10 August 2012

Mr Daniel McAuliffe
Manager, Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton crescent
PARKES ACT 2600

By email: financialmarkets@treasury.gov.au

Dear Mr McAuliffe

Competition – Equity Clearing & Settlement

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the discussion paper of the Council of Financial Regulators: *Competition in the clearing and settlement of the Australian cash equity market*. AFMA's comments are set out in the attached paper.

Please contact me at dlove@afma.com.au or (02) 9776 7995 if you wish to discuss or have queries regarding the matters raised in this submission.

Yours sincerely

David Love
Director – Policy & International Affairs

Australian Financial Markets Association
ABN 69 793 968 987
Level 3, Plaza Building, 95 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

COMPETITION IN EQUITY MARKET

CLEARING AND SETTLEMENT

August 2012

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1. Executive Summary

AFMA has been a long-time advocate for coherent public policy development. Warnings about being alert to unintended consequences are regular points made in submissions on government proposals from us and other groups. It is recognised that this makes public policy development a difficult task but nevertheless important to deal with because of the often serious consequences that can flow from effects outside the scope of the particular policy measure being considered.

Unintended consequences are more likely to arise when a narrow approach to law reform is taken. The problem of unintended consequences is well illustrated by the Government's cost recovery measure for market supervision which was introduced as part of the changes supporting equity market competition. It was hoped that the public policy decision to support market competition would reduce transaction costs for the benefit of investors. With regard to the exchanges this has been the case. However, this positive impact has been overwhelmed by the negative impact of an over fourfold increase in the cost of market supervision since it was taken over by the government regulator which is paid through a levy on market participants. The levy was introduced without a proper cost/benefit analysis taking into account the whole cost of regulation borne by investors and their service providers along with the distorting effect it has on market behaviour. As a result, revenue raising on this basis is having a real impact on market efficiency.

The deleterious impact of the market supervision levy means that firms are very wary of more regulatory intervention in support of market competition if it results in a further spiral in regulatory costs. This public policy concern currently overrides arguments in favour of further regulatory intervention.

Overall, the regulatory framework for clearing and settlement (C&S) financial market infrastructure (FMI), that takes into account current and proposed legislation and administrative policy along with existing competition law, provides effective rules and administrative tools for market supervision and allows a level playing field to exist in relation to equity clearing and settlement services in an open access market.

There is one specific component of the Australian C&S FMI that merits specific consideration. This is the Clearing House Electronic Sub-register System (CHESS) in isolation from other related services within ASX Settlement, including the payments system. The submission explains the special industry utility status of CHESS which differentiates it from other contestable C&S services that justifies specific access and governance arrangements being applied to it.

2. Competition in Clearing and Settlement

From a competition perspective we approach clearing and settlement infrastructure as a network. In terms of economic discourse such a network typically facilitates the delivery of goods and services, or links together the participants in a market, and is thus part of the structure underlying a market. The relationship between relevant producers and consumers takes place on, or via, the shared facilities or single medium provided by the infrastructure. Clearing and settlement infrastructure has the key characteristics of a network, namely that:

- It is composed both of the physical structure linking market participants, and the associated commercial arrangements and rules for using this structure.
- It exhibits economies of scale.
- It requires large, long-term, immobile, and sunk investments.
- It may be, or operates, a natural monopoly.

There has been a long standing debate about whether exchange ownership of clearing and settlement institutions is optimal. Several key benefits have been identified in separating ownership of the trading, clearing, and settlement functions. In such circumstances, there would be no need for the internal governance of a market infrastructure to stop it behaving anti-competitively. A central argument is that such separation may stop an exchange foreclosing competition from other trading systems if it owns a clearing or settlement institution with market power. Trading platforms will be able to compete with each other, without such competition being distorted either by inappropriate cross-subsidies coming from the provision of clearing or settlement services, or by any restrictions on access to a clearing and settlement provider which an exchange owning it may impose.

