

# Council of Financial Regulators: Review of Financial Market Infrastructure Regulation

Consultation Paper

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## CONSULTATION PROCESS

### Request for feedback and comments

This paper seeks stakeholder feedback on the Council of Financial Regulators (Council) proposals for reform of the framework for financial market infrastructure (FMI) in Australia.

You are invited to comment on the proposals canvassed in this paper, which are not final policy at this stage. Your comments on any preferred alternatives would also be appreciated.

Submissions should include the name of your organisation (or your name if the submission is made as an individual) and contact details for the submission, including an email address and contact telephone number where available.

While submissions may be lodged electronically or by post, electronic lodgement is strongly preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

In addition to seeking submissions, the Council will be conducting stakeholder consultation meetings on this issue.

Closing date for submissions: 2 December 2011.

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## GLOSSARY

|               |  |
|---------------|--|
| ACCC          | Australian Competition and Consumer Commission   |
| ADI           | Authorised Deposit-taking Institution  |
| AFSL          | Australian financial services licence (-holder)  |
| AML           | Australian market licence (-holder)  |
| APRA          | Australian Prudential Regulation Authority   |
| ASIC          | Australian Securities and Investments Commission   |
| ASX           | ASX Limited  |
| ASX Group     | ASX Limited and its subsidiaries   |
| ASX 24 market | The market operated by Australian Securities Exchange Limited, formerly known as Sydney Futures Exchange |
| ASXCC         | ASX Clearing Corporation Pty Ltd   |
| BCBS          | Basel Committee on Banking Supervision   |
| CCP           | Central counterparty   |
| CHESS         | Clearing House Electronic Subregister System   |
| Chi-X         | Chi-X Australia Pty Ltd  |
| COAG          | Council of Australian Governments  |
| CPSS          | Committee on Payment and Settlement Systems  |
| CS facility   | Clearing and settlement facility   |
| CSD           | Central securities depository  |
| CSFL          | Clearing and settlement facility licence (-holder)   |
| Dodd-Frank    | Wall Street Reform and Consumer Protection Act (US) 2010   |
| DvP           | Delivery versus payment  |
| EMIR          | European Market Infrastructure Regulation (proposed)   |
| ESA           | Exchange Settlement Account  |

|          |  |
|----------|--|
| FIRB     | Foreign Investment Review Board                          |
| FMI      | Financial market infrastructure                          |
| FMU      | Financial market utility                                 |
| FSB      | Financial Stability Board                                |
| FSOC     | Financial Stability Oversight Council (US)               |
| FSS      | Financial stability standards                            |
| G20      | Group of Twenty Countries                                |
| IOSCO    | The International Organization of Securities Commissions |
| MAS      | Monetary Authority of Singapore                          |
| Minister | Minister for Financial Services and Superannuation       |
| NGF      | National Guarantee Fund                                  |
| NOHC     | Non-Operating Holding Company                            |
| OTC      | Over-the-counter   |
| RBA      | Reserve Bank of Australia                                |
| RITS     | Reserve Bank Information and Transfer System             |
| RTGS     | Real-time Gross Settlement                               |
| SEGC     | Securities Exchanges Guarantee Corporation Ltd           |
| SGX      | Singapore Exchange                                       |
| SSS      | Securities settlement system                             |
| TR       | Trade repository   |

## PART A — INTRODUCTORY

### 1. EXECUTIVE SUMMARY

At the request of the Deputy Prime Minister and Treasurer, the Hon. Wayne Swan MP, the Council of Financial Regulators (the Council) is conducting a review of the regulatory framework for financial market infrastructure (FMI) in Australia (the Review).

The need to undertake the Review was highlighted in the course of the regulatory agencies' consideration of the proposed takeover of ASX Limited (ASX) by Singapore Exchange Limited (SGX).

The regulatory issues considered in this paper are among the reasons why the Deputy Prime Minister and Treasurer concluded that SGX's proposed takeover of ASX was not in the national interest. The Deputy Prime Minister and Treasurer in his decision referred to the Foreign Investment Review Board's (FIRB's) finding, which incorporated advice from the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA), that:

*not having full regulatory sovereignty over the ASX-SGX holding company would present material risks and supervisory issues impacting on the effective regulation of the ASX's operations, particularly its clearing and settlement functions. Australia's financial regulators have advised me that reforms to strengthen our regulatory framework should be a condition of any foreign ownership of the ASX to remove these risks.<sup>1</sup>*

To address these issues, the Deputy Prime Minister and Treasurer asked the Council to establish a Working Group to consider potential measures that could be introduced to ensure that Australian regulators could continue protecting the interests of Australian issuers, investors and market participants. A key consideration is to preserve the integrity of Australia's financial infrastructure and the ability of supervisors to maintain robust oversight and appropriate control in all market conditions, including in the advent of a range of different ownership structures for FMIs of systemic importance to the Australian financial system.

More broadly, the increasing interconnectedness of global markets means that the Australian regulatory framework must keep pace with developments offshore. In that regard, if Australian FMIs are to link with an offshore FMI, or offshore-owned FMIs are to operate in domestic markets, there is a need to maintain robust oversight and appropriate control of such infrastructures. These regulatory concerns extend to crisis resolution arrangements.

While some relevant international regulatory concerns pre-date the global financial crisis, the crisis has given impetus to ensuring that the interconnections between systemically important financial

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<sup>1</sup> Deputy Prime Minister and Treasurer, Media Release No. 030 of 8 April 2011, available at <http://www.dpm.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/030.htm&pageID=003&min=wms&Year=&DocType=>.

institutions and FMIs do not give rise to significant systemic risks (or that those risks are robustly mitigated). The *Wall Street Reform and Consumer Protection Act* (US) 2010 (Dodd-Frank), the proposed *European Market Infrastructure Regulation* (EMIR)<sup>2</sup> and the United Kingdom (UK) Treasury's *White Paper on Financial Markets*,<sup>3</sup> all address these issues.

One approach has been to seek to centrally manage risks formerly addressed bilaterally (for example in over-the-counter (OTC) derivatives markets). The Group of Twenty countries (G20) have committed to require that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs) by the end of 2012.

At the same time as this regulatory scrutiny has been unfolding, there has been an acceleration of consolidation activity across FMIs. Some FMIs and trading venues are seeking alliances to enhance their competitiveness. Other trading venues and FMIs have been seeking consolidation at the exchange or clearing level. It is not yet clear how these strategies, or regulators' reactions to them, will play out.

Accordingly, quite apart from the circumstances surrounding ASX, which have prompted renewed focus of Australian Government and agencies on these issues, a review of Australia's regulatory framework for FMIs is timely to ensure Australia's regulatory framework is at least as robust as those of other international financial centres.

Improving the regulatory framework for FMIs in Australia will not only underwrite the continued integrity of Australia's market infrastructure and so contribute to the efficiency and stability of Australia's financial system, but will also ensure that Australia remains open to foreign investment and foreign financial service providers.

Part A of this paper:

- describes the Treasurer's terms of reference and the regulatory framework including the existing responsibilities and powers of regulators (see chapter 2);
- describes Australia's FMIs of systemic importance (see chapter 3); and
- describes certain weaknesses in the regulatory framework, particularly in comparison with regulatory powers in respect of authorised deposit-taking institutions (ADIs) (see chapter 4).

Part B of this paper sets out the Council's proposed regulatory responses to the issues identified.

Part C of this paper explains the next steps and sets out the questions for stakeholder feedback.

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2 On 15 September 2010, the European Commission published its final proposal for a Regulation of the European Parliament and of the Council (also widely known as European Market Infrastructure Regulation – EMIR), which sets out to increase stability within OTC derivative markets. The EMIR introduces: a reporting obligation for OTC derivatives; a clearing obligation for eligible OTC derivatives; measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives; common rules for central counterparties (CCPs) and for trade repositories; and rules on the establishment of interoperability between CCPs. At the time of writing the most recent draft compromise text published by the European Council was available at <http://register.consilium.europa.eu/pdf/en/11/st13/st13595.en11.pdf>.

3 HM Treasury, *A new approach to financial regulation: the blueprint for reform* (Cm 8083 June 2011).

## 2. BACKGROUND

### 2.1 TERMS OF REFERENCE

On 8 April 2011 the Deputy Prime Minister and Treasurer referred a number of issues relating to the regulation of FMIs to the Council.<sup>4</sup>

The Deputy Prime Minister and Treasurer asked the Council for advice on measures that could be introduced to ensure Australia's regulatory system for FMIs continues to protect the interests of Australian issuers, investors and market participants, including under a scenario where the ASX is part of a foreign-domiciled group.

To this end, a Working Group was established, chaired by the Treasury, comprising representatives of the Australian Prudential Regulation Authority (APRA), ASIC and the RBA.

The issues referred include, but are not limited to, the adequacy of oversight, powers of direction and crisis management arrangements for markets and clearing and settlement (CS) facilities.

In particular, the Deputy Prime Minister and Treasurer sought advice relating to the adequacy of regulatory powers to ensure the smooth operations of Australian financial markets and CS facilities in all market conditions.

The intent of the Council is for this paper to address these matters, noting that the issues discussed are part of a broader range of connected issues that have their roots in the response of the G20 to the global financial crisis. Some of those issues include:

- central clearing of OTC derivatives, addressed in the Council's recent Discussion Paper *Central Clearing of OTC Derivatives in Australia* (June 2011); and
- reporting of OTC derivative transactions to trade repositories and requiring OTC derivatives trades to take place on electronic trading platforms, where appropriate, both issues being considered by the Council in separate work.

### 2.2 REGULATORY OBJECTIVES OF THE EXISTING REGULATORY FRAMEWORK

The current regulatory system for FMIs reflects the findings of the *Wallis Inquiry 1997* (the Wallis Inquiry) in respect of the need to balance competing economic objectives. The Wallis Inquiry sought an appropriate balance between achieving competitive outcomes and ensuring financial safety and market integrity.<sup>5</sup> It found that regulation imposes costs both directly and on the wider economy.

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4 Technically, payment systems and trade repositories are also FMIs but are not subject to licensing requirements under Part 7.2 or Part 7.3 of the Corporations Act. For payment systems, this is because the exchange of cash is excluded from the scope of the Corporations Act provisions, as it does not give rise to key issues that are applicable to markets and CS facilities (for example issues around trades, price discovery and market risk). The scope of the Working Group does not include the regulation of payment systems or of trade repositories. Within the context of this paper, therefore, the term 'FMI' is taken to be limited to market licensees and clearing and settlement (CS) facility licensees.

5 Revised Explanatory Memorandum to the Financial Services Reform Bill 2001, para 2.5.

This highlights the need to balance financial safety regulation and efficiency considerations.<sup>6</sup> The principles of regulation that guided the Wallis Inquiry were competitive neutrality, cost effectiveness, transparency, flexibility and accountability.<sup>7</sup>

In practical terms, the Wallis Inquiry argued for a regulatory regime with clear delineations between regulatory mandates,<sup>8</sup> and with a preference for market-based outcomes as a first option. Regulatory action was thought to be warranted only after a demonstration of persistent market failure (or, for market integrity issues, where there is a breach of a requirement). While such a principles-based approach is not unique, it stands in contrast to a number of jurisdictions that rely on a wide-ranging prescriptive approach and multiple regulators with joint jurisdiction over particular segments of the financial system.

Reflecting this preference, the 2001 Financial Services Reforms, which implemented many of the Wallis Inquiry's proposals, sought to harmonise and liberalise the regulatory regimes around financial markets and CS facilities. Specifically:

- the creation of the Australian market licence (AML) regime had the stated objective of providing a more flexible regulatory framework than had applied to securities and futures exchanges;<sup>9</sup> and
- similarly, the creation of the Australian CS facility licence (CSFL) regime had the stated objective of providing a more flexible and comprehensive regime for the regulation of CS facilities.<sup>10</sup>

This licensing regime establishes a mutual understanding between regulators and licensees of outcomes that are expected to be achieved. An undesirable outcome is likely to be met with regulatory intervention and, ultimately, the possibility of withdrawal of any given licence.

The Council considers that this overarching framework continues to be appropriate and that the regulatory regime for financial stability promotes sound risk management with a view to minimising the probability of financial distress or dysfunction. However, the regulatory regime should also be able to resolve distress or adverse events quickly and effectively if and when they arise. The Council's view is that there are limitations on the power of regulatory agencies to respond in an effective and timely manner to undesirable outcomes, which need to be addressed.

