NZX Limited
Level 1, NZX Centre
11 Cable Street
PO Box 2959
Wellington 6140
New Zealand
Tel +64 4 472 7599

www.nzx.com

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Cavan O'Connor-Close
Manager, Prudential Operational Policy
Financial System Policy and Analysis Department
Reserve Bank of New Zealand

By Email: fmibill@rbnz.govt.nz

NZX Clearing – Submission on FMI Bill Exposure Draft

Introduction

1. Thank you for the opportunity to provide this submission in respect of the draft Financial Market Infrastructures Bill (**FMI Bill**) that was released on 1 August 2019.

2. NZX Limited (**NZX**), New Zealand Clearing Limited and other wholly owned NZX subsidiary companies (**NZX Clearing**) are currently operators of the NZCDC settlement system which is a designated settlement system under Part 5C of the Reserve Bank of New Zealand Act 1989 (**RBNZ Act**)[1]. NZX Clearing will be directly affected by the regulatory regime proposed by the FMI Bill.

3. As we discussed with RBNZ and the FMA at our meeting of 9 September, we have fundamental concerns with the process by which the FMI Bill is being introduced, and the proposed scope of the joint regulator's powers under the legislation.

4. While we understand that RBNZ considers that these are not matters for consultation, we consider it appropriate to elaborate on these concerns, as we intend to share these views with the Select Committee considering the FMI Bill, when it is introduced to Parliament.

5. We also comment on the proposed differential treatment of FMIs. We are concerned that the proposed regulatory framework does not preserve competitive neutrality given the differentiation of overseas FMIs. We also note that there are potential conflicts in the oversight model, given that RBNZ will regulate two designated settlement systems that it owns.

[1] By operation of the Reserve Bank of New Zealand (Designated Settlement System – NZCDC) Order 2010 (**Order**).

6. We also address certain matters on which RBNZ is consulting, along with ancillary and technical aspects of the FMI Bill. These matters include the transition arrangements for current designated settlement system operators, and the proposal that direction notices be kept confidential despite an operator's continuous disclosure obligations (which is directly relevant for NZX).

7. We caution that it is fundamental to the health of New Zealand's broader financial markets that the regulators implement a right-sized regime, that is proportionate to the risks to the soundness and efficiency of the New Zealand financial system, consistent with Responsibility E of the PFMI[2].

Implementation process and interface with Phase II

8. We appreciate the origins of the FMI Bill, and the RBNZ's and Government's desire to address the concerns raised in the 2017 FSAP report[3], and to ensure that New Zealand's regulatory regime incorporates the requirements of the PFMI.

9. We are however concerned with the approach that the RBNZ has taken in relation to the development to the FMI Bill. In particular, we are concerned that the consultation process to date has not adequately considered the ongoing compliance and operational costs that will arise under the proposed revised regulatory regime. In this regard, we note that the Cabinet Paper that recommended the implementation of the new regime was based on a series of principles, including the importance of minimising compliance costs and avoiding unjustified constraints to innovation as a result of regulatory actions.

10. The Regulatory Impact Statement prepared by RBNZ quantified the compliance costs of the new regime for existing designated operators as negligible, on the basis that additional compliance costs would be minor. We disagree with this assessment. We currently estimate that our transitional and additional ongoing compliance costs will be between $230,000 - $400,000, depending on how the new regime is implemented.

11. We also have concerns around the proposed timetable for implementation of the regulatory arrangements. We consider that the new requirements and supervisory approach have not been explained in sufficient detail, to provide clearly defined criteria (contemplated by Responsibility A and C of the PFMI), that would allow existing operators to effectively plan for the effect of the FMI Bill on their businesses. It is suggested that existing operators could be designated under the FMI Bill while standards are developed, and afforded a grace period for compliance with the new requirements contained in the standards. We consider that it is very difficult for existing

[2] CPSS-IOSCO Principles for Financial Market Infrastructures (**PFMI**).

[3] 'New Zealand: Financial Sector Assessment Program: Financial System Stability Assessment', International Monetary Fund, May 8 2017.

operators such as NZX Clearing to determine how to transition to the new regime and develop appropriate compliance models, in the absence of clarity of these new requirements.

12. We also note that a relatively short consultation period has been allowed for affected parties to comment on the specific provisions of the FMI Bill, which is the first time that detail of the new regime has been made available. In addition, we note that the approach taken to certain aspects of the Phase II review of the Reserve Bank of New Zealand Act 1989 (**RBNZ Act**), will affect the approach to the revised FMI regulatory regime. We consider that it is inappropriate and inefficient to introduce these aspects of the revised FMI requirements (such as the approach to continuous disclosure) until the outcomes of the Phase II review are known.