Separation of trading, clearing, and settlement services may also allow for different horizontal models at different levels of the industry. For example, while it may be most efficient to centralise clearing services across markets in a single CCP, it may in contrast be more efficient to have competition between multiple trading systems. In addition, integration of ownership may lead to opaque pricing for clearing and settlement services, if the costs of trading, clearing, and settlement are not clearly distinguished. The central justification for integrated ownership of trading, clearing, and settlement is that it can yield significant efficiencies. Pirrong[1] argues that trading, clearing, and settlement, each exhibit strong natural monopoly tendencies, and accordingly supply of these functions

[1] Pirrong C, The Industrial Organization of Execution, Clearing and Settlement in Financial Markets, Bauer College of Business University of Houston, 2006 p.38

by separate firms can give rise to multi-marginalisation problems and opportunistic holdups. Integration of these functions into an exchange can economise on these costs.

While the merits of different models might be debated at the theoretical level in pursuit of devising an optimal FMI model to champion, the realities of dealing with existing infrastructure, ownership interests and costs of change considerations need to be recognised and accepted. This means we are looking to address the shortcomings in the existing arrangements and do not propose that there should be large scale structural reform to impose a theoretically optimal model which could be both quite disruptive and impose significant additional costs on the industry at a time when conditions in the market are particularly difficult.

2.1. Clearing contestability

1. *Do you agree that clearing of ASX securities is contestable?*

While there are substantial entry barriers to contesting the market for securities clearing services in Australia it is nevertheless open to competition and therefore clearing is potentially contestable. The *Financial Services Reform Act 2001* changes to the financial services law governing clearing and settlement licensing removed the regulatory barriers to competition for services in this area. In a formal regulatory sense we are dealing with a contestable market for clearing services.

While the market is contestable, the market environment has not been conducive to new entrants offering competing services. The economies of scale deriving from current vertically integrated infrastructure suggest that a natural monopoly exists. This situation may be changing. Global trends are affecting the underlying demand for equities and hence the FMI that serves them. A McKinsey report[2] predicts that as a result of shifting global wealth and investor behaviour by 2020 investors around the world may allocate just 22 per cent of their financial assets to equities, down from 28 per cent today. The rise of wealth in emerging nations is the largest factor in this shift, followed by ageing populations in mature economies and growth of alternative investments. The growth of emerging market nations will be felt increasingly in capital markets. As the wealth of these investors grows, their preferences will shape global capital markets and the providers of services to them. This is placing pressure on equities FMI in mature markets and shifting growth and development of FMI to emerging markets. The pressure is on equity exchange operators to improve the efficiency of their businesses which drives them to look for greater economies of

[2] McKinsey Global Institute, The emerging equity gap: Growth and stability in the new investor landscape, 2011.

scale through cross border mergers and acquisitions when we are looking at dominant national exchanges. Such changes encourage global operators to reassess national markets and to consider entering them to meet an emerging strategic competitor or to take advantage of opportunities which change brings.

The logic of the market place leads to the conclusion that change is likely to take place and that existing ownership and control of current equities FMI may change in the not too distant future. Growing reliance on automated trading is diminishing the importance of geography for financial markets as the pursuit of liquidity and transaction efficiency becomes more important than parochial knowledge of a local environment and social interactions for both issuers and investors.

A market which is open to the entry and exit of FMI service providers and allows for easy connectivity with global markets would allow Australian industry to adapt more quickly and efficiently, as infrastructure reconfigures to meet commercial imperatives. It also provides a safeguard from marginalisation of the Australian market through being isolated from changes occurring at a global level.

2.2. Competition for settlement services

2. *Do you agree that there is no evident demand for competition in the settlement of ASX securities? If so, do you have any views on whether price or non price issues could emerge in relation to ASX's settlement facility?*

The focus of our comments is on the Clearing House Electronic Sub-register System (CHESS) rather than ASX Settlement as a whole. There are various functionalities incorporated within ASX Settlement, one of which is CHESS but also the DvP payments arrangements.

Since full dematerialisation of shares for domestic issuers occurred at the beginning of 1999 domestic shares are held in certificated form. Uncertificated securities held within CHESS are recorded on the CHESS sub-register which is maintained directly on the clearing system while uncertificated securities which are held outside CHESS are registered on the issuer sponsored sub-register. The two sub-registers together form the complete register of securities. CHESS maintains an electronic sub-register of CHESS-approved securities to enable electronic transfer of ownership. This sub-register forms part of the central register of an issuer's equity holders. CHESS is not a depository and it does not acquire title to securities dematerialised in the CHESS sub-register. Transfers of uncertificated securities (whether within the CHESS sub-register or to and from the CHESS sub-register and the issuer sponsored sub-register) are effected electronically and take effect when the name of the transferee is registered on the CHESS sub-register or the issuer sponsored sub-register. CHESS also offers a

name on register facility. Shareholders can hold the securities either in their own names or in the name of a broker nominee.

