



G.R. Stevens  
GOVERNOR

10 February 2012

The Hon. Wayne Swan, MP  
Deputy Prime Minister and Treasurer  
Parliament House  
CANBERRA ACT 2600

Dear Deputy Prime Minister,

## **REVIEW OF FINANCIAL MARKET INFRASTRUCTURE REGULATION**

I refer to your letter of 8 April 2011 asking the Council of Financial Regulators (Council) to consider possible measures to ensure that the regulatory regime for financial market infrastructures (FMIs) continues to protect the interests of Australian issuers, investors and market participants.

In response to your letter, a Working Group was established by the Council, chaired by the Treasury, and comprising representatives of the Council agencies. During 2011, the Working Group developed a number of proposals to maintain the integrity, stability and efficiency of Australia's FMIs and the ability of FMI supervisors to maintain robust oversight and appropriate control in all market conditions and under a range of different ownership structures.

The Working Group consulted on its proposals in late 2011, publishing a consultation paper, *Council of Financial Regulators: Review of Financial Market Infrastructure Regulation*, and holding roundtable meetings with interested stakeholders. Four confidential responses and eighteen public responses were received; the public responses were published in early December. A list of respondents is attached.

Most stakeholders acknowledged that the paper identified valid regulatory considerations, though some expressed concerns about the implementation of the proposals and sought clarity on points of detail. The Council therefore recommends legislation broadly in line with the proposals in the consultation paper, but with some refinements and clarifications to ensure that any reforms introduced include appropriate checks and balances.

The following advice sets out the Council's final proposals, based on the analysis carried out by the Working Group during 2011, and stakeholder feedback received during consultation. In formulating the proposals, the Council has had regard to relevant international developments.

### **Proposals for reform**

The Council considers that, while FMIs have different characteristics to Authorised Deposit-taking Institutions (ADIs), both types of entity can be of systemic importance. It is therefore vital that the FMI regulators, ASIC and the Reserve Bank, have appropriate powers to ensure that FMIs manage risks effectively and that any financial distress or operational disruption to an FMI can be dealt with in a manner consistent with continued financial stability. As will be outlined below, the Council considers that statutory powers for the regulation of ADIs under the *Banking Act* provide a useful model for a number of reforms to strengthen the regulatory framework for FMIs.

The Council has also identified areas of further reform, including the extension of ASIC's and the Reserve Bank's powers to ensure that a related entity takes reasonable steps to comply with a direction or licence condition where it provides critical services to an FMI. It is recommended that these reforms also be considered in due course, perhaps alongside any relevant future amendments to the *Banking Act*, or in conjunction with other proposals that may arise from ongoing international dialogue on FMI resolution.

The Council's proposals cover a broad scope of issues and seek to ensure that ASIC and the Reserve Bank can continue to preserve the integrity, stability and efficiency of Australia's financial infrastructure and maintain robust oversight. The proposed measures are designed to be effective in all market conditions, including in the event of any future commercial arrangement between the ASX and another overseas exchange group, or where an overseas facility offers critical FMI services in Australia.

The Council recommends that the following reforms be pursued, with a view to having the framework in place as soon as reasonably practical. The Council is also considering releasing a short paper in the coming months summarising the purpose of the reforms and articulating Council agencies' views on concerns raised by stakeholders during the consultation process.

### ***Regulatory powers of direction and intervention over FMIs***

The Council considered the effectiveness of regulatory powers of direction and intervention under various operational and financial stress scenarios. The Council also considered interactions with Australia's G-20 commitments in relation to infrastructure supporting over-the-counter (OTC) derivatives markets.

*Location requirements*

One direct way to increase the scope and effectiveness of regulatory oversight would be to streamline and clarify ASIC's and the Reserve Bank's powers to impose location requirements on licensed FMIs.

In particular, the Council recommends that existing powers to impose licence conditions be clarified by giving ASIC and the Reserve Bank an explicit power to impose location requirements in key areas, such as financial and risk management and operational arrangements. In the case of an overseas-based FMI, the scope of such a power should also extend, where appropriate, to the establishment of oversight arrangements that give Australian regulators sufficient influence. In some circumstances, Australian regulators may also insist on a legal presence in Australia, or seek assurance as to the compatibility of the FMI's rules with Australian law. Importantly such requirements should be imposed in a proportional and graduated fashion, striking an appropriate balance between efficiency costs and stability benefits.

It is recommended that the basic power be afforded to ASIC and the Reserve Bank by way of enabling legislation through amendments to the *Corporations Act*. This should set out the objectives of this power and related criteria, while also providing agencies with flexibility to tailor requirements in a graduated way on a case-by-case basis. The scope of requirements could then be established in accompanying regulations.

