts or close-out netting contracts made in accordance with the *Payment Systems and Netting Act*.

23. *Do you have any comments on the proposed powers for business transfer and the proposed conditions for such a transfer? Are there any changes you would propose? If so, why?*

Working on the assumption that the provisions would follow the model of those for business transfer in the case of an ADI no suggestions are made. Scrutiny of the draft legislation is required with regard to this point.

24. *Do you have any comments on the proposed powers for establishment of a temporary bridge institution? Are there any changes you would propose? If so, why?*

The ability to create a bridge institution is an important feature of a special resolution regime for CS facilities. The proposed establishment powers appear to be appropriate to the task.

25. *Do you have any comments on setting a timeframe for the duration of a temporary stay (for example, 48 hours)? Do you agree that there may be circumstances in which it would be necessary to extend the duration of the stay in order to support financial system stability?*

AFMA has previously advised the Government that industry is concerned about the effect of temporary stays on netting certainty and that they should be as short as possible and not subject to discretionary extensions.

AFMA considers that 48 hours is the maximum that can be permitted. Counterparties of an Australian CS facility need to be able to re-hedge or manage their risks efficiently and with certainty. A 48 hour period increases the difficulty of managing risk and reduces certainty particularly in volatile market conditions which be likely to give rise to conditions which would put a CS facility into a stressed condition. It is important to participants in a CS facility that they should be able to exercise their termination rights in accordance with their contracts to close-out existing positions in order to insulate themselves from further market risk.

The suggested ability to extend beyond a fixed 48 hours would not be consistent with the approach taken in other jurisdictions and would expose participants in an Australian CS facility to risks which are not present in clearing houses in major financial centres.

It needs also to be clearly articulated in the legislation that a temporary stay can only be imposed to terminate rights which are based on statutory management itself, not other events such as the failure by a CS facility to make payments or deliveries payable under its market netting or close-out contractual obligations.

Safeguards and Funding Arrangements

26. *Do you have any comments on the proposed provisions, especially with respect to compensation arrangements?*

The principle in the FSB's Key Attribute 5 is of high importance. Resolution powers should be exercised with due regard to the hierarchy of claims under insolvency law. We agree that this objective should be clearly articulated in the legislation.

We are concerned with the circumstance set out in paragraph 4.3 of the consultation paper where a business of a CS facility is to be transferred and either:

- some of the obligations under the same netting contract are separated as part of the transfer, or
- secured obligations and the collateral which secures them are separated as part of the transfer.

In the event of such a transfer of business the counterparty to the CS facility loses its ability to rely on the netting or collateral. Participation in the CS facility was based on the ability to net and use the collateral so rights are fundamentally altered and the counterparty as a creditor is worse off than would occur in a winding up under the standard law. The possibility of allowing a discretion to 'cherry-pick' obligations under netting contracts or to separate a security from obligations it secures is not agreed with by AFMA.

27. *Do you agree with the scope of proposed protections for those that act in accordance with the resolution authority's binding instructions?*

The protections are appropriate.

28. *Do you have any comments on the provisions that need to be put in place to recover any public funding? Who should be liable to contribute to the recovery of costs — shareholders, unsecured creditors (including FMI participants) and/or participants in the financial system more widely?*

Recovery from shareholders, unsecured creditors and FMI participants is consistent with the design and objectives of waterfall arrangements for CS facilities. However, in relation to TRs and market operators the injection of public funding and consequent need to

recover it is highly questionable. In relation to TRs and market operators it should be the shareholders who bear the burden of the loss not user of the FMI service.

The reference to possible recovery from "participants in the financial system" is very vague and is not supported. The restriction of any temporary public funding to CS facilities should obviate the need for such an undefined recovery power.

