HENRY DAVIS YORK

LAWYERS

RESERVE BANK OF AUSTRALIA CONSULTATION

"ASSESSING SUFFICIENT EQUIVALENCE" UNDER THE VARIED FINANCIAL STABILITY STANDARD FOR CENTRAL COUNTERPARTIES

SUBMISSIONS
BY
HENRY DAVIS YORK
LAWYERS

30 JUNE 2009

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INTRODUCTORY

We thank the Reserve Bank of Australia (**Reserve Bank**) for the opportunity to provide our submissions on the Reserve Bank Consultation on Assessing Sufficient Equivalence issued in May 2009 (**Consultation**).

Henry Davis York is a major Australian law firm based in Sydney. We have a practice which focuses on the banking and financial services industries as well as the government and corporate sector. In particular we have a highly developed practice in financial markets and derivatives. We have acted for many of the major world exchanges including Sydney Futures Exchange, London Metals Exchange, Hong Kong Futures Exchange, and Chicago Mercantile Exchange, as well as providing advice and representation for smaller markets.

We also have extensive experience advising on clearing and settlement issues and we have acted on the establishment, recognition in Australia and development of operational and clearing and settlement rules for many derivatives exchanges.

We provided submissions on the Reserve Bank's Consultation Paper issued in October 2008 on proposed variation of the Financial Stability Standard for Central Counterparties.

Further comments or discussion in relation to the present submissions should be directed to:

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Format of these submissions

We have formulated these submissions on a basis which we hope will be useful, as follows:

- we have made general observations in relation to the proposed methods for assessing sufficient equivalence;
- we have then addressed the relevant specific issues identified in the Consultation; and

- finally we have made brief comments on two of the contentions raised by the Australian Securities Exchange Limited (**ASX**) in its submissions on behalf of the Australian Clearing House and the SFE Clearing Corporation (**the ASX Submission**).

GENERAL OBSERVATIONS

1. In general terms we support the Reserve Bank's proposal to establish guidance on how "sufficient equivalence" would be assessed for the purposes of applying the exemption for overseas facilities from the Financial Stability Standard for Central Counterparties (**FS Standard**).

2. We support the approach set out in paragraph 3 of the Consultation, whereby the sufficient equivalence of an overseas regulatory regime in relation to systemic risk will take into account three specific factors namely:

    - the clarity and coverage of stability-related principles applied by the overseas regulator, relatively to the FS Standard;

    - the nature and intensity of the overseas regulator's oversight process; and

    - observed outcomes relative to those in Australia, as reflected in an initial assessment of clearing and settlement facilities operated under the overseas regime under consideration.

3. We also agree that it will need to be demonstrated that the overseas regime under consideration is sufficient similar to the Australian regime in all three of these aspects.

4. We note that the Reserve Bank's role is limited to assessing sufficient equivalency in relation to systemic risk; and that under the terms of s824B(2)(c) that leaves the sufficient equivalency of the level of effectiveness of fairness of services, to be assessed by the Australian Securities and Investments Commission (**ASIC**). Now that the Reserve Bank has issued its guidelines as to the assessment of sufficient equivalence for its part of the formula, we would welcome more specific guidelines from ASIC as to how it would assess sufficient equivalence in relation to the effectiveness and fairness of services. It would be extremely helpful to have some specific guidance in this respect, to supplement the general principles set out in ASIC Regulatory Guide 54 (**RG54)**. Having said that, we appreciate that this is a matter for ASIC.

RESPONSE TO "KEY ISSUES FOR RESPONDENTS"

The general approach proposed for assessing sufficient equivalence in relation to the degree of protection from systemic risk

5. As indicated above, we agree in general terms with the three factors enumerated in paragraph 3 of the Consultation, and believe that they will provide a sound basis for the Reserve Bank to make a decision in relation to sufficient equivalence.

6. In relation to paragraph **3.1 "Clarity and Coverage",** we do have one suggestion, and that is that there would not necessarily need to be a high degree of overlap in the broad coverage of the principles and measures underpinning the relevant Standard between the offshore jurisdiction and the regime applicable in Australia. The Consultation seems to require this high degree of overlap. Actually, the

wording of Principle 8 in Section 4.4 of RG54 refers to consistency with relevant IOSCO objectives and standards where a foreign regulator:

> "reasonably determines that the regulatory regime is broadly compliant with those objectives and standards." (Our emphasis).

Accordingly we believe that it may be too prescriptive to require a "high degree of overlap" in every case. If the overseas regime is broadly compliant with the relevant IOSCO objectives and standards then, to be completely consistent with Principle 8 in RG54 it seems to us that the Reserve Bank would be safe in assessing "sufficient equivalence" to have been achieved.

7. We do agree however that where there are substantial material gaps between the two regimes, the Bank should be able to assess equivalence by objective reference to rules and procedures.

8. In relation to paragraph **3.2 Oversight process**, we make the following observations. Whilst we recognise the Reserve Bank's requirement to report to the Minister each year on how each CS facility licensee complies with the Standards and whether it is doing all things necessary to reduce systemic risk, and we agree with the description of the six factors which the Reserve Bank proposes to take into account (as set out in the six bullet points on page 4 of the Consultation), we do believe that a slightly different process in assessing these matters should be implemented and would be more consistent with RG54 principles.

