Financial Market Infrastructure Regulatory Reforms

Advice to Government from the
Council of Financial Regulators

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Contents

Glossary

ADI	Authorised deposit-taking institution
AML	Australian market licensee
ASIC	Australian Securities and Investments Commission
CCP	Central counterparty
CFR	Council of Financial Regulators
Corporations Act	*Corporations Act 2001*
CSFL	Clearing and settlement facility licensee
Domestic CSFL	A body corporate that is incorporated in Australia and holds an Australian clearing and settlement facility licence under section 824B(1) of the Corporations Act
DTRL	Derivative trade repository licensee
FMI	Financial market infrastructure
FSB	Financial Stability Board
FSS	Financial Stability Standards
IMF	International Monetary Fund
Licensed Entities	Collectively, AMLs, BALs, CSFLs and DTRLs
Overseas CSFL	A body corporate that holds an Australian clearing and settlement facility licence under section 824B(2) of the Corporations Act
RBA	Reserve Bank of Australia
Regulators	ASIC and the RBA

Executive Summary

Introduction

Financial market infrastructures (FMIs) are the key entities that enable, facilitate and support trading in Australia's capital markets. FMIs include financial market operators, benchmark administrators, clearing and settlement facilities and derivative trade repositories. The financial system's reliance upon FMIs, particularly central counterparties (CCPs), has increased significantly following the 2008 crisis as a result of reforms intended to reduce systemic risk. Today, FMIs in Australia support transactions in securities with a total annual value of $18 trillion and derivatives with a total annual notional value of $185 trillion. A disruption to the orderly provision of FMI services could cause a disruption to the wider financial system, which may have large economic costs.

FMIs face a wide variety of risks. The 2008 crisis illustrated the financial and counterparty risks to which financial institutions, including FMIs, are exposed, and the importance of sound risk management to address these risks. More recently, the operational disruption and market volatility associated with the economic fallout from the coronavirus disease (COVID-19) has highlighted the potential for an unforeseen event to impact the smooth functioning of FMIs. In the most extreme cases, these risks could threaten the viability of these critical infrastructures.

As the regulators of FMIs, the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) (together, the Regulators) need strong and dependable powers to carry out their mandates and mitigate the risk of disruption to FMI services. The Regulators currently have a range of powers with respect to FMIs. However, the options available to the Regulators to address the potential insolvency of an FMI or other severe threats to its continued operation are very limited. The proposed reforms are also needed to improve the ability of the Regulators to manage such risks ahead of any potential crises, by enhancing the day-to-day regulatory regime and introducing powers to prepare for the orderly resolution of a clearing and settlement facility. In addition, the current distribution of regulatory powers does not always reflect the responsibilities of each Regulator, and the legislation provides a number of operational powers to the Minister (which are currently delegated to ASIC).

The Council of Financial Regulators (CFR) considers that the limitations of the current framework, combined with the current heightened global risk environment and the growing systemic importance of FMIs, means that reforms to existing powers – as well as some additional powers to manage the risks associated with FMIs and promote reliability and integrity of the markets that FMIs support – are required. This has been acknowledged in a number of independent reviews including the 2014 Financial System Inquiry and the International Monetary Fund's (IMF's) 2019 Financial System Assessment Program review.

Recommendations

This advice to Government sets out the CFR's case for reform and makes 16 recommendations for regulatory reform that are intended to:

- introduce a resolution regime for licensed clearing and settlement facilities;
- strengthen the Regulators' supervisory and enforcement powers in relation to FMIs; and
- redistribute existing powers between ASIC, the RBA and the Minister to make the regulatory process more efficient and to better distinguish between operational and strategic functions.

The recommendations outlined in this advice were broadly supported by stakeholders in the recent public consultation (conducted between November 2019 and March 2020). In some cases, the recommendations have been refined to address the feedback provided during that consultation.

Should the Government proceed with the reforms, stakeholders will have the opportunity to engage further with the proposed reforms at a later stage in the process, once draft legislation to enact the reforms has been released publicly.

1 Introduction

This document sets out the CFR recommendations to the Government on reforms to the regulation of FMIs. The recommended actions set out in this advice are essential if the Australian financial system is to be supported by resilient, efficient and stable FMIs.

The recommendations have been informed by the submissions received by the CFR through the recent consultation process.

1.1 Background

The reforms set out in this advice focus on the four classes of FMI currently licensed under Chapter 7 of the *Corporations Act 2001* (Corporations Act). These are:

- financial market operators;
- clearing and settlement facilities;
- financial benchmark administrators; and
- derivative trade repositories.

In Australia, FMIs support transactions in securities with a total annual value of $18 trillion and derivatives with a total annual value of $185 trillion.[1] These markets turn over value equivalent to Australia's annual GDP every three business days. Without clearing and settlement facilities, and access to financial benchmarks, many financial markets could not operate. Financial markets supported by FMIs are used to raise capital, borrow and lend funds, invest in equities and debt securities, and transact in derivatives for risk management purposes. Investors rely on FMIs for access to transparent prices and a safe means of transacting in their investments, which include over $640 billion in superannuation assets held in Australian equities and fixed income assets.[2] Australian governments rely on the Austraclear system to issue debt securities used to raise funds, and most holdings of government debt securities are kept in the Austraclear system. These activities are vital to the smooth functioning of the financial system and to the economy more broadly.

Financial market operators provide the listing and trading services that allow financial products to be issued and traded. They also facilitate transparent and competitive pricing of these securities, and trading that is fair and orderly.

Clearing and settlement facilities mitigate and manage risk by the centralised management of post-trade processes (i. e. 'clearing' and 'settlement') in equity and debt securities and derivatives contracts. The two main types of clearing and settlement facility are CCPs and securities settlement facilities. By interposing themselves between the parties to transactions, CCPs reduce counterparty risk for market participants and manage these risks centrally, allowing investors to transact confidently on financial markets. However, if a participant fails to meet its obligations the CCP will be required to meet these obligations itself and, at least temporarily, may assume significant risk in doing so. Securities settlement facilities play a key role in reducing settlement risk between market participants, by linking the settlement of related obligations from a trade (e. g. by ensuring that payment for securities is made to the seller only if the securities are delivered to the buyer).

