



GETCO

Comments on June 2012 Discussion Paper

**Council of Financial Regulators: Competition in the clearing and settlement
of the Australian cash equity market**

GETCO Australia Pty LTD: August 2012

About GETCO

GETCO is a global liquidity provider. GETCO was founded in Chicago in 1999, and the firm now employs about 400 people worldwide. The firm provides liquidity on over 50 markets in North and South America, Europe and Asia. The liquidity GETCO supplies allows individual and institutional investors to immediately transfer the risk often associated with financial instruments while saving money on trading costs. As a liquidity provider, we do this by:

- increasing liquidity;
- reducing market volatility;
- facilitating price discovery; and
- promoting competition among market centres and liquidity providers.

In these ways, GETCO plays an important role in making financial markets more efficient, lowering the cost of capital for businesses and reducing trading costs for investors. Our strategy is to align our business with the values we believe best serve the market and investors: efficiency, transparency, reliability and competition. GETCO maintains a long-term view on the markets, which means that we understand the importance of stable, well-regulated markets.

From offices in London, Chicago, New York, Singapore, and Palo Alto, the firm transacts business in cash, futures and options products across four asset classes: equities, fixed income, currencies and commodities.

Since 2007, GETCO has traded the Asian markets through GETCO Asia Pte Ltd. (GETCO Asia), located in Singapore. GETCO Asia acts as a high volume liquidity provider in the Asian markets and has established itself as one of the leading proprietary trading firms in the Asia region.

In 2011, GETCO Asia established an Australian subsidiary, GETCO Australia Pty Ltd (“GETCO Australia”), to provide liquidity in the Australian markets. GETCO Australia holds an Australian Financial Services License (“AFSL”) for market making and exchange participations on ASX, ASX 24, and Chi-X. Full details of GETCO’s responses to regulatory consultations world-wide can be found on our website at www.getcollc.com

GETCO'S COMMENTS ON DISCUSSION PAPER

COUNCIL OF FINANCIAL REGULATORS: COMPETITION IN THE CLEARING AND SETTLEMENT OF THE AUSTRALIAN CASH EQUITY MARKET

GETCO welcomes the opportunity to comment on the questions posed by the Council of Financial Regulators ("CFR") in relation to competition in the clearing and settlement of Australian cash equity market.

GETCO commends the Australian Government on its support of exchange market competition for trading in listed products in Australia. The launch of Chi-X has had the expected benefits of providing efficiency and innovation. Chi-X often provides a better quoted price for a security than ASX and offers a less expensive trading venue, both benefits to the end investor. Competition from Chi-X also prompted ASX to improve its technology. Moreover, ASX substantially reduced the costs of executing trades in July 2010, a direct result of the Financial Services Minister's in-principle approval of Chi-X's application for an Australian market license in March of that year.

The CFR observes that there is interest from potential competing providers for clearing of ASX-listed equity and other ASX-quoted securities ("ASX securities"). For this reason, the Discussion Paper sets out the potential implications of competition and seeks comment on the issues raised by competition in the clearing and settlement space and possible policy responses to mitigate adverse consequences.

GETCO agrees that clearing of ASX securities is contestable. GETCO participates in the European markets and our experience with the introduction of competing CCPs has been that clearing costs have fallen and efficiencies improved.

The CFR also requests comment on the contestability of settlement services. GETCO agrees that there is no evidence of demand to compete in providing settlement services. Thus, assuming that ASX Settlement remains a monopoly provider of settlement services, it is critical that access to settlement is available to all participants on fair and non-discriminatory terms.

Our views on the questions raised in the Discussion Paper are set forth below.

MARKET FUNCTIONING

GETCO agrees that competition between or among CCPs would be expected to have an impact on market functioning. In our view, the impact of competing CCPs would be generally positive and that adverse consequences can largely be mitigated through interoperability arrangements. Importantly, the absence of competition in the post-trade space may have an adverse effect on competition and user choice at the trading level.

In particular, the CFR requests views on the potential impact of competition and, therefore, fragmentation on (1) less liquid securities; and (2) participants.