9. As stated in the Consultation, ASIC's focus has typically been on the outcomes achieved by a particular foreign regulatory regime, rather than the regulatory mechanisms adopted by that regime to achieve those outcomes (RG54, Section 3.8). Although we agree that as a practical matter some assessment of mechanisms and approach is necessary, it seems to us much more consistent with the RG54 principles that the factors enumerated in the six bullet points should be generally (i.e. collectively rather than individually or severally) satisfied.

10. For example, if it were clearly established that say the factors in the first, third, fourth and fifth bullet points were satisfied (that is: it was established that there was an established framework for ongoing formal assessment, a well defined process for communication of material changes and evidence of dialogue, adequate enforcement capability and adequate arrangements for information provision by the licensee) but there was an absence of the factor in the second bullet point (that is, evidence of regular dialogue between the regulator and the CS facility licensee on matters related to stability), in our view it would be inconsistent with the RG54 principles to find automatically that the overseas regulator's oversight process was lacking.

11. RG54 seems to require a focus on outcomes rather than procedures. Requiring satisfaction of all six factors enumerated in the bullet points on page 4 would to us seem to lead to a "box ticking" exercise, rather than constituting a more general assessment of the overseas regulator's oversight process based on the six stated factors generally.

12. We reiterate that we agree with the formulation of the six factors enumerated in section 3.2. It is just that we do not think that all six factors need to be satisfied on every occasion, because that is less consistent with RG54 principles.

13. In relation to paragraph **3.3 Observed outcomes**, we agree with the imposition of an outcomes test, as this is consistent with the principles annunciated in RG54.

14. We also agree that the supplementary assessments should be conducted at a higher level using only publicly available information.

- **Practical issues in assessing the degree of overlap in the coverage of standards or principles underpinning the Australian and overseas regimes; and**

- **Practical issues in assessing overall sufficient equivalence should a regime appear stronger in some respects (eg a more intensive oversight process) but weaker in others (eg a less formal assessment process, lack of legislative backing and enforcement, or more general principles/standards).**

15. We have no particular comments on the practical issues involved in either form of assessment other than those stated in paragraphs 8 to 12 above.

16. We reiterate that if the Reserve Bank wishes to keep its assessment of sufficient equivalence consistent with the principles enunciated in RG54, it is important to maintain a flexible approach, particularly when assessing regulatory mechanisms covered under heading 3.2.

17. It is recognised that the test is not one of absolute, or even substantial, equivalence but **sufficient** equivalence. We think that "sufficient" is a qualitative term as opposed to a quantative measure such as is implied by terms like "absolute" or "substantial". That implies a need for flexibility.

18. This is recognised in paragraph 3.5 of RG54 which states as follows:

> "3.5. The equivalence test in Principle 1 is flexible. What degree of equivalence is "sufficient" will depend on a number of factors. For example, if a foreign provider is given only limited relief from the Australian regulatory regime, it may not be necessary for the home regulatory regime to achieve all the relevant outcomes of the Australian regulatory regime: see Principle 10. Likewise, the degree of equivalence that is sufficient may be affected by the conditions imposed on any relief from the Australian regulatory regime granted to a foreign provider."

Practice issues in carrying out the outcomes test to gauge sufficient equivalence of outcomes

19. As the outcomes assessment is (in our view, sensibly) going to be restricted to publicly available information and such other information as is supplied by the applicant, we do not see any practical issues in relation to this outcomes test.

Comments on ASX submissions

20. We have had the advantage of reading and considering the ASX Submissions. We wish to take issue with two things said by the ASX.

21. Firstly in ASX's paragraph 2.2 ASX states its expectation that where an overseas applicant is seeking a licence to operate a facility to serve a particularly large or systemically important market in Australia, the exemption under the varied FSS would never apply. (ASX's emphasis).

22. This sort of prescriptive approach is in our view inconsistent with RG54 and the flexibility needed in this process. To the contrary of ASX, we believe that the Consultation both in the footnote on page 2 and in the relevant text, sets out the principles correctly. Of course, in the circumstances where there is a particularly large or systemically important market in Australia there should be some reserve power or discretion in the Reserve Bank to advise the Minister that that alternative regime under section 824B(2) should not be applied. However, we believe that the intended advantage and flexibility of the recent amendments to the FSS might be lost if every new large market facility were automatically banned from using the s824B(2) route. We read the ASX's contention as supporting that unfortunate result.

23. Our other comment on the ASX Submission is in relation to ASX's contention at paragraph 3.1. This calls for the Reserve Bank's analysis of a regime's equivalence to be made public.

24. We say that Principle 6 of RG54 is fully satisfied by the Reserve Bank stating its conclusions as to any significant differences between the regulation of the foreign facilities and the regulation of an Australian facility, being made public.

25. Moreover, we believe it likely that in practical terms, the efficiency of the Reserve Bank's assessment process will to a significant extent depend upon cooperation by offshore regulators: so that the "sensitivities" of the offshore regulators should most definitely be taken into account. We see no need for the full Reserve Bank analysis of each regime's equivalence to be made public.

Conclusion

26. We hope these submissions are helpful and we would welcome the opportunity to discuss our views with the Reserve Bank.

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