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Dear Mr McAuliffe

Review of Competition in Clearing Australian Cash Equities

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Council of Financial Regulators Consultation Paper on the Review of Competition in Clearing Australian Cash Equities.

These comments build on the long standing dialogue which AFMA has had with the Treasury and the other members of the Council of Financial Regulators (Council) on issues surrounding financial market infrastructure and competition among clearing and settlement service providers. The comments are structured around the questions posed in the consultation paper and are framed by the historical context which lead up to the decision of the Government to announce the 2 year moratorium on competition in cash equities clearing and settlement in 2012.

Summary

In summary, AFMA member feedback indicates concern with a lack of competitive pressure on the ASX and the desire for change to achieve more account being taken of market user interests. The following points summarises our comments –

I. Policy issue analysis should start with the primacy of market effectiveness over that of service providers or any other group.

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II. The moratorium is seen as a statement of policy intent over the short term. Market dynamics are considered to be a more important determinant in the likelihood of competition emerging for equities clearing. This is considered to be low in the foreseeable future.

III. While the current Code arrangements have provided welcome scope for dialogue it does not provide a means for effectively handling the challenges of an ongoing monopoly situation particularly with regard to pricing.

IV. For some clearing participants the length of a future moratorium is dependent on whether satisfactory pricing certainty can be provided over a matching period. For others, the question of a moratorium, or any moratorium at all, is affected by other determinants as well.

V. There is a range of views among clearing participants on the desirability of regulatory intervention to provide for balance between the interests of users and the interests of the ASX.

VI. Any regulatory measures that may be considered necessary as an outcome of this review should work with the existing regulatory framework, such as using licensing conditions.

VII. The CHESS system is considered to be essential utility infrastructure in which users have the highest level of interest from a governance perspective in order to guide its development.

VIII. Greater governance independence for the ASX's clearing and settlement (CS) services is seen as desirable and should enable the interests of markets users in addition to shareholders to be taken into account.

IX. Open standards are important for financial market infrastructure (FMI) to adapt and survive in a rapidly changing world and their adoption should be set as an objective.

General Policy

1. Which policy approach would you prefer, and why?

At the outset, the context in which the moratorium policy is operating should be clearly stated as the framework for policy discussion.

I. The regulatory environment in Australia allows for competition in clearing of financial products, including equities. The *Corporations Act 2001* regime embodies the principle of competition for market services, and allows for licensing and operation of multiple market venues. The *Financial Services Reform Act* amended the previous Corporations Act to remove almost all references to specific market operators and instead set out general obligations that apply equally to all operators of financial markets. Nothing in the scheme or policy of the Corporations Act suggests there should not be direct competition between different market operators dealing in the same financial products.

II. Competition for clearing services is working successfully in relation to other financial products such as derivatives. ASX operates in a globally competitive environment for clearing services in relation to derivatives and debt securities.

III. It is open for a clearing and settlement service provider to make an application for a license to clear equity securities listed on a market other than the ASX. This could be either for an existing market operator or if an offshore competitor entered this space. The current government policy position with regard to the moratorium is purely ephemeral in nature as it is merely a statement of intent with regard to how a ministerial decision making discretion would be handled if an application did come forward within the announced period.

AFMA supports the law in its current form allowing for competition. It is consistent with allowing competition for Recommendation 44 of the Financial System Inquiry (FSI) to be accepted. The FSI recommends removing market ownership restrictions from the Corporations Act once the current reforms to cross-border regulation of financial market infrastructure are complete. This will allow ASX to be subject to the same ownership restrictions as other entities in the financial sector so that it is on a level playing field with other FMI.

While the Australian equity market is still local in character the evolution of securities markets is one of increasing regional and global integration as well as consolidation. Policy settings need to allow industry the freedom to adapt FMI to meet the needs of an evolving market environment.

2. *Are there alternative policy approaches to those outlined in this paper that you think should be considered by the Agencies? If so, please provide details.*

Given that we are working within an existing infrastructure environment no serious debate has occurred in Australia around an alternative model such as that adopted in the United States of a collective industry solution based on a public utility structure. AFMA does not advocate this approach as one suited to Australia as we are dealing with different existing arrangements. For completeness, we have outlined below our understanding of how the US arrangements work.

The National Securities Clearing Corporation provides central counterparty clearing and settlement services for various securities transactions in the United States. NSCC is a wholly owned subsidiary of DTCC and is registered as a clearing agency with, and subject to regulation and supervision by, the SEC. DTCC is an industry owned and governed utility which offers an alternative approach to market organisation.

NSCC functions as a central counterparty clearer (CCP) for the equities and corporate and municipal bond markets. Equities trade over exchanges or ECNs; corporate and municipal bonds trade over the counter. Trading activity, regardless of trade source, enters NSCC on trade date and is taken to final settlement. In its clearing process, NSCC conducts a multilateral net of its members' trade positions, resulting in a net long or net short position in each traded security for each member and a single overall net funds position for each member. NSCC maintains a settlement account at the Depository Trust Company (DTC) to allow settlement of net securities obligations. NSCC maintains a securities settlement account at DTC to allow settlement of net securities obligations. DTC also acts

as settlement agent for NSCC to effect net funds settlement over NSS through a single NSS file. Each DTC and NSCC member designates a settling bank that participates in the DTC-NSCC NSS arrangement.

