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FMI Regulatory Reform Consultation Submissions
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Reserve Bank of Australia
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Financial Market Infrastructure Regulatory Reforms

Dear Consultation Team

The Australian Financial Markets Association (AFMA) is making comment on the consultation paper by the Council of Financial Regulators (CFR) on Financial Market Infrastructure Regulatory Reforms (CP).

1. Purpose of Regulatory Reform

These comments start on Chapter 2 dealing with the revisions to regulatory powers covering a range of licensed entities. The proposals are seen as significant reforms and there is concern that the CP does not analyse more deeply the changing nature of Financial Market Infrastructure (FMI) and the why and how it is being regulated. The CP relies too much on derivative predecessor justifications without pulling the elements into a coherent regulatory picture for going forward. AFMA is not suggesting that the reform proposals are necessarily wrong but that the case for change has not been sufficiently made out and a more fundamental analysis is required to provide signposts for the future.

The documentation produced by the CFR is viewed by the industry as foundational strategic thinking by the authorities on a collective basis. It is desired that the final proposals to the Government on regulatory reform in this area lay out basic policy thinking on FMI at this time, explain why current regulatory arrangements are failing to the extent that justifies change to the law, and indicate how these changes are seen serving into the future in a rapidly changing technology and investor needs environment. This analysis should be community directed and not focused on matters of administrative convenience as regulation serves the community not the regulators.

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AFMA is concerned with two main aspects of the presentation of arguments in Chapter 2 of the CP. The first relates to the justifications and rationalisations for the restructure of supervisory powers which is presented purely from the view point of convenience for administration of licensed entities not what benefits this may bring to those entities, investors and other users and the economy more broadly. The second is with the lack of consideration to the expanding concept of financial market infrastructure and how aspects of the current arrangements do not serve market needs with regard to the nature of supervision powers, along with the lack of differentiation and attention to the new types of licensed entities such as benchmark administrators

It is suggested that the CFR should provide in its final policy document, analysis to support its proposals which:

- Identifies the functions undertaken by the FMI categories.
- Specifies the goals of regulation.
- Evaluates whether the FMI has the incentive to deliver the specified regulatory objectives.
- Assess which types of regulatory intervention in the FMI governance will best achieve the regulatory objectives.
- Assess whether a given regulatory intervention in FMI governance will promote market efficiency.
- Integrate into the new regulatory structure a range of previous policy statements[1] on FMI into a coherent whole.

1.1. Concept of Financial Market Infrastructure

The concept of financial market infrastructure is a relatively recent one, having come into vogue over the last twenty years and is expanding in scope. The idea started with identifying trading venues for market participants to transact with one another in an efficient manner in the form of stock exchanges along with their clearing and settlement systems as foundational economic infrastructure that allows activity to place and expand, in the same was as transport links and energy utilities do. Since 2008, there has been expanding recognition of other systems as fundamental to economic functioning, notably central counterparties (CCPs), other financial product trading platforms, payments systems, trade repositories and most recently benchmark administrators. By their nature they provide fundamental systems upon which economic activity depends. Financial market infrastructures operate at the heart of the financial system and contribute to its good functioning and hence are often ‘systemic’.

The central position in the financial ecosystem means that FMI often concentrate a number of risks, which rationalises the need for more intense regulation. These risks include:

[1] For example, Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities’ (July 2012 CFR paper), as well as other foundation policy guidance documents relied upon in the CP.

- Settlement (or financial) risk, which be divided into credit risk is the risk of loss stemming from a counterparty's failure to meet its contractual obligations at the specified date or in the future; and liquidity risk where a participant in an infrastructure has insufficient funds or securities to meet, partially or wholly, an obligation at the specified date, even if the participant is not insolvent.
- Operational risk, which is the risk of a loss resulting from inadequate or failed internal processes, people, systems or external events.
- Legal risk which is the risk of a loss resulting from an unpredictable or ambiguous application of a law or regulation, or from a situation where it is impossible to execute a contract.
- Systemic risk, which is the risk that a particular event affecting the infrastructure, resulting notably from a financial or operational risk, leads by a chain reaction to significant disruptions on all financial markets that are liable to produce nearly simultaneous large adverse effects on the economy more generally.
- Cyber risk, which used to be part of operational risk but given the heightened external threat profile is becoming treated increasingly as a separate key risk category.
- Market data risk, the markets are highly dependent on timely data flows, so data collectors, disseminators and repositories need to be able to maintain their services at a high level of reliability.

