Law Council
OF AUSTRALIA

*Business Law Section*

**12 February 2024**

Capital Markets Unit
Financial System Division
Treasury
Langton Crescent
Parkes ACT 2600

By email: FMIConsultation@treasury.gov.au

Dear Sir/Madam

**Financial market infrastructure regulatory reforms**

1. This submission is made by the Financial Services Committee and Insolvency and Restructuring Committee of the Business Law Section of the Law Council of Australia (the **Committees**) with respect to the exposure draft legislation, regulations and accompany explanatory memorandum and explanatory statement relating to financial market infrastructure (**FMI**) regulatory reforms, which Treasury released for consultation on 15 December 2023 (the **Proposed Reforms**).

2. The Committees apologise for not responding by the official deadline of Friday 9 February 2024. The Committees have taken the time to prepare this submission and ensure that it is well considered and clearly expressed. The Committees therefore hope that Treasury will take the time to carefully review and consider this submission, having regard to the importance of the Proposed Reforms and the meaningful expertise which the Committees bring to the law reform development process.

*Background*

3. The Committees believe that the Proposed Reforms will play an important role in ensuring that Australia's financial markets remain strong and resilient, and that the regulators have appropriate powers to provide appropriate oversight and supervision of FMI entities.

4. The Proposed Reforms are extensive and consist of three core elements:

   (a) a framework for the exercise of powers by the Reserve Bank (the **RBA**) in a crisis situation;

   (b) further powers for regulators to issue directions and access a broader range of enforcement tools; and

   (c) the transfer of existing ministerial powers to the Australian Securities and Investments Commission (**ASIC**) and the RBA relating to the licensing and supervision of FMI entities.

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5. The Committees support these proposals and the principles which underpin them. The Committees note that a crisis resolution regime for central counterparties has been adopted in international jurisdictions in accordance with a comprehensive set of standards, and considers that it is therefore similarly appropriate for the RBA to have comprehensive powers to resolve a crisis in Australia.

6. The Committees wish to raise certain matters, with a view to:

   (a) ensuring that the legislative objective of the Proposed Reforms can be achieved; and

   (b) seeking greater clarity as to the scope and operation of new and amended provisions under the Proposed Reforms.

***Key Points***

7. The key matters the Committees wish to bring to Treasury's attention are as follows:

   (a) the Committees support the Proposed Reforms and the principles which underpin them;

   (b) the Committees consider that the following matters warrant more careful consideration and should be refined:

      (i) inconsistencies between the exposure draft legislation and the explanatory materials;

      (ii) the test for "material connection to Australia" in the context of whether a particular market or facility needs to be licensed in Australia;

      (iii) proposed section 821J of the *Corporations Act 2001* (Cth) (the **Corporations Act**) (which deals with when a licensee must notify the RBA of a change in circumstances); and

      (iv) proposed section 836D of the Corporations Act (which deals with suspending a time for doing an act); and

   (c) with respect to insolvency related matters:

      (i) the Committees agree that a tailored regime for FMI entities is appropriate; and

      (ii) the Committees are of the view that the Proposed Reforms could be improved upon by:

         - requiring the RBA to consider certain prescribed matters before exercising its statutory management power; and

         - clarifying the interaction of other legislation, including the *Payment Systems and Netting Act 1998* (Cth) (the **Netting Act**), with the proposed stays and moratoria.

8. The Committees are quite concerned about the quality of the draft legislation and explanatory materials, and sincerely hope that an appropriate level of care, skill and

attention to detail will be afforded to the drafting of the amending legislation and accompanying explanatory material before they are tabled in Parliament.

***Submissions***

9. Unless otherwise specified, the submissions below reflect the views of the Financial Services Committee.

*Scope of application – resolution powers*

10. The Committees note that all the powers contemplated under the draft legislation for crisis resolution – covering matters such as the appointment of a statutory manager, compulsory transfer of shares or business, direction to manage and respond to a crisis and application of resolvability standards – apply to a "CS facility licensee". Many of these powers are enlivened when any of the crisis conditions under proposed section 831A of the Corporations Act is met, which again apply in relation to a "CS facility licensee".

11. The term "CS facility licensee" applies to both a domestic licensee and an overseas licensee (i.e. irrespective of whether the licence was granted under section 824B(1) or section 824B(2) of the Corporations Act). On the face of the exposure draft legislation, these powers therefore appear to apply equally to an overseas CS facility licensee. However, the explanatory materials clearly state that these powers are only intended to be applied to a "domestic CS facility licensee" (i.e. a body corporate registered under Chapter 2A of the Corporations Act which holds a CS facility licence). The explanatory materials appear to suggest that only the cross-border crisis resolution regime under Division 9 is intended to apply to an overseas CS facility licensee.