Main points:

- Fragmentation of clearing services will not lead to a decrease in the supply of trading platforms for less liquid securities because exchanges that offer listing services will continue to provide trading platforms for all listed securities.
- CCPs will increase the margin demanded of clearing members to reflect the risk of managing a less diverse or less liquid portfolio, but these increased costs for market participants will not impact CCPs' willingness to supply clearing services for smaller companies.
- Fragmentation of clearing services may lead to an increase in aggregate funding costs to market participants as netting opportunities decrease, but this increase in funding costs would be expected to be offset by lower per-trade clearing costs. If a competing CCP cannot offer sufficient savings on per-trade clearing costs to offset clearing members' increased funding costs, it will be unsuccessful in competing with the incumbent CCP.
- Interoperability can be an effective means to reduce inefficiencies between two competing CCPs.

The CFR expresses concern that competition in clearing could result in the fragmentation of trading and clearing of ASX securities along the lines of liquidity and that this fragmentation could have implications for the economics of providing clearing and services for smaller companies' equities. GETCO does not believe this would be the case for the following reasons.

Exchanges that list securities will continue to offer trading services for all listed securities

One of the primary services offered by an exchange is a trading platform for securities. As the CFR notes, internationally, many new trading platforms and their CCPs have only offered trading and clearing in the most liquid securities. It is noteworthy, however, that – unlike traditional, incumbent exchanges -- these new trading platforms do not “list” securities. Instead, they offer a competing trading venue for securities that are listed on other exchanges. New trading platforms, at least initially, are not competing with incumbent exchanges to list companies’ securities because companies generally prefer to list on markets that have established reputations.

If a new trading platform does not offer trading and clearing services for the securities of smaller companies, those securities will nevertheless continue to trade on the listing exchange. Listing fees are paid by corporate issuers and are an independent source of revenue to exchanges from transaction fees, which are paid by anyone who used the executing and clearing facilities of the exchange. Listing revenue is often an important source of revenue to exchanges. Further, incumbent exchanges face less threat from competing exchanges in listing services because of the importance to corporate issuers of the “brand” and prestige of an exchange on which its securities are listed.

GETCO believes it is improbable that exchanges will cease to offer listing services to smaller companies because new trading platforms are competing to offer trading services only in more liquid securities. In the US and Europe, where competition in trading services is intense, listing fee revenues for the NYSE and Nasdaq remain a significant proportion of those exchanges’ total revenue.¹ Accordingly, we believe that competition from non-ASX providers of trading and clearing services will not impact the economics of the ASX continuing to provide trading services for smaller companies in connection with the ASX’s listing services.

CCPs will increase the margin demanded of clearing members to reflect the risk of managing a less diverse or less liquid portfolio, but these increased costs for market participants will not impact the supply of clearing services for smaller companies

A CCP incurs two types of costs in clearing securities, both of which are paid by the clearing member.

¹ Nasdaq OMX Group reported listing services revenues in 2011 of \$317 million, 18.8% of total net revenues. The NASDAQ OMX Group, Inc. Securities and Exchange Commission Form 10-K for year ended December 31, 2011. NYSE Euronext reported \$446 million in listing revenues, 16.7% of total net revenues. NYSE Euronext, Securities and Exchange Commission Form 10-K for year ended December 31, 2011.

First, there are high fixed costs associated with operating a CCP. The more trades a CCP clears, the lower the cost to clear each trade. There is little incremental cost associated with clearing each individual trade, regardless of whether the trade is in liquid or illiquid securities. Competition would be expected to put pressure on these costs as each CCP tries to attract participants to clear through its facilities. In Europe, the introduction of competitive clearing lowered these costs.

