

Application of the Regulatory Influence Framework for Cross-border Central Counterparties

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Introduction

In July 2012, the Council of Financial Regulators (CFR) published the paper 'Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities' (July 2012 paper).¹ The paper sets out the safeguards that may be imposed to ensure that the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) (together, the Regulators) have sufficient regulatory influence over cross-border clearing and settlement (CS) facilities that operate in Australia. It develops a graduated framework for imposing additional requirements on cross-border facilities proportional to the materiality of domestic participation, their systemic importance to Australia, and the strength of their connection to the domestic financial system or real economy.

The July 2012 paper lists the criteria that are relevant to assessing systemic importance and the strength of a facility's domestic connection, but notes that the Regulators will take decisions on a case-by-case basis as to which additional requirements are appropriate for a given facility. ASX's CS facilities are subject to the full range of these requirements, while the regulators have determined that requirements relevant to systemically important facilities should apply to LCH.Clearnet Limited's (LCH.C Ltd's) SwapClear service.

In response to interest from existing and prospective licensees, this paper provides further guidance on how the regulatory influence framework articulated in July 2012 would be applied to central counterparties (CCPs) in various Australian financial markets. In discharging their responsibilities under the *Corporations Act 2001* (Corporations Act), the Regulators are required to provide advice to the Minister on any application for a licence or licence variation, based on the facts available at the time. Accordingly, the guidance in this paper is necessarily indicative.

Summary of the July 2012 Regulatory Influence Framework

The framework

The CFR's framework for ensuring appropriate influence over cross-border CS facilities applies a hierarchy of requirements based on the materiality of domestic participation in the facility, the systemic importance of the facility in Australia, and the strength of its connection to the domestic financial system or real economy.

- *Foundational requirements*
 - *for all CS facilities licensed in Australia*: legal compatibility of the facility's rules with Australian regulatory objectives; adequate channels to demonstrate compliance with the RBA's Financial Stability Standards (FSS) and other obligations under Part 7.3 of the Corporations Act
 - *for CS facilities licensed in Australia that have material Australian-based participation and/or provide services in Australian-related products*: governance and operational arrangements that promote stability in the Australian financial system.
- *Additional requirements for systemically important CS facilities*: holding an Exchange Settlement Account (ESA) with the RBA; strengthened influence for the Regulators.
- *Additional requirements for CS facilities that have a strong domestic connection*: holding a domestic CS facility licence; a domestic legal presence; controls on the degree of offshore outsourcing of critical functions, including systems, data and staffing.

¹ Available at <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/cross-border-clearing>>.

The most significant requirements apply to facilities that are systemically important, and particularly those that also have a strong connection to the domestic financial system or real economy. Most notably, a systemically important facility with a strong domestic connection would be required to incorporate locally and hold a domestic licence, such that:

- ASIC and the RBA would be the primary regulators
- the activities of the facility – including the location and administration of collateral – would be under Australian law
- the facility would fall within the scope of the proposed special resolution regime for financial market infrastructures (FMIs) in Australia.

While the Corporations Act does not place any explicit ‘location requirements’ on CS facility licensees, several provisions support the CFR’s framework for ensuring appropriate regulatory influence over cross-border licensees. Part 7.3 of the Corporations Act provides two paths for obtaining a CS facility licence. A facility may seek a ‘domestic’ licence under section 824B(1), effectively submitting to the primary regulation of the Australian authorities; alternatively, if it is subject to sufficiently equivalent regulation in another country it may seek an ‘overseas’ licence under section 824B(2).² The Minister may impose conditions on either type of licence under section 825A. Under section 827A, the Minister must have regard to a number of matters in deciding whether to grant (or vary) a licence and, if so, whether a domestic or an overseas licence would be appropriate, and whether to impose any licence conditions. These matters include:

- the nature of the facility’s services, and the financial products that it clears or settles
- the size, or proposed size, of the facility
- the degree of retail or wholesale participation
- common participants with other CS facilities or financial markets
- whether the proposed action would be in the public interest
- advice received from the Regulators.

