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

Dear Sir

Consultation Paper – Proposals of the Australian Council of Financial Regulators on the Regulation of Operators of Financial Market Infrastructure

Chi-X Australia Pty Ltd is grateful for the opportunity to respond to the above consultation paper (CP), which deals with issues of significant importance to Australia.

Chi-X Australia Pty Ltd commends Treasury and the relevant authorities for transparently seeking to address the adequacy of local regulatory measures in the increasingly global and cross border area of financial market infrastructure.

Overview

Chi-X Australia Pty Ltd is the licenced operator of an Australian market and is a member of the Chi-X Global group of companies that operate trading venues throughout the world. This response represents the views of Chi-X Australia Pty Ltd only and as such any references to 'Chi-X' are solely to Chi-X Australia Pty Ltd. Other members of the Chi-X group, including Chi-X Global itself, may respond independently to the issues that are raised in the CP.

In addition to responding on each of the questions posed, Chi-X has comments on the following overall aspects of the CP:

(i) whether the analysis within the paper and the consultation process is in keeping with the seriousness and potentially significant impact of the proposals;

(ii) the potential for the some of the proposals to exacerbate the very problems the paper is seeking to address;

(iii) the impact of the public utility nature of the settlement function on market infrastructure issues.

The CP Analysis and consultation process

As the licenced operator of what the Stockbroker's Association of Australia has labelled Australia's first truly competitive exchange, Chi-X is well aware that the case for changing the regulatory landscape of Australia's financial market infrastructure has to be made before the changes take place. Prior to the introduction of competition, regulatory authorities issued several consultation papers and proposed draft regulations which were extensively analysed and considered. This is in contrast to the CP, which has been the subject of a very brief consultation period and contains only cursory examination of some proposals that may fundamentally change Australia's market infrastructure.

The role the financial market infrastructure (FMI) of Australia plays in the capital raising process and channelling of funds to economically productive and job creating areas is integral to the economic wellbeing of the country and all Australians. Australia aspires to create a financial hub and the presence of globally competitive infrastructure is integral to realising that goal. Proposals that may have a fundamental impact on FMI must therefore be subject to a considered and thorough analysis of their costs, benefits and potential knock on effects, particularly if they are untried globally. That analysis should ensure that proposed measures are specifically addressed to correct identified breakdowns or gaps in the application of local regulations and are not generally worded, broadly defined proposals capable of potential implementation that is not clearly understood by all stakeholders. Unfortunately the CP:

(a) proposes that new powers be granted without identifying:

  (i) why existing regulations and powers will not work;

  (ii) the detailed circumstances in which the proposed powers would be exercised; and

(b) does not analyse the costs, benefits and potential knock on effects of the proposals becoming law.

Each of these issues is explored below in the context of the individual CP questions to which they relate.

Chi-X is concerned that implementing the proposals outlined in the paper without a further analysis that addresses the above issues and an extensive industry consultation process, gives rise to unjustifiable risks and the potential for unintended outcomes. Any delay in or further cost of implementing measures as a result of undertaking that further examination is fully justified as some of those unintended outcomes may have a significant negative impact on Australia's FMI, potential capital raising by Australian companies and, ultimately, job creation and the welfare of all Australians.

Exacerbating the problems that it is intended be resolved

The consultation paper seeks to address issues raised by the systemic importance of market infrastructure operated in Australia by a monopoly provider. In the case of clearing and trading infrastructure, these issues can best be addressed by creating an environment that encourages competing FMI operators[1]. By introducing diverse suppliers, Australia will reduce the systemic

[1] The barriers to entry for new FMI providers make it likely that any new providers will be part of a global group or have significant offshore links. It is also relevant in this context that the ADI regime from which the paper seeks to

importance of any single operator and provide appropriate contingency options in the event of the failure of any one provider.[2]

However, there is a risk that global market infrastructure providers will not be attracted to Australia if regulatory measures are introduced that create an uncertain and bespoke Australian impact on the business model, operation and/or governance of an international provider. This risk is heightened if those measures are broadly defined, capable of eliminating shareholder interests and not clearly articulated. On the face of the paper, this risk is particularly pronounced in respect of the measures relating to step in powers, location mandates, the pre-approval of appointments to parent company boards and the subjective definition of systemic importance. These measures risk causing the very outcomes that the Johnson Report emphasised it is crucial to avoid if Australia is to successfully develop a financial centre, stating:

> *It is thus crucial that domestic policies do not inhibit companies that have the capacity, skills and comparative advantage from expanding into offshore markets and transacting with offshore counterparties; and also that domestic policies do not inhibit offshore international financial services companies from competing domestically or from using that financial centre as a regional base*[3].