The CFR should address the expansion of the FMI concept. This is important because the notion of what is FMI is expanding, for example benchmark administrators only became a regulatory concept five years ago. The CP focuses on ASIC administrative powers for Australian Market Licensee (AML) and Clearing and Settlement Facility Licensee (CSFL) and makes incidental references to Derivative Trade Repository Licencee (DTRL) and Benchmark Administrator Licencee (BAL) as needing to be treated in the same way. It is incumbent on those advocating reform to explain the regulatory impact and justify its costs and benefits across the different categories of FMI which are quite different in nature and function.

In addition, the concept of FMI may continue to expand and could be envisaged in the future to extend to other information technology systems. For example, in European fixed income markets we see Information Networks (INs) – providing sourcing and aggregation of liquidity. IN firms provide an aggregation layer, that offers the trader two key sets of functionality: a global view of liquidity and a choice of trading protocols and execution mechanisms from which to select. The trader uses this layer to obtain an accurate, timely view of available liquidity across markets. INs use a high degree of technology embedded in buy‑side and sell‑side's internal systems. Another one is consortium‑owned networks between buy‑side and sell‑side. These are collaborative efforts between the buy–side and sell–side, where market participants come together to attempt to create liquidity in the bond markets. These collaborative based firms use open standard technology, allowing participating sell‑sides to send pre‑trade indications to their clients (asset managers) across the network. Consortium networks provide flexibility of connectivity options. The buy‑side can receive pre‑trade indications from multiple banks in a standard format using a single connection. AFMA does not advocate that the concept of FMI should be extended to such things but merely makes the point the increasing use of information technology networks means that more and more elements which are in the nature of infrastructure are being introduced into financial markets.

As the makeup of FMI grows less of it will be necessarily systemic in character. For example, many AML are not systemic calling into question ministerial decision making in their supervision. It would be beneficial for the CFR to explain now the conceptual framework for deciding what is FMI and whether the regulatory intensity should be modulated with regard to the systemic importance of the FMI.

1.2. Moving on from last century

The drafting of the Corporations Act with regard to financial market licenses (AML) and Clearing and Settlement Licences (CSL) reflects pre-FMI thinking from 30 years ago. Discussion at that time was about which function in the regulatory process, should govern which areas of activity and the types of participants in the market, and to which institutions the regulatory functions should be allocated. The current law arose out of the debates at the time over who should regulate what. A fundamental question concerning any regulation is whether it is necessary, or conversely whether market forces can deliver the desired objective without regulatory intervention. Policy debate at the time was dominated by the demutualisation of the ASX and its role as a Self Regulatory Organisation (SRO). A demutualised SRO exchange was seen as having to manage conflicts when it acts in the interests of shareholders at the expense of undertaking its regulatory duties to the investing public. A for-profit exchange was thought to be more sensitive to the needs of its shareholders than its customer, the market participants. This focus and lack of real competition to enable market force moderation meant that regulatory intervention was justified from a policy perspective so that the law gave special prominence to that one exchange, its systems like CHESS and its ownership control. The 2001 Financial Services Reform changes to Chapter 7 of the Corporations Act went a considerable way down the road to making AML regulation competition neutral but there remained a number of artefacts which singled out the ASX for special treatment. The eventual transfer of market supervision to ASIC was an important milestone in policy thinking as it indicated the SRO model was no longer considered suitable for Australia.

In the past, trading a specific security in a single venue generated economies of scale and network externalities that caused stock exchanges to be considered as natural monopolies sustained by regulatory advantages. However, technological advances are challenging the paradigm; notably, information technology that makes the geographical allocation of a trading venue less important and information technologies that have drastically decreased costs and time required for processing and disseminating large amounts of information, such as orders and quotes.

Financial markets have changed significantly in that last twenty years and are likely to continue change in the future with technological advances. Declining economies of scale, increasing standardisation and commoditisation, and falling up-front costs should result in more competition, better services and lower costs for consumers.

The role of the Minister in making approval decisions about individual FMI needs to be considered in the context of where we are moving away from an environment where FMI is synonymous with a single large piece of vertically integrated national infrastructure to a world of fragmented trading venues with their related CSD and data services. The question that should be addressed is whether the policy thinking from last century that a decision regarding individual financial markets with SRO responsibilities was a matter of national policy importance that justified a ministerial decision is applicable in the contemporary environment where trading venues and supporting infrastructure multiply but are of lesser individual systemic importance and the volume and need for timely decision-making is increasing.

1.3. Reform should improve regulatory efficiency and avoid the unintended

The economic role of the financial markets is to channel capital resources or savings to those who will make the best use of them and in this regard the markets will theoretically ensure that there is the least-cost transfer of financial resources from those with a surplus of funds to those that can use them more productively, and also the enhancement of the risk-bearing capacity of the economy as well as ensuring that funds flow to the highest value.

