Overseas Clearing and Settlement Facilities: The Australian Licensing Regime

A response to consultation by the
Council of Financial Regulators

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1. Introduction and Background

In March 2015, the Council of Financial Regulators (CFR) released the consultation paper 'Overseas Clearing and Settlement Facilities: The Australian Licensing Regime'.[1] The consultation paper sought stakeholder views on a proposed new approach to assessing whether an 'overseas' clearing and settlement (CS) facility (i.e. a CS facility that is not operated by a body corporate registered under Chapter 2A of the *Corporations Act 2001* (the Corporations Act)) must be either licensed in Australia or exempted from Part 7.3 of the Corporations Act.

The Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) – together, the regulators – are receiving an increasing number of queries from overseas CS facilities as to whether they fall within the scope of the licensing regime. These queries have arisen primarily due to a lack of clarity around whether an overseas CS facility is 'operating in this jurisdiction', which is the relevant test in Part 7.3 of the Corporations Act. The purpose of the proposed new approach is to promote Australian entities' access to a diverse range of CS options, both in Australia and overseas, by providing clarity and increased legal certainty to all stakeholders on the scope of the Australian CS facility licensing regime.

The proposal rests on a two component test of the materiality of the CS facility's connection to the Australian financial system. An overseas CS facility will be required to be licensed (or formally exempted from licensing) if, and only if, it has a material domestic connection. The policy intention is to capture only facilities with operations that have, or are expected to have, implications for the safe, efficient and effective functioning of the Australian financial system or the confident, fair and effective dealings in financial products by Australian investors. At the same time, the approach aims to strike an appropriate balance between public policy relevance and appropriate cross-border reach.

- *First component*: *A CS facility's domestic connection.* The first component of the test would establish objectively if the operations of a CS facility were in any way connected to the Australian financial system. It is intended that this component provide a high degree of certainty for all stakeholders as to when a CS facility is not within the scope of the Australian CS facility licensing regime. The factors that would constitute a domestic connection include: the location of a CS facility's operations in Australia; the provision of CS services for financial products connected with Australia; the provision of CS services to one or more Australian participants; or having arrangements with the operator of a domestically licensed or exempted financial market or CS facility.
- *Second component*: *Materiality of a CS facility's domestic connection.* Where the first component of the test established that an overseas CS facility had a domestic connection, the second component would assess the materiality of that connection. A CS facility's connection to the Australian financial system would be material if ASIC, in consultation with the RBA, was satisfied that the facility's current or expected activities were material to the safe, efficient and effective functioning of the Australian financial system or the confident, fair and effective dealings in financial products by Australian investors. To provide additional clarity to all stakeholders, the circumstances in which the materiality test was likely to be met and the factors that the regulators would take into consideration could be described in revised regulatory guidance or another legislative instrument.

1 The CFR consultation paper is available at <http://www.cfr.gov.au/publications/cfr-publications/2015/overseas-clearing-and-settlement-facilities-australian-licensing-regime.pdf>.

The proposed test would be implemented through legislative reform to the Corporations Act. It is proposed that the Corporations Act would set out the test at a high level, with more detailed criteria set out in legislative instruments (e.g. a Ministerial determination or regulations) and/or revised regulatory guidance.

It is not expected that the proposed new approach would result in additional CS facilities falling within the scope of Australia's CS facility licensing regime. Furthermore, the rest of the Australian CS facility licensing regime would remain unchanged by this proposal. The factors relevant to consideration of the materiality of a CS facility's connection to the Australian financial system by the regulators are already listed in ASIC's *Regulatory Guide 211 – Clearing and Settlement Facilities: Australian and Overseas Operators* (RG 211). The intent of the proposed approach is to formalise how these factors are currently, and in the future will be, weighed in reaching judgements around regulatory scope so as to provide clarity and transparency for prospective future CS facility licence applicants.

The CFR has considered feedback received from consultation on the initial proposal. The remainder of this report summarises the key feedback from stakeholders along with the CFR's views on how this feedback should be addressed in implementing the proposed framework. Any legislative change will ultimately be a matter for the government to consider.

2. Overview of Consultation Responses and Response to Feedback

The CFR received five written submissions from stakeholders, including from major overseas CS facilities. This section summarises the stakeholder feedback received and sets out the CFR's responses.

