15 August 2018

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Australian Securities and Investments Commission
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Dear Ms So-Xu

ASIC CONSULTATION PAPER 302 – Proposed Changes to ASIC's Capital Requirements for Market Participants

Thank you for the opportunity to provide comment in relation to ASIC Consultation Paper 302 (the consultation paper). AFMA represents the collective interests of over 110 members many of whom are market participants on the exchanges to which the consultation relates and will be directly affected by the proposed changes.

Finding the correct balance in relation to capital requirements is an important exercise. While on the one hand higher capital requirements protect investors, creditors and other market participants in the event of an issue with a particular participant, they are also a direct cost to market participants that can lead to higher costs for investors, and are a barrier to new entrants and thereby can limit competition and innovation.

AFMA is supportive in general of adjustments to reflect underlying risk, and a number of the changes proposed in paper fit well into this categorisation. Where risks cannot be efficiently calculated on a case by case basis we also support the use of proxy standard estimates as proposed in a number of cases as an appropriate balance between accuracy and efficiency.

In relation to the removal of subordinated debt from the core capital requirement we do not object to this change. However, given the importance of subordinated debt to allow the timely adjustment

of capital levels to meet the intermittent demands of the market, we seek confirmation that this change will not affect the utility of subordinated debt for these other regulatory capital requirements.

Regarding the liquidity requirements we note concerns around the difficulties of calculating cash flows out twelve months in a markets business, and the proper roles of management and boards in relation to managing liquidity risks. To ensure an appropriate outcome we suggest relevant changes to the regime that would still address liquidity requirements while maintaining the appropriate distinction between governance and management roles.

Please find attached our responses to the detailed questions in the consultation. We would be pleased to assist with further information if required, I can be contacted on 02 9776 7993 or at djeffree@afma.com.au.

Yours sincerely

Damian Jeffree

Futures Capital Rules

> B1Q1 Do you agree that market participants of futures markets should be subject to a risk-based capital framework? If not, please provide detailed reasons.
>
> B1Q2 Do you consider a minimum core capital requirement of $1,000,000 to be an appropriate threshold? If not, please provide details.
>
> B1Q3 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).
>
> B1Q4 Would you prefer ASIC to retain the existing NTA requirement or move to a risk-based approach? Please give detailed reasons for your answer.
>
> B1Q5 Do you foresee any practical issues with imposing a risk-based capital framework on participants of futures markets?
>
> B1Q6 Do you consider six months to be an appropriate length of time to allow futures market participants to transition from the NTA requirement to the risk-based capital framework?

In general, AFMA is supportive of the proposed move to a risk-based capital framework for futures market participants. As noted, risk-based systems better align the required capital with the associated business risks and allows firms to manage their capital costs via controlling their risks, which is a logical and desirable outcome.

We are also supportive of the use of the same set of capital rules for both futures market and securities market participants as this will enhance comparability of capital requirements of market participants and introduce efficiencies in calculation and certification processes. Having unified rule books where possible is generally preferable as it removes an element of complexity in having two different approaches being implemented with no chance for operational efficiencies.

With regard to implementation timing, we support the proposed minimum of 6 months' notice from the time the rules are finalised and published to their commencement.

Commodities Position Risk

> B2Q1 Do you agree that market participants should be required to hold additional capital if they hold commodity positions? If not, please provide detailed reasons.
>
> B2Q2 Do you consider the proposed commodity position risk amount adequately addresses the position risk of holding commodity positions? If not, please provide details.

B2Q3 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

B2Q4 Do you foresee any practical issues with imposing a commodity position risk amount?

B2Q5 Do you agree with the proposed commodity position risk factors? If not, please provide details.

AFMA supports the provision of a standard risk factor for commodities that is more reflective of their actual risk in broad terms. The standard method factors proposed appear appropriate for this purpose.

However, we recommend that ASIC also consider the parallels with other risk-based capital regimes and allow appropriate netting of these exposures before applying the risk factors. Netting produces a more accurate result where risks offset each other.

To assist with accurate position calculation we would be pleased to work with ASIC to set a framework for how OTC commodity derivatives such as commodity swaps should be calculated.

Securities Capital Rules

C1Q1 Do you agree that the core capital requirement should be increased?

C1Q2 Do you consider that this proposal provides greater protection for retail clients?

C1Q3 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

C1Q4 Do you consider the proposed core capital requirement too onerous? If so, why?

C1Q5 What do you consider an appropriate length of time for market participants of securities markets to meet the minimum core capital requirement of $500,000?

