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Committee Secretariat
Finance and Expenditure Committee
Parliament Buildings
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By Email: fe@parliament.govt.nz

NZX Clearing – Submission on Financial Markets Infrastructure Bill

Introduction

1. Thank you for the opportunity to provide this submission in respect of the Financial Market Infrastructures Bill (**FMI Bill**) that was introduced to the House on 17 December 2020.

2. As NZX Clearing will be directly affected by the regulatory regime proposed by the FMI Bill, we request that we are provided the opportunity to present our submission orally, before the Select Committee.

Background

3. NZX Limited (**NZX**), New Zealand Clearing Limited and other wholly owned NZX subsidiary companies (together, **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].

4. Specifically, NZX Clearing operates a central counterparty clearing house and securities depository (**NZX Clearing System**). The NZX Clearing System is an integral piece of infrastructure for New Zealand's capital markets, providing market integrity as a transparent and orderly mechanism by which the industry is able to clear and settle trades conducted on the markets operated by NZX.

5. NZX is a licensed market operator of the NZX Main Board, NZX Debt Market, the Fonterra Shareholders' Market and the NZX Derivatives Market. The NZX securities markets comprise 200 listed issuers with a total market capitalisation of approximately

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

$196 billion[2]. NZX supports vital sectors of New Zealand's economy and lowers the cost of capital for listed New Zealand companies, delivering $2.4 billion of value to the New Zealand economy[3].

6. The central counterparty model (**CCP**) utilised by the NZX Clearing System means that New Zealand Clearing Limited (**NZC**) becomes the counterparty to each side of a trade transacted on NZX's markets. When orders are matched in the NZX Trading System, the resulting contract is immediately novated between the trading participant and the clearing participant under the NZX Participant Rules[4] and then novated between the clearing participant and NZC under the NZX Clearing & Settlement Rules.[5] This process of novation causes the trade to be replaced by two separate transactions (reflecting the buy and sell side of the trade), between NZC and the clearing participant, as demonstrated in the diagram below:

7. This approach to settling transactions, makes the settlement system more efficient by allowing clearing participants to net the entirety of their buy and sell trades for each financial product line, across each day, regardless of the various counterparties involved. This allows clearing participants to settle one net financial product obligation per financial product line, and one net cash obligation with NZC.

8. The CCP model also allows NZC to assume the counterparty risk (the risk that a clearing participant defaults in respect of its settlement obligations) for all trades that it clears and settles. This risk arises due to the time-lag between the time a trade is entered into, and the time at which it is settled. CCPs commonly manage these risks by imposing margin and collateral obligations on clearing participants, maintaining risk capital that can be accessed in the event of a default, and utilising other recovery and resolution tools. The CCP's assumption of risk in effect re-distributes and mutualizes the risk of settlement failure, by sharing that risk amongst participants.

[2] Please refer to NZX's monthly shareholder metrics for February 2020 available here. This does not include the Fonterra Shareholders' Market.

[3] Refer to the New Zealand Institute of Economic Research Report "The economic contribution of NZX" dated February 2018.

[4] NZX Participant Rule 6.4.1.

[5] NZX Clearing & Settlement Rule 3.3.

Introduction

Rationale for the CCP Model

9. The Global Financial Crisis of 2007-2008, demonstrated that entities that were "too big to fail" could indeed collapse. As a result, international regulators required clearing houses to move from a bilateral to centralized CCP model, enabling the better allocation of default risk[6].

10. The use of the CCP model re-allocates risk within the financial system and reduces the systemic risk associated with bilateral trading. The CCP acts as a neutral risk-manager contributing to broader financial stability by spreading the default risk across all clearing participants. Its role is to both minimize, and insulate taxpayers from the consequences of a default.

11. We consider that it is important for the Committee to approach its consideration of the FMI Bill, by considering the role of a CCP as a manager, rather than source of risk. In particular, we note that the CCP performs a different function, and poses different risks to the financial system, than those posed by New Zealand's registered banks and other financial market infrastructures.

Regulation of CCPs

12. International regulation of CCPs has been in place since 2011, and is well developed. NZX Clearing is already required to align its practices with the Principles for Financial Market Infrastructures (**PFMI**)[7]. It is important that the regime created by the FMI Bill aligns with these established global requirements, recognising the role that CCPs play.

