NZX Clearing

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

www.nzx.com

18 November 2022

FMI Consultation, Prudential Policy Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

FMI Consultation, Market Infrastructure, Capital Markets
Financial Markets Authority
PO Box 1179
Wellington 6140

By email: *fmiconsultation@rbnz.govt.nz*

Financial Market Infrastructures Standards: Exposure Drafts and Exposure Draft Guidance

We refer to:

(a) the *FMI Standards Exposure Drafts* (the **Draft Standards**); and

(b) the *Financial Market Infrastructures Standards: Exposure Draft Guidance* (the **Draft Guidance** and, together with the Draft Standards, the **Draft Documents**),

released by the Reserve Bank of New Zealand and the Financial Markets Authority (the **regulator**) in September.

This letter sets out the submissions of the NZX group of companies that operate the NZCDC settlement system (**NZX**) on the Draft Documents. As you are aware, the NZCDC settlement system operated by NZX is currently declared to be a designated settlement system under Part 5C of the Banking (Prudential Supervision) Act 1989.[1] You have indicated that, once the Financial Market Infrastructures Act 2021 (the **FMI Act**) is in full force, the NZCDC settlement system will be 'called in' to that Act as a "systemically important" designated financial market infrastructure (**FMI**). The NZCDC settlement system would then become subject to the FMI standards on which the regulator is now consulting.

NZX's submissions on the Draft Documents are as follows:

1. Status of the Guidance Notes

The issue

Page 8 of the Draft Guidance contains the following statement:

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

> This guidance document does not itself impose legal obligations on operators of FMIs, instead it provides guidance on how the regulator expects operators to consider and apply the obligations imposed by the FMI Standards, in order to comply.

By contrast, the Cover Note released by the regulator at the same time as the Draft Documents describes the status of the Guidance Note differently:[2]

> The draft guidance does not impose legal obligations on operators of FMIs. Instead, it provides clarification on how the regulator will interpret the legal obligations on operators imposed by the FMI Standards, *or one way of complying with the FMI Standards*. The guidance also outlines international best practice for managing risks associated with operating FMIs. [our emphasis]

We find it difficult to reconcile the statement in the Draft Guidance, on the one hand, with the statement in the Cover Note and our discussions with you, on the other hand. The Draft Guidance says it provides guidance "on how the regulator expects operators to consider and apply" the standards. By definition then, any action taken by an FMI that does *not* follow the guidance would not meet regulator expectations and so, we assume, would be considered non-compliant. By contrast, the Cover Note suggests, consistent with our discussions with you, that alternative actions not set out in the guidance could still be considered compliant.

To give an example of how this issue could play out in practice, standard 2(2)(d) requires an operator to ensure its board of directors consistently reviews the performance of the board and that of its individual directors. Paragraph 2.11 of the Draft Guidance states that compliance with this standard "should" include independent assessments of performance carried out at least annually. The 'independent' and 'annual' elements of this guidance are not contained in the standard itself. That being the case, if an operator forms the view that, for its specific circumstances, a *biannual* assessment would suffice, has it breached the standard?

The submission

We submit that the Draft Guidance should be amended to reflect the Cover Note. In particular, the Draft Guidance should make it clear that, in order for an FMI to comply with the standards, the FMI need not follow the (international best practice) guidance. Rather, it should be open to an operator to conclude that compliance with a standard could be achieved in another way, and to proceed on that basis.

Also, our understanding from our discussions with you is that, while an FMI must be able to explain to the regulator its reasons for not following a particular guidance (if the FMI takes an alternative approach), it is not required to document upfront every instance of such a departure and the rationale for it. Please let us know if we have misunderstood you in this regard.

2. **Cover 2**

The issue

Standards 4(6)(b) and 7(9)(c) requires an operator of a central counterparty (a **CCP**) to maintain:

(a) sufficient liquid resources for it to meet its payment obligations under potential stress scenarios that include the default of its two largest participants; and

(b) financial resources to cover a wide range of potential stress scenarios, including the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure in extreme but plausible market conditions.

The regulator acknowledges in the Cover Note[3] that applying these standards to FMIs that are not involved in activities that have a more complex risk profile, and that are not systemically important in multiple jurisdictions, (such as the NZCDC settlement system) is inconsistent with the PFMIs. The regulator has sought to justify this inconsistency on the basis that having two levels of requirements in

---

[2] Section 4 of the Cover Note.

[3] Section 7.5.

New Zealand would make the regime “confusing and unnecessarily complex” for both regulated entities and FMI participants.

We disagree. First, the entities that would supposedly be confused by a second level are inevitably large, sophisticated and well-resourced organisations. They operate in highly-regulated environments and have access to experienced internal and external compliance advisers. They are not easily confused. Secondly, the additional complexity that would be introduced by a second level is, in the context of the overall complexity that will be introduced by the standards and the guidance, immaterial. Once again, the FMIs and their participants are well-equipped to handle that complexity.

