Resolution Regime for Financial Market Infrastructures

ASX Submission

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Executive Summary

ASX welcomes the opportunity to comment on the Australian Government's legislative proposals for a resolution regime for financial market infrastructure ("FMI resolution regime"). As the operator of critical market infrastructure for Australia's financial markets ASX is a key stakeholder. ASX strongly supports implementation of an FMI resolution regime.

ASX recognises that a well designed FMI resolution regime is critical to maintaining and enhancing Australia's reputation for safe and well regulated markets. It also highlights the importance of the operating rule frameworks which central counterparties in G20 markets are developing to improve the resilience of those institutions to unforseen financial shocks.

ASX is at an advanced stage of developing recovery rules for its clearing houses, in consultation with customers and regulators. An FMI resolution regime completes the regulatory framework to provide Australia's regulators with contemporary tools for managing the ongoing viability of critical market infrastructure in situations of major financial distress.

ASX broadly supports the proposals in the Consultation Paper. Our submission raises some key points of principle in relation to the legislative proposals set out in section 1.2 of the Consultation Paper. Attachment A provides a number of suggestions for clarifying the legislative proposals and responds to the specific consultation questions.

Points of Principle

Institutional Scope and Resolution Authority

The failure of a systemically important clearing and settlement (CS) facility could cause significant disruption to the functioning of the Australian financial system, even if it lacks the level of domestic connection that would require domestic licencing and supervision. The effect of the legislative proposals appears to be that Australian regulatory agencies have no resolution powers over the local operations or assets of a licensed offshore CS facility other than to support a resolution carried out by the foreign home authority.

ASX believes there is a strong case for the Australian resolution authority to have statutory powers with respect to the local operations and assets of a licensed offshore CS facility. This will enable Australia's regulators to act to protect Australian interests or financial system stability if needed. If Australia's regulators do not have these "reserve powers", and rely on cross-border "crisis management groups" or co-operative arrangements, ASX believes that they are giving up regulatory influence that may be needed in a financial crisis.

While a cooperative cross-border solution should always be the first priority of the Australian resolution authority, ASX submits that the foreign home authority's proposed resolution actions should be evaluated by Australian authorities, found to be fair to Australian creditors and unlikely to adversely affect Australian financial system stability. The Australian resolution authority should be empowered, if needed, to take measures on its own initiative where the foreign home authority is not taking action, or acts in a manner that does not take sufficient account of Australian creditors' interests or the need to preserve Australia's financial stability. This would be consistent with the Financial Stability Board's Key Attributes for Effective Resolution Regimes.

ASX submits that a graduated approach to resolution powers addresses these matters. Under this approach the Reserve Bank, as the Australian resolution authority for all licensed CS facilities, would have:

- in relation to licensed domestic CS facilities, the full suite of resolution and directions powers canvassed in the Consultation Paper;
- in relation to licensed overseas CS facilities, powers:
    1. either to support a resolution carried out by a foreign home authority or to take measures on its own initiative where the home jurisdiction is not taking action, or acts in a manner that does not take sufficient account of Australian creditors' interests, or the need to preserve Australia's financial stability;
    2. to manage and deal with the licensee's operations and assets located in Australia for either of the purposes described in 1 (for example, by ordering a transfer of property located in Australia to a bridge institution established by the foreign home authority);
    3. to issue directions to the licensee's personnel located in Australia for either of the purposes described in 1 (for example, by directing that personnel are not to act in a way that assets of the licensee cease to be under the control of the licensee's Australian operations).

It is important to ensure that disclosure to Australian users of licensed offshore CS facilities is clear on the potential for different resolution processes and outcomes. They should be properly informed up-front, in a manner approved by the Reserve Bank, that the Reserve Bank will not be the resolution authority for the facility in the event of its failure, and that the foreign resolution regime to which the facility would be subject may result in different outcomes for the user than if the facility had been subject to resolution by the Reserve Bank. This would align with the disclosure which a foreign ADI is required by the Banking Act to make to an Australian depositor, namely that the foreign ADI is not subject to the full suite of APRA's statutory management powers. Up-front and clear disclosure of this nature is essential if the direct and indirect Australian users of licensed offshore CS facilities, including Australia's four largest banks and, increasingly, major Australian investment and superannuation funds, are to make fully informed decisions about the implications of where they acquire central clearing services.

Resolution Powers

A guiding principle in the exercise of resolution powers must be that the resolution authority will adhere to the loss allocation and other recovery related powers in the central counterparty's operating rules. This is critical to the preservation of commercial certainty for participants and their clients as consumers of central clearing services. Market confidence in a central counterparty could be undermined by a resolution regime which empowered a resolution authority to step in and re-write the operating rules on the allocation of losses or liquidity shortfalls, in the event the central counterparty should enter resolution. ASX welcomes the Consultation Paper's acknowledgement of the centrality of this principle and looks forward to this being reflected in the draft resolution legislation.

