Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities

Council of Financial Regulators: Supplementary Paper to the Review of Financial Market Infrastructure Regulation

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1. Introduction

In October 2011, the Council of Financial Regulators (the Council) consulted on a broad package of reforms to the regulatory framework for financial market infrastructures (FMIs).[1] The Council subsequently wrote to the Treasurer and Deputy Prime Minister outlining its final recommendations, with this letter released in March 2012 along with an invitation for further stakeholder comment on implementation. Among its proposed reforms, the Council recommended legislative change to underpin the imposition of graduated 'location requirements'. These may be more broadly defined as measures to be taken by the Reserve Bank of Australia (RBA) and the Australian Securities and Investment Commission (ASIC) (together, the Regulators) to ensure that they retain sufficient regulatory influence over cross-border FMIs that operate in Australia. The term cross-border is used throughout this paper to refer to the provision of services to domestic participants by offshore-based facilities, and 'offshoring' by domestic facilities.

The purpose of this paper is to provide further clarity on measures that could be applied in the case of cross-border clearing and settlement (CS) facilities and how they might be implemented in practice under current legislative arrangements.[2] The need for further detail in this regard has become evident in consultation with stakeholders on the proposed regulatory reforms for FMIs. The framework described in this paper would apply equally to overseas facilities operating in Australia and domestic facilities seeking to move some operations offshore.

This paper focuses primarily on how the Regulators' existing powers under the *Corporations Act 2001* (the Act) could be used to apply to the framework. The relevant powers include the following:

- Under advice from the Regulators, section 825A of the Act gives the Minister assigned responsibility for the Act (currently, the Minister for Financial Services, Superannuation and Corporate Law) the power to impose, vary or revoke conditions on CS facility licenses. ASIC's Regulatory Guide (RG) 211 sets out ASIC's broad approach to advising the Minister on CS facility licence applications and associated conditions.
- Section 827D of the Act gives the RBA the power to determine Financial Stability Standards (FSSs).

ASIC and the RBA intend to consult on revisions to RG 211 and the FSSs, respectively, later in the year. These consultations will have two objectives. First, the Regulators will consult on revisions required to align their regulation of CS facilities with best practice as reflected in the recently released CPSS-IOSCO

1 On 8 April 2011, further to the Government's rejection of a proposed merger between the Australian Securities Exchange and the Singapore Exchange, the Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP, referred a number of issues to the Council relating to the regulation of financial market infrastructures. The Council released a consultation paper on 21 October 2011, seeking stakeholder views on a number of regulatory reform measures. On 30 March 2012 the Deputy Prime Minister and Treasurer released the Council's letter of advice in relation to the review. The Treasurer's referral, the public submissions and the Council's advice are available on the Treasury website at <http://www.treasury.gov.au>.

2 This paper does not discuss the application of this framework to other classes of FMI currently, or prospectively, covered by the *Corporations Act 2001*, such as financial markets or trade repositories. ASIC will consider in the future the application of similar measures to other types of cross-border FMIs. The focus on CS facilities in this paper reflects the scope of stakeholder feedback.

'Principles for Financial Market Infrastructures' (the Principles).[3] Second, the consultation will provide an opportunity for stakeholder input on revisions to RG 211 and the FSS that would give effect to the specific additional measures for cross-border CS facilities envisaged under the framework described herein.

As stated in their advice to the Deputy Prime Minister and Treasurer, the Regulators see merit in having the scope of existing powers buttressed by amendments to the Act to enhance regulatory influence. The Regulators anticipate that the framework outlined in this paper would be capable of ready adaptation should legislative amendments create explicit powers.

3 CPSS-IOSCO (Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions) (2012), 'Principles for Financial Market Infrastructures', April. Available at <http://www.bis.org/publ/cpss101a.pdf>.

2. Background

2.1 The Regulators' Responsibilities

In accordance with powers granted under Part 7.3 of the Act, the Regulators work closely in the regulation of CS facilities. Each of the Regulators may advise the Minister in relation to applications for CS facility licences, and each has a role in the ongoing regulatory oversight of licensees, reporting to the Minister at least annually on licensees' compliance with their regulatory obligations.

In particular, ASIC is responsible for assessing whether licensees comply with their general obligations under section 821A(a)–(h) of the Act, including that licensees, 'to the extent that it is reasonably practicable to do so, do all things necessary to ensure that [their services] are provided in a fair and effective way'. The RBA has a complementary power to determine standards (i.e. FSSs) 'for the purposes of ensuring that CS facility licensees conduct their affairs in a way that causes or promotes overall stability in the Australian financial system'. In accordance with this provision, the RBA has determined FSSs for central counterparties (CCPs) and securities settlement facilities (SSFs) and annually assesses whether each licensed CS facility has complied with the relevant FSS and done all 'other things necessary to reduce systemic risk'. Under the *Reserve Bank Act 1959*, the Payments System Board has a statutory role in ensuring the RBA exercises its powers under the Act so as to best contribute to the overall stability of the financial system.

The Act provides for two classes of CS facility licence: a 'domestic' licence, granted under section 824B(1); and an 'overseas' licence, granted under section 824B(2). The Minister may grant an overseas licence where, among other conditions, an overseas facility is authorised to operate a CS facility in the foreign country in which its principal place of business is located, and the operation of the facility in that country is subject to requirements and supervision that are sufficiently equivalent to those under the Act. In this case, the Regulators would place reliance on information and reports provided by the facility's home regulator in assessing the facility's compliance with its licence obligations.

