

CONSULTATION ON
VARIATION OF THE
FINANCIAL STABILITY
STANDARD FOR CENTRAL
COUNTERPARTIES:
OVERSIGHT OF OVERSEAS
FACILITIES

OCTOBER 2008

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Reserve Bank

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Consultation on Variation of the Financial Stability Standard for Central Counterparties: Oversight of Overseas Facilities

1. Introduction

Under powers set out in the *Corporations Act 2001*, the Reserve Bank has determined *Financial Stability Standards* for both central counterparties and securities settlement facilities which aim to ensure that licensed facilities conduct their affairs in a way that promotes overall stability in the Australian financial system. In accordance with the *Corporations Act*, the Reserve Bank assesses licensed facilities against these standards, reporting its findings annually to the Minister with portfolio responsibility for financial markets, and to the Australian Securities and Investments Commission (ASIC). These assessments are also released publicly.

The Reserve Bank is proposing a modification to the *Financial Stability Standard for Central Counterparties* to clarify that, subject to certain conditions, the Standard will not apply to an overseas facility that is subject to an overseas regulatory regime deemed to be sufficiently equivalent to that in Australia (i.e. a facility licensed under Section 824B(2) of the *Corporations Act*). This consultation document seeks views from interested parties on the Reserve Bank's proposed modification.

This document is structured as follows. Section 2 provides an overview of the current scope of the Standard and the rationale for the proposed variation. Section 3 then discusses in more detail the conditions that would apply if an overseas facility is to be exempt from the requirements of the Standard. Section 4 concludes with some specific issues on which those making submissions might wish to focus.

Interested parties are invited to make submissions by 21 November 2008. Submissions will be placed on the Reserve Bank's website and those making submissions will be offered the opportunity to discuss their views with Reserve Bank staff. Submissions should be sent to:

Head of Payments Policy Department or pysubmissions@rba.gov.au
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

2. Variation of the *Financial Stability Standard for Central Counterparties*

Under Section 827D of the *Corporations Act*, the *Financial Stability Standards* apply to all clearing and settlement (CS) facility licensees, or a *specified class of CS facility licensee*. In 2003,

the Reserve Bank determined standards for two classes of facilities: central counterparties; and securities settlement facilities. The standards are supported by a set of measures that the Reserve Bank considers relevant in assessing compliance. In the case of central counterparties, these measures cover matters such as: the legal framework; participation requirements; risk controls; and governance arrangements.

Under Section 823CA(1) of the *Corporations Act*, the Reserve Bank is obliged to conduct an assessment at least once a year regarding whether licensed facilities have complied with the relevant standard and, in addition, to assess whether a licensee is ‘doing all *other* things necessary to reduce systemic risk’. Although these are separate obligations, the Reserve Bank in practice conducts both assessments by reference to the measures underpinning the relevant standard, as these comprehensively cover issues pertaining to the management of systemic risk. The Reserve Bank reports to the relevant Minister on the outcome of these assessments and also publishes its findings.

Currently, two licensed central counterparties are subject to the Reserve Bank’s *Financial Stability Standard for Central Counterparties*. These are Australian Clearing House (ACH) and SFE Clearing Corporation (SFECC), which provide clearing services for the cash equities and exchange-traded derivatives markets. Both facilities are owned by the Australian Securities Exchange (ASX). These central counterparties have been granted licences under Section 824B(1) of the *Corporations Act*.

A CS facility licence can also be granted under Section 824B(2) of the *Corporations Act* to an overseas central counterparty if the Minister is satisfied that the central counterparty is subject to a regulatory regime that is ‘sufficiently equivalent, in relation to the degree of protection from systemic risk and the level of effectiveness and fairness of the services they achieve, to the requirements and supervision to which clearing and settlement facilities are subject under this Act in relation to those matters’. ASIC, in conjunction with the Reserve Bank, advises the Minister as to whether an overseas regime is ‘sufficiently equivalent’. In making its assessment, the Reserve Bank would, amongst other things, map the requirements of the overseas regime to the measures underpinning the Standard, and undertake an informal assessment of whether the applicant would meet the Standard at the time of its application.

As the Standard is currently drafted, an overseas facility granted a licence under Section 824B(2) would be required to comply with the Standard and the Reserve Bank would therefore assess the facility against the various measures underpinning the Standard on an ongoing basis. The Reserve Bank, however, sees a strong case for granting an exemption from the Standard where an overseas facility has been licensed under Section 824B(2) (and thus is subject to a ‘sufficiently equivalent’ overseas regime), provided that the facility is able to satisfy the Reserve Bank that it is in compliance with the relevant requirements of the overseas regime. Specifically, the Reserve Bank proposes to vary the Standard to read (new text in bold):

*A CS facility licensee must conduct its affairs in a prudent manner, in accordance with the standards of a reasonable CS facility in contributing to the overall stability of the Australian financial system, to the extent that it is reasonably practicable to do so. **This standard applies to all CS facility licensees with the exception of any CS facility licensed under Section 824B(2) of the Corporations Act where the Reserve Bank has received an annual statement***

that the licensee has complied with the requirements of the overseas regulator related to matters affecting stability, in a form and at a time agreed with the Reserve Bank.

The objective of this variation is to establish a framework for regulation of overseas facilities that does not impose an unnecessary regulatory burden, while ensuring competitive neutrality in the Australian regulatory environment.¹ Given the increasing incidence of cross-border provision of clearing and settlement services, this is becoming an important issue for regulators internationally. The Reserve Bank is keen to ensure that its regulatory arrangements reflect the changing nature of the international landscape for financial infrastructure, while at the same time promoting the stability and efficiency of the Australian financial system.²

It is proposed that the annual statement referred to above would include sufficient information to satisfy the Reserve Bank that the overseas facility was in compliance with the overseas regime. It is anticipated that this statement would also document any specific areas of investigation by the regulator during the period. By providing a channel for ongoing regulatory engagement with the facility, the inclusion of such conditionality in the Standard would be consistent with competitive neutrality vis-à-vis domestic facilities. Another advantage of granting a conditional exemption is that it would offer the fall-back of assessment against the Standard should the licensee fail to comply with the stated conditions.