Safeguards and Funding Arrangements

Immunity from liability for those acting pursuant to the directions of the resolution authority is an integral part of the resolution regime. As directors' statutory duties may constrain the ability of an FMI's directors to exercise recovery powers fully, or the ability of related entities' directors to continue providing support services to the FMI through recovery and resolution processes, immunity should extend to the FMI (even if it has not yet entered resolution), its related entities, and managers, directors and officers of the FMI and its related entities. This protection will give the FMI's own recovery plan the best chance of maintaining the continuity of critical services.

International Cooperation and Supporting Requirements

The regime proposal provides that the Australian resolution authority will be empowered to support the resolution of a licensed offshore CS facility by the foreign home authority. As explained under "Institutional Scope and Resolution Authority", the Australian resolution authority should have a positive obligation in every case to first evaluate the fairness of the foreign resolution procedures to Australian creditors' interests and the impact of those procedures on Australian financial system stability. The final decision on recognition of foreign proceedings should be made by an Australian Court, aided by submissions of the Australian resolution authority.

Directions Powers

ASX supports the Government's proposals for enhanced directions powers and sanctions. The incentive effect of strengthened sanctions will be maximised if coupled with comprehensive statutory immunity for directed persons and entities.

Attachment A – ASX's response to Consultation Questions

Consultation Questions

Institutional scope

1. Do you agree with the proposal that all CS facilities that are incorporated in Australia and hold a domestic CS facility licence should be potentially within the scope of the resolution regime and that a judgement would be made at the point intervention was being considered as to whether to exercise resolution tools or to leave the distressed CS facility licensee to be dealt with under the general insolvency regime?

Yes. All CS facilities that are incorporated in Australia and hold a domestic CS facility licence should be subject to the FMI resolution regime.

As one of the primary objectives of the FMI resolution regime is to avoid the uncertainty and delay associated with the general insolvency regime, it is difficult to imagine circumstances where it would be preferable for regulators to allow a distressed FMI to be dealt with under the general insolvency regime rather than to exercise resolution tools.

2. Do you agree with the proposal to introduce enforceable commitments and a new category of licence conditions to support the influence of Australian regulators and resolution authorities over cross-border CS facilities?

Yes. ASX supports this proposal. Please also refer to our comments in Points of Principle: Institutional Scope and Resolution Authority.

3. Do you have any comment on the proposed power for the Minister to require a licensed overseas CS facility that is systemically important with a strong domestic connection to transition to a domestic licence?

ASX understands that CFR agencies have balanced a number of competing considerations in reaching the conclusion that an offshore CS facility licensee should be required to incorporate in Australia and obtain a domestic licence (i.e. is subject to 'location requirements') only if it is systemically important to the Australian financial system and has a sufficiently strong connection with the domestic economy ('domestic connection'). Those competing considerations include the implications of location requirements for Australian regulators' influence, market functioning, and the choice and costs of clearing arrangements available to participants. In short, CFR agencies have balanced the benefits of enhanced regulatory influence against the costs of location requirements, and determined that systemic importance and domestic connection represent the appropriate point at which to apply location requirements.

The lack of a sufficiently strong domestic connection on the part of an offshore CS facility licensee means that it can provide central clearing services in Australia from offshore. This does not mean that the facility has no connection with the Australian economy at all, or that the failure of the facility could not cause significant disruption to the functioning of the Australian financial system. CFR agencies' characterisation of LCH.Clearnet's SwapClear service as lacking a strong domestic connection, illustrates why 'domestic connection' is not the only indicator of a CS facility's capacity to cause significant disruption to the functioning of the Australian financial system in the event of its failure. CFR agencies' characterisation was based on the international nature of the OTC markets served by LCH.Clearnet, the largely international nature of its participant base, and its multicurrency service offering.[1] None of the considerations set out by CFR agencies that are relevant to the strength of the facility's domestic connection directly addresses the potential for the failure of LCH.Clearnet, or of the SwapClear service in particular, to cause

[1] *Application of the Regulatory Influence Framework for Cross-Border Central Counterparties*, Council of Financial Regulators (March 2014), page 8.

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significant disruption to the functioning of the Australian financial system. CFR agencies cited the fact that "*Australian-based participants constitute only a small share of LCH.C Ltd's highly international participant base*", as a reason why the facility does not have a strong domestic connection. It does not necessarily follow that the failure of this facility could not cause significant disruption to the functioning of the Australian financial system. CFR agencies recognise that LCH.Clearnet is systemically important in Australia.[2] From the perspective of the Australian financial system, rather than the international markets serviced by LCH.Clearnet, ASX believes that the failure of LCH.Clearnet, or of the SwapClear service in particular, could cause significant disruption to the functioning of the Australian financial system. Relevant considerations include:

- Australia's four largest banks (who between them determine interest rates for a large portion of Australian business and household borrowers) are direct participants in LCH.Clearnet's SwapClear service. The share of six large Australian banks' interest rate derivatives positions cleared by LCH.Clearnet rose sharply from about 2% at the beginning of 2013 to over 35% at the end of 2014.[3] This illustrates the increasing concentration of Australian banks' OTC interest rate derivatives clearing activity through LCH.Clearnet and the rapidity with which an offshore FMI's systemic importance and risk to the Australian financial system can grow;
- A significant number of Australia's largest investment funds have either cleared A$ interest rate swaps, or are establishing the capability to do so, as clients of direct participants in LCH.Clearnet's SwapClear service.

