BY EMAIL

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PRIVATE AND CONFIDENTIAL

Dear Sirs and Madams

Australia: Consultation Paper published by Council of Financial Regulators on Financial Market Infrastructure Regulatory Reforms

The International Swaps and Derivatives Association, Inc.[1] ("**ISDA**") welcomes the opportunity to respond to the Consultation Paper ("**Consultation Paper**") on Financial Market Infrastructure ("**FMI**") Regulatory Reforms published by the Council of Financial Regulators ("**CFR**") in November 2019.

ISDA is actively engaged with providing input on regulatory proposals in North America, the European Union and across the jurisdictions encompassing the Asia-Pacific. Our response is derived from this international experience and dialogue, in addition to consultation with our members operating in the Asia-Pacific region.

ISDA supports the efforts made by the CFR to provide a robust framework for the regulation and supervision of FMIs and welcomes further dialogue with the CFR on this submission. ISDA's submission on the Consultation Paper is focussed on the impact of the proposals on the exercise of termination and other risk mitigation rights, the impact of certain resolution

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 71 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA.

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actions on netting and collateral rights and cross-border issues, rather than all aspects of the Consultation Paper.[2] Accordingly, ISDA's submission addresses the following topics:

- Conditions for resolution
- Stays
- Transfers
- Moratoria
- Location requirements for overseas markets and clearing and settlement facilities
- Interaction between new Australian regulatory powers and existing powers of home regulators
- Domestic connection
- Other considerations (concerning statutory management, resources and tools, and confidentiality)
- Next steps

These are addressed in turn below.

1 Conditions for resolution

While we agree that there is a need for discretion in particular circumstances, for instance to respond to dangers to financial stability, ISDA would like to emphasise that it is of utmost importance that there is clarity and transparency in relation to the operation of the triggers for the application of the resolution powers (particularly the appointment of a statutory manager and the application of any stays and moratoria). This is also the case for the other supervisory and enforcement powers contemplated by the Consultation Paper and for the proposed jurisdictional scope of the Australian regulatory regime.

On the general conditions for resolution contemplated by the Consultation Paper, ISDA strongly agrees that clear conditions for resolution are required to ensure the resolution powers are available when they need to be, and that FMIs, market participants and regulators have certainty, clarity and transparency as to when, and how, their rights (and the very markets themselves) may be affected by resolution. Accordingly, ISDA submits that the general conditions and any other specific conditions for specific

[2] Whilst ISDA has provided comments in this submission on certain aspects of the Consultation Paper, we note that our members and other trade associations may choose to make their own individual submissions to the CFR on the Consultation Paper.

powers should be clearly established in the relevant legislation and should be able to be determined with a high level of certainty.

As set out in our submission on the Australian Government's Consultation Paper *Resolution Regime for Financial Market Infrastructures* ("**2015 Resolution Consultation**"), ISDA considers that the conditions for resolution should take into account, and be consistent with, the recovery plans of the clearing and settlement facilities ("**CS facilities**").[3]

Further, all guidance which can be provided by the CFR and resolution authority as to the manner in which these conditions would be interpreted and how the resolution powers could be exercised would be welcomed by market participants (noting that, necessarily, circumstances will dictate different uses of different powers).

2 Stays

We refer to the proposed stays regime which is intended to operate during the resolution of a domestic CS facility licensee. We note that the CFR has stated that the regime is modelled on comparable international regimes and is consistent with the recommendations of the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions* ("**Key Attributes**").[4]

ISDA strongly agrees that any exclusion of a resolution action as a trigger for the exercise of termination rights must not prevent counterparties from exercising contractual termination rights for any other reason, or prevent central counterparty ("**CCP**") participants from continuing to clear new transactions (including new transactions that would have the effect of closing out existing positions). Further, it is important that any stay is clearly limited to the exercise of specified rights for specified

[3] For further detail on this, we would be grateful if you could please refer to our submission on the 2015 Resolution Consultation. In this submission, we noted "*For example, if the recovery plan of a CS facility is in operation and the CS facility is returning to viability, then no exercise of resolution powers should be necessary. If the recovery plan is not in operation then the resolution powers should first be used to ensure that the recovery plan is followed. Only if severe systemic disruption would arise if the recovery plan were followed, financial stability is compromised, or if insolvency processes would commence despite the recovery plan, should the wider and more discretionary resolution powers be used. This would provide certainty to market participants that the recovery plan of a CS facility is the most likely process in the event of the CS facility's financial distress.*"

[4] Section 4.12, pp33–34, Consultation Paper.

reasons[5] and that either the legislation, or associated explanatory materials, clearly state that the stays do not prevent the exercise of rights for any other reason.