The legal finality given by this system provides major value to the Australian market in terms of transaction efficiency, risk management and legal certainty.

Most communications between issuers and shareholders in relation to corporate actions, such as the notification of entitlements or obligations and the lodgement of applications, elections of any monies payable, occur directly between the issuer's appointed share registrar and the holder without the involvement of CHESS.

In 1989 the National Companies and Securities Commission formed a steering committee that included representatives from key industry stakeholders to coordinate reform of Australia's equities settlement system. This reform was carried out over three phases, the third of which was the creation of the CHESS. The development of CHESS was funded by brokers through the channel of the then Securities Industry Development Account (SIDA - predecessor to the Financial Industry Development account).

During the 1990s $30 million[3] in SIDA funding was approved for the following CHESS development purposes:

- electronic transfer and registration of quoted securities (Phase I, implemented in 1994);
- settlement of market transactions in cleared funds (Phase II, the Delivery versus Payment phase, implemented progressively between April and August 1996); and
- the capacity to achieve T+3 settlement.

There is broad industry consensus that the core registry function of the CHESS system is one which is in the nature of a utility service that is most efficiently provided through a single service provider to the market. As a core piece of essential utility infrastructure the development of which was indirectly funded by brokers its status should be considered different to that of other commercial clearing and settlement infrastructure and related services when considering competition for market services.

3. Market Functioning

3.1. Fragmentation

3. Have the Agencies identified the right issues around fragmentation?

[3] SECG submission to Financial System Inquiry 1998, p8

Integration is an economising response to large scale economies in the complementary activities of execution and clearing as it may enhance economic efficiency by reducing frictions between the suppliers of highly complementary services. On the other hand, strong scale economies in trading and clearing may also contribute to competitive imperfections in financial trading when scope economies in clearing are more extensive than those in execution. In this case, integration results in increased costs for clearing services. The efficient organisation of FMI services involves a trade-off between scope economies and transactions costs.

The scale and scope economies in clearing make it arguable that we are dealing with a natural monopoly situation in Australia. Pirrong's research indicates[4] that execution, clearing, and settlement of financial transactions are all subject to substantial scale and scope economies.

These scale economies arise from the effects of diversification. A clearing house has a portfolio of risks that it insures. The gains, losses, and capitalisations of a clearing house's customers are not perfectly correlated. In effect we are dealing with the importance of diversification on insurance risk. As a consequence, the variability of the clearing house's average exposure declines as the number of insured risks increases. Accordingly increasing the number of risks insured increases the diversification of the clearer's portfolio, and the well-known diversification effect means that the riskiness of the portfolio if properly scaled should decline with size.

A claimed benefit for the US DTCC service, which is a user-owned, user-governed, at-cost model is that its centralised post-trade infrastructure produces significantly lower fees in the US compared to the fragmented European system.

3.2. Impact on less traded stocks

4. *Do you have views on whether particular product or participation segments of the market for ASX securities would be affected in the event that competition in clearing emerged?*

Fragmentation of the clearing services market does raise concerns with possible impacts on liquidity for less traded stocks. The question of the effect of fragmentation on less liquid stocks is one that goes to the effect of introducing multiple trade platforms rather than clearing and settlement services. It is typically cheaper to execute transactions in markets where large numbers of other participants gather.

[4] Pirrong C, The Industrial Organization of Execution, Clearing and Settlement in Financial Markets, Bauer College of Business University of Houston, 2006

As noted above, clearing and settlement may contribute additional sources of scale and scope economies that further challenge competition in financial markets.

3.3. Other factors – Cost of regulation

5. *Are there any other factors related to the effective functioning of the market for ASX securities that should be considered?*

AFMA has previously warned that the rapid rise in the cost of regulation for market supervision has stymied trading venue competition and not only taken away the potential benefits of competition for market participants and investors but is adding frictional costs to equities trading which deters participation in the Australian market to the detriment of our market efficiency, international competitiveness and national productivity. The imposition of additional regulatory costs and burden would further exacerbate this problem.