A number of these matters are similar to considerations identified by the Regulators in the assessment of a facility’s systemic importance or the strength of its domestic connection (see below). In providing advice to the Minister on licence applications or variations, the Regulators therefore seek to ensure that the licence type and any conditions attached are appropriate for the facility in question. For example, in the case of a CS facility that was regarded as systemically important with a strong domestic connection, the advice would be that a licence only be granted if the facility operated via an entity incorporated in Australia.

Achieving such an outcome could be more difficult if a facility with initially small operations later became systemically important with a strong domestic connection. At present, there is no specific legal provision to underpin a requirement that a licensee incorporate locally and transition from an overseas to a domestic licence. However, under current legislation, licence conditions could be imposed that envisage a transition to a domestic licence and domestic incorporation once a facility reached a certain activity threshold.

In addition to advising the Minister on licence applications and variations, to give effect to the

² The RBA has published guidance on how it would assess the sufficient equivalence of an overseas regulatory regime, available at <<http://www.rba.gov.au/payments-system/clearing-settlement/standards/overseas-equivalence.html>>. Guidance on the RBA’s approach to assessing overseas licensees against the FSS is available at <<http://www.rba.gov.au/payments-system/clearing-settlement/standards/201212-new-fss-ris/attachment-6.html>>.

framework the Regulators have implemented a number of the measures via their respective regulatory frameworks: ASIC has stated clearly in its Regulatory Guide 211 (RG 211) that it will apply the framework when assessing an application for either a new CS facility licence or a licence variation; and the RBA has implemented key measures in its Financial Stability Standards for Central Counterparties (CCP Standards) and Securities Settlement Facilities (SSF Standards). Table 1 summarises how the Regulators have implemented the various measures.

The Regulators' considerations

As noted above, in considering a licence application or variation, the Minister must have regard to, among other things, the public interest. The regulatory regime should support efficiency and innovation in the provision of financial market infrastructure services and accommodate competition where consistent with financial stability. This argues in favour of imposing domestic incorporation and domestic licensing requirements only where the Regulators consider it absolutely necessary to protect against systemic risk.

By considering the imposition of requirements on a case-by-case basis, and by considering not only systemic importance but also the strength of a facility's domestic connection, the framework aims to balance the benefits of enhanced regulatory influence against the costs of imposing additional requirements. As noted in the July 2012 paper (page 6):

The benefits are likely to be greatest where the underlying market is systemically important to Australia, particularly where the facility also has a strong connection to the domestic economy (perhaps by virtue of its participation base or its product mix), such that a disruption could give rise to instability and reputational, confidence or integrity concerns. In such circumstances, a key consideration for the Regulators would be whether adequate channels existed whereby the services of the facility to the Australian market could continue uninterrupted in the event of distress to the facility. This might imply tighter influence through primary regulation and restrictions on offshore outsourcing of critical operational functions, such that appropriate resolution actions could readily be applied. Potential costs, on the other hand, may extend to unintended changes in the market structure, including potential fragmentation, or a disproportionate increase in costs for some participants relative to others.

Importantly, additional regulatory requirements under the framework are set at the level of the CS facility, rather than the underlying product class. This recognises that the costs and benefits of additional regulatory requirements will be determined by *both* the characteristics of the underlying product market and a given facility's role in that market. For instance, even where a product is highly systemically important, it may be that a particular CS facility's activities will never be of such a scale and nature that they pose a material risk to the stability of the wider financial system or real economy. In these circumstances, it is appropriate that any additional regulatory requirements remain proportional to its role.³

The characteristics of particular products may also change over time. It is important, therefore, that the Regulators implement the framework in a way that is sufficiently flexible to accommodate any such changes. For instance, as over-the-counter (OTC) derivatives are increasingly traded on electronic platforms, and as exchanges develop 'swap futures' and other products based on traditional OTC derivative products, the distinction between OTC and exchange-traded products is blurring. For now, the structure of participation and the organisation of participants' trading activity differ between OTC and exchange-traded markets, but these could evolve.

³ A CS facility licensee could feasibly be subject to different regulatory influence requirements for its services in different products. Depending on the profile of its activities, it could potentially provide some services to the Australian market via a domestic entity and some from overseas.