It would be important to clarify in regulations and guidance the potential scenarios in which location requirements would typically be imposed, and set out the matters that regulators would take into account. These might include, for example, the systemic importance of the underlying market and the composition of the FMI's participants. Clear guidance along these lines would help address stakeholder concerns around arbitrary application of location requirements and their potential to act as a barrier to entry. Any such requirements should also be subject to consultation with affected parties.

Location requirements are an essential element in equipping ASIC and the Reserve Bank to effectively resolve FMI distress. They would also address a number of fundamental concerns identified by the agencies in the context of the SGX-ASX merger proposal. These include the potentially diminished capacity of domestic regulators to influence the operations of a systemically important FMI that is located offshore, particularly if that FMI serves markets in multiple jurisdictions.

This proposal would also support the Government's implementation of its G-20 commitments by providing a framework to establish whether location requirements are appropriate where central clearing or the use of trading platforms is mandated for OTC derivatives.

*Direction-giving powers and sanctions*

Regulators' capacity to influence outcomes would be enhanced by amendments to the direction-giving powers and sanctions provided for in the *Corporations Act*.

In particular, the Council recommends that the process by which ASIC can give directions to Australian Market Licensees (AMLs) and Clearing and Settlement Facility Licensees (CSFLs) be streamlined and clarified so as to facilitate more rapid and certain actions either in a financial or operational distress situation or in the event of a significant breach of licence conditions. The Council also recommends that the Reserve Bank be given the power to issue directions to CSFLs in relation to matters affecting financial stability.

To further increase the effectiveness of regulatory actions, the Council recommends broadening the range of sanctions available where licensees fail to comply with directions and licence conditions. In particular, these should be extended to include criminal sanctions, fines, and civil and administrative penalties. Furthermore, the scope of sanctions should be extended to individual directors and officers of the licensee.

Stakeholders expressed some concern that directors' rights might be infringed and that the possibility of more severe sanctions might discourage some suitable candidates from becoming directors of FMIs. In response to these concerns, the Council recommends that enabling legislation, regulation and guidance articulate clearly the scope of the sanctions, delineate the circumstances in which they would be deployed, and clarify that the obligation to comply with directions and licence conditions overrides other duties owed by directors. This is consistent with international principles proposed by the Financial Stability Board, among other international bodies.

*A 'fit and proper' standard for directors and officers*

Relatedly, the Council considers that it would be beneficial for the efficiency, stability and integrity of the market to strengthen ASIC's power to ensure that key persons involved directly or indirectly in the management of the affairs of FMIs meet a 'fit and proper' standard. A similar standard is applied by the Australian Prudential Regulation Authority (APRA) in relation to ADIs.

Currently, under the *Corporations Act*, ASIC is obliged to demonstrate that because of the unfitness of the person involved, there is a risk that the relevant licensee or applicant would breach its obligations under Chapter 7 of the Act. This additional requirement could limit the effectiveness of ASIC's supervision of directors of licensees and its consideration of applicants. The Council considers that a fit and proper standard, without the additional requirement, would therefore be more appropriate.

### *Step-in powers*

To further enhance ASIC's and the Reserve Bank's scope to maintain financial stability, particularly in times of stress, the Council recommends that 'step-in' powers be introduced. In particular, the Council recommends that ASIC and the Reserve Bank be given the power to appoint a statutory manager, where appropriate and in consultation with the Minister, to any domestically licensed FMI (i.e. an FMI operating in Australia as its principal place of business) in certain defined circumstances. These should include circumstances such as a threat of insolvency, significant operational outage or distress, or a significant and persistent failure to comply with licence obligations or directions. Similar powers are again available to APRA in respect of ADIs and the absence of a specialised resolution regime for FMIs represents a gap in the current regulatory framework. Location requirements could support effective step-in in such situations.

To address concerns raised by stakeholders in consultation, the enabling legislation, regulations and published guidance should give clarity around the potential application of these powers. In particular, it should be noted that the Council envisages that ASIC and the Reserve Bank would exercise these powers only where deemed necessary to maintain the continuity of critical services and mitigate systemic risk. The Council considers that it will also be important to provide clarity as to how regulators will ensure that a manager with appropriate experience is appointed.

### *Systemic importance*

A key consideration in regulators' decisions around the exercise of their powers is the systemic importance of an FMI.