A number of the measures that might be considered within the framework set out in this paper are relevant to the regulatory responsibilities of both ASIC and the RBA.

2.2 Australian Context

Given the complementary responsibilities of ASIC and the RBA, the Regulators have worked collaboratively to develop the framework described in this paper. These issues have also been discussed actively among

the wider group of Council agencies, given their relevance to the Council's work on reform of FMI regulation, competition in clearing and settlement, and regulation of the over-the-counter (OTC) derivatives market.[4]

Through this work, the Council has further defined the objectives of a policy on cross-border provision of clearing and settlement services. In its report on a framework to implement Australia's G-20 commitments in relation to OTC derivatives, the Council articulated these objectives in terms of:

- minimising potential disruption and loss to Australian financial institutions, financial markets and the real economy in the event of a participant's default or other financial stress to a CS facility;
- ensuring continuity of provision of clearing and settlement services to the most systemically important Australian financial markets; and
- establishing conditions whereby Australian regulators have effective oversight of a cross-border CS facility and can exercise sufficient influence to ensure that the facility meets domestic and international standards for systemic risk management, provides its services in a fair and effective way, and offers due protection to Australian participants.[5]

Among its final recommendations on FMI regulatory reform, released by the Deputy Prime Minister and Treasurer on 30 March 2012, the Council proposed that the Regulators be given explicit powers to impose 'location requirements' in pursuit of these objectives. It was envisaged that these could encompass a broad spectrum of financial, operational, regulatory and legal measures to protect Australian interests in the functioning of an FMI licensed to operate in Australia, including ensuring continuity in the provision of services in times of stress. Importantly, however, the Council proposed that any such requirements be 'imposed in a proportional and graduated fashion', taking into account factors such as the systemic importance of the underlying market and the composition of the FMI's participants. This paper elaborates on the Council's proposal. Treasury is currently considering legislative changes that may be required to support the implementation of this and the other elements of the recommended package of reforms. The government will consider legislative reform proposals in due course.

At the same time, the Council's proposals for the implementation of Australia's G-20 commitments on OTC derivatives regulation raise the near-term prospect of an offshore CCP entering the Australian market to clear products such as interest rate swaps. And a recently released Council discussion paper on competition in the clearing and settlement of cash equities acknowledges that competition in the clearing of ASX securities is perhaps more likely to emerge from an offshore CCP seeking to leverage its existing operations.

2.3 International Context

The Regulators' consideration of policy on influence over cross-border CS facilities is consistent with a broader international focus on these issues, primarily in the context of CCPs. A number of jurisdictions have articulated

4 See, for example, the Council's recent releases on: the review of FMI regulation, available at <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Council-of-Financial-Regulators-Financial-Market-Infrastructure-Regulation>; a regulatory framework for OTC derivatives, available at <http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/Over-the-counter-derivatives-commitments-consultation-paper>; and competition in clearing and settlement, available at <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/Competition%20in%20the%20clearing%20and%20settlement%20of%20the%20Australian%20cash%20equity%20market/Key%20Documents/PDF/Australian_cash_equity_market_Discussion_Paper.ashx>.

5 See 'OTC Derivatives Market Reform Considerations: A Report by the Council of Financial Regulators', March 2012, p 31. Available at <http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2012/CFR%20report%20on%20over%20the%20counter%20derivatives/Downloads/PDF/CFR%20Report.ashx>. The precise wording of these objectives has been adapted slightly in this paper to broaden their scope to CS facilities generally, rather than CCPs specifically.

policy measures in this area, including the euro area, the US and Japan.[6] The framework proposed in this paper shares many of the aims of other jurisdictions' policies. However, it addresses a broader range of cross-border regulatory issues, while at the same time providing for a graduated approach to the imposition of additional requirements.

The Council's work also reflects, in the Australian context, some of the thinking under way internationally, led by the Financial Stability Board (FSB), around 'four safeguards' for access to and oversight of offshore-based CCPs.[7] This work recognises that in meeting the G-20 commitments on clearing of standardised OTC derivatives, market participants in some jurisdictions may seek recourse to an offshore-based CCP with international reach. Authorities and market participants alike therefore need to have confidence in such an option. The four safeguards comprise: a framework for international cooperative oversight; fair and open access criteria that promote competition; appropriate liquidity arrangements in all relevant currencies; and procedures for effective resolution. These safeguards are, in part, embedded in the recently released Principles.

This work is also informed by the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the Key Attributes), which is now an international standard on crisis resolution and will be incorporated into future assessments by international financial institutions, such as the International Monetary Fund. Ongoing international work on recovery and resolution of FMIs is examining the application of the Key Attributes to FMIs. The measures set out in this paper relate to principles in the Key Attributes that speak to the need for both home and host authorities to have the necessary powers and capacity to resolve distress effectively.

6 Japan's focus is domestic clearing for certain types of products, whereas the Eurosystem has developed a policy stating that all CCPs clearing euro-denominated products over a certain threshold should be incorporated in the euro area including management and operations of all core functions. Other jurisdictions, such as the US, require that CCPs hold sufficient US dollars in segregated client accounts in the US.