13. As part of ensuring that NZX Clearing remains abreast of international trends, we maintain close linkages with other international clearing houses and industry forums, including by attending CCP Risk Management conferences run by the Federal Reserve Bank of Chicago, European Central Bank and Deutsche Bundesbank. We note that there are currently common concerns among international clearing houses that regulatory regimes are developed in a proportionate manner, so as not to adversely affect financial markets.

[6] See for example the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010.

[7] Clause 1(i)(ii) of the Schedule to the Reserve Bank of New Zealand (Designated Settlement System – NZCDC) Order 2010.

14. Currently, international concerns around the development of regulatory standards are centred around two key issues. These concerns are relevant to the Committee's consideration of the FMI Bill.

15. The first concern is the anti-competitive effects of high compliance costs, which increase systemic risk to the financial markets. High compliance costs act as barriers to entry for new clearing participants, and may squeeze existing clearing participants out of the market. This results in a concentration of the number of clearing participants who share the risk of default, reducing the ability for a default to be absorbed.

16. The second concern is the need for international regulatory cohesion. CCPs wish to ensure that regulatory standards are adopted in a manner that preserves equitable regulation regardless of the jurisdiction in which they operate. It is important that New Zealand's regime does not outweigh international requirements, which would result in participation in our markets becoming unattractive to international participants, and in turn have a negative effect on liquidity and market stability.

Prior Engagement on the development of the FMI Bill

17. NZX Clearing has been highly engaged with the RBNZ and the FMA (**Joint Regulator**) throughout the development of the FMI Bill. We provided written submissions in both 2015 and 2016 relating to the policy design for the regulation of financial markets infrastructures. We also provided a written submission on the draft FMI Bill last year, and have met with the FMA and RBNZ policy and regulatory teams to make our views clear. Our previous submissions are set out in Appendix One to this letter.

18. We have expressed the following concerns with the design of the regulatory settings:
    a. opacity: it is difficult for FMI to transition to a new regime when the substantive requirements to be set by standards are not yet known.
    b. principles based approach: the standards should impose 'principles based' rather than prescriptive obligations. Such an approach would address the International Monetary Fund (**IMF**) Financial Sector Assessment Program (**FSAP**)[8] recommendations while recognizing the nature of New Zealand FMIs (which are not as complex as their international counterparts).
    c. compliance costs: insufficient consideration has been given to the importance of minimising compliance and operational costs. While it was reported to the Economic Growth and Infrastructure Committee[9] that the RBNZ quantified the compliance costs as minor, we expect NZX Clearing's additional compliance costs arising from the introduction of the new regime to be between $230,000 -

[8] 'Financial Sector Assessment Program', International Monetary Fund, May 2017, Paragraph 37.

[9] 'An Enhanced Oversight Framework for Financial Market Infrastructures', Office of the Minister of Finance, para 109.

$400,000[10]. Some of these compliance costs may be passed through to participants, which could have adverse effects on market participation, risk and efficiency.

d. parity: the FMI Bill needs to ensure that foreign FMI are not given unduly favourable treatment, and that as regulator and operator, and that RBNZ implements appropriate controls to address conflicts of interest, to enable consistent regulation.

19. We appreciate that some of our submissions have been addressed through the development of the FMI Bill (for example: the recalibration of the penalty settings, and the change of default confidentiality status for direction notices).

Submission to the Select Committee

20. FMIs play a critical role in ensuring the operation of a sound and efficient financial system, and they must be appropriately regulated to ensure the operation of a robust economy.

21. We acknowledge the origins of the FMI Bill, and the RBNZ's and Government's desire to address the concerns raised in the 2017 IMF FSAP report, however the resulting regulation must be proportionate to the characteristics of New Zealand's markets. We re-iterate our views which are summarised in paragraph 18, above.