12. The Committees note the discrepancy between the clear wording of the exposure draft legislation on the one hand, and the commentary in the explanatory materials, on the other. The Committees submit that the inconsistency must be resolved, particularly as there would be significant implications for an overseas CS facility licensee if these resolution powers were to apply to them (in addition to any foreign authority exercising resolution powers in the relevant home jurisdiction).

*Licensing requirement for an overseas facility*

13. The Committees note that the proposed new test of "material connection with Australia" is intended to provide certainty on the scope of the Australian licensing regime for overseas markets and facilities. The Committees agree that further clarity and certainty is necessary, given the unclear application of the existing guidance in ASIC Regulatory Guide 172 *Financial markets: domestic and overseas operators* (**RG 172**) and ASIC Regulatory Guide 211 *Clearing and settlement facilities* (**RG 211**).

14. It is helpful that the exposure draft legislation provides for a list of factors which would give rise to a connection with Australia. However, the Committees note that these largely track the factors set out in RG 172 and RG 211, some of which have always been unclear in their application and do not necessarily reflect how ASIC applies its policy in practice.

15. For example, one of the factors that gives rise to a domestic connection is whether there is/are "one or more users of the market/facility". In the context of a market or CS facility which is generally intermediated through market participants or clearing

membership, the scope of who would be considered a "user" (rather than a "participant", which has a specific meaning as someone who is able to directly participate under the relevant operating rules) is unclear.

16. Another example of a situation in which adopting a factor directly from RG 172 and RG 211 into legislation may be inappropriate is where the market "targets investors resident or based in this jurisdiction". This test is not consistent with activities under Chapter 7 of the Corporations Act which could trigger licensing obligations, such as the more commonly understood concepts of solicitation or inducement.

17. The Committees also note that the critical principles for determining materiality would be determined by ASIC. It is not clear what would be contained in any such ASIC determination, as a draft has not been provided. However, the Committees would support transparent, quantitative measures and ascertainable criteria in assessing materiality.

*Notification of material changes in circumstances*

18. The Committees agree that a CS facility licensee should be subject to an obligation to notify the RBA of significant matters which could impact upon its financial position and solvency, so that the RBA can monitor and assess the risk of potential impact to the Australian financial system.

19. However, the Committees consider that the new notification obligation under proposed section 821J of the Corporations Act is too broadly drafted, as it provides an inclusive list (rather than exhaustive list) of matters that could be a "material change to the body corporate's circumstances". The scope of notifiable matters is therefore potentially unclear, which is not ideal in circumstance where non-compliance constitutes an offence.

*Time for doing an act does not run while the act is prevented*

20. The Committees note that proposed section 836D of the Corporations Act appears to be based on a similar provision set out in section 451D of the Corporations Act, which applies during voluntary administration. However, the Committees consider that the scope of the current drafting could have unintended consequences and potentially adversely affect market participants' certainty about events of default, grace periods and payment obligations, for the following reasons.

21. Section 836D is currently drafted to apply to anything under proposed Part 7.3B which prevents an act being done, and provides that if the act must be done within a particular period or before a particular time, but Part 7.3B has prevented this from occurring, then the period is extended according to how long Part 7.3B prevented the act from being done.

22. The Committees note that proposed section 836D is broader than the scope of section 451D of the Corporations Act, particularly given the wide powers which the RBA would have under proposed Part 7.3B, including a proposed power under section 844A to direct a body corporate to do, or refrain from doing, "specified acts or things". Paragraph 1.273 of the draft explanatory materials notes that this may include a direction "not to pay or transfer any amount or asset to any person".

23. As a result of this, circumstances may arise where the RBA directs a person not to pay an amount under, for example, a contract or operating rules of a financial market,

either indefinitely, or for a particular period, which failure would ordinarily, if it were not made within a set grace period, result in a default or similar event by that person under the arrangement. However, a possible interpretation of the operation of section 836D is that, if the direction made by the RBA prevents the payment (the "act") from being done within the required grace period under the arrangement, then the grace period is effectively extended or the payment date deferred, according to how long Part 7.3B prevents the act from being done.

24. The Committees submit that this could mean that the consequences as set out in the arrangement between the parties which would ordinarily follow a non-payment are not enlivened or, at a minimum, are postponed or deferred for a potentially unlimited time (depending on the direction which was made by the RBA). This appears very broad in application and potentially far wider than the scope of the moratorium and stays provisions set out in proposed Division 5 of Part 7.3B.

25. The Committees note that the heading of proposed section 836D refers to "Time for doing act does not run while act prevented by this Division" whereas the text of section 836D refers to "this Part". The Committees therefore query whether the reference in the body of section 836D to "this Part" should in fact be "this Division". This would mean that section 836D would only apply to Division 3 (statutory management).