Scope of the joint regulator's powers

13. We note that the RBNZ has signalled that it will exercise its supervisory powers under the FMI Bill in a more 'intense' and interventionist manner[4]. We encourage the RBNZ to exercise its new powers under the FMI regime in a sensible and efficient way, in the spirit of the supervisory oversight envisioned by the PFMI, which contemplates the ability to obtain information and induce change.

14. We consider that the supervisory arrangements must recognise that the PFMI are principles based and non-prescriptive in nature. The new requirements must be implemented in a manner that is consistent with international practice, but acknowledges that the PFMI are designed to provide a breadth of compliance obligations, including for globally, interconnected systemic central counterparties. We recommend that the PFMI are implemented in a manner that acknowledges the nature of central counterparties in New Zealand, that although locally important, are not as sophisticated or complex as their international counterparts. This will be essential in allowing for FMI within New Zealand to operate efficiently in accordance with PFMI Principle 21.

15. The regime needs to ensure there is a right balance of compliance costs for operators, as such costs will invariably flow through to the market in some form, and impact the overall efficiency of New Zealand's financial markets. We are concerned with suggestions that the new regime could duplicate information verification and assurance requirements. This approach does not appear to align with principle 13(2)(e) of the FMI Bill, which recognises the need to avoid unnecessary compliance costs.

Standards

16. The standards that are to be developed to support the new regime will be pivotal to the framework and must balance regulatory concerns with commercial pragmatism. We

[4] We refer to your letter to us dated 19 September 2019.

understand that a consultative process will be run in the development of the standards, in which we intend to fully participate.

17. We would not expect the standards to require existing operators to fundamentally re-design their business operations and note the established contractual relationships existing operators have with their participants (through the rule sets by which those systems are operated) and current service providers. The standards must be developed with a recognition of the New Zealand environment in which FMI operate.

18. We understand that the content of the standards is not intended to go beyond the scope of the PFMI, relevant parts of the Financial Stability Board's Key Attributes of Resolution Regimes for Systemically Important Financial Institutions and other relevant international standards. The PFMI are principles based, and with few exceptions, the PFMI 'do not prescribe a specific tool or arrangement to achieve their requirements and allow for different means to satisfy a particular principle'[5]. We are aware that internationally regulators have taken alternative approaches to modelling their regulatory requirements on the PFMI. We consider that in the context of the New Zealand environment it would be appropriate for the joint regulator to develop the standards on a 'principles' basis rather than a prescriptive basis[6].

Crisis management powers

19. We also have significant concerns with certain powers that are proposed to be afforded to the joint regulator, in particular:
    a. the ability for the joint regulator to prepare a rule change to ensure compliance with relevant standards;
    b. the ability for the joint regulator to remove and appoint a director of an operator; and
    c. the ability for the joint regulator to issue a direction notice to a participant to comply with the FMI's rules in accordance with that direction.

20. We consider that if these powers are implemented, they should be exercised sparingly by the joint regulator, in a manner that recognises the importance of NZX Clearing as the primary regulator of the NZX Clearing system. This will be fundamental in enabling the proposed regime to promote confident participation in the financial markets.

21. We note that one of the gating criteria for the joint regulator to issue a direction notice to a participant, is that the joint regulator has reasonable grounds for believing the operator's rules are either inapplicable, insufficient, or have not been implemented

[5] Paragraph 1.19, CPSS-IOSCO Principles for Financial Market Infrastructures.

[6] We understand that this is the approach taken by the Commodity Futures Trading Commission (**CFTC**) in the United States.

properly. We again suggest that a cautious approach should be taken in the exercise of this power, noting the subjectivity inherent in the assessment of whether rules are applicable to a situation. We do not consider that the joint regulator should be able to issue a direction notice simply because it believes that a participant has not met its obligations correctly, given that the operator should be the frontline regulator of compliance with its rule set. Where a direction notice is issued to a participant (particularly where it relates to the manner in which the participant should comply with the FMI's rules), we consider it fundamental that the operator is informed of the position, in order that it may appropriately regulate the participant. We consider that the use of direction notices should be reserved for extreme situations, and that the affected party should be consulted before the direction is issued. We support the requirement that Ministerial approval is a pre-requisite for the issuance of a direction notice.