Second, there is the cost of the risk carried by the CCP in holding positions until settlement. Settlement in Australia is 3 days after trade date. After a trade is submitted for clearing until it is settled, a CCP needs to manage the risk that a clearing member will default on its obligations. The principle tool used by all CCPs to manage this risk is to collect margin from the clearing member submitting the trade for clearing. To manage this risk, a CCP will demand a clearing member post margin in amounts that reflect the cost to the CCP in managing the risks posed by that clearing member. Accordingly, a CCP will demand more margin from a clearing member that submits trades in less liquid – and thus more volatile – securities because, in the event of a clearing member default, these less liquid securities are more difficult for the CCP to liquidate. In other words, a CCP's higher risks associated a clearing member's submission for clearing of less liquid securities, or a less diverse portfolio of securities, will be reflected in higher margin collected by a CCP from that clearing member. Both monopoly CCPs and CCPs that operate in competition with other CCPs collect margin from a clearing member commensurate with the risks that clearing members' trades pose to the CCP.

Unless a monopoly CCP is collecting too little margin to cover the risks associated with clearing trades in less liquid securities, the CCP will continue to offer clearing services for these securities even if it clears a lesser proportion of trades in the most liquid securities. It is true that a market with multiple CCPs will offer clearing members fewer netting opportunities and thus, aggregate margin costs to clearing members will increase. GETCO's views of the impact on market participants of fragmentation of clearing services is discussed below.

GETCO does not believe that a market with competing CCPs will lead to a decrease in the supply of clearing services for less liquid securities. While aggregate margin requirements would be expected to grow as fragmentation of clearing reduces netting opportunities, these increased costs would be

offset by lower per-trade clearing costs.² GETCO does not believe that the reduction in netting opportunities resulting from multiple CCPs would have more of an impact on less liquid securities than more liquid securities. Thus, we do not believe that the costs associated with clearing less liquid securities would be disproportionately impacted, even if a non-ASX CCP were to clear only more liquid securities.

Unless an increase in aggregate funding costs to market participants as netting opportunities decrease is offset by lower per-trade clearing costs, there will be no demand for multiple CCPs.

A market with multiple CCPs will increase costs to clearing members because margin requirements will grow as netting opportunities decrease. The fragmentation of clearing activity that accompanies competition means that, in the aggregate, there will be fewer netting opportunities. As a consequence, clearing members will be required by CCPs to post more margin, in the aggregate.

Interoperability can be an effective means to reduce inefficiencies between two competing CCPs.

The CFR discusses interoperability between CCPs as a means to address the capital inefficiencies introduced when there are multiple CCPs. GETCO has experience with interoperability of CCPs in the EU and our comments reflect that perspective.

In general, GETCO believes that interoperability can be an effective means to reduce the inefficiencies to market participants of multiple CCPs. We do not, however, believe that interoperability must be in place before a non-ASX CCP is allowed to offer services in Australia. Nevertheless, a timeframe for implementation of interoperability should be clearly established when a non-ASX CCP enters the market.

In addition, the CFR should be aware that, while interoperability between two CCPs can offer important netting opportunities, interoperability among more

² If a new CCP cannot offer savings on the per-trade clearing cost that offsets any increase to a clearing member's margin requirements, clearing members will not use that new CCP's clearing services.

than two CCPs presents different challenges. This challenge is illustrated by the following example.

- Firm 1 buys 100 shares from Firm 2. Firm 1 clears the trade at CCP A and Firm 2 clears the trade at CCP B, which creates an exposure of 100 shares between CCP A and CCP B.
- Firm 1 sells 100 shares to Firm 3. Firm 1 clears the trade at CCP A and Firm 3 clears the trade at CCP C, which creates an exposure of 100 shares between CCP A and CCP C.

In this example, Firm 1's position at CCP A is flat and, thus, CCP A cannot collect margin from Firm 1. However, CCP A has exposure to CCP B and CCP C. This problem does not arise if there are only two CCPs that interoperate; in that case, netting occurs automatically.

The CFR identifies several regulatory measures that may be required in order to support interoperability between CCPs. In particular, the CFR notes that regulatory standards might be needed to mandate "open access" obligations on CCPs to facilitate the establishment of interoperability links. GETCO agrees with the CFR that regulatory standards are a prerequisite to successful interoperability. Our experience in Europe is that, in the absence of regulatory requirements, incumbent CCPs will be unwilling to create the links necessary to interoperate, imposing a cost on market participants.