In formulating a revised policy framework to address these limitations, the regulators have sought to avoid creating the potential for moral hazard.

## 2.3 EXISTING REGULATORY FRAMEWORK

The financial system comprises financial intermediaries and financial instruments that investors, fundraisers and intermediaries utilise to take on or lay off risk, and FMIIs that intermediaries use to manage and extinguish obligations that arise from financial transactions (that is to make payments and to transfer assets).

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6 Report of the Financial System Inquiry, 1997, p. 176.

7 Report of the Financial System Inquiry, 1997, p. 176.

8 To the extent of any overlap these are addressed by memoranda of understanding between regulators.

9 Revised Explanatory Memorandum to the Financial Services Reform Bill 2001, para 7.2 .

10 *ibid*, para 8.2.

The regulatory structure affects all aspects of the financial system. Broadly:

- APRA has responsibility for the prudential supervision of financial institutions;
- ASIC is responsible for the regulation of Australia's corporate and financial services sectors;
- the Australian Competition and Consumer Commission (ACCC) is the competition regulator; and
- the RBA is responsible for the oversight of payments systems and, in respect of stability, CS facilities.

As described in more detail below, there are significant differences in the enforcement and directions powers available to each regulator. While these may have been appropriate around the time of the Wallis Inquiry, it is the Council's view that local and international developments since then require that the adequacy of the regulatory powers of ASIC and the RBA with regard to FMI be reconsidered.

For FMIs, the relevant regulatory structure is set out in the *Corporations Act 2001* (the Corporations Act).

- Under the Corporations Act, ASIC is responsible for oversight of market operators. For CS facilities, the Corporations Act requires the RBA to assess those facilities against stability principles. Oversight of the facilities is shared with ASIC, which has responsibility for ensuring that the facilities comply with all other licence obligations, including providing services in a fair and effective way.
- A core part of the RBA responsibility is establishing principles, the Financial Stability Standards (FSS), and assessing compliance. The FSS aim to ensure that a CS facility is sufficiently robust. The RBA must also assess whether the CS facilities have 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 Corporations Act so as to best contribute to the overall stability of the financial system.

Despite the RBA's responsibility, the RBA, by itself, has relatively limited powers of enforcement. Its most direct sanction would be to publish an unfavourable assessment of a CS facility. Beyond that, the RBA can request that ASIC issue directions to the licensed operator, though this is at ASIC's discretion. A failure to comply is an offence, which is punishable by a fine (although this would only arise after a court determined that a fine was appropriate). Ultimately, the Minister for Financial Services and Superannuation (the Minister) may vary, suspend or terminate a CS facility's licence, and may also issue a direction; if the latter is ignored, ASIC must seek a court order to enforce compliance.

A number of specific powers are available to the Minister and ASIC to issue directions to market operators and CS facility licensees.

## 3. FINANCIAL MARKET INFRASTRUCTURE

### 3.1 FINANCIAL MARKETS

A financial market is a facility through which offers to buy and sell financial products are regularly made. Anyone who operates a financial market in Australia must obtain an AML from the Minister, or be exempted by the Minister.

Licensed financial markets operate under contractually-based rules that establish the rights and obligations of market operators and their direct participants (trading participants). Trading participants in financial markets are required to hold an AFSL where they are providing a financial service. Trading participants can act on their own account or on behalf of clients.

Markets that provide listing services list entities on their market and quote products which are issued by those entities for trading on their market. An important part of the role of this type of market is the setting, monitoring and enforcement of listing rules. Investors value products traded on such markets, in part because the entities are required to comply with listing standards, and in part because the market offers a venue for secondary trading in the products. Securities markets that provide listing services can facilitate efficient capital formation and allocation, and for that reason may become systemically important to the financial system.

Markets that quote futures and derivatives products can provide an important venue through which participants and investors can hedge their exposures to underlying financial products. For example, interest rate futures contracts can be used by investors and financial institutions to hedge their interest rate exposures. The reliance of investors on these markets to hedge positions can result in the markets becoming systemically important to the financial system, particularly where there is no readily available alternative.

Financial markets are licensed under Part 7.2 of the Corporations Act and regulated by ASIC.

### 3.2 CLEARING AND SETTLEMENT

Clearing is a post-trade and pre-settlement function performed by financial market participants to manage bilateral trades and associated exposures, and to reduce the various risks associated with the potential failure of one of the counterparties. Settlement is the point at which those exposures are eliminated. Under the Corporations Act, facilities that conduct clearing and settlement are required to hold a CSFL issued by the Minister (on the advice of ASIC), and to comply with the relevant FSS determined by the RBA.

Clearing and settlement processes occur whether the transaction is conducted bilaterally (for example in non-centrally cleared OTC markets) or through a central facility.

Clearing and settlement are distinct activities and are often (as in Australia) carried out by different corporate entities. Each entity operates under separate contractually-based rules that establish the rights and obligations of the clearing facility and the settlement facility and their direct participants (respectively, clearing participants and settlement participants). A trading participant may also be a clearing participant and a settlement participant, but, in Australia, unless the settlement participant

is an ADI, it cannot participate in final settlement of payments obligations at accounts held at the RBA.

For central clearing to take place, a clearing facility and a settlement facility must be appointed. The settlement facility will usually (as in Australia) have a link to the central bank and either operate a central securities depository (CSD), or have a link to the registry, or registries, where the final titles of securities or other obligations are held. Each of the trading, clearing and settlement entities may be part of the same corporate structure, or independent corporate entities.

Similarly, a trading participant appoints a clearing participant, the clearing participant appoints a settlement participant, and the settlement participant (unless it is an ADI) appoints an ADI to meet its final payment obligations in central bank funds.

### 3.2.1 Role of a central counterparty (CCP) in clearing

A CCP provides specialised clearing services to a market. A CCP concentrates pre-settlement risk for the market it serves by becoming principal to every transaction that it clears through the legal process of novation. That is, the original contract between counterparties to a transaction is 'novated' or replaced by two matching or 'back-to-back' contracts, between the CCP and each counterparty.<sup>11</sup>

By becoming central to all transactions in the market, the CCP assumes the role of manager of risk for that market. This is advantageous in terms of efficiency and promoting depth in the market (because trade counterparties can be less concerned about the creditworthiness of their counterparties), but risks the failure of any one clearing participant disrupting the entire market. CCPs and their regulators both seek to ensure that CCPs' risk controls are sufficiently robust to guard against that risk.

Because the CCP is counterparty to each of its participants it will potentially have, at the end of each daily cycle, buy and sell transactions for each participant for each security that it accepts for clearing. In principle, each separate buy and sell transaction could be settled individually, however, that would require a tremendous amount of liquidity. To avoid this issue, many CCPs net the buys and sells for each security so that each participant has a single net buy or sell position in each security. In Australia, that process is taken a step further on the payment side with each participant's obligations reduced to a single net debit or credit for all of its trades. By facilitating netting in this way, CCPs can significantly reduce the overall levels of collateral and cash that need to be held by market participants.<sup>12</sup>

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11 The term counterparty is used for ease of exposition. The trade is conducted between trading participants which, through the process of novation, are replaced by clearing participants (and the CCPs exposure is to those clearing participants rather than the trading participant). That exposure persists until it is settled successfully between settlement participants that act on behalf of clearing participants, but do not assume their obligations to the CCP. Settlement participants are responsible for prepositioning securities for delivery and, if they are not an ADI, managing a relationship with an ADI such that final settlement may take place in central bank funds.

12 However, regulators need to ensure that any risks arising from this process are robustly managed.

### 3.2.2 Importance of risk management for CCPs

It is important that CCPs identify and robustly control risks associated with their operation in order to contribute to the stability of the financial system. The RBA's FSS aim to ensure these outcomes are achieved.

Because a CCP centrally manages risk for market participants, its stability is critical to all members of the trading system. CCPs use two main types of control to mitigate exposures to participants. They:

- require margins from participants, taking into account each individual participant's overall net position, historical price volatility and correlations in price behaviour of products; and
- hold default resources, which are a combination of own equity, bank guarantees and/or bank participants' paid-up and promissory contributions.

Margins defend against a participant default during periods of normal volatility. Default resources defend against a default in abnormal volatility. Nevertheless, it is possible that an extreme event could occur that is beyond the capacity of both margins and default resources. Moreover, any default that draws upon default resources creates the need to replenish those resources in a timely manner and this gives rise to additional issues.

The level of robustness required of a CCP is set out in the FSS. That requirement is consistent with international standards. In general, compliance with the current standard is non-controversial as there is a clear alignment of regulatory interests with that of a prudently managed CCP.

### 3.2.3 Securities settlement facility

Settlement, which involves the exchange of the asset bought for the asset sold, is the final process that occurs to complete a trade. The settlement process itself involves two key risks. First, principal risk, which occurs where one party delivers the asset due before delivery of the asset expected to receive. This can be eliminated by use of an appropriate delivery versus payment (DvP) mechanism. Second, legal risk is the risk that a court may seek to unwind a settled transaction. To guard against this risk, it is important that settlement facilities take advantage of any statutory protections (such as are available under the *Payment Systems and Netting Act 1998*) as well as contractual safeguards (such as legally binding rules and procedures for the security settlement facility in question).

A securities settlement facility provides for the final settlement of transactions undertaken on securities markets.

In Australia, settlement services for cash equities are conducted by ASX Settlement Pty Ltd and involve two related functions:

- DvP settlement: The transfer of the title of a security and transfer of cash consideration on a T+3 basis (that is three business days after the buyer and seller agree to a trade).<sup>13</sup>
- Sub-registry function: The sub-registry electronically records the change in title (ownership) of securities.<sup>14</sup>

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<sup>13</sup> T+3 settlement for cash equities is established in the ASX rules. Trading on an exchange is anonymous, but buyer and seller are advised of a successful bid or offer by the system.

Austraclear Limited (Austraclear) provides similar services for government and corporate debt securities:

- DvP settlement that occurs in real time throughout the day with the cash leg settling through the RBA’s real-time gross settlement system, the Reserve Bank Information and Transfer System (RITS). As Austraclear services an OTC market, the terms of settlement (that is T+ the number of days to settlement) are established by market convention or bilateral agreement.
- A CSD of the electronic record of title.<sup>15</sup>

Austraclear plays a key role in the provision of intraday liquidity required for RITS operation (that is eligible securities that can be sold to the RBA are held in the Austraclear CSD) and also facilitates the implementation of monetary policy. As such, the system is critical to the smooth operation of the Australian financial system.

### 3.3 WHAT FMIs ARE RELEVANT FOR THE REVIEW?

The view of the Council agencies is that FMIs relevant to the Review include operators of financial markets, and of CS facilities.

Under the Corporations Act, operators of these FMIs have one of two types of licences, granted under either the domestic or foreign licensing regimes:

| Type of licence                                 | Domestic licence granted under... | Foreign licence granted under... |
|---|-----------------------------------|----------------------------------|
| Australian market licence (AML)                 | Corporations Act s. 795B(1)       | Corporations Act s. 795B(2)      |
| Clearing and settlement facility licence (CSFL) | Corporations Act s. 824B(1)       | Corporations Act s. 824B(2)      |

The foreign regime is available where the applicant’s principal place of business is in a foreign country, and it is authorised in that country to operate a financial market, or CS facility, respectively.<sup>16</sup> Foreign bodies corporate may, however, also be licensed under the domestic regimes.

### 3.4 ENTITIES CURRENTLY PROVIDING FMI SERVICES

Currently, the ASX Group companies play a key role in providing FMI services for the cash securities and derivatives markets in Australia.<sup>17</sup> There are a number of other licensed market operators and

14 In Australia, the record of ownership of issued shares is retained on the registries of listed corporations. To facilitate trading, ASX provides an electronic sub-register (CHESS) that performs both clearing (for ASX Clear Pty Ltd) and settlement functionality (for ASX Settlement Pty Ltd).

15 The final record of title to Government Securities is through a register at the RBA.

16 Subject to a number of tests, including sufficient equivalence of the foreign country’s regulatory regime.

17 As at 30 June 2011, there were 2247 entities listed on ASX’s market, with a market capitalisation of approximately \$1.35 trillion.

one other licensed CS facility provider, but the services provided by these entities are arguably not as critical to the financial system overall.