7 The FSB's 'four safeguards' are outlined in Dudley WC (2012), 'Reforming the OTC Derivatives Market', Remarks at the Harvard Law School's Symposium on Building the Financial System of the 21st Century, Armonk, New York, 22 March. Available at <http://www.newyorkfed.org/newsevents/speeches/2012/dud120322.html>.

3. Graduated Approach to Additional Requirements

CS facilities may differ significantly in the nature of their activities, their scale, the products and participants, and their importance to the Australian financial system. In recognition of this, it is proposed that specific requirements for cross-border CS facilities be applied in a graduated and proportional manner.

Under this approach, there would be some basic requirements imposed on all cross-border CS facility licensees, both domestic and overseas, which largely clarify, elaborate and interpret general licence obligations under Part 7.3 of the Act, including under the FSSs. While in principle it would be expected that these requirements would be met by all licensees, some specific measures may not in practice apply unless a facility had material Australian-based participation or provided services in Australian-related products (e.g. Australian dollar-denominated products, or securities issued by Australian-domiciled issuers).

Other requirements would apply only if the licensee was deemed to be, or over time became, systemically important in Australia, and/or exhibited a particularly strong connection with the Australian financial system and real economy. Determination of which specific measures should apply to a given facility would reflect a case-by-case assessment of the benefits from enhanced influence for the Regulators, relative to the costs of imposing additional requirements.

The benefits are likely to be greatest where the underlying market is systemically important to Australia, particularly where the facility also has a strong connection to the domestic economy (perhaps by virtue of its participation base or its product mix), such that a disruption could give rise to instability and reputational, confidence or integrity concerns. In such circumstances, a key consideration for the Regulators would be whether adequate channels existed whereby the services of the facility to the Australian market could continue uninterrupted in the event of distress to the facility. This might imply tighter influence through primary regulation[8] and restrictions on offshore outsourcing of critical operational functions, such that appropriate resolution actions could readily be applied.[9]

Potential costs, on the other hand, may extend to unintended changes in the market structure, including potential fragmentation, or a disproportionate increase in costs for some participants relative to others. The proposed framework therefore spans the following:

8 Primary regulation may be defined for the present purposes as regulatory oversight by the regulator in a licensee's principal place of business. Where a CS facility was domestically incorporated and had a domestic licence, Australia would be deemed to be its principal place of business. ASIC and the RBA would therefore be primary regulators, since they would conduct their regulatory oversight with no routine reliance on assessments or reports from a regulator of the facility in another place of business.

9 The capacity to take appropriate actions could equally be undermined by the outsourcing of critical functions to another domestically located entity. This issue is, however, out of the scope of the framework articulated in this paper and will be addressed separately in the planned revisions to the FSSs.

- *Foundational requirements*
  - *for all CS facilities licensed in Australia*: legal compatibility of the facility's rules with Australian regulatory objectives; adequate channels to demonstrate compliance with FSSs and other obligations as CS facility licensees under Part 7.3 of the Act;
  - *for CS facilities licensed in Australia that have material Australian-based participation and/or provide services in Australian-related products*: governance and operational arrangements that promote stability in the Australian financial system.
- *Additional requirements for systemically important CS facilities*: holding an Exchange Settlement Account (ESA) with the RBA; strengthened influence for the Regulators.
- *Additional requirements for CS facilities that have a strong domestic connection*: holding a domestic CS facility licence (and hence submitting to primary regulation by the Regulators), which may also require a domestic legal presence; and controlling the degree of offshore outsourcing of critical functions, including systems, data and staffing.[10]

At least in theory, a CS facility could have a strong domestic connection without also being systemically important. An example might be a CCP serving an alternative trading platform for ASX securities that commanded only a small share of the market. Even though such a facility might be integrated with the Australian financial system and real economy, its small scale might limit the potential for reputational or system-wide confidence concerns to arise. From a stability perspective, therefore, only the foundational requirements would apply. However, in some circumstances, for instance if a trading platform served by an offshore CS facility had a high degree of retail participation, retail consumer protection concerns or market integrity considerations might nevertheless lead ASIC to recommend that the facility apply for a domestic licence and thereby submit to primary regulation by the Regulators.[11]

More generally, even if a facility initially entered the Australian market with a small operation, the requirements for both *systemically important* facilities and those for *facilities with a strong domestic connection* would be expected to apply should its market share grow substantially or the nature of its operations or participants change.

3.1 Foundational Requirements

In principle, the class of foundational requirements should not generate substantial incremental costs for CS facilities, particularly since they generally clarify or make explicit requirements already contemplated within the Act. Of the measures considered here, some will be more relevant to CCPs, and others more relevant to SSFs. Furthermore, the requirements may be applied differently, and indeed may not apply at all, depending on the characteristics of a facility, and in particular whether the facility has material Australian-based participation or provides services in Australian-related products.

10 The framework as articulated in this paper does not incorporate any requirements in relation to how the assets (e.g. posted margin or default fund contributions) of a CCP's clearing participants or its clients should be held. However, the Regulators will continue to monitor the case for such requirements and may consult on proposals in this area in the future.

11 If such a judgement were made prior to the facility obtaining a licence, the Minister could reject any application for an overseas licence and insist that the facility applied for a domestic licence. If this judgment occurred subsequent to the facility obtaining an overseas licence, perhaps in response to a change in the nature and scope of the facility's business, the facility might be requested to reapply for a domestic licence. As will be discussed in Section 4, amendments to the Act are under consideration which would enhance the legal certainty around any such request.