26. If, however, the objective is to effectively impose an additional stay on the parties' ability to exercise rights under their arrangements, the Committees submit that, rather than using section 836D, this objective might be better achieved through additional inclusions to the moratorium and stays provisions of Division 5 of Part 7.3B, subject to safeguards to ensure that this power does not adversely affect counterparties' rights and capital treatment of their exposures to the CS facility.

*Feedback on insolvency matters*

27. This part of the submission has been prepared by members of both the Insolvency and Restructuring Committee and the Financial Services Committee.

<u>Tailored insolvency approach</u>

28. The Committees consider that the more tailored approach for dealing with insolvency issues for FMI entities is justified on public policy grounds, as the consequences to the wider economy could be systemically significant or critical if an FMI entity was to fail.

29. The Committees note that:

    (a) the proposed reforms are in line with the recommendations of the Financial Stability Board (**FSB**) - an international body tasked with promoting international financial stability, of which Australia is a member;

    (b) the FSB recommends that jurisdictions implement ongoing processes for recovery and resolution planning for domestically incorporated systemically important firms; and

    (c) some aspects of the proposed reforms are similar to corresponding legislation or proposed legislation in the United Kingdom, Canada, Hong Kong and the United States, which allow a regulator to take over and resolve systemically important financial institutions.

30. The Committees wish to make the following comments on particular aspects of the proposed tailored insolvency regime within the Proposed Reforms.

Appointment power

31. In light of the extensive powers afforded to the RBA under the Proposed Reforms, the Committees recommend that the barriers to the exercise of these powers be heightened as follows:

    (a) firstly, in making the decision to exercise the proposed crisis resolution powers, the RBA should be required to have regard to a set of objectively reviewable factors, which might encompass:

        (i) an evaluation of whether the licensee is in default or danger of default;

        (ii) an assessment of the effect the default would have on the stability of the Australian financial system;

        (iii) a recommendation of the nature and extent of the actions to be taken under the legislation;

        (iv) an evaluation of why external administration, a scheme of arrangement or liquidation under the Corporations Act is not appropriate for the licensee; and

        (v) an evaluation of the effects of that the proposed course of action would have on the licensee, creditors, counterparties, and shareholders and other market participants; and

    (b) it should be a condition of the RBA exercising a crisis resolution power that, in each case, the exercise of power is for the purpose of maintaining the stability, or the function, of the financial system in Australia.

Interaction between proposed stays and moratoria with other existing legislation

32. The Committees note that:

    (a) statements made in paragraphs 1.222 and 1.268 of the draft explanatory materials which state that it is important for the protections set out in the Netting Act (and other legislation) to continue to apply; and

    (b) proposed sections 841C and 847D of the Corporations Act clarify that certain legislation, including the Netting Act, prevails over sections 841A, 841B, 847B and 847C of the Corporations Act to the extent of any inconsistency.

33. However, the Committees would welcome clarity as to:

    (a) how the other stays (including those set out in proposed sections 824B, 823V and 849E of the Corporations Act) are intended to interact with other legislation, including the Netting Act; and

    (b) whether any specific types of contract are to be excluded from the application of any of the stays.

*Power of statutory manager to deal with secured property of a body corporate (proposed section 836F of the Corporations Act)*

34. The Committees note that, while proposed section 836F is similar to the existing section 442B in the Corporations Act, as drafted it would perpetuate the uncertainty as to whether a circulating security interest in respect of particular collateral can be re-characterised as not being a circulating security interest after it has attached to the relevant collateral by including 'control event' type provisions in the security agreement.

35. The Committees believe there is considerable uncertainty around this issue, notwithstanding section 442B, because the definitions of 'circulating security interest' and 'floating charge' and other provisions in the Corporations Act such as sections 561 and 433 suggest that re-characterisation should not occur. The Committees would welcome further clarity as to the policy intention and operation of section 442B (which would similarly assist in the interpretation of section 836F).

*Drafting related comments*

36. The Committees wish to bring the following observations to Treasury's attention regarding the accuracy of some of the content of the proposed draft legislation and explanatory materials.