ASX believes that Australian regulatory agencies should not be placed in a position where they have no resolution powers over an offshore CS facility operating in Australia other than to support a resolution carried out by the foreign home authority. This appears to be the effect of the legislative proposals, which leave offshore CS facility licensees wholly outside the ambit of the resolution regime, simply because they lack the requisite domestic connection. This would appear to be contrary to the Financial Stability Board's guidance on FMI resolution.

Unless this issue is addressed under the legislative proposals, if an offshore CS facility licensee fails, Australian regulatory agencies could be powerless to exercise influence over the resolution of the FMI. A foreign resolution authority will have exclusive jurisdiction over adjustments to the contractual rights and obligations of direct and indirect Australian participants in the FMI, and dealings with assets of the FMI which may be located in Australia. This will occur irrespective of the potential impact of these actions on Australian financial system stability. The Consultation Paper proposes that Australian authorities should be empowered to support or facilitate foreign resolution proceedings, without being required to interrogate the fairness of those proceedings to Australian interests. Whatever comfort CFR agencies may derive from participation in "crisis management groups" to be formed in respect of global CCPs that are licensed in Australia, or other cross-border cooperative arrangements, any consideration which a foreign resolution authority may in fact give to Australian interests in a financial crisis will be overridden by its statutory duties to promote foreign public interests.[4] ASX believes the Consultation Paper's apparent approach would leave the Australian financial system exposed and Australian authorities would not have all the powers Australian market users would expected them to have in the event of an offshore FMI's failure.

ASX submits that the Australian resolution authority should have resolution powers over all offshore CS facility licensees and the capacity to use its powers either to support a resolution carried out by a foreign home authority or, if needed, to take measures on its own initiative where the home jurisdiction is not taking action, or acts in a manner that does not take sufficient account of Australian creditors' interests, or the need to preserve Australia's financial stability. This does not mean that the Australian resolution authority should not, wherever possible, act to achieve a cooperative solution with foreign resolution authorities, and use "crisis management groups" to prepare for a co-

[2] *Application of the Regulatory Influence Framework for Cross-Border Central Counterparties*, Council of Financial Regulators (March 2014), page 8.
[3] *Financial Stability Review*, Reserve Bank of Australia (March 2015), page 31.
[4] In the case of LCH.Clearnet, the resolution authority is the Bank of England, which is responsible under its charter for promoting the good of the people of the United Kingdom by maintaining monetary and financial stability in the United Kingdom. In exercising its stabilisation (resolution) powers with respect to central counterparties under its jurisdiction, the Bank of England is required by statute to have regard to a number of objectives, the first of which is "*to protect and enhance the stability of the financial systems of the United Kingdom*": Banking Act 2009 (UK), section 4. Neither the Banking Act 2009 (UK) nor the Code of Practice issued by HM Treasury for the use of stabilisations powers, requires the Bank of England to consider or contains any reference to the potential impact of stabilisation powers on financial systems outside the United Kingdom. Any consideration which the Bank of England may give to the impact on Australian financial system stability would in essence be voluntary.

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operative solution. But it does mean that the Australian resolution authority will at least be equipped with legal powers to take "discretionary national action" with respect to the local operations and assets of a failed offshore FMI. The existence of such "reserve powers" may provide Australian regulatory agencies with valuable leverage in dealing with a foreign resolution authority in a crisis situation.[5]

In addition to the Australian resolution authority having adequate powers with respect to a licensed offshore CS facility, Australian users of such facilities need to be properly informed up-front, in a manner approved by the Reserve Bank, that the Reserve Bank will not be the primary resolution authority for the facility in the event of its financial failure, and that the foreign resolution regime to which the facility would be subject may result in different outcomes for the user than if the facility had been subject to resolution by the Reserve Bank. This would be analogous to the disclosure which a foreign bank authorised to operate in Australia through a local branch ('foreign ADI') is required to make to an Australian depositor prior to accepting the deposit. In that case, the foreign ADI is required to inform the depositor that the foreign ADI is not subject to Division 2 of the Banking Act ('Protection of Depositors'), which includes APRA's full suite of statutory management powers.[6]

4. Do you have any comment on the proposal to restrict the availability of a domestic CS facility licence to domestically-incorporated entities?

ASX supports this proposal.

5. Do you agree that there is less of a presumption of systemic importance for TRs than for CS facilities?

No comment.

6. Do you have any comments on the proposal that a domestically incorporated TR may be identified as being systemically important where it holds a material volume of information on transactions involving systemically important Australian financial institutions, bringing it within the scope of the domestic resolution regime?

No comment.

7. Do you have any comments on the proposal to exclude licensed TRs that are not incorporated in Australia from the scope of the domestic resolution regime?

No comment.

8. Do you have any comments on the application of the domestic resolution regime proposed in this paper to covered TRs, having regard to the existing regulatory provisions relating to recovery and resolution of licensed TRs?

No comment.

[5] Cross-border disputes between insolvency officials of different entities within a failed global business enterprise are not new. The winding up of Lehman Bros. supplies many examples, a number of which were litigated in US and UK courts. There is no reason to think that disagreements about how a failed FMI should be resolved will not arise in future between resolution authorities of different jurisdictions. It would be prudent for the Australian Government to prepare fully for such events.