In addition, the CFR identifies the new risk exposure of CCPs to each other when they interoperate. GETCO believes it is critical that this risk is prudently managed and that regulators play a critical role in ensuring that each CCP manages its exposures to its own participants and protections to withstand a linked-CCP default.

FINANCIAL STABILITY

Main points:

- It is essential that financial market infrastructures, such as CCPs, are robust and regulators play a critical role in ensuring that this goal is met.
- The presence of multiple CCPs would not increase the risk of a disorderly exit from market by a CCP and provides regulators with an alternative not available when there is a monopoly CCP.

Central counterparties are widely recognized as one of the essential financial market infrastructures and the international regulatory community has rightly

focused on ensuring that CCPs are robust. CCPs generally functioned well during most recent financial crisis and continue to be viewed as essential to mitigating systemic risk.

GETCO believes that regulators play a critical role in overseeing CCPs to make sure that their risk management controls are sound. The importance of this regulatory oversight exists whether a CCP is a monopoly or competes with one or more other CCPs. While, in theory, competition might provide incentives for competing CCPs to engage in a “race to the bottom,” GETCO’s experience in Europe with competing CCPs does not reveal such a problem. The CFR should also recognize that there are also significant incentives for clearing members, whose money is at risk in the event of a default, to ensure that a CCP’s risk management controls are strong.

The CFR also asks about the risk of instability in the event of the exit of a competing CCP. The impact of the exit of a CCP will depend entirely on whether this exit is orderly or disorderly. GETCO believes that there are strong arguments that the exit of a CCP from the Australian market is more likely to be orderly if regulators have the option of transferring accounts and other responsibilities to another CCP. The exit of a monopoly CCP would be highly disorderly and it is unclear how regulators could manage such an exit in an orderly way.

GETCO agrees with the CFR’s suggestions that it would mitigate the risk of an exit if all CCPs had exit plans and commit to a specified notice period prior to any commercially driven exit. While such requirements would create barriers to entry, the importance of CCPs to the orderly operation of markets justifies such a requirement.

COMPETITION AND ACCESS

Main Points:

- To ensure than non-ASX CCPs can compete on fair terms with ASX Clearing, access to ASX Settlement should be subject to a regulated access.
- ASX’s divestiture of ASX Settlement should be considered as an alternative to regulated access.

GETCO agrees that there is no evidence of demand to compete in providing settlement services. Moreover, GETCO believes it would be difficult for competition in settlement to work in practise because the Australian settlement system delivers direct legal title to the beneficial owner of the securities.

GETCO believes that the CFR should be concerned about competition and access to ASX Settlement by non-ASX CCPs. As a monopoly provider of settlement services, ASX would have strong economic incentives to make access to ASX Settlement difficult for a non-ASX CCP. Moreover, ASX could assign costs to its monopoly settlement service, which would effectively provide a cross-subsidy to services for which ASX has competitors.

The CFR asks about the effectiveness of the existing policy and legislative framework in addressing access to ASX Settlement. GETCO is concerned that the existing framework is unlikely to be effective in enabling a non-ASX CCP access to ASX Settlement. In particular, the National Access Regime would likely cause unnecessary delays in a non-ASX CCP gaining access to ASX Settlement. The 12-month transitional arrangements proposed in other areas would be a significant and unnecessary encumbrance to opening up competition in clearing.

Instead, GETCO believes that ASX Settlement should be subject to regulated access. The terms of regulated access should include requiring ASX Settlement to provide any non-ASX CCP access via the same interface as ASX.³ In addition, GETCO believes that regulated access should be managed and overseen by a third party (preferably composed of industry participants). This third party should have the power to enforce timely actions by ASX Settlement and the power to impose substantial financial penalties should ASX Settlement fail to meet such timelines.

Finally, the CFR should strongly consider requiring the divestiture by ASX of ASX Settlement and operate ASX Settlement as an industry utility. Divestiture would address concerns about an essential monopoly infrastructure being operated by a for-profit company, while retaining the benefits of the Australian approach of direct legal title in securities held in the names of beneficial owners.

³ For example, all CCPs wishing to access ASX Settlement could be required to comply with a single common interface and common terms by a date not later than 6 months after the enablement of competition.