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By email

1. INTRODUCTION

1.1 This letter sets out Russell McVeagh's submissions on the Financial Market Infrastructures Bill ("**FMI Bill**").

1.2 Clause references in this letter are to the FMI Bill. In this letter, "**RBNZ Act**" means the Reserve Bank of New Zealand Act 1989; "**IPS Act**" means the Insurance (Prudential Supervision) Act 2010; "**NBDT Act**" means the Non-bank Deposit Takers Act 2013; and "**FMC Act**" means the Financial Markets Conduct Act 2013.

2. OVERVIEW

Scope of the FMI Bill

2.1 We think the scope of the regulatory regime as currently proposed in the FMI Bill is too broad, and applies to users of financial market infrastructures ("**FMIs**") (i.e. participants and indirect participants) in circumstances that are neither appropriate nor necessary. In our view, the primary focus of the regime should be on the prudential supervision of FMIs (including operators), and that it should apply to participants and indirect participants only to a very limited extent. Systemically important FMIs will be subject to prudential supervision as set out in standards. These standards will reflect the matters covered in the CPSS-IOSCO principles, and will include requirements relating to governance, capital and liquidity. If an FMI is required to comply with these standards, and to have its rules and procedures approved by the regulator, then there is less need for the regulatory regime to apply directly or indirectly to participants and indirect participants.

Purpose of the FMI Bill

2.2 There needs to be a clear purpose for the new regulatory regime, and it should be applied consistently throughout the legislation. We agree with the explanatory note that well-managed and operated FMIs are essential to the operation of a "sound and efficient" financial system. However, in some areas of the FMI Bill this purpose appears to change to "the stability of, or confidence in" the financial system (e.g. at clause 76(1)(b)). If public confidence in FMIs is a desired purpose, then we suggest that it be expressly set out in clause 3, in a similar way that it is in s3(1) of the IPS Act. Soundness and efficiency of the financial system are the objects of the regulatory regime, but soundness and efficiency are not the only two requirements of a successful FMI. In a number of places in the FMI Bill the macro-objectives of soundness and efficiency are inappropriately applied to the micro-prudential supervision of FMIs. One example is paragraph (w) of the definition of "distressed", as discussed at paragraph 4.12.

Uncertain meaning of key terms

2.3 The word "problems" is used in several key parts of the FMI Bill, for example in the purpose of the FMI Bill at clause 3(1)(a) and in the definitions of "distressed" and "systemically important". "Problems" is not defined in the FMI Bill and its meaning is not clear.

2.4 We do not think "problems" is an appropriate test, as this could mean that even relatively minor problems could lead to regulatory intervention. We suggest replacing "problems" with a more clearly defined concept, which sets a higher threshold to justify such intervention.

Consistency of approach

2.5 We think there are benefits if, to the extent practicable, there is consistency regarding how banks, non-bank deposit takers, insurers and FMIs are prudentially regulated. Accordingly, in this submission we have considered comparable provisions applicable to those entities.

Potential conflicts of interest

2.6 We note the potential conflict that could arise if a regulator is also an operator of an FMI. Thought should be given to whether the FMI Bill should prescribe any level of separation within the regulator between its role as an operator and its regulatory function. Alternatively, this issue may be able to be dealt with by adding appropriate provisions to the legislation that establishes and governs the activities of the relevant regulator (i.e. the RBNZ Act).

3. PURPOSE OF THE FMI BILL

3.1 We agree with the purposes set out in clauses 3(a), (c), and (d) of the FMI Bill. However, we suggest clause 3(b) be redrafted to read:

"avoid significant damage to the financial system that could result if an FMI becomes distressed;"

3.2 For the reasons set out in paragraph 2.1 above, we think that the primary focus of the FMI Bill should be on FMIs, not participants. Further, as discussed at paragraphs 2.3 and 2.4, the concept of "problems" is too uncertain and is not an appropriate test for regulatory intervention. We think "distressed" is a more appropriate test in this context. This would be consistent with the approach taken in clause 2(e) (where powers are conferred on the regulator to act in respect of distressed FMIs) and more closely aligned to the similar objectives in s 68(b) of the RBNZ Act, s 3(2)(d) of the IPS Act, and s 3(b) of the NBDT Act.

4. DEFINITIONS

Definition of FMI

4.1 The FMI Bill should only apply to the New Zealand financial system. We suggest that paragraph (a)(i) of the definition of "FMI" be amended to read "payments within the financial system" to make this clear, and to be consistent with paragraphs (a)(ii) and (a)(iii).

4.2 We query whether the reference to "personal property" in the definition of "FMI" under paragraph (a)(ii) is appropriate, as it potentially expands the ambit of the FMI Bill too far. It could, for instance, potentially capture systems that operate merely as registers of personal property by recording such transactions. Replacing "personal property" with "financial products" may be more appropriate and better align the focus of the FMI Bill to the New Zealand financial system.