The Council recommends that ASIC and the Reserve Bank be given responsibility for determining the systemic importance of market operators and clearing and settlement facilities, respectively, applying an approach and criteria aligned with those developed by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (CPSS-IOSCO) in their *Principles for FMIs* (which are currently in the process of being finalised). This approach would ensure that the basis for assessment in Australia is consistent with other jurisdictions.

### *Other reforms*

In addition to these enhancements to powers of direction and intervention, the Council also consulted on a number of other potential reforms, spanning powers over market operators' listing rules, compensation fund arrangements for securities markets, and client account protections.

Of the additional reforms considered, the Council recommends that legislative changes be pursued in relation to listing rules and compensation fund arrangements. Further policy analysis will be undertaken on client account protections before proceeding with firm recommendations.

In the course of the review of FMI regulation, the question of competition in clearing and settlement also arose. In 2011, the Working Group engaged with the ACCC to further develop analysis on the competition aspects of clearing and settlement. This work is continuing.

#### *Making of listing rules*

The Council considered whether there is a case to reform oversight or governance of the ASX's listing rules-making function and associated consultative machinery and, if so, how that could best be achieved.

Currently, neither the Minister nor ASIC have explicit power to require a market operator to make new listing rules, even if this is deemed necessary to promote market integrity and investor confidence. Council agencies are concerned that the incentives of a systemically important Australian market operator to continue to develop and improve its listing rules could diminish in the event that it was acquired by a foreign entity. The agencies are also concerned about investor perceptions that such an acquisition would result in Australian listing standards coming under the influence and ultimate control of a foreign entity, which may be regarded as having weaker standards than the Australian market operator.

Under current arrangements, ASIC may work with market operators in Australia from time to time to make improvements to their listing rules. However, if a proposed improvement were inconsistent with the listing standards adopted by a foreign acquirer in another jurisdiction, informal dialogue between ASIC and that market operator may not be so effective.

The Council therefore recommends that ASIC be given a power to direct market operators to make listing rules with specified content. To address stakeholders' concerns about ASIC involvement in the monitoring of listing rules, enabling legislation, regulations and guidance should clarify that the directions power would be exercised only in exceptional circumstances. It would also be subject to comprehensive checks and balances; in particular, a consultation requirement and Ministerial disallowance. Primary responsibility for monitoring and enforcing listing rules would remain with market operators.

*Compensation funds*

The Council also considered ways to ensure that the governance around securities exchange compensation arrangements continues to be fit for purpose. The Council considers that reform to governance is desirable to strengthen perceptions of independence in such arrangements.

The National Guarantee Fund (NGF) is the fidelity fund for the ASX established under the *Corporations Act*. It provides investor protection in relation to transactions on the ASX's equity market. The Council recommends that the governance arrangements for the NGF be reformed to allow for a more broadly representative board of directors, appointed by the Minister. Introducing a more representative and transparent governance regime to the NGF could enhance the perceived independence of the NGF and ASX, increase retail investor confidence in the funds, and ultimately raise investor participation in Australia's licensed markets.

The Council also sees merit in reviewing the scope of eligible claims for the NGF, the treatment of Financial Industry Development Account funds, and the possibility of amalgamating the NGF with other investor compensation mechanisms. The goal would be to establish consistency of coverage across the market and ensure that the best use is made of any surplus funds. The Council will consider the need for further consultation in this regard.

Together, these proposed reforms should help to ensure the robustness, resilience and effectiveness of Australia's financial market infrastructure in a rapidly changing global financial system. Should your office wish to discuss or clarify any aspects of these proposals, please direct any enquiries to [REDACTED]

Yours sincerely,



Encl.

cc. Dr John Laker, Chairman, Australian Prudential Regulation Authority  
Mr Greg Medcraft, Chairman, Australian Securities and Investments Commission  
Dr Martin Parkinson, Secretary to the Treasury

LIST OF SUBMISSIONS TO CONSULTATION PAPER

**Public submissions**

1. Australian Bankers' Association (ABA)
2. Australian Council of Super Investors (ACSI)
3. Australian Financial Markets Association (AFMA)
4. ANZ, CBA, Macquarie, NAB and Westpac
5. ASX Limited
6. Benjamin Saunders
7. Chartered Secretaries Australia (CSA)
8. Chi-X Australia
9. Chi-X Global Holdings LLC
10. CHOICE
11. GETCO
12. International Swaps and Derivatives Association (ISDA)
13. LCH.Clearnet
14. NSX
15. Ownership Matters
16. Securities Exchanges Guarantee Corporation
17. Stockbrokers' Association of Australia (SAA)
18. Yieldbroker

**Confidential submissions**

- 19.
- 20.
- 21.
- 22.