ISDA refers to the proposals in the Consultation Paper that there will be stays on exercise of contractual rights based on a default event arising from a resolution action. In this regard, we refer to paragraph 5 of II-Annex 1 – Resolution of Financial Market Infrastructures (FMIs) and FMI Participants in the Key Attributes, which provides that:

> "*5.1 Entry into resolution of, or the exercise of any resolution power in relation to, an FMI should not trigger a right to acceleration or early termination by any participant in an FMI or any other counterparty of an FMI. Such rights should remain exercisable where the FMI (or the authority, administrator, receiver or other person exercising control over the FMI in resolution) fails to meet payment or delivery obligations, including collateral transfers, when due in accordance with its rules, but subject to any application of loss allocation to margin or collateral under the rules of the FMI or through the exercise of statutory loss allocation powers.*
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> *5.2 Where such rights to acceleration or early termination nevertheless arise by reason only of entry into resolution or in connection with the exercise of any resolution powers, the resolution authority should have the power to stay temporarily such rights. When considering whether to impose a temporary stay on the exercise by FMI participants and other relevant counterparties of acceleration or early termination rights triggered by entry into resolution of the FMI, the resolution authority should take into account the impact on the financial markets and on the safe and orderly operations of the FMI and any linked FMI.*".

We note that the 2015 Resolution Consultation referred to a determination at the expiration of 48 hours (or sooner) which may contemplate the FMI being wound up and, if so, this would provide a trigger for termination rights. We would be grateful if the CFR could provide further background as to whether this determination is still proposed to be made, and whether the determination would still constitute a trigger for termination rights.

Further, ISDA refers to the proposal that, during resolution, the resolution authority will be able to temporarily suspend contractual termination rights of a counterparty. It is important that any termination rights for substantive and non-resolution-related defaults (including in relation to payment and delivery obligations and the provision of collateral)

[5] Reference is made to section 15C of the *Banking Act 1959* (Cth) (and the associated mechanics in the *Payment Systems and Netting Act 1998* (Cth)), and it is suggested that this is a more appropriate example than, for example, the "ipso facto" stays in the *Corporations Act 2001* (Cth).

are not affected by any suspension of termination rights. Further, while there is a reference to any suspension being "temporary", the specific timeframe for any such suspension does not appear to be indicated in the Consultation Paper. While it is noted that the FMI Annex of the Key Attributes[6] does not specifically refer to a timeframe, any suspension should be strictly limited in time and must not exceed the 2 business day timeframe which is described in the Key Attributes generally in relation to suspensions of termination rights. Further, it is important that any suspension is subject to adequate safeguards that protect the integrity of financial contracts (including in relation to netting and collateral rights) and market participants.

Generally, we note that any stays on close-out rights, particularly indefinite stays, are carefully scrutinised in determining the application of regulatory capital requirements for both clearing members and their clients to exposures under both Australian, and international, regulatory capital rules. May we please check whether, in formulating this stay regime, the CFR has considered the impact of this proposed stay regime on the amount of capital regulated entities are required to hold under capital rules?

3 Transfers

ISDA notes the proposals in the Consultation Paper to create transfer powers which allow the resolution authority to transfer, among other things, all or part of the business of a domestic CS facility licensee or a related body corporate.[7] We also note that it is proposed that this proposed transfer regime would be similar to the equivalent regime for authorised deposit-taking institutions ("**ADIs**") in the *Financial Sector (Transfer and Restructure) Act 1999* (Cth). As noted in ISDA's submission on the 2015 Resolution Consultation, the exercise of transfer powers with respect to a CS facility licensee is likely to be more problematic than with respect to an ADI.[8]

Further, ISDA strongly agrees that with the CFR's proposal that transfer powers would not be able to be exercised in a way that disrupted netting sets, or separated collateral from associated positions. In effecting a transfer, netting sets and related positions and collateral would be required to be transferred intact. This should be clearly established in any legislation proposed to implement the reforms.

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6 The *II-Annex 1: Resolution of Financial Market Infrastructures (FMIs) and FMI Participants* ("**FMI Annex**") of the Key Attributes.