For the New Zealand market, we remain of the view that Cover 2 for credit exposure and liquidity purposes is not required, as per the PFMIs. The products cleared (being securities and equity derivatives) are not complex, and the NZX clearing house is not systemically important in any jurisdiction outside of New Zealand. To take a different approach in the Draft Standards is, in our view, contrary to the following requirements in the FMI Act:

(a) section 13(2)(b), which requires the regulator to take into account the importance of recognising that primary responsibility for ensuring that an FMI is sound and efficient rests with its operators and participants and their owners; and

(b) section 13(2)(d), which requires the regulator to take into account the importance of regulating FMIs in a way that is consistent with international standards for their regulation.

Significant additional capital costs if Cover 2 adopted

To increase the capital requirements on FMIs would impose significant costs on the NZX markets. From our analysis, for the securities market, it would increase the amount of pre-funded capital required to be held by the clearing house (as provided by clearing participants, through margin, and the clearing house, through risk capital):

Reduced efficiency in the financial system

Increasing capital costs will increase the overall costs of operating the NZCDC settlement system. These costs, while in part borne by the clearing house and participants, will likely flow through to the fees charged to end clients, increasing the cost to participate in the NZX markets. That is a consequence at odds with one of the purposes of the FMI Act — to promote the maintenance of an *efficient* financial system (section 3(1)(a)). All things being equal, efficiency drops as costs increase.

Higher barriers to participation

Also, higher costs are a barrier to participation. This discourages those wishing to participate in the market, but is also detrimental to the overall health of the settlement system, as liquidity decreases with reduced participation. That is a consequence at odds with another of the purposes of the FMI Act — to promote the confident participation of businesses in the financial markets (section 3(1)(c)).

Higher concentration risk

Further, while Cover 2 is a risk mitigation step, the increasing costs it imposes may increase the high concentration risk already apparent in New Zealand’s market. Concentration risk is a core risk of a small financial market, such as the NZX markets. NZX is required to continuously manage this risk and encourage participation within the standards appropriate. Increasing the standards beyond what is reasonably required may put participation out of reach of current or future participants, and increase the concentration risk NZX already faces. Higher concentration risks are contrary to the FMI Act’s purpose of promoting the maintenance of a sound financial system (section 3(1)(a)).

Further, we note there are currently eight active clearing participants for the cash market. The two largest participants generally make up 50% of the market. While there is limited public information on

the participant make-up of other FMIs internationally, we have used the CPMI-IOSCO Public Quantitative Disclosure to provide some insight on other markets. For both ASX Clear and SGX Central Depository (both securities market CCPs), on average (as of 30 June 2022) the top five members made up 50% of the open positions on market. Comparatively, the top five participants in NZX's market (as of 30 June 2022) made up 94% of the trading in the securities market. This indicates the higher concentration in the New Zealand market, which has significantly fewer participants than other markets (34 participants for the ASX and 26 participants for the SGX). Consequently, Cover 2 in the New Zealand market would require significantly greater contributions and coverage than in other markets, which would come at a cost to the New Zealand market.

Similarly, we expect that, should trading and clearing in the equity derivatives market increase, clearing is likely (at least in the short term) to be concentrated in a small number of clearing participants (less than five).

The submission

We submit that the Draft Standards should be made consistent with the PFMIs by the inclusion of a second level of requirements for FMIs that are not involved in activities that have a more complex risk profile and are not systemically important in multiple jurisdictions. For them, the requirement should be to have sufficient liquid resources to meet their payment obligations following the default of their (single) largest participant.

3. **Governance**

The issue

Standard 2 sets out various requirements for an operator that relate to its board of directors. For example, standard 2(2)(g) requires an operator to ensure its board of directors has:

> a clear, documented risk-management framework for the FMI that includes the FMI's risk-tolerance policy, assigns responsibilities and accountability for risk decisions, and addresses decision making in crises and emergencies.

It is unclear how standards such as this are to be applied in the context of an FMI (such as the NZCDC settlement system) that has multiple "operators".[4] From our discussion with you, we understand the intention is that, for those FMIs, the relevant operators can reach their own agreement about which of them the standard should apply to. We also understand that the regulator is comfortable with the current governance structure of the boards of the operators of the NZCDC settlement system, and does not expect any changes will be required as a consequence of the transition across to the FMI Act regime.

The submission

Where the Draft Standards refer to obligations that relate to the board of directors of an operator, the Draft Standards should:

(a) identify which obligations must be satisfied by *each operator*, even if an FMI has multiple operators; and

(b) identify which obligators need only be satisfied by *one operator* of an FMI that has multiple operators (in which case, those multiple operators can determine among themselves which operator that should be).