There are already examples in Australia's financial markets where locally focused business has migrated to take advantage of offshore infrastructure[4]. There is a significant risk that the CP proposals on step in powers, location mandates and the pre-approval of appointments to parent company boards will deter the entry of FMI operators to Australia and lead to the progressive migration of business to offshore centres that contain internationally integrated infrastructure.

In these circumstances, some of the proposals in the paper may decrease the likelihood of competition mitigating the systemic importance of the current monopoly provider and consequently increase the very risks and problems that the paper is seeking to resolve.

Settlement Infrastructure

The settlement infrastructure in Australia is consistent operationally, economically and geographically, with a public utility. The cost benefit analysis of many of the proposed measures in the paper will be different for, on the one hand, trading and clearing infrastructure and, on the other, settlement operations. Chi-X is of the view that in these circumstances the proposals relating to the settlement function should be subject to a separate and urgent analysis.

Chi-X is also of the view that serious consideration needs to be given to exploring the options for operating Australian settlement infrastructure on a public utility basis. It is the view of Chi-X that this is potentially the most efficient and effective method of dealing with the issues raised by the systemic importance and non-contestable nature of the settlement functions.

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borrow some of its proposed regulatory measures applies to an Australian market that is far more advanced in its competitive offering than that of FMI providers.

[2] The benefits of competition are highlighted in *Competition among electronic markets and market quality*, Peter Gomber, Markus Gsell, Marco Lutat, Goethe University 2009.

[3] Page 8. *Australia as a Financial Centre: Building on our Strengths,* Australian Financial Centre Forum, November 2009.

[4] For example local participants in the interest rate derivatives markets use offshore clearing participants and infrastructure.

The Questions

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

The location proposal is loosely described and theoretically provides regulators with an unlimited discretion to dictate the business model of a licenced entity. This can only send a negative message to offshore entities looking to commence or expand business activity in Australia. It potentially conflicts with the recommendations in the Johnson Report to improve the regional engagement of Australia's financial sector within the context of greater regional integration and cooperation[5]. In addition, due to its size and scale, the ability of the Australian market to attract global providers is dependent on the extent which those providers can leverage offshore technology, resources and capital.

In these circumstances, some key issues that the CP does not discuss in any depth and which impact on whether the proposals are in Australia's best interests include the following. Would the offshore development and maintenance of IT systems be prohibited? What impact would this have on the standard of IT systems used in Australian market infrastructure? Would the global management of clearing risk be prohibited? What impact would location requirements have on globally implemented margin offset policies that may represent global best practice? How would cross border products such as interest rate swaps or forex contracts be dealt with when two jurisdictions clearly have equal interests? What impact would the requirements have on the relative standards of Australian market infrastructure and its aspiration to be a financial centre? How would an Australian regulator seek to enforce location requirements in a global organisation? How would a global operator manage incompatible directions from different regulators? The lack of clarity on issues such as these may lead to "worse case" assumptions by suppliers considering entry to the Australian markets.

Chi-X is of the view that these and similar key questions should be analysed and addressed before finally considering whether the power to impose location requirements should be made law.

2. Do you have comments on the flexible graduated approach [to the location requirement] for systemically important FMIs?

Chi-X agrees that a greater focus on the application of local regulatory measures is required as infrastructure becomes more systemically important. However it is not clear that specific measures imposing location requirements will be more effective than, for example, the current requirements for an Australian licenced FMI provider. For example, existing requirements of maintaining sufficient resources empowers the regulator to examine the adequacy of the operations and resources at the licenced entity as against those existing elsewhere within the corporate group of which it is a member.

Chi-X would also expect any analysis of this proposal to consider international co-operation between regulators as an effective and potentially preferable alternative to granting arbitrary and subjective powers to local regulators.