3.1.1 Foundational requirements for all CS facilities licensed in Australia

Some requirements should apply to all licensed CS facilities, irrespective of the nature and scope of their activities in Australia. These include requirements that underpin both the legal status of the facility's activities within the Australian jurisdiction, and the exercise of the Regulators' responsibilities under the Act. These are discussed below.

Legal compatibility of rules with Australian regulatory objectives

As already acknowledged in the Act, and elaborated in ASIC's RG 211 and the FSSs, it is essential that any CS facility operating in Australia can enforce its rules, procedures and contracts, and that the application of overseas laws does not deliver outcomes that are incompatible with Australian regulatory objectives.

Facilities are already required under the current FSSs to have rules that are clear and legally enforceable in all relevant jurisdictions. It is additionally proposed that under the revised FSSs, any offshore-based CS facility intending to operate in Australia obtain (and make available to the Regulators) an independent legal opinion stating that rules relevant to its activities in Australia are enforceable, and identifying any conflicts of law between Australia and the facility's home jurisdiction that may be relevant to Australian regulatory objectives.[12] This should enable the Regulators to determine the potential for outcomes that may be incompatible with Australian regulatory objectives. The facility would be required to refresh the opinion periodically and submit a revised opinion in the event of a material legislative change in either jurisdiction. The Regulators would seek, as appropriate, their own independent legal advice on the soundness of opinions submitted by facilities.

Channels to demonstrate compliance with Australian regulatory requirements

All CS facility licensees must comply with their obligations under the Act, even where a level of reliance is placed on an overseas facility's home regulator. Facilities should therefore provide for adequate channels to demonstrate to the Regulators their compliance with these requirements. The appropriate form of this demonstration may, again, depend on the type of facility and the nature of its activities. In the case of an overseas licensee, for the Regulators to conduct their respective annual assessments as required under Part 7.3 of the Act, there should be adequate information-sharing arrangements between the Regulators and the licensee's home regulator. These arrangements should clarify procedures for sharing and requesting relevant information.[13]

Where a facility holds a domestic licence, it is important that the Regulators have adequate channels to execute their responsibilities as primary regulators. In particular, the Regulators are obliged to conduct *direct* assessments of facilities' compliance with their obligations under the Act and therefore, irrespective of a facility's systemic importance or the strength of its domestic connection, its operations must be organised in such a way that the Regulators' capacity to carry out direct oversight is not impeded.

Such capacity could be compromised where a domestic CS facility licensee outsourced management capacity or critical operations to offshore entities (including related entities). Similar issues could arise in the event that arrangements were established for outsourcing or the sharing of functions with an offshore CS facility in the context of a merger, joint venture or other form of cooperation. Indeed, such concerns were raised in the

12 Guidance to Principle 1 (Legal Basis) of the Principles envisages that an FMI obtain a legal opinion for such purposes. Explanatory note 3.1.3 states that 'one recommended approach to articulating the legal basis for each material aspect of an FMI's activities is to obtain well-reasoned and independent legal opinions or analyses'.

13 In accordance with the Act, the Minister must have regard to the adequacy of arrangements for cooperation between ASIC, the RBA and an overseas licensee's home regulator when making a decision as to whether to grant, revoke or suspend an overseas licence.

context of the proposed ASX-SGX merger. It would therefore be appropriate for Australian regulators to vet arrangements for the offshore outsourcing of critical functions by domestic CS facility licensees to ensure adequate access to information and effective oversight.

There is precedent for such a policy in banking regulation. The Australian Prudential Regulation Authority (APRA) has developed a Prudential Standard on outsourcing under which authorised deposit-taking institutions (ADIs) must consult with APRA prior to any offshore outsourcing of material business activities, and include in any outsourcing agreement an explicit right for APRA to gain access to information and conduct on-site visits.[14] The Regulators could adopt a similar approach to vetting arrangements for the offshore outsourcing of important functions of domestic CS facility licensees.

Under section 825A(3) of the Act, the Minister can impose or vary conditions if deemed appropriate, having regard to the licensee's obligations under Part 7.3 and any change in the facility's operations or the conditions under which the facility is operating. Were a CS facility to seek to outsource some or all of its material business activities offshore, in a way that could compromise its capacity to demonstrate compliance with its obligations under the Act, ASIC or the RBA may advise the Minister that a condition be imposed to restrict or prohibit such outsourcing.

3.1.2 Foundational requirements for CS facilities licensed in Australia that have material Australian-based participation and/or provide services in Australian-related products

In respect of those facilities that have material Australian-based participation and/or provide services in Australian-related products, a particular concern of the Regulators will be whether the facility's governance and operational arrangements support stability and effective provision of services in the Australian financial system.

In the absence of effective competition between CS facilities operating in Australia, commercial considerations alone may not be sufficient to ensure that the interests of smaller markets such as Australia are adequately reflected in a CS facility's governance and operational arrangements. The failure of a facility to consider these interests could have implications for both the RBA's responsibility to promote stability in the financial system and ASIC's responsibility to assess whether CS facility licensees provide their services in a fair and effective way.

With respect to the RBA's responsibilities, governance arrangements that did not adequately consider Australian interests could in some circumstances introduce additional risks to the Australian financial system. For example, failure to account for Australian interests in a CCP's governance of risk and default management arrangements could give rise to stability risks by creating disproportionate obligations for surviving Australian-based participants in the event of a default, or generating other spillovers to the Australian financial system via the close-out process. Similarly, failure to provide adequate operational support or money settlement arrangements to Australian-based participants could lead to undue disruption in the event of a crisis or operational incident. Equally, the fair and effective delivery of services to Australian-based participants and their clients could be compromised if governance and operational arrangements did not adequately consider Australian interests.