7 Section 4.9, pp31–32, Consultation Paper.

8 For the reasons noted in our submission on the 2015 Resolution Consultation, we suggested in that submission that the exercise of these powers should be only a fall-back if the use of the CS facility's recovery plan, and then statutory management powers, fail.

4 Moratoria

We refer to the proposal in the Consultation Paper that a moratorium apply to prevent a person from taking certain litigation and enforcement actions in relation to the body corporate or its property during the statutory management or transfer of a domestic clearing and settlement facility licensee or related body corporate.[9] There are three points ISDA would like to raise on this proposal.

First, we note that the moratorium proposals "*expand upon the 2015 Resolution Consultation, which only proposed a moratorium on non-enforcement proceedings, for example court proceedings or arbitration.*" However, we note that the 2015 Resolution Consultation also referred to a moratorium on the FMI's payments to unsecured general creditors. We would be grateful if it could be clarified whether a moratorium on payments to general creditors is still intended to be introduced. If it will be, ISDA refers to its previous submissions that any such moratorium should not apply to payments made by the CS facility under market netting contracts or close-out netting contracts[10] and that it should be clearly limited such that it can only be applied when it is necessary to prevent the discontinuity or disruption of the critical functions of the CS facility.

Secondly, we note that one of the proposed moratoria is that "*enforcing any security that may be attached to any property that the body corporate owns, uses, possesses, occupies or otherwise has any interest in*" will be prohibited during the resolution of a domestic CS facility licensee or relevant related body corporate without the consent of the statutory manager, resolution authority or leave of the Court. While we note that this description of property appears in other contexts (including in one of the moratoria in the *Banking Act*),[11] we would note that this moratorium would cover a very broad range of property. Staying the enforcement of any security that may be attached to any property that the CS facility licensee or related body corporate owns, uses, possesses, occupies or in which the entity otherwise has an interest would have a significant impact on market participants, potentially beyond the primary objective of the moratorium. This impact may include preventing third parties from pursuing valuable and time-critical claims which do not directly affect the CS facility licensee (or related body corporate) or its business. ISDA would be grateful if the CFR could please consider

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9 Section 4.13, pp34–35, Consultation Paper.

10 In our previous submission, we noted in this regard that "*Imposing any suspension on these payments is unlikely to be appropriate or consistent with the greater level of protection given to these arrangements under Australian law. Further, as these are contracts which usually require payments both to, and by, the CS facility, imposing a moratorium would result in an imbalance of payment obligations which were always intended to be mutual.*"

11 *Banking Act 1959* (Cth), section 15B(8) (albeit in the context of the effect of Banking Act statutory management on court and tribunal proceedings and proceedings to enforce security).

whether this moratorium is intended to prevent, for example, a third-party secured party from enforcing a security interest granted to it by a third party grantor, where the only connection to the CS facility licensee is that the security interest was granted over property (eg securities) held in the CS facility (noting it seems that the current drafting of the proposal could be argued to be broad enough to cover this situation). If this is not the policy intention, ISDA would be grateful if the CFR could please consider restricting the scope of the moratorium to ensure it achieves the CFR's policy objective without unnecessarily impacting on third party security rights.

Thirdly, ISDA strongly supports the longstanding policy that the *Payment Systems and Netting Act 1998* (Cth) ("***Netting Act***") prevails despite any other law, and appreciates the efforts of prior reforms (including those relating to collateral protection, porting, and arising from G20 OTC derivative reforms) giving effect to this policy. ISDA notes that the protections in the *Netting Act* apply to discrete actions such as terminating obligations, calculating termination values and a net cash amount becoming payable, enforcing security, and transferring rights and obligations as well as other dealings with property. This is consistent with the approach taken in other similar legislative frameworks around the world which protect close-out netting and related rights in other jurisdictions. Generally, these protections are understood as not extending to protecting the beginning or continuation of court or tribunal proceedings (as these actions are generally taken without the need for a court or tribunal process). Accordingly, ISDA strongly agrees with the proposal in the Consultation Paper that the protections in the *Netting Act* will not be disturbed by the moratoria. However, we would be grateful if the CFR could please clarify the meaning of the reference on Page 34 of the Consultation Paper to "*aside from the prohibition on beginning or continuing court or tribunal proceedings*". For example, we would suggest that it would not be necessary to indicate that any prohibition on beginning or continuing court proceedings prevails over the protections in the *Netting Act*. ISDA considers that any such provision that had this effect could create uncertainty as to the intended primacy and scope of the protections of the *Netting Act*, which would be detrimental to FMI operators and participants in the Australian market. Generally, ISDA supports the implementation of legislation clearly identifying that the *Netting Act* applies despite any other law (including any of these moratoria).