3. Are there any other overarching issues that should be taken into consideration?

The guiding principle for examining questions around the provision of clearing and settlement services is whether they are serving the needs of users of markets services and supporting the maintenance and development of an effective market. Clearing and settlement services exist solely for serving the needs of users and regulation should not impede freedom of users to determine what services are demanded and whether providers of these services prosper.

When considering the question of how a monopoly works within the Australian market, public policy consideration need to also look ahead and consider how it might be affected by commercial developments such as a merger or how it might be connect up the Australian equities market into a bigger cross border market.

The Government should be prepared to deal expeditiously with any merger, takeover, or new listing exchange entrant. There should be clear identification of what services are of national interest concern. AFMA has previously said that the CHESS system is essential utility infrastructure which raises the national interest question. It is important that there be policy transparency around how changes in control of the CHESS system might be approached given the high level of user interest in its governance.

Competition

4. What particular benefits would you expect to arise from competition in the clearing of Australian cash equities? What level of fee reduction, or specific innovation in product offerings or service enhancements would you expect to arise? Please share any relevant experiences from overseas or in related markets.

Economics of clearing and settlement in cash equity markets

Cash equities trading involves trade execution, clearing and settlement. Trade execution, clearing and settlement are thus complementary goods - i.e. they are consumed together. The demand for clearing and settlement is what economists call a 'derived demand' and is directly proportional to trade execution.

On the supply-side, trade execution, clearing and settlement are subject to significant economies of scale and scope that give rise to natural monopolies. Financial market liquidity also has the characteristics of a network good that lends itself to a natural monopoly.

Generally speaking, securities trading has large fixed costs in relation to software, hardware and other trading infrastructure but relatively small variable costs per trade. Average costs decline with the volume of trades giving rise to a minimum efficient scale

that is large relative to the size of the market. Securities trading is also characterised by network effects. As liquidity concentrates in a particular trading venue, bid-ask spreads narrow and the price impact of trades is reduced, encouraging further concentration.

Securities trading is also subject to economies of scope, since the same trading infrastructure can be used to trade different types of securities or products. These economies of scale and scope and network effects will tend to concentrate securities trading in a single, multi-product trading venue that is a natural monopoly. The natural monopoly may be contestable in a regulatory sense, but not in an economic sense due to large sunk costs in trading infrastructure and switching costs for market participants.

Clearing is subject to similar scale and scope economies as trade execution, but also benefits from economies of scale in bearing default risk. An important cost of clearing is the capital that must be held to insure against non-performance on the part of counter-parties to a trade. A single clearing house can hold less capital than multiple competing clearing houses because it is better able to net exposures across a larger number of trades. These netting efficiencies reinforce the natural monopoly position that arises from economies of scale and scope.

Multiple competing clearers for the same security may give rise to additional transaction costs and the need for clearers to hold collateral against each other. There are also economies of scope if multiple products are cleared together, for example, exchange-traded and OTC products. These economies of scale and scope and the associated network effects in clearing will drive the structure of the securities trading industry towards multi-product exchanges that integrate trading and post-trade services. The securities trading value chain typically exhibits a high degree of vertical integration, although this is the modal rather than a universal business model.[1]

The integration of trade and post-trade services can be viewed as efficient in so far as it minimises collateral and other transaction costs. This assumes the integrated exchange has appropriate external and internal incentives to minimise these costs. This has been queried in relation to ASX Clear. For example, concerns have been raised that the ASX Clear default fund may be inefficiently collateralised by not distinguishing between securities with different risk profiles.[2]

Generally speaking, while vertical integration may be productively efficient, it can also be allocatively inefficient by increasing the potential for inefficient monopoly pricing and rents. Vertically integrated monopolies in trading and post-trade services can be viewed as a second-best outcome because they capture economies of scale and scope and other efficiencies that render the market non-contestable and the first-best competitive outcome unattainable.

In theory, an incumbent integrated exchange could take advantage of its monopoly over clearing and settlement to prevent entry of new firms into trade execution. However, if the trade execution business is not contestable due to its natural monopoly characteristics, then a monopoly over clearing and settlement adds little to the integrated exchange's natural monopoly position.

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[1] Craig Pirrong, *The Industrial Organisation of Execution, Clearing and Settlement in Financial Markets*, January 23, 2007.

[2] Market Structure Partners, *International Transaction Cost Benchmarking Review*, October 2014.

Where the trade execution business is competitive, there is less of an incentive to use control over clearing and settlement to prevent entry into trade execution, since above normal profits can already be earned on clearing and settlement services. In fact, a natural monopolist in relation to clearing and settlement benefits from competition in the market for complementary services such as trading.

In Australia's case, trade execution in cash equities is already the subject of competition and the behaviour of ASX in relation to clearing and settlement is regulated by a Code of Conduct. The ASX monopoly in relation to post-trade services for cash equities has not prevented competition in trade execution and ASX benefits from any increase in secondary market volume associated with competition in execution.