[6] A foreign ADI's assets in Australia are statutorily ring-fenced to satisfy its liabilities in Australia in priority to all other liabilities of the bank (Banking Act, section 11F). While a foreign ADI is not subject to the full suite of APRA's statutory management powers under the Banking Act (sub-section 11E(1)), APRA is empowered to give directions to a foreign ADI to ensure among other things that the assets of the foreign ADI in Australia remain in Australia, and that the Australian branch of the foreign ADI does not accrue liabilities that are not properly referable to it (sub-section 11CA(2B)). It is a criminal offence for a foreign ADI to accept a deposit from a person in Australia unless it first discloses to the person that the foreign ADI is not subject to Division 2 of the Banking Act ('Protection of Depositors'), which includes APRA's full suite of statutory management powers (sub-section 11E(2)).

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9. Do you have any comments on the proposal that the Corporations Act be amended to provide for any liquidator or receiver appointed over a related body corporate of a covered FMI to comply with any directions given by the FMI's resolution authority?

ASX supports this proposal, for related bodies corporate that are contractually obliged to provide funding or services to a covered FMI. It is not necessary to extend this to related bodies corporate generally, many of which may have no service provision relationship with a covered FMI.

If a group service company is under external administration, then the prevailing situation is likely to involve 'group failure' rather than the failure of a single licensee within an otherwise viable group enterprise. Where the group comprises other licensed entities, 'resolution directions' to a group service company need to be carefully considered in terms of the impact on continuity of service by all licensees.

ASX expects that 'resolution directions' to the external administrator of a related body corporate would be limited to:

- directions to comply with the terms of any pre-existing contract between the FMI in resolution and the related body corporate for the provision of funding or services; or
- directions to exercise discretions or powers under any pre-existing contract in a particular way.

Amendments to the Corporations Act should clarify that directions issued by the resolution authority to comply with a pre-existing contract override any statutory authority or duty which the external administrator of the related body corporate may otherwise have to disclaim the contract (Division 7A of Part 5.6 of the Act).

10. Do you have any comments on the proposal to extend these powers to all service providers for key outsourced functions, even if those service providers are not related bodies corporate?

It is more important that the resolution authority should have the ability to preserve the benefit of contracts with viable service providers. In respect of ASX's CS facilities, the Reserve Bank derives this ability through the incorporation of "step in" clauses in all of ASX's material outsourcing contracts.

ASX does not support the extension of these powers to external service providers because:

- It may complicate (and in some circumstances preclude altogether) the formation of commercial relationships by ASX with prospective external suppliers, who will need to understand and assess fully the implications of the potential exercise of these powers by the resolution authority;
- The likelihood of ASX's CS facilities entering resolution is remote, and the likelihood of such an event coinciding with the failure of a major external service provider is even more remote;
- The benefit to be derived by the resolution authority from preserving contractual rights against an insolvent external service provider is doubtful. (The resolution authority can gain access to source code for the CS facility's IT systems by issuing directions to the CS facility or its related service company to enforce contractual rights against the third party escrow agent);
- The ability of the resolution authority to enforce its directions against an external administrator in foreign insolvency proceedings (e.g. where the external service provider is headquartered offshore) is doubtful.

11. Do you have any comments on whether the resolution regime for market operators should be different to that for FMIs as defined in Section 1?

ASX does not believe that the case for applying a complete resolution regime to market operators — and in particular, statutory management powers — has been clearly established. ASX agrees in principle that there is a case for giving proper policy consideration to how to enhance the regulatory regime for dealing with the failure of domestically licensed market operators (see response to Question 13).

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12. Do you have any comments on whether, given the different risk profile of market operators, it would be appropriate for a regulator to have statutory management powers in relation to market operators?

See response to Question 11.

13. Do you have any comments on an appropriate alternative regime for market operators, and how market disruption in the event of failure of such entities could be mitigated?

ASX supports policy consideration of an alternative regime under which:

- market operators would be required to develop a comprehensive recovery plan in accordance with CPMI-IOSCO Guidance on *Recovery of financial market infrastructures*;
- ASIC would have strengthened directions powers in relation to the market operator, including powers to ensure the market operator is implementing its recovery plan effectively.

ASX submits that this regime should apply to all domestically licensed market operators *in a systemically important market*, rather than only to those operators that are deemed to be systemically important.

Objectives of the resolution regime

14. Do you have any comments on the proposed objectives of the resolution regime? Are there other relevant objectives or considerations that should be included?

ASX agrees with the objectives and considerations outlined in the Consultation Paper.

An additional objective should be: *comply in so far as is practicable with the loss allocation and other recovery related powers in the FMI's operating rules*. Observance of the operating rules is essential to the integrity of FMIs as service providers. Few things would more quickly undermine market confidence in an FMI than the prospect of a resolution authority stepping in and re-writing the operating rules with respect to the allocation of losses or liquidity shortfalls, in the event the FMI should enter resolution. ASX welcomes the acknowledgement in the Consultation Paper of the centrality of this principle.