Consistent with the objectives of minimising disruption and ensuring effective oversight, it is therefore proposed that a cross-border CS facility be required to demonstrate that its governance and operational

14 This is set out in Prudential Standard CPS 231 (replacing the previous standard APS 231 from 1 July 2012).

arrangements take appropriate account of stakeholder interests in all relevant markets and jurisdictions, including in Australia. Specific measures may, for instance, encompass the following:

- In respect of governance of a CCP's risk and default management arrangements, Australian interests could be accommodated in a variety of ways. For example, a CCP may offer Australian-based participants representation on its counterparty credit risk management committee; or it may consult bilaterally, or via a more focused forum. The appropriate degree of representation would depend at least in part on the relative importance of Australian-based participants to the CCP's overall activities.
- A CS facility should ensure that any obligations created for surviving participants in the event of a participant default – such as responsibilities under a CCP's default management arrangements – are commensurate with the scale and nature of individual participants' activities. Furthermore, in the case of a CCP, consideration of the effectiveness of arrangements for the close-out of a defaulter's positions should take into account the potential for spillovers in all relevant markets, including in Australia.
- A CS facility should provide adequate operational support to Australian-based participants during Australian market hours. This would mitigate operational risk arising from participation in a CS facility with operations based in another time zone.
- To the extent reasonably practicable, a CS facility should support effective access by accommodating local market practices. This would reduce operational risk and compliance costs. For a CCP, this might imply the need to review its arrangements for marking Australian-related positions to market, its approach to making and settling margin calls, and its collateral eligibility criteria. A CS facility should provide for appropriate channels by which participants can communicate their views, influence operational arrangements, and offer participant feedback on operational matters. In the case of Australian-based participants, this might take the form of a seat on a user group, should one exist, or perhaps a dedicated participant forum to reflect Australian interests.

3.2 Requirements for Systemically Important CS Facilities

Where a CS facility is, or is likely to become, systemically important in Australia, additional measures may be necessary to manage the systemic risk implications of the facility's activities. The determination of systemic importance will be made by the Regulators, as appropriate, and may require a degree of judgement in some cases. Consistent with the indicators considered by the Basel Committee on Banking Supervision (BCBS), and those outlined in the Principles, relevant factors in assessing the systemic importance of a facility in Australia would ordinarily include:[15]

- the size of the facility in Australia (for example, the absolute number and value of transactions processed by the facility in Australian dollar-denominated products, or its market share; or, for CCPs, the total amount of initial margin held in respect of Australian dollar-denominated products)
- the availability of substitutes for the facility's services in Australia
- the nature and complexity of the products cleared or settled by the facility
- the degree of interconnectedness with other parts of the Australian financial system.

An approach to determining systemic importance that aligned with that in the Principles was also recommended by the Council in its conclusions on reform of FMI regulation.

15 BCBS (2011), 'Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement'. Available at <http://www.bis.org/publ/bcbs207.htm>.

Additional measures that might be considered where a CS facility was deemed to be systemically important are elaborated below.

3.2.1 Holding an Exchange Settlement Account with the RBA

In the case of a systemically important CCP, it is essential that the facility has sufficient access to Australian dollar liquidity to ensure that it can meet its settlement obligations in a timely manner. This accords with the objective of minimising disruption and is firmly enshrined in the new Principles.

To reflect this, the RBA is updating its policy on access to ESAs. In particular the revised policy introduces a specific 'CCP' category of ESA holder, and requires that any licensed CCP deemed to be systemically important operate its own ESA for settlement of its Australian dollar obligations.[16] In accordance with the policy, a CCP would have access to Australian dollar liquidity under the RBA's overnight and intraday liquidity facilities (against eligible collateral) to support settlement of its Australian dollar obligations, including in times of market stress. Subject to the RBA's reaching agreement with the relevant central banks, Australian dollar liquidity extended against eligible Australian dollar collateral could potentially be supplemented by arrangements whereby the CCP posted eligible securities to its home (or another) central bank and the RBA then provided Australian dollars to that central bank under a swap agreement. Furthermore, settlement across an ESA rather than the books of a commercial bank would mitigate any settlement and operational risks arising from the use of an agent – either for the CCP or its participants.

Operating an ESA brings with it certain ancillary financial, operational and legal requirements (which in the context of an overseas CS facility provide comfort that the facility has the capacity to operate effectively in Australia), including the following:

- a CCP would be expected to hold a specified quantum of RBA-eligible collateral in an Austraclear account in its own name;
- at a minimum, sufficient management resources should be located in Australia, with the ability to make timely decisions, operate the ESA account, and liaise with the RBA as appropriate. Day-to-day operation of the account could, however, be carried out remotely;
- the CCP would be required to obtain (for the benefit of the RBA) a legal opinion confirming that it can comply with the Reserve Bank Information and Transfer System (RITS) Regulations.[17]

3.2.2 Strengthened influence for Australian regulators

To achieve adequate influence in the supervision of a systemically important overseas CS facility licensee, the Regulators would seek membership of any multilateral cooperative oversight group. The Regulators would also seek participation in any crisis management groups or other such arrangements to provide for representation of Australian financial stability or other regulatory interests in the event of the actual or potential default of a major clearing participant, disruption to relevant markets, or financial stress to the CS facility itself.