The economies of scale and scope and network effects in relation to trade execution and post-trade services make the efficiency implications of vertical integration and barriers to entry into these markets somewhat ambiguous given that these productive efficiencies need to be traded-off against allocative inefficiencies arising from a lack competition in the market for post-trade services. As Cantillion and Yin note, the standard industrial organisation 'toolkit is not sufficient to answer questions such as…the likely or even optimal market structure for the financial exchange industry.'[3]

This argues for caution in imposing regulatory solutions to correct for an apparent lack of competition in clearing and settlement. Structural remedies, such as mandatory disintegration could lead to higher transaction costs, a loss of netting efficiencies and wasteful entry into the industry in search of rents that offset the benefits of increased competition.[4]

By the same token, the maintenance of existing regulatory barriers to entry in clearing cash equities could have the effect of precluding competitive entry and long-run dynamic efficiency gains through innovative business models.

This analysis suggests that the market structure for clearing and settlement should be allowed to find an efficient outcome that is driven by the search for economies of scale and scope and the minimisation of transaction costs. If trading and post-trade services are natural monopolies, this will reinforce the existing market structure based on a multi-product, integrated exchange without the need for regulatory barriers to entry. This outcome may be second-best in trading-off competing efficiency considerations given that the first-best competitive outcome may not be feasible given existing cost structures and technologies. Any attempt to impose competition via regulation would need to jointly address barriers to entry in trade execution, settlement and clearing to be effective. The alternative of a regulated monopoly might mitigate some of the efficiency loss from monopoly pricing and rents, but preclude long-run dynamic efficiency gains driven by new entrants with innovative business models.

As the empirical evidence discussed below suggests, vertical integration is the dominant form of industrial organisation for equity exchanges globally. While these outcomes reflect a combination of efficiencies, transaction costs, government and self-regulation, it

[3] Estele Cantillon and Pai-Ling Yin, *Competition between Exchanges: A Research Agenda*, November 2010, 1.

[4] Pirrong, *The Industrial Organisation of Execution, Clearing and Settlement in Financial Markets*, 41.

is consistent with the view that it is primarily efficiency considerations rather than anti-competitive behaviour or regulation that drive these outcomes.

5. *What costs or other impediments might you expect that you, and the industry as a whole, may incur if competition in clearing emerged? Please provide a description of the nature of these costs and any relevant estimates?*

In response to this question we follow on from the first part of the analysis in response Question 4 with a look at the empirical evidence.

Business Strategies of Equity Exchanges

Vertical integration is a widespread business strategy on the part of equity and other securities exchanges. The World Federation of Exchanges reports that 77% of its members offer post-trade services, defined as clearing, settlement and depository services.[5] Even where exchanges are not vertically integrated, they often have ownership stakes or participate in the governance of clearing and settlement businesses. The LSE is the only prominent example of an equity exchange that has mostly had little or no ownership and control over its clearing entity and that actively encourages competition in clearing. This follows regulatory intervention by the Bank of England in the early 1990s.[6] Disintegrated business models for clearing and settlement have generally been supplied by user-owned and governed non-profits that return fees to members (the utility model).

Past studies show that a majority of equity exchanges are vertically integrated. For example Schaper (2012) shows 65% are such. Vertically integrated is defined as providing different but integrated services (mostly clearing and settlement) along the securities trading value chain within a single entity or group of entities.[7] Horizontal integration for the purposes of the table is defined as integration of trading services through consolidation. Diversification is defined as providing IT or trading services other than equities.

[5] World Federation of Exchanges, *2012 Cost and Revenue Survey* (World Federation of Exchanges, July 2013), 11.

[6] Pirrong, *The Industrial Organisation of Execution, Clearing and Settlement in Financial Markets*, 52.

[7] Torsten Schaper, "Organising Equity Exchanges," *Journal of Information Systems and E-Business Management* 10 (2012): 48.

Table 1 Business strategies of equity exchanges in 2008

Exchange	Horizontal integration	Vertically integration	Diversification
Australian securities exchange	–	X	–
BME Spanish exchanges	–	X	–
Borsa Italiana	–	X	–
Bursa Malaysia	–	X	–
Deutsche Börse group	–	X	X
Dubai financial market	–	X	–
Euronext	X	–	X
Hellenic exchanges group	–	X	–
Hong Kong exchanges and clearing	–	X	–
Istanbul stock exchange	–	–	–
Johannesburg stock exchange	–	X	–
London stock exchange	–	–	–
Mexican exchange group	–	X	X
NASDAQ OMX group	X	–	–
New Zealand exchange	–	–	–
NYSE Euronext	X	–	–
OMX group	X	X	X
Osaka securities exchange	–	–	–
Oslo Børs	–	X	–
Philippine stock exchange	–	X	–
Singapore exchange	–	X	–
SIX group	–	X	X
Taiwan stock exchange	–	X	–
Tokyo stock exchange	–	–	–
TMX group	–	–	–
Wiener Börse	–	X	–

Source: Schaper (2012)

Table 1, from Schaper, shows 62% of the 13 listed equity exchanges operate clearing and settlement as a division or wholly-owned subsidiary of the exchange, including ASX.