C1Q6 Should ASIC instead introduce a two-tier core capital requirement that distinguishes between market participants based on the type of business being conducted (e.g. a $500,000 core capital requirement for market participants that hold client money, and a $250,000 core capital requirement for market participants that do not hold client money)?

AFMA agrees that after 17 years without indexation a revision of the capital requirements for securities market participants with a view to increasing in the minimum requirement may be appropriate.

AFMA members, given their typical size, are not affected by the proposed level of the new capital requirement. However, given it does create a barrier to competition in the markets, particularly for new entrants, we note the risks associated with the proposed increase.

Higher levels will inherently have benefits for orderly wind-ups and but these benefits are paid for in both direct and indirect costs to participants and investors.

In relation to the argument that additional funds will reduce the risk that a market participant will use client money to fund operating expenses, this activity is already illegal under the client money provisions. These provisions should provide an efficient way of preventing these practices and it may not be appropriate for the market to bear additional costs to further deter this already illegal activity.

While comparisons with other regulatory requirements, including those from other jurisdictions can be validly used to give greater confidence that appropriate levels are being suggested, the primary analysis should examine the question of appropriate levels for the inherent risks from first principles, and an analysis of any problems observed in practice. ASIC's calculations would benefit from such an approach.

Based on Figure 1 on page 13 of the report it appears ASIC proposes to make the capital requirement for Australia the third highest in comparable jurisdictions behind only Hong Kong and Singapore.

It appears to be over ten times the requirement in Canada, over five times higher than the UK requirement, six times higher than in Germany, and a little under four times higher than the US. It is not clear why this should be the case. If there are further experiences ASIC is drawing on for the proposed levels it would benefit the argument for these outcomes to be discussed.

We would encourage ASIC to ensure it gets the balance right between the levels required to protect the market and encourage competition.

Underwriting and sub underwriting risk requirement

> C2Q1 Do you agree that a market participant should hold additional capital if it engages in underwriting or sub underwriting activity? If not, please provide reasons.
>
> C2Q2 Do you consider our proposed underwriting and sub underwriting risk requirement adequately addresses underwriting risk? Does your business have alternative approaches to manage underwriting risk?
>
> C2Q3 Do you agree that a market participant need not hold additional capital if the underwriting or sub underwriting is fully sub underwritten or fully subscribed? If not, please provide reasons.
>
> C2Q4 Are you satisfied that our proposed underwriting and sub underwriting risk requirement adequately addresses the risk of regulatory arbitrage among entities that engage in underwriting/sub underwriting?

C2Q5 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

C2Q6 Is it sufficiently clear how the underwriting and sub underwriting risk requirement must be calculated?

AFMA accepts that it is reasonable to expect market participants to provide capital for underwriting risk. We recommend further calibration be done on the 5% to determine the appropriate magnitude of the underwriting risk requirement.

In regard to the timing of the start of the risk, we would like to confirm whether this to be at the start of the offering, after the book build and pricing.

C3Q1 Do you agree that a market participant should hold additional capital if it engages a sub underwriter? If not, please provide reasons.

C3Q2 Do you consider our proposed sub underwritten positions method adequately addresses the counterparty risk associated with sub underwriting? Does your business have alternative approaches for managing this risk?

C3Q3 Do you agree that the counterparty risk amount for a sub underwriting should commence at the time the sub underwriting commitment is entered into, and cease 31 days after the commitment becomes unconditional? If not, please provide reasons.

C3Q4 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

C3Q5 Is it sufficiently clear how the counterparty risk requirement using the sub underwritten positions method must be calculated?

With regard to sub-underwriting arrangements AFMA is of the view that a market participant should only hold capital if it has a legal obligation to settle on the sub-underwriter’s behalf in the event of the sub-underwriters default when it engages in a sub-underwriting arrangement.

If it is clear in the legal contract that a market participant does not have legal obligation to step in to settle on behalf of the sub-underwriter in the event that it defaults, then the market participant should not be required to take an additional capital charge for counterparty risk. To require capital provisions for the failure of sub-underwriters where there is no legal obligation would decrease the efficiency of sub-underwriting and increase costs to issuers and potentially reduce competition.

Where there is a legal obligation for market participants to step in then the proposed arrangements are appropriate to cover these risks.

Unusual or non-standard exposures—Credit derivatives

C4Q1 Do you agree that a market participant should be required to calculate a credit derivative-specific non-standard risk amount? If not, please provide details.

