LCH.CLEARNET

Banking and Capital Markets Regulation Unit
Financial Systems and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

March 28 2015

Dear sirs,

RESOLUTION REGIME FOR FINANCIAL MARKET INFRASTRUCTURES (FMI)

This letter provides the submission of LCH.Clearnet Ltd ("LCH.Clearnet") to the Treasury's Consultation Paper: Resolution Regime for Financial Market Infrastructures.

LCH.Clearnet is a subsidiary of the LCH.Clearnet Group, the world's leading clearing house group, which services major international exchanges and platforms, as well as a range of over-the-counter ("OTC") markets. It clears a broad range of asset classes including cash equities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps, bonds, repos, and foreign exchange derivatives. The Group's central clearing counterparties ("CCPs") have over 190 clearing members and over 600 clients across 22 countries.

LCH.Clearnet was the first non-Australian CCP to be granted an Australian Clearing and Settlement Facility Licence and is currently providing clearing services for OTC interest rate swaps to a number of major Authorised Deposit-taking Institutions through its SwapClear service. LCH.Clearnet is also licenced in Australia to clear for the FEX commodities and energy exchange. LCH.Clearnet is supervised directly by both ASIC and the RBA. In addition to its Australian licence, LCH.Clearnet Ltd is regulated in the EU, Norway, Switzerland, the US, Singapore, Quebec and Ontario. LCH.Clearnet SA is regulated in the EU and the US. LCH.Clearnet LLC is regulated in the US, and has applied for recognition in the EU.

Comments on the proposals

As a global multi-currency clearing house, LCH.Clearnet has an interest in the policy frameworks for CCP recovery and resolution that exist or are under development in each of the jurisdictions in which we operate. We welcome the Australian Government's consultation on resolution for FMI and have provided responses to those questions most relevant to our business. Our comments are in respect to Section 2.1.3 "Cross-border CS

facilities", as LCH.Clearnet is neither incorporated in Australia nor hold a domestic CS facility licence. In addition, we comment on Sections 3.3 "Moratorium on payments to general creditors" and 3.6 "Temporary stays on early termination rights".

Section 2.1.1 "Domestically licensed CS facilities"
Question 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 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?

We support this proposal, on the basis it is similar to the approach taken in other jurisdictions that have a regulatory framework for CCP resolution. However, it should be clear under what circumstances general insolvency law should be applied and in what circumstances specific CCP resolution would be applied. We believe that this would be best addressed by developing realistic resolution plans for systemically important CS facilities before the point at which intervention is being considered.

Section 2.1.3 "Cross-border CS facilities"
Question 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?

Question 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?

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

Taken together, these proposals would enshrine in law the CFR's existing policy of requiring an overseas CS to incorporate in Australia if certain threshold conditions are met. LCH.Clearnet does not support this policy which is already having a practical, and in our view, damaging effect on the potential for enabling competition in clearing in Australia and also the potential for intensifying potential competition for the provision of trading services. However, we believe that the current situation is workable as it allows the regulators to make the appropriate judgements in a flexible and agile fashion. To enshrine the provisions in legislation risks introducing unnecessary rigidity and complexity into what is a dynamic area.

We understand the Government's and the regulators' concerns regarding the need to ensure appropriate influence over the resolution of any FMI that is critical to the smooth functioning of the Australian financial system. We are also aware of the current practical difficulties of establishing adequate cooperation arrangements with overseas regulators so that Australian authorities can be assured of having such influence over a cross-border

facility. Nevertheless we believe that the only way that Australia will be able to have efficient and innovative financial infrastructure is to enable the entrance of overseas CCPs for all domestic markets. Efforts should be focused on developing arrangements with other jurisdictions that will enable such an outcome, rather than reinforcing the status quo and maintaining barriers to effective competition of CCP infrastructures.

Section 2.1.5 "Application to TRs"

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

Yes, we agree that clearing and settlement infrastructure is likely to be of greater systemic importance than Trade Repositories. Clearing infrastructure has a degree of counterparty risk for participants (where it substitutes the risk of facing the CCP as opposed to multiple counterparties) in the event of the CCP's failure. Similarly, settlement infrastructure mutualises custody and market settlement risk which participants are also exposed. Trade repositories, however, do not share the same level of counterparty, custody or market risk as clearing or settlement infrastructure does, so they should not be considered as systemically important in the same manner as other FMIs.

Section 2.1.7 "An FMI's holding company and other non-regulated group entities"

Question 9: Do you have any comments on the proposal that the Corporation 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?