Table 1: Graduated Requirements for CS Facilities

| Requirement | Summary | Instrument for implementation |
|--|---|---|
| Foundational requirements | | |
| <i>(i) For all CS facilities licensed in Australia</i> | | |
| <i>Legal compatibility of rules with Australian regulatory requirements</i> | Facilities to provide up-to-date legal opinions dealing with conflicts of law and enforceability of rules. | All licensed CS facilities operating in multiple jurisdictions are required to provide an up-to-date legal opinion addressing enforceability and conflicts of law (CCP and SSF Standard 1.6). |
| <i>Channels to demonstrate compliance with Australian regulatory requirements</i> | The Regulators to enter into cooperative arrangements and share information with overseas regulators. Direct oversight of domestic licensees; vetting of outsourcing arrangements. | Corporations Act requirements for information sharing in respect of overseas licensees (s 824B(2)); ASIC advice to Minister on adequacy of cooperation and information sharing arrangements (RG 211); RBA's approach to assessing overseas licensees against the FSS. Assessment against FSS relating to operational risk; ASIC guidance on outsourcing arrangements (RG 211). |
| <i>(ii) For all CS facilities licensed in Australia that have material Australian-based participation and/or provide services in Australian-related products</i> | | |
| <i>Governance and operational arrangements that promote stability in the Australian financial system</i> | Facilities to demonstrate that governance arrangements give appropriate consideration to Australian interests, including default obligations proportional to the scale and scope of participants' activities. Facilities to provide for operational support during Australian market hours and, to the extent reasonably practicable, accommodate local market practices. | FSS requirements to consult with stakeholders, and apply proportional requirements to Australian participants, including in default management (CCP Standards 2.8, 3.2 and 12.5, and SSF Standards 2.8, 3.2 and 11.5); requirements to provide operational support and accommodate local market practices, where practicable (CCP Standards 5.2, 6.8 and 16.5, and SSF Standards 5.2 and 14.5). |
| Requirements for systemically important facilities | | |
| <i>Holding an ESA with the RBA</i> | Systemically important CCPs to hold an ESA and comply with ancillary requirements (operational, financial and legal). | FSS requirement for a systemically important CCP to hold and operate an ESA at the RBA in order to manage its Australian dollar liquidity requirements (CCP Standards 7.7 and 9.1). |
| <i>Strengthened influence for Australian regulators</i> | Adequate participation in any supervisory college for systemically important facilities including any crisis management arrangements. | Corporations Act requirements for cooperative arrangements in respect of overseas licensees (s 827A(3)); advice to Minister on licence application (RG 211). |

| Requirement | Summary | Instrument for implementation |
|--|--|---|
| <i>Requirements for systemically important facilities with a strong domestic connection</i> | | |
| <i>Holding a domestic CS facility licence</i> | Periodic and/or activity-based review of the need for a domestic licence and a domestic legal presence. | Advice to Minister on licence application or variation, including the possible imposition or variation of licence conditions (RG 211). |
| <i>Overseeing the outsourcing of critical functions</i> | Facilities to maintain operational arrangements such that, under a future resolution regime, any appointed statutory manager would have control over critical functions. | FSS requirement to organise operations to facilitate effective crisis management actions, commensurate with the nature and scale of their operations (CCP Standard 16.11 and SSF Standard 14.11); ASIC guidance on outsourcing arrangements (RG 211). |

In determining which requirements would apply to a given facility, the Regulators would consider a number of factors.

For systemic importance:

- the size of the facility in Australia (for example, the absolute number and value of transactions processed by the facility in Australian dollar-denominated (AUD) products, or its market share; or, for CCPs, the total amount of initial margin held in respect of AUD products)
- the availability of substitutes for the facility's services in Australia
- the nature and complexity of the products cleared or settled by the facility
- the degree of interconnectedness with other parts of the Australian financial system.

For the strength of domestic connection:

- whether the CS facility offers services in a domestic or international market
- the mix of domestic and international participants in the facility
- the potential for market disruption to affect the real economy
- whether the market serviced by the facility is retail or wholesale
- whether the facility clears or settles a domestic securities market
- links that the facility has with other FMIs.

Challenges in applying the framework

It is challenging to determine appropriate thresholds for additional regulatory influence requirements, particularly those around domestic incorporation and domestic licensing which could substantially alter the economics of a facility's service provision. In particular, there is a risk that by the time a threshold is reached it may be difficult or disruptive to impose new requirements.