C4Q2 Do you consider that this proposal adequately addresses the counterparty risk of credit derivatives?

C4Q3 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

AFMA supports the introduction of a credit derivative specific weighting as a sensible amendment to the capital requirements. Further we suggest ASIC considers, consistent with other capital management regimes, allowing the netting of positions before application of the weighting. Netting provides a more accurate assessment of the inherent risks where positions offset each other.

Removal of risk calculation methods

C5Q1 Do you agree that reducing the number of risk calculation methods will make it easier to comply with the Securities Capital Rules? If not, please provide reasons.

C5Q2 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

C5Q3 Would you prefer ASIC to retain the existing risk calculation methods, or make further changes to simplify risk requirement calculations? Please give detailed reasons for your answer, and include in your response what risk calculation methods (if any) you consider can either be removed from the rules or simplified.

Generally, AFMA supports increased flexibility in the calculation of risk. We do not necesarily agree that removing options for risk calculations would make it easier for participants to calculate their risk as it would seem merely reduce their options. Guidance as to which methods are generally used and not used may be of more assistance in this regard. We are advised that the Equity Building Block method may still in use for some purposes, we suggest further dialogue on this point.

Furthermore, AFMA would support ASIC allowing the use of approved accredited internal risk models to calculate position risk requirements. As with the APRA framework this can lead to significant efficiencies, particularly in larger firms that have a greater variety of exposures, while maintaining appropriate and consistent risk management.

Amended counterparty risk requirement

> C6Q1 Do you agree that margined equities, debt instruments and warrants should be subject to the non-margined financial instruments method? If not, please provide details.
>
> C6Q2 Do you agree that where an initial margin isn't charged (or where the initial margin is low) that the counterparty risk amount should be the potential credit exposure factor in Table A5.2.2?
>
> C6Q3 Do you consider that this proposal adequately addresses counterparty risk?
>
> C6Q4 Is it sufficiently clear how the counterparty risk requirement must be calculated?
>
> C6Q5 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

AFMA supports the wider availability of the non-margined financial instruments method to margined equities, debt instruments, and warrants.

We seek clarity on the definition of margined *equities*. The ASIC Market Integrity Rules refers to margined *financial instruments* which is usually understood to include futures and exchange traded options.

Requirement to report a net asset balance of zero or lower
Reporting requirements of 'partnership' market participants
Aged debtors report
Updated accounting terminology
Amended definition of 'Liquid'
Amended definition of 'Qualifying Debt Instruments'
Updated recognised market indexes table
Updated recognised regulator tables

> C7Q1 Do you agree that market participants with negative net assets should be required to lodge daily returns with ASIC? If not, please provide reasons.
>
> C7Q2 Do you consider that this proposal will help ASIC to identify liquidity and solvency issues in a more timely manner?
>
> C8Q1 Do you consider that market participants that are partnerships should largely be required to comply with the same requirements as other market participants? If not, please provide reasons.
> C8Q2 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

C9Q1 Do you agree that a market participant should be required to disclose its aged debtors to ASIC? If not, please provide details.

C11Q1 Do you have any comments on our proposed amendments to the definition of 'Financial Asset Revaluation Reserves' or 'Future Income Tax Benefit'?

C12Q1 Do you have any comments on our proposed amendment to the definition of 'Liquid'?

C13Q1 Do you have any comments on our proposed amendment to the definition of 'Qualifying Debt Instruments' or our proposed definition of 'Credit Rating Agency'?

C14Q1 Do you agree with the inclusion of Euronext 100, NZX 50, FTSE STI and KOSPI 200 in our list of recognised market indexes? If not, please provide details.

C14Q2 Are there any other market indexes that you believe should be recognised by ASIC?

C15Q1 Do you agree with our proposal to increase the number of recognised financial regulators? If not, please provide details.

C15Q2 Are there any other financial regulators that you believe should be recognised by ASIC?

We note no comments.

Removal of subordinated debt from core capital calculation

C10Q1 Do you agree that approved subordinated debt should not be used to meet the core capital requirement? If you disagree, please provide reasons.

C10Q2 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).

C10Q3 Do you think a 24-month transitional period would give sufficient time to comply with an increased core capital requirement?

It is common practice that subordinated-debt is not considered a part of core capital given its level of seniority at repayment.

Given the importance of subordinated debt to managing capital requirements we seek confirmation from ASIC on the usage of core capital in the rule. Specifically we seek assurance that the usage of core capital will be limited to a minimum capital assessment, and there are no other financial or risk requirements for which it will be used as a measurement.