Table 2 Listed equity exchanges (ordered by market value) and corresponding clearing and settlement institutions

Exchange	Clearing house	Central securities depository	Main markets	Market value 2008 in EUR
Deutsche Börse group			Germany	13,782,600,000
Hong Kong exchanges and clearing			Hong Kong	9,816,312,314
NYSE Euronext	National securities clearing corporation (US), LCH. Clearnet (Europe)	Depository trust company (US), Euroclear Group (Europe)	US, France, Netherlands, Belgium, Portugal	5,200,748,596
NASDAQ OMX Group	National securities clearing corporation (US), EMCF (Europe)	Depository trust company (US), Nordic CSD (Europe)	US, Sweden, Norway, Finland, Denmark, Iceland, Estonia, Latvia, Lithuania	4,469,629,459
Australian securities exchange			Australia	3,646,297,500
London stock exchange	LCH. Clearnet	Euroclear group	UK	3,346,071,414
BME Spanish exchanges			Spain	1,899,745,478
TMX Group	Clearing and depository services		Canada	1,737,730,531
Singapore exchange			Singapore	1,669,790,945
Bursa Malaysia			Malaysia	732,998,350
Hellenic exchanges group			Greece	562,474,793
Johannesburg stock exchange			South Africa	343,893,133
New Zealand exchange	Austraclear		New Zealand	88,846,192

Source: Schaper (2012)

Economies of scale and costs per trade

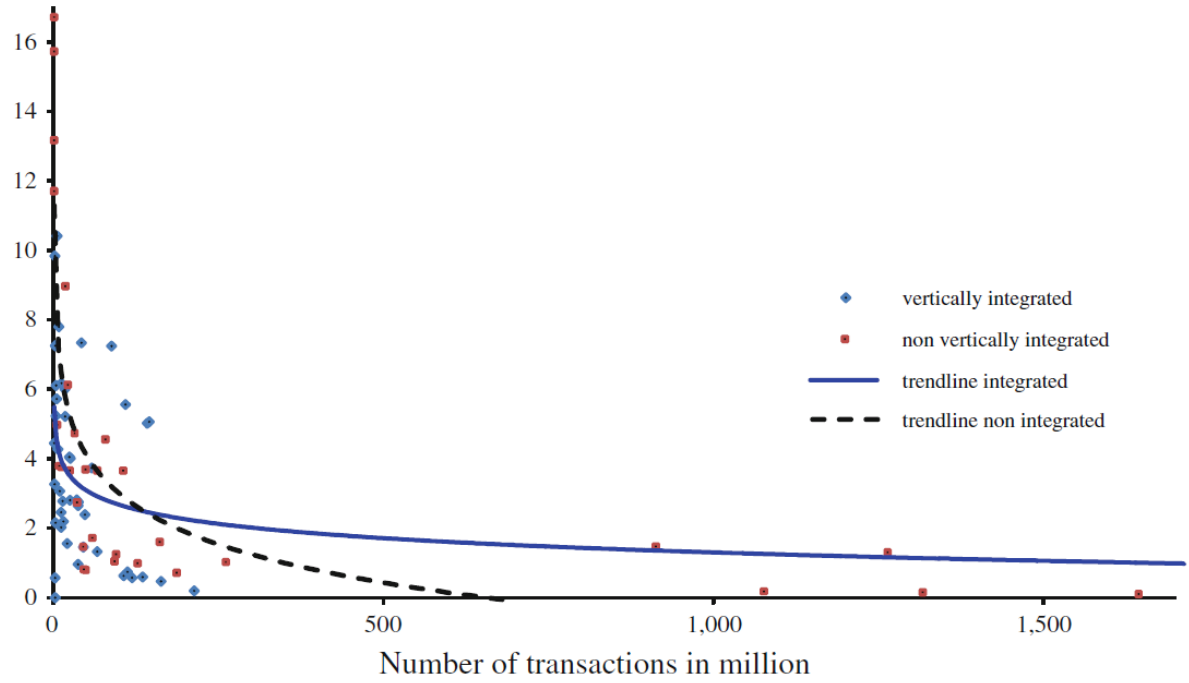
Global benchmarking of cash equity clearing and settlement services based on bottom-up user profiles show that there are significant economies of scale in post-trade services.[8] Oxera and Market Structure Partners have examined the cost of clearing cash equities in Australia on behalf of ASX and Chi-X respectively. Oxera maintain that ASX Clear's higher relative costs reflect smaller scale economies than available in other markets and a default fund that puts more of its capital at risk, necessitating higher fees to realise the same

[8] Oxera, *Global Cost Benchmarking of Cash Equity Clearing and Settlement Services: Prepared for ASX Clear Pty Ltd and ASX Settlement Pty Ltd.*, June 2014; Market Structure Partners, *International Transaction Cost Benchmarking Review*.

return on equity.[9] By contrast, Market Structure Partners (MSP) point to markets such as Norway with smaller volumes but lower costs. They also question whether ASX Clear is efficiently collateralised given its internationally anomalous default fund arrangements.[10]

Top-down approaches to identifying economies of scale yield similar results. Economies of scale can be shown by comparing average costs per trade to the number of exchange transactions, as in Figure 1:

Figure 1: Average Costs Per Trade (in EUR) on Equity Exchanges (2005-08)



Source: Schaper (2012)

While economies of scale are clearly evident, Figure 1 also shows that integrated exchanges tend to have higher costs per trade, consistent with a lack of competition in execution and post-trade services. Schaper's empirical results show that both diversification and vertical integration lead to higher costs per trade controlling for the number of transactions.