Internationally, both Japan and the Eurosystem place explicit requirements on CCPs to incorporate domestically under certain conditions. In Japan, these are set at the product level, with credit derivatives that are closely related to Japanese bankruptcy criteria required to be cleared through a domestic CCP. The Eurosystem, by contrast, applies a value-based threshold for its domestic incorporation requirement. The requirement applies to all CCPs that have a daily net credit exposure in excess of €5 billion in a major euro-denominated product, and that control at least a 5 per cent market share based on the same measure. The Japanese and European approaches reflect different ways in which authorities have responded to the challenge of determining an appropriate threshold for domestic incorporation: an entry-level requirement applied to a narrow range of products; or a materiality threshold applied to a broader range of major products.

The Regulators have considered international precedent and the challenges of applying a threshold-based approach and favour a flexible approach that sets thresholds based on prevailing circumstances. Accordingly, where it is possible that a facility's business will evolve in such a way that additional requirements will in future be necessary, the Regulators would require the facility to demonstrate at the outset that its service offering would remain viable even if the additional measures were imposed. Further, to ensure timely compliance with additional requirements should they ultimately prove necessary, two thresholds would be set:

- an initial low size or market share threshold at which the facility would be required to articulate a concrete plan for implementation of the additional measures within a defined timeframe
- a second higher threshold at which the additional measures would be expected to be in place.

In some cases, the Regulators may also set expectations based on factors other than size or market share, where relevant to the facility's systemic importance and the strength of its domestic connection. One such factor could be the mix of domestic and international participants.

The appropriate thresholds and other relevant metrics would be discussed and agreed with any facility seeking a licence. These would also be made transparent to market participants, market operators and other facilities, so as to ensure that all stakeholders were able to formulate business plans with certainty.

There may, however, be circumstances in which additional requirements should ideally be imposed from the outset rather than only once a threshold was breached. Consider, for instance, a CCP that was permitted to operate initially with the clearing of Australian products integrated with the clearing of other international products. Such a facility could be attractive for some international participants due to the availability of margin offsets across an international portfolio. If the CCP later became sufficiently systemically important and integrated with the Australian financial system that it was required to clear via a domestically incorporated entity, it might be more costly for the CCP to provide its service for Australian products. There might also be less scope to offer margin offsets with related international products, potentially making the CCP a less attractive clearing venue for many participants. However, at the same time, it could be

disruptive for participants to shift their activity back to the original venue.

Accordingly, where on the basis of its business plans a facility was likely to breach a threshold on a short to medium term horizon, the Regulators would consider recommending to the Minister that the relevant additional requirements be imposed from the outset.

Application to CCPs in Different Markets

This section considers how the Regulators would expect to apply the regulatory influence framework to cross-border CCPs operating in the various Australian product classes: OTC derivative markets; cash equity markets; and exchange-traded derivative markets.

The analysis in this section is intended to give current and prospective licensees high-level guidance, reflecting the Regulators' current views on the characteristics of each product class and assuming a particular profile for a new entrant or licensee. Since the scenarios considered here are not exhaustive, and given the need to respond to future developments in product markets and licensees' profiles, the Regulators retain the flexibility to consider each case on its merits.

OTC derivative markets

The framework for ensuring appropriate regulatory influence over cross-border CS facilities has already been applied in the clearing of OTC derivative markets. LCH.C Ltd obtained a licence in April 2013 to clear energy, commodity and environmental futures to be listed on the soon-to-be-launched Financial and Energy Exchange (FEX). This licence was subsequently varied in July 2013 to permit LCH.C Ltd to offer its SwapClear OTC derivative clearing service in Australia. In assessing which requirements should apply to LCH.C Ltd's SwapClear service, the Regulators took the view that the service could rapidly become systemically important in Australia. This view reflected the integral role of the sizeable (\$9.2 trillion notional) AUD interest rate derivative market in interest rate risk management, the significant share of the market already cleared via LCH.C Ltd by international participants, and the prospect that Australian banks would become direct participants of the service.

Consistent with this conclusion, LCH.C Ltd has applied to open an ESA at the RBA and has taken steps to establish the local presence required to operate an ESA. LCH.C Ltd is also opening an account with Austraclear to hold AUD securities collateral. Once the ESA is in place, LCH.C Ltd will begin settling its AUD margin flows across this account.⁴ In addition, the RBA participates in the supervisory college established by the Bank of England for oversight of LCH.C Ltd's SwapClear service.