ASX strongly agrees that intervention by a resolution authority would be likely to be most effective and least disruptive if the resolution authority could simply complete the actions contemplated in the FMI's own recovery plan. ASX acknowledges the need for a resolution authority to have "ancillary" powers that provide flexibility to pursue alternative means of maintaining continuity of service. However, it is important that those powers (and the way in which they are exercised) do not result in a worse outcome for the FMI or its participants than would have resulted from execution of the FMI's own recovery plan.

Resolution authority

15. Do you have any comments on the proposed choice of resolution authority for each FMI type?

ASX supports the proposal that RBA should act as lead resolution authority for CS facilities.

16. Do you have any comments on the proposal that the determination of an FMI group resolution authority be governed by a memorandum of understanding between the regulators?

ASX supports this proposal.

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Entry into resolution

17. Do you have any comments on the proposed conditions for entry into resolution and use of resolution powers, and, in particular, the distinction between general and specific conditions? Is there another option you prefer? If so, why?

ASX agrees with the proposed general conditions and specific conditions stated in the Consultation Paper.

Statutory management

18. Do you have comments on the proposed powers of a statutory manager? Are there additional powers that should be included? If so, why?

ASX supports the proposals to give a statutory manager the powers of the Board of Directors, together with powers to facilitate recapitalisation consistent with the Banking Act. These proposals make it unnecessary for the rights of shareholders to be suspended or terminated automatically by the appointment of a statutory manager (see response to Question 20).

19. Do you have any comments about the proposal that an external administrator cannot be appointed to an FMI during the term of the statutory manager, except with the consent of ASIC or the RBA?

ASX supports this proposal, which aligns with the Banking Act model of statutory management.

20. Do you have any comments on whether the appointment of a statutory manager to an FMI should suspend or terminate the rights of shareholders, subject to ex-post compensation? Moreover, do you agree that the statutory manager should have the ability to facilitate recapitalisation where an FMI would otherwise be insolvent?

If the model of statutory management under the Banking Act is adopted for FMIs, shareholders of an FMI in resolution would be unable to exercise control over the FMI's business or interfere with the statutory management process because they would be unable to appoint directors or an external administrator to the FMI while the statutory manager is in control. ASX's view is that it is unnecessary (and could be counterproductive) for shareholders' rights to be suspended or terminated automatically by the appointment of a statutory manager. The statutory manager should be empowered to vary or cancel rights attaching to shares, or to take other steps with respect to the share capital of the FMI, only where it is necessary to achieve the objectives of the statutory management process, for example as part of recapitalisation of the FMI.

21. Do you have comments on the proposals related to issuance of directions to a statutory manager? Are there other relevant considerations?

ASX supports these proposals.

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Moratorium on payments to general creditors

22. Do you have any comments on the proposal to empower the resolution authorities to impose a limited moratorium on outgoing payments from an FMI? Do you have comments on the proposed limitations applied to the scope of the moratorium? Is there another option you prefer? If so, why?

ASX supports this proposal. The exclusion of clearing and settlement-related obligations from the scope of the moratorium power is critically important to the maintenance of commercial certainty for participants regarding the allocation of losses and liquidity shortfalls. See further our response to Question 14 on the importance of respecting the loss allocation and other recovery related powers in the FMI's operating rules.

Transfer of critical operations to a solvent third party

23. Do you have any comments on the proposed powers for business transfer and the proposed conditions for such a transfer? Are there any changes you would propose? If so, why?

ASX supports these proposals, but emphasises the importance of legislative clarification that:

- In the case of a central counterparty, the resolution authority's power to transfer 'market netting contracts' (as defined in the Payment Systems and Netting Act) is subject to the limitations articulated in Section 4.3 of the Consultation Paper, that is:
  - all market netting contracts with the same counterparty and subject to the same netting arrangement must be transferred together or left behind;
  - where liabilities under market netting contracts are secured by collateral held by the central counterparty, the liabilities and the associated collateral must be transferred together or left behind.

  ASX does not support the proposal that the resolution authority should have the discretion to "waive" these limitations (Consultation Paper, Section 4.3). The mere existence of a discretion to depart from these limitations would undermine the certainty which the limitations are intended to give clearing participants (and which the Consultation Paper has recognised as necessary) that the resolution authority will not 'cherry pick' individual contracts for transfer. The transfer of some but not all of a clearing participant's netted portfolio to an alternative clearing facility could significantly increase its margin obligations overall, through un-netting of financial obligations. It would also impose additional default fund contribution obligations on the participant. Ex-post compensation would not assist affected clearing participants to manage the liquidity impact of these increased obligations, which would arise at a time of extreme financial stress.
- Service providers to an FMI in resolution, including both group service companies and external providers, whose agreements are novated by the resolution authority to a third party purchaser or bridge institution should have a statutory right to receive (and the resolution authority should be required to make adequate provision for) reasonable commercial fees for services provided. (Those fees may differ from contracted fees where an FMI in resolution is transferred out of a corporate group comprising other post-trade market infrastructure, since the costs of service provision to the FMI as a stand alone entity may be higher with the loss of operational efficiencies derived from integration in a wider group.) In addition to clarifying that any transfer of assets or liabilities under this power would not constitute a default or termination event under any contract to which the FMI in resolution was a party, it should equally be clear that service providers may exercise termination rights if the FMI in resolution fails to meet its contractual obligations when due (e.g. non-payment of service fees).