The reports by Oxera and MSP provide data which illustrate economies of scale indirectly, showing that smaller exchanges have higher costs. This comparison is shown in Figures 2 and 3.

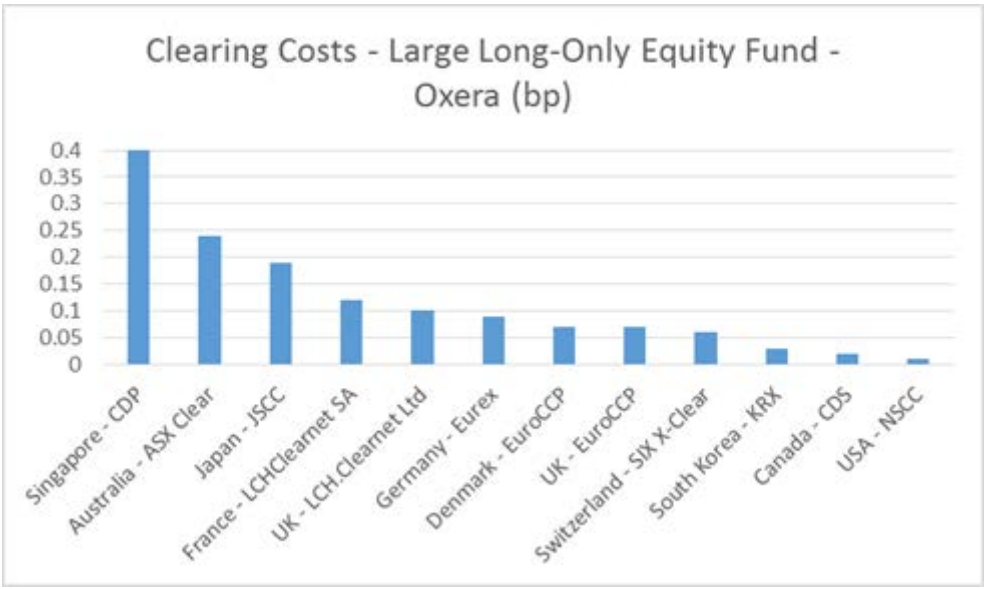
[9] Oxera, *Global Cost Benchmarking of Cash Equity Clearing and Settlement Services: Prepared for ASX Clear Pty Ltd and ASX Settlement Pty Ltd.*

[10] Market Structure Partners, *International Transaction Cost Benchmarking Review*.

Figure 2

Source: MSP Report (2014)

Figure 3



Source: Oxera Report (2014)

Conclusion

Introducing contestability into the market for clearing cash equities can be expected to increase market discipline on the incumbent to maximise available productive efficiencies and pre-empt competitive entry into the market for post-trade services. At the same, it should be recognised that while the market can be made contestable in a regulatory sense, it may not be effectively contestable in an economic sense due to scale and scope economies. Prohibition on competitive entry into clearing cash equities may in fact be redundant in determining the existing market structure for post-trade services. The removal of regulatory barriers to entry may yield a second-best outcome that trades-off scale and scope economies and other productive efficiencies against less competitive pricing.

Given that this trade-off cannot be quantified with any precision, it is not clear that structural remedies imposed via regulation will lead to a superior outcome from an efficiency standpoint. In particular, a regulated monopoly risks losing potential long-run dynamic efficiency gains to the extent that it precludes future entry on the part of innovative business models.

It may therefore be preferable to allow the efficiencies and transaction costs associated with existing and future business models and strategies to determine the long-run market structure for the industry, coupled with non-market based regulatory mechanisms such as codes of conduct to minimise the risk of abuse of market power. While the market-determined industry structure may be sub-competitive, such a second-best outcome may nonetheless be efficient in capturing available economies of scale, scope and liquidity while leaving open the possibility of long-run dynamic efficiency gains driven by new entrants into the market for post-trade services.

Market dynamics are considered to be a more important determinant in the likelihood of competition emerging for equities clearing. This is considered to be low in the foreseeable future.

6. *What are your views on the specific risks that competition in clearing could pose to market functioning and financial system stability? Do you think the 'minimum conditions' identified by the Agencies would be appropriate to both promote competition and protect the stability and effective functioning of securities markets? Are there any other conditions that should be considered or other issues that the minimum conditions should seek to address? Please describe these.*

Some major components of a CS facility's risk management measures may not match those of another CS facility such as how minimum capital requirements and obligation to participate in loss sharing. Differences in a CS facility's rights and obligations towards its own participants versus another CS facility could create additional exposure to a CS facility. Such differences must be identified and appropriately managed. In Europe CS facilities applying different risk management models was considered to be prone to under collateralisation when there is a significant difference in the margin requirement coefficients associated with different trade flow patterns.

