

GBST Response: Review of Competition in Clearing Australian Cash Equities

Consultation Questions

Policy Approaches

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

No comment.

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.

No comment.

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

The costs to the industry of implementing competition should be more clearly identified and discussed. In the absence of this information it is likely that potential users of a competing CCP may focus on transaction fees as their main decision criteria. A situation where all participants incur additional costs even if they do not choose to use an alternate CCP should be avoided.

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.

In the absence of a proposed charging model for a new entrant and a lack of clarity of the costs involved in supporting multiple interoperable CCPs makes any determination of the benefits subjective. Whilst the experience in Europe has delivered significant reductions in clearing fees the differences in the size of the markets makes direct comparisons difficult. Given that ASX Clear has proposed a reduced fee structure to apply if competition is not introduced there is obviously some room for reduced costs; the key question is, however, whether the size of the reduction would be sufficient to offset the additional costs of supervising multiple CCPs, modify participant systems to support multiple CCPs, implement interoperability and to fund the extra margin costs associated with mitigating the inter-CCP risk.

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?

If multiple CCPs were allowed it would require modification of participant clearing and settlement systems; the costs of these modifications would be passed back to the participants wishing to utilise the new offering. The extent of the modifications would be dependent on the operating model of the new CCP and the level of validation of the CCP's calculation of obligations required by participants.

There is also a lack of clarity on the additional costs which may be incurred by participants to cover the risk which would arise between competing CCPs. The RBA has stated that they would expect each CCP to adequately cover the exposure to other CCPs; this would presumably require each CCP to margin the others on the same basis as other participants. These reciprocal margins could not be netted as this would greatly reduce the risk mitigation benefits they would provide. The re-use of client collateral would also not be allowable so each CCP would be required to fund the full value of margins levied by the others. Given that CCPs are traditionally margin receivers not margin providers they would have to pass on the costs of these margins to their participants. This could result in a situation where all participants are required to provide significantly increased margins irrespective of whether they utilise the new CCP and receive the benefit of any fee reductions which they deliver.

Evaluating the benefits of competition without clarity on the charging methodology of potential entrants, their participation criteria and default fund contribution requirements makes informed comparisons of alternate services difficult.

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.

In general the proposed “minimum conditions” appear appropriate to manage the additional risks.

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)?

No comment.

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?

Given the size of the Australian market it is unlikely that a competing settlement service could be established and operated on a commercial basis whilst delivering sufficient cost reductions to make its use attractive to the market. The technical and operational requirements of supporting multiple settlement services would be significantly greater than supporting multiple CCPs utilising a single settlement service. It would also greatly reduce the efficiency of the current settlement model through the reduction in the netting benefits currently achieved in the Australian market and the imposition of additional operational overheads in managing split settlement venues.

Support for multiple CCPs should not be very difficult in a technical sense as their settlement requirements do not differ significantly from other participants. Under the current model clearing processing is performed within CHES as part of a vertically integrated system which increases automation of the clearing and settlement of market executions from both trading venues. Whilst the processing is done in a single system there is still a logical split between clearing and settlement processing which is reflected in the market structure (separate CCP and settlement entities) and regulations.

At the most basic level a competing CCP could perform the clearing and netting functions in an external system with the resulting netted obligations being settled in CHES on a similar basis to client side DVP settlements. Under the current model they would be at a disadvantage compared to the incumbent CCP as ASX Clear obligations are prioritised for settlement over broker to client settlements; if a competing CCP entered the market they could expect that this priority would be extended to their obligations on a similar basis to those of the existing CCP. This could require modification of the current CHES system to support the additional requirements which, given the limited time CHES will be maintained, would not be a priority for ASX Settlement without it being mandated by regulation. The issue of cost recovery for the modifications would also have to be resolved.

If a new settlement system was being introduced the ability to capture CCP obligations from multiple sources should not be a significant extra cost (if an existing system from off shore was selected it would probably already support this functionality). ASX Clear may also decide to use an external clearing application rather than including it in the new settlement system. Introduction of a competing CCP would be simplified if the requirements were known prior to the replacement of the settlement system as support for multiple CCPs would be a known requirement.

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?

Interoperability between CCPs serving the same markets is essential if the efficiency of the clearing and settlement process is to be maintained and cost savings realised. Lack of interoperability would require all participants to belong to all CCPs serving the markets on which they trade. As both Australian trading markets operate on an anonymous basis participants have no control over the counter parties with which they trade; as such the selection of which CCP would clear a particular trade would have to be done on an arbitrary basis where the counter parties have differing CCP preferences e.g. it could be directed to the sellers preferred CCP. The overheads of clearing participants having to manage multiple sets of CCP obligations with their associated margin requirements would greatly reduce any opportunity for realising cost savings.

If interoperability is not implemented it would reduce participant's ability to select the CCP which best suits their needs, impose additional costs and reduce the efficiency of the market.

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

Realising the benefits of cost reduction arising from competition would require that a participant clear through the CCP with the charging scheme which best suited their business model and transaction volumes. Supporting multiple CCPs would impose significant operational costs which would offset any reduction in fees payable to the preferred CCP. As with the current situation it is unlikely that a new CCP could limit their offering to trades performed on one of the competing markets. Both markets already support user specified selection of the clearing participant which will be responsible for post-trade processing of a market execution on an exception basis (i.e. varying the default destination). Given the functionality exists within the markets to define both a default and alternate clearing participant responsible for post-trade processing of executions done by a given Trading Participant extending this functionality to also support the capture and use of a default CCP would not be a significant enhancement (if it does not already exist). As such the CCP which will clear the execution should not be a factor in selecting the venue for trade execution and should have no impact on achieving best execution.

(c) 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?

The need for equality of treatment for competing CCP obligations within the settlement system may require a regulatory mandate to facilitate the required modifications to the settlement system. The costs of implementing this may, however, exceed what a new entrant is prepared to fund.

(d) What are your views on the stability and effectiveness of interoperability between CCPs in other jurisdictions?

Based on available information it appears that interoperability currently operates effectively within the European markets. The issues involved in reaching this situation were, however, significant. It should also be noted that many European participant systems already supported multiple CCPs serving different markets, as such a lack of interoperability was less of an issue than in Australia where connectivity to a single CCP is the norm.

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 CCP 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?

Entry of a competing CCP would have to be based on their commercial evaluation of the market. Given the current scale of the Australian market it is not clear that a new entrant would be able to commercially justify entering the market whilst also delivering significant cost reductions to participants.

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)?

No comment.

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?

No comment.

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?

No comment.

14. 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

To date the Code has facilitated the adoption of a T+2 settlement period, provided increased transparency into the costs and returns of ASX clearing and settlement activities, provided a means for industry feedback on the adoption of a CHES replacement and provided comparative data relating to clearing and settlement costs in other markets. It appears that most of the substantive consultation is done through the Business Committee which includes a relatively wide cross section of participant and other stakeholders.

(b) the responsiveness of ASX to the issues raised by the Forum and Business Committee

No comment.

(c) the composition of ASX's Boards.

No comment.

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

The level of transparency has increased.

(b) the cost allocation policies adopted by ASX

This information is now available at a high level.

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

The external research commissioned by the Forum has provided useful information on other markets.

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

No comment.

(b) whether the scope of access provisions should be expanded beyond ASX securities

No comment.

(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

No comment.

(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?

No comment.

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.

As noted above the Code has delivered greater transparency into the operation of clearing and settlement services. To date the main concrete result is the adoption of T+2 which was facilitated by the code.

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?

No comment.

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?

No comment.

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

No comment.

(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?

No comment.

Contact:

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