We suggest that resolution authorities consider the extent to which such actions would be possible where related body corporates are domiciled in a different jurisdiction. It may be that the resolution authority would not have the required competence to give directions to such entities. We believe that this is most important where critical services are performed by group entities under service arrangements. Where this is the case, such service arrangements should be identifiable and subject to terms which require continuity of critical services. However, we would not expect resolution authorities to have the power to compel related body corporates to undertake activities that they had not been providing before the FMI went into resolution.

Question 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?

The main importance for key service providers is to ensure that such functions can carry on during a resolution period uninterrupted. To achieve this, without casting the net of special resolution powers to all entities, would be to have a general moratorium on terminating contracts for a certain period due to the imposition of resolution action. Therefore, so long as the resolved entity is able to meet its contractual requirements for such outsourced functions, they should be able to continue. Our preference would be to oblige FMIs to ensure that their contracts for key services have continuity obligations and identify such

contracts in resolution planning as opposed to extend the powers of the regime to non-financial entities.

Section 2.1.10 "Feedback sought"

Question 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?

As is noted in the consultation paper, the UK Government has chosen not to apply a resolution regime for market operators. We support the approach taken in the UK for the reasons identified in the paper, namely that the systemic risks are different to CCPs and settlement systems. Market operators can have a diverse range of business and funding models. Therefore, any inclusion in a special resolution regime should only be at high level principles-based rules. These could take account of how to identify systemic importance and plan suitable recovery and resolution arrangements.

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

Where the main resolution strategy for market operators is to wind down an entity which is financially unviable, we would normally expect insolvency law to appoint a liquidator or administrator to achieve an orderly wind-down of business. It is not clear why a separate resolution regime for FMIs would be necessary in this regard.

Question 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?

There should be a distinction between market operators in general and those which are specifically identified as being of systemic importance. Where barriers to entry for new market operators are low or users of such services can switch providers easily, the presumption should be that the class of market operator is not required to be subject to the same type of resolution regime as other FMIs. Where there are systemically important market operators, the application of resolution regimes should be proportionate so as not to, in themselves, create or enhance a dominant position in the marketplace.

Section 2.2 "Objectives of the Resolution Regime"

Question 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?

We broadly agree that the overall objectives and the detailed considerations are appropriate and similar to special resolution regimes in other jurisdictions, including the UK. However, we would expect that FMI services which are not critical to market stability could be dealt with under normal insolvency laws if they are not economically viable and meant to be wound down.

Section 2.3.1 "Resolution Authorities"

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

As a general principle, we believe that the regulator with lead day-to-day supervisory responsibility for the FMI is best placed to act as the lead resolution authority, so agree that in the case of CCPs the RBA should have this responsibility.

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

We support this approach. It will be essential for regulators to have agreed cooperation arrangements in advance, and ideally to have tested these as part of a crisis management exercise (if possible, with the participation of the relevant FMI).

Section 3.1 "Entry into Resolution"

Question 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? If so, why?

Under CPSS-IOSCO's Principles for Financial Market Infrastructure, CCPs are required to hold resources sufficient to absorb the default of the two largest clearing members. We believe the authorities should only intervene when the recovery measures undertaken by the CCP have failed to restore the viability of the clearing service or have not been implemented in a timely manner, or where the designated resolution authority determines that the CCP's recovery measures are not reasonably likely to return the CCP to viability or would be likely to compromise financial stability. This is the position taken by the Financial Stability Board (FSB) in its recent guidance, and we support this approach.

In our view, the authorities should not intervene while the CCP is executing its (pre-planned) default management process and some pre-funded resources remain and additional resources are available for example Assessment calls.

Section 3.3 "Moratorium on payments to general creditors"

Question 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?

It is not clear if the stated intention to preserve the enforcement of netting and collateral arrangements would mean that clearing members would still be able to make and receive payments to and from the CCP. However, if it were to apply, it would be to the initial detriment of members rather than the CCP itself. Where a CCP would be adversely

impacted would be in relation to general, unsecured creditors such as landlords, suppliers, IT vendors and potentially even staff who are potentially crucial for keeping the CCP running if it is to continue as a going concern – if the moratorium on payment does not also prevent the creditor in question from defaulting the CCP, or otherwise withholding the service it is supposed to be paying for, then the ability to resolve the CCP may be adversely impacted by the unavailability of crucial services required for the CCP's day to day operations. Given the CCP will hold wind up capital against these sort of costs, and that they are likely to be very small amounts compared to the CCP's liabilities under cleared trades, it is not clear what a moratorium like this would really achieve in terms of preserving the financial viability of a CCP that presumably has suffered considerable losses as a result of a member default.

Section 3.4 "Transfer of critical operations to a solvent third party"
Question 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?

Although the FSB envisages a sale of business tool as one resolution option that could be available to the authorities, in practice we consider it unlikely to be feasible in a crisis scenario. Speed and certainty will be key – but a sale of business will require a valuation, which may be difficult to complete in the short timeframe one would envisage in a resolution.

