Financial Market Infrastructure Regulation

Submission and feedback in relation to the Consultation Paper

To:

The Council of Financial Regulators

From:

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Commonwealth Bank of Australia Markets

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This submission is in response to the Council of Financial Regulators (the "**Council**") Consultation Paper on Financial Market Infrastructure, issued in October 2011 (the "**Consultation Paper**"). It is made on behalf of the banks named above (the "**Group**") in their role as financial market participants and reflects a common view on the issues raised in the Consultation Paper.

Importantly, this submission is limited in scope to OTC clearing and the extent to which OTC CCPs may be deemed systemically important Financial Market Infrastructure (FMI).

We understand the need for FMIs to be subject to regulatory safeguards to protect the Australian financial system. We are pleased to provide feedback in this submission with a view to assisting the Council in assessing the potential impact of those regulatory safeguards, and to help the Council make and recommend regulatory safeguards that are commercially effective and workable.

We note that many issues regarding the structure and development of OTC CCPs are being determined by regulatory developments at a global level and by national jurisdictions. We note that CPSS-IOSCO is developing a framework for the resolution of systemically important FMIs, which will include a cross-border component. Our suggestion is that the finalisation of an Australian framework should be dependent on an agreed global framework.

We have limited our feedback to the specific Feedback Questions set out below.

Feedback questions

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

We agree that all systemically important FMIs should be subject to certain location requirements. Further we support a flexible approach that can be tailored to the specific circumstances of individual FMIs and the markets and participants they serve.

The setting of such requirements should ensure that, absent a mandated domestic CCP environment, offshore CCPs can offer services in Australia whilst satisfying not only the regulations in Australia, but those they are subject to in both their home and other jurisdictions in which they operate. The work of CPSS-IOSCO is considered important in this regard. Further, to minimise the risks that Australian banks are not disadvantaged relative to global peers, the setting of the requirements should be mindful of increasing the cost or reducing the willingness of offshore CCPs to provide services to Australian banks.

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

It is important to ensure that any OTC CCP seeking to offer services in Australia is provided a degree of certainty as to both the nature and implementation of requirements that may be imposed. It is important that CCP providers understand the framework that may apply as their business develops, volumes grow, and product offerings and participants expand. A framework that is so flexible that requirements are identified ex-post business expansion may hinder the ability of the CCP to continue to provide services which have been deemed systemically important.

The above will particularly be the case in the start-up phase, and requirements and expectations in the early years of development must be provided with a high degree of certainty.

On the whole we expect than any effective OTC CCP based in Australia will be systemically significant. An OTC CCP based in Australia that is not systemically significant is likely to be not sustainable in terms of liquidity and operability.

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

We support the proposed mechanism but reiterate the comments provided immediately above.

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?

We do not agree that these powers should apply directly to foreign incorporated entities. Our preference would be through an indirect application. That is, that the relevant home jurisdiction regulator is considered to hold ultimate responsibility for the approval of directors and that Australian regulatory influence is conveyed through supervisory colleges.

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

Yes.

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?

It is very difficult to comment without understanding how it is proposed that an otherwise unregulated service provider (merely performing its obligations under the terms of a contract, negotiated by the licensed FMI) should be penalised.

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?

Yes, subject to requirements that time is of the essence in any appointment process, and that the manager is appropriately skilled in management of such services.

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?

Any appointee should have appropriate capacity and experience to operate the FMI and have a clear mandate in which to operate. We recommend that the circumstances under which this power is exercised would need to be defined more clearly as per the next question.

The Council might like to give some consideration to how the relevant FMI would be run once a step-in had occurred, and what expertise would be available that was adequate for the challenges that would be faced by the statutory manager. A market or CS facility will have significant and concentrated operational expertise, and displacing that expertise in turbulent conditions could be risky. An experienced statutory manager for an ADI would be easier to locate, given the number of ADIs in Australia, than one for a CS facility, for example. While the ability to appoint a Statutory Manager might potentially be a useful power, it raises the prospect of how a Statutory Manager would carry out its function, and we think this needs parallel consideration.

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?

Recapitalisation of the FMI, by whatever means, needs to be through the whole default waterfall structure including default fund contributions.

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?

The powers need to be understood up front with sufficient certainty in relation to OTC CCPs, to give confidence to participants as to how they will be dealt with in such an event.

In particular, the rules of the OTC CCP would need to be explicit about the extent to which the step in may affect the orderly and timely application of funds in the waterfall in a default.

The power to suspend or cancel the obligations of an FMI participant should be subject to rigorous controls, and only be used in extreme circumstances when all other alternatives have been exhausted. Such a power should only be used in the context of a robust resolution regime. We support ISDA's submission that a statutory manager should not be entitled to cherry-pick individual unprofitable transactions under a single close-out netting contract for cancellation or suspension.

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?

We reiterate our comments above regarding the importance of ensuring that the final Australian framework is in accordance with the CPSS-IOSCO resolution framework for FMIs.

We also note and support ISDA's submission that the application should not interfere with the effective operation of netting laws in Australia.

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?

The overall stability and integrity of the financial system is the primary concern. But within that general aim it is essential that both direct and indirect participants' rights prevail as much as practically possible. This appears to be implied but it would be desirable to make this explicit.

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

Yes, in order to ensure the integrity of the system all FMIs should be subject to step in. As noted above, a foreign CCP should not be subject to step-in.

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?

We agree that the CPSS IOSCO principles provide the best guidance to criteria for designation of systemically important FMIs.

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?

We agree that amendment of insolvency provisions to better enable portability is highly desirable. We note that there may be a limited universe of participants able or prepared to take the ported accounts, i.e. participants who are sufficiently capitalised and have the operational ability and capacity to absorb the ported positions in a timely manner.

We note there is a very significant difference between guaranteed portability and best efforts portability. We believe any capital benefits should not be conditional on guaranteed portability.

The Council should consider supporting Australian banks and other Australian participants with some requirements that protect those client accounts, while allowing those participants to participate effectively on offshore CCPs.

Before legislating in this area it might be worth observing how overseas efforts to enshrine portability in insolvency legislation are handled, as well as considering carefully lessons for the whole industry that will come from the MF Global insolvency.

We also take this opportunity to reiterate below some comments made in our previous submission in relation to the local OTC-related CCPs.

Any local OTC-related CCP should comply with global best practice on Risk Management. The structure of any CCP, including an Australian domestic CCP, must meet an internationally agreed standard in terms of membership criteria, corporate and governance structure, waterfall and default proposals and submission to regulator direction in times of crisis. Being a DCO under Dodd-Frank will be essential, for example. From a systemic risk perspective and a desire to attract participants who would otherwise choose not to use the CCP, effectiveness and efficiency of the CCP is critical.

If the Council agencies and Government determine on balance that mandating central clearing of OTC derivatives onshore in Australia is desirable (as opposed to mandating central clearing of OTC derivatives which is not required to take place onshore in Australia), then we believe it is important the industry as a whole quickly moves to a scoping and design phase to support that outcome.

We appreciate the opportunity to comment on these proposals, and look forward to working with the Council on this and other matters as they develop the regulatory framework for OTC derivatives in Australia.

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