22. We are concerned that the FMI Bill creates a regime whereby inflexible and disproportionate requirements could be imposed on New Zealand FMIs, if the standards to be issued under clause 31 of the FMI Bill, adopt the PFMI in a prescriptive manner. We consider that the PFMI cater to more complex and sophisticated FMI who operate internationally, and that there must be recognition of the scale and simplicity of the New Zealand market. We support the implementation of the PFMI requirements on a principles basis, rather than in a prescriptive manner, recognizing "*FMIs' differing organisations, functions and designs, and the different ways to achieve a particular result*"[11]. Such an approach would be consistent with the IMF FSAP recommendations.

23. We are also concerned with the opacity of the regulatory regime being introduced. In particular, the transition process for existing FMI is unknown, and the joint regulators will be afforded the discretion to develop requirements for FMI (post transition to the new regime). While we understand the Government's intention to move to a more interventionist regulatory model, the powers afforded to the Joint Regulators are serious and significant, and we will be reliant on their discretion in implementing those powers in

[10] Against revenue of approximately $7 million for the year ended 31 December 2018, refer to New Zealand Clearing and Depository Corporation Limited's annual report here,

[11] 'Principles for financial market infrastructures', Technical Committee of the International Organization of Securities Commissions, April 2012, paragraph 1.2

an appropriate and proportionate manner. This creates significant uncertainty for us as an FMI, as we look to understand the implications on our business through the transition period, and on an on-going basis.

Adoption of a proportionate regime

24. The standards that are to be developed to support the new regime will be pivotal to the new regulatory framework, and must balance regulatory concerns with commercial pragmatism. The standards must be developed in recognition of the New Zealand environment. 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.

25. 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[12]. We consider that such an approach would satisfy the IMF FSAP recommendations, while preserving the operation of an efficient regulatory regime.

26. The standards must be implemented in a manner 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.

Efficient and transparent implementation of the regime

27. We have concerns that there remains a lack of clarity around the transition process for existing designated FMIs, and that the FMI Bill is silent in this regard. While we understand that the Joint Regulator intends to re-designate FMI under the new regime, we are uncertain as to what will be expected of us through the transition process.

28. We suggest that it may be helpful for the FMI Bill to clarify the transitional arrangements, including the matters that the Joint Regulator is able to consider through the re-designation process, and how the considerations in clause 23 of the FMI Bill will apply in a re-designation context. While the Joint Regulator may need to consider whether an

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

existing designated FMI is systemically important, we do not consider that any additional considerations should be relevant.

29. In particular, we do not consider that it would be appropriate for the Joint 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 Joint Regulator is not required to approve contingency plans or changes to contingency plans (unless the change is required under clause 51). We also 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. Therefore, we do not see a role for the Joint Regulator to re-assess contingency plans of existing designated FMI at the time of transition. It would be helpful if these considerations were clarified in the FMI Bill.

30. We are also concerned about the significant increase in compliance costs that will result from the new regime, and their effects on market efficiency. While we acknowledge the need for the Government to address the IMF recommendations, and that any change in regulatory regime will result in additional compliance costs, we are concerned that the Regulatory Impact Statement prepared by RBNZ did not appropriately quantify the compliance costs of the new regime for existing designated operators. We disagree that these costs would be minor, and as noted in paragraph 18 above, 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.

31. 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, primarily by being passed on to participants. In addition, participant's own compliance costs may increase, directly (if new obligations are imposed on them under the standards), and indirectly (as they assess and participate in the development of the new regime, through the standards' consultation process). These additional costs may have the anti-competitive effects on systemic risk described in paragraph 15 above, and negatively impact the overall efficiency of New Zealand's financial markets.

32. We are also concerned with suggestions that the new regime could duplicate information verification and assurance requirements. This approach does not appear to align with the principle contained in clause 13(2)(e) of the FMI Bill, which recognises the need to avoid unnecessary compliance costs.

Crisis management powers

33. We 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 require an operator to prepare a rule change to ensure compliance with relevant standards (including in a non-distressed scenario);
b. 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; and
c. the ability for the joint regulator to remove and appoint a director of a New Zealand domiciled operator.

34. 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.

35. We therefore support the inclusion of clause 79 of the FMI Bill which requires (amongst other things) Ministerial consent for the use of a direction notice in a distressed scenario. We consider that clause 79 could be amended to require the Joint Regulator to consult with an affected party before issuing a direction notice, and that clause 84 should be amended to require the Joint Regulator to notify an operator when a direction notice is issued to a participant.