'Responsibility E: Cooperation with Other Authorities', included in the Principles, underpins the establishment of such arrangements for FMIs operating in multiple jurisdictions. The level of Australian regulatory

16 Any non-systemically important CCP licensed to operate in Australia would also be entitled to hold an ESA, but would not be required to do so.

17 RITS, Australia's high-value payments system, is used by banks and other approved institutions to settle their payment obligations on a real-time gross settlement (RTGS) basis. Final and irrevocable settlement is achieved by the simultaneous crediting and debiting of ESAs held at the RBA. Payments are entered into RITS directly, or delivered via the external feeder systems, SWIFT and Austraclear. RITS is the means by which ESAs are accessed. Membership of RITS is compulsory for all ESA holders, which mainly comprise Australian-licensed banks.

representation would need to be commensurate with the nature of the facility's activities in Australia. For a systemically important overseas CS facility licensee, this would imply representation sufficient to ensure that the Regulators were party to key strategic decisions concerning the facility and had an opportunity to raise any issues or concerns regarding the facility's risk management, default procedures, and operational arrangements. It is recognised that each Regulator's role in cooperative oversight or crisis-management arrangements may differ, depending on the particular circumstances.[18]

3.3 Requirements for CS Facilities with a Strong Domestic Connection

All CS facilities that are licensed to operate in Australia will have some domestic connection.[19] The strength of this connection will, however, differ among facilities. For some CS facilities, the connection may be relatively weak; for instance, the facility may serve a market that is inherently highly international, or it may have only a small number of Australian participants. For others, the mix of products or participants will imply a strong domestic connection, which may be evident in a predominantly domestic focus or a strong link to the Australian economy. A CS facility that is *both* systemically important and has a strong domestic connection is likely to be regarded as critical to overall confidence in the Australian financial system. In such cases, it is especially important that regulatory requirements promote financial stability, minimise reputational risks and underpin confidence and integrity.

In particular, where an overseas CS facility licensee has a strong domestic connection, the Regulators may in some circumstances seek to further strengthen their influence by assuming a primary regulatory role. This would imply requiring that the facility apply for a domestic licence, which in turn might require that it establish a domestic legal presence. Furthermore, as recommended by the Council, the Regulators would also wish to have the capacity to 'step-in' in certain defined circumstances, such as a threat of insolvency, significant operational outage or distress, or a significant and persistent failure to comply with licence obligations or directions. It is anticipated that this capacity would be available only in the case of a domestic CS facility licensee, and that to be effective it may imply additional restrictions on outsourcing.[20]

The strength of a facility's domestic connection will reflect the characteristics of the markets it serves, including the nature of its products and participants, and any Australian clients of those participants, as well as any links and dependencies with other domestic FMIs or the domestic legal framework. Determining whether a facility's domestic connection is sufficiently strong to warrant the imposition of these more stringent requirements will entail consideration of a number of factors relevant to an assessment of the costs and benefits. Factors relevant to this assessment include, but are not limited to, the following:

- *Whether the CS facility offers services in a domestic or international market.* A facility's domestic connection is likely to be stronger where it serves a domestic, as opposed to international, market. In this case, the benefits from strengthening influence are likely to be higher, and the costs of doing so lower. By contrast, where a market is by its nature international (e.g. the markets for interest rate swaps or cross-currency

18 In some cases, representation by just one of the Regulators would be sufficient to ensure that Australia's interests were adequately represented. As is currently the case, ASIC and the RBA anticipate sharing information wherever it is legally permitted and practically possible to do so.

19 In establishing whether a CS facility is operating in Australia and requires a domestic licence, ASIC will establish whether there is a 'sufficient nexus between the facility's operations and Australia'. See ASIC's RG 211, p 9.

20 In the case of a systemically important overseas facility that did not have a strong domestic connection, the Regulators would assess the adequacy of the arrangements for recovery and resolution in the facility's principal place of business – including actions that might be taken to ensure the continuity of critical services – as part of its assessment of sufficient equivalence of the overseas regime, and on an ongoing basis.

swaps), imposing costly additional requirements could lead to fragmentation. This may outweigh the benefits of additional influence.

- *The mix of domestic and international participants in the facility.* Similarly, a systemically important facility with primarily Australian-based participants is likely to have a strong connection with the domestic financial system. In this case, any disruption would be likely to have widespread and prominent confidence and reputational effects. The benefits of greater influence would therefore probably also be high in this case. Furthermore, these benefits might come at a relatively low cost, since fewer participants may be seeking the netting and liquidity pooling benefits associated with participating in an internationally integrated facility.
- *The potential for market disruption to affect the real economy.* Where disruption to a CS facility has the potential to affect transactions or confidence in the real economy, perhaps via its effect on securities-issuing firms or its effect on the confidence of Australian retail investors, the benefits of enhanced influence for Australian regulators are likely to be high.
- *Whether the market serviced by the facility is retail or wholesale.* Disruption to a CS facility serving a market with a high level of retail participation may have a disproportionate impact on confidence, and may carry greater reputational risks for the Regulators due to the reliance placed on them by retail investors. The benefits of increased regulatory influence may therefore be greater than in a wholesale market of comparable size and complexity.[21]
- *Whether the facility clears or settles a domestic securities market.* A CS facility that clears or settles domestic securities traded on an Australian licensed market is likely to have strong links to other FMIs and the domestic legal framework. For instance, a CCP that clears domestic equities or fixed-income securities will typically have links to a domestic SSF, which in turn will be subject to Australian laws underpinning securities transfers. These factors imply a strong domestic connection and a more substantial benefit from enhanced influence.
- *Links that the facility has with other FMIs.* More generally, a facility may have links to other FMIs through the clearing and settlement process or through interoperability arrangements. Where a facility has links to other FMIs overseen by the Regulators (e.g. Australian domestic markets), the resulting interconnections with the Australian financial system and other Australian regulatory activities may strengthen the case for greater influence.