[5] See recommendation 6.1 of *Australia as a Financial Centre: Building on our Strengths,* Australian Financial Centre Forum, November 2009.

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

The proposed mechanism by which location requirements will be imposed is not clearly described. Chi-X is of the view that:

(i) it is difficult and problematic to comply with uncertain and unclear regulations (we also suspect that they are not easy to implement);

(ii) the lack of certainty makes Australia less attractive as a place to do business;

(iii) uncertain regulations import subjectivity into the regulatory decision making process, which in turn gives rise to potential regulatory arbitrage and the application of different regulatory standards (unintended or intended) to different FMI providers.

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?

Chi-X is of the view that the existing powers to approve and monitor a licenced provider of FMI is sufficient to take action in respect of the directors of the licenced entity. The approval process and transparent annual assessments that are conducted are sufficient to ensure that any regulatory concerns over the directors appointed to the board of an FMI provider can be addressed.

Chi-X is of the view that it is inappropriate for a local regulator to impose pre–approval requirements on the board of an entity that is not licenced locally and indeed may be subject to oversight and regulation by more geographically and operationally appropriate authorities. The proposal potentially conflicts with the recommendations of the Johnson Report on the greater regional integration of Australia's financial markets[6]. If a locally licenced market entity has sufficient resources, appropriate governance and adequate arrangements for operating its infrastructure in compliance with the licence requirements (including those relating to conflicts that may arise between the commercial interests, broadly defined, of a parent and the need to have adequate supervisory arrangements), then that should be sufficient to satisfy local regulatory requirements. The principal underpinning these requirements would also enable the regulator to address circumstances where a parent was a malignant influence on a local entity not necessarily through the appointment of directors but due to other measures (eg a parental dictate to impose fund transfer arrangements that enabled funds to be sent offshore without appropriate sign off from local management/the board).

There are also practical issues raised by requiring regulatory approval of the appointment of directors of a parent company that are not addressed in the CP. For example, what time limits would apply to regulatory approval being granted? Could the nominee commence duties pending approval? What if the Australian and off shore regulators disagreed on the pre-approvals?

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

Chi-X queries whether the existing requirements on sufficient resources enables a regulator to apply a fit and proper test to human resources at the licenced entity that is sufficiently flexible to capture the influence of parental entities upon the operations of the local licenced entity. A clear analysis of the existing requirements would assist in this regard.

[6] Above note 5.

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?

CXA queries whether the CP makes a sufficient case for changing the current requirements in respect of making listing rules but agrees that this is an area in which work needs to be done to ensure that Australia develops a listing rules regime that is competitive on a national, regional and global level.

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

The Banking Act applies to entities holding deposits that are subject to a statutory guarantee. As such the government and tax payers are direct stakeholders in the operation of those entities during times of crises. It is not necessarily appropriate to take the high water mark of regulatory power over office holders in an ADI and apply it to infrastructure operators. The reputation of persons on the board of an infrastructure provider is their key asset and damage to it as a result of mishandling regulatory requirements will severely damage their career irrespective of any subsidiary regulatory measures. In these circumstances it is not clear how the added processes and possible litigation that would come with a directions power, undertaken contemporaneously with the unfolding of any applicable crises, provides a clear benefit to the existing regime. This would particularly be the case in a time of crises, when a flexible dynamic response may be more productive than court proceedings and/or an adversarial process involving the issue of directions with criminal sanctions.

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?

To the extent that there is such a directions power, there is an appeal in principle in allowing a regulator to impose requirements directly on a third party provider in order to avoid the problematic scenario of an FMI operator being directed to do something that required steps to be taken by a third party. However, Chi-X is concerned as to how legislating this power could play out practically. Would the mere existence of this power increase the cost of third party providers? Would it diminish the available pool of competent third party providers willing to engage with FMI providers? Would it make contractual negotiations more difficult and in turn add to the already high costs of entry into the FMI space? Would this in turn reduce the likelihood of competition developing between FMI providers?

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?