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Bridge institutions

24. Do you have any comments on the proposed powers for establishment of a temporary bridge institution? Are there any changes you would propose? If so, why?

ASX supports these proposals. Our comments on the transfer of 'market netting contracts', in response to Question 23, apply equally to the onward transfer of contracts by a bridge institution to a third party purchaser.

Temporary stays on early termination rights

25. Do you have any comments on setting a timeframe for the duration of a temporary stay (for example, 48 hours)? Do you agree that there may be circumstances in which it would be necessary to extend the duration of the stay in order to support financial system stability?

ASX supports the temporary stay proposal. If it is necessary to extend the stay beyond the initial 48 hour period, unambiguous Government support for the future obligations of the FMI in resolution is likely to be required in order to avoid further destabilisation of the affected markets. An announcement that the FMI "may be restored to financial viability" (as contemplated in the Consultation paper) may not slow down the disorderly exit of participants from the CS facility (an outcome the resolution authority will seek to avoid). The legislation should specify what forms of Government support will justify the extension of the stay, for example, a Government guarantee of the FMI's obligations and/or a Government undertaking to provide financial resources for the FMI to meet minimum prudential standards. This would be consistent with the proposed approach to Banking Act amendments (foreshadowed in recent years but not yet enacted) which would impose a temporary stay on the close-out of market netting contracts with an ADI under statutory management.

ASX welcomes the Consultation Paper's clarifications that:

- Clearing participants may exercise early termination rights, notwithstanding a temporary stay, if the FMI in resolution fails to meet payment or delivery obligations when due in accordance with its rules (i.e. an event of default not directly related to entry into resolution or exercise of the relevant resolution power). Being able to terminate for the FMI's non-performance at any time is a technical pre-condition to banks risk weighting their derivatives trade exposures to qualifying central counterparties on a net rather than gross basis, and thereby taking advantage of Basel III capital incentives which are designed to encourage central clearing. To this end, the definition of "external administration" in the Payment Systems and Netting Act should be broadened to encompass resolution regimes for bank and non-bank financial institutions.
- Non-performance of obligations refers to the FMI's obligations as determined in accordance with its operating rules, which may provide for pro-rata reductions in the quantum of those obligations through recovery mechanisms such as haircuts to daily settlement or termination payments.

These are important clarifications and ASX recommends they are carried over to the Explanatory Memorandum for the draft resolution legislation.

Consultation Questions

Respect of creditor hierarchy and 'no creditor worse off' principle

26. Do you have any comments on the proposed provisions, especially with respect to compensation arrangements?

'No creditor worse off' and compensation to creditors

ASX accepts the need for regulators to pay due regard to the hierarchy of claims under applicable insolvency law and the 'no creditor worse off' principle, given that these are embedded in the FSB's Key Attributes. These principles need to be applied in the context of an overriding principle that the resolution authority will adhere to the loss allocation and other recovery related powers in the FMI's operating rules. This is fundamental for the preservation of commercial certainty for participants and their clients as consumers of FMI services. This does not mean that the resolution authority should not have "ancillary" powers that it can exercise in a way that is complementary to the loss allocation regime under the operating rules (e.g. power to make a temporary injection of funds to meet a small shortfall in a central counterparty's financial resources, where this is likely to be less disruptive than the tear-up of all open contracts; or power to remove or supplement an FMI's management with outside resources by appointing new management). But it does mean that the resolution authority should rely on the pre-agreed suite of tools to allocate among participants any losses and liquidity requirements that cannot be avoided through reliance on ancillary powers conferred by the resolution regime.

If the resolution authority restores an FMI to viability on the above basis (i.e. adherence to recovery powers under the operating rules and complementary ancillary powers under the resolution regime), ASX sees no case for the Government to pay compensation to creditors under the principle of 'no creditor worse off'. This is because the outcome in that event in terms of loss allocation will be no more or less than what the FMI and its participants (and their clients) bargained for in the operating rules. Stated another way, the counterfactual posited by the 'no creditor worse off' principle (i.e. what would a creditor have received in a liquidation of the FMI under general insolvency?), and the case for compensation, is relevant only where the FMI is in fact unviable and wound-down under the resolution regime.

The recovery rules which ASX's central counterparties are developing in consultation with direct and indirect participants will not confer on participants any rights to compensation in respect of losses allocated in accordance with the recovery rules. Neither the Financial Stability Standards, nor CPMI-IOSCO guidance on CCP recovery, require central counterparties to offer such compensation. ASX has received submissions from some participants and industry groups that rights to compensation should be included in recovery rules. ASX's review of emerging practice among central counterparties globally is that rights to compensation are generally not being adopted as part of recovery rules. CFR agencies need to consider carefully the incentives that could drive behaviour if there is compensation available under resolution. If the resolution regime confers rights to compensation on creditors in circumstances where an FMI in resolution is restored to viability, participants may be incentivised to prefer resolution over recovery and accordingly withhold their cooperation with the central counterparty's own recovery efforts.