One of the key potential problems raised around the sale of business is the ability to separate the business being sold from critical support functions or otherwise healthy parts of the troubled entity. These considerations are similar to those which are identified by banks in drafting "living wills". Some practical considerations include:

- Maintaining technological support operations for both the part of the business sold and any part retained (including outsourced contracts) would be one of the most challenging considerations given that many CCPs rely on bespoke technical systems;
- Meeting capital requirements for the business sold and any business retained; and
- The ability to distinguish collateral pools so that collateral for solvent services could be transferred separately from the service in financial difficulty.

In addition, there may also be challenges in selling different service lines to different buyers because of set-off rights under the rulebook. Consideration is also needed about the impact of transfer of client assets (margin).

Question 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?

Many of the practical issues would be the same as with the sale to a third party. In addition, consideration is needed as to how best to ensure the bridge institution meets the requisite requirements to be an authorised CCP under the relevant domestic legislation. Presumably,

a bridge institution would need to be brought into existence with the relevant authorisations already in place by order of the resolution authority. This would need to be reconciled with the detailed provisions on CCP authorisation under the Corporations Act 2001 to ensure that a bridge institution meets the organisational and capital requirements for a CCP seeking authorisation from the Government. Therefore, the resolution regime should take account of such situations and require ministerial approval where necessary or be considered as acting within the ministerial approval required under the Corporations Act.

3.6 "Temporary stays on early termination rights"

Question 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?

We welcome the proposal, consistent with the FSB guidance, that the entry into resolution of an FMI should not in itself allow any counterparty of a FMI to exercise contractual acceleration and early termination rights, unless the FMI fails to meet payment or delivery obligations. We believe this approach is central to any successful CCP resolution.

The resolution of a CCP may require the transfer of one or more clearing services to another CCP or a bridge institution and winding up of other, non-viable elements. Depending on the complexity of the CCP in resolution, it is difficult to envisage how long the implementation of these measures may take, and therefore we agree that there may be circumstances where the duration of a temporary stay would need to be extended beyond a prescribed time. In the case of LCH.Clearnet, it can only default against its members in the event that it fails to pay amounts due (which is subject to a 30 day resolution period) or it becomes insolvent. LCH. Clearnet's loss allocation processes should ensure that it is highly unlikely to become financially insolvent as a result of a member default, so therefore going into a resolution process may be one of the few ways that the insolvency default could be triggered, and so switching that off, albeit temporarily, is almost certainly helpful.

Section 4.1 "Respect of creditor hierarchy and 'No Creditor Worse Off' principle"

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

In general, we consider this a sound principle. However, it should be clear that a CCP's default arrangements should be the first line of defence when dealing with the default of its members and this is reflected in the default waterfall provisions required of CCPs seeking authorisation. Any contributions that members or participants are obliged to make under default arrangements should be considered separately from the question of no creditor being worse off than in insolvency. To judge this test from where a CCP begins its default procedures would be premature and to do so would disincentive a member or participant from participating fully in the default management process. Instead, any such evaluation should be made at the time which the resolution authority intervenes to ensure that a CCP is prevented from otherwise going into insolvency.

Section 4.4 Funding arrangements

Question 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?

If public funding has arisen as a result of a clearing member default, then we believe that costs should be recovered from the the surviving clearing members.

Section 5.1.4 Crisis management groups

Question 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?

We would like to express our support for the establishment of CMGs as they will facilitate dialogue and discussion between the relevant supervisors, central banks and other public authorities. However, we agree that it may be too early to amend the legal framework with respect to the formation of such CMGs, since these have not yet been established for those cross-border FMIs that are relevant to the Australian financial system. In addition we would like to highlight the point that, following the formation of such groups, the decision making should ultimately reside with a single resolution authority, which in our view should be the resolution authority of the jurisdiction in which the CCP is established.

5.2.3 Access to information and information sharing

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

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

The important consideration is that the decision to suspend or revoke a licence must be taken in the same context of a key objective being the continued provision of systematically important services. Where action by foreign authorities is taken which limits the amount of information needed by the ASIC or RBA to perform effective oversight, the first course of action should be to encourage the FMI to provide information unilaterally and seek a solution with the overseas regulatory authorities. Suspension or revocation is a serious action which should only be taken if there is a systemic risk which cannot be mitigated effectively.

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We hope that the Government finds this submission useful and we look forward to engaging further as policies are developed. Please do not hesitate to contact me at rory.cunningham@lchclearnet.com regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours faithfully

Rory Cunningham
Director, Asia Pacific Compliance & Regulatory Affairs