As stated above, Chi-X is of the view that the existing incentives on FMI licensees to comply with regulations and requirements are sufficient. FMI licensees are traditionally risk focused organisations that do not take leveraged principal positions or engage in other business activities that may create incentives that need to be addressed by the introduction of new penalties and sanctions. The incentive for a licensee and its employees to avoid the business and career consequences of breaching a direction/condition is at least as strong, and arguably more economically productive, than that provided by any penalty or sanction.

Chi-X is also of the view that government should be reluctant to empower employees at a single agency to legislate, prosecute and adjudicate upon offence provisions. Chi-X would be concerned about the

necessary checks and balances being in place for the just operation of punitive sanctions if a single government agency (and perhaps person) could create the initial FMI policy environment, supervise FMIs, create offence provisions for directors at FMIs and finally decide upon and sign off on the imposition of penalties in respect of the offence provisions that they have created.

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?

It is the view of Chi-X that the case has not been made that the existing laws and regulations applying to the directors and officers of FMIs are inadequate to deal with all plausible scenarios that may arise. Directors at FMIs will not have supervised business lines that take proprietary positions from which they stand to gain directly. FMIs operate a traditionally conservative risk managed business that is heavily dependent on the integrity and reputation of the business and its leaders for it viability. There is no evidence that the existing sanctions are insufficient and it is possible that creating an environment driven by the threat of punitive sanctions would have a detrimental impact on the measured and efficient discharge of duties during a time of crises. The transparent annual assessment conducted by ASIC, which culminates in a publicly available report[7], provides a significant incentive to comply with existing requirements and it is not clear how these existing measures are deficient in achieving the required regulatory outcomes.

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?

Chi-X is of the view that the case for the proposed step in powers has not been made.

The business of operating an FMI that has become systemically important will be complex and highly specialised[8]. It is not clear how a third party parachuted into the FMI business will be better placed than existing management to achieve the outcome goals of the step in power. FMIs are inherently managed on conservative risk management lines consistent with entities that do not take large proprietary positions or pose the traditional conflicts that may arise at an ADI or other leveraged financial institutions. FMI providers are entities that seek to manage and minimise risk.

The practical outcome if circumstances were to arise that threatened the solvency of an FMI provider, is that management and the Board would develop, consider and decide upon a proposed rescue plan. If the plan was successful then the solvency crises would be adverted. If it was unsuccessful then a third party administrator would be appointed. It is therefore possible (and perhaps probable) that the proposed measures will not be triggered if a solvency crises did indeed arise.

The lack of clarity on (a) when the step in powers are triggered and (b) what happens to the interests of creditors/shareholders and other stakeholders when the government "steps in" to an FMI provider, will diminish the attraction of Australia relative to other developed markets that do not have such regulatory measures.

In these circumstances, the potential cost of legislating a power for ASIC or the Minister to appoint a statutory manager may exceed its benefits.

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[7] See http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Market%20assessment%20reports

[8] See, for example, the FT article "LCH.Clearnet completes MF Global UK transfer" retrieved from www.ft.com on 30 November 2011.

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?

If the proposal were to go ahead then Chi-X would be supportive of a third party being appointed rather than empowering a regulator that had previously established the policy setting, supervised the FMI entity, legislated offence provisions and had or was able to decide upon and issue punitive sanctions in respect of alleged contraventions. Further it may also be appropriate to have an independent agency take responsibility for making the final decision on whether the step in power should be exercised.

It should also be noted that introducing competition and alternate FMI providers is also more likely to result in it being possible to appoint suitable third party managers with appropriate skills, knowledge and experience.

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?

Chi-X is opposed to the proposals for step in powers as prescribed. It is not clear how the step in powers would operate with the existing requirements on directors of an entity that was at risk of insolvency and how any duties to creditors and shareholders would be impacted by the step in regime.

The triggers proposed are broadly worded and it is not clear what is caught by the term "timely manner".

It is not clear why, given the nature of the FMI business, there is a perceived need for a regime that would remove the persons who may be best placed to run what are highly specialised businesses and are subject to a wide ranging and relatively developed mix of legislative provisions and common law duties, and replace them with a bespoke regime involving third parties.

Legislating step in powers with the breadth of those proposed would risk diminishing the attraction of Australia to global FMI providers.

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?