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1 Figures reflect the value of securities trades and notional value of derivatives trades for the year to 31 December 2019.

2 Australian Prudential Regulation Authority (APRA)-regulated superannuation funds; does not include assets held by self-managed superannuation funds. Fixed income assets may include some loans made by superannuation funds that do not rely on FMI services.

Financial benchmarks measure the price or performance of certain financial products or classes of financial products. Financial benchmarks are used to determine the price of, or payments due under, a large number of financial products, and are therefore critical to the smooth functioning of financial markets. Financial benchmark administrators are responsible for administering benchmarks that have been declared to be systemically important to the Australian financial system or where disruption to the benchmark would risk material financial disruption.

Derivative trade repositories store information about derivative transactions, including information about market participants' derivative exposures. This information is disseminated to regulators and provides a critical window into the risks in derivative markets.

1.2 The need for regulatory reform

FMIs' importance to the financial system continues to grow. International reforms led by the G20 since the global financial crisis, including the mandates to clear and report certain types of trades, have led to a greater proportion of financial transactions flowing through financial markets, clearing and settlement facilities and derivative trade repositories.

These changes have also been accompanied by an evolution of business models under which FMIs are operated. Where previously many FMIs were mutually owned and operated by market participants, they are increasingly run as for-profit entities that are exposed to commercial pressures that may create tensions between profitability and resilience. Meanwhile, the sudden outbreak of COVID-19 has highlighted the serious operational and financial risks to which FMIs are exposed. During this event, FMIs had to rapidly transition to remote working at the same time as managing record transaction volumes and responding to highly volatile markets; the mismanagement of any one of these steps could have had catastrophic consequences in a highly stressed market. In addition, the increasing complexity and interconnectedness of systems is also increasing operational risk and FMIs' exposure to growing cyber security threats.

The significance of FMIs as central elements of the financial system, the increased risks they face, the business models they operate and the fact that use of FMIs is now in some cases officially mandated, mean that effective supervision and regulation are critical. In particular, regulators need strong powers to promote financial stability and financial markets that are stable, fair, orderly and transparent. As the number of financial products and transactions increase each year, financial benchmarks and derivative trade repositories grow in importance which means regulators must be able to safeguard their quality, reliability and integrity. Meeting these regulatory objectives will be of significant benefit to the direct and indirect users of these facilities and the broader financial system.

While the regulatory framework currently provides the Regulators with some of these powers, the regime still suffers from the following weaknesses and inefficiencies:

- the Regulators do not have crisis management powers to resolve a distressed clearing and settlement facility;
- the distribution of powers between the Minister, ASIC, and the RBA does not correspond to their legislative mandates or international best practice. In particular, the distribution of powers between ASIC and the RBA does not appropriately reflect their respective mandates, and the Minister exercises some operational powers that more appropriately sit with the Regulators; and
- the Regulators do not have sufficient supervisory or enforcement powers to most effectively monitor or manage the risks posed by FMIs to the orderly provision of services and financial stability.

Several independent reviews of Australia's financial system have come to similar conclusions, including the 2014 Financial System Inquiry and the IMF's 2019 Financial Sector Assessment Program. The IMF assessment recommended finalising the FMI resolution regime and strengthening the Regulators' independence and supervisory and enforcement powers.[3]

Australia's financial system has not yet faced events that would expose the weaknesses in the current regime. As highlighted by COVID-19, it is possible for unexpected risks to emerge suddenly with severe and unpredictable effects. The conduct of licensees has also rarely required the Regulators to take explicit enforcement action. Experience in other parts of the financial sector, including examples highlighted by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, suggests that it cannot be assumed that such conduct will continue indefinitely, particularly if new entrants, or changes in ownership or management were to negatively affect the conduct of licensees. Without reform, the Regulators will have limited ability to intervene in the event of misconduct, poor risk management or an inadequate response by FMIs to an unexpected and severe event which could inflict significant costs on the financial system and, ultimately, the broader economy.

1.3 Policy development principles

In developing its recommendations, the CFR has been guided by the following regulatory design principles:

Principle 1: Clear purpose and objectives: The reforms should clearly identify policy goals; and set out a mechanism for prioritising those goals and coordinating regulatory activities to achieve the desired outcome.

Principle 2: Clarity of regulators' roles and responsibilities: Regulators should have well-defined responsibilities and objectives, and have sufficient powers to achieve them. Regulators should not have conflicting functions. If there is an overlap in responsibilities, there should be a mechanism to coordinate regulators' actions.

Principle 3: Regulatory consistency: To minimise costs for both regulators and regulated entities, the reforms should aim to achieve similar objectives and align the regulatory regimes of similar sectors. Where different approaches are taken, they should be justified by differing circumstances. Alignment should be based around the most fit-for-purpose model for the needs of the regime.

Principle 4: Proportionality: The powers available under regulatory regimes should be proportionate to the scale and nature of the problems those regimes address. Regulatory regimes should not impose an undue compliance burden on regulated entities, nor should they unduly constrain the activities of the regulated entities. This may mean that certain powers are only available in certain circumstances.

1.4 Proposed reforms

The recommendations in this advice are designed to better equip the Regulators to identify and address emerging risks pursuant to their respective mandates. For ASIC, this is for fair, orderly and transparent markets; fair and effective clearing and settlement services; and to promote the quality, integrity, availability, reliability and credibility of financial benchmarks. For the RBA, this is for promoting the reduction of systemic risk by clearing and settlement facilities.

[3] See Recommendation 5 of the *Financial System Inquiry Final Report* (2014). Available at <http://treasury.gov.au/publication/c2014-fsi-final-report>. The IMF FSAP *Technical Note on Supervision, Oversight and Resolution Planning of Financial Market Infrastructures* (2019). Available at <http://www.imf.org/en/Publications/CR/Issues/2019/02/13/Australia-Financial-Sector-Assessment-Program-Technical-Note-Supervision-Oversight-and-46609>.