[4] Under clause 9(a) of the NZCDC Designation Order, both New Zealand Clearing Limited and New Zealand Depository Limited are "operators" of the NZCDC settlement system. We understand that this (dual operator) position will be carried over into the designation of the NZCDC settlement system as an FMI.

4. **Legal opinion**

The issue

Standard 1(2)(a)(ii) requires an operator to obtain a legal opinion that demonstrates the enforceability of the FMI's rules, procedures, and contracts across all relevant jurisdictions. This raises two questions. First, to what extent should the opinion be able to rely on the effect of Subpart 5 of Part 3 of the FMI Act applying to it.[5] Secondly, what are the "relevant jurisdictions"?

As to the first question, our view is that, for those FMIs to which Subpart 5 applies, the legal opinion should be able to rely fully on the effect of Subpart 5. In other words, to the extent that Subpart 5 (in particular, sections 54 and 57) confirms the legal enforceability the opinion is required to address, the opinion need not include any further (back-up) legal analysis. We believe paragraph 1.10 of the Draft Guidance supports this approach,[6] and we do not submit that any change is required. However, please let us know if you disagree with our view.

As to the second question, the Draft Standards define "relevant jurisdiction" in standard 1 as "any jurisdiction in which the FMI operates, and will always include New Zealand".[7] The Draft Guidance repeats that definition.[8] However, confusingly, the Draft Guidance also states that the legal opinions should confirm enforceability "across all jurisdictions where the FMI has participants".[9] From our discussions with you, we understand that this suggestion in the Draft Guidance that "relevant jurisdiction" has a broader meaning is unintended.

There is another aspect of this second question, which arises in the specific context of conflicts of law. This is addressed in paragraph 1.12 of the Draft Guidance. As you know, potential conflict of laws issues will always exist whenever an FMI has participants incorporated in, or operating out of, a foreign jurisdiction. Requiring those issues to be addressed through a foreign law legal opinion is inconsistent with the position on the "relevant jurisdiction" definition we outline in the previous paragraph. Consequently, we understand the guidance in the last sentence of paragraph 1.12 is another example of a step an FMI *may choose* to take but is not *required* to take, as part of the broader exercise to "identify and analyse potential conflict-of-laws issues and develop rules and procedures to mitigate this risk", for the purposes of complying with standard 1(2)(e).

The submission

Paragraph 1.3 of the Draft Guidance should be amended to remove the statement to which we refer above.

5. **Segregation and portability**

The issue

Standard 11

Standard 11(2)(e) requires an operator of a central securities depository to have appropriate rules, procedures and controls to ensure:

---

[5] Subpart 5 does not apply automatically on designation. The designation notice for the FMI must specify that that is to be the case: section 29(2)(e) of the FMI Act. NZX's expectation is that Subpart 5 would be stated to apply to the NZCDC settlement system. Please let us know if that is incorrect.

[6] "Where an FMI's designation notice states that it is covered by subpart 5 of part 3 of the Act, this provides legal certainty about the enforceability of the FMI's rules."

[7] As an aside, standard 1(2)(b) refers to "all relevant jurisdictions in which the FMI operates, including New Zealand". Given the definition of "relevant jurisdiction", those words that follow that term should be deleted so as to remove the double-up.

[8] See paragraph 1.2.

[9] See paragraph 1.3.

(a) segregation between its own assets and the securities of its participants; and

(b) segregation among the securities of its participants.

Standard 11(3) requires an operator to ensure it "operationally supports" the segregation of securities belonging to a participant's customers and facilitates the transfer of customer holdings. It is unclear what "operationally supports" means. Does it mean the operator must *permit* this (where requested by the participant)? Or does it mean the operator must *require* this?

Standard 14

Standard 14 also deals with segregation,[10] and with portability also, for CCP operators. Standard 14(1) requires an operator to have rules and procedures for the FMI that "enable" the segregation and portability of customer positions and collateral. The use of "enable" suggests an FMI must allow for segregation and portability to be possible, but it is not *required* unless a participant makes an election. However, that interpretations seems inconsistent with standard 14(2)(a), which states an operator "must … have segregation and portability arrangements".

The position under the NZX clearing and settlement rules

As discussed at our recent meeting, NZX Clearing currently has the ability for participants to request segregation in its rules, but does not require segregation. Currently, cash market clearing participants manage in their books the segregation of client positions and assets, as per the client asset rules. Positions at the clearing house are held in omnibus accounts. Clearing participants must themselves pay the margin against these accounts, rather than simply being required to pass on to the clearing house all client margin received by them.

Requiring segregation and portability arrangements for these accounts would be a significant market change, requiring rule and market behaviour changes. We would need to consult with the market on how this should operate before we could implement such change. We would expect some participants to oppose mandatory segregation on the basis that they do not have the operational capability to offer that feature.

