BELL GULLY

Caroline Ramsey
Manager Financial Sector
Competition, Trade & Investment Branch
Ministry of Economic Development
33 Bowen Street
Wellington

MATTER NO. 01-327-4361
DATE 10 March 2008

Dear Caroline

Draft Emissions Units Settlement Systems and Futures Bill

We act for CLS Bank International (**CLS Bank**) and are making this submission on the draft Emissions Units Settlement Systems and Futures Bill (the **Bill**) on its behalf.

This submission principally relates to Part 1 of the Bill (covering the proposed new designated settlement system (**DSS**) regime). However, we also comment on the amendments to the Personal Property Securities Act 1999 (the **PPSA**) in Part 2 of the Bill, as it is possible that CLS Bank, as a DSS operator, could require collateral from one of its members in certain circumstances.

1. ***About CLS Bank***

Globally

CLS Group was founded in 1997 to create the first global settlement system, eliminating settlement risk in the foreign exchange market.

The CLS System is operated by CLS Bank, which currently has 60 members with their head or home offices located in 23 jurisdictions. According to CLS Bank's research, which is based upon information received from financial institutions, it is highly likely that CLS Bank now settles 55% of foreign exchange transactions across the globe. The CLS System is a unique real-time process enabling simultaneous foreign exchange settlement across the globe, eliminating the settlement risk caused by delays arising from time-zone differences. The CLS System also settles instructions relating to certain underlying derivative transactions.

Fifteen currencies are currently eligible for CLS settlement, including the New Zealand dollar. Subject to receipt of all necessary approvals, CLS Bank will settle instructions in two additional currencies, the Israeli shekel and the Mexican peso, later this year.

CLS Group has two main operating companies - CLS Bank and CLS Services. CLS Services provides technical and operational support to CLS Bank.

AUCKLAND VERO CENTRE, 48 SHORTLAND STREET
PO BOX 4199, AUCKLAND 1140, DX CP20509, NEW ZEALAND
TEL 64 9 916 8800 FAX 64 9 916 8801

WELLINGTON HP TOWER, 171 FEATHERSTON STREET
PO BOX 1291, WELLINGTON 6140, DX SX11164, NEW ZEALAND
TEL 64 4 473 7777 FAX 64 4 473 3845

In New Zealand

Currently, the CLS System is one of two payment systems designated under Part 5C of the Reserve Bank of New Zealand Act 1989 (the **RBNZ Act**).[1] The CLS System's designation was made pursuant to the Reserve Bank of New Zealand (Designated Payment Systems) Order 2004.

For a period of several years leading up to the CLS System's designation, CLS Bank had extensive discussions with the Reserve Bank of New Zealand (the **RBNZ**) relating to the legal certainty it required in order to be able to settle instructions relating to underlying foreign exchange transactions in a jurisdiction's currency. Part 5C of the RBNZ Act was enacted in part to address the inadequacy of the then current law in New Zealand relating to fundamental issues such as settlement finality.

CLS Bank acknowledges that the new Part 5C proposed in the Bill does not materially change the operative provisions of the current regime. However, the "regulatory wrap" that surrounds those operative provisions *would* change significantly – in particular, if a joint regulator approach is adopted. It is that regulatory wrap that is the principal focus of this submission.

2. ***Submissions on Part 1 of Bill***

(a) ***Joint regulators***

At the time CLS Bank applied for, and was granted, designation for the CLS System, there was of course a single regulator for this regime – the RBNZ. As a result of the discussions referred to above, when Part 5C was enacted, CLS Bank had established a good working relationship with the RBNZ and had become familiar with the RBNZ 's views on the regulation of this regime and its requirements.

Lack of a global precedent

CLS Bank's view was then, and continues to be now, that the most appropriate person to oversee the CLS System's operation in New Zealand is the RBNZ. This mirrors the approach adopted in the 22 other jurisdictions in which CLS Bank either has members or settles instructions in the currency of that jurisdiction (the **Other CLS Jurisdictions**). In none of these Other CLS Jurisdictions is CLS Bank also subject to regulation by the local securities regulator.

In support of the proposed joint regulation regime, the MED's Consultation Paper that accompanies the Bill (the **Consultation Paper**) notes (at para. 6.3(c)) that:

> Reliance on a dual regulator regime in the approval of settlement and clearing systems has precedent in other jurisdictions, including Australia.

