Financial Market Infrastructures Bill: Third reading

30 March 2021

Financial Market Infrastructures (FMIs) are multilateral systems that provide clearing, settlement and reporting services in relation to payments, securities, derivatives and other financial transactions. FMIs include payment and settlement systems, central securities depositories, central counterparties, and trade repositories. The Financial Market Infrastructures Bill (the Bill) establishes a new regulatory regime for FMIs, and revokes Parts 5B and 5C of the Reserve Bank of New Zealand Act 1989 (Parts 5B and 5C).

The new regulatory regime has three main components:

- information gathering and investigative powers that allow for the ongoing oversight and monitoring of the FMI sector;
- a new designation regime that provides for the enhanced regulation and oversight of systemically important FMIs, and FMIs that opt-in to the regime;
- crisis management powers for designated FMIs that are systemically important (specifically, direction powers and a statutory management regime for FMI operators).

Background

FMIs play a critical role in the operation of financial markets and broader economy. All electronic payments, and most transactions involving the buying and selling of financial products, rely upon the sound and efficient operation of FMIs. Disruption to the services provided by an important FMI can make it difficult or impossible to make payments, or enter into other types of financial transaction. In turn, this can place market participants under severe solvency or liquidity stress. The disruption or failure of a significant payment system can also have serious implications for consumers and businesses in the real economy, by disrupting their ability to buy and sell goods and services.

However, FMIs can have characteristics which mean that they are not operated in a manner consistent with their importance and the risks they can raise. For example, most of the consequences of the disruption or failure of a systemically important FMI are borne by participants and the broader financial system or economy, rather than the FMI's operator. This can result in inadequate incentives on the operator to manage risks.

The current regulatory regime for FMIs is established by Parts 5B and 5C of the Reserve Bank Act. Part 5B provides the Reserve Bank with information gathering powers in respect of payment systems, and Part 5C establishes a designation regime for settlement systems wishing to access legal protections around settlement finality, netting, and the enforceability of their rules.

The designation regime established under Part 5C is opt-in, and does not cover FMIs other than settlement systems. It includes a very narrow range of supervisory powers, and does not include any provisions to deal with the distress or failure of an FMI (i.e. crisis management provisions). While this regime fulfils its original objective of providing a mechanism for settlement systems to access legal protections around settlement finality, netting, and the enforceability of their rules, it does not reflect international standards around the regulation of FMIs (or the significance of systemically important FMIs and the risks their disruption or failure can raise). This was recognised by the International Monetary Fund in its most recent Financial Sector Assessment Programme review of

New Zealand. The findings of this review were published in 2017,[1] and included a recommendation to adopt the basic regulatory framework now established by the Bill in order to broadly align with international standards and reduce the risks should an FMI not be operated in a prudent manner.

Key features of the Bill

The purposes of the Bill are to:

- promote the maintenance of a sound and efficient financial system (including by responding to threats to the stability of, or confidence in, the whole or a significant part of the financial system);
- avoid significant damage to the financial system that could result from problems with an FMI, an operator of an FMI, or a participant of an FMI that threatens the stability of, or confidence in, the whole or a significant part of the financial system;
- promote the confident and informed participation of businesses, investors and consumers in financial markets; and
- promote and facilitate the development of fair, efficient, and transparent financial markets.

The role and functions of the regulator under the Bill are carried out jointly by the Reserve Bank and Financial Markets Authority (FMA), except in relation to designated payment systems, where the Reserve Bank is the role regulator.

Under the Bill all FMIs are subject to the regulators' information gathering powers, and the regulators' ability to require independent reports into aspects of an FMI's operations. These powers are important to allow the regulator to monitor risks within the sector, and to identify when an FMI may be systemically important.

Enhanced regulation applies to those FMIs that are designated. This reflects a proportionate approach to the regulation of FMIs that focuses on those that are more significant (as well as minimising compliance costs for smaller FMIs and new entrants to the FMI sector).

The regulators may recommend that an FMI be designated if it is systemically important, or if the FMI applies to be designated in order to access legal protections in the Bill around settlement finality, netting, and the enforceability of their rules (these legal protections are largely carried across from Part 5C). In assessing whether an FMI is systemically important for these purposes, the regulators are required to have regard to certain matters such as the nature and scope of the activities carried out under the FMI, and the concentration of financial risks within the FMI.

The Bill provides the regulators with the power to issue legally binding standards that designated FMIs must comply with. This power is designed to permit standards to be issued in any of the areas covered by international guidelines (in particular, the Committee on Payment and Market Infrastructures – International Organisation of Securities Commission (CPMI-IOSCO) Principles for Financial Market Infrastructures). Standards may cover the management of various risks (e.g. operational, credit, liquidity, and cyber risks), and a variety of other matters such as governance, disclosure, and access to the FMI.