Although LCH.C Ltd is regarded as systemically important in Australia, the Regulators have concluded that LCH.C Ltd does not have a strong domestic connection. In the Regulators' view, the AUD interest rate swaps market is part of a much larger global market for OTC interest rate derivatives. International participants in this market organise their trading activity and post-trade processes on a multicurrency basis. The clearing service provided by LCH.C Ltd is similarly organised on a multicurrency basis and Australian-based participants constitute only a small share of LCH.C Ltd's highly international participant base.

⁴ Two Australian banks have joined as direct participants of SwapClear. The other large Australian banks have client clearing arrangements that allow them to clear trades indirectly through this service; these banks are expected to join as direct participants in coming months.

Table 2: Cross-border Regulatory Influence
Application to OTC Derivative Markets

| | Considerations on systemic importance | Considerations on domestic connection | Regulators' expectations |
|---|--|--|--|
| AUD interest rate derivatives <i>Overseas CCP clearing significant volume of AUD derivatives as part of multicurrency offering</i> | Underlying product inherently systemically important and integral to interest rate risk management in the financial system A CCP clearing a significant share of the AUD OTC interest rate derivative market, including for Australian banks, would be likely to be considered systemically important | AUD derivatives expected to be a relatively small part of a linked multicurrency product offering A large international CCP with a multicurrency offering would be expected to have a highly international participant base; Australian direct participants would be expected to comprise a small share Possible interoperable links | While proportionally small, Australian participation nevertheless likely to be material Likely to be systemically important, especially with the direct participation of large Australian banks Given the international nature of the market, unlikely to conclude that the CCP had a strong domestic connection |
| Foreign currency-denominated interest rate derivatives <i>Overseas CCP clearing a limited volume of AUD derivatives, or none at all</i> | Foreign currency-denominated underlying products not expected to be considered systemically important in Australia CCP could expand activity in AUD products | Primarily international products Largely international participation base Possible interoperable links – may be limited by the degree of overlap in product coverage | Australian participation may not be material, at least at the outset Unlikely to be systemically important without a significant expansion of activity in AUD products Given the international nature of the products, unlikely to conclude that the CCP had a strong domestic connection |

In the case of a CCP that provided a clearing service in only (or primarily) interest rate swaps denominated in currencies other than Australian dollars, it is likely that the service would be regarded as neither systemically important nor having a strong domestic connection (Table 2). The Regulators would recommend that such a CCP be required to obtain an Australian CS facility licence if it offered its services to Australian participants. However, if it did not clear a significant volume of AUD products, its links to the Australian financial system would not be expected to pose large direct stability risks.

Should an interoperable link be introduced between an overseas-based OTC derivative CCP and an Australian-based CCP, to allow a participant in one CCP to clear trades entered into with a participant in the other CCP, this would strengthen the overseas CCP's domestic connection. However, this would be unlikely by itself to lead Regulators to conclude that there was a strong domestic connection. Risks arising from any such link would be managed and overseen in accordance with CCP Standard 19 (FMI Links).

Cash Equity Markets

In its report 'Competition in Clearing Australian Cash Equities: Conclusions', the CFR provided guidance on how it would apply the regulatory influence framework to a CCP clearing Australian equities listed by ASX.⁵ In February 2013, on the advice of the CFR, the government announced that no licence application from a competing CCP for ASX-listed equities would be considered for at least two years. It is nevertheless instructive to consider how the Regulators would apply the framework in this product class if the current prohibition on competition were to be lifted following the CFR's review at the end of the two-year period.

The market capitalisation of the Australian cash equity market (\$1.5 trillion) and its daily on-market turnover (around \$3.8 billion) are low relative to notional values in exchange-traded and OTC interest rate derivative markets, and indeed the Australian fixed-income market. However, the cash equity market is highly visible and is often seen as a barometer of wider investor confidence in the Australian financial system. A CCP with a material share of this market would therefore be deemed to be systemically important. A CCP that cleared a material share of the market for ASX-listed cash equities would also be regarded as having a strong domestic connection due to the high level of retail participation (either directly or through superannuation and other managed funds) in this market, its links to securities issuers in the real economy, and the need for such a CCP to link to key trading and settlement infrastructure.