In addition, the Cabinet Paper entitled *Designated Settlement Systems and the Primacy of Clearing House Interest in Collateral* (CAB (07) 632) states (at para. 67) that the UK is also a precedent for this proposed regime.

---

1 As an aside, we note that the Cabinet Paper entitled *Reform of the Law Relating to Futures Exchanges and Clearing Settlement Systems* (POL (07) 382) states (at para. 40) that there are currently two designated payment systems in New Zealand – the Reserve Bank of New Zealand's ESA System and the Austraclear System. As far as we are aware, Austraclear is not a designated payment system. But, more importantly, the CLS System most certainly is.

These statements are, at best, misleading. The regimes in Australia and the UK (both jurisdictions in which the CLS System operates) are structured as follows:

(i) *Australia*

"Netting markets" receive certain protections given by the Australian Payment Systems and Netting Act 1998, such as protection of finality of payment. Netting markets are either arrangements that are *declared* as such by the relevant Minister (which is the case for the CLS System), or "licensed markets" or "licensed CS facilities" that have been *approved* by the Minister as netting markets.

"Licensed CS facilities" refers to clearing and settlement facilities that hold an Australian CS facility licence granted under the Corporations Act 2001 (Cth). Applications for CS facility licences are lodged with ASIC (which, as you are aware, is the Australian equivalent of the Securities Commission (the **Commission**)). The Minister has primary responsibility for granting such licences, but in practice the input of ASIC is sought by the Minister.

Therefore it is correct to say that ASIC does have a role in the regulation of this regime in Australia. *However*, the reason for that role is because of the financial services licensing regime in Australia, overseen by ASIC. Under this regime, which has no equivalent in New Zealand, operators of clearing and settlement facilities require a licence from ASIC and the Treasury (as the department of the relevant Minister) under the Corporations Act.[2] This licensing regime has a different focus to the designation regime. The former has a consumer protection focus, which imposes positive obligations on CS facility licensees, whereas the latter focuses more on prudential issues and does not actively regulate the activities of those designated.

Accordingly, because of this fundamental difference (i.e., the absence in New Zealand of a licensing regime for operators of clearing and settlement facilities), the Australian model should not be held up as a precedent for the proposed New Zealand one.

(ii) *The UK*

Under the UK Settlement Finality Regulations, the designating authority is either the Bank of England (the **B of E**) or the Financial Services Authority (the **FSA**). The B of E designates payment systems, in relation to which it retains an oversight role. Hence, it is the designator of the CLS System. The FSA designates securities settlement systems. To that extent, it is correct to say that the UK has dual regulation. However, it is *not* correct to say that the UK has joint regulation, in the sense that both regulators designate a single system.

No basis for securities regulator to oversee purely payment system

CLS Bank's principal objection to the joint regulator approach is that it is simply inappropriate for the Commission to jointly regulate a purely payment system (as opposed to, say, a hybrid payment and securities settlement system). This is particularly so given the Commission's statutory duty to only exercise its powers for the purposes of:

- promoting the integrity and effectiveness of securities markets and settlement systems in New Zealand; and

---

2 CLS has been granted an exemption from obtaining an Australian CS facility licence.

- enhancing the confidence of investors in securities markets in New Zealand.

These purposes are quite different from those for which the RBNZ must exercise its powers, namely:

- promoting the maintenance of a sound and efficient financial system; or
- avoiding significant damage to the financial system that could result from the failure of a participant in a settlement system.[3]

From CLS Bank's perspective, the practical outcome of an additional and unfamiliar regulator, which is required to apply a different statutory approach, is uncertainty. This uncertainty would manifest itself in all dealings CLS Bank has with its regulators – for example, in seeking approval for rule changes, in seeking a variation to its designation order, and in responding to requests for information. We comment specifically on some of these matters below.

CLS Bank's view is that it is inappropriate for the Commission to be a regulator of a system that has no connection with the securities markets. As we understand it, the principal rationale for the joint regulator approach is to prevent the need to duplicate essentially the same regulatory regime for payment systems, on the one hand, and settlement systems, on the other.[4] Put another way, we are not aware of anyone suggesting that a joint regulators approach, in the case of a purely payment system, would provide "better" regulation than is currently the case with the RBNZ as sole regulator.