4.3 We agree with the inclusive list in paragraph (b) of the definition.

Definition of overseas FMI

4.4 An overseas FMI should be defined as an FMI that is already regulated as an FMI in another jurisdiction. The current definition identifies an overseas FMI by reference to the jurisdiction in which the operator is incorporated or established, which is a different test. If, for example, an operator is established in Australia, but operates an FMI in New Zealand only, then the FMI should not be treated as an overseas FMI.

4.5 To aid in developing a framework for determining whether an FMI is an overseas FMI, guidance can be taken from sections 313 and 317 of the FMC Act. Section 313(1) states (without limiting the circumstances in which a financial product market is operated in New Zealand) that a financial product market is taken to be operated in New Zealand if:

(a) the operator is incorporated or registered (or ordinarily resident if an individual) in New Zealand;

(b) all, or a significant part of, the facility for the financial product market is located in New Zealand; or

(c) the financial product market is promoted to investors in New Zealand by or on behalf of the operator of that market (but is not promoted to investors in New Zealand merely because it is accessible by those investors).

4.6 The description of an overseas-regulated market in section 317 should be considered when defining "overseas FMI". In line with this, the definition of overseas FMI could be amended to "an FMI that is authorised to operate in an overseas jurisdiction in which its principal place of business is located".

Definition of participant

4.7 It is not clear why an operator is included as a participant under paragraph (b) of the definition of "participant". For the reasons set out in paragraph 2.1, we think there should be a clearer distinction in how the regulatory regime applies to FMIs, including distinguishing between an operator and the users of an FMI (i.e. the participants and indirect participants).

Definition of indirect participant

4.8 As presently drafted, an "indirect participant" could also be a "participant" because the expression "or has agreed to participate, in the FMI," is used in the definitions of both terms. Again, it is important that there is a clear distinction between these two groups.

4.9 We think there should only be a very limited application of the FMI Bill to indirect participants. An indirect participant can include an occasional user of an FMI via a participant. We do not consider that an entity that has no direct contractual relationship with an FMI should be subject to comprehensive supervision under the FMI Bill or be able to influence regulatory actions in relation to an FMI.

Definition of distressed

4.10 The consequences for an FMI that is distressed are very serious. They include the regulator giving directions to an operator under clause 78; removing a director under clause 83; and recommending that an FMI be put into statutory management under clause 87. "Distressed" is therefore a key definition that needs to be carefully defined.

4.11 We agree with paragraphs (a)-(d) of the definition.

4.12 In relation to paragraph (e), there is no requirement in the FMI Bill for an FMI to be operated in a way that is "sound and efficient". These may be desired attributes of an FMI (and may be reflected in the standards) but they will not be the only attributes of a successful FMI (as reflected in the subject matter of standards in clause 34). We think this test of distressed should apply only in relation to the impact on the financial system (to be consistent with the purpose of clause 3(1)(a)), and so paragraph (e)(i) of the definition of distressed should be removed.

4.13 For similar reasons, the test in paragraph (f) should apply to the financial system only, and not to participants and indirect participants. Nor do we think the test

should be actual or potential "problems", as this is too uncertain. We also query why this paragraph refers to the "stability of, or confidence in" the financial system as opposed to the "soundness and efficiency" of the financial system (which reflects the purpose in clause 3(1)(a)). We suggest paragraph (f) should only refer to a disruption to the activities of an FMI that undermines the soundness or efficiency of the whole, or a significant part of, the financial system.

4.14 For the reasons given above, paragraph (g) should be deleted.

Definition of home jurisdiction

4.15 See our comments in paragraph 4.4 above.

Definition of participant default

4.16 We agree with the inclusion of paragraphs (a), (b), and (d) in this definition.

4.17 However, we query whether paragraph (c) is appropriate. To the extent relevant, a breach of this type of obligation should be expressly included in the FMI's rules, which, in the case of a designated FMI, are subject to scrutiny by the regulator. It is possible for a participant to have contractual obligations to entities listed in (i) to (iii) of paragraph (c) outside of the FMI arrangements. In addition, not every breach of an obligation would necessarily be material enough to constitute a "participant default".

The concept of "problems"

4.18 See our comments in paragraphs 2.3 and 2.4 above.

Meaning of systemically important

4.19 "Systemically important" is defined in clause 27(1). It refers to the uncertain test of "problems" and an object of "stability of, or confidence in" the financial system, which differs from the purpose in clause 3. We think guidance of what amounts to systemically important can be taken from the way in which the Reserve Bank of New Zealand proposes to identify systemically important banks. A systemically important FMI could be defined as an FMI that, if it became distressed, would have a material impact on the financial system as a result of its size, interconnectedness, lack of substitutability, and complexity.

5. THE REGULATOR

Exercising powers

5.1 We query whether the principles in clause 13(2)(b) are correct. We think the primary responsibility for the operation of an FMI should rest with the owner and operator, and not the users of the FMI (i.e. the participants and indirect participants). Participants and indirect participants will not have any ability to control an FMI or make decisions in relation to the FMI. The operator, by setting and enforcing the rules and procedures of the FMI (including eligibility criteria for

participants and capital requirements), is the entity with the ability to influence the activities of the FMI. In addition, we do not think that "soundness and efficiency" is the appropriate test in this context, for the reasons set out in paragraph 2.2 above.