While some of these recommendations could increase costs to industry, the CFR considers these costs are outweighed by the benefits of increased resilience and maintaining financial stability. Clearer and stronger powers that better enable the Regulators to meet their respective mandates more effectively will increase the confidence of market participants and other users of FMI services. The reforms will also support regulatory action to increase the resilience of Australia's FMIs, contributing to a reduction in the overall level of risk in the financial system and reducing the likelihood that market participants will be exposed to substantial losses from a systemic risk event.

Most of the proposals in this advice are based on relevant international standards and guidance, as well as other financial regulations in Australia, including those applying to authorised deposit-taking institutions (ADIs).

The CFR's recommendations can be grouped into three categories:

1 Introducing a crisis management regime for licensed clearing and settlement facilities.

2 Redistributing existing powers and decision-making authority between the Regulators and the Minister to reflect their respective responsibilities.

3 Strengthening the Regulators' supervision and enforcement powers.

The first recommendation relates to the introduction of a crisis management regime for clearing and settlement facilities. A crisis management regime would give a resolution authority the tools to take action in respect of a distressed clearing and settlement facility and to support the continuity of the facility's critical market functions. These proposals broadly implement the international standards for resolution regimes for financial institutions adopted by the Financial Stability Board (FSB). Most major economies have put in place, or are putting in place, similar powers for regulators to intervene in systemically important failing institutions. These proposals have also considered the crisis management powers available to the Australian Prudential Regulation Authority.

The second group of proposed reforms would redistribute existing regulatory powers and decision-making authority between the RBA, ASIC and the Minister. Currently, the Minister has powers that more appropriately sit with the Regulators, while ASIC has powers that more appropriately sit with the RBA. Formally redistributing these powers will better distinguish the Regulators' operational responsibilities from the strategic role of Government and align the Regulators' powers with their respective mandates.

The final group of proposed reforms would strengthen the Regulators' supervisory powers, including information-gathering powers, and broaden the range of enforcement tools they have available. This will give the Regulators significantly more capacity to monitor the ongoing conduct of FMIs, identify risks as they emerge, and take appropriate action to prevent those risks escalating.

1.5 Consultation process

The CFR consulted on these proposals in November 2019. The *Council of Financial Regulators: Financial Market Infrastructure Regulatory Reforms* consultation (2019 Regulatory Reforms Consultation) brought together the CFR's views from a number of earlier consultations, along with extensions to some of the arrangements covered by those consultations, and a number of new proposals. The paper set out a broad set of proposals covering licensing, regulation, supervision and crisis management powers.

Feedback was received from a number of stakeholders including operators of FMIs, participants and industry associations. The CFR has considered the feedback and refined its proposals in light of written submissions and engagement with stakeholders. A summary of stakeholder feedback and the CFR's response is provided as an attachment to this advice.

2 Recommendations

This section sets out the policy measures that the CFR recommends to the Government.

2.1 Crisis management and resolution

Recommendation 1: Implement a resolution regime for clearing and settlement facilities.

Introduce a resolution regime to allow a resolution authority to act to manage distress at clearing and settlement facilities.

Information gathering

Require clearing and settlement facility licensees (CSFLs) that are incorporated in Australia and hold a 'domestic' licence[4] (Domestic CSFLs) and related bodies corporate to provide such assistance to the resolution authority as it requires for the performance of its functions and duties under the crisis management regime.

Empower the resolution authority (and a statutory manager) with certain information-gathering powers during the resolution of a Domestic CSFL.

Obligation to notify the resolution authority

Require Domestic CSFLs and their related bodies corporate to notify the resolution authority once they become aware of certain circumstances, including regarding solvency and any threat to continuity.

Require any person seeking to appoint an external administrator to a Domestic CSFL or related body corporate to give one week's prior notice to the resolution authority (with certain accompanying exemptions for directors of the Domestic CSFL or related body corporate from their statutory duty to prevent insolvent trading).

Resolution planning and resolvability

Provide the resolution authority with powers to compel Domestic CSFLs (and their related bodies corporate) to provide the resolution authority with information relating to their operations and financial position.

Empower the resolution authority to prepare a resolution plan for each systemically important Domestic CSFL.

Empower the resolution authority to set standards of resolvability and to compel Domestic CSFLs (and when appropriate their related bodies corporate) to take measures for the Domestic CSFL to comply with those standards, or otherwise to address an impediment to resolution.

Conditions for resolution

Empower the resolution authority to exercise any of its resolution powers once any one of a set of general conditions relating to solvency, viability or threats to service continuity (including a significant operational outage) has been met.

[4] Under section 824B(1) of the Corporations Act.

Resolution powers

Provide the resolution authority with the following powers with respect to Domestic CSFLs (and where necessary to effectively resolve the Domestic CSFL, a related body corporate) to facilitate resolution:

- *Directions* – to give a direction to take a specified action to support resolution.
- *Statutory management* – to allow the resolution authority to appoint itself and/or another person as statutory manager of a Domestic CSFL or related body corporate, to take control of the entity. The statutory manager will have strong powers to secure the continued provision of critical clearing and settlement services, including but not limited to all powers of the entity's board and a power of sale of the entity or its business.
- *Transfer* – to initiate a transfer of shares or business of a Domestic CSFL or related body corporate to a third-party buyer or to a government-owned bridge entity. The use of this power is subject to Ministerial consent.

Introduce statutory protections for reasonable actions taken by a directed entity and certain others, such as its board and staff, in good faith to comply with a direction.

Introduce a number of supporting arrangements designed to preserve the integrity and effectiveness of resolution:

- *Stay* – exclusion of a resolution action as the grounds for the exercise of contractual rights (including early termination rights), to allow resolution to proceed without being undermined by the termination of key contracts.
- *Moratorium* – to prevent the commencement or continuation of certain litigation and enforcement actions against the Domestic CSFL or related body corporate (or their property) during statutory management or transfer of the relevant entity.
- *Confidentiality* – to compel entities not to disclose that they have been given a direction, or to keep specified information confidential, in order to prevent untimely disclosure of sensitive information that may impede effective resolution.
- *Funding* – to access temporary public funding, in certain circumstances, to support the resolution of a Domestic CSFL. Any funds expended would be sought to be recovered.