22. We expect that the joint regulator would only exercise its power to remove and appoint directors in an extreme situation given that such an action would fundamentally cut across the rights of the owners of an operator. Such an action would have severe consequences for operators in general, but is particularly significant for widely held listed companies like NZX, whose business extends beyond the operation of a settlement system and who is subject to governance obligations under the Listing Rules. We understand that this power is out of line with standard international practices for adopting the PFMI, and appears inconsistent with the supervisory approach contemplated by the PFMI, that regulatory oversight will either induce change or ensure observance of the principles.

Differential treatment of FMI

23. We set out below our concerns regarding the structure of the proposed regulatory framework, which appears to have the potential to remove competitive neutrality between commercial FMI operators.

24. We note that the FMI Bill contemplates standards applying to overseas operators on a differential basis. We appreciate that this may be appropriate where the overseas operator is subject to standards in its home jurisdiction that are equivalently prescriptive to those to be adopted by the RBNZ. However, we are concerned that the FMI Bill does not allow the joint regulator to exercise certain crisis management powers against a systemically important overseas operator (for example: the ability to appoint and remove directors).

25. We also note that the consultation paper notes that crisis management powers might only be exercised in relation to the New Zealand presence of an overseas FMI to support the resolution of the FMI in its home jurisdiction. These differences do not appear to be predicated on comparable home jurisdiction requirements. If this is the case the differential regime would create an unequal oversight framework, removing

commercial neutrality, and would also expose the New Zealand financial system to risks which the FMI Bill seeks to avoid.

26. As a licensed market operator, NZX Limited is subject to a statutory obligation to ensure that it has adequate arrangements for handling conflicts between the commercial interests of NZX and the need for NZX to ensure that its markets to operate in a fair, orderly and transparent manner[7]. We note that no specific obligation has been included in the FMI Bill, in respect of the RBNZ's ownership and operation of NZClear. We expect that RBNZ will develop internal processes and arrangements to ensure any potential self-regulatory conflicts are appropriately managed. We also expect that the PFMI will be implemented in a manner which ensures equal treatment of central bank and private sector operators, in accordance with Responsibility D of the PFMI.

Consultation matters

27. In this section of our submission, we provide responses to the specific matters raised in the consultation paper, on which the RBNZ has sought comment.

Regime for Rule changes

28. We agree with the sentiment in the consultation paper that the current disallowance process contained in Part 5C of the Reserve Bank of New Zealand Act 1989 is working well in practice. We are not opposed to the lack of a prescribed period in which the joint regulator must approve amendments to the rules of a designated FMI. However, for completeness, we note the process contained in sections 330 of the Financial Markets Conduct Act 2013 (**FMCA**), which could be leveraged if the RBNZ wished to provide more certainty around the timeframes for rule approvals. We note that the FMA is already familiar with this approach.

29. We appreciate the need for a level of prescription around the time within which designated FMIs must apply for rule amendment approval, where the amendment is required by the regulator under clause 40 of the FMI Bill. We consider that 40 working day period may be too short to enable an application to be prepared, and recommend that this period is extended to 60 working days (consistent with the approach taken in section 333 of the FMCA). We also prefer the process contained in the FMCA, whereby a designated FMI has the opportunity to explain why it has not prepared a rule amendment and to suggest alternative ways in which a matter may be dealt with for the joint regulator's consideration.

Finality of settlement

30. Clause 55 of the FMI Bill contains the provisions relating to finality of settlement which appear to broadly mirror the provisions of section 156S of the RBNZ Act. This includes

[7] Section 314 of the Financial Markets Conduct Act 2013.

protections from recovery for any settlement effected within a 24 hour period after an insolvency event. NZX Clearing & Settlement Rule 4.1.3 provides that settlement is effected when money or approved products are debited from or credited to a settlement account within the clearing system.

31. NZX Clearing considers that within one trading day of an insolvency event it would be able to: calculate an insolvent participant's net settlement obligation; use the insolvent participant's collateral and margin for the purpose of settling that obligation (to the extent possible); and suspend the insolvent participant from creating further settlement obligations. However, we note that it could take longer (up to 6 business days) to obtain any additional money or financial products, to the extent available, necessary to settle an insolvent participant's outstanding obligation that arose prior to insolvency. As outlined in our recovery and replenishment consultation paper, the implementation of tools to recover these assets, may take longer than one trading day.

32. We also note that the definition of an insolvency event in the FMI Bill is broader than that included in section 156M of the RBNZ Act, as it includes where "a process similar to a process for which an insolvency manager may be appointed starts in relation to the [operator]". We are unsure whether this limb of the definition has been included with the intention that it apply only to overseas operators, if so we suggest that this could be clarified. We also note that it may unclear as to when such a process has commenced, which could cause uncertainty as to when the 24 hour protection window commences, reducing the certainty that this provision is intended to provide.