36. The ability for the Joint Regulator to remove and appoint directors in an extreme situation fundamentally cuts across the rights of the owners of an operator. 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. We are also unsure how this power would operate 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 NZX Listing Rules. We recommend that this power is removed from the FMI Bill.

Differential treatment of FMI

37. 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 equivalent to New Zealand requirements. 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). We consider that these differences have the potential to remove competitive neutrality between commercial FMI operators.

General

38. 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.

39. We would like to thank the Committee for the opportunity to provide this submission. We look forward to discussing the matters raised in our submission with you.

Yours sincerely,

Felicity Gibson
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NZX Clearing

Kristin Brandon
Head of Policy and Regulatory Affairs
NZX Limited

Appendix One

The written submissions that have previously been provided by NZX Clearing in relation to the development of the FMI Bill are contained in the following pages.

NZX Limited Submission

Reserve Bank of New Zealand Consultation Document: Crisis Management Powers for Systemically Important Financial Market Infrastructures

NZX Limited ("**NZX**") sets out below its responses to the Reserve Bank of New Zealand's ("**RBNZ**") questions in its Consultation Document: Crisis Management Powers for Systemically Important Financial Market Infrastructures ("**Consultation Document**"). These responses relate to NZX's views on how these crisis management powers would operate in respect of its clearing and settlement business ("**NZX Clearing**"), currently operated by New Zealand Clearing and Depository Corporation Limited ("**NZCDC**"),[1] rather than on generally how effective or appropriate these powers are across all financial markets infrastructure ("**FMI**") potentially affected.

NZX Clearing consists of rules relating to:

(a) clearing and settlement; and

(b) its depository.

NZX Clearing is operated by three entities that are subsidiaries of NZCDC, being:

(a) New Zealand Clearing Limited;

(b) New Zealand Depository Limited; and

(c) New Zealand Depository Nominee Limited.

However, much of the infrastructure and resources to operate NZX Clearing are provided by NZX.

1.	*Do you agree with our general approach to the design of a crisis management framework for FMIs? Are there other matters we should be considering?*

NZX does not have any particular issues in relation to the general approach to the design of a crisis management framework for FMIs proposed by the RBNZ. However, NZX notes that FMIs can vary markedly which means that not just are they different from banks and insurers, but also different from each other.

There is a real danger in a "one size fits all" approach to crisis management of FMIs.

[1] Under current proposals, NZX Limited is also to be added as an operator reflecting its role in providing resources and governance to NZCDC and its subsidiaries.

2.	*Do you agree with the proposed objectives of the crisis management framework? Are there other objectives we should be considering?*

NZX is comfortable with the proposed objectives of the crisis management framework, although it notes that while, in concept, there is an alternate provider for the NZX Clearing services, in fact, it may be better that, if NZX Clearing were to fail, any failure is resolved rather than its operation being transferred to an alternate provider just because one is available.

3.	*Do you agree with the proposed two tier approach to the crisis management framework? If this approach is adopted are there detailed aspects of the framework you would change?*

NZX broadly agrees with the proposed two tier approach to the crisis management framework, subject to specific comments made later in this submission in respect of the particular proposed powers.

In relation to the tier one powers:

- NZX does not believe that business continuity planning should be part of crisis management. While NZX does not have any concerns regarding the RBNZ requiring business continuity planning, this should be a business as usual requirement that is imposed, rather one that fits into the crisis management framework and associated powers. NZX has a comprehensive business continuity plan in place already and would be interested to understand whether this would be sufficient for the RBNZ's purposes, or if it would need to undertake additional work.
- NZX acknowledges the need for a recovery and orderly wind-down plan, particularly given recovery and resolution planning is a both a key attribute of effective resolution regimes for financial institutions and something it already must self-report against under the CPSS and IOSCO Principles for Financial Market Infrastructures ("**PFMIs**").

In relation to the tier two powers, NZX believes that it is important that:

- any statutory powers are only able to be exercised when the soundness of the financial system is at risk.
- any statutory powers exercised are related to the triggers for those powers and proportionate to the risk they are intended to address or mitigate.

Finally, NZX believes that it is important that the regime is applied proportionately to both NZX Clearing and NZClear relative to the risks they respectively pose to the soundness of the financial system.