Table 3 considers two scenarios: an entrant CCP clearing for a competing trade execution venue for ASX-listed cash equities; and an entrant CCP clearing for a competing listing market.

An entrant CCP for ASX-listed cash equities traded on a competing execution venue might quickly become integral to the functioning of the Australian cash equity market. It might therefore soon be regarded as being both systemically important and having a strong domestic connection. As set out in the CFR's conclusions on competition in clearing Australian cash equities, a number of factors argue in favour of setting a threshold market share for domestic incorporation and licensing at a low level:

- the importance and profile of the Australian cash equity market
- the central role of the Australian cash equity market in the Australian financial system
- the high level of retail participation in the Australian cash equity market
- the connections that a competing CCP would have to other components of the domestic financial market infrastructure
- stakeholder expectations as to the handling of client monies related to Australian equity trades.

The considerations relevant to a CCP clearing equities listed on an alternative exchange would differ from those for ASX-listed equities (Table 3). Existing alternative listing markets for equities in Australia are small and typically focused on particular industry segments. This is likely to remain the case in the near term, given the dominant position of ASX in listings. It is therefore unlikely that a CCP seeking to clear for an alternative listing market would become systemically important on a short time horizon. The strength of the CCP's domestic connection would also be limited by the narrow industry focus. A business model focused on specialised listings would also limit the potential for the service to become systemically important over time.

⁵ The report is available at <<http://www.treasury.gov.au/~media/Treasury/Publications%20and%20Media/Publications/2013/Council%20of%20Financial%20Regulators%20advice%20on%20competition/Downloads/Competition%20in%20clearing%20and%20settlement%20of%20the%20Australian%20cash%20equity%20market.ashx>>.

Table 3: Cross-border Regulatory Influence
Application to Cash Equity Markets

| | Considerations on systemic importance | Considerations on domestic connection | Regulators' expectations |
|--|---|--|--|
| ASX-listed equities <i>CCP for a competing alternative trade execution venue for ASX-listed equities</i> | Activity is highly visible to the public; any disruption to services could damage investor confidence Share of on-market transactions on a competing trade execution venue likely to be sufficient to be regarded as systemically important Could gain a larger share with interoperability | Domestic underlying market, with material retail participation Likely to have a mixed domestic and international participation base, both in the underlying market and the competing CCP Indirect links to domestic issuing companies; direct links to other FMIs (e.g. ASX Settlement and, in the event of interoperability, possibly also ASX Clear) | Given the profile of the underlying product class, Australian participation is likely to be material Could be systemically important from the outset Since the CCP would also be likely to have a strong domestic connection, domestic licensing and incorporation likely to be necessary at a relatively low threshold market share |
| Non-ASX-listed equities <i>CCP for alternative listing market</i> | A competing listing market would be likely to be small, at least initially With a small size, disruption to services would have limited implications for investor confidence, especially if listings were concentrated in a single or few industries | Domestic listing market, but likely to focus on a narrow industry segment Direct links both to domestic issuers and to other FMIs in Australia (e.g. ASX Settlement) | Australian participation likely to be material Unlikely to be deemed to be systemically important if narrowly focused Unlikely to have a <i>strong</i> domestic connection, given narrow industry focus |

Exchange-traded derivative markets

A wide range of exchange-traded derivative contracts are currently traded in Australia. These are primarily listed on the ASX 24 market and cleared by ASX Clear (Futures). They span financial futures (interest rate and equity index futures), electricity and commodity contracts. ASX also has an important equity options business referencing ASX-listed cash equities. These products are cleared by ASX Clear.

The most actively traded Australian exchange-traded contracts are financial futures. These derivatives are integral to financial risk management in the Australian financial system and are actively used by both domestic and international banks as well as a wide range of Australian investment institutions. Should a competing trade execution venue and CCP emerge for these products and begin to attract liquidity from ASX, the competing CCP could rapidly become systemically important with a strong domestic connection. As in the case of ASX-listed cash equities, given the role and importance of these products and the strong domestic orientation of activity in this market, the Regulators would expect to set the threshold market share for domestic incorporation and licensing of a competing CCP operating in these markets at a

relatively low level (Table 4). The Regulators would expect to reach a similar conclusion for equity options referencing ASX-listed equities, with particular emphasis on their links to the prominent cash equity market.