On balance, stakeholders agreed that the proposed approach would provide useful additional clarity on whether a CS facility should be licensed in Australia or exempt from Part 7.3 of the Corporations Act. There was support for the proposed criteria and stakeholders generally acknowledged the need for the test to be flexible. Such flexibility was seen as important to ensure that the regulators could respond appropriately to future changes in the provision of CS services.

Case for reform

- Two stakeholders commented that the current test in section 820A of the Corporations Act (i.e. whether a CS facility was 'operating in this jurisdiction') and the broader Australian CS facility licensing regime were functioning effectively. One of those stakeholders considered that the case for reform was not made in the consultation paper and that higher priority should be assigned to other more important financial sector reforms currently underway.
  - As noted in the consultation paper, the regulators have identified, through discussions with a number of overseas CS facilities, that there is a lack of clarity in the existing regime. Accordingly, the CFR considers that there would be substantial benefit to providing greater clarity, as well as increased legal certainty, for all stakeholders on the circumstances in which a CS facility must be either licensed in Australia or exempted from Part 7.3 of the Corporations Act. Indeed, the majority of feedback agreed that the proposed approach provided more clarity relative to the current test. Furthermore, by providing additional clarity, while maintaining flexibility, it is expected that the proposal will continue to promote Australian entities' ongoing access to a diverse range of CS options, both in Australia and overseas.
  - The CFR recommends that the changes to the Corporations Act required to implement the proposal set out in the consultation paper be made in conjunction with proposed legislative reforms required to implement a special resolution regime for CS facilities and trade repositories (together referred to as financial market infrastructures (FMIs)). Linking the proposal to this high-priority package of legislative changes, for which there is considerable industry support, should address any concern that it might divert resources from other more pressing financial sector reforms. There is a natural link between these proposals. In particular, clarity as to the scope of the Australian CS facility licensing regime is foundational to defining the scope of application of the special resolution regime for FMIs. The core elements of the FMI resolution regime would apply to CS facilities that held a domestic CS facility licence, but a subset of proposed powers would apply to any overseas CS facility within the scope of the Australian CS facility licensing regime. These reforms are expected to occur as part of a broader package of financial sector reforms implemented in response to the Financial System Inquiry.

Notification requirement

- There were no objections to the proposal that a CS facility with a domestic connection should notify the regulators. However, some stakeholders queried how this requirement would be enforced and noted that appropriate incentives would be required to encourage overseas CS facilities to assess themselves against the test and notify the regulators accordingly.
  - The CFR would generally expect most overseas CS facilities to have a sufficiently strong incentive to notify the regulators of any domestic connection. Such a notification would trigger a determination from the regulators as to whether the domestic connection was material. A determination on materiality would in turn provide certainty for the CS facility and its participants as to whether the CS facility needed to be licensed to conduct any activities that had a connection with Australia. The CFR would also generally expect that some Australian participants would encourage any overseas CS facility that they used to seek the necessary determination, in order to avoid the potential for implementation of higher capital requirements if there were uncertainties about the regulatory regime that applied to the CCP. Accordingly, the CFR considers there should already be sufficient incentives in place to encourage correct self-assessment and notification to the regulators.
  - Nevertheless, the CFR proposes that in consulting on the draft legislative amendments to the Corporations Act to implement the proposed framework, further consideration could usefully be given to additional mechanisms to promote compliance with the notification requirement. This could include the regulators being granted a specific and limited power to make enquiries of an overseas CS facility to ascertain whether the CS facility had a domestic connection. It is expected that any such power would only be exercised in limited circumstances; for instance, where the regulators had reason to believe that a CS facility had a domestic connection but had not provided the required notification.

Materiality of a CS facility's domestic connection

The majority of stakeholder feedback related to the second component of the test, which addresses the materiality of a CS facility's domestic connection.

- *Further guidance and quantitative thresholds*: Some stakeholders sought further guidance on various aspects of the materiality component of the test. In particular, they favoured quantitative criteria and thresholds to provide additional certainty.
  - The CFR acknowledges the desire for more certainty. However, close consideration was given to this matter in developing the proposal and the CFR concluded that to adopt quantitative thresholds would unduly restrict the regulators in weighing the various factors relevant to determining the materiality of a CS facility's domestic connection. This could result in the regime capturing some CS facilities that were not relevant to the safe, efficient and effective functioning of the Australian financial system or the confident, fair and effective dealings in financial products by Australian investors, and excluding some CS facilities that were relevant. Including quantitative criteria and thresholds in the proposal would also add rigidity by limiting the scope of the regulators to respond to future changes in the provision of CS services. Ensuring sufficient flexibility was a particular consideration for the CFR in developing the approach. Indeed, the need to avoid undue rigidity was seen by two stakeholders as crucial to ensuring that the licensing regime was not a barrier to Australian entities accessing overseas CS facilities to support their financial market activities.