The deleterious impact of the market supervision levy means that firms are very wary of more regulatory intervention in support of market competition if it results in a further spiral in regulatory costs. This public policy concern currently overrides arguments in favour of further regulatory intervention.

3.4. Interoperability

6. *Do you have views on the stability and effectiveness of interoperability in other jurisdictions? Should interoperability between competing CCPs be encouraged in Australia?*

Interoperability offers multiple advantages, starting with capital efficiency. When firms can concentrate their trades at their CCP of choice, rather than being required to use different CCPs designated by each trading venue, it reduces their overall collateral and margin requirements. It also cuts settlement costs by allowing them to settle once with their CCP of choice, instead of with multiple CCPs.

Risk reduction is another advantage. Interoperability allows firms to choose the CCP with the risk profile best suited to their business. In addition, interoperability gives trading venues built-in redundancy. If one CCP exits the business, the trading venue is already connected to other CCPs that can clear its trades.

Achieving interoperability has been a policy goal of EU regulation. What makes the process difficult are the mechanics of achieving it. Under current EU rules firms on each side of a trade can pick their preferred clearer, but if that differs from the clearer used by the execution venue, it will require the two CCPs to face each other and for one to post margin to the other. European law requires additional margin on top of the original trade to cover the counterparty risk of

the extra CCP. The interoperating margin will fall into a new, separate pool to cover inter-CCP exposures. This has meant an additional margin funding cost. European market participants have been willing to bear this additional funding cost because it's outweighed by the benefits of reduced costs and risks in a fragmented market. This factor does not exist in the Australian market and the significant additional cost associated with implementation of interoperability may outweigh the benefits of more efficient margin funding.

It needs to be recognised that the drive to creating a single market in financial services underlying the drive to promote competition between FMI in Europe does not apply to the Australian market. In contrast to Europe's competition imperative the need to have an open market environment that is readily adaptable to rapid global structural change in FMI is the prevailing policy imperative for Australia.

The practical challenges of achieving interoperability between CCPs in the Australian market where we are starting out with a single incumbent would be of much less magnitude than the issues encountered in Europe where a large number of existing operators with quite different histories in different jurisdictions have to be brought into a cooperative network. In a system with just a single incumbent a new service provider faces a simpler task in adapting their system to those of the incumbent so long as provision is made for non-discriminatory access.

Interoperability needs to be supported by the standard approach to risk management practices through the CPSS-IOSCO principles for financial market infrastructures providing substantive guidance on clearing links. Interoperability requires inter-CCP risk management providing adequate protection against market, operational and other risks. Recommendation 11 of the CPSS-IOSCO recommendations for Central Counterparties requires interoperable CCPs to ensure that the risks are managed prudently on an ongoing basis. This is in addition to the CCPs' defence lines that ensure that the CCP can endure extreme market conditions. Any inter-CCP risk framework for interoperability should therefore be carefully designed, on the basis of mitigation of residual risks in case of a CCP default.

In contemplating interoperability we are referring to peer-to-peer interoperability, where there is a direct link between the interoperating CCPs. Each CCP has full capacity to assume the direct counterparty relationship with the respective members and undertake risk management including full collateralisation. The issue for peer-to-peer interoperability is determining margin requirements between the two CCPs when there are differences between their margin methodologies and/or collateralisation processes differ from each other, or where they wish to apply an approach which is different from that applied to members. This also opens the CCPs up to cross default of the other CCP. The other form of interoperability where one CCP is a participant in another as a subordinate CCP is not proposed as an appropriate model to follow.

3.5. Market Functioning

> 7. *Can you suggest any other responses to the issues raised in relation to market functioning?*

Fragmentation of clearing may lead to more complex collateral management. This increases operational risk for market participants. This increases the risk of missing the payment deadlines imposed for margin calls if they are required by ACH or another CCP. There is also the possibility that in stressed market conditions, it might be more difficult to meet margin calls in a timely manner if this involved moving collateral from one CCP to another. More generally, competition requires participants to manage connections to multiple CCPs and settlement locations. This is likely to increase the complexity of the participant's back office operations. This is particularly true where CCPs' message standards differ.

4. Financial Stability

4.1. Race to the bottom risk

> 8. *Do you consider that there is a risk of a race to the bottom on risk control standards in the event that competition in clearing emerged?*

The effectiveness of the regulatory environment is important in mitigating this risk. In the context of current regulation and announced Government reforms to FMI regulation it is our view that Australian regulation should effectively mitigate the "race to the bottom" risk.