Penalties

33. We consider that many of the criminal offences contained in the FMI Bill would be better replaced by pecuniary penalties, for the reasons noted in the consultation paper. In particular the penalties that are identified as being within levels 1 to 3 should in our view be reframed as pecuniary penalties. We consider that if some of the criminal penalties are to be maintained, that would be better designed to include a mens rea element, rather than operating as strict liability offences to which defences are available. This would both shift the burden of proof and reduce administratively inefficiencies because an adjudicatory body would not be required to determine whether a defence is available.

34. We also consider that many of the offences should apply only to the corporate legal entity rather than to natural persons who are employees of an operator. The ability for penalties to apply on an individual basis could be concerning for NZX Clearing staff, and may have impacts on insurance and recruitment costs. For example: it seems inappropriate that an individual employee could be liable for the failure to publish rules on a website, or to arrange for an independent review of information, where the cause for such failures are likely to be due to an operator's processes or resources.

Transitional arrangements

35. We note that the proposed staging of the implementation of the new regime, with standards being developed following the enactment of the FMI Bill, and gradually brought into effect. We reiterate that it is difficult for current operators to transition into the regime, when the nature and content of the standards are largely unknown.

36. We note the comments in the consultation paper that RBNZ considers that it would be preferable to re-designate settlement systems that are currently designated under the RBNZ Act, rather than deeming them to be designated under the new regime. We consider that the transition process for currently designated settlement systems should be designed to minimise the cost of transition. While we agree that the regulator will need to actively consider whether current systems are systemically important in line with the new requirements, we do not see that any additional consideration would be required to bring currently designated systems into the new regime.

37. In particular, we do not consider that it would be appropriate for the regulator to review the rules of current designated settlement systems at the point of transition (which have already been reviewed and approved by the joint regulator and are relied upon by existing participants). We also note that the regulator is not required to approve contingency plans or changes to contingency plans. As we understand that the standards that will provide more detail as to the contents of contingency plans will not be available at the time the FMI Bill is enacted, we do not see a role for the regulator to re-assess contingency plans at the time of transition.

38. We also note that if an existing operator of a designated settlement system were not to be re-designated under the new regime, that this in itself could cause a systemic risk. We consider that if the joint regulator has current concerns these should be being addressed through the supervisory arrangements under the current regime.

Continuous Disclosure

39. The consultation paper notes that the confidentiality provisions contained in the FMI Bill would operate to prevent operators who are listed entities from disclosing the fact that a direction has been issued, despite that information being material information under the continuous disclosure provisions of the Listing Rules. This proposal has direct consequences for NZX Limited.

40. We note that unlike the Phase II proposal that continuous disclosure be suspended temporarily, clause 80(2) of the FMI Bill creates a blanket offence by providing that a person who discloses that a direction notice has been given, commits an offence. We consider that the disclosure of material information by listed issuers provides the foundation for price discovery and market integrity. While we understand that additional policy considerations arise in the context of a direction notice being given to a listed

operator, we consider that the suspension of continuous disclosure obligations should be tightly controlled and permitted only for a very short time period.

41. We also note that if NZX were unable to disclose that NZX or NZX Clearing had received a direction notice, NZX would not be able to operate its markets in a fair, orderly and transparent manner, in accordance with its FMCA licensed market obligations. We consider that NZX may require further relief from that contained in clause 79 of the FMI Bill, because the failure to disclose the material information would not necessarily be an action that was taken in reliance on the direction notice, rather the non-disclosure would be to ensure compliance with clause 80 of the FMI Bill.

42. We note that under NZX Clearing's standard default management procedures, the fact of a participant's default may be immediately communicated to other participants and the defaulting participant's clients. This would likely occur well before a direction notice had been issued. We consider that the inability to subsequently communicate that a direction notice had been issued to those affected, could further compound the crisis event, and may cause further distress to the NZX Clearing system.

43. We also question whether in the scenario where a direction notice had been issued to NZX Clearing as an operator, NZX would be able to disclose the fact that NZX Clearing was distressed without referencing the direction notice. We note that in such a scenario, NZX may need to take further action as a market operator to preserve the orderliness of its markets, such as applying a trading halt to prevent further trades giving rise to settlement transactions.

44. We note that we provided a submission to the Treasury and RBNZ on 16 August 2019, as part of the Phase II consultation, which expands on these comments further.