For clearing participants multiple CS venues increase operational risk.

In respect of the condition for "Appropriate safeguards in the settlement process" our comments about the importance of the CHESS system in response to Question 8 are referred to you.

7. *What changes, if any, would be necessary to effectively oversee a multi-CCP environment in the cash equity market (e.g. additional regulatory arrangements)?*

Competition between clearing and settlement facilities takes place in respect of other asset classes in an existing, effectively regulated environment. This view takes into

account the extensive policy review work that was conducted through the Council's Review of the Regulatory Framework for Financial Market Infrastructures, in particular in relation to regulatory influence over cross-border financial market infrastructures resulting in the specific measures incorporated into the Bank's Financial System Standards and ASIC's Regulatory Guide 211 (RG 211) on CS facilities, revised in December 2012.

No additional regulation is considered to be needed beyond that being proposed in the Government's 'Resolution regime for financial market infrastructures' Proposals Paper, which is of general application to CCPs.

8. *Is there likely to remain a single provider of equity settlement services, either in the short or long term? Should competition in clearing emerge, what implications might this have for the design of the equity settlement facility, the cost of equity settlement services, access to equity settlement for the competing CCP, and future investment in the settlement infrastructure? Would the Code be sufficient to achieve access to equity settlement on appropriate terms, or would an alternative regulatory approach be necessary?*

Clearing and settlement are separate functions. It is the settlement function which is the most utility-like in character and where we have the benefit of legal certainty in equity settlements under the CHESS system which is worth safeguarding. Contestability around clearing services is a lesser concern from an infrastructure efficiency point of view.

The CHESS system provides the certainty of legal title rather than just beneficial ownership and is now crucial to the efficient functioning of the market. Its fundamental beneficial characteristic is that it involves an electronic transfer of ownership in the CHESS subregister. This is in contrast to more common securities register settlement systems like Austraclear which do not make registry changes; instead, electronic records of entitlement to securities are recorded. In many other markets where the depository model is used, investors do not obtain the benefit of direct legal title to their securities; instead units of beneficial ownership are exchanged and recorded with their systems. This is a key difference between those markets and Australia, where CHESS is a part of the register of shareholders.

The policy objective for Australia is to ensure that the system preserves the benefits of direct legal title and transparency of ownership. When examining how to treat the separate functions of clearing and settlement the highest importance should be attached to considering the CHESS system separately as a utility because the key benefit of legal certainty it provides is dependent on Australian law which means that there is a national interest issue associated with maintaining the benefit it provides to the system as a centralised mechanism.

The ASX is the custodian of the current CHESS system. The system was first developed as utility infrastructure funded collectively by securities market participants through the then Securities Industry Development Account. The evolution of CHESS is not purely a commercial decision for the ASX, but one of how as the custodian of this industry utility infrastructure it should support its future development. Decisions around how this should

occur need to be made. It is suggested that the governance of ASX Settlement should be made more independent in order to assist this objective.

9. *If competition in clearing emerged, should interoperability between CCPs be encouraged in Australia?*

    a. *How might competition in clearing affect the organisation and conduct of your operations? In the absence of interoperability, would you expect to establish connections to multiple trading platforms and CCPs? If so, would implications such as this diminish the commercial attraction of competition between CCPs?*

    b. *With interoperability in place, would you expect to consolidate clearing in a single CCP?*

    c. *How would this decision be affected by best execution obligations? What effect would interoperability have on the costs that you may expect to incur from competition in clearing?*

    d. *What actions might the Agencies need to take (in addition to the requirements around management of financial exposures between interoperating CCPs specified in the Bank's FSS) in order to ensure that interoperability did not introduce additional financial stability risks? Would 'open access' obligations need to be imposed to facilitate interoperable links?*

    e. *What are your views on the stability and effectiveness of interoperability between CCPs in other jurisdictions?*

The desirability of interoperability goes beyond the narrow question of whether an actual competitor is actually operating in the market. Interoperability supports infrastructure resilience and adaptability. As noted earlier, the competitive market environment for stock exchanges is increasingly regional in character. In a dynamic market environment closed systems are vulnerable to being rapidly bypassed as they cannot readily adapt.

Interoperability is about the long term benefits of encouraging FMI providers to adopt open and common standards to promote market efficiency and to facilitate the rapid reconfiguration of CS facilities in the event that ownership or business objectives change as well as providing systemic resilience in the event of the failure of a CS facility. Based on European experience, interoperability has proven most feasible in the area of equities clearing. In Asia where cross market links and the need to build critical mass for market infrastructure through cross border collaboration on infrastructure are under current discussion future Australian planning must take into account the strategic desirability of having a clearing system that can readily work with other clearing systems.

Development of Australia's securities market infrastructure needs to contemplate a more interconnected world where CS systems are not just domestic in character but regional or even global. Given the utility nature of such FMI it is important in looking forward that it develops in the direction of adopting interoperability capability around open standards.