Power to require information

5.2 Clause 14(1) provides the regulator with extremely broad powers to require an operator, a participant or an indirect participant to provide it with information relating to an FMI. We think the primary source of information in relation to an FMI should be the operator, and that the information gathering powers of the regulator should be limited to requiring information from the operator only. The powers of the regulator under clause 14(1) are, by comparison, more extensive than the equivalent powers under s 93C of the RBNZ Act, s 124 of the IPS Act and s 47 of the NBDT Act. If clause 14 is modified, clause 16 will also need to be amended for consistency.

5.3 Clause 15(1) provides that a contravention of clause 14 is an offence, unless the contravenor has "reasonable excuse". This is a different approach to s93(5) of the RBNZ Act, which provides that no offence occurs for a breach of s 93 if there is "lawful justification or excuse" for the breach.

5.4 Information being subject to legal privilege has been held to be a lawful justification or excuse for withholding information under the Legal Practitioners Act 1982.[1] If legislation is capable of being interpreted on the basis that privilege is not abrogated by it, it should be interpreted in that way.[2] For consistency with the RBNZ Act and to make it clear that privilege is not abrogated, we suggest clause 15(1) is amended to expressly include "lawful justification or reasonable excuse".

Clause 25

5.5 Clause 25(2) states that a designation notice will come into force once the FMI is established. This does not contemplate the possibility of an operator of an existing FMI making an application. Clause 25 should be modified to allow for the designation of an existing FMI.

Clause 31

5.6 Clause 31 sets out the procedure for issuing standards. If the standards are to apply to operators or FMIs, then the consultation should be with all operators or FMIs who may be affected by the proposed standard, rather than just those who may be substantially affected.

[1] *B v Auckland District Law Society* [2003] UKPC 38, [2004] 1 NZLR 326.

[2] At [59], citing Commissioner of Inland Revenue v West-Walker [1954] NZLR 191 (CA).

Clauses 40 and 42

5.7 If the regulator requires changes to an FMI's rules, the operator must apply for approval of the rule changes within the specified timeframes of 40 working days and 20 working days. We query whether these periods are sufficient, given that prior to application to the regulator, the FMI would be likely to consult with participants (even if not required by the rules themselves) and potentially the market more generally in respect of any proposed changes to its rules.

6. DEALING WITH DISTRESSED FMIS

Purposes of Part 4

6.1 Consistent with our comments in paragraph 2.2, we do not think the reference to "stability of, or confidence in," the financial system at clause 76(1)(b) is the appropriate test, given this is not consistent with the overall purpose of the FMI Bill.

6.2 Subpart 2 of Part 4 applies if an FMI is distressed or in certain circumstances in respect of an operator of an overseas FMI. Accordingly, the powers under this subpart should only be able to be exercised against the FMI and its operator(s).

6.3 However, the regulator's powers at clause 81 can be exercised in relation to a participant. We do not think it is appropriate that the regulator can direct a participant to comply with the FMI's rules. The ability for an unrelated person to control the activities of an entity should be limited to extreme situations, such as where the entity is subject to insolvency proceedings (and so an insolvency official has been appointed to manage the entity). In the circumstances contemplated at clause 81, it is the FMI that is in distress rather than the participant.

Powers of the regulator

6.4 Clause 90(1)(b) sets out a general duty of the statutory manager. We query whether "best protects the interests" is the appropriate test, in the context of a statutory management of an FMI where there may be competing interests. "Having regard to the respective rights and interests" may be a more appropriate test.

6.5 Similarly, we query whether clause 91(a)(ii) is appropriate in having losses allocated "fairly and efficiently" between owners, creditors, the operator, participants and indirect participants. The allocation of losses should not interfere with the pre-existing legal priority of claims.

7. OTHER PROVISIONS

Clause 128

7.1 While clause 128 is similar to director liability provisions in other legislation, subclause (3) is unusual. Subclause (3) states that a director may still be convicted of an offence, and ordered to pay a pecuniary penalty, even if the body corporate of which they are a director is not convicted of that offence or ordered to pay a pecuniary penalty. Such a provision is not present in the equivalent provisions of s 216 of the IPS Act, s 534 of the FMC Act, or s 68 of the NBDT Act, and we do not think it should be included in the FMI Bill either.

Clause 151

7.2 Under clause 151(1)(a)(iii) the regulator may give notice to an individual by email to the individual's email address provided to the regulator or investigator. It is unclear who the email address is provided by and in what circumstances. For instance, whether the operator of an FMI would have to provide the email addresses of certain individuals and, if so, in what circumstances or at what stage (e.g. on designation).

7.3 Given the importance of certain notices (such as a direction notice and a remedial notice under clauses 65, 78, and 81 respectively), these should not be able to be delivered by email given the lack of clarity around how this is achieved.

Yours faithfully
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