Cross-border powers

Where an overseas regulator has initiated resolution of an Overseas CSFL in its home jurisdiction, empower the Australian resolution authority to recognise the resolution of the Overseas CSFL and use its resolution powers in support of the home resolution authority.

Empower the Australian resolution authority to give a direction with respect to the Australian assets and liabilities of an Overseas CSFL in certain circumstances.

Increased use of clearing and settlement facilities reduces systemic risk by increasing the transparency of market participants' exposures and centralising risk management of those exposures in a specialist entity. However, increased use, combined with the fact that clearing and settlement facilities are connected (both directly and indirectly) to a wide range of market participants, also means that prolonged disruption of critical clearing and settlement services would likely pose a threat to financial stability.

The risk posed by clearing and settlement facilities as potential transmitters and amplifiers of financial shocks is well recognised internationally and they are therefore required by regulators to have robust risk

management arrangements – including recovery plans – to allow them to weather some disruption. Nonetheless, a shock of sufficient magnitude remains a threat. A resolution framework can combat this risk by providing a final backstop against failure. The importance of robust resolution arrangements for clearing and settlement facilities is widely acknowledged by regulators, the facilities themselves and market participants alike, and common design principles for a resolution framework have been outlined in the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes).[5] The resolution regime put forward by the CFR in this recommendation is designed to be consistent with the Key Attributes wherever appropriate to the Australian environment.

Clearing and settlement facilities have significant resources intended to allow them to survive financial distress. The CFR considers that the conditions for resolution should reflect that resolution is a final line of defence against failure and should only be initiated when the clearing and settlement facility's own resources are (or are likely to be) insufficient to address threats to the continuity of its services, or prevent its failure.

The objectives of the proposed resolution framework would be to:

- maintain the overall stability of the financial system; and
- provide for continuity of critical clearing and settlement services.

To facilitate resolution, a resolution authority should be nominated and provided with certain powers. In the Australian regime this would be the RBA, because of its mandate to promote financial stability and its ongoing role in supervising clearing and settlement facilities. Allowing any resolution powers to be used by the resolution authority once a general condition for resolution has been met will provide the resolution authority with the flexibility to choose the resolution strategy that is appropriate to specific circumstances. This is important because of the difficulty in predicting the best possible resolution strategy in advance.

To allow the resolution authority to prepare for resolution and require providers of critical clearing and settlement services to operate in a way that is consistent with effective resolution, the regime should include powers and obligations for the resolution authority in respect of resolution planning.

To be effective, the resolution framework requires sufficient scope to address threats to continuity and financial stability. In many instances, the use of resolution powers with respect to a distressed CSFL itself may be sufficient for successful resolution. However, these powers need to be able to be applied, in a proportionate manner, to different types of corporate group structures of which clearing and settlement facility operators are part. For example, in the event of the failure of a CSFL, it may not be sufficient to apply powers only to the CSFL where it is a member of a corporate group. Critical functions or services may be provided by other group entities and contagion can occur within corporate groups. The resolution authority needs to be able to move swiftly to safeguard the operations of other group entities that are essential to the continued operation of critical clearing and settlement services where the need arises. The CFR therefore proposes that the regime allow the resolution authority to exercise powers with respect to related bodies corporate of a Domestic CSFL, where this is necessary for the effective resolution of the Domestic CSFL.

In most instances, resolution powers will be exercisable only in relation to Domestic CSFLs. However, Overseas CSFLs can play an important role in the Australian financial system and it is important to consider how the resolution authority would respond to any resolution of an Overseas CSFL in its home jurisdiction. It is expected that, in the event of a crisis affecting an Overseas CSFL, its home regulator would be primarily responsible for resolution, with the cross-border powers proposed within the Australian regime primarily aimed at supporting

[5] See *Key Attributes of Effective Resolution Regimes for Financial Institutions*, available at <http://www.fsb.org/work-of-the-fsb/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/>.

the home regulator's efforts. There may, however, be circumstances where resolution actions by other authorities could threaten the stability of the Australian financial system. In those instances, the proposed power to direct an Overseas CSFL could be used to protect Australian interests.

2.2 Enhancing the licensing regime

Recommendation 2: Transfer to ASIC and, where relevant, the RBA powers that are currently delegated by the Minister to ASIC.

The powers to be transferred from the Minister are:

- *Licensing:* in respect of Australian market licensees (AMLs) and CSFLs: issue or vary a licence; impose, vary, and revoke licence conditions; suspend or cancel a licence; vary or revoke a suspension; and approve a change of country.
- *Operating rule changes:* disallow AML and CSFL operating rule changes.
- *Exemptions:* issue, vary or revoke an exemption from compliance with all or part of Part 7.2, 7.2A, 7.3 or 7.5 of the Corporations Act.
- *Information:* in relation to AMLs or CSFLs: require a special report; and require an audit report on the operator's annual report to ASIC on its compliance with its licence obligations.
- *Directions:* give, vary or revoke a direction to promote compliance by an AML or CSFL with its obligations as a licensee under Chapter 7 of the Corporations Act.
- *Compensation regimes for financial markets:* approve or revoke approval of compensation arrangements; give directions; approve changed compensation arrangements; disallow changes to compensation rules or to the Securities Exchanges Guarantee Corporation operating rules; and require the preparation of risk assessment reports.

The Minister will retain powers over Licensed Entities that relate to matters of strategic or national importance.

Effective regulation relies on a clear separation of responsibilities between the Government and regulators,[6] with the Government responsible for making and reviewing laws and independent regulators empowered to apply those laws in an objective and impartial manner. The current arrangements, where the Minister has responsibility for a number of operational decisions in relation to licensing and supervision of market operators and clearing and settlement facility operators, is inconsistent with this approach and out of step with comparable international regimes.