In the regulatory reform debate the costs of reform and ongoing compliance are ignored or dismissed as being easily outweighed by the perceived benefits. Analysis in terms of divergences between private interests and public policy concentrates attention on particular deficiencies in the system and inclines the policy maker to the view that any measure which will remove the deficiency is necessarily desirable. It diverts attention from those other changes in the system which are so often associated with the corrective measure, changes which may well produce more harm than the original deficiency. To illustrate this point, a European example is presented, which was chosen because it raises no current contentious issues from an Australian perspective and so can be discussed from a neutral standpoint.

The Tale of Market Data Cost

Market data contains information indispensable for financial market participants to carry out their core business. Data on bids, asks and last traded price for financial securities (such as equities, fixed income, derivatives and currencies) enables security dealers to decide on which instruments to buy, together with where and when to buy them. Trading venues have a monopoly on the market data generated on their trading platform. This provides the major trading venues with extensive market power in selling their market data. Consequently, without effective regulation in place, there is a risk that trading venues will exploit the situation and charge market data fees significantly above the costs of producing such market data.

MiFID I, which entered into force in 2007 – contained a clause that market data should be provided on a "reasonable commercial basis". This was confirmed in MiFID II/MiFIR6 with a delegated regulation to MiFIR stating that market data fees should be set with a "reasonable relationship to the cost of producing and disseminating that data". To this point all is well.

The policy lesson lies in what happens next. Aspects of MiFID II/MiFIR work unintentionally in the opposite direction to increase market data costs. Primarily because the “best execution” requirement in MiFID II establishes by law the need for security dealers to obtain market data from trading venues. This gives trading venues an even stronger market power, which can further push up market data costs. MiFID II also requires many security dealers to establish themselves as a so-called Systematic Internaliser (SI), which the trading venues are using as an occasion to significantly increase market data fees.

Market data are generated through the trading and execution activities at the trading venues, and market data can be regarded as a by-product of those activities. In other words, it is not possible to execute trades at the trading venues without at the same time creating the raw data that form the basis for selling market data. In this sense, direct costs of distributing raw market data should be a relatively low-cost service. Furthermore, radical improvements in digital technologies should have put market data fees on a downward trend.

Since MiFID I was implemented in the mid-2000s, market data fees have soared. This is despite a heavy cost reduction in the underlying technology used, e.g. the cost of transmitting 1 Mbps is today around 1/20 of the cost in 2008.

The consequence of high data fees is that security dealers provide limited access to view market data for investors, both retail and institutional. This makes the investment decisions of investors less informed and in general hamper the intentions in MiFID II/MiFIR to increase financial market transparency. Security dealers themselves try to cut back on their use of market data by limiting the number of employees having access to market data. These cutbacks are costly to implement, give rise to less informed traders and analysts and are entirely unproductive as the marginal costs of distributing the market data within a security dealer are close to zero. Limitations in market data can give rise to less efficient financial markets, including less efficient pricing of securities, more volatile and less liquid markets, as well as higher cost of capital for SMEs. The mirror to this is a lower risk-adjusted return for retail or institutional investors such as pension funds.

The case for regulatory intervention rests on the premise of correcting instances of market failure. Regulation should only modify market freedom where there are clear regulatory objectives and the benefits of intervention outweigh the costs. The Australian investment industries are major drivers of innovation and competition which, in turn, contributes to Australia’s economic development. Market regulation should facilitate the development of new products and promote competition between market providers and participants. Markets and participants benefit from fair and efficient trading environments. To this extent, internal market structures and mechanisms have developed to enhance market efficiency and integrity. For example, clearing and settlement systems were developed by markets themselves in order to promote efficient trading practices and to reduce risk. Regulation should recognise, support, and if necessary, build upon pre-existing internal market structures. For example, regulation should promote market stability by ensuring appropriate clearing or other contract protection arrangements apply to securities and derivatives markets.

Regulation should be applied consistently and fairly across the marketplace as a whole. There should be minimal barriers to entry and regulation should not restrict innovation. Advantages should not be conferred on particular market structures or products unless there is a clear regulatory justification. The regulatory framework should also avoid creating regulatory distinctions which have no sound policy justification, and which may result in the structuring of products or services in order to take advantage of a particular regulatory regime.