  - Through the proposed framework, the CFR has sought to strike an appropriate balance between the need for legal certainty and the need both to allow the regulators flexibility to exercise judgement in weighing relevant factors, and to respond to future changes in the structure and operation of financial markets and CS facilities. Accordingly, the regulators favour engaging bilaterally with overseas CS facilities and providing additional guidance on a case-by-case basis.

- *Australian users*: Informal bilateral feedback was provided querying whether the term 'user' could be defined more restrictively to apply to an ascertainable population of indirect users of CS facilities.
  - One of the purposes of regulating CS facilities is to protect investors dealing in financial products and other users of CS facilities. The CFR therefore considers it appropriate that the reference to 'Australian users' be retained in the materiality component without defining the term more restrictively. The CFR recognises there may be some practical impediments to a CS facility's ability to identify Australian users, particularly where a CS facility has no direct contractual relationship with its indirect users – and especially where there are several tiers of indirect users. The regulators would expect to engage with any overseas CS facility that had a domestic connection to understand what information on indirect users was available and how the determination could best be made without imposing an undue regulatory burden.
- *Affiliated operators*: One stakeholder recommended that where different entities in an affiliated group operate CS facilities (i.e. CS services) for different classes of products, the materiality of those different CS facilities be assessed separately.
  - In assessing the materiality of a CS facility's connection, the regulators would expect to assess each CS facility separately, recognising that a legal entity may operate multiple CS facilities, or that multiple CS facilities may be operated by different legal entities that are part of the same affiliated group (particularly for different product types). Part 7.3 of the Corporations Act recognises that one entity could operate more than one CS facility. The regulators would consider, on a case-by-case basis, what constituted an individual CS facility as this would depend on a number of factors, including the corporate, organisational, operational and financial structure of the CS facility operator's activities. In addition, the regulators would assess each legal entity that operates a CS facility individually, and would not assess affiliated legal entities together.

Transitional arrangements

- Stakeholders sought additional clarity on transitional arrangements, where a CS facility's domestic connection that was not previously determined to be material became material over time (e.g. where the number of Australian participants or volume grew over time).
  - The CFR proposes that in consulting on the draft legislative amendments to implement the proposed framework, further consultation be undertaken on appropriate transitional arrangements for CS facilities that become more materially connected over time. For a CS facility that was determined not to have a material domestic connection, it is envisaged that some form of regular reporting and/or engagement would continue with the regulators. Through this process, the regulators would be able to guide such a facility through any transitional arrangements should the assessment of its materiality change. It is expected that any transitional arrangements would provide the affected entity with a reasonable period of time to either transition to become licensed, or to reduce the materiality of its Australian activities.

The process for making a materiality determination

- Two stakeholders expressly agreed with the proposed approach that ASIC, in consultation with the RBA, would make a determination as to whether a CS facility's activities were material. One stakeholder, however, favoured a single regulatory point of communication, while another suggested that a decision on materiality should be subject to public consultation before a final determination was made.
  - Both ASIC and the RBA have regulatory responsibilities under the Corporations Act in relation to CS facilities, and it is therefore appropriate that overseas CS facilities communicate with both regulators. However, the regulators carry out their responsibilities in a cooperative and coordinated manner in order to prevent unnecessary duplication of effort and to minimise the regulatory burden on facilities.
  - The regulators would not generally expect to consult publicly in determining the materiality of a CS facility's domestic connection, since such a decision would be taken in the context of the routine exercise of regulatory responsibility.

Implementation

- *Implementation*: One stakeholder agreed that codifying the key elements of the framework in the Corporations Act and associated regulations would provide more certainty for stakeholders; although two stakeholders noted that the proposed approach could introduce unnecessary rigidity. It was also suggested that in making the legislative changes, the regulators should consult on timing and content with overseas regulators to mitigate cross-border regulatory conflict.
  - Consistent with the consultation paper, the CFR considers that the overarching, high-level test could be incorporated into the Corporations Act, with the associated circumstances and factors for consideration implemented through a legislative instrument (e.g. a Ministerial determination or regulations) and/or revised regulatory guidance. Including the more detailed factors for consideration in revised regulatory guidance would ensure that the proposed framework retained the flexibility necessary for the regulators to consider each CS facility's circumstances on a case-by-case basis, while providing clarity for stakeholders about how the regulators expected to apply the framework. Further public consultation would take place on the text of draft legislation, regulation and guidance, and any comments from overseas entities and regulators would be considered.