The CFR recommends that powers under the Corporations Act to make a number of decisions in relation to licensing and supervision of market operators and clearing and settlement facility operators should be transferred from the Minister to ASIC and, in certain instances, the RBA. These instances are in respect of CSFLs only. It is recommended that the Minister's powers (both exemptions and directions) that relate to the requirements on a CSFL to comply with the FSS and to do all other things necessary to reduce systemic risk should be transferred to the RBA. Further, the Minister's power to require a CSFL to provide a special report would be transferred to both ASIC and the RBA.

[6] See *OECD Best Practice Principles for Regulatory Policy, The Governance of Regulators,* available at <http://www.oecd.org/gov/regulatory-policy/the-governance-of-regulators-9789264209015-en.htm>.

By realigning the powers between the Minister, ASIC and the RBA to reflect their respective responsibilities, the proposed changes will bring Australia's regulatory and supervisory regime for FMIs in line with international best practice standards.

Recommendation 3: Clarify the circumstances where a licence can be suspended or cancelled.

A licence held by an AML, CSFL, benchmark administrator licensee or derivative trade repository licensee (DTRL) may be cancelled or suspended, where:

- an entity has not commenced the activity for which a licence was granted within three years; or
- an entity did not carry out a licensed activity for a period of 12 months.

A material deterioration of the information-sharing arrangements with the home regulator of an overseas AML or Overseas CSFL is grounds for suspension or cancellation of the licence.

A regulatory licence is granted for specific purposes and permits the holder of the licence to carry out an activity consistent with those purposes. The granting of a regulatory licence is accompanied by stringent and well-defined obligations for the entity being licensed as well as supervision by the relevant Regulators. Regulatory licences are granted with the intention that the activities authorised by the licence are undertaken.

The CFR recommends clarifying that failing to commence or use a licence after a specified period of time should be grounds for the suspension or cancellation of that licence, limiting a licensee's ability to warehouse or commoditise such a licence. In addition, the proposal will minimise the use of regulatory resources involved in administering a licence where the licensed activity is not being undertaken. By expressly stating the acceptable period of time without use before a licence may be suspended or cancelled, the recommendation adds specificity to the legislation and provides transparency to participants as to when these powers may be exercised.

The overseas licensing regime relies on sufficiently equivalent regulation in the licensee's home jurisdiction. When making licensing decisions about overseas markets and clearing and settlement facilities, the Minister must consider whether there are adequate cooperation arrangements between ASIC, the home regulatory authority and, for clearing and settlement facilities, the RBA. A high degree of cooperation and information sharing will be needed between the relevant regulators on an ongoing basis to ensure that both duplicative regulation and regulatory gaps are minimised as much as possible, and to monitor the ongoing sufficient equivalence of the entity's home regulatory regime. It is therefore appropriate that, if there is a material deterioration in the information sharing arrangements, the Regulators should have an opportunity to consider if it is appropriate for the licensee to continue to be licensed.

Recommendation 4: Amend the arrangements under which an overseas market operator or overseas clearing and settlement facility operator is required to be licensed or exempt.

Overseas operators of markets and clearing and settlement facilities that have a connection to the Australian financial system would be required to notify ASIC of this fact, and provide information to ASIC to enable it to assess this connection, including on an ongoing basis.

If ASIC (in consultation with the RBA for clearing and settlement facilities) determined the connection to be material, the operator would need to be licensed or exempted from the licensing regime. These

determinations will be made public, as will the connection and materiality criteria. ASIC should be able to access sufficient information to enable it to make informed determinations of material domestic connections, including through an information-gathering power.

Under the current licensing framework, an operator of a financial market or a clearing and settlement facility is required to be licensed or exempt if it operates a financial market or clearing and settlement facility in this jurisdiction. The Corporations Act does not comprehensively set out the circumstances in which an entity is, or is taken to be, operating a financial market or clearing and settlement facility in this jurisdiction.

The increasingly global nature of many financial markets, combined with regulatory reforms, has prompted an increasing number of overseas entities to contact the Regulators to seek clarity on whether they fall within the scope of the licensing regime. Under existing arrangements, this is typically followed by repeated ad-hoc engagements between the Regulators and the overseas operator to clarify its status in Australia.

The current arrangements would be replaced by a two-step test. Firstly, an operator would be considered to have a domestic connection to Australia if it met one or more of a set of objective criteria to be determined by ASIC, which may be via a legislative instrument. For example, one Australian participant in the market or clearing and settlement facility could constitute a domestic connection.[7]

Secondly, ASIC (in consultation with the RBA for clearing and settlement facilities) would then assess the materiality of the domestic connection against a different set of criteria to be determined by ASIC, which may be published in a legislative instrument to maintain appropriate parliamentary oversight. For example, one criterion could be that the market or clearing and settlement facility has a material number of Australian participants. The criteria to be determined by ASIC are not intended to materially change the scope of the current licensing framework. Rather, the factors that the Regulators apply in their interpretation of the current test (operating in this jurisdiction) are intended to be codified and given legislative backing.

This proposal will add clarity to the factors considered when deciding whether an overseas operator needs to be licensed in Australia. Determinations of which domestic connections are material will be made public. Information on markets and clearing and settlement facilities with a known domestic connection to Australia could also be published. Further guidance will outline case studies to demonstrate how the proposed test would be applied. This will provide greater transparency to overseas operators and prospective entrants as to when they need to be licensed. Having access to sufficient information will also enable the Regulators to more effectively monitor, over time, whether an overseas operator should be licensed or exempt.

Recommendation 5: Provide ASIC with the power to impose limits on the scope and level of activity that a licensed overseas AML or Overseas CSFL is permitted to undertake as an overseas licensee.

Provide ASIC with powers to specify and enforce a limit on the scope and level of activity of overseas licensees in Australia.

The relevant activity criteria would be discussed with the overseas licensee and be implemented through the use of licence conditions.