Increased costs per trade and reduced participation would result from mandatory segregation and portability

To provide for segregation and portability, gross client margin would need to be paid to the clearing house. As noted above, currently in the cash market the margin owed to the clearing house by a participant (whether on its own account or on account of its clients) is payable by that participant alone. The records of the clearing house recognise the participant as being the sole person (other than the clearing house) having rights in respect of that margin. Requiring all client margin to be paid to the clearing house on a segregated basis would increase the cost to trade in the NZX cash market, as clients would be required to pay for the trade plus margin obligations. Further, if netting in relation to margin were to operate on the basis of segregated client accounts (as opposed to on an omnibus basis), netting efficiency would be lost. Based on current margin rates, this could be a 5-50% cost increase on each trade. An inevitable consequence of this cost increase would be a decreased participation by clients in the NZX cash markets (again, an outcome contrary to a number of the purposes in section 3(1) of the FMI Act).

Unresolved AML/KYC issues and small number of alternative clearing participants

For portability to work effectively, client relationships must be set up in advance so that AML/KYC issues are resolved in advance (unless an exemption is provided by the regulator). Also, the effectiveness of portability depends on their being *other* general clearing participants in the relevant market that are able to take over the positions of the trading participants of the defaulting clearing participant. Here, again,

[10] We note that "segregation" as used in standard 14 is the type of segregation referred to in standard 11(3), not standard 11(2)(e) (i.e., it is participant/customer segregation).

the small size of the New Zealand market must be taken into consideration in setting the scope of this standard.

Portability and short-dated positions.

Portability has been identified by CPMI-IOSCO as unnecessary for very short-dated positions, where the applicable client positions will settle before porting can be completed. Given the cash market settles on a T+2 basis, we expect the majority of positions in a default will fall into this category, and therefore it is not appropriate to require segregation and portability.

The submission

Standards 11 and 14 should be amended to make it clear the obligation on the operator is simply to permit segregation and portability where requested by a participant.

6. **External assurance assessments**

The issue

Standards 17 and 17C require external assurance assessments by qualified auditors of the operational risk-management framework and the cyber resilience and strategy framework, respectively.

The standards are drafted broadly such that:

(a) all of the operational risk-management framework appears to require assessment irrespective of the area in which the material incident or outage occurs. The complexity of FMIs is such that this results in assessments extending to areas with no link to the incident and where no issue has been identified (noting there is already a requirement to have a full assessment of the framework every two years); and

(b) there is no materiality requirement related to the cyber incidents, with the only gating requirement being that it impacts or could impact the FMI's continuing operations. It is conceivable that a cyber incident could impact operations without having a material impact on the FMI.

Both of these requirements go beyond the comparative requirements – the PFMIs and the Reserve Bank guidance on cyber resilience. Given the time and cost aspects of engagements of this nature, we consider they should be limited to where they are necessary.

The submission

Standard 17 should be amended to require an external assurance assessment after an incident or outage on that particular area in the operational risk-management framework only.

Standard 17C should be amended to require an external assurance assessment after *a material* cyber incident that impacts, or could impact, the FMI's continuing operations.

7. **Transitional arrangements**

The issue

In section 5 of the Cover Note, the regulator proposes a transition period of 4-5 months between the date on which the standards are issued (following designation under the FMI Act) and the date on which the standards come into force. The regulator invited submitters to identify specific standards that they consider might require a longer transition period.

The submission

This is a difficult matter for NZX to submit on, as much depends on the outcome of other submissions made above. For example:

(a) if NZX is required to move to Cover 2 (see section 2 above), it would need at least 12 months to change its risk management framework accordingly (including by modifying its current default fund arrangements); and

(b) if NZX is required to provide for (mandatory) segregation of customer positions and collateral (see section 6 above), it would need at least 18 months to two years to implement the necessary rule changes and participant structures.

Given this difficulty, we would appreciate the opportunity to discuss with you as soon as possible the outcome of our other submissions. Based on that discussion, we would then be able to identify those standards that will apply to the NZCDC settlement system for which we believe a longer transition period will be necessary.

Lastly, and as a related point, we understand from our discussions with you that, where a standard requires an external assurance engagement on an ongoing basis,[11] the start date for the cycle is the date on which the relevant standard comes into force. Please let us know if we have misunderstood you in this regard.

We appreciate the opportunity to be able to make submissions on the Draft Documents. We look forward to our further discussions with you on those documents and, more broadly, on matters relating to designation and the FMI Act coming into full force.

Yours sincerely

Mark Peterson

CEO
NZX Limited

Felicity Gibson

COO/ Head of Risk
New Zealand Clearing and Depository Corporation Limited

[11] For example, standard 17(3)(b) for the operational risk-management framework, and standard 17C(4) for the cyber resilience strategy and framework.