Subordinated debt allows a flexible and efficient way to adjust required capital levels to align with market usage demands. It can often be arranged within hours versus weeks for equity. Any requirement to exclude subordinated debt from total capital requirements would greatly reduce the efficiency of capital arrangements required by firms. AFMA supports, as we understand is consistent with ASIC's drafting, that subordinated debt continue to be allowed for the regulatory capital requirement of total liquid capital and all other non-core capital metrics.

Liquidity requirements

> D1Q1 Do you agree with our proposal to impose liquidity requirements on market participants? If not, please provide detailed reasons explaining why not.
>
> D1Q2 Do you consider our proposals adequately address the liquidity risks likely to be faced by market participants? Does your business have alternative approaches for managing liquidity risk?
>
> D1Q3 What impact would this proposal have on your business? Please include any benefits or costs (in dollar terms) associated with the proposal (as a one-off benefit or cost, and on an annual basis).
>
> D1Q4 Are the proposed liquidity requirements sufficiently clear? Do you consider that additional guidance is required?

Given the critical nature of liquidity to ongoing business viability AFMA agrees with the principle that market participants should maintain a plan that outlines liquidity requirements expected to arise over the coming twelve month period as part of their liquidity management framework in a normal or business as usual environment.

We further believe that such a plan should consider whether a market participant has sufficient liquidity or access to sufficient liquidity to address expected changes in their business strategy, financial circumstances and business plans. If a change to a market participant's business strategy, financial circumstances or business plans is expected, management should ensure they have a plan of action to address liquidity requirements associated with these changes.

However, we would not support the view that this outcome can be best achieved by production of cash flow estimates over such an extended period, particularly given the variability in liquidity demand generated by the settlements process.

Market participants operate in a market governed by a T+2 settlement cycle and settlement requirements typically represent a significant portion of a market participants' liquidity requirements and liquidity risk. Consequently, a cash flow projection by a participant in a normal or business as usual scenario only provides an accurate representation of the participant's liquidity requirements in the near or short term. As the projection becomes less and less accurate over time estimates at the twelve month mark are likely to be of very limited utility.

Operating expenses and other ongoing costs can be accurately projected over a longer time horizon. But total overall liquidity requirements, as a result of the demands of market and settlement activity cannot be accurately projected.

As a result, we propose market participants to be required to draft and maintain 12-month liquidity plans that cover and consider expected changes to a market participants' business strategy, financial circumstances and business plans, as well as sources of liquidity, as opposed to a cash flow projection which will become less accurate over time.

AFMA also raises concerns in relation to the proposal to require the projection of cash flows to be approved at least quarterly by the board of directors of the market participant. As we have noted cash flows are highly variable in the context of market participant businesses due to the financial demands of market participation. Predictions of cash flows in such an environment are inherently difficult and even medium term predictions are likely to be incorrect even where appropriate methods have been used with due care and diligence.

Boards play important governance roles in relation to companies. This governance role acts as a check on the actions of senior management, including the oversight of budgets and signing off on annual reports which are independently audited. It is important however, that it not distort over time into a management role. Boards are not equipped to undertake management calls or to confirm their accuracy and to require them to do so without independent points of reference may be counterproductive.

For Boards to approve management forecasts would require either shadow management of the company to determine the accuracy of the estimates or independent verification by external audit. Neither of these options is likely to be appropriate on a quarterly basis given the governance role Boards properly exercise, or efficient particularly given the frequency.

Annual approval of the liquidity plan we propose above by Boards would be more workable and could be rolled in with Annual Report preparations which include external audits. This annual approval would be consistent with ASX requirements.

Authorised deposit taking institutions exempt from complying with ASIC's capital requirements for market participants

> D2Q1 Do you agree with our proposal to exempt market participants that are also authorised deposit taking institutions from complying with the Securities Capital Rules and the Futures Capital Rules? If not, please provide detailed reasons explaining why not.

AFMA agrees with this proposal.

Further to this, AFMA requests that ASIC consider extending the ADI exemption to include additionally a non-operating holding company of an ADI (NOHC) and its subsidiaries. This is because an entity

authorised by APRA under the Banking Act as a NOHC is subject to risk-based capital requirements approved by APRA that apply to the whole of the corporate group.

Obligation to notify ASIC in relation to other capital requirements

> D3Q1 Do you agree with our proposal to require market participants to notify ASIC in relation to other capital requirements? If not, please provide detailed reasons explaining why not.

We note no comments.