[7] For examples of criteria considered for overseas clearing and settlement facilities see Tables 1 and 2 of the 2015 *Overseas Clearing and Settlement Facilities: The Australian Licensing Regime*, available at <http://www.cfr.gov.au/publications/consultations/2015/overseas-clearing-and-settlement-facilities-australian-licensing-regime/pdf/overseas-clearing-and-settlement-facilities-australian-licensing-regime.pdf>.

Overseas licensees would be required to demonstrate their ability to observe any limit which may be imposed.

An overseas licensee that wanted to further increase its presence in Australia beyond the limits imposed under its licence conditions would retain the option to apply for a domestic licence provided it met the required criteria. Consistent with the proposal in Recommendation 6, for CSFLs this would include the applicant for the domestic licence being a domestically incorporated entity.

ASIC and the RBA need to have an appropriate degree of regulatory influence over the activities of overseas incorporated licensees to protect the smooth functioning of the Australian financial system.

This power would be used to limit the extent to which overseas licensees that are not subject to primary regulation by ASIC (and the RBA in respect of clearing and settlement facilities) can pose substantial risks to the functioning of the Australian financial system.

For Overseas CSFLs, it is envisaged that any limits would be set at a level where ASIC and the RBA consider it absolutely necessary to protect against systemic risk, and where other regulatory measures are not appropriate to mitigate these risks. Appropriate limits and other relevant activity metrics would be discussed with any AML or CSFL before such limits were imposed. It is intended that any limits imposed on a licensee through a licence condition would be published, thereby providing all participants with greater certainty when formulating their business plans. It is intended that regulatory guidance will be published outlining how these limits may be applied.

Recommendation 6: Domestic clearing and settlement facility licences to only be available to operators that are domestically incorporated.

Holders of a domestic clearing and settlement facility licence would be required to be domestically incorporated.

ASIC should have the power to exempt entities from this licensing requirement.

The CFR proposes that only domestically incorporated entities be able to hold a domestic clearing and settlement facility licence. This would facilitate the exercise of any resolution powers in respect of Domestic CSFLs. Unless exempt by ASIC, Domestic CSFLs would be required to be incorporated under, and therefore be primarily governed by, the laws of Australia so that the resolution authority could resolve Domestic CSFLs effectively. ASIC would be able to exempt an entity from this particular requirement on a case by case basis.

An operator of a clearing and settlement facility that is an overseas incorporated company will continue to have a route to be licensed as an operator of an overseas clearing and settlement facility if it meets the relevant requirements under the Corporations Act.

Recommendation 7: Provide ASIC with the power to declare a financial market to be a prescribed financial market.

Provide ASIC with a power to declare that a financial market is a prescribed financial market.

Declarations by ASIC would be in the form of a disallowable legislative instrument.

This proposal would replace the current process for adding or removing a financial market to the list of prescribed financial markets, which currently requires an amendment to the Corporations Regulations 2001.

The current arrangements do not permit the regulatory regime to adapt quickly to new entrants. Allowing ASIC to declare that a market is a prescribed financial market will permit the list of prescribed financial markets to be updated more readily and efficiently, reducing the potential for this process to delay an associated licence application or variation. The declaration would be in the form of a disallowable legislative instrument, retaining Parliamentary oversight of the process.

The recommendation does not propose changing the:

- policy rationale for when a financial market should be a prescribed financial market; or
- application of provisions within the Corporations Act to those markets.

Recommendation 8: Provide ASIC with a power to declare a body to be a 'widely held market body'.

Provide ASIC with a power to declare a body to be a 'widely held market body'.

Declarations by ASIC would be in the form of a disallowable legislative instrument.

This proposal would replace the current process for adding a body corporate as a 'widely held market body', which currently requires an amendment to the Corporations Regulations 2001.

Allowing ASIC to declare that an AML or CSFL, or their holding company, is a widely held market body will permit the list of widely held market bodies to be more readily and efficiently updated to adapt to changes.

The declaration would be in the form of a disallowable legislative instrument, retaining Parliamentary oversight of the process.

This proposal does not change the policy rationale for when a body corporate should be a widely held market body, or the restriction on voting power in a widely held market body.

Recommendation 9: Allow the Minister to approve increases in voting power in ASX Limited above 15 per cent under the widely held market body provisions.

For a person to have more than 15 per cent voting power in ASX Limited, ministerial approval, rather than a change to regulation, would be required.

Currently, a person's voting power in a widely held market body cannot be greater than 15 per cent unless there is ministerial approval or, in the case of ASX Limited, approval via a regulation. The Minister may provide approval if satisfied that it is in the national interest.

Under this recommendation, all widely held market bodies (including ASX Limited) would be subject to the one set of approval arrangements.

This recommendation promotes regulatory consistency with other widely held market bodies.

This proposal does not change the criteria for approval of large shareholdings or what level of control would constitute a large shareholding in the widely held market body regime.

This proposal will implement Recommendation 44 of the Financial System Inquiry Final Report which recommended that the proposal be implemented after reforms to cross-border regulation of FMIs (as outlined in this advice) are complete. The CFR is supportive of this approach and recommends that, in addition, Recommendation 5 be implemented before or at the same time as Recommendation 9 is implemented.

2.3 Enhancing supervision and enforcement

Recommendation 10: Implement a fit and proper standard for those involved in Licensed Entities.

> Introduce a fit and proper standard for those involved in Licensed Entities.
>
> A fit and proper standard that applies to individuals 'involved in' a Licensed Entity should encapsulate attributes like competence, experience, knowledge, diligence, honesty and judgement.
>
> Under existing legislation, ASIC has a disqualification power in respect of those involved in a Licensed Entity. ASIC's powers in respect of those 'involved in' a Licensed Entity should also include the adoption of a fit and proper standard.
>
> Remove the need for ASIC to demonstrate before disqualification 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 Corporations Act.

Each person involved in a licensee plays an important part in ensuring a licensee complies with its obligations. The CFR considers that playing an important role and making important decisions for a business in the financial services industry requires competence, experience and knowledge that is commensurate with their role and responsibilities. A person who is not fit and proper should not be involved in the licensee because they may not fulfil their responsibilities to the requisite standard.