The following table shows the role of the six licensed entities within the ASX Group. Three licensed entities provide corresponding services (trading, clearing and settlement) in relation to two markets, broadly corresponding with the ASX market, centred on cash equities, fixed income and equity related derivatives, and the ASX 24 market centred on financial and other derivatives. Austraclear primarily provides DvP settlement services for debt securities.

|                 | ASX Market                           | ASX 24 Market                          | OTC debt securities market    |
|-----------------|--------------------------------------|--|-------------------------------|
| Trading         | ASX Limited                          | Australian Securities Exchange Limited |                               |
| Clearing (CCPs) | ASX Clear Pty Ltd                    | ASX Clear (Futures) Pty Ltd            |                               |
| Settlement      | ASX Settlement Pty Ltd <sup>18</sup> |  | Austraclear Ltd <sup>19</sup> |

Within the overall ASX Group structure, functionality that is common to licensed entities has been outsourced and centralised to ASX related entities. These are ASX Operations Pty Ltd, which provides staff and other operational services, ASX Compliance Pty Ltd, which is responsible for provision of compliance services to group entities, and ASX Clearing Corporation Pty Ltd (ASXCC). ASXCC is particularly important as it is interposed between the Group parent and the CCPs (as their parent company). ASXCC manages debt raising and investment (under a trust arrangement) on behalf of the CCPs.

In addition to the six licensed ASX CS facilities indicated above, IMB Limited (an APRA regulated ADI) provides a CS facility for the sole purpose of settling transactions in its own shares. No other CS facilities are currently licensed in Australia.<sup>20</sup>

The Minister has also authorised numerous financial markets in addition to the two ASX group companies mentioned above. In addition to a range of specialist financial markets, the Minister has licensed Chi-X Australia Pty Ltd (Chi-X) to provide trading in ASX-listed equities. Chi-X is expected to commence operations on 31 October 2011.<sup>21</sup>

In addition, the Minister has exercised his powers under s. 791C of the Corporations Act to exempt a number of professional financial markets from the obligation to hold an AML, on a number of conditions, including that they hold an AFSL.<sup>22</sup>

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18 ASX Settlement operates CHESSE.  
 19 Margins and other obligations arising from ASX 24 Market transactions settle through Austraclear.  
 20 Note, CLS Bank International is exempt from section 794E and Part 7.3 of the Corporations Act by virtue of regulation 9.12.02.  
 21 A list of domestic and overseas licensed financial markets is available at ASIC’s website, [www.asic.gov.au](http://www.asic.gov.au).  
 22 A list of exempt markets is also available at ASIC’s website, [www.asic.gov.au](http://www.asic.gov.au).

## 3.5 SYSTEMIC SIGNIFICANCE OF FMI SERVICES

Significant financial markets and CS facilities provide critical services (FMI services) to participants in the financial system. Consequently, any disturbance to the smooth operation of these services can cause significant systemic disruption, damage market integrity and result in loss of investor confidence.

Each of the ASX market and CS facility licensees provide crucial FMI services to participants. Moreover, CS facilities within the ASX Group are currently the only providers of services both to the ASX and ASX 24 markets as well as other markets, including the proposed Chi-X market.

Disruptions can occur at any point in the chain linking trading, clearing and settlement, with disruptions flowing up and down the chain. Moreover, disruption to an FMI's operations can also disrupt the activities of both financial intermediaries and the real economy (via impacts on capital-raising and market confidence).

Because FMIs link all financial market participants, the potential for systemic disruption, particularly where the viability of a CCP is at risk, is arguably at least as great as where an ADI is at risk of failure.

### 3.5.1 Market services

ASX Limited and Australian Securities Exchange Limited operate markets for securities (ASX market) and financial derivatives (ASX 24 market). The smooth operation of those markets is important for price discovery, which in turn is a crucial input into assessment of market exposure by investors, financial institutions and participants seeking to hedge positions arising from other obligations. Any protracted disruption to the price discovery process risks uncertainty, contributing to volatility in related markets (such as OTC markets) that use exchange-traded price movements as an input into trading, credit decisions and hedging.

A protracted market outage could be accompanied by counterparty calls to increase collateral coverage, which may trigger a systemic liquidity shortage. There is a prospect that sharply reduced financial market activity will spread across all markets and may negatively impact real economic activity. Finally, an outage risks reputational damage to Australian markets and could undermine the confidence of consumers and investors in this market.

### 3.5.2 CCP (clearing) services

ASX Clear Pty Ltd and ASX Clear (Futures) Pty Ltd provide CCP services to the exchange markets described above. These entities centrally manage counterparty risk arising from transactions on markets. Any disruption to the smooth operation of those services would directly impact on the smooth operation of the markets to which they provide central clearing services to.

Moreover, a disruption arising from the potential insolvency of a CCP risks large exposures spilling over to clearing participants which risks systemic disruption more broadly to the financial system.

### 3.5.3 Settlement services

ASX Settlement Pty Ltd provides settlement services for ASX Clear Pty Ltd. A disruption to that service, such that settlement cannot take place as expected (that is on T+3), would mean that

exposures to ASX Clear Pty Ltd will accrue until the settlement service is restored. Potentially, this accrual of exposure could be beyond the capacity of the CCP to manage (that is exposures may become so large that default resources are inadequate). To guard against this risk, the CCP may issue margin calls or limit clearing participants' accrual of exposure. As values involved in cash equities are not overly large, such risk mitigation in periods of normal volatility and stability may not significantly disrupt markets. However, where volatility is extreme, and/or there is pre-existing financial instability, there is a prospect that the failure of settlement services (which also exposes clearing participants to the CCP) and CCP risk mitigation may have adverse market impacts and, in extreme cases, trigger a clearing participant default.

The smooth functioning of the settlement system operated by Austraclear provides critical services to the functioning of OTC markets, the settlement of obligations arising from the ASX 24 market, and Australia's real-time gross settlement system (including the provision of intraday liquidity through repurchase agreements against securities lodged in Austraclear), and facilitates the implementation of monetary policy. Any disruption to Austraclear would lower financial markets participants' capacity to manage their own liquidity needs and the RBA's capacity to manage system liquidity. A cessation of Austraclear settlement services would be extremely disruptive to financial markets. It is for this reason that the RBA has entered in to a contractual arrangement with Austraclear to ensure it is able to 'step-in' and manage Austraclear's business. Step-in is triggered in defined circumstances — broadly where Austraclear is not providing its services in a satisfactory manner.

## 3.6 CONCLUSION

For the reasons set out above, each of the ASX market and CS facility licensees providing FMI services is regarded as systemically important. There should be sufficient regulatory tools available to ensure that financial system stability is not threatened by concerns over the continuity of systemically significant markets and CS facilities, including those operated by ASX Group members. Those tools should be adequate to deal with threats to disruption of the smooth provision of service whether they arise from financial shocks, a change in business plans, or prolonged disruption to services through operational difficulties. These tools should be applicable to any other systemically important FMI.

## 4. ADEQUACY OF REGULATORY POWERS

### 4.1 OVERVIEW

To date, the existing regulatory framework surrounding Australia's FMIs has been perceived to work well, but it has not been tested by a participant failing to meet its obligations.<sup>23</sup> It has also not had to operate in a situation where a foreign holding company, that is not subject to direct Australian supervision and oversight, has had control of any systemically significant FMI.

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<sup>23</sup> Excluding operational outages and noting that there have been instances of participants being suspended from participation.

As financial markets become more globally integrated, it is appropriate to consider whether greater clarity can be provided to operators of FMIs in Australia regarding the regulatory framework and the obligations of operators under this framework. Clarifying these obligations could allow operators of FMIs to pursue integration on a global scale and also provide potential providers of services to the Australian marketplace greater certainty regarding what their obligations will be.

Such integration may bring risks. A systemically important FMI controlled from offshore, even where the facility's infrastructure is located in Australia, may give rise to competing obligations between domestic regulation and regulatory requirements of an offshore regulator that fall upon the owner-operators of the FMI. To ensure that Australian interests are protected, it is important that the Australian regulatory framework is at least as strong as any regulatory framework applying offshore.

That framework should be designed to provide Australian regulators with the capacity to address four core concerns:

1. a potential FMI insolvency event (such as might arise from the failure of multiple CCP clearing participants in extreme market volatility);
2. the failure of an FMI to recapitalise (such as might arise if an FMI suffers a loss arising from participant default, investment loss, market loss, or other financial stress);
3. a disruption to the smooth provision of FMI services from a prolonged operational outage (which could arise from the inability, or unwillingness, of FMI operators to rectify a variety of problems); and
4. a risk to the smooth provision of FMI services from failure to comply with regulatory requirements and, in particular, requirements around financial resources and liquidity (which might arise if exposures from increased financial market activity grow beyond the coverage of financial resources and/or the risk appetite of the FMI owner).

Of these four core concerns, the first two would most probably arise from a large scale crisis while the remaining issues may reflect systemic weaknesses that could unfold more gradually. Nevertheless, where the smooth operation of FMI services is affected by any of these events, there is always a risk that a market's or CS facility's services are withdrawn, even if the FMI provider is not actually insolvent. (For example, the parent entity may decide to withdraw those services if they are no longer seen to be profitable). A robust Australian regime should include the capacity for regulators to step in to ensure that FMI services continue in any of these sorts of circumstances.

It should be noted that the strongest regulatory sanction currently available, withdrawal of licence, is counterproductive to addressing any of the four core concerns.

Notwithstanding that the risks of systemic disruption are arguably at least as great as those arising from the failure of an ADI, existing powers to issue directions to, and impose conditions on, licensees of CS facilities and markets, as well as the sanctions for breaches of the same, are considerably less powerful than similar provisions applying to ADIs.

### APRA's regulatory powers

Among other things, APRA, in regulating ADIs (and non operating holding companies (NOHCs) under the *Banking Act 1959* (Banking Act);

- may make prudential standards for ADIs (and authorised NOHCs);<sup>24</sup>
- applies fit and proper requirement to directors and executives;<sup>25</sup>
- may issue binding directions, including removing directors and appointing directors, and to require recapitalisation and other remedial measures;<sup>26</sup>
- may administer or appoint a statutory manager to assume control of an ADI, including for the purpose of recapitalisation;
- may apply to the Court to wind up an ADI;
- under the *Financial Sector (Business Transfer and Group Restructure) Act 1999*, may make a compulsory transfer of some or all of the business of an ADI or related party to another regulated entity, with Ministerial consent, and with the agreement of the board of the receiving entity; and
- may make use of resolution funding powers provided for in the Banking Act, which are relevant to many crisis resolution options.

Moreover, failure to comply with APRA's directions is an offence,<sup>27</sup> and provisions in the Banking Act also make it an offence for an officer of an ADI to fail to take reasonable steps to ensure that the entity complies with a direction, where the officer's duties include ensuring such compliance.<sup>28</sup> Together, these powers are designed to enable APRA to meet its responsibilities to protect depositors and to prevent systemic disruption in the event of the failure of an ADI.

Arguably, powers available to the regulators in respect of systemically important FMIs should be as clear and robust as those available to APRA, given the potential for significant systemic disruption to the financial system arising from a market or CS facility experiencing difficulties.

## 4.2 EXISTING POWERS AND SANCTIONS

The following describes existing powers available for regulators and the Minister in respect of markets and CS facilities relevant to the core concerns.

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24 Under section 827D, the RBA may determine standards applicable to CS facility licensees.

25 Under section 853C, ASIC may disqualify an individual from involvement in a market or CS facility licensee if it is satisfied that because the individual is unfit to be involved there is a risk that the licensee or applicant will breach its obligations under Chapter 7 of the Corporations Act. This is not the same as a fit and proper requirement in the Banking Act.

26 ASIC and the Minister can also issue binding directions to market and CS facility licensees: see further discussion in section 4.2.3.

27 Failure to comply with some types of directions results in a market or CS facility licensee committing an offence, but does not result in an individual director or officer committing an offence.

28 Subsection 11CG(2) and section 13Q of the Banking Act.

### 4.2.1 Withdrawal of licence

The ultimate sanction currently available if a market or CS facility licensee breaches its obligations under the Corporations Act is removal of its licence. However, the withdrawal of the licence of an operator of a systemically important FMI may not be an appropriate response and may be counterproductive from the perspective of systemic stability as a tool to address a crisis. This is because it would require the complete cessation of the service if a suitably licensed buyer of the FMI cannot be found in the time available. This in turn is likely to deter regulators from using this sanction.