By contrast, the Regulators would be unlikely to conclude that a CCP operating primarily in the market for non-AUD financial futures, Australian electricity derivatives or commodity derivatives was systemically important with a strong domestic connection. While the electricity market is undoubtedly systemically important in a ‘whole economy’ sense, electricity derivatives are not highly integrated with the wider financial system and any disruption to clearing in that market might be unlikely to give rise to financial contagion. Similarly, commodity derivatives are not highly integrated with broader financial market activity. Further, the Regulators would be unlikely to conclude that a CCP operating primarily in these product classes had a ‘strong’ domestic connection. As noted earlier, when launched, FEX is expected to list derivative contracts in energy and commodity products. Accordingly, in respect of its clearing for this exchange, only the foundational requirements would apply to FEX’s appointed CCP, LCH.C Ltd.

Links to other components of the financial market infrastructure are also likely to be important to the Regulators’ assessment. For instance, if a competing trading venue and CCP emerged for exchange-traded derivatives, participants could seek interoperable links between the competing CCP and ASX Clear (Futures). This could strengthen the competing CCP’s domestic connection.

It is instructive to consider why the expected regulatory settings for a CCP operating in the AUD exchange-traded interest rate futures market are different to those for a CCP clearing AUD OTC interest rate swaps. In both cases, the underlying market would be regarded as systemically important in Australia. However, while a clearing service for AUD interest rate futures would be deemed to have a strong domestic connection, it is likely that (on the basis of prevailing market characteristics) the opposite conclusion would be reached for AUD OTC interest rate swaps. The rationale for this position is as follows:

- the underlying market for exchange-traded interest rate futures is largely domestic, while the OTC derivative market is global
- the OTC derivative market is a largely wholesale market, dominated by a small number of large institutions, including the international broker-dealers and the large domestic banks; the exchange-traded interest rate futures market, while considerably smaller in outstanding notional terms, has broader participation, higher turnover (\$149 billion notional daily, versus \$73 billion), and is integral to the risk management and investment activities of a wider range of domestic financial institutions
- in the OTC derivative market, participants are able to take independent decisions on their preferred clearing venue (subject to agreement with their bilateral counterparties); in the case of exchange-traded derivatives, the clearing venue is determined by the execution venue
- for many international dealers in the OTC interest rate swaps market, trading and post-trade processes – including counterparty relationships, documentation and risk management – are organised on a multicurrency basis; these dealers therefore seek to organise their clearing arrangements on a similarly multicurrency basis
- AUD interest rate futures, by contrast, are not inherently linked – neither in how they are traded, nor how they are cleared – to similar futures products denominated in other currencies.

Table 4: Cross-border Regulatory Influence
Application to Exchange-traded Derivative Markets

| | Considerations on systemic importance | Considerations on domestic connection | Regulators' expectations |
|--|---|--|---|
| AUD interest rate/equity index futures | Large, systemically important market for Australia | Domestic products, linked to domestic underlyings | Australian participation likely to be material |
| <i>CCP for AUD financial futures traded on a competing domestic exchange</i> | Integral to interest rate and broader financial risk management in the financial system Any entrant CCP might have a low market share initially, but based on experience in other markets internationally its share could grow rapidly if liquidity began to shift | Products not inherently linked with international exchange-traded derivative products Any entrant CCP would be likely to have a mixed domestic and international participation base Link to domestic exchange and possible interoperable links | An entrant CCP could rapidly become systemically important if market liquidity began to shift Since the CCP would also be likely to have a strong domestic connection, domestic licensing and incorporation likely to be necessary at a relatively low threshold |
| ASX-listed equity options | Visible market with close links to the prominent market for ASX-listed equities | Domestic products, linked to domestic underlyings; material retail-linked activity | Australian participation likely to be material |
| <i>CCP for ASX-listed equity options traded on a competing domestic exchange</i> | Any entrant CCP might have a low market share initially, but based on experience in other markets internationally its share could grow rapidly if liquidity began to shift | Products not inherently linked with international exchange-traded derivative products Any entrant CCP would be likely to have a mixed domestic and international participation base Link to domestic exchange and possible interoperable links | An entrant CCP could rapidly become systemically important if market liquidity began to shift Since the CCP would also be likely to have a strong domestic connection, domestic licensing and incorporation likely to be necessary at a relatively low threshold |
| Non-AUD interest rate/equity index futures | Scale of Australian participation likely to be relatively low | International products traded on an international exchange | Australian participation may not be material, at least at the outset |
| <i>CCP for non-AUD financial futures traded on an international exchange</i> | Direct interconnections with the Australian financial system likely to be limited since the products traded/cleared would be referenced to non-Australian underlyings | Largely international participation base | An entrant CCP clearing non-AUD financial derivatives would be unlikely to be systemically important in Australia Given the international nature of the products, also unlikely to conclude that there was a strong domestic connection |