4. *If the proposed framework is adopted, do you agree with our description of how it should apply in different crisis situations?*

NZX generally agrees with how the RBNZ proposes to apply the framework in different crisis situations. However, it notes that in relation to NZX Clearing there are multiple operators. While applying these powers to NZCDC and its subsidiaries may be relatively straightforward, applying these powers to NZX may be more difficult, particularly in relation to statutory management where NZX has a significant business which is not part of NZX Clearing and potentially would need to continue operating outside of the statutory management regime.

NZX is interested to understand what the RBNZ would likely want to do with NZX Clearing and how it would apply these powers given the integration of systems and relevant people that are involved in both NZX Clearing and NZX's other activities. NZX believes the best approach is likely to be to only have NZCDC and its subsidiaries governed by statutory management, with access to resources governed by contracts between NZX and NZCDC.

5. *If the proposed framework is adopted, do you agree with our description of how it should apply to FMIs with these two basic types of legal form?*

NZX broadly agrees with the description of how the proposed framework should apply to FMIs with different types of legal form. However, NZX again notes that consideration is required as to how the proposed framework would apply to FMIs with more than one operator, such as NZX Clearing.

6. *If the proposed framework is adopted, do you agree with our description of how it should apply to FMIs with different levels of New Zealand presence?*

In the current environment, NZX has no particular concerns regarding the application of the proposed framework to FMIs with different levels of New Zealand presence.

However, the RBNZ has identified both the ASX and LCH as potential FMIs in New Zealand. NZX would be disappointed if the limited application of the proposed framework to ASX and LCH, or other potential competitors to NZX in the future, meant that those entities would get a competitive advantage by operating their businesses from offshore.

7. *Are there potentially "associated entities" of FMIs that are not operators or critical service providers, but are nonetheless essential to the operation of an FMI and its ability to provide essential services?*

No associated entities essential to the operation of NZX Clearing have been identified.

8.	*Do you agree with the proposed power to require operators to ensure that their FMIs have business continuity plans, and recovery and orderly wind down plans?*

NZX is comfortable with the requirement to have a business continuity plan but does not believe this should be part of a crisis management framework. NZX's commercial incentives to have a business continuity plan for NZX Clearing mean that NZX does not believe that the joint regulators need to be closely involved in this process. Rather than reviewing and approving business continuity plans (which could lead to moral hazard for the joint regulators), NZX believes the current self-assessment process (contained in the designation order that requires a self-assessment against the Principles of Financial Markets Infrastructure) should suffice.

NZX agrees with the requirement for a recovery and orderly wind-down plan. However, NZX believes that any requirement for such a plan will need to be flexible and proportionate to take into account the circumstances of, and risks associated with, the FMI. In its case, NZX believes the less prescriptive requirements in the PFMIs should be all that is required for NZX Clearing.

NZX is interested in whether it would be expected to participate in the creation of a recovery and orderly wind-down plan for NZClear, given NZX Clearing is a potential alternative provider for those services, and whether NZClear would be involved in the creation of a recovery and orderly wind-down plan for NZX Clearing. Given NZX and NZClear are competitors, NZX foresees that level of collaboration could be problematic.

9.	*Do you agree with our proposed lists of matters that must be included in business continuity plans, and recovery and orderly wind down plans? Are there matters that you would add to, or remove from, these lists?*

NZX is generally comfortable with the proposed lists of matters that need to be included in the business continuity plan (which it sees as being consistent with the PFMIs that it currently believes it complies with), subject to the comments regarding business continuity plans made elsewhere in this submission.

NZX has reservations about whether the requirements for recovery and orderly wind-down plans could be too prescriptive, especially the requirement to include procedures to change an operator and prefers the more generic requirements of the PFMIs. NZX believes it is important that there is flexibility in the requirement for these plans such that they are proportionate to the risk they are attempting to address and also are relevant to the circumstances of the FMI.[2]

In addition, NZX questions how testing of a recovery and orderly wind-down plan could be achieved in practice.

[2] As highlighted in Recovery of financial market infrastructures, published by CPMI and IOSCO in October 2014.