### 4.2.2 Imposition of additional conditions

An alternative sanction, short of removing a licence, involves the imposition of additional licence conditions, such as requiring an FMI to recapitalise following an event of participant default that erodes default resources.

While this approach may be useful where the FMI licensee is responding to regulatory guidance, it is ineffective to address any of the four core concerns identified in 4.1, where the FMI is either insolvent, or is unable or unwilling to comply with regulatory guidance. The underlying issue is that the remedial powers and sanctions for breach of conditions are relatively weak. Even if the remedial powers and sanctions were strengthened, the legislation is arguably too vague regarding the type and scope of conditions that may be imposed. Moreover, the FMI licensee may choose to surrender the licence if conditions are too onerous.

### 4.2.3 Direction-giving powers

Currently, the Minister and ASIC are able to issue directions to a market operator or a CS facility operator in the event of threatened, or actual failure. Directions powers can be used not just in response to a breach of conditions but used also as remedies in their own right. The types of directions powers, and the relevant grounds, are set out below.

## Existing powers of direction

In respect of market operators:

- the Minister may give directions under s. 794A (if the Minister considers the licensee is not complying with its obligations) or s. 794B of the Corporations Act (if the Minister requires a special report on specified matters); and
- ASIC may give directions under s. 794D of the Corporations Act (if in ASIC's opinion it is necessary or in the public interest to protect people dealing in financial products). However, these directions can only have effect for a maximum period of 21 days.

In respect of CS facility operators:

- the Minister may give directions under s. 823A of the Corporations Act (if the Minister considers the licensee is not complying with its obligations) or s. 823B (if the Minister requires a special report on specified matters);
- ASIC may give directions under s. 823D (if it considers these necessary or in the public interest to protect people dealing in financial products or considers the licensee has not done all things reasonably practicable to ensure the facility's services are provided in a fair and effective way). However, these directions can only have effect for a maximum period of 21 days; and
- ASIC, following consultation with the RBA, may give directions under s. 823E of the Corporations Act (if it considers the licensee has not done all things reasonably practicable to reduce systemic risk).

In the event that the licensee breaches a direction, ASIC may apply for a court order requiring the licensee to comply with the direction.<sup>29</sup> Breach or non-compliance with a direction given to a market licensee or CS facility exposes the licensee to a penalty of up to 100 penalty units a day (a penalty unit is \$110) for each day the contravention persists.<sup>30</sup> Failure to comply with such an order would also render the licensee liable for prosecution for contempt. As noted above, sanctions applying to a breach by an ADI under the Banking Act are significantly stronger.<sup>31</sup>

There is a strong case to buttress directions powers to strengthen incentives that apply in normal circumstances. The main limitations of these existing processes are as follows:

- **Untimeliness:** Imposition of directions, and any subsequent court action to enforce directions, may take a long time. This is particularly so given the consultation and

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29 Sections 794A(3), 794D(4), 823A(3), 823D(6) and 823E(3A).

30 Items 251C, 257C and 257D of Schedule 3 to the Corporations Act. This is the penalty for contravention of a direction issued by ASIC to a market licensee under section 794D(1) and a direction given by the Minister under subsection 794B(1) to prepare a special report. It is not an offence to fail to comply with a direction issued by the Minister under subsection 794A(1) (that is a direction to do specified things to promote compliance with its obligations). This is also the penalty for contravention of a direction issued by ASIC to a CS facility licensee under section 823D or section 823E and a direction given by the Minister under subsection 823B(1) to prepare a special report. Correspondingly, it is not an offence to fail to comply with a direction issued by the Minister under subsection 823A(1) (that is a direction to do specified things to promote compliance with its obligations).

31 An offence under the Banking Act may attract criminal penalty: Banking Act section 11CG.

notification requirements that are built into the Corporations Act for certain kinds of directions.

- **Uncertainty:** The legislation is not explicit about the types of directions that may be issued. This contrasts with the approach in the Banking Act, which provides considerable guidance by describing specific directions which may be given (as well as a catch-all provision).
- **Unenforceability:** In non-crisis situations, directions at the level of the licensee may be sufficiently enforceable through the threat of fines. By contrast, the enforceability of directions in extreme circumstances is less certain. Fines, or the threat of a loss of licence, to an entity already experiencing financial distress are likely to be inconsistent with the goal of ensuring the continued operation of the FMI, as they undermine the business's viability.

#### 4.2.4 Liability of directors and others involved

The current regulatory framework may not adequately deal with conglomerate entities that operate systemically important FMIs in Australia through subsidiaries. Currently, the sanctions can only be applied to the subsidiary licensee company rather than the parent company of the licensee, a subsidiary of the licensee, a related body corporate of the licensee, or individual directors or officers.<sup>32</sup> Moreover, breach of a licence condition or direction by a licensee does not currently give rise to a civil or criminal penalty for directors, officers or other individuals involved in the contravention.

### 4.3 STEP-IN POWERS

In the event that there is a risk to the continued operation of a systemically important FMI, there may be a need for a regulatory agency to take control of the operation of an FMI to ensure its continued operation. This is the case regardless of whether the risk arises from operational difficulties beyond the capacity of management to address, or from financial difficulties that the licensee and the group of which it forms part may find themselves in.

The Corporations Act does not explicitly provide ASIC or the RBA with the ability to intervene directly by 'stepping in' to take control of the operation of market and CS facility licensees. Conceivably in a crisis the Minister and ASIC might consider such action under broad directions powers,<sup>33</sup> however it is by no means clear that these powers would extend to the appointment of an external manager to 'step in' to manage the affairs of the licensee and its assets. Without a clear indication of Parliamentary intent, a court may be reluctant to conclude that the current broadly-worded directions powers are intended to authorise appointment of an external manager, and may also be reluctant to conclude that the powers permit steps to be taken to take control of the licensees' assets.<sup>34</sup>

Because Austraclear is considered to be crucial to the Real-time Gross Settlement (RTGS) system, the provision of system liquidity and the implementation of monetary policy, the RBA has established

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<sup>32</sup> Although there are possible means through which individuals may be targeted (for example accomplice laws), the legal certainty of such methods is questionable.

<sup>33</sup> See section 4.2.3.

<sup>34</sup> One example where this type of direction may be appropriate is if a liquidator or administrator was appointed to a licensee or its holding company, and was considering suspending or ceasing the licensee's operations.

contractual powers to step-in under certain circumstances to take control. However, as these arrangements have not been tested by a court, some uncertainty remains as to their reliability.

To provide certainty, and to ensure the continued smooth operation of FMIs' services necessary to protect the interests of participants and users of a market or facility, it is proposed that the capacity to step-in be provided in legislation.

### 4.3.1 International comparisons

While there is broad international agreement on the need for robust crisis resolution arrangements for FMIs, this work continues to evolve. This is likely to be influenced by principles for the resolution of a bank crisis, which are in a more advanced stage of development.

At this stage, the draft CPSS-IOSCO Principles for FMIs do not discuss a regime for a regulatory response to an FMI crisis. Instead, the draft principles include an obligation for FMIs to preserve sufficient funds, protected from bankruptcy proceedings, in order to continue to operate an FMI for several months following a crisis event that depletes the FMI's financial resources. The Council's view is that this approach may not be effective in light of Australia's insolvency regime and, in any event, this leaves unaddressed the issues that arise from partial or complete loss of a CCP's default resources.

Notwithstanding that international work is incomplete, one possible outcome is that regulators of FMIs in Europe and the United States will be given the sorts of powers available to prudential regulators of banks. In that regard, the powers of APRA, which the Australian regulatory authorities are drawing upon for a model for FMIs, are not dissimilar to those applying in Europe and the United States.

## 4.4 FMIs SUBJECT TO COMPETING OBLIGATIONS

Where systemically important financial markets and CS facilities are integrated with entities that are also subject to foreign regulation and obligations, the operators of FMIs may be unclear as to the expectations of Australian regulators and/or may be subject to competing obligations. One such instance would be where the local operator of an FMI required recapitalisation, and where recapitalisation was also required on the part of the controlling entity across multiple jurisdictions.

Given the potential for increasing interconnectedness of significant entities across different jurisdictions there is a need for clearer codification of regulators' powers to direct recapitalisation to ensure that FMIs remain adequately resourced and to ensure that regulators have clearly defined powers to step in to ensure that systemically important FMIs remain in operation. This codification would also better clarify the regulatory structure for exclusively Australian domiciled and regulated entities.

## PART B — COUNCIL PROPOSALS FOR REFORM

### 5. OVERVIEW OF PROPOSALS

To address the concerns identified in Part A of this paper, the Council considers that regulatory reform is required.

#### 5.1 COUNCIL PROPOSALS

The Council proposes strengthening the regulators' powers to prevent adverse outcomes. These strengthened powers would include the capacity to make direct interventions in the operations of FMIs, including through enhanced powers to issue directions and, in certain specific circumstances, to step in to take control of FMIs. The proposals are set out in detail in the remainder of this paper and are summarised below.

Proposals to enhance the regulators' ongoing capacity to ensure that the Australian financial market is protected (Section 6):

- Location requirements (Section 6.1);
- Pre-approval of directors of FMIs and parent entities to ensure they are fit and proper persons (Section 6.2); and
- Responsibility for making listing rules (Section 6.3).

Strengthened directions powers and increased sanctions for breach of conditions to buttress the regulators' capacity to ensure that FMIs remain robust on an ongoing basis (Section 7):

- Broadening the types of direction (Section 7.1);
- Streamlining the issuance of directions (Section 7.2);
- Applying sanctions to directors and officers (Section 7.3);
- Applying sanctions to related bodies corporate (Section 7.4); and
- Broadening sanctions for breach of conditions (Section 7.5).

Step-in powers to resolve a crisis situation in relation to a systemically important FMI (Section 8).

Establishing criteria for identifying systemically important FMIs to which some or all of these requirements would, or would chiefly, apply (Section 9).

Client protection through portability (Section 10).

Compensation fund arrangements for securities (Section 11).

Consideration of competition matters for clearing and settlement (Section 12).

## 6. PROPOSALS FOR STRENGTHENING GENERAL COMPLIANCE

### 6.1 LOCATION REQUIREMENTS

#### 6.1.1 Existing regime

Currently, the Corporations Act provides for markets and CS facilities to be licensed as either domestic or overseas facilities. The primary distinction between the two is that the overseas licence is potentially available where the facility is subject to a sufficiently equivalent overseas regulatory regime by its home regulator.

In principle, a facility located offshore can be licensed either as a domestic or overseas facility. If an overseas facility is licensed as a domestic facility it is subject to direct oversight and regulatory requirements under the Australian regulatory framework as well as under its overseas regulatory framework. Neither type of licence makes any requirement as to location of the facility.

No matter which type of licence is granted, the Corporations Act provides for the facility to be subject to the FSS. However, to avoid duplication of regulation, the RBA allows an overseas licensed CS facility to be exempt from assessment against the FSS provided that it is able to demonstrate compliance with the requirements of the overseas regulator.<sup>35</sup>

#### 6.1.2 Problem identification

In the context of the regulators' consideration of the SGX's bid to take over ASX, concerns were identified about the location of infrastructure considered essential to the smooth operation of the Australian financial system. The ability of domestic regulators to influence an FMI that is located offshore is diminished, particularly if that FMI serves markets in multiple jurisdictions.

It may also be that an FMI located onshore might want to move some aspects of its operations offshore, for example, to take advantage of opportunities to reduce costs, or to increase investment returns on funds under its control. Consideration therefore should be given to the powers of regulators to require critical aspects of the operations of any FMI providing systemically important services in Australia to be located onshore.

These considerations have also arisen in the context of mandatory CCP clearing of OTC derivatives markets. Stronger capacity to impose location requirements on systemically important facilities may provide for more direct control by Australian regulators of some aspects of those facilities' business (for example the location and control of margins and default resources).

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<sup>35</sup> FSS 2009.1, does not apply to CS facility licensees granted a licence under section 824B(2). This exception applies only for such time as the Reserve Bank receives annual documentary evidence from the licensee's overseas regulator that the licensee has complied in all material respects with the requirements of the overseas regulator related to matters affecting stability.