Technical and drafting matters

45. In this section of our submission, we comment on certain definitions that are contained in the FMI Bill.

'Distressed'

We note that this definition is fundamental to the regime, because it acts as the principal criterion by which the joint regulator's ability to exercise its crisis management powers is determined. While we are comfortable with limbs (a) to (e) of the definition, we consider that limbs (f) and (g) unduly broaden the scope of the definition. These limbs cause an operator to be regarded as distressed when there are problems with, or for, 1 or more direct or indirect participants that cause problems that directly or indirectly threaten the stability of, or confidence in the whole or a significant part of the financial system. We consider that these limbs could be interpreted such that the inherent risk to the financial system of a participant's actions could cause an operator to be considered 'distressed'.

We consider that in such a scenario, it would be appropriate to consider the actions taken by the operator to manage an incident. We consider that limb (e) of the definition is sufficiently broad to address disruptions that threaten the whole or part of the financial system.

'Operator'

We note that this definition is broad, and includes a person who is maintaining, or administering the FMI's rules. In this regard, we note that NZX Clearing currently has an outsourcing arrangement whereby NZX Regulation makes regulatory decisions under the Clearing & Settlement Rules and Depository Operating Rules (together, **Rules**), and that NZX Policy maintains the Rules.

The definition also includes a person who is wholly or partially responsible for either providing or managing services under the FMI. In this regard, we note the Infrastructure, Resources and Services Agreement between NZX and NZX Clearing, by which NZX provides the infrastructure, technology support, operational resource and corporate support to enable NZX Clearing to offer settlement services.

We do not consider that the above arrangements should cause NZX to be automatically regarded as an 'operator' under the FMI Bill (in circumstances where it was not specified in a designation notice, for the purposes of limb (b) of the definition). We suggest that the definition of 'operator' should be narrowed, so that the types of arrangements described above do not automatically trigger resource providers such as NZX to fall within the 'operator' definition.

'Rules'

We consider that the definition is framed too broadly, in particular because it would appear to capture the Clearing & Settlement Procedures and Depository Operating Procedures (together, **Procedures**), and potentially other documents, such as operational policies, that describe how NZX Clearing's activities are to be carried out (for example: the Net Exposure Limit Policy and Mutualised Default Fund Policy). We note that the approach taken in the Order and section 156M of the RBNZ Act, provides certainty as to which documents evidence the rules of the NZX Clearing settlement system, in particular because only certain Procedures are specified to bear the status of rules[8].

It also appears that the definition could capture general commercial contracts and agreements entered by NZX Clearing. In this regard, we note that the list of matters set out in limb (a)(ii) does not provide sufficient certainty as to when such a document will be

[8] Clause 5 of the Reserve Bank of New Zealand (Designated Settlement System - NZCDC) Order 2010.

regarded as a 'rule', in part because the it is framed to be inclusive ('amongst other things') and also because the stated matters are very broad.

We do not consider it appropriate for the joint regulator to be required to approve amendments to the additional documents that appear to fall within the 'rules' definition contained in the FMI Bill, that are beyond the scope of the documents that must be approved under the current Order.

'Systemically Important'

Clause 24 of the FMI Bill sets out the criteria that the regulator must consider when determining whether an FMI is systemically important. The first criterion is "the FMI's size, including the number of participants…and indirect participants". We do not consider that the number of participants (and indirect participants) is a valid criterion by which to assess systemic importance, rather, we suggest that the factors that should inform the size of the FMI should be the volume and value of the transactions it conducts. As noted in our 2017 submission, we do not consider the fact that NZX Clearing is currently designated to be determinative of its systemic importance. We note that NZX Clearing has a lower transaction value processed each day than any of the other FMI that RBNZ has indicated may be considered systemically important, including ESAS, NZ Clear, High Value Clearing System and Settlement Before Interchange.

General

46. We note that our submission focuses on the impacts of the FMI Bill on NZX Clearing. We are aware that the framework proposed by the FMI Bill will have consequences on FMI that are not settlement systems, such as pure payments systems. We consider that the framework proposed may be even less suitable for those operators, and would support the FMI Bill being structured to create bespoke obligations based on an operator's activities.

47. We would like to thank the RBNZ for the opportunity to provide this submission, which we would be happy to discuss further with you. We look forward to working with the RBNZ to ensure a smooth transition to the new regulatory regime.

Yours sincerely,

Mark Peterson
Chief Executive Officer, NZX Limited
Director, New Zealand Clearing Limited

Kristin Brandon
Head of Policy and Regulatory Affairs