Currently, persons involved in a Licensed Entity are not explicitly required to have the requisite competence, experience or knowledge. This means that ASIC cannot ensure that Licensed Entities are being run by appropriate persons, which may raise the risk profile of a Licensed Entity. This could affect the entity's users or the financial system more broadly. This gap can be addressed by introducing a fit and proper standard for persons involved in a Licensed Entity, which would allow ASIC to take action against persons who raise the entity's risk profile because of a lack of competence, experience, knowledge, diligence, honesty or judgement.

The CFR also proposes removing the existing qualifier that ASIC may only disqualify a person who is unfit if the licensee may breach its licence conditions as a result of that person's unfitness. This qualifier limits the effectiveness of ASIC's supervision of persons involved in a licensee, by setting the bar disproportionally high given the fundamental premise that a person who is unfit for their role should not be in that role.

Implementing a fit and proper standard for all licensed FMIs is consistent with regulatory regimes in other contexts, for example ADIs, and with the intention of the Parliament as expressed in the explanatory memorandum of the *Financial Services Reform Bill* in 2001 which was to 'ensure that only appropriate people are associated with the management, ownership and control of all financial markets and clearing and settlement facilities which are the subject of Australian licences'.[8] This reflects that provisions in respect of governance are an important part of the regulatory toolkit for promoting confident participation in the financial system and its infrastructure.

With respect to overseas licensees, the CFR intends that the sufficient equivalence assessment would look at the corresponding home regulatory arrangements. If the home regulatory regime incorporates a sufficiently equivalent fit and proper standard then deference would apply such that the Regulators would rely on the

[8] The benchmark and derivative trade repository regulatory regimes did not exist in 2001.

primary regulator's oversight of the overseas licensee to verify compliance with the sufficiently equivalent standard.

Recommendation 11: Require ASIC approval for a person to hold more than 15 per cent voting power in a Licensed Entity that is incorporated in Australia.

ASIC's consent would be required for a person to hold more than 15 per cent voting power in a licensee that is incorporated in Australia.

ASIC must give consent if it has no reason to consider that the revised ownership structure will impede the ability of the licensee to meet its obligations under the Corporations Act.

The review would take place before the proposed change in control transaction is permitted to occur and a time limit on the review period would apply.

Transitional arrangements would be included to ensure that existing shareholders would not be in breach for current ownership holdings.

This approval process would operate alongside, and not replace, the existing restriction on widely held market bodies.

This proposal will enable ASIC to review whether a prospective significant shareholder (or increase in shareholding of an existing significant shareholder) would have an adverse effect on the licensee's ability to meet its licence obligations.

Those with significant voting power in a Licensed Entity can influence the business and operations of the licensee in a way that has an effect on its compliance with its obligations as a licensee. Currently, there is a requirement to notify ASIC of certain changes in the control of a licensee, but since this notification is after the fact, there is no ability for ASIC to prevent the change in control transaction from occurring.

There are precedents for a change in control approval process in other contexts, for example, approval of a change in control of a registrable superannuation entity.

If the fit and proper proposal (Recommendation 10) is implemented, fit and proper persons, including those who will be involved in the licensee in the future, will be reviewed as part of the change in control approval process.

Recommendation 12: Provide ASIC with the power to make rules for the purpose of promoting the fair and effective provision of clearing and settlement services.

ASIC will be given the power to make rules for Domestic CSFLs to promote fair and effective provision of clearing and settlement services.

The Minister's written consent, consultation with the RBA and public consultation would be required before ASIC could make such a rule.

Domestic CSFLs, as well as any other class of persons prescribed by regulation, will be required to comply with the rules.

In the event of any conflict between rules made under this rulemaking power and the RBA's financial stability standards (FSS), the FSS will prevail.

While ASIC is already able to recommend the imposition of obligations on CSFLs through licence conditions on a broad range of matters, licence conditions are not well suited to imposing detailed obligations, or obligations that need to be imposed on multiple licensees. This rulemaking power will enable ASIC to more efficiently and effectively promote the fair and effective provision of clearing and settlement services.

Detailed obligations require flexible enforcement mechanisms that are proportionate to the severity of the breach. A breach of a licence condition could result in suspension or cancellation of the licence. This is not always appropriate for the type of detailed obligations that could be imposed under rules.

Licence conditions cannot be effectively imposed on multiple licensees in a uniform manner as each licence would need to be individually varied. Further, it would be difficult for users of the clearing and settlement facility to determine whether the obligations are consistently applied across multiple licensees when considering which clearing and settlement facility they wish to use.

The proposal provides regulatory consistency across the broad scope of entities regulated by ASIC by aligning ASIC's powers for Domestic CSFLs with the rule making authority it already has over other FMI entities. The ability to prescribe by regulation other classes of persons required to comply with the rules will provide ASIC with flexibility to meet future requirements, and would be subject to government decision and consultation processes at that time.

Since the RBA has an existing power to determine FSS in respect of CSFLs, it is important that the legislation resolves any potential conflict between the FSS and any ASIC rules. In light of the critical importance of addressing potential risks to financial stability, the CFR recommends that, to the extent of any conflict between an ASIC rule made under this power and the FSS, the FSS should prevail.

Recommendation 13: Provide the Regulators with a power to obtain a report from an expert on specified matters.

Give ASIC the power to obtain a report from an expert on specified matters in relation to Licensed Entities, and give the RBA a corresponding power in relation to CSFLs.

The licensee may be required to bear the costs of obtaining the report.

It is critical that the Regulators have access to accurate and timely information about the operations of Licensed Entities, so that they can form an accurate view of how these entities are meeting their obligations under the Corporations Act. The power to obtain an expert report will provide the Regulators with a mechanism to access appropriate expertise from an independent source.

This recommendation is in addition to the recommended transfer of the power for the Minister to require a licensed market operator or clearing and settlement facility to provide ASIC with a special report, which is part of Recommendation 2. It will provide ASIC and the RBA with the flexibility to seek a report from an appropriately qualified and independent expert, rather than from the AML or CSFL itself (as is the case in relation to the special report power).