CLS Bank's submission

That being the case, CLS Bank submits that a more appropriate model would operate as follows:

- if a DSS is identified (perhaps in its designation order) as a purely payment system, it should be subject to the sole regulation of the RBNZ. This is the current position and, clearly, the one that Parliament considered was the most appropriate when Part 5C was enacted in 2003;[5]

---

3 The Consultation Paper notes (at para. 6.3(c)) that:

> While both agencies are concerned with the health and functioning of the financial system, they each view the problem from different but complementary perspectives.

4 Also, there was a concern that introducing parallel regimes would create the potential for inconsistent treatment, regulatory arbitrage between application processes, and potential confusion about the nature of the differences between the regimes: see *Designated Settlement Systems and the Primacy of Clearing House Interest in Collateral* (CAB (07) 632), para. 61.

5 A key premise of the May 2005 report of the Committee on Payment and Settlement Systems entitled *Central Bank Oversight of Payment and Settlement Systems* (the **CPSS Report**) is that the principal regulator of a payment system should be the relevant central bank. The CPSS Report acknowledges that in some jurisdictions it may be appropriate to subject payment systems to additional oversight (such as banking regulation or financial services licensing). As noted above, this is the position in Australia. However, the CPSS Report supports the central bank as being the most appropriate regulator of a payment system *as a payment system.*

- if a DSS is identified as a purely securities system, it should be subject either to the sole regulation of the Securities Commission or to joint regulation;[6] and
- if neither of the above applies, the default position should be that the DSS is subject to joint regulation.

(b) ***Amendments to rules***

CLS Bank currently has members in 23 jurisdictions. From a compliance perspective, the administrative requirements of the current Part 5C (which will continue under the Bill) are the most burdensome that CLS Bank faces globally. This is particularly the case in relation to the requirement for rule changes.

Currently, in order for a rule change to be included in the key definition of "rules", it must be notified to, and agreed by, the RBNZ. Rule changes are an inevitable part of a system that is evolving as rapidly as the CLS System. Accordingly, CLS Bank frequently has to consider this requirement. In doing so, it has to overcome two practical problems.

The first problem – what rule changes must be approved?

The first problem is determining what rule changes should be notified and agreed, and what changes do not go to the heart of the matters addressed in Part 5C and, therefore, should not be relevant. In this regard, the current definition of "rules" is not particularly helpful. Paragraph (a) of the definition (which applies to *all* payment systems) seeks to restrict "rules" to those that deal with certain key matters. However, it is not clear whether this refinement flows through to paragraph (b) of the definition (which applies to *designated* payment systems). Moreover, in any event, given the breadth of these key matters identified in paragraph (a), it is extremely difficult to be able to conclude with any certainty that a particular rule change would *not* be covered.

Because of this interpretation problem, CLS Bank has adopted the uniform approach of seeking the RBNZ's consent to *all* rule changes. This approach is, CLS Bank suggests, hardly in the best interests of it or the RBNZ.

CLS Bank does not believe that, in practice, this problem would be resolved by the "critical rules" approach proposed in the Bill. This is because it is inevitable that the rules of a DSS will, through the use of defined terms and cross-referencing, be a complex and inter-related set of provisions. For this reason, it will be impossible to effectively ring fence certain rules as being "critical rules" to the exclusion of the remaining rules. Whether the critical rules are identified by clause number or by subject matter, there would always be an issue as to whether a "non-critical" rule change nonetheless touches on critical rule matters and, therefore, requires approval.

The second problem – administrative burden

The second problem is simply the administrative burden of seeking the RBNZ's consent to rule changes. This is not something that CLS Bank is required to do in any Other CLS Jurisdiction.

---

6 See, for example, section 3.3 of the CPSS Report, where the Committee favours central banks having a role in the regulation of securities settlement systems.

CLS Bank's submission

CLS Bank submits that the "rules" requirement should be the same in New Zealand as it is in the Other CLS Jurisdictions. That is, a DSS might be required to notify its regulator(s) of a rule change, as the new section 156Z(1) in the Bill states. But it should not require consent from this regulator. The control for the regulator(s) is the fact that the designation could be varied or revoked if the change is unacceptable.