5 Location requirements for overseas markets and clearing and settlement facilities

The CFR proposes that ASIC[12] has the power to impose location requirements on market licensees and clearing and settlement facility licensees to transfer from an overseas licence to a domestic licence held by a domestically incorporated entity.[13] An

[12] ASIC, on receiving advice from the RBA, in the case of CS facility licensees.

[13] Section 2.4, p14, Consultation Paper.

exercise of this power would have a significant impact on the business of the licensee and the participants of the facility, and could cause significant disruptions to the market generally (noting, for example, complexities which would arise in relation to netting sets and collateral, and associated termination rights, if a separate new entity was required to clear and settle particular transactions) and functioning and financing of the real economy. ISDA considers that the implementation of any location requirement should seek to minimise market fragmentation and distortions in competition, as well as avoid potential risks and costs which could arise from any such requirement, such as:

- the isolation of domestic FMIs from international cross border liquidity;[14]
- systemic risk of more correlated, less robust CCPs due to fewer participants mutualising risk;
- increased liquidity risk for firms intermediating between CCPs;
- risk of virtual interconnectivity, as firms intermediating between CCPs would likely be all in the same direction and could pose stability concerns to both on-shore and off-shore CCPs;
- potential for retaliatory action from other regulators;
- migration of positions to a new domestically incorporated entity would pose significant operational risk and execution costs;
- less choice for Australian participants and competition would be stifled;
- higher costs as a result of a difference in price for the same product cleared through different CCPs, wider bid/ask spreads, higher costs for end-users and an uneven playing field for Australian participants; and
- higher margin and capital requirements, reducing the efficiency of Australia's capital markets.

ISDA is not in support of a location policy that causes geographical fragmentation of markets and distortions in competition, as well as material adverse impacts on the reduction of systemic risk, added costs, and reduced market liquidity and efficiency.

[14] This could arise because, for example, any new domestically incorporated entity would not have the required licences in other jurisdictions to be able to operate in those jurisdictions and, without equivalence agreements on the recognition of FMI with foreign regulators, obtaining those licences can be a lengthy and costly exercise.

Accordingly, ISDA suggests that a location requirement should be enacted only after a detailed impact analysis has been conducted, covering risk to participants and the financial system, and cost to end users. We encourage the CFR to build on regimes that rely on regulatory coordination, cooperation and deference, with action that may lead to regulatory jurisdiction arbitrage or retaliation to be avoided.

If the policy remains that a location requirement is to be introduced, we ask that the CFR provide additional clarity around the circumstances in which this power would be exercisable by ASIC, and that the legislation provide for clear conditions and criteria applicable to the exercise of this power which are able to be determined with a high level of certainty.

6 Interaction between new Australian regulatory powers and existing powers of home regulators

We refer to the proposals in the Consultation Paper that enhance ASIC's and RBA's supervisory and enforcement powers (including in relation to directions and rule-making powers).[15]

ISDA acknowledges that ASIC and the RBA need to have appropriate powers to enable them to administer the relevant laws in respect of FMIs. However, we suggest that, in making any directions or rules or enforcing any such powers, ASIC and the RBA consider the existing legislative and regulatory frameworks to which FMI operators, and market participants, are subject and seek to avoid, wherever possible, situations in which the Australian rule-making or directions powers impose requirements on an overseas entity which are inconsistent or irreconcilable with the entity's obligations in other jurisdictions. Such a situation could leave such an entity in the unenviable position of potentially not complying with either an overseas regulatory regime or the Australian regulatory regime. It would be helpful if the legislative framework and associated regulatory guidance could address this issue.

We also encourage the CFR to continue its dialogue with foreign regulators in other jurisdictions to ensure that international FMI supervision is based on deference to home country regulations and compliance with the Principles of Financial Market Infrastructures, with the aim of avoiding any fragmentation of global cleared derivative markets which might be caused by the application of inconsistent or duplicative regulatory frameworks to FMIs.[16]

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[15] Section 3.5, pp20–21; Section 3.7, p22–25, Consultation Paper.

[16] Regulatory-Driven Market Fragmentation (January 2019), https://www.isda.org/a/MlgME/Regulatory-Driven-Market-Fragmentation-January-2019.pdf.