Applying this framework, a SSF that settles Australian securities would almost certainly have a strong domestic connection under this test. Such a facility would operate in a primarily domestic market, perhaps with a high level of domestic retail participation. It would also have a nexus with real economy issuers, and most likely have links to other Australian-based FMIs. In the case of a CCP, quantifying the costs and benefits of greater influence might not be so straightforward, and a degree of judgement may be necessary in determining whether the costs of imposing additional measures outweigh the benefits.

The specific additional requirements proposed for the case where a facility is not only systemically important but also has a strong domestic connection are elaborated below. As previously acknowledged, there may also be some circumstances in which similar requirements would be considered by ASIC in the case of a CS facility that had a strong domestic connection but was not deemed to be systemically important.

21 The typically greater size and complexity of wholesale markets is, however, relevant in determining systemic importance.

3.3.1 Holding a domestic CS facility licence

To meet the objectives of minimising disruption and providing for effective oversight, it is proposed that a systemically important CS facility deemed to have a sufficiently strong domestic connection be required to hold a domestic CS facility licence. The facility would then be directly assessed by the RBA against the applicable FSSs on an annual and ongoing basis, and also by ASIC against the licensee's other obligations under Chapter 7 of the Act.[22] A primary regulatory role for the Regulators would provide for an enhanced role in influencing the activities of the facility, proportional to the potential impact of those activities on stability, confidence and integrity in the Australian financial system, or indeed the real economy.

At present, the Act allows a registered foreign company with a principal place of business outside of Australia to apply for a domestic CS facility licence. This could reduce the benefits of a primary regulatory role, particularly to the extent that conflicts in insolvency laws remained. One area in which existing powers could therefore usefully be strengthened through legislative change would be to provide for an ancillary requirement that a systemically important facility with a strong domestic connection also establish an Australian subsidiary, subject to Australian insolvency law and other obligations under the Act. While this would create additional costs and obligations for an overseas facility, these costs may be justified where the connection of the facility with the domestic financial system was sufficiently strong.

3.3.2 Overseeing the outsourcing of critical functions

Consistent with the Regulators' continuity of services objective, controls around the offshore outsourcing of critical functions may enhance the effectiveness of step-in powers, should these be granted.[23] To the extent that the critical functions of a CS facility were outsourced (and in particular if they were outsourced to an independent third party), any statutory manager appointed by the Regulators to step in to operate the facility in the event of acute financial or operational stress might not be able to assume direct control. Indeed, the manager might be unable to maintain continuity of operations if the outsourcing provider repudiated the original outsourcing agreement.

The limitations on offshore outsourcing for a systemically important facility with a strong domestic connection might therefore be stronger than the vetting of outsourcing arrangements for domestic licensees set out in Section 3.1. The additional controls envisaged for systemically important facilities with a strong domestic connection would seek to ensure that the Regulators were able to step in to operate the facility in stressed circumstances. The facility's critical operations should therefore be organised so as to facilitate such actions. This could include a requirement that any offshore outsourcing agreement provide for contractual rights of access for the Regulators' appointed manager in a step-in scenario, and that such rights of access survive termination of the agreement.

22 It is noted that a facility with an overseas licence would also be assessed on an annual basis. In practice, however, the Regulators would place at least some reliance on information provided by, and assessments carried out by, the home regulator in conducting its assessment in those circumstances.

23 As in Section 3.1, references to 'outsourcing' here encompass other arrangements involving the sharing of facilities or services with an offshore FMI as a result of a merger, joint venture or other cooperative agreement.

4. Implementation

This section outlines further work that the Regulators expect to undertake later this year to incorporate this framework within their supervisory approach. Separately, it also proposes some additional changes to legislation which Treasury may consider in its own review. Table 1 outlines, on the basis of a preliminary assessment, potential vehicles for implementation of the various measures articulated in the framework.

4.1 Revisions to Financial Stability Standards

The proposed revision to the FSSs to incorporate the Principles provides an opportunity for the RBA to clarify and consult on how it would be able to provide adequate influence over the cross-border activity of a CS facility. This would be achieved by incorporating some of the requirements described in this paper explicitly within the proposed revisions to the FSSs.

An overseas CCP is currently exempt from the relevant FSS for such time as the RBA receives annual documentary evidence from the licensee's home regulator that the licensee has complied in all material respects with the requirements of the home regulator relating to matters affecting financial stability. One possibility in varying the FSS might be to hold overseas CCPs (and SSFs) to the same standard as domestic entities, but to place conditional reliance on a sufficiently equivalent overseas regulator. The conditions might include that a 'materially equivalent' standard is explicitly applied in the overseas regulatory regime, and that the Reserve Bank receive, as under the current exemption, annual documentary evidence from the overseas regulator that the licensee has complied with relevant regulatory requirements. Where these conditions were not met, the Reserve Bank would carry out a direct assessment against the relevant FSS.