### 6.1.3 Scope of location requirements

A number of questions arise as to the scope of any location requirements, including the types of FMIs to which they apply, whether they should apply to both domestic and overseas licensees and whether they should be limited to systemically important FMIs. Given that the overriding regulatory objective is the reduction of systemic risk, and that systemic risk can arise from market licensees as well as CS facilities, the Council proposes that location requirements apply to FMIs regardless of whether they are market licensees or CS facilities. The Council also proposes that they apply regardless of whether the provider is licensed as a domestic or overseas facility.

Consideration of systemic importance is more difficult. It is possible that if offshore FMIs were permitted to provide services in Australia, and they were deemed not to be systemically important initially, they may become so over time if their market presence grows. Conceivably such an FMI could be required to be located in Australia from the outset, but in some cases this might ultimately prove to be unnecessary as the FMI might not reach a scale that would make it systemically important. On the other hand, there may be situations where it is not feasible for an FMI that is providing services that are considered to be systemically important to be located in Australia.<sup>36</sup>

These factors suggest that a location requirement must be flexible. Under existing legislation, the Minister is able to impose a location condition on a licence on the advice of the regulators. Potentially this could apply from start up, or from such time as an FMI becomes systemically important. However, it is preferable to strengthen the legislation so as to provide for the regulators to determine whether the degree of systemic importance of a facility should require some part or all of that facility's operations to be located in Australia. On balance the Council considers that FMIs that are not considered to be systemically important should not be subject to location requirements, although this implies that some may become subject to such requirements at a later time as the size and nature of their operations change.

The Council proposes that all systemically important FMIs be subject to a location requirement at the discretion of the regulators (if in the opinion of the regulators such a requirement is appropriate to the nature of the FMI).

#### Your feedback

Q1. Do you have comments on the location requirement proposal?

### 6.1.4 Content of the location requirements

The Council proposes a flexible and graduated approach to the application of the location requirement that takes account of the relative systemic importance of an FMI. As the systemic importance of an FMI increases, a location requirement might escalate along the following lines:

- requirements as to location of default resources and margin funds, in the case of CCPs;
- requirements as to location of certain staff (for example, heads of IT and compliance); and/or

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<sup>36</sup> For example, if Australian participation in a systemically important facility servicing a global market required that facility to hold an Australian licence, but it was impractical to impose a location requirement.

- requirements as to location of certain operations (for example, critical IT infrastructure).

While regulatory flexibility is desirable to allow regulators to react to changed circumstances as an offshore FMI's business grows in systemic importance, it is acknowledged that the regulators will need to provide clear guidelines on the approach to exercising these powers, to ensure foreign FMIs are not deterred from entering the market by the existence of these powers. It is recognised that regulators will need to closely monitor the degree of systemic importance of new offshore FMIs so that the exercise of these powers does not give rise to commercial uncertainty. Further, regulators will need to ensure that there is sufficient time for an offshore FMI to comply with any proposed additional location requirements, or alternatively that there is sufficient time for users of the affected FMI to seek out other service providers, if the offshore FMI chooses to withdraw from the Australian market rather than comply.

#### Your feedback

Q2. Do you have comments on the flexible, graduated approach for systemically important FMIs?

### 6.1.5 How could location requirements be imposed?

The Council proposes that the regulators should be provided with considerable flexibility in imposing location requirements. It is expected that an existing or prospective licensee will provide the regulators with sufficient information to determine whether an FMI is, or is likely to become, systemically important. Moreover, the dialogue between the regulators and a prospective licensee will establish that an FMI may at some point be required to meet any or all of the location requirements set out in 6.1.4 if the regulators assessment of the facility's relative systemic importance changes over time, including because of any change to the extent and nature of the CS facility's operations.

Section 9 provides a discussion of how systemically important FMIs might be identified.

#### Your feedback

Q3. Do you have comments on the proposed mechanism to allow for the power to impose location requirements?

## 6.2 PRE-APPROVAL OF DIRECTORS OF FMIs AND PARENT ENTITIES

Under the Corporations Act, individuals can be prevented from being involved in the management of an FMI if ASIC declares that, because the individual is unfit to be involved in a licensee or applicant, there is a risk that the licensee or applicant would breach its obligations under Chapter 7 of the Corporations Act if the declaration was not made.<sup>37</sup> To prevent an individual from serving, ASIC would need to make a declaration, and provide the individual procedural fairness to enable the finding to be challenged.

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<sup>37</sup> Section 853C(1) of the Corporations Act.

The Council proposes requirements to enable ASIC to ensure that the ultimate decision-making bodies of FMIs, such as an authorised holding company, comprise individuals who meet a fit and proper standard. This is because, in a crisis situation, the FMI's parent company may well be the crucial decision-maker (for instance, in a decision whether or not to recapitalise a failing local subsidiary).

The regulatory regime applying in Singapore provides an example of how this can be achieved. In Singapore, all prospective directors of FMIs and their parent entities must obtain pre-approval of the Monetary Authority of Singapore (MAS) before being appointed.<sup>38</sup>

The Council considers the requirements for ADIs under the Banking Act to be relevant. Individuals must meet a fit and proper standard to serve as a director. This standard requires individuals to both demonstrate they have appropriate qualifications and experience for the role and demonstrate that they should not be prevented from acting as a director by reason of criminal record or bankruptcy.

The Council sees merit in adopting a similar requirement for FMIs, as doing so will ensure only directors who meet a fit and proper standard can be appointed.

#### Your feedback

Q4. 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?

Q5. Do you agree with the adoption of a fit and proper standard similar to that in the Banking Act?

## 6.3 RESPONSIBILITY FOR MAKING LISTING RULES

### 6.3.1 Role and importance of ASX listing rules for Australia's capital markets

ASX is the primary listing market in Australia. As at 30 June 2011, there were 2,247 entities listed on ASX's market, with a market capitalisation of approximately \$1.35 trillion.<sup>39</sup> While there are other Australian market operators who provide listing services, ASX has far more listed entities with a much higher aggregate market capitalisation than the next largest Australian listing market.<sup>40</sup>

ASX develops standards for the behaviour of listed entities through its listing rules, which are both supplementary and complementary to the requirements in the Corporations Act. ASX's listing rules cover such matters as:

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38 Section 28 of the *Securities and Futures Act 2001*. Under the *Securities And Futures (Markets) Regulations 2005* Regulation 22, MAS may have regard to three factors:

(a) whether the person is fit and proper to be so appointed;

(b) whether the appointment of the person would be consistent with any applicable written law relating to the qualifications for the position or the requirements for the composition of the board of directors or any committee of the approved exchange;

(c) whether it would be contrary to the interests of the public to approve the appointment of the person.

39 Source: ASX 2010/2011 Annual Report and ASX website, [www.asx.com.au](http://www.asx.com.au).

40 The second largest listing market in Australia, NSX, operated by NSX Limited, had 40 listed issuers with a market capitalisation of approximately \$2.4 billion, as at 30 June 2011 (Source: NSX Limited 2010/2011 Annual Report).

- continuous disclosure obligations to immediately disclose information likely to have a material effect on the price or value of an issuer's securities;
- periodic reporting obligations;
- additional reporting obligations for mining and exploration activities;
- obligations to obtain shareholder approvals for related party transactions and certain significant transactions; and
- restrictions on the issue of new capital without prior shareholder approval.

In the Council's view, the characteristics and rigour of ASX's listing rules, and the quality of the monitoring and enforcement of its listing rules by ASX, are critical to promoting market integrity and investor confidence in Australia's equity capital markets.

The benefits of high quality, well-enforced listing rules accrue not just to ASX, entities listed on ASX and participants of ASX, but to the broader Australian community. Accordingly, there is a clear regulatory objective in ensuring that the framework in which listing rules are set, monitored and enforced remains appropriate and continues to evolve towards best practice.

### 6.3.2 Making of listing rules

The Minister and ASIC have an oversight role in respect of the listing rules of Australian market operators. This oversight takes two primary forms.

#### Disallowance power

Under s. 793D of the Corporations Act, market operators must lodge any proposed amendments to their operating rules, including listing rules, with ASIC. Under s. 793E of the Corporations Act the Minister may disallow any proposed amendment to an operator's listing rules. This power enables the Minister to prevent a market operator from changing its listing rules in a way which would be detrimental to market integrity and investor confidence. ASIC's views influence the outcome, as it advises the Minister whether to disallow a rule change.

#### Monitoring of market operator

ASIC does not monitor listed entities' compliance with listing rules (including Chapter 3 of the Listing Rules). In contrast, since 1 August 2010 ASIC has been responsible for monitoring market participants' conduct on licensed markets.

However, ASIC does assess the compliance of market operators with their obligation to have adequate arrangements in place to monitor and enforce their operating rules, including their listing rules.

At a minimum, ASIC is required to undertake an annual assessment of the market operator's compliance with its obligations.

Historically, the annual assessment process has enabled ASIC to identify areas where improvements could be made by market operators, including changes to operating rules and the manner in which they monitor and enforce compliance with those rules.

The annual assessment process, in addition to other informal dialogue between ASIC and market operators, has resulted in market operators agreeing to make changes both to their processes for monitoring and enforcing compliance and also to the content of their operating rules.

## Directions power

As mentioned elsewhere in this paper, both the Minister and ASIC have powers of direction that could potentially be relevant in this context (see box in section 4.2.3). However, these powers of direction are narrowly circumscribed and do not extend to all situations where, for market integrity reasons, a change to the listing rules might be considered desirable. In addition any attempt to rely on these powers to direct an AML to change listing rules would be susceptible to the limitations of the direction powers identified in section 4.2.3 above.

### 6.3.3 Problem identification

#### Responsibility for making listing rules

Neither the Minister nor ASIC have explicit power to make or require ASX (or other market operators) to make new listing rules, if, for example, the Minister or ASIC considers it necessary to promote market integrity and investor confidence.

By way of contrast, ASIC has the ability to make market integrity rules under s. 798G of the Corporations Act, subject to the Minister's consent. S. 798G of the Corporations Act was enacted to facilitate the transfer of responsibility for supervision of conduct on licensed financial markets to ASIC effective from 1 August 2010.

#### Increasing global competition for listing and integration of listing markets

A number of merger proposals, including the proposed takeover of the ASX by SGX and other forms of international alliances, have been announced since October 2010. The potential for control of a systemically important Australian market operator by a foreign entity warrants a review of the existing framework of responsibilities in the Corporations Act for setting listing rules.

Council agencies are concerned that if a systemically important Australian market operator were acquired by a foreign entity, particularly by a foreign entity that maintains its own listing service with its own listing standards in a foreign jurisdiction, the incentive structure of the Australian market operator to continue to develop and improve its listing rules could change.

The agencies are also concerned about investor perceptions that such an acquisition will result in Australian listing standards coming under the influence and ultimate control of a foreign entity, which may not be perceived as maintaining the same standards as the Australian market operator.

There may be circumstances where ASIC and the Minister identify a need to introduce listing rules that provide particular protections to Australian investors and/or enhance the integrity of participating and investing in the relevant market. Examples do exist where market operators in

Australia have worked with ASIC from time to time to make improvements to their listing rules. However if a proposed improvement is inconsistent with the listing standards adopted by a foreign acquirer in another jurisdiction then informal dialogue between ASIC and a foreign owned market operator may not be as effective in the future.

## Reform proposal

The Council agencies propose 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 ASIC views that the making of that rule is appropriate and proportionate for the enhancement and/or protection of market integrity. Following a direction, a licensed financial market operator would be required to make the rules, and be responsible for monitoring and enforcing compliance with them.

Adopting this proposal would address the concern that a market operator may fail to improve and adapt listing standards to Australian circumstances over time. The existence of the power may be sufficient to ensure the market operator remains focused on continuing to improve its listing standards. ASIC and the Minister will have a much greater ability to influence the market operator even if the power is not exercised.

The Council agencies consider that this approach is preferable to other approaches. One such alternative is to give ASIC or the Minister the power to make separate statutory listing rules. However, requiring listed entities to comply with two sets of listing rules creates uncertainty and risks operational issues. Another alternative is to completely transfer responsibility for setting, monitoring and enforcing all listing rules to ASIC, or another independent third party. However, it is not clear that there is a sufficient case to pursue such a significant change on market integrity or efficiency grounds.

### Your feedback

Q6. 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?