International Cooperation and Supporting Requirements

29. *Do you agree with the proposal that Australian regulators should have the right to prevent an application from being made to the court? Are there any other amendments to the Cross Border Insolvency Act that may be necessary?*

It is not appropriate to prevent such application being made as it is inconsistent with the purposes of the *Cross-Border Insolvency Act* and affect recognition of Australia under the cross border rules in which it works. Instead it is proposed that the regulators have standing to intervene and that the court be required to take into account the wider implications of granting recognition to foreign insolvency proceedings, including implications for the stability of the Australian financial system.

It is suggested that additional advice should be sought from legal experts in the field of cross border insolvency before proceedings with amendments to the *Cross-Border Insolvency Act*.

30. *Do you agree that no specific action to amend the legal framework is required at this stage with respect to the formation of CMGs? If not, why not, and what do you think needs to be done??*

No need for amendment has been identified.

31. *Do you agree that it is too early for detailed consideration of regulatory issues associated with the development of resolution strategies, operational resolution plans and resolvability assessments for covered FMIs? If not, why not, and what do you think needs to be done??*

Agree.

32. *Do you agree that no specific action is required at this stage with respect to the ability of ASIC and the RBA to share information with foreign authorities?*

Current law is deemed to be sufficient to enable this to take place.

33. *Do you agree with the proposal to make a material adverse change in cooperation or information-sharing arrangements with a licensed overseas FMI's or market operator's home regulator a grounds for licence suspension or revocation?*

Not agreed. This would be unduly harsh and outside the control of the FMI service provider. Furthermore, it would be highly disruptive to markets participants in Australia using their services. They should not be subject to punitive action arising out of the actions of home jurisdiction authorities. It would be appropriate in such circumstances to engage in dialogue with the FMI and negotiate with them around how best to address the situation.

Directions Powers

34. *Do you have comments on the proposal to consolidate the directions powers with ASIC and the RBA? Or is there another option you prefer? If so, why?*

We agree that directions with regard to CS facilities that relate to fair and effective provision of services, should remain with ASIC and that overall financial system stability, which would be reallocated to the RBA.

35. *Do you have comments on the proposed scope of recovery directions?*

The proposed scope for recovery directions appears to be appropriate to the needs of the situation.

36. *Do you have any comments on giving precedence to resolution directions over directions issued in day-to-day oversight? Or is there another option you prefer? If so, why?*

Giving precedence to resolution directions over day-today oversight is logical in the context of the extraordinary situation in which they would be issued.

37. *Do you agree that ASIC and the RBA should be able to give directions to an external administrator of an FMI or financial market, and the specified conditions under which directions may be given? If not, why not, and what changes should be made?*

Not agreed. If the situation does not justify the use of the special resolution regime the use of special directions power in relation to an external administrator would not be

justified. An external administrator should be allowed to manage the event in the context of current rules.

38. *Do you have comments on whether the relevant regulator should have the power to issue directions to non-regulated group entities to enforce ex-ante legal arrangements? Should these powers extend to recovery and day-to-day oversight as proposed?*

Such powers should not be granted. Powers should only apply to regulated entities and all arrangements that are desired should be organised through the licensing arrangements with the FMI only. At a principles level it is not consistent with legal authority to propose having administrative powers in respect of non-regulated entities and is objected to at a conceptual level. The implications of this proposal are quite radical and very much need to be reconsidered. The attempt to control the actions of non-regulated entities would set a bad precedent and could lead to a high degree of legal uncertainty in the financial services community. Furthermore, it would be highly surprising if a court would support the enforcement of such a directions power in the event it was challenged.

39. *Do you agree with the proposal to strengthen sanctions for non-compliance with a direction?*

Sanctions should be proportionate. Sanctions consistent with those in the *Banking Act* would be appropriate.

40. *Do you agree that the process for issuing a direction should be streamlined?*

Given that time is of the essence in the event of a failure of CS facility, we agree that a streamlined issuance process is desirable.

Thank you for the opportunity already provided to present our views in the meeting with you and the regulators. AFMA would be pleased to provide further comment if desired. Please contact David Love either on 02 9776 7995 or at dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

David Love
General Counsel & International Adviser