Recommendation 14: Provide the Regulators with directions powers that are aligned with their respective mandates.

ASIC's power to give a direction to a CSFL to take an action to comply with the FSS, or to reduce systemic risk, be transferred to the RBA.

The RBA be given a new power to give a direction to a Domestic CSFL to take specific actions if the RBA reasonably considers that the action is required to support financial stability.

The RBA's directions powers be accompanied by statutory protections for reasonable actions taken in good faith to comply with an RBA direction.

The RBA be given a new power to direct a CSFL to provide information related to the RBA's powers and functions in relation to CSFLs.

Sanctions for non-compliance with ASIC or RBA directions be extended to apply to directors and officers of the Licensed Entity.

It is important that the Regulators have powers that align with their mandates in order to promote the objectives of regulation. If the Regulators have inadequate powers to support and enforce compliance with their regulations, they may have difficulty ensuring that these objectives can be met.

The RBA is a co-regulator of clearing and settlement facilities, with the objective of promoting the overall stability of the financial system, but currently does not have a power to issue a direction to a CSFL. If the RBA wanted to direct a CSFL to take actions to comply with the FSS, or otherwise reduce systemic risk, it would have to request ASIC to issue a direction. However, ASIC is not required to meet this request.

Independent directions powers for the RBA will strengthen its ability to enforce compliance with CSFLs' obligations to comply with the FSS and to do all other things reasonably practicable to reduce systemic risk. In addition, the proposed power to direct a Domestic CSFL to take specific actions will allow the RBA to intervene in targeted ways to prevent actions that may have unintended financial stability consequences or to require actions be taken to mitigate such consequences. For example, the power would allow the RBA to prevent a Domestic CSFL from taking default management actions that may interfere with the resolution of an ADI.

Statutory protections for reasonable actions taken in good faith to comply with an RBA direction will reduce the risk that CSFLs delay compliance with a direction due to concerns that this may conflict with other obligations of the CSFL. A delay in complying with a direction has the potential to exacerbate the financial stability risks that the direction is intended to address.

The information-gathering directions power would complement the power to obtain an expert report (Recommendation 13), ensuring that the RBA has timely and sufficient access to information required to meet its financial stability objectives in respect of CSFLs.

Finally, the extension of sanctions for non-compliance with ASIC or RBA directions to directors and officers of a Licensed Entity who are responsible for the licensee's non-compliance will strengthen the incentives for these key individuals to support timely compliance with directions given by the Regulators. However, the CFR notes this particular proposal potentially overlaps with proposals under the Financial Accountability Regime and this will need to be managed during the implementation of the proposals in legislation.

Recommendation 15: Remove the qualification on the obligation of CSFLs to comply with the FSS, and on the RBA's proposed directions power to take action to comply with the FSS.

The qualification on the obligation of a CSFL to comply with the FSS, that compliance is necessary only to the extent 'reasonably practicable', be removed.

The power for the RBA (under Recommendation 14) to issue a direction to a CSFL to take an action to comply with the FSS should not be subject to a qualification of this type.

Currently, a CSFL is only required to comply with the FSS to the extent that it is 'reasonably practicable' to do so. The CFR is concerned that the meaning of this qualifier is open to interpretation, and it may prevent the effective exercise of the related directions power (which is proposed to be transferred from ASIC to the RBA under Recommendation 14).

The qualifier that a CSFL must meet the FSS only to the extent 'reasonably practicable' means that in some situations it may be difficult to establish whether a CSFL has breached its FSS compliance obligations. It also limits the enforceability of the FSS, as a CSFL may argue that remediation actions are not 'reasonably practicable'. Even if the RBA was eventually successful in proving that the required actions are 'reasonably practicable', the delay in enforcing the original requirement may undermine the financial stability objectives of the FSS.

Consistent with the removal of the qualification on the obligation to comply with the FSS, the RBA should be able to issue a direction to take an action to comply with the FSS if it considers that there has been a breach of this obligation, without having to also consider that it was reasonably practicable for the CSFL to comply with the FSS.

Recommendation 16: Streamline ASIC's existing directions power and remove the time limit on the period a direction may remain in place.

Streamline ASIC's power to give a direction to AMLs, CSFLs and DTRLs to remove the two-step process currently required before ASIC can issue a direction.[9]

Remove the time limit for which directions can have effect so that a direction can remain in place for as long as is required.

In cases where a regulator considers it necessary to issue a direction, it is important that it is able to act quickly and efficiently. For example, where the direction is for the protection of people dealing in a financial product, time is likely to be of the essence. The current process requires ASIC to give written advice to a licensee that ASIC intends to give the licensee a direction and the reasons why, and give the licensee time to address those concerns. If, in ASIC's view, the licensee does not take adequate steps to address the situation, and it is appropriate to do so, ASIC may then give the direction, along with a statement setting out its reasons.

Streamlining the directions procedure by removing the two-step process will enable ASIC to issue directions in a timely and efficient manner once an issue is identified.

The current limit on the period during which a direction is effective (up to 21 days) impedes ASIC's ability to use its directions power in circumstances which may take longer than 21 days to resolve. That is, in the case that 21 days is not enough time for a licensee to be able to implement or carry out a direction, the direction would cease to apply and there would no longer be any obligation on the licensee. The proposal addresses this limitation.

9 Sections 794D, 823D and 904G of the Corporations Act.

Appendix

The parties that provided a submission to the 2019 Regulatory Reforms Consultation (excluding individuals and those that requested their submission to be confidential) are:

Australia Financial Markets Association (AFMA)

Australian Restructuring Insolvency & Turnaround Association (ARITA)

ASX Limited

CHESS Replacement Stakeholder Group

Chi-X Australia Limited

CME Group

Computershare Limited

Depository Trust and Clearing Corporation (DTCC)

Intercontinental Exchange Inc (ICE)

International Swaps and Derivatives Association, Inc (ISDA)

Macquarie Bank Limited

National Stock Exchange of Australia (NSX)

Yieldbroker Pty Limited