| | Considerations on systemic importance | Considerations on domestic connection | Regulators' expectations |
|--|---|--|--|
| Electricity derivatives <i>CCP for electricity derivatives traded on a competing domestic exchange</i> | The market for exchange-traded Australian electricity derivatives is small both in absolute terms and relative to the market for AUD financial futures While integral to financial risk management in a prominent real sector, electricity derivatives are not highly integrated with broader risk management activities in the financial system | Narrow, but prominent domestic underlying segment Largely domestic participation base Link to domestic exchange | Clear connection to a prominent domestic real sector If an entrant CCP operated only (or primarily) in this niche, and/or with a low market share, unlikely to conclude that it was systemically important or that it had a sufficiently strong domestic connection to justify domestic licensing and incorporation |
| Commodity derivatives <i>CCP for commodity derivatives traded on a competing domestic exchange</i> | The market for exchange-traded commodity derivatives in Australia is small both in absolute terms and relative to the market for AUD financial futures While important for some companies' financial risk management, commodity derivatives are not highly integrated with broader risk management activities in the financial system | Some commodity products closely linked to Australian real economy; others largely international products Mixed domestic and international participation base Link to domestic exchange | Some connection to domestic real sector If an entrant CCP operated only (or primarily) in this niche, and/or with a low market share, unlikely to conclude that it was systemically important or that it had a sufficiently strong domestic connection to justify domestic licensing and incorporation |

The framework is, however, sufficiently flexible to accommodate changing market structures and a changing market environment. Consider for instance the hypothetical scenario of a regional or global trend whereby currently nationally siloed exchange-traded interest rate futures markets were gravitating to international exchanges served by international CCPs. Under such a scenario, market participants' business models could change and the 'domestic connection' of these markets could weaken, potentially causing the Regulators to reconsider the case for domestic incorporation and licensing requirements. To the extent that such a facility remained systemically important, however, the requirement to hold an ESA with the RBA would continue to apply. The Regulators would also seek to influence regulatory outcomes through a combination of bilateral arrangements with both the CCP's home regulator and the CCP itself, and through any multilateral college arrangements.

Summary

On the basis of the analysis in this paper, Table 5 summarises the Regulators' likely recommendations or determinations on location requirements for each of the product classes considered. The table takes the case of an entrant CCP that has material domestic participation and either has or is likely quickly to gain a significant share of the market for the relevant product class.

An entrant CCP would be expected to be subject to domestic incorporation and licensing requirements at a relatively low market share threshold in each of the following product classes: ASX-listed cash equities; ASX-listed equity options; AUD interest rate futures; and AUD equity index futures.

Table 5: Summary of Regulatory Settings for CCPs Clearing Different Markets

| | Regulators' likely assessment for a facility with material Australian participation and a significant market share | Highest expected additional regulatory requirements once market share threshold reached |
|---|---|---|
| ASX-listed equities, AUD interest rate/equity index futures, ASX-listed equity options | Systemically important Strong domestic connection | Domestic CS facility licence Domestic incorporation Offshore outsourcing restrictions |
| AUD OTC interest rate swaps | Systemically important No strong domestic connection | ESA at the RBA Strengthened influence for Australian regulators |
| Non-AUD OTC interest rate swaps, non-ASX-listed equities, non-AUD interest rate/equity index futures, electricity derivatives, commodity derivatives | Not systemically important No strong domestic connection | Governance and operational arrangements that promote stability in the Australian financial system |