Implementation via the FSS would require no additional powers for the RBA; existing powers under the Act would be sufficient.

4.2 Revisions to RG 211

Further to publication of the Principles, ASIC is reviewing RG 211 and proposes to consult on changes to that document later in 2012 both in light of the Principles and in order to incorporate relevant aspects of the framework into its regulatory guidance.

4.3 Legislation

Most of the requirements considered in this paper could be implemented without the need for legislation. Additional legislative powers may nevertheless be useful in some cases. Possible changes to legislation stemming from the Council's review of FMI regulation are being considered by Treasury. Subject to any decision by the government to proceed with any reforms, legislative amendments may be expected to be enacted in several stages.

Specific legislation could underpin the requirement for a systemically important facility with a strong domestic connection to apply for a domestic licence, including through a locally incorporated entity. Similarly, legislation might be used to strengthen the requirements for adequate information sharing and cooperative oversight arrangements, as well as overall compliance with the FSS. These are currently considerations for Regulators in advising the Minister about granting, suspending or revoking an overseas licence (and decisions relating to licence conditions), but they are not more general ongoing requirements.

4.4 Expectations

As a complement to measures implemented via any of the above channels, the Regulators would propose to communicate directly to any licence applicant their expectations as to the circumstances in which additional requirements might be imposed under this framework. Similarly, expectations would be communicated to any existing licensee that might contemplate outsourcing certain functions offshore. Further legislative amendments might be considered to give legal force to such expectations.

On an ongoing basis, as part of their annual assessment of the facility, the Regulators would review changes to the facility's Australian-based participation and its services in Australian-related products, as well as its systemic importance and domestic connection. In accordance with the published framework and the Regulators' stated expectations, the review would determine any need for additional measures. In the event that further action was necessary, the Regulators would establish an implementation plan with the facility. Should the facility fail to take the required action, the Regulators could rely on directions and sanctions, which as part of the broader reform of FMI regulation the Council has recommended be enhanced.

Table 1: Potential Vehicles for Implementation of the Framework

Requirement	Summary	Instrument for implementation
Foundational requirements		
(i) For all CS facilities licensed in Australia		
Legal compatibility of rules with Australian regulatory requirements	Facilities to provide up-to-date legal opinions dealing with conflict of laws and enforceability of rules.	FSSs relating to legal basis.
Channels to demonstrate compliance with Australian regulatory requirements	The Regulators to enter into cooperative arrangements and share information with overseas regulators.	*Corporations Act 2001* requirements for information sharing in respect of overseas licensees; advice to Minister on type of licence granted; scope of exemption granted from direct assessment against FSSs; possible legislative strengthening.
	Direct oversight of domestic licensees; vetting of outsourcing arrangements.	Direct assessment against FSS relating to operational risk; ASIC regulatory guidance.

Requirement	Summary	Instrument for implementation
Foundational requirements		
(ii) For all CS facilities licensed in Australia that have material Australian-based participation and/or provide services in Australian-related products		
Governance and operational arrangements that promote stability in the Australian financial system	Facilities to demonstrate that governance arrangements give appropriate consideration to Australian interests, including default obligations proportionate to the scale and scope of participants' activities. Facilities to provide for operational support during Australian market hours and, to the extent reasonably practicable, accommodate local market practices.	FSSs relating to: – governance – participant-default rules – operational risk – risk-management framework – collateral – margin.
Requirements for systemically important facilities		
Holding an ESA with the RBA	Systemically important CCPs to hold an ESA and comply with ancillary requirements (operational, financial and legal).	FSSs relating to liquidity and money settlements. Potential strengthening through licence conditions. RBA's role as operator of RITS.
Strengthened influence for Australian regulators	Adequate participation in supervisory college for systemically important facilities including any crisis management arrangements.	*Corporations Act 2001* requirements for cooperative arrangements in respect of overseas licensees; advice to Minister on licence application; possible legislative strengthening.
Requirements for systemically important facilities with a strong domestic connection		
Holding a domestic CS facility licence	Periodic and/or activity-based review of the need for a domestic licence and a domestic legal presence.	Possible legislative changes; advice to the Minister; potential strengthening through licence conditions/expectations.
Overseeing the outsourcing of critical functions	Facilities to maintain operational arrangements such that an appointed manager would have control over critical functions in a step-in scenario.	FSS on operational risk; ASIC regulatory guidance; possible legislative changes regarding FMI resolution.

5. Next Steps

The purpose of this paper has been to offer further clarity to stakeholders on the Council's recommendation that the Regulators be given the power to set 'graduated and proportional location requirements'. The paper has therefore set out the intended scope of such requirements and the framework within which they might be applied.

It has been acknowledged, however, that the specific measures will be the subject of further consultation by the Regulators later in the year, in the context of planned revisions to ASIC's RG 211 and the RBA's FSSs. These future consultations will also provide an opportunity for stakeholders to discuss with the Regulators aspects of the framework described in this paper and how it might be applied in practice.

In the meantime, the Regulators stand ready to discuss with existing CS facility licence holders and prospective CS facility licence applicants how the framework set out in this paper and the specific requirements that will be the subject of future consultation might apply in their particular circumstances.