7 Domestic connection

We refer to the proposal in the Consultation Paper that any foreign FMI that has a "domestic connection" would be required to notify Australian regulators, and have an "ongoing reporting requirement" to enable ASIC to assess any changes to materiality over time.[17]

Due to the breadth of the "domestic connection" concept set out in the Australian Government's Consultation Paper, ISDA expects that this test could result in a significant number of foreign FMIs being subject to Australian regulatory requirements where those entities may not be generally expected to have any meaningful connection to Australia or Australian regulation. We would be grateful if the CFR could please consider whether this was the intended policy consequence and whether any parameters could be developed to ensure that the legislative framework (and any associated penalties) only apply to those entities which are intended to be caught by the proposed regime.

8 Other considerations

Statutory management: We refer to the proposal in the Consultation Paper that the resolution authority, or a person appointed by it, would be able to temporarily take control of a distressed Australian-incorporated CS facility licensee by way of statutory management.[18] [19] ISDA suggests that it would be appropriate for any such appointee to have relevant experience in managing clearing and settlement facilities (rather than, for example, in corporate liquidations generally).[20]

Resources and tools: The 2015 Resolution Consultation discussed resolution powers and contemplated temporary funding arrangements for the facilitation and implementation of resolution actions, and also proposed that the recovery tools available to an FMI also be available to any statutory manager appointed by the resolution authority. ISDA agrees that the resolution authority should have sufficient tools and resources to carry out resolution actions, and submits that these should be

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17 Section 2.4, pp13–14, Consultation Paper.

18 Section 4.10, p31, Consultation Paper.

19 We note that the Response in respect of the 2015 Resolution Consultation had considered that "*the process for selecting a statutory manager will be considered as part of a broader resolution planning process to be undertaken by CFR agencies*".

20 We note that our submission to the 2015 Resolution Consultation stated that "*ISDA submits that the empowering legislation should prescribe competency requirements to which the RBA must have regard when appointing a statutory manager to a CS facility. This is because the management of a clearing and settlement facility will require particularly specialist knowledge, with the result that competency in this area will be a critical factor.*"

clearly identified in any proposed legislative framework in order to provide certainty to market participants.

Confidentiality: We refer to the proposal in the Consultation Paper that the resolution authority will be able to issue a secrecy determination or a confidentiality notice to certain parties.[21] ISDA acknowledges that a resolution authority should have capacity to impose confidentiality where it is appropriate to do so in the relevant circumstances due to issues regarding market confidence and financial system stability. As noted in the Consultation Paper, it is also critical to maintaining market confidence that participants have a clear and timely understanding of actions taken by the resolution authority.

ISDA suggests that it is also important to carefully consider issues which arise in relation to secrecy orders in the context of resolution proceedings, including in relation to:

- the impact of foreign laws (including those which may impose disclosure obligations, noting the difficulties in any protection from liability under Australian law applying to the breach of any non-Australian law); and

- more immediate issues about to whom inside the FMI, its direct advisers and even primary regulators or other FMIs or interested market participants, the recipient of any such direction or determination should be able to disclose particular information (noting that at least some sharing between key personnel within the entity and to key advisers will be critical).

9 Next steps

The Consultation Paper covers a broad range of proposals, many of which are highly complex, technical and will have a material impact on key risk mitigation rights of market participants, and consolidates (in many cases by reference) issues consulted on in 2011 and 2015.

Accordingly, ISDA would welcome a separate consultation process in respect of the specific proposed legislative changes to implement these proposals (with consultation drafts of the proposed bills and explanatory materials). It will be crucial for the market to carefully consider the drafted legislation, supporting explanatory material and regulatory guidance to ensure that any legislation appropriately achieves the policy objectives. ISDA would welcome an opportunity to engage with the CFR on the draft legislation when it is released in due course.

[21] Section 4.14, p35, Consultation Paper.

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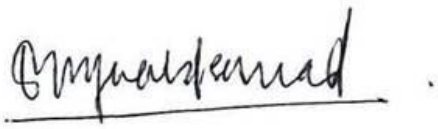
Thank you again for the opportunity to respond to this Consultation Paper. ISDA can be of any assistance in the interim, please do not hesitate to contact Rishi Kapoor, Director, Public Policy, Asia-Pacific (rkapoor@isda.org; +852 2200 5907) or Erryan Abdul Samad, Assistant General Counsel (eabdulsamad@isda.org; +65 6653 4172).

Yours sincerely,



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