ASX acknowledges potential constitutional constraints on Australian official sector actions with respect to the rights of creditors. However, if the resolution authority relies exclusively on recovery powers under the operating rules to allocate losses and liquidity shortfalls, as ASX believes it should, constitutional constraints may be less acute.

Compensation to shareholders

ASX supports the adoption of a model for compensation of shareholders consistent with section 69E of the Banking Act and section 44 of the Financial Sector (Business Transfer and Group Restructure) Act 1999.

Consultation Questions

Indemnities and other protections

27. Do you agree with the scope of proposed protections for those that act in accordance with the resolution authority's binding instructions?

ASX supports these proposals. Immunity from liability for those acting pursuant to the directions of the resolution authority is an integral part of the resolution regime. As directors' statutory duties may constrain the ability of an FMI's directors to exercise recovery powers fully, or the ability of related entities' directors to continue providing support services to the FMI through the recovery process, it is essential that immunity should extend to the FMI (even if it has not yet entered resolution), its related entities, and managers and directors and officers of the FMI and its related entities. This protection will give the central counterparty's own recovery plan the best chance of maintaining the continuity of critical services.

Funding arrangements

28. Do you have any comments on the provisions that need to be put in place to recover any public funding? Who should be liable to contribute to the recovery of costs — shareholders, unsecured creditors (including FMI participants) and/or participants in the financial system more widely?

The costs of resolution should be regarded as the price of the public benefits derived from the maintenance of financial system stability through either the restoration of an FMI to viability (continuity of critical services) or its orderly wind-down. The costs of this public intervention should therefore be borne publicly.

To recover the costs of resolution from the FMI's (former) shareholders would be a precedent-setting departure from the foundational principle of shareholders' limited liability.[7] To recover the costs from the FMI's participants seems to run counter to bank prudential regulations which forbid banks to expose themselves to open-ended liabilities which they cannot unilaterally control.

Apart from any point of principle relating to shareholders or participants, there is a case for spreading the potentially immense costs of resolution across the broadest possible base, given that these costs are most likely to accrue during a financial system crisis.

By way of comparison, the Banking Act provides that APRA's costs of being in control of an ADI's business are payable from the ADI's funds and are a debt due to APRA.

Resolution of overseas – based FMIs and financial markets

29. Do you agree with the proposal that Australian regulators should have the right to prevent an application from being made to the court? Are there any other amendments to the Cross-Border Insolvency Act that may be necessary?

Overseas CS facility licensees

The strong impression given by the Consultation Paper is that the only resolution power the Australian resolution authority needs in respect of overseas CS facility licensees is the power to support or facilitate foreign resolution proceedings. The expectation is that "*Australian regulators would not ordinarily object to the recognition of foreign insolvency proceedings for FMIs or financial markets, especially where such proceedings were taken in respect of an Australian-licensed FMI that had its main operations based outside Australia*". ASX submits that whether particular foreign resolution proceedings should be given effect locally is a question that should be determined on a

[7] The recovery of costs or compensation from shareholders in a business undertaking that is adjudged by a Court to have acted culpably (for example, by trading while insolvent or acting in breach of environmental protection laws), stands in a different class. It cannot and should not be assumed that an FMI in resolution is in that situation because it acted culpably.

Consultation Questions

case by case basis having regard to the fairness of those procedures to Australian creditors and the likely impact on Australian financial system stability. These are matters that should be determined judicially by an Australian Court, on an application by the foreign home authority for recognition in Australia of its resolution proceeding. The Australian resolution authority should have a right to submit its views to the Court on such an application.

It is consistent with international resolution guidance for the Australian resolution authority to be given the power, in exceptional cases, to take measures on its own initiative where the foreign home authority is not taking action or acts in a manner that does not take sufficient account of the need to preserve Australia's financial stability.

Domestic CS facility licensees

Domestic CS facility licensees should be carved out from the operation of the Model Law, as enacted by the Cross-Border Insolvency Act, in the same way as for ADIs and insurance companies, and for similar reasons. ASX does not support the proposal that this matter should be left to an *ad hoc* application procedure to be managed by Australian regulators, as this lacks *ex ante* legal certainty and transparency.

30. Do you agree that no specific action to amend the legal framework is required at this stage with respect to the formation of CMGs? If not, why not, and what do you think needs to be done?

ASX is unable to comment at this stage, as the proposed scope of information sharing and cooperation among members of the Crisis Management Groups is unclear.

Supporting requirements

31. Do you agree that it is too early for detailed consideration of regulatory issues associated with the development of resolution strategies, operational resolution plans and resolvability assessments for covered FMIs? If not, why not, and what do you think needs to be done?

The timing of detailed consideration of regulatory issues arising in connection with the resolution strategies, plans and assessments of Australian regulatory agencies is a matter for those agencies in consultation with the Government. As ASX is unaware of the details of those strategies, plans and assessments, it is unable to comment further at this time.

32. Do you agree that no specific action is required at this stage with respect to the ability of ASIC and the RBA to share information with foreign authorities?