Technological development is one of the most pervasive influences over the continuing evolution of the financial system. Markets will continue to face challenges presented by technological developments, financial innovation and interaction with global markets. The regulatory framework needs to be sufficiently flexible to permit market participants to respond to inevitable change in an innovative, timely and sensitive manner. Financial market regulation should not be structured around particular financial products, institutions or services as innovation coupled with technological development will quickly overtake structures which are considered appropriate in the current business environment. Financial innovation and the evolution of market structures is best left to the market itself, provided that transparent regulatory standards are satisfied.

The generic costs associated with regulations are many and varied. Some of the more obvious costs for businesses include the paper burden or administrative burden from complying and reporting on particular requirements, complying with standards, licence fees and other charges levied by governments, charges likely to be required in production, transportation and marketing procedures, shifts to alternative sources of supply and delays to the introduction of services in demand into the marketplace or, alternatively, restrictions on service availability, with consequent competition implications. The length of time required to approve licensed market rule changes for new product offerings is a case in point.

Consumers will be adversely affected by regulations to the extent that they will often pay higher prices for goods and services, face a reduced level of quality and choices, experience delays in the introduction of goods into the marketplace and restrictions in product availability and expensive or complicated redress. There are also costs for government from introducing new regulatory processes or amendments. These costs are a result of the numbers and level of staffing, salary costs, costs of other relevant items such as any special advertising, accommodation and travel and, finally, enforcement costs. In the case of Australian financial market regulation these are passed on directly to investors and consumers of financial products.

There is the argument that it is important to have stringent laws in order to improve the confidence of overseas market participants who will then feel comfortable investing in the Australian economy. This has validity only to a certain point. Overseas investors are also bound by the financial market regulation and bear a portion of the associated regulatory costs. Overseas investors seek stable and predictable markets on a globally comparative basis. The costs associated with rulemaking are an important parameter of international competitiveness, as regulatory machinery that imposes comparatively high costs will tend to delay the introduction and implementation of new technologies or adaptation to the consequences of their implementations. Such delays may well cause the diversion of business to a more agile investment centre.

For overseas investors Australia is not an essential financial market venue like London. There is a need to keep costs proportionate to the lesser volumes and complexity of the markets here to make it worthwhile to participate in them. If the regulatory costs flow through into Australia's economic performance then the performance of the financial products acquired by the overseas investors will be similarly affected.

Consumers of financial services are vitally interested in all embedded costs, a large proportion of which are now the result of government regulation, which make up the price they pay for a service. Regulators commonly completely discount the cost impacts on regulated entities from addressing regulatory requirements and focus on purely their own organisational resource demands, as exampled by the ASIC cost recovery regime. It is, therefore, important to show that changes in regulatory arrangements will improve overall efficiency by reducing regulatory costs. An important way to demonstrate this is by showing that lengthy licensing approval processes, which are a common source of industry frustration, should be more efficient as a result of the reforms.

2. Overseas entities – requirements to be licensed

In relation to the proposal to extend the requirement for overseas market operators to be licensed or exempt, the Council is reminded of the principles restated in the June 2019 IOSCO Report on *Market Fragmentation & Cross-border Regulation*. The report makes note, in particular, of fragmentation with regard to FMI. The report raises concerns over the lack deference: where authorities in certain jurisdictions have decided not to, or are prohibited from, using tools that allow them to defer to home jurisdictions, firms that conduct cross-border business may be unwilling to subject themselves to different types of rules and may therefore withdraw from certain markets, resulting in market fragmentation. Australia is singled out in the report for specific criticism over ASIC's foreign financial service provider proposals, which is illustrative of the range of practical problems, such as with tax status, that arise when Australia seeks to license service providers not operating here.

3. Widely held market body – declaration power

Section 2.6 of the CP proposes that the Minister approve increases in voting power in the ASX Limited or a widely held market body above 15 per cent

It is queried as to why this proposal to amend the law does not consider rationalisation of the law and alignment or alternatively substitution with the *Financial Sector (Shareholdings) Act 1998* (the FSSA)? The FSSA was amended in 2018 to increase the ownership limit from 15% to 20%, that can be sought in a financial sector company without having to seek approval from the Treasurer; and a new streamlined FSSA approval path for owners to hold (or invest) more than 20% in a new or recently established financial sector company provided the investors meet a "fit and proper" test and comply with asset requirements and ongoing conditions.

The increase of the shareholding threshold to 20% brought the FSSA in line with the *Foreign Acquisitions and Takeovers Act 1975* (FATA) as there was no real policy rationale for the discrepancy between the FSSA and the FATA, and consistency simplified investment (and approvals) in Australia's financial system.

The current specific referencing of the ASX in the law and the stand alone provisions for shareholding approvals in declared widely held market bodies presents an anachronistic administrative mechanism.