Further controls in the case of CLS Bank

While CLS Bank is supervised and regulated as a bank by the Federal Reserve Bank of New York (the **Fed**), it is also subject to a cooperative oversight arrangement with the central banks whose currencies are settled by CLS Bank (including the RBNZ). As a practical matter, significant changes to the CLS service and to the products delivered by CLS Bank are reviewed and approved by the Fed and the overseeing central banks.

In addition, if a rule change were unacceptable to the RBNZ, it could (as an alternative to varying or revoking the designation order) restrict the use of CLS Bank's account at the RBNZ or terminate CLS Bank's ESA agreement. In that case, CLS Bank could not settle any instructions with a New Zealand dollar component.

(c) ***Supply of information***

Once again, this is an area in which the New Zealand regulation goes beyond the generally accepted approach in the Other CLS Jurisdictions. However, when Part 5C was enacted, CLS Bank accepted these provisions on the basis of:

- the fact that only the RBNZ could request information;
- the restrictions on the purpose for which information could be sought; and
- the restrictions on the use and disclosure of the information.

The introduction of a joint regulator would mean that these restrictions become less stringent than is currently the case. This would be of considerable concern to CLS Bank. CLS Bank cannot see why a securities regulator (either alone or jointly with another regulator) should have the power to request information from the operator of, or a participant in, a purely payment system. The appropriate approach is, CLS Bank submits, as set out in (a) above.

3. **Submissions on Part 2 of Bill**

Section 12 of the Bill proposes the insertion of a new section 103A into the PPSA. This covers the "super priority" of collateral held by a DSS operator.

While CLS Bank does not, as a matter of course, require its settlement members to post collateral to secure their payment obligations within the CLS System, collateral can be required in certain circumstances. For this reason, CLS Bank is interested in ensuring that section 103A will in fact operate as intended. To that end, CLS Bank's submissions on section 103A relate more to technical drafting issues than to issues of policy.

CLS Bank submits as follows:

- The wording in section 103A(1)(a) relating to the purpose for which collateral is provided should be amended. Currently, that provision refers to the collateral being provided "for the purpose of, or in connection with, effecting a settlement or processing a settlement instruction" in accordance with the DSS's rules. However, in our experience, it is unlikely

that a DSS would require collateral *for the purpose of effecting a settlement.* Much more likely, the collateral is required *to secure the obligation to effect a settlement.* So perhaps this provision would be better reworded to state:

> for the purpose of securing an obligation of that participant under the rules of that designated settlement system

As a related point, section 103A(2)(b) could be reworded to state:

> can apply that collateral immediately towards the satisfaction of the obligation secured by that collateral.

- The effect of section 103A(1)(b) is that a DSS operator does not have priority until the relevant participant has defaulted. This is quite a different approach from that adopted in the related sections 95 and 97 of the PPSA. In those sections, default is not a prerequisite to priority (but it is, of course, a prerequisite to enforcement).

  This could be more than just a theoretical problem – consider the following example. A bank has a security interest over a participant's securities and has satisfied the requirements of section 97. The participant then pledges the same securities as collateral to a DSS operator. If the participant defaults to the bank before defaulting to the DSS operator, the bank could have priority.

  To remedy this, CLS Bank submits that the default requirement should be shifted from subsection (1) to subsection (2). In other words, subsection (2) would then read:

  > If the interest of a specified designated settlement system operator in collateral has priority under subsection (1) and the relevant participant has, under the rules of that system, defaulted, that operator ...

- Section 103A(3) defines "participant" to mean "a person who has agreed to participate in either a settlement system or a payment system ...". However, as the definition of "settlement system" expressly includes a payment system, the words "or a payment system" are redundant and could be deleted.

  This comment applies equally to those other provisions in the Bill that refer to both these terms separately.

CLS Bank appreciates the opportunity to comment on this draft legislation. It would be happy to discuss further any of the submissions made above.

Finally, for the purposes of the Official Information Act 1982, CLS Bank requests that this submission be kept confidential. If necessary, CLS Bank would be happy to discuss separately the grounds on which it believes this submission should be kept confidential.

Yours sincerely

David Craig
Partner