## 7. PROPOSALS FOR STRENGTHENING POWERS OF DIRECTION AND SANCTIONS

More clearly defined powers allowing ASIC and the RBA to issue directions to a FMI could provide more rapid responses to crisis situations. Stronger powers to enforce directions could also ensure that necessary changes to risk controls and operational standards are made by operators of systemically important FMIs on an ongoing basis.

## 7.1 TYPES OF DIRECTION

As discussed in Section 4.2.3, the Corporations Act currently allows directions to be given by ASIC and the Minister to licensees of financial markets and CS facilities in certain circumstances. Currently, the potential scope of permissible directions is broad (although as discussed above, there is uncertainty as to whether a court would permit directions to be used to take control of a licensee's property and to take control of the operations of the licensee).

The Council agencies consider that the types of direction that could be issued should be specifically provided for by legislation in a similar fashion to the Banking Act model. To the extent applicable, the types of directions set out in the Banking Act (see the Attachment) should be available with regards to FMI. The grounds for giving directions must also be cast broadly, such that they can be given early enough to effectively address a situation before it becomes acute.

## 7.2 STREAMLINING THE ISSUANCE OF DIRECTIONS

There are currently powers of direction in the Corporations Act, but the processes that must be followed before a valid direction is given may not allow for timely and targeted directions to deal with the range of crisis situations that may arise.

Currently, ASIC is required to go through a two-stage process before a direction takes effect: first, to explain why the direction is required; and second, for the licensee to be given a reasonable time to respond.<sup>41</sup> The second part of this process is arguably inconsistent with the need to ensure continued provision of services in time critical situations. It is therefore appropriate to examine whether the existing processes can be streamlined or improved while maintaining protections for licensees to ensure that the processes are appropriate for use in stressed scenarios.

On the issue of consultation among regulators, the Corporations Act currently allows the Minister and ASIC to give directions to a licensed market operator or a licensed CS facility operator. The RBA can request that ASIC issue directions to the licensed operator of a CS facility,<sup>42</sup> although this is at ASIC's discretion.

Given the regulatory responsibilities of the RBA, the Council proposes that the Corporations Act explicitly acknowledge that the RBA may initiate a direction to CS facilities regarding financial stability, with implementation to occur in consultation with ASIC.

## 7.3 APPLYING SANCTIONS TO DIRECTORS AND OFFICERS

The ability to extend sanctions to individuals for failing to comply with a direction or an existing condition on a licence would significantly enhance the regulatory regime's effectiveness in crisis management situations. On this basis, the Council proposes extending the power of directions to directors and officers of relevant licensees.

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41 Subsections 794D applies to giving a direction to a market licensee. Section 823D applies to ASIC giving a direction to a CS facility licensee. Note that section 823E provides for a streamlined process for directions issued in circumstances related to financial stability or systemic risk reduction.

42 Section 823E(8).

This could be achieved in line with the Banking Act model, by providing for an offence, where:

- the director or officer's duties include ensuring compliance with the directions and conditions; and
- the director or officer of a licensed FMI fails to take reasonable steps to ensure that the licensee complies with directions or conditions.

The Council also proposes to provide legislative protection for directors and managers who comply with directions that may, without such protection, conflict with other obligations placed upon those officers.

#### Your feedback

Q7. Do you have comments on the proposal to extend the power of directions to directors and officers of relevant licensees?

## 7.4 APPLYING SANCTIONS TO RELATED BODIES CORPORATE

A further concern is that circumstances could arise in which a domestic licensee may take actions at the direction of a foreign parent, regulator or insolvency administrator that cause it to breach its obligations in Australia. Although potential application of meaningful penalties to individuals could minimise such occurrences, there may also be a case to extend the regime further to allow sanctions to be imposed on related bodies corporate that fail to assist a licensee to follow a direction or condition.

There may be potential extraterritoriality concerns with any proposal to extend sanctions to holding companies. With regards to overseas entities, which may be subject to contrary directions from overseas regulators, there are also questions about: how to enforce such directions (or penalty provisions), how to identify the entities to whom the provisions would extend, and what the appropriate triggers would be. While the Banking Act provisions apply to NOHCs, in the sense that directions may be issued against them, there is first a step of authorising the NOHC, which has no equivalent for FMIs as yet.

Given the importance of entities such as ASX Operations Pty Ltd and ASX Compliance Pty Ltd to the licensed FMIs in the ASX Group, the Council proposes to extend sanctions for failure to take reasonable steps to comply with a direction or condition, to a service provider that is a related body corporate of a licensee where the service provider is otherwise under an obligation to provide critical services to an FMI. Such a regime is a relatively light-touch alternative to establishing a full-fledged authorised NOHC regime for FMIs.

### Your feedback

Q8. 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 which is a related body corporate, where the service provider is ordinarily (absent the direction) under an obligation to provide critical services to the FMI?

## 7.5 BROADENING SANCTIONS FOR BREACH OF CONDITIONS AND DIRECTIONS

Currently, the primary sanction available to regulators where a licensee breaches the conditions of its licence is the suspension or removal of the licence.<sup>43</sup>

Breach of directions given to licensed FMIs by ASIC attracts fines under the current regime.<sup>44</sup> However, relative to the scale of FMI activity, these fines are arguably too small (100 penalty units or \$11,000) to provide sufficient incentive to ensure compliance with a direction. Failure to comply with a direction given by the Minister under s. 794A and s. 823A is not an offence.

For reasons described in Sections 4.2.3, there is a strong case for ensuring the effectiveness of incentives for licensees to comply with conditions and directions. In this regard, further consideration could be given to increasing the range of sanctions available for failure of licensees to comply, including:

- making a failure to comply a criminal offence;<sup>45</sup>
- fines;
- civil penalties; and
- infringement notices.

Appointment of a statutory manager, which can in some circumstances be seen as a sanction for non-compliance, is dealt with in Section 8 below.

### Your feedback

Q9. 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?

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<sup>43</sup> Addition restrictions could be imposed via additional licence conditions or directions. The ability to enforce those are covered previously in the paper, in Section 4.2.

<sup>44</sup> Section 794D, 823D and 823E.

<sup>45</sup> Any proposal to impose criminal liability provisions must comply with the Council of Australian Governments (COAG) Principles on the imposition of personal criminal liability for directors and other corporate officers as a consequence of a corporate offence. These Principles were adopted in December 2009, amid concerns that there appeared to be an increasing tendency for such provisions to be introduced as a matter of course and without proper justification, and because of a concern that inconsistencies in the standards of personal responsibility.

Q10. Do you have comments on the proposal that further sanctions be provided for in the Corporations Act for breach of directions and licence conditions?

## 8. PROPOSALS FOR STEP-IN POWERS

A key limitation identified in Section 4 is the inability of regulators to take control of a systemically important FMI to ensure its continued operation and therefore the stability of Australia's financial system. Most obviously, this may be necessary if an FMI is in financial distress, although a significant operational disruption that threatened the stability of financial markets may also be a sufficient cause to step in.<sup>46</sup> Such powers may be also used in circumstances where an FMI is not in financial or operational difficulty, but where it continues to breach its licence obligations nonetheless.

### 8.1 THE MECHANICS OF STEP-IN

#### 8.1.1 Who should make the appointment?

The question of who should decide to take control of an FMI is important and requires careful consideration. Under s. 16A of the Banking Act, APRA has the power to appoint a statutory manager to an ADI. APRA must inform the Treasurer annually of its appointments.<sup>47</sup>

Because of the potential for liability to the Commonwealth (set out in detail in section 8.2), it would be important for the Government to be consulted ahead of any decision to step in, and to have the capacity to object. This could be achieved by requiring that the Treasurer (or the Minister) provide a letter of indemnity to cover any potential financial losses that might be incurred following the appointment of a statutory administrator.

The Council proposes 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.

#### Your feedback

Q11. 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?

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<sup>46</sup> FMI are subject to operational risk and no facility operates at 100 per cent availability. However, international best practice is that an FMI should be available 99.9 per cent of the time and that recovery from a system outage should be within two hours. This is a contractual obligation for Austraclear. If a significant disruption occurred, such that an essential FMI ceased to function entirely for a prolonged period, or a pattern of ongoing disruptions emerged with no resolution being credibly pursued by the FMI (including complying with any directions given by the regulators), it is likely that the regulators would conclude that the FMI was not complying with the requirements of its licence.

<sup>47</sup> The power to appoint a statutory manager is section 13A(1) of the Banking Act. Section 16A provides that APRA must inform the Treasurer annually of its appointments.

### 8.1.2 Who should be eligible for appointment?

Under the Banking Act, APRA may appoint itself or a third party (individual or legal entity) as statutory manager of an ADI.<sup>48</sup>

This approach has the advantage of providing flexibility, allowing appointment of an experienced person with market credibility, a liquidator or a similar professional, or the regulator itself, depending on circumstances.

For these reasons, the Council proposes that, if required, 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.

#### Your feedback

Q12. 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?

### 8.1.3 Triggers for the appointment

A regime for appointment of a statutory manager to an FMI, broadly an equivalent regime applying to APRA's power of appointment over ADIs, would need to carefully define the conditions or triggers justifying appointment.

It is proposed that regulators be given powers to appoint a statutory manager where the regulator considers that:

- there is a material risk of an FMI insolvency;
- an FMI fails to recapitalise in a timely manner following a participant default, where it is necessary to do so to maintain normal operations or ensure compliance with FSS;
- an FMI is unable to rectify a material operational outage in a timely manner; or
- an FMI's failure to comply with Australian regulatory requirements risks the smooth operation of the FMI.

#### Your feedback

Q13. 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?

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<sup>48</sup> Subsection 13A(2).

#### 8.1.4 Powers of the statutory manager

Under the Banking Act, a statutory manager assumes complete control of the entity, replacing the management and board. The statutory manager has the powers of the board. A statutory manager is empowered to seek information, alter the ADI's constitution, facilitate recapitalisation of the entity or transfer some or all of the entity to another regulated entity.<sup>49</sup>

A statutory manager of an FMI may require analogous powers, however they would be used to meet a different objective. While a statutory manager of an ADI has a specific statutory obligation to protect depositors, a statutory manager of an FMI would seek to protect financial stability through the continuation of the FMI's services.

In the most extreme example of a shortfall of assets to meet obligations as a result of an insolvency event, a statutory manager of an FMI might suspend or cancel obligations. Such a situation might arise, for example, should a CCP clearing participant fail in a period of extreme market volatility.

A statutory manager of a CCP in such a situation would need to address how the shortfall would be allocated across participants (note that the alternative is for clearing participants to pursue a claim against the liquidator of the CCP as unsecured creditors in insolvency proceedings). This may require the statutory manager to take action not contemplated by the CCP's rules.

To support this, it is proposed that the statutory manager of an FMI have powers to operate the FMI, including the ability to:

- exercise the powers of the board;
- replenish default resources;
- recapitalise or alter the capital/ownership structure of the FMI;
- amend the constitution of the entity under statutory management (which may be necessary if participants favour a different structure);
- suspend or cancel the FMI's obligations or those of an FMI participant (this may be necessary to deal with novated obligations that cannot be met because of a shortfall);
- enter into a compromise with creditors; and
- issue and cancel securities or other financial products.<sup>50</sup>

As step-in is seen as a means of continuing operation of an FMI, it is necessary to protect an FMI under statutory administration (which may be technically insolvent) from claims by creditors. Accordingly, the Council proposes to allow for a moratorium on creditors enforcing debts, effective from the appointment of the statutory manager. Moreover, appointment of a statutory manager replaces external administration arising from any other action.

The Council proposes that appointing regulators have powers in relation to the statutory manager (for example to give binding directions to the statutory manager, to remove and replace the

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<sup>49</sup> Banking Act, sections 14A and 14AA.

<sup>50</sup> An ADI may issue securities or other financial products in its own name. Currently, no FMI does so.

statutory manager, etc) and powers to terminate and/or replace the statutory manager, if this is required.

#### Your feedback

Q14. Do you have comments on the proposed powers to be exercised by the 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?

### 8.1.5 Interaction with insolvency law

Under the Banking Act model, appointment of a statutory manager vacates any existing appointment of an external administrator such as a liquidator or administrator under the Corporations Act. Similarly, an external administrator cannot be appointed, except with APRA's consent, during the term of a statutory manager.<sup>51</sup> Also, the statutory manager is given priority in a liquidation of the ADI in respect of any costs it incurred while administering the ADI: subsection 16(2) of the Banking Act.