Separately, information would be sought on a regular basis from the overseas regulator in respect of material changes to the overseas regime, to support assessment of the regime's continued 'sufficient equivalence'.

If an exemption from compliance with the Standard were granted, the Reserve Bank would continue to have an obligation to assess whether the facility was doing all other things necessary to reduce systemic risk. As noted above, for currently licensed facilities, this assessment is undertaken with reference to the measures underpinning the Standard. An overseas facility would, therefore, be expected to provide additional information to the Reserve Bank, on a pre-agreed frequency, about its activities and the conduct of its business. It would also be requested to provide sufficient information to enable the Reserve Bank to assess compliance with any measures underpinning the Standard that are not considered under the overseas regime.

This information exchange would support ongoing assessment of the facility's role and presence in the Australian financial system and its systemic importance. If an overseas facility were to grow to become a critical component of the Australian financial infrastructure, it might be appropriate to establish a framework for cooperative oversight, as is currently the case for international facilities such as CLS Bank which settles foreign exchange transactions. This would not be precluded by the proposed variation of the Standard or indeed the provisions of the *Corporations Act* more generally.

1 While such an exemption may be consistent with competitive neutrality in the Australian market, a reciprocal agreement with the overseas regulator may be required to ensure competitive neutrality in the international context.

2 The mutual recognition agreement recently signed by the Australian Government, ASIC, and the US Securities and Exchange Commission was similarly motivated. This agreement provides a framework for these agencies to consider regulatory exemptions that would permit stock exchanges and broker-dealers from the United States and Australia to operate in both jurisdictions, without the need for them to be fully regulated in both countries.

3. Variation of Guidance to the *Financial Stability Standard for Central Counterparties*

As noted above, the *Financial Stability Standard for Central Counterparties* is supported by a set of minimum measures that the Reserve Bank considers are relevant in determining whether a CS facility licensee has met the Standard. The Reserve Bank has also issued guidance to assist in interpretation of the Standard and its measures.

As the proposed variation to the Standard is intended to provide a conditional exemption for overseas facilities, the Reserve Bank proposes to issue guidance in relation to the nature of such conditionality. The proposed wording of the guidance reflects the Reserve Bank's preference to retain a principles-based approach, thereby recognising differences between overseas jurisdictions (notwithstanding that they may be sufficiently equivalent) and accommodating evolution over time. Furthermore, the guidance is intended to be indicative, not exhaustive. Specifically, it is proposed that the guidance would read:

Guidance for Section 824B(2) licensees

The Standard does not apply to any overseas CS facility licensed under Section 824B(2) where the Reserve Bank has received an annual statement that the facility has complied with the requirements of the overseas regulator related to matters affecting stability. Such a statement must be in a form agreed with the Reserve Bank and must be received prior to the commencement of operations under the licence and annually thereafter. The Reserve Bank's preference is that the statement be provided directly by the overseas regulator, although it is acknowledged that this may not be possible in some circumstances. Where this is the case, the Reserve Bank may rely on indirect provision of the regulator's assessment of compliance via the licensee, or self-certification by the directors of the licensed facility. The statement should include details of any specific areas of investigation by the regulator during the period.

Separately, the Reserve Bank would also expect to receive information from the licensee to support its assessment of whether the CS facility licensee is doing all other things necessary to reduce systemic risk. Such information should include, at a minimum:

- detail of any material changes in the overseas facility's activities, processes, or people: *The facility is expected to provide information on material changes in the conduct of its business as well as audited annual accounts and annual data detailing stress-test outcomes relative to its risk resources; and*
- additional information to allow assessment of measures not explicitly covered by the overseas regime: *Where the measures underpinning the Standard are not explicitly covered by the overseas regime, the Reserve Bank will, as part of its general oversight, assess the facility against these measures.*

A critical element of this arrangement will be the framework for the exchange of information between the Reserve Bank, the overseas facility, and the overseas regulator. The *Corporations Act* requires that the facility 'cooperate with ASIC and the Reserve Bank of Australia by sharing information and in other ways'. It is envisaged that this would be governed by a letter signed by the facility in conjunction with its obtaining a CS facility licence. It is also envisaged that arrangements for the exchange of information with the overseas regulator would be established

prior to the Minister granting a licence under Section 824B(2). Reflecting this, the Reserve Bank would seek to conclude a Memorandum of Understanding with the overseas regulator, capturing, amongst other things:

- information regarding relevant consultations or regulatory developments;
- information relevant to developments which may have an impact on the regulatory responsibilities of the other agency; and
- information relevant to each agency's annual assessment obligations.

4. Key Issues for Respondents

The Reserve Bank invites comments on any aspect of this consultation document. In providing submissions, interested parties might wish to consider the following issues:

- the general approach proposed for regulation of overseas facilities in respect of matters related to stability;
- the proposed wording of the variation to the Standard and the nature of the proposed conditionality;
- the form of the annual statement of compliance and, in particular, whether the facility should be exempt only if it is able to provide a statement from its overseas regulator;
- the proposed wording of guidance for Section 824B(2) licensees and, in particular, the additional information requirements proposed; and
- the nature of the proposed information-sharing arrangements between the Reserve Bank, the overseas facility and the overseas regulator.