The goal of seeking to protect financial stability through the continuation of the FMI's services may be a simple one to state but an incredibly complex one to implement. An FMI that occupies a systemically important position will be doing so at least in part because of its management and Board expertise. In these circumstances, there is a risk that removing the management of an FMI provider during a time of crises will be counterproductive. While the legislation of a step in power does not mean that it would be exercised in every circumstance where it could, it is the view of Chi-X that it may be worthwhile to further consider the proposals and whether:

(i) they create an expectation that the powers should be used, even in circumstances where that may in fact be counterproductive;

(ii) the impact of that expectation being created on the cost of the proposals and in particular on the damage to Australia's attraction as a place to operate FMI.

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?

It is not clear how the appointment of a statutory manager would interact with the insolvency law when the entity was solvent prior to his/her appointment. The triggers for the appointment that are listed in section 8.1.3 go beyond the insolvency situation. There may be circumstances in which opinions, at Board level and elsewhere, differ over the solvency of an entity and it is not clear how the appointment of a statutory manager would interact with the insolvency law in these situations.

It is also unclear whether legislating for the possible appointment of a statutory manager will encourage a Board to err on the side of handing its responsibilities to statutory authorities in circumstances when it may in fact be preferable, for the sake of the stability of the overall financial system, for the Board to continue working through the crises.

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?

Chi-X queries whether a more thorough examination is required of any proposed regime involving a statutory manager as there are many complex issues that could be raised in this area. A range of issues that could be considered include: what if the statutory manager assumed control in a non-insolvency situation but rendered the FMI operator insolvent? What are the consequences for the existing shareholders of the infrastructure entity? How would a statutory manager resolve potential conflicts between different views on obtaining overall financial stability? Between stability in the short and longer term?

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

It is in keeping with the comments elsewhere that the proposal empowering a government step in for all FMIs creates a material risk of diminishing the attraction of Australia for leading global infrastructure providers. The paper is not clear on what benefits are obtained from the proposal that warrant creating this risk. In particular it is not clear what regulatory outcomes could be achieved from the exercise of this power that would not be achieved, potentially more effectively, through the use of existing powers.

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?

Chi-X is of the view that there should be a process for designating a systemically important FMI that affords impacted persons, including shareholders and offshore parents of locally licenced entities, the opportunity to have input to the decision making process.

Chi-X is opposed to a broadly worded criteria of "any other factors a government agency think relevant" as it creates uncertainty and a risk of undisciplined decision making processes with little or no governance.

Chi-X is also of the view that any uncertainty over the definition of 'systemically important' will exacerbate the uncertainty created by any broad definitions in, or lack of clarity over the implementation of, the powers to which it relates. This will in turn diminish the attraction of Australia to overseas operators of FMIs.

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?

Given the complexities in this area[9], while timely portability has an in principle appeal, Chi-X queries whether a more in depth consultation and examination of this issue is required before legislative proposals are implemented.

20. Do you see any areas in which the governance of the NGF, or other arrangements under Part 7.5 could be improved?
21. If so, please explain why and how you think improvements can be made?

Chi-X agrees with the Council that a more representative and transparent governance regime for the NGF and Division 3 arrangements would be beneficial. Chi-X is of the view that any such arrangements should clearly identify the beneficiaries and stakeholders in the statutory trust to facilitate those beneficiaries being afforded an appropriate degree of control and influence over the operation of the fund. The application of trustee duties to the operation of the fund should assist in the management of conflicts of duties arising in a multi-market environment. However to the extent these duties would allow the operations of the NGF to be focused upon a single market operator, it may be worthwhile embarking on a process of prescribing the governance regime and affording stakeholders, beneficiaries and their representatives to have say in how the fund and trust would be managed going forward.

Chi-X is strongly of the view that there should be transparency over the acquisition and pricing of shares in the SEGC and the process for new markets becoming party to Division Four arrangements.

Please do not hesitate to contact me if you have any queries.

Yours faithfully

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[9] For example, the different models of retail/wholesale client money treatment, the intricacies of multijurisdictional insolvency, trust, rehypothecation and contractual laws, and the potential for Australian laws to be circumvented by a global flow of funds thus defeating the intention of any legislative amendments.