The Council proposes that this regime be adopted for FMIs.

#### Your feedback

Q15. 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?

## 8.2 LIABILITY OF THE ADMINISTRATOR AND THE COMMONWEALTH

### 8.2.1 Potential for exposure

Step-in by way of appointment of a statutory manager would involve significant risk for the statutory manager and, in turn, the Commonwealth if there is a lack of legislative provision to mitigate those risks (for example step-in should not transfer any losses that might accrue in insolvency proceedings from shareholders and participants to the statutory manager for a prior event that gave rise to step-in powers being utilised).

Under a scheme like that provided for by the Banking Act, the statutory manager would have immunity from suit for actions taken in the course of the proper performance of its functions, with exceptions such as acts done dishonestly or with negligence.<sup>52</sup> Similar protections for a statutory manager of an FMI may also need to cover events such as a loss incurred from a participant default while the statutory manager is in control of a CCP.

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<sup>51</sup> Banking Act, section 15A.

<sup>52</sup> If an ADI incurs any loss because of any fraud, dishonesty, negligence or wilful failure to comply with the Act by the ADI statutory manager, the ADI statutory manager is liable for the loss. The statutory manager will not be liable for any other losses: Banking Act section 14C(2). Under the Insurance Act 1973, a judicial manager of a general insurer is liable only for acts done in bad faith: see section 62ZM.

As a condition of its appointment, the statutory manager could be expected to request indemnity from the Commonwealth for some or all acts for which it is not shielded under its statutory immunity. This arrangement would be a matter of prior negotiation between each statutory manager and the Commonwealth. Depending on the outcome of the negotiation, the Commonwealth potentially faces extensive liabilities for actions of the statutory manager, where that liability falls outside the statutory manager's statutory immunity.

It is not proposed that the Commonwealth will necessarily inject capital or other financial resources to assist the FMI (such as via guarantees).<sup>53</sup> However, the Commonwealth may face operating costs in the interim between step-in and recapitalisation — particularly where this involves a change in ownership. While it is expected that these would be recouped through normal transaction fees, ad-hoc levies<sup>54</sup> on participants, or as part of the recapitalisation process, if, for example, a statutory manager were to continue to operate a CCP with severely depleted default resources, some mechanism may be required to meet a potential second clearing participant default.

Actions by the Commonwealth, and regulators, to ensure the ongoing operation of a distressed FMI would not be directed at absolving shareholders of any obligation to meet debts, or disturbing any loss allocation that might flow from insolvency proceedings. Rather, any action will be directed in the best interest of financial market stability.

However, operating a CCP without adequate default resources in circumstances where clearing participants may face the possibility of uncertain and unquantifiable future loss is likely to give rise to the sort of systemic disturbance that appointment of the statutory manager seeks to avoid.

The best method to avoid such an outcome is a rapid resolution but this may not always be possible. In the interim, other measures such as placing greater emphasis on margining rather than default resources may provide cover against a second clearing participant default.<sup>55</sup> If a resolution proved to be protracted there would be scope to negotiate the replenishment of default resources from participant contributions, thereby allowing margins to be run down to more normal levels.<sup>56</sup>

## 8.2.2 Comparison with the ADI regime

When drawing a comparison with APRA's powers under the Banking Act, it is worth noting that the risks arising from taking control of an FMI may be different to taking control of an ADI.

- Under the Banking Act, a statutory manager has broad powers to manage the operations of the ADI, enabling the statutory manager to make all decisions which the ADI could make, including the power to issue equity and borrow funds. If APRA's capacity to take control of an ADI is exercised then this requires a decision about whether to recapitalise that ADI or take some other remedial measure (for example transferring some or all of the business to another entity), or to apply for the ADI to be wound up. APRA has statutory protection from

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53 Although clearly it could if a decision was taken to operate an FMI as a government, or regulator, owned entity.

54 To the extent that this or similar capacity exists within the FMI rules.

55 Margin levels are set to cover a participant default in a period of normal volatility. In principle, a CCP could choose to not hold any default resources and instead rely entirely on margins to cover defaults in periods of both normal and abnormal volatility. CCPs do not normally rely solely on margins because overly high margin rates have more deleterious effects on market liquidity than does an equivalent level of default resources.

56 Ultimately, if a participant chooses not to contribute to a replenishment of a CCP they are choosing no longer to be a direct participant. It is expected that participants will have views on the future structure of the CCP (for example they may express a preference for a mutualised model).

any risks that may arise from that process (for example, claims from creditors or others that that may suffer a loss as the result of action by APRA). Where a troubled ADI is restored to health, the ADI will have the capacity to meet its obligations as and when they fall due. The ADI will be able to operate normally so that control may be returned to private hands and any government statement of support withdrawn. Where an ADI returns to health, there are low taxpayer exposures, as generally, the ADI would be contracted in some way to repay the costs incurred by any explicit public support. There may, however, have been some expenditure that is difficult to recover, and where the institution fails there is potential for losses to be borne by the taxpayer.

- By contrast, if a decision has been made to appoint a statutory manager to a systemically important FMI in financial difficulty, allowing the FMI to fail is probably not a realistic option (at least not within a relatively short period). Moreover, the circumstances where an FMI may require regulators to take control are likely to be where the FMI has suffered a financial loss that is beyond the capacity (or willingness) of its existing owners or members to rectify. Instead, it is likely that regulators will be required to maintain the operations of the FMI until such time as new ownership can be arranged (perhaps even under a different model of ownership, such as a mutual structure). In markets where there is competition among FMIs, participants may be able to move their existing positions and trading activity to alternate FMIs. However, limited competition in particular markets will limit the ability of regulators to use this avenue to deal with many FMIs.

Until an alternative structure is put in place — and default resources restored in the case of a central counterparty (CCP) — the statutory manager, and by extension the public sector, are at risk that a further event, such as a participant failure, will give rise to further losses and hence the need to call upon public funds.

### 8.3 IN WHOSE INTERESTS SHOULD THE STATUTORY MANAGER ACT?

Any step-in powers will need to clearly articulate whose or which interests are acted upon by the relevant agency that has ‘stepped in’. Notwithstanding that there are numerous stakeholders (for example participants, clients or investors, and FMI shareholders), the statutory manager should be legislatively obligated to act in the best interest of overall financial system stability and market integrity.

#### Your feedback

Q16. 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 market integrity?

### 8.4 TERMINATION OF STEP-IN

Any step-in arrangement must establish a means by which regulators can ‘step-out’ of operating the FMI once a crisis situation is resolved. Clearly, stepping out will in practice only be possible when there is resolution of whichever of the four core concerns identified in section 4.1 led to ‘step-in’. That is when:

1. the potentially insolvent FMI's financial situation has been restored such that it is no longer in danger of insolvency, or a suitable alternative FMI has been established;
2. the FMI has been recapitalised to satisfactory levels;
3. the persistent operational outage has been rectified; or
4. the failure to comply with regulatory requirements has been resolved.

## 8.5 SCOPE OF THE STEP-IN PROVISIONS

### 8.5.1 Coverage of step-in

The intent of revised regulatory powers is to ensure the smooth operation of Australian financial markets and CS facilities in all market conditions. To achieve this requires 'step-in' powers that apply to at least all systemically important FMIs. However, it is conceivable that any FMI can disrupt financial markets under particularly adverse conditions. To provide the flexibility to protect financial system stability in all circumstances, the Council recommends that the regulators (ASIC in the case of an AML and the RBA in the case of a CSFL, in each case following consultation with the Deputy Prime Minister and Treasurer) should have the capacity, though not the obligation, to 'step-in' to resolve a crisis for any FMI.

It is expected that 'step-in' is most likely to be used only where an FMI is clearly systemically important, however providing the regulators with the capacity to 'step-in' to any FMI:

- is consistent with the approach of the Reserve Bank in determining the scope of the FSS;<sup>57</sup>
- guards against inadvertently establishing overly onerous and potentially inappropriate regulatory requirements for entities that are technically caught within the scope of the definition of a CS facility, notwithstanding that they do not provide meaningful, or any, clearing and settlement services as described in section 3; and
- provides for flexibility to remain with regulators.

Section 9 provides a discussion of how systemically important FMIs might be identified.

#### Your feedback

Q17. Do you have comments on the proposal that all FMIs should be subject to step in unless exempted by regulators?

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<sup>57</sup> The Corporations Act establishes that all licensed CS facilities must comply with any FSS determined by the Bank. However, as it is conceivable that a CS facility's operations may be too small to warrant full compliance with the FSS, the Bank has, within the FSS, established exemptions for CS facilities that do not give rise to financial stability concerns, that is a class of CS facility that is not systemically important.

## 9. IDENTIFYING SYSTEMICALLY IMPORTANT FMIs

The concept of 'systemic importance' is currently undefined by legislation. While this provides flexibility, greater transparency could be brought to the process by setting out the framework for determining or 'designating' whether an FMI is systemically important.

However, defining 'systemic importance' inflexibly is not without risk. Broad system-wide disruption can arise from small events, particularly if the financial system as a whole is vulnerable to a shock. The design of an FMI can concentrate risk (for example a CCP) and concentration of risk is a systemic concern. While that concern may be slight if the scale of an FMI is small at start up, this situation might change in response to factors that are difficult to objectively quantify.

### 9.1.1 International approaches

#### Financial Stability Oversight Council (FSOC) (US)

In March 2011, the US Financial Stability Oversight Council (FSOC) outlined proposals for identifying systemically important financial market infrastructures. Section 804 of Dodd-Frank provides the FSOC the authority to designate a financial market utility (FMU) or financial market infrastructure as systemically important.

The FSOC considers systemically important FMIs or FMUs as institutions where significant liquidity or credit problems could spread among financial institutions or markets by a failure or disruption to their functioning. Such problems could weaken the financial system's ability to serve the economy and dramatically increase the risk of financial instability and economic downturn, thus threaten the stability of the financial system.<sup>58</sup>

#### Committee on Payment and Settlement Systems (CPSS) and International Organisation of Securities Commissions (IOSCO)

The CPSS-IOSCO joint consultative paper on 'Principles for Financial Markets Infrastructures', published March 2011, is intended to cover systemically important payment systems, central securities depositories (CSDs), securities settlement systems (SSSs), central counterparties (CCPs), and trade repositories (TRs). Determination of which FMIs are systemically important is explicitly left to individual national authorities, but there is a presumption that CSDs, SSSs, CCPs and TRs are systemically important because of their critical roles in the markets they serve.

The principles suggest that relevant authorities at the national level should use publicly disclosed criteria to identify FMIs that should be regulated, supervised, and overseen. However, there is

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58 The FSOC outlined criteria to guide the decision on whether infrastructure is systemically important financial market infrastructure or financial market utilities (FMU) these are:

- the aggregate monetary value of transactions processed by the FMU;
- the aggregate exposure of the FMU to its counterparties;
- the relationship, interdependencies, or other interactions of the FMU with other FMUs or payment, clearing or settlement activities;
- the effect that the failure of or a disruption to the FMU would have on critical markets, financial institutions, or the broader financial system; and
- any other factors that the FSOC deems appropriate.

considerable flexibility in how systemically important FMIs should be identified, with possible approaches including:

- regulation of all FMIs because they play a critical role in the financial system;
- identification by objective criteria;<sup>59</sup> and
- identification by other criteria relevant in national jurisdictions (for example a desire to universally apply the principles across all FMIs).

### 9.1.2 Proposal

The Council proposes that the consideration of systemic importance of an FMI would be determined by the regulators (ASIC in the case of an AML and the RBA in the case of a CSFL). However, some guidance should be provided on how systemic importance would be determined. In this regard, the Council is attracted to the criteria identified in the CPSS-IOSCO draft Principles for FMIs and proposes the following definition of systemic importance.

An FMI is systemically important if it plays a critical role in the Australian financial system as indicated by one or any combination of the following:

- number and value of transactions processed;
- number and types of participants;
- nature of the markets served;
- market share controlled;
- interconnectedness with other FMIs and financial institutions;
- the availability of alternatives to using the FMI at short notice; or
- any other factors the relevant regulator deems appropriate.

#### Your feedback

Q18. 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?

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<sup>59</sup> Such as the number and value of transactions processed; the number and type of participants; the markets served; the market share controlled; the interconnectedness with other FMIs and other financial institutions; and the available alternatives to using the FMI at short notice.