While NZX accepts that it needs to draft a recovery and orderly wind-down plan, NZX is interested to understand if the RBNZ believes NZX would need to, in practice, change any of its rules relating to managing losses and liquidity shortfalls.

10.	*Do you agree with the proposed role of joint regulators in assessing business continuity plans, and recovery and orderly wind down plans? If not, what role (if any) do you consider joint regulators should have in assessing these plans?*

NZX does not believe that the joint regulators should be monitoring the content and testing of business continuity plans. Business continuity planning is not part of crisis management, but business as usual. NZX believes the current self-reporting requirement in its designation order as to the adequacy of the business continuity plan and its testing should be sufficient. This approach would also avoid any moral hazard for the joint regulators in reviewing the plans and checking testing.

While it is reasonable for the joint regulators to monitor the content of the recovery and orderly wind-down plans, it is difficult to see how these plans can be tested (without an actual failure). Furthermore, there is a serious risk that testing a recovery and orderly wind-down plan could "spook" the market if it became public by accident.

NZX agrees with the ability of the joint regulators to give directions in respect of the recovery and orderly wind-down plan, subject to appropriate safeguards being in place (ie Ministerial consent).

11.	*Do you agree with the proposed direction power and its scope? Are there any changes you consider should be made to this power?*

NZX is generally comfortable with the direction powers that the RBNZ is proposing.

However, it is important that these directions powers have appropriate safeguards to ensure that they are only exercised in situations where there is a risk to the soundness of the financial system and are relevant and proportionate to the risk for which they are triggered.

In respect of the triggers for giving a direction, in NZX's view, the second bullet point in paragraph 70 of the Consultation Document is the key trigger, (ie a risk to the soundness of the financial system).

NZX does not agree that inadequate business continuity plans should be grounds for a direction. As noted earlier, entities have commercial incentives to have appropriate business plans in place and the level of oversight that the joint regulators need to have in respect of these should be low.

In respect of the proposed directions that could be given, NZX does not agree with the following:

- The second and fourth bullet points in paragraph 72 of the Consultation Document refer to directions in respect of risk to the soundness *and efficiency* of the FMI. We note that the triggers for giving a direction consider the soundness of the FMI and the financial system, and this appears inconsistent with a right to give a direction regarding the efficiency of an FMI. The

proposed direction should be amended to refer to soundness only and should be linked to the risk to the financial system, rather than just the FMI.

- The ability to give a direction in relation to a business continuity plan as this should not be included in the crisis management framework.
- The ability to replace and appoint directors. It is difficult to see what use the ability to appoint a director would have, particularly as an individual director is unlikely to be able to make a difference in decision making at the board and may give rise to a number of governance issues. The appointment of a director could also potentially give rise to moral hazard for the joint regulators.

NZX does have some reservations about joint regulators exercising crisis management powers. Its experience, being subject to regulation already by joint regulators, is that the decision making process is more cumbersome and there could be value in a crisis situation in only one regulator being responsible for the exercise of the powers.

12.	*Do you agree with the proposed power to appoint or remove directors? Are there any changes you consider should be made to this power?*

It is difficult to see what use the ability to appoint or replace a director would have, particularly as an individual director is unlikely to be able to make a difference in decision making at the board and may give rise to a number of governance issues. The appointment of a director could also potentially give rise to moral hazard for the joint regulators. For this to be effective, a majority of the board would need to be replaced. At that point, we imagine it would be easier to simply appoint a statutory manager rather than replacing that number of directors on the board.

NZX has no particular concerns regarding the ability to remove directors. However, it is also difficult to see a situation in which the RBNZ would want to use this power. The Companies Act 1993 applies to NZX and provides for a range of circumstances in which directors are disqualified. If the concern in relation to a director was not caught by the disqualification provisions, NZX would expect the RBNZ to have an initial discussion with the NZX regarding the concern with the director and moral suasion would be sufficient in those circumstances to ensure that the director was appropriately dealt with. We think this is the preferable approach.

In addition, as part of the designation process, NZX has agreed detailed governance requirements with the joint regulators that should be sufficient to ensure the joint regulators are comfortable with the governance of NZX Clearing.