<u>Inconsistencies between the content of draft explanatory materials and the proposed draft legislation</u>

37. The Committees have detected a number of inconsistencies between the draft explanatory materials and the corresponding proposed draft legislation, including by way of example:

    (a) as noted above, the draft explanatory materials contain a number of references to a "domestic CS facility licensee" in descriptions of certain sections of Part 7.3. However, the proposed draft legislation refers in many places to a "CS facility licensee", which would also capture an overseas licensee. The Committees recommends that these references are revisited to ensure that they operate within their intended scope;

    (b) paragraph 1.157 of the draft explanatory materials does not appear to correctly describe proposed section 127(2A)(d) of the *Australian Securities and Investments Commission Act 2001* (Cth), which applies to disclosure of information by ASIC to a statutory manager and therefore is more limited in scope than the draft explanatory materials would suggest;

    (c) paragraphs 1.251 and 1.258 of the draft explanatory materials do not appear to correctly describe proposed subsections 841A(11) and (12) of the Corporations Act;

    (d) it is not clear which provision paragraph 1.258 of the draft explanatory materials is purporting to describe;

    (e) paragraph 1.263 of the draft explanatory materials does not appear to correctly describe proposed sections 841B and 847C of the Corporations Act. The Committees submits that it is not correct to describe the stay provisions as "self-executing". Rather, the stay would apply to self-executing provisions;

(f) paragraph 1.302 of the draft explanatory materials does not appear to correctly describe proposed subsections 84A(1) and (2) of the *Reserve Bank Act 1959* (Cth) (the **RBA Act**), which applies to a much more limited set of persons than those described in the draft explanatory materials;

(g) the Committees believe that paragraph 1.304 of the draft explanatory materials may be referring to the protections set out in proposed sections 849F and 823X of the Corporations Act, rather than those in proposed section 84A of the RBA Act; and

(h) paragraph 2.23 of the draft explanatory materials states that "the initial notification may be communicated verbally to the RBA with written notification following that." Proposed sections 821BA, 821H and 821J of the Corporations do not appear to contemplate such verbal notification. Similar observations also apply to paragraph 1.153 of the draft explanatory materials and proposed section 835C of the Corporations Act.

Incorrect cross-references to provisions of the proposed draft legislation in the draft explanatory materials

38. The Committees believe that the following cross-references in the draft explanatory materials to proposed sections of the Corporations Act should be corrected as set out in the table below:

| **Paragraph number in draft explanatory materials** | **Section number mentioned** | **Suggested correction** |
|---|---|---|
| 1.124 | 839G | 849G |
| 1.264 | 847A(4) | 847A(3) |
| 1.265 | 888 | 847D |
| 1.272 | 844A(2) | 844A(1) |

39. The Committees also note that paragraph 1.282 of the draft explanatory materials refers to proposed subsection 844B(4) of the Corporations Act, but there is no such corresponding subsection in the proposed draft legislation.

Internal inconsistency between provisions of the proposed draft legislation

40. The Committees encourage Treasury to revisit and resolve the following matters:

(a) the conflicting amendments to proposed paragraph 821A(1)(aa) of the Corporations Act in items 18 Schedule 1 and item 85 of Schedule 2 of the proposed draft legislation;

(b) the absence in proposed section 842B of the Corporations Act of an obligation to notify the RBA if an application for leave is made to the Court and an

entitlement of the RBA to be heard on the application – which is out of alignment with proposed sections 842C and 842E of the Corporations Act;

(c) the discrepancy between proposed subsections 844A(2) and 844B(2) as to whether the direction must include the time period for compliance – paragraph 1.285 of the draft explanatory materials suggests that both subsections should require this; and

(d) the difference in the language used in proposed subparagraph 267(1)(a)(iiib) of the *Personal Property Securities Act 2009* (Cth) and proposed paragraph 588FL(1)(a)(v) of the Corporations Act – which the Committees believe ought to be aligned for consistency.

Typographical errors

41. The Committees have detected a number of typographical errors, including:

(a) in the following paragraphs of the draft explanatory materials:

(i) 2.34;

(ii) 2.51;

(iii) 2.77;

(iv) 2.79; and

(v) 3.18; and

(b) in the proposed draft legislation:

(i) there is a note following proposed subsection 847B(1) of the Corporations Act which refers to subsections 847B(5) and (7), yet section 847B appears to end at subsection 847B(4); and

(ii) Schedule 1, item 35 cross-refers to Division 5 or 7A of Part 7.3B of the Corporations Act – the Committees believes that Division 7A should be replaced with Division 8; and

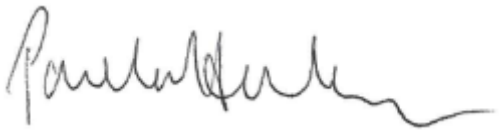
(iii) Schedule 1, item 36 cross-refers to Part 7.5B of the Corporations Act – the Committees believes Part 7.5B should be replaced with Part 7.3B.

**Conclusion and further contact**

42. The Committees would be pleased to discuss any aspect of this submission.

43. Please contact the chair of the Financial Services Committee Pip Bell (committeechairfsc@gmail.com) or the chair of the Insolvency and Restructuring Committee Natasha Toholka (natasha.toholka@nortonrosefulbright.com), as appropriate, if you would like to do so.

Yours faithfully



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