Other stakeholder feedback

Some stakeholders also raised issues that were less widely commented on among respondents.

- *A CS facility's domestic connection – branches of Australian institutions*: One stakeholder suggested that in considering whether a CS facility provided CS services to an Australian participant, the regulators should differentiate between overseas branches of Australian financial institutions that were also supervised by an overseas authority, and the Australian financial institutions located in Australia.
  - Where a CS facility provides CS services directly to an overseas branch of an Australian institution, that branch would be considered to be an Australian participant since it is not a separate legal entity. While the provision of services to an Australian participant would constitute a domestic connection requiring notification to the regulators, it would not automatically mean that the CS facility was required to be licensed in Australia or exempt

from licensing under Part 7.3 of the Corporations Act; the regulators would still need to form a judgement as to whether the CS facility's domestic connection was material.

- *Arrangements with other financial markets or CS facilities*: One respondent suggested avoiding a direct link between licensing requirements for CS facilities and market operators that belonged to the same group.
  - Under the proposed approach, a CS facility that had an arrangement with a financial market or CS facility operator that was licensed or exempt under the Australian regime would be considered to have a domestic connection. Furthermore, an arrangement with a holder of a domestic Australian market licence or an Australian CS facility licence (i.e. granted under section 795B(1) or section 824B(1) of the Corporations Act, respectively) would constitute a material domestic connection.
  - However, an arrangement with the holder of an overseas Australian market licence or an overseas Australian CS facility licence (i.e. granted under section 795B(2) or section 824B(2) of the Corporations Act, respectively), would not in and of itself constitute a material domestic connection.

Other matters

Individual stakeholders also raised other matters that were not within the scope of the consultation paper.

- *Mutual recognition with overseas jurisdictions*: It was suggested that the CFR consider mutual recognition of regulatory oversight between the Australian and overseas regulatory authorities.
  - The Australian regulatory regime already provides for recognition of oversight by an overseas regulatory authority. In particular, Part 7.3 of the Corporation Act provides an alternative licensing route for overseas CS facilities, which is intended to avoid regulatory duplication. This is available where the operation of a CS facility in an overseas country (i.e. a CS facility's 'home jurisdiction') is subject to requirements and supervision that are sufficiently equivalent to those in Australia. An assessment of sufficient equivalence is made when the facility submits an application for an Australian CS facility licence under section 824B(2) of the Corporations Act, rather than at the point at which a determination is made as to whether a facility falls within the scope of the licensing regime.
- *Disclosure for CS facility users about domestic and overseas CS facilities*: Another stakeholder suggested that the framework should establish disclosure requirements to ensure that CS facility users understand the differences between dealing with an overseas licensed CS facility and a domestically licensed CS facility.
  - The CFR does not propose to consider such disclosure requirements as part of the legislative proposal at hand. Such disclosure requirements are only relevant once a CS facility is licensed. The Australian regulatory regime for CS facilities already requires certain disclosures which help to ensure that participants and other users are appropriately informed in their dealings with licensed CS facilities, whether domestic or overseas, including under the RBA's Financial Stability Standards. The regulators would consider if any additional disclosure was required on a case-by-case basis, and have, in some cases, imposed licence conditions requiring such disclosure.

3. Next Steps

The CFR is advising the government on the development of draft legislation that reflects the proposals set out in the CFR's March 2015 consultation paper and this response to consultation. The draft legislation will incorporate changes to the Corporations Act to implement a special resolution regime for FMIs, since the resolution regime for CS facilities would build on the licensing regime.[2]

Stakeholders will be given the opportunity to comment on draft legislation to implement the proposed changed approach to assessing whether an overseas CS facility must be either licensed in Australia or exempted from Part 7.3 of the Corporations Act in due course.

As similar issues also exist for financial markets, ASIC and Treasury are also considering the application of this proposed new approach to financial markets regulated under Part 7.2 of the Corporations Act.

2 These proposals are described in the paper 'Resolution Regime for Financial Market Infrastructures: Response to Consultation', available at <http://www.cfr.gov.au/publications/cfr-publications/2015/resolution-regime-financial-market/>.