13. *Do you think joint regulators should have a power to direct participants in a limited range of circumstances? If so, do you agree with our description of how this power could be framed, and in what circumstances do you consider it could be used?*

In respect of NZX Clearing, NZX cannot foresee a situation where this power would be useful. None of the circumstances in paragraph 81 of the Consultation Document are likely to be relevant to the NZX Clearing as, even if NZCDC was insolvent or unable to provide essential services, its participants should be able to make their own commercial decisions on what to do.

None of the NZX Clearing infrastructure is provided by participants and hence it is hard to foresee what they could be directed to do. NZX believes it has adequate powers under the NZX Clearing rules to ensure participant compliance and does not see any value that could be provided by a regulator that it does not already have.

14. *Do you agree with our description of how statutory management could be applied to an FMI or its operator? If not, how do you consider that it could be applied to an FMI and its operator?*

NZX is broadly comfortable regarding the proposed way in which statutory management could be applied to an FMI or its operator, although the Consultation Document does not address the position of multiple operators (which will likely be NZX Clearing's position). In those circumstances, we suggest statutory management applies to NZCDC and its subsidiaries on the basis that those are the entities that participants have a contractual relationship with.

However, we note that the types of arrangements set out in paragraph 87 of the Consultation Document only refer to a "separate legal entity" rather than a group of entities (as the Consultation Document does earlier). This broader wording should also be included here to capture FMIs such as NZX Clearing, where there are four legal entities, all of which are important to the operation of NZX Clearing.

15. *How practical would it be to sever the FMI business of the operator from the rest of the operators business? What costs might be involved in pre-positioning the ability to do this?*

Separating the NZX Clearing infrastructure from NZX would be very difficult due to the level of integration of both systems and employees, although those arrangements are covered by a contract between NZCDC and NZX. In practice, NZX believes the best approach to a clearing system failure is to put NZCDC and potentially its subsidiaries into statutory management and to rely on the contractual arrangements with NZX for infrastructure and resources. Attempting to segregate clearing and settlement infrastructure and services from NZX is likely to be complex and potentially have wider ramifications for the financial system if NZX was either placed in statutory management or forced to segregate some of its business into a separate entity. Any issues about priority of resources in NZX is something that the joint regulators are best placed to resolve.

16. *Do you agree with our proposed trigger for when joint regulators could recommend statutory management? If not, what changes would you make to this trigger?*

As with triggers for directions, NZX does not agree with an inadequate business continuity plan being a trigger. In addition, NZX does not believe that inadequate recovery and orderly wind-down plans should be a trigger for statutory management. If the RBNZ is unhappy with the plan, the RBNZ has the ability to give a direction. There should be no reason why the RBNZ would need to put an entity in statutory management in this situation when they have a direction right.

17. *Do you agree with the proposed objectives and considerations that would influence the exercise of powers in a statutory management by the statutory manager and joint regulators? Are there any changes you consider should be made to these objectives and considerations?*

NZX agrees with the proposed objectives and considerations, particular in relation to respecting the rules of the FMI and preserving the position of creditors and maintaining the ranking of creditors.

18. *Do you agree with the core powers of the statutory manager that are being proposed? Are there any changes you consider should be made to these powers?*

The core powers of the statutory manager proposed appear reasonable, subject to the detailed drafting.

19. *Do you agree with the proposed moratorium and the resolution powers? Are there any changes you consider should be made to these?*

The proposed moratorium powers and resolution powers are appropriate. However, it is particularly important that there is legal certainty for the NZX Clearing rules and that the operation of the moratorium and resolution powers do not interfere with the rights of creditors or the security given under the NZX Clearing rules. Specifically, it is vital that priority under section 103A of the Personal Property Securities Act 1999 is not affected and the loss allocation provisions in the NZX Clearing rules are honoured by a statutory manager.

20.	*Do you agree with our proposals relating to miscellaneous matters connected to the proposed statutory management regime? Are there any changes you consider should be made to these proposals?*

NZX's only concern in relation to miscellaneous matters is regarding the interaction of the statutory management regime proposed with that in the Corporations (Investigation and Management) Act 1989. Having two regimes applying in the event of a failure, each with different thresholds to be triggered and different regulators involved, will lead to uncertainty. If there is a specific statutory management regime that is being created to apply to NZX Clearing as an FMI, there does not appear to be any reason why the Corporations (Investigation and Management) Act 1989 regime would also apply.