## 10. CLIENT PROTECTION THROUGH PORTABILITY

The robustness of client protection, for customers of participants of central counterparties, is a function of the related concepts of segregation (where client funds are separately identified) and portability (where client funds may be transferred away from an entity at risk). If portability is not possible segregated client funds, while bankruptcy-remote, are at risk of being unavailable to clients for a considerable period as insolvency proceedings are worked through.

Segregation can help to protect customer collateral and contractual positions by accounting for them separately from a direct participant's proprietary transactions. Without such separation there is a risk that a customer's position or collateral becomes temporarily or permanently unavailable should that direct participant become insolvent.

In general, there are three types of segregation models:

- single house account (that is no segregation as client transactions are included with proprietary);
- omnibus account (that is all client transactions are in the one account and insulated from proprietary transactions, but not other clients); and
- individual accounts (that is each client has a separate account and is not exposed to either proprietary or other client transactions).

The attraction of omnibus (and indeed single house) account models is that offsetting transactions can be netted and the resulting liquidity and other savings<sup>60</sup> can be passed back to clients.

One attraction of achieving some separation from house positions is that it can facilitate the transfer of those positions from a failing, or failed, participant to a surviving participant or participants. This is the concept of portability. To date, Australian regulators have not directed either CCPs, or their participants, to adopt any particular segregation model. Instead, there is the requirement that the risks of accepting a particular structure must be made transparent to clients.

There can be legal obstacles to portability. This is because administrators, or liquidators, can be constrained in their obligations by insolvency law and thus prevented from co-operation with CCPs (or indeed regulators) to achieve a timely transfer of client positions. While it may be possible to obtain a court order to transfer client positions, this is uncertain and such action may be protracted.<sup>61</sup> Because a CCP must act rapidly to ensure that positions it inherits from a failed clearing participant do not expose the CCP to market risk, positions that cannot be transferred will be closed out. This implies that clients' market risk is crystallised at that point, and where derivatives are held by clients of a failed clearing participant as hedges, that hedge is lost. This has broader financial market stability implications and indeed may be a significant impediment in Australia to the migration of OTC derivatives markets to CCPs as called for by G20 leaders.

Principles that will guide international best practice currently being developed suggest that insolvency legislation be modified to allow for portability of client positions and adoption of an

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<sup>60</sup> For example, in a 'retail' market where there are likely to be numerous individual clients, the cost of administering an individual account structure may be so expensive as to be prohibitive to client participation.

<sup>61</sup> An administrator or liquidator may feel obliged by legislation to oppose such action.

omnibus account structure.<sup>62</sup> It has been proposed that these principles be adopted as a common global minimum standard. Also, it is likely that regulations arising from Dodd-Frank and the proposed EMIR legislation in Europe will require compliance with these principles, and preclude US and EU participation in CCPs established in non-compliant jurisdictions. Moreover, Basel Committee on Banking Supervision (BCBS) work on OTC clearing suggests that arrangements without portability will attract more risk-weighted capital.

Council agencies propose that further consideration be given to amending the Corporations Act, to allow for portability of client positions on financial stability grounds.

#### Your feedback

Q19. 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?

## 11. COMPENSATION FUND ARRANGEMENTS FOR SECURITIES MARKETS

### 11.1 BACKGROUND

The National Guarantee Fund (NGF) is a compensation fund established under Division 4 of Part 7.5 of the Corporations Act. The Securities Exchanges Guarantee Corporation Ltd (SEGC) was established in 1987 as its trustee. The SEGC is a company limited by guarantee, and its sole member is ASX Limited.

Under Part 7.5, Division 4 of the Corporations Act, the SEGC must keep and administer the NGF, and has the power to determine claims made by retail investors for compensation out of the NGF.

As the sole member of the SEGC, ASX Limited has the power to appoint board members to SEGC. Currently, ASX Limited appoints two directors to the SEGC board, and those two directors in turn appoint three other directors who are independent of ASX Limited.<sup>63</sup>

The company secretary and legal counsel for SEGC are employees of ASX Operations Pty Ltd, which is a wholly owned subsidiary of ASX Limited. When performing functions on behalf of SEGC, these individuals are obliged to act in the interests of SEGC, and not ASX Operations Pty Limited. SEGC pays ASX Operations Pty Limited a management fee for time spent by ASX Operations Pty Limited staff on SEGC business.

The Corporations Act does not prescribe the governance arrangements for SEGC or the NGF, in terms of who makes board appointments, what type of qualities directors should have, how the board should operate, or how the secretarial and legal support should be provided.

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<sup>62</sup> Proposed CPSS-IOSCO Principles for Financial Market Infrastructures.

<sup>63</sup> See SEGC constitution.

Part 7.5 of the Corporations Act contemplates that other market operators could become members of SEGC, and if so the NGF would be available to meet claims by investors who deal with participants of those other market operators. However, no other market operator is a member of SEGC. Instead, other market operators who are required by Part 7.5 of the Corporations Act to maintain compensation arrangements have established arrangements pursuant to Division 3 of Part 7.5 of the Corporations Act.

The Corporations Act also does not prescribe governance arrangements in respect of Division 3 compensation arrangements established by market operators under Part 7.5 of the Corporations Act.

## 11.2 PROBLEM IDENTIFICATION

The Council considers that introducing a more representative and transparent governance regime to the NGF and Division 3 compensation arrangements could enhance the perceived independence of the NGF and ASX, retail investor confidence in the funds, and ultimately investor participation in Australia's licensed markets.

The Council considers that the foreign acquisition of a market which controls the NGF or Division 3 compensations arrangement could in itself undermine investor confidence in the ongoing availability of compensation, as there could be a concern among local investors that the arrangements are under the ultimate control of a foreign entity. While the compensation arrangements would continue to be governed by Part 7.5 of the Corporations Act in those circumstances, investor perception of foreign control of compensation arrangements may change.

### Your feedback

Q20. Do you see any areas in which the governance of the NGF, or other arrangements under Part 7.5 could be improved?

Q21. If so, please explain why and how you think improvements can be made?

## 12. CONSIDERATION OF COMPETITION ASPECTS OF CLEARING AND SETTLEMENT

In the course of the review of FMI, the question of competition in clearing and settlement has arisen. The Working Group has invited the ACCC to work with it to further develop analysis on the competition aspects of clearing and settlement.

It is anticipated that if proposals are developed relating to competition in clearing and settlement, these will be consulted upon separately in coming months.

## PART C — NEXT STEPS AND FEEDBACK

### 13. NEXT STEPS

It is expected that the Council will deliver its advice to the Government in late 2011 or early 2012. This would enable the Government to consider the advice and decide on the need for any legislative reforms during 2012.

To this end, the Council seeks stakeholder feedback (see section 14). Interested stakeholders are also invited to seek discussions with the Council agencies through the contact point given on page iii of this paper.

### 14. FEEDBACK SOUGHT

This consultation paper seeks your views on the Council proposals for reform of the framework for FMIs in Australia. An index to these questions and the context in which they have been posed is provided below.

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| 6.1. Location requirements                                       | 1. Do you have comments on the location requirement proposal?   | 24   |
|  | 2. Do you have comments on the flexible graduated approach for systemically important FMIs?   | 25   |
|  | 3. Do you have comments on the proposed mechanism to allow for the power to impose location requirements?   | 25   |
| 6.2 Pre-approval of directors of FMIs and their parents          | 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? | 26   |
|  | 5. Do you agree with the adoption of a fit and proper standard similar to that in the Banking Act?  | 26   |

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| 6.3 Responsibility for making listing rules                                     | 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?                                 | 29   |
| <b>Section 7: Proposals for strengthening powers of direction and sanctions</b> |   |      |
| 7.3 Applying sanctions to directors and officers                                | 7. Do you have comments on the proposal to extend the power of directions to directors and officers of relevant licensees?  | 31   |
| 7.4 Applying sanctions to related bodies corporate                              | 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? | 32   |
| 7.5 Broadening sanctions for breach of conditions and directions                | 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?   | 33   |
|   | 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?  | 33   |
| <b>Section 8: Proposals for step-in powers</b>                                  |   |      |
| 8.1 Mechanics of step-in  | 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?  | 34   |
|   | 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?  | 34   |
|   | 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?  | 35   |

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| 8.1 Mechanics of step-in (continued)   | 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?      | 36   |
|  | 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?  | 36   |
| 8.3 In whose interests should the statutory manager act?                         | 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?  | 39   |
| 8.5 Scope of the step-in provisions  | 17. Do you have comments on the proposal that all FMIs should be subject to step-in unless exempted by regulators?  | 40   |
| <b>Section 9: Identifying systemically important FMIs</b>                        |   |      |
|  | 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?  | 42   |
| <b>Section 10: Client protection through account segregation and portability</b> |   |      |
|  | 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? | 43   |
| <b>Section 11: Compensation fund arrangements for securities markets</b>         |   |      |
|  | 20. Do you see any areas in which the governance of the NGF, or other arrangements under Part 7.5 could be improved?  | 44   |
|  | 21. If so, please explain why and how you think improvements can be made?   | 44   |

## ATTACHMENT: THE BANKING ACT SCHEME

### DIRECTIONS

Under the Banking Act (s. 11CA), *Insurance Act 1973* (s. 104) and *Life Insurance Act 1995* (s. 230B) APRA has powers to give binding directions to a regulated entity and its authorised non-operating holding company.

The direction powers are wide-ranging and enable APRA (as prudential supervisor and resolution authority) to direct the entity to undertake specified actions or activities, to cease to take specified actions or activities, to remove and replace directors and senior management, and to take actions to recapitalise.

Directions are binding and must be complied with. Failure to comply with a direction provides the grounds for APRA to take enforcement actions against the entities in question.

Specific directions powers include:

- to remove a director or senior manager and appoint persons in those roles;
- to remove and appoint an auditor;
- not to accept the deposit of any amount (ADIs only);
- not to renew any policy (general insurers and life insurers only);
- not to borrow any amount;
- not to give financial accommodation to any person;
- not to repay any amount paid on shares;
- not to pay a dividend on any shares;
- not to pay or transfer any amount to any person, or create an obligation (contingent or otherwise) to do so; and
- anything else as to the way in which the affairs of the body corporate are to be conducted or not conducted.

The grounds for giving directions are relatively broad and include:

- actual or likely breach of the Act under which the financial institution has been licensed;
- breach of a prudential standard or regulation applicable to the financial institution;

- where the direction is considered by APRA to be necessary in the interests of depositors/policyholders;
- the financial institution is about to become unable to meet its liabilities;
- there has been or might be a material deterioration in the institution's financial condition;
- the institution is conducting its affairs in an improper or financially unsound way; and
- the institution is conducting its affairs in a way that may cause or promote instability in the Australian financial system.

APRA tends to issue around ten directions and contravention notices per year.

APRA may also obtain an enforceable undertaking from a person in connection with a matter to which APRA has a function or power under the legislation. (s. 18A *Banking Act*; s. 126 *Insurance Act*; s. 133A *Life Insurance Act*).

## STATUTORY/JUDICIAL MANAGEMENT

Under the industry acts, APRA also has powers to appoint a statutory manager to an ADI or to apply to the court to appoint a judicial manager to a general insurer or life insurer. The statutory manager or judicial manager acts in the interests of depositors or policy holders and in the interests of a stable financial system. APRA may appoint a statutory manager where APRA considers that in the absence of external support the ADI may become unable to meet its obligations; the ADI may suspend payment; or, it is likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of depositors or financial system stability in Australia.

In the case of statutory management, the statutory manager is appointed directly by APRA and either is APRA or is subject to binding directions from APRA. In the case of judicial management, the judicial manager is appointed by the court and is subject to binding directions from the court. However, APRA may apply to the court to give instructions to the judicial manager.

A statutory or judicial manager assumes complete control of the entity, replacing the management and board — it is understood to have the powers of that body — in a sense, it 'fills the shoes' of the directors.

A statutory manager is empowered to seek information, alter the ADI's constitution, facilitate recapitalisation of the entity or transfer some or all of the entity to another regulated entity.

If an ADI incurs any loss because of any fraud, dishonesty, negligence or wilful failure to comply with the Act by the ADI statutory manager, the ADI statutory manager is liable for the loss. The statutory manager will not be liable for any other losses.

APRA has not, to date, appointed a statutory manager to an ADI, however, during 2009/10, a judicial manager was appointed to two small general insurers.