4.2. Risk control standards

> 9. *Are you aware of such a race to the bottom in other jurisdictions in which competition in clearing has emerged? What risk control standards have been impacted and how?*

The study of three European CCPs by Zhu[5] is helpful on this point by providing some empirical analysis. His conclusions are worth consideration:

> *As a driving factor in shaping CCPs' behaviours, competition has given rise to a significant reduction in the cost of clearing and an increase in market efficiency. Although there is no solid evidence suggesting that competition*

[5] Zhu S, Is there a "race to the bottom" in central counterparties competition? - Evidence from LCH.Clearnet SA, EMCF and EuroCCP, DNB Occasional Studies Vol.9/No.6 2011

has forced CCPs to take drastic actions that will result in a "race to the bottom", a prudential oversight on CCPs' response to the increasing competition is vital to ensure the functioning of CCPs and the resilience of the financial market infrastructure, particularly in light of the recent development regarding interoperability which is expected to shape the post-trade landscape and level the playing field. By the launch of interoperable arrangement, it is envisaged that competition among the pan-European CCPs will be noticeably sparked. Therefore, it is important for policymakers and overseers to make efforts to strike an appropriate balance between safeguarding a sound and stable financial system and preserving the advantages of having a highly competitive market.

4.3. CCP exit

10. *Do you have views on the risks that the exit of CCPs could pose to financial stability?*

Allowing for more competition may also lead to more frequent instances of exit. Hence, regulators should be concerned that such an exit is managed in an orderly way to minimise instability. It is critical to have a clear plan for how such an exit would be managed with minimal disruption to market functioning. Such a plan should be discussed and developed with industry participation and be available for reference by users of CCPs to aid their contingency planning.

4.4. Access to ASX Settlement

11. *Do you have comments on the issues identified around access to ASX Settlement and settlement arrangements for non ASX CCPs more generally?*

Reference has been made above to the particular status of the CHESS system within Australia's clearing and settlement infrastructure. It is a piece of utility infrastructure that was funded indirectly by the brokers to improve market efficiency and reduce systemic risk.

In 1989 the National Companies and Securities Commission formed a steering committee that included representatives from key industry stakeholders to coordinate reform of Australia's equities settlement system. This reform was carried out over three phases, the third of which was the creation of the CHESS. The development of CHESS was funded by brokers through the channel of the then Securities Industry Development Account (SIDA - predecessor to the Financial Industry Development account)

During the 1990s AUD 30 million in SIDA funding was approved for the following CHESS development purposes:

- electronic transfer and registration of quoted securities (Phase I, implemented in 1994);
- settlement of market transactions in cleared funds (Phase II, the Delivery versus Payment phase, implemented progressively between April and August 1996); and
- the capacity to achieve T+3 settlement.

While there can be valid debate over the best way forward from a market efficiency perspective with competition for clearing services, the core utility nature of CHESS means that open access to it on an at-cost basis is fundamental to market operation quite distinct to commercial services in the clearing and settlement value chain.

More information is needed around CCP functioning, in particular novation of trades. It is desirable to achieve consistency between CCPs around their basic functioning.

4.5. General financial stability

> 12. *Are there any other factors related to financial stability that should be considered?*

No comment

4.6. CPSS-IOSCO risk management standards

> 13. *To what extent do you consider that application of risk management standards consistent with the CPSS IOSCO Principles for financial market infrastructures would mitigate the risk of a race to the bottom?*

The "race to the bottom" concern that CCPs could engage in a debilitating price-cutting war each hoping the competitor will eventually withdraw by offering less stringent margin requirements or lower default contributions and lowering access requirements falls away in an environment where CCPs are under close regulatory scrutiny. This is the situation that exists in Australia. The planned developments for regulation of financial market infrastructure and the application of risk management standards consistent with the CPSS-IOSCO Principles for financial market infrastructures along with the new capital requirements for CCPs are intended to effectively mitigate this risk.

The successful implementation of this regulatory framework is dependent on the relevant authorities around the globe having the requisite resources and expertise to effectively implement the rules.