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20 May 2016

To
Ashley Tomlinson
Advisor
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Reserve Bank of New Zealand
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By Email
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Dear Ashley

Consultation Document: Crisis Management Powers for Systemically Important Financial Market Infrastructures

NZX attaches its response to the specific questions contained in the Consultation Document. However, NZX would also like to supplement that submission by specifically addressing some matters in this letter.

As you know, New Zealand Clearing Limited ("**NZCL**") is currently the specified operator of a designated settlement system ("**NZX Clearing**") jointly regulated by the Reserve Bank of New Zealand ("**RBNZ**") and Financial Markets Authority ("**FMA**"). New Zealand Clearing and Depository Corporation Limited ("**NZCDC**"), which owns the settlement system, has had the rules of NZX Clearing designated in order to give legal certainty to those rules (which include clearing and settlement rules, depository operating rules and relevant operating procedures). In particular, this ensures that NZCL as the specified operator of NZX Clearing, is entitled to the priority given by Section 103A of the Personal Property Securities Act 1999.

NZX is currently working with the RBNZ and FMA to amend (and/or replace) the terms of the designation order by adding NZX as an operator to reflect the fact that NZX is providing resources and governance to NZX Clearing. Those changes have been the subject of extensive discussion with both the RBNZ and FMA. While NZX acknowledges there is no indication that those changes would be affected by the RBNZ's proposed new regime for oversight of financial markets infrastructures, it would like some assurance that this is in fact the case.

NZX notes that in the RBNZ's "*Summary of Submission and Final Policy Proposals on a Consultation Paper: Oversight of Designated Financial Market Infrastructures*" dated December 2015 NZX Clearing was identified as a domestic financial markets infrastructure ("**FMI**") that may be of systemic importance. It appears that this assessment could have been made, in part, because NZX Clearing is currently designated. However, NZX Clearing has a lower transaction value processed each day than any of the other FMIs that are considered potentially of systemic importance, being ESAS, NZClear, High Value Clearing System and Settlement Before Interchange.

While NZX believes there is a case for excluding NZX Clearing from the list of FMIs of systemic importance, it is more concerned to ensure that any proposed oversight powers (and, in particular, crisis management powers) are proportionately applied to NZX Clearing based on the risk that it poses to the soundness and efficiency of the financial system as a whole. For example, NZX believes that the self-assessment approach imposed on it through the designation order has proved sufficient and it would be concerned if the proposed crisis management powers added significantly greater compliance costs for NZX Clearing.

In this respect, NZX acknowledges that the terms of the designation order require it to publish a self-assessment carried out against the "required standards". It understands these required standards to be the CPSS/IOSCO Principles for Financial Markets Infrastructure ("**PFMI**") dated April 2012. These require FMIs to:

a. have a recovery and orderly wind-down plan (under Principle 3: Framework for Comprehensive Management of Risks); and

b. a business continuity management plan (under Principle 17: Operational Risk).

However, the requirements in the PFMIs are less prescriptive than those which are proposed in the Consultation Document. Certainly requiring all systemically important FMIs to have these plans and to be subject to directions and/or statutory management if they fail to have adequate plans is significantly more onerous than the current requirements (which the RBNZ and FMA appear to have been comfortable with to date).

In respect of any recovery and orderly wind-down plan, NZX believes that the content of this plan should reflect the risk that NZX Clearing bears to the New Zealand financial system as a whole. It believes that any such requirement for a plan needs to be capable of being proportionately applied and it should not be mandatory to cover all aspects of a recovery and orderly wind-down plan referred to in the Consultation Document.

Finally, NZX would be concerned if the power to give directions could be extended to its participants, especially if these included powers to replace directors. NZX Clearing's rules are sufficient to manage its relationship with participants. Any attempt to extend the RBNZ's powers to NZX Clearing participants is likely to receive a negative reaction from those participants, particularly if the costs of compliance outweigh the benefits of those powers.

Yours faithfully

Mandy Simpson
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25 September 2019

Cavan O'Connor-Close
Manager, Prudential Operational Policy
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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