Open standards enable efficient payments clearing and settlement among FMI globally through the use of a common set of messages and language that the institutions agree to use in a consistent way. It allows participants and systems across different financial markets (e.g. payments, securities, foreign exchange, cards) to communicate using consistent terminology or syntax, which supports interoperability and more remittance information. An open standard is one that anyone can use, and to which anyone can contribute.

Interoperability cannot be dictated in detail given the pace of technological advancement but setting the policy principle that open standards should be adopted sets the path in the right direction for development.

10. *If the moratorium were lifted, would you expect a competing CCP to seek entry to the Australian market in the near future, noting the 'minimum conditions' set out in the Agencies' 2012 Report (refer to Section 4.3)? If competition were permitted but no competing entered the market, at least for a time, should transitional regulatory measures (such as the existing Code) remain in place until such time as competition did emerge?*

The above economic analysis indicates that while the market can be made contestable in a regulatory sense, it may not be effectively contestable in an economic sense due to scale and scope economies. Businesses looking at the Australian market have to make commercial judgments about the viability of entering this market with no certainty about being able to be profitable quickly.

At present there are no indications of which AFMA is aware of service providers keen on making an early entry into the Australian market even if the moratorium were to be lifted. The scenario of a de facto monopoly continuing for the foreseeable future is considered to be likely. Given this situation change is seen as necessary. Such change is discussed in the answers below.

11. *If the moratorium on competition were to be lifted, would the threat of competition be sufficiently credible to encourage ASX to retain and adhere to the Code, or would the Code need to be mandated (see Section 5.4)?*

To the extent that competition issues arise they should be dealt with under the framework of existing competition law administered by the ACCC. It would be in this regulatory context and the prevailing environment that such a question would need to be to be considered. To the greatest extent possible rules under the Corporations Act should apply in the same way to all licensees.

12. *Would you support an extension to the moratorium on competition in clearing? If so, why? What time period would be appropriate before the industry was ready for competition in clearing to emerge?*

As already noted the de facto monopoly of the ASX is likely to continue with or without the moratorium so a policy decision to extend it would have more of a perception effect about Australia's attitude to competition than a practical effect.

There has been generally negative feedback on a period as long as five years being considered. The market environment is too dynamic and hard to predict for such a timeframe to be contemplated.

Otherwise there is debate about whether any fixed period would be sensible as it only give certainty to the ASX. It does not give clearing participants certainty on pricing. There is not certainty around pricing when a pricing model relies on contingent events.

The level of acceptability of a moratorium to some clearing participants is dependent on whether they have certainty about acceptable prices they will be charged for a known period. Accordingly, this leads to the view that for those clearing participants the length of a moratorium would have to be dependent on whether satisfactory pricing certainty can be provided over a matching period. The period of known pricing is seen as being directly correlated to any period of a moratorium. It should be noted that some clearing participants either remain unwilling to accept an extended moratorium or any moratorium. For those participants pricing is seen only as one of many determinants.

In addition, long term pricing structures, not subject to negotiation or competition influences are considered to be not in the interests of clearing participants.

Monopoly

13. *If competition in the clearing of Australian cash equities were to be deferred indefinitely, what form of regulation may be necessary? Would a self-regulatory regime under the Code be sufficient to deliver the benefits of competition in clearing, or would some other form of regulation be necessary?*

There are a range of views among AFMA members on the appropriateness of greater regulatory intervention. Preference is given to encouraging the ASX to voluntarily make changes that would result in governance independence for its CS services.

14. Expand on this in answer to below questions. How effective are the governance arrangements under the Code? For example, please expand upon the following:

   a. the effectiveness of the Forum and Business Committee

b. *the responsiveness of ASX to the issues raised by the Forum and Business Committee*

c. *the composition of ASX's Boards?*

ASX relies on the continuing support of market participants and issuers to maintain its business services, including clearing and settlement.

The Forum is considered to be a high level discussion group rather than a functional governance mechanism. It does provide a forum where important strategic issues facing the equities market can be discussed.

There is positive feedback on the value of the Business Committee and its responsiveness as it deals with issues of practical importance to users. This is attributed to it being composed of people who are closely engaged with the day to day realities of the market.

There is support among market participants for a greater level of governance independence to be introduced for ASX's clearing and settlement services. This is not restricted to equities clearing only and has broader application to ASX CS services.

The ASX has an existing model for such an independent governance arrangement in the form of ASX Compliance, which has a separate Board of Directors to other ASX Group entities and a distinct board composition. Currently only one out of four ASX Compliance directors is also a director of other ASX Group entities. The Group Executive for ASX Compliance reports directly to the ASX Compliance Board.

Greater governance independence is particularly desirable for the management of the CHESS system as it is a fundamental piece of utility infrastructure for the market and its origins are founded in a collective clearing participants' effort to develop it.

15. *How effective are the current pricing arrangements? For example, please expand upon the following:*

    a. *the level of transparency of pricing, revenues and costs associated with ASX's cash equity clearing and settlement services*

    b. *the cost allocation policies adopted by ASX*

    c. *whether pricing is comparable with overseas clearing and settlement services.*

Transparency around the costing of ASX CS services is an important objective. While the publication of the cash market clearing and settlement management accounts has been a positive outcome of the Code, a clear delineation of clearing and settlement services of the financial statements from trading platform and listing services would improve the ability to understand costs and the efficiency of the services.