Under the Bill the regulators are responsible for approving any changes to the rules of designated FMIs, and can require that any deficiencies in the rules be remedied. The Bill also requires all designated FMIs to have comprehensive, adequate, and credible contingency plans for dealing with

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[1] See the IMF technical note "Regulation and Oversight of Financial Market Infrastructures", which is available at: https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/FSAP/Technical-note-Regulation-and-oversight-of-financial-market-infrastructures.pdf?la=en&revision=4c342970-5c20-4a3d-acff-6f3d2a347bc3.

operational or financial failure. The regulators have powers to require that any deficiency in these plans be remedied, and must be notified by the operator of the FMI when a contingency plan is activated.

The Bill provides two broad types of crisis management power for dealing with the disruption or failure of a designated FMI that is systemically important. These are direction powers and statutory management. In broad terms, these powers can only be used when an FMI is distressed (e.g. where a disruption in the operation of the FMI is affecting the stability of, or public confidence in, the financial system), and the FMI's contingency plan is not being properly implemented or is inadequate to deal with the situation.

The direction powers in the Bill may include directions to the operator of an FMI, directions to participants of an FMI to comply with the FMI's rules, and directions removing or appointing directors of an FMI operator.

The statutory management regime in the Bill is based upon the basic statutory management framework in other legislation (such as the Corporations (Investigation and Management) Act 1989), but tailored in a variety of ways to the special circumstances of FMIs. For example, by ensuring (subject to some limited exceptions) the continued application of the FMI's rules during statutory management in order to provide certainty for participants.

The Bill also provides for a variety of supervisory and enforcement tools, such as the ability to issue notices requiring entities to remedy non-compliance, the ability to enter into voluntary undertakings that are enforceable in the courts, civil pecuniary penalties, and criminal offences. This will help ensure that the regulators can respond to any breaches in a flexible and proportionate manner.

Amendments made by the Finance and Expenditure Committee and during the committee of the whole House

The Finance and Expenditure Committee recommended a variety of amendments to the Bill, all of which have been adopted by the House. These include adding a new principle the regulator will have to have regard to when exercising its powers under the Bill, adding a new streamlined process for transitioning settlement systems that are current designated under Part 5C across to the new designation regime, and a variety of other amendments designed to support the operation of the new regulatory framework.

During the committee of the whole House, a number of further amendments were made to the Bill. These amendments involve:

- Clarifying certain aspect of the interface between the Bill and the Legislation Act 2019;
- Bringing into force the day after the Royal assent almost all of Parts 5 and 6 of the Bill, and some consequential amendments;
- To ensure that the Reserve Bank acts as sole regulator of payment systems under the Bill as intended, providing that powers under Part 2 of the Bill are exercised by the Reserve Bank alone in respect of pure payment systems, that the Reserve Bank is solely responsible for recommending that a pure payment system be designated, and that the Minister of Finance is solely responsible for issuing the designation notice for a pure payment system;
- Providing a more specific threshold for when a standard may be made under the Bill that deals with, or otherwise relates to, requirements set out in one or more standards or requirements set by international organisations;
- Ensuring that the list of matters in the Bill that directions to FMI operators may require is exhaustive (including by prescribing that directions may require taking any action to remedy,

or mitigate the consequences of, any event or circumstance that resulted in the FMI being distressed);

- Adding an additional circumstance where it is not unreasonable for the regulators to withhold consent to a party disclosing information covered by a confidentiality notice. Specifically, where disclosure would be inconsistent with achieving the purposes in clause 78;
- Confirming the publication requirements that apply to an Order in Council placing the operator of a designated FMI in statutory management, or an Order in Council terminating a statutory management;
- Confirming that the moratorium that applies in statutory management does not affect the statutory manager's obligation to pay creditors' claims under the rules of the FMI whose operator is in statutory management;
- Clarifying that that where clause 139 means that the Reserve Bank may not disclose information to a third party, this creates an automatic ground for withholding a request for this information under the Official Information Act 1982;
- Requiring the regulators to publish statements that outline in general terms their policies for determining when to recommend that an FMI be regulated and how they will carry out their functions in relation to designated FMIs;
- Narrowing the scope of clause 151 so that it just allows the Minister of Finance to issue directions to the Reserve Bank to have regard to a government policy, rather than allowing the Minister of Finance and the Minister of Commerce and Consumer Affairs to jointly issue such a direction to the Reserve Bank and FMA (amendment to clause 151);
- Removing the consequential amendment to section 68A of the Reserve Bank of New Zealand Act 1989 (section 68A requires the Reserve Bank to take certain steps relating to trans-Tasman co-ordination around banking and insurance regulation. The consequential amendment would have extended it to cover FMI regulation. However, the reciprocal Australian provisions do not cover FMIs, and the different context of FMI regulation means there is much less case for this kind of provision);
- Making a variety of other minor amendments, which largely involve:
    - minor drafting changes to further support the clarity and consistency of wording used in certain provisions (without changing the substantive effect of those provisions); or
    - adding additional consequential amendments to other legislation into the Bill.