4. Crisis management and resolution

4.1. General support

AFMA has previously stated general policy support for the crisis management and resolution regime outlined in the *Resolution Regime for Financial Market Infrastructures* consultation paper of February 2015 (FMICP 2015). We also note reforms brought about by the *Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018* which augmented APRA's crisis management powers. General alignment of the crisis management toolkit for Domestic CSFL with those for prudentially regulated APRA entities is a sensible development.

Given the systemic importance of the proposals for crisis management further clarity regarding the resolution power is desired. Questions such as whether:

i) Will it be the intention for the RBA to provide liquidity for ADIs to be made available during the resolution period? If so, will this be by way of providing surplus liquidity via RBA-eligible collateral?

ii) If the intention is for the RBA (or its resolution authority) to step in to ensure payment systems stay open, will it stand between the Domestic CSFL and its members?

4.2. Conditions for resolution – Section 4.7

It is proposed that the regime will not contain specific conditions to select between resolution powers. Instead, once a general condition is satisfied, a range of resolution powers will be enlivened. Particular powers may have additional specific or alternate conditions.

AFMA considers that further detail on the conditions that should be satisfied before the resolution authority is permitted to exercise its resolution powers should be provided. Given that this proposal departs from the FMICP 2015, additional detail should be provided about this, beyond reference to general conditions relating to solvency and viability.

4.3. Transfer powers – Section 4.9

It is proposed that the resolution authority have the power to transfer the shares of a Domestic CSFL.

It is essential for members of CSFLs that this proposal addresses the need to avoid disruption to netting sets, or separation of collateral from associated positions.

4.4. Statutory management - Section 4.10

It is proposed that the resolution authority may appoint a statutory manager to a related body corporate of a Domestic CSFL where necessary for the effective resolution of the Domestic CSFL.

In relation to such an appointment what additional oversight will there be from the RBA with respect to the exercise of statutory powers by the statutory manager? Will any decisions made by the resolution authority with respect to powers of the statutory manager also be subject to a merits review by the AAT?

4.5. Stays

Close-out netting

Attention to the effect of proposed amendments on close-out netting is requested. Section 14(3) of the *Payment Systems and Netting Act 1998* (Netting Act) provides that section 14(1) and section 14(2) have effect in relation to a close-out netting contract "despite any other law (including the specified provisions)", but subject to any specified stay provision that applies to the close-out netting contract. A specified stay provision which applies to a close-out netting contract will prevent the contract or a counterparty from closing out transactions relating to the contract on the grounds specified in the relevant specified stay provision. However, a specified stay provision does not prohibit a counterparty from closing out transactions under a close-out netting contract for any other reason.

The "specified provisions" definition is a list of the provisions of other laws over which the Netting Act prevails and is inserted for transparency and ease of reference. The term "specified provisions" includes the references to sections of the Banking Act, Insurance Act and the Life Insurance Act. These provisions were included to clarify that the protections afforded in the Netting Act prevail over the regimes set out in those Acts which allow for counterparties under a contract with a body corporate to be relieved of their obligations under that contract if the body corporate is prevented from fulfilling its contractual obligations because of a specified direction under the nominated APRA regulated entity acts. The effect being that the counterparty can close-out transactions under the contract, rather than being merely relieved of their obligations under the contract.

It is presumed and requested that the drafting for the Domestic CSFL stay provision will include an analogous coverage as a “specified provision” under the Netting Act.

Insolvency law – ipso facto clauses

In 2018 there were amendments made to insolvency law provisions of the Corporations Act relating to ipso facto clauses. An ipso facto clause entitles a party to immediately terminate or exercise another contractual right under a contract on the occurrence of an Insolvency Event. The entitlement of a counterparty to rely on an ipso facto clause to terminate a contract may deprive a company of any prospect of economic recovery. The reforms in general stayed the enforcement of contractual rights triggered upon the entry of a corporate counterparty into certain restructuring and insolvency processes. However, importantly certain types of contract, including debt and equity capital markets contracts, securities financing transactions, and derivatives, as well as certain contractual rights, including rights of set-off and netting were excluded from the stay.

How is the stays proposal to be reconciled with the general insolvency law exclusion of these financial contracts?

4.6. Cross-border issues - Section 4.15

How will the resolution authority apply to overseas CSFLs who are not licenced to operate in Australia, but with whom Australian ADIs may have Regulator approval to participate in their services? AFMA has members which are in the process of applying for membership of clearing houses that are not licensed in Australia, but who hold licences in overseas jurisdictions. In what manner and to what extent will Australian regulators “support” overseas resolution regimes when there are gaps between Australian regulatory obligations and those of overseas jurisdictions?

Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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