The European Code of Conduct for Clearing and Settlement of cash equities notes that price transparency is an essential requirement. The European Code outlines several measures to increase price transparency. The objective is to enable customers to better understand the services they will be provided with and the prices they will have to pay for

these services and to facilitate the comparison of prices and services on an individual basis. These measures are a useful guide in approaching the question of transparency.

Both the Oxera and MSP reports indicate that clearing costs of the ASX are at the high end of the cost comparison scale when compared to other service providers around the globe. Those benchmarking reports have influenced clearing participants pricing expectations that the ASX pricing should be more in line with other financial centres. At present there is a wide gap between ASX prices and clearing participant expectations. The way forward on closing this gap may sit outside the Code framework and is a matter of ongoing consideration.

16. *How effective are the access provisions under the Code? For example, please expand upon the following:*

    a. *the adequacy of existing access provisions to support competition in trading of ASX securities*

    b. *whether the scope of access provisions should be expanded beyond ASX securities*

    c. *whether the information-handling standards implemented under the Code are sufficient to support innovation, by mitigating potential conflicts of interest for ASX staff and management*

    d. *whether any further commitments are required to improve necessary access to ASX's clearing and settlement facilities by alternative market, and listing market, operators. If so, what measures are required?*

As we have noted elsewhere in these comments a more delineated separation of ASX's clearing and settlement services is supported. This would be a more appropriate response to address management of possible conflicts of interest for ASX staff and management.

In addition, the existing National Access Regime (NAR) under Part IIIA CCA regulatory framework provides appropriate regulatory mechanisms for dealing with access issues in the event that a party needs more robust means to ensure access.

17. *In general, how effective do you think the Code has been in addressing the issues identified by stakeholders in the 2012 Review? Do you think a Code of Practice is an effective mechanism for delivering outcomes similar to those that might be expected under competition? Please share your experience in relation to the operation of the Code.*

The Code and its consultative mechanism has improved accountability and dialogue. The Code itself does not substitute for competition but provides an enhanced approach for the ASX to communicate with its users. The Code was a temporary outcome of the government's decision to have a moratorium and its effects are short term in nature. It does not provide a long term framework for addressing a lack of competition in the market.

18. *Are there any other issues that the Code should seek to address? What steps, if any, should be taken to strengthen the arrangements under the Code in order to realise the benefits of a competitive market? Are formal enforcement mechanisms or extended accountability commitments necessary?*

The direction of these comments is to look at the long term governance independence and arrangements and resulting greater transparency for the ASX CS facilities. Therefore, it would be possible for the ASX to follow this direction and consider how a revised Code might support such a change where ASX Clear and ASX Settlement are operating at arm's length from the rest of the ASX businesses. A voluntary evolution is preferred to the introduction of formal mechanisms.

19. If you think that another form of regulation would be necessary:

a. What would be the appropriate scope of such regulation? Should both ASX Clear and ASX Settlement be regulated?

b. What aspects of each service should be regulated (e.g. pricing, access, structure, ownership, infrastructure development)?

c. *Would the measures available under the existing legislative and policy framework be sufficient for this purpose? If not, what new regulation or legislation might be necessary?*

Australia has developed over time a sophisticated and regulatory framework for supervising FMI which should be administered in a way that treats all providers on an equal and fair basis with low administrative barriers to entry.

AFMA's overall approach to FMI providers is that they exist to serve market users and it is market users who should determine whether providers prosper depending on the quality and value of their services. FMI providers should be able to enter and compete in this market under our sound regulatory framework. It is desirable for FMI providers to be able to freely operate here and look to expand their services into the Asian region from an Australian base.

Under current law access, structure, ownership and infrastructure development can each be strongly influenced by the regulators. The CS licensing powers of the Corporations Act in particular are a powerful tool.

Governance independence should be considered for both ASX Clear and ASX Settlement based on the view that this will produce a different dynamic between the interests involved. This is both to address the competition issues under present consideration as well as allowing for a more nuanced approach to dealing with national interest decisions in the event of future merger or acquisition proposals. It is suggested in answer to Question 18 that the ASX could voluntarily follow this course rather than being obliged to do so. It is desirable to encourage current structures to evolve in response to commercial needs of all those involved without immediate resort to regulatory measures.

ASX Settlement is of the highest importance in relation to governance independence. In regard to ASX Settlement there should also be greater participation of market users in determining how it should be developed.

In looking at governance independence, there is a need to allow directors to balance the interests of market users against those of shareholders and their duties should be modified to expressly allow for this. This is a matter on which complementing regulatory would be needed.

Regulation of pricing is not supported at present. This is because over time it could produce distorting effects and lead to unintended consequences. Governance reforms and financial transparency are looked to as the way to handle a lack of competition for the time being.

AFMA thanks the Council for the opportunity to discuss this subject with it and the attention you have paid to our comments. AFMA would be pleased to provide further comment if desired. Please contact David Love or Stephen Kirchner in this regard.

Yours sincerely

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