ASX submits that information disclosed by licensed FMIs should not be shared by regulators where it is subject to disclosure under Freedom of Information legislation in the recipient jurisdiction. This is consistent with the Financial Stability Board's consultative document on information sharing for resolution purposes.

33. Do you agree with the proposal to make a material adverse change in cooperation or information-sharing arrangements with a licensed overseas FMI's or market operator's home regulator a grounds for licence suspension or revocation?

ASX supports the proposal and suggests that "material adverse change" should extend to a situation where a licensed overseas FMI ceases to comply fully with foreign law requirements to provide information to its home regulator.

Consultation Questions

New and enhanced directions powers

34. Do you have comments on the proposal to consolidate the directions powers with ASIC and the RBA? Or is there another option you prefer? If so, why?

ASX supports these proposals, except for the removal of the Minister's separate directions power. ASX submits that it is important for the Minister to retain a 'reserve power' to issue directions based on a broader market perspective that involves considerations that may be beyond the regulatory remits of ASIC and the RBA. While this already-existing power is unlikely ever to be exercised by the Minister, its retention will apply a continuing 'market discipline' on the exercise (or non-exercise) of directions powers by ASIC and the RBA.

Directions issued pursuant to consolidated directions powers as part of day-to-day oversight need to be either:

- issued subject to the obligations of the 'directed person or entity' under the operating rules and the law; or
- complemented by statutory immunity from liability arising from the directed person or entity's compliance with the direction.

ASX has a strong preference for the latter (i.e. statutory immunity), because it would:

- align with the protections proposed by the Government in relation to 'recovery directions' and 'resolution directions';
- enhance incentives for compliance with directions by comprehensively resolving any potential conflict between the legal and contractual obligations of the 'directed person or entity' and their obligation to comply with the direction. This is particularly important given the proposed streamlining of the process for issuing directions, which at present gives the party to be directed a formal opportunity to raise potential conflicts prior to issuance of the direction.

35. Do you have any comments on the proposed scope of recovery directions?

ASX supports these proposals.

It will be important for the legislation to spell out the objectives for which recovery directions may be issued (in a similar fashion to the exercise of resolution powers, including resolution directions).

As noted in our response to Question 27, it is essential that statutory immunity should extend to an FMI (even if it has not yet entered resolution), its related entities, and managers, directors and officers of the FMI and its related entities. This protection will resolve any potential conflicts with legal certainty and give the central counterparty's own recovery plan the best chance of maintaining the continuity of critical services.

36. Do you have comments on giving precedence to resolution directions over directions issued in day-to-day oversight? Or is there another option you prefer? If so, why?

ASX supports this proposal.

Consultation Questions

37. Do you agree that ASIC and the RBA should be able to give directions to an external administrator of an FMI or financial market, and the specified conditions under which directions may be given? If not, why not, and what changes should be made?

As one of the primary objectives of the FMI resolution regime is to avoid the uncertainty and delay associated with the general insolvency regime, and to address threats to the continuity of critical services, it is difficult to imagine circumstances where:

- the appointment of an external administrator to an FMI would not satisfy the conditions for the resolution authority to act (this would indicate that the conditions are incorrectly calibrated); or
- it would be preferable for regulators to allow a distressed FMI to be dealt with under the general insolvency regime rather than to exercise resolution tools.

On this basis, ASX considers the proposed power to issue directions to the external administrator of a licensed CS facility as largely unnecessary. However, beyond this observation, ASX does not object to these proposals.

38. Do you have comments on whether the relevant regulator should have the power to issue directions to non-regulated group entities to enforce ex-ante legal arrangements? Should these powers extend to recovery and day-to-day oversight as proposed?

ASX supports these proposals, on the basis that directions to a related body corporate would be limited to:

- directions to comply with the terms of any pre-existing contract between the FMI and the related body corporate for the provision of funding or services; or
- directions to exercise discretions or powers under any pre-existing contract in a particular way.

As noted in our responses to Questions 27 and 34, it will be important to the efficacy of these directions powers that statutory immunity extends to related bodies corporate and their directors or officers and management, and that the immunity applies to compliance with directions given as part of day-to-day oversight, in recovery or in resolution.

Housekeeping and sanctions

39. Do you agree with the proposal to strengthen sanctions for non-compliance with a direction?

ASX supports these proposals.

ASX agrees that the incentive effect of strengthened sanctions will be maximised if coupled with comprehensive protections for directed persons or entities in respect of actions taken in compliance with directions.

Sanctions should only apply, as under the Banking Act, when there is a failure to take reasonable steps to ensure compliance with directions and when a director's or officer's duties include ensuring compliance with the directions or conditions.

40. Do you agree that the process for issuing a direction should be streamlined?

ASX supports these proposals. As noted in our response to Question 34, streamlining the process in the way proposed will remove the formal opportunity which licensees have under the current legislation to raise potential conflicts prior to issuance of the direction. This strengthens the case for extending comprehensive statutory immunity to licensees, related bodies corporate and their directors and management, for actions taken in compliance with directions given as part of day-to-day oversight, in recovery or in resolution. Only statutory immunity can resolve any potential conflict between the legal and contractual obligations of the directed person or entity and their obligation to comply with the direction.