4.7. Living wills

> *14. To what extent do you consider that exit plans and ex ante commitments would mitigate the risk of instability in the event of the exit of a competing CCP?*

The idea of having a 'living will' for a CCP is desirable, which in practice revolves around the robustness of the default waterfall arrangements. AFMA supports CCPs being required to draw up an ex ante resolution plan that would be implemented if losses exhausted the CCP's financial resources so that its clearing members and clients can quantify their exposure to CCPs and manage their risk in a prudent manner.

A CCP's financial resources would comprise its clearing members' initial margin, funded and unfunded guaranty fund contributions, and the CCP's own capital. In the case of the default of a client, the CCP's financial resources would also include the collateral of the defaulted client and, depending on the client collateral segregation model applicable to the CCP, in some cases a measure of loss mutualisation between clients may be applicable.

A benefit of having more than one CCP in the market is that it provides some additional redundancy to the system.

4.8. Ex ante commitments

> *15. Do you have views on what ex ante commitments might be reasonable and how these might be imposed without creating barriers to entry?*

The Government's proposed FMI statutory management proposals provide the framework for the possible recapitalisation of a CCP if clearing members considered that worthwhile. On the other hand it is important that a CCP should be allowed to fail in an orderly manner. Ex ante commitments can play an important role helping regulators and clearing members make decisions in a time of crisis. However the challenge of developing ex ante commitments should not be under estimated. Development of ex ante commitments requires a sophisticated market risk model being developed that takes into consideration all variable factors at play in which stakeholders can have a high level of confidence.

One component of a CCP's resolution plan would be clear loss-sharing rules for participants (both direct and indirect) that, among other things, would limit clearing members' liability to the CCP so that the clearing members would not be legally obligated to make unlimited payments into the CCP but rather would be liable up to an amount that they could calculate and risk manage. A limited or capped liability structure would allow clearing members and clients to monitor and manage their exposure to the CCP and promote systemic stability.

4.9. Graduated location requirements for cross-border CCPs

> 16. *To what extent do you consider that location requirements could help to mitigate the risk of diminished regulatory influence and control in the event that an overseas based CCP provided clearing services for ASX securities?*

AFMA agrees with the views of the Council of Financial Regulators (CoFR) recommendation to the Government that clearing and settlement facilities may differ significantly in the nature of their activities, their scale, the products and participants, and their importance to the Australian financial system. Accordingly, in line with the Government's announced FMI reforms specific requirements for cross-border clearing and settlement facilities should be applied in a graduated and proportional manner. The recent CoFR supplementary paper[6] on ensuring appropriate influence over cross-border clearing and settlement facilities indicates how a graduated approach can be applied to equity clearing and settlement facilities. AFMA considers the proposed approach coupled with the FMI regulatory reforms will address the issue of how a location requirement should be applied

4.10. Location requirements for ASX FMI

> 17. *Do you have views on what location requirements – and other measures to enhance regulatory control and influence – might be reasonable in the case of clearing ASX securities and how these might be imposed without creating unnecessary impediments to entry?*

As noted in the previous answer, the CoFR supplementary paper[7] is considered to provide an appropriately graduated framework for determining whether location requirements should be applied to clearing and settlement infrastructure controlled by the ASX.

4.11. CHESS access

> 18. *Do you have views on what would constitute appropriate settlement arrangements for non ASX CCPs?*

With regard to securities that have registrations maintained through CHESS, CHESS should be the default settlement system. Access to CHESS should be provided on an at cost basis, supported by transparency around the cost

[6] *Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities*, Council of Financial Regulators: Supplementary Paper to the Review of Financial Market Infrastructure Regulation, July 2012
[7] *idem*

structure of CHESS. DvP arrangements need evaluation to ensure that they do not discriminate against non-ASX clearers.

4.12. Cross-border regulatory cooperation

> *19. Do you have views on what would constitute a reasonable basis for cooperation with overseas regulators?*

To date much of the attention placed on addressing overlapping and contradictory national and regional regulation has involved bilateral negotiations between jurisdictions. AFMA supports the development of a framework for multilateral mutual recognition agreements between financial market regulators. Prior to the emergence of the global financial crisis, regulators in the U.S., Australia, Canada, the EU and elsewhere had begun to explore the concept of "mutual recognition" as a way to facilitate cross-border financial transactions. A mutual recognition agreement was actually signed between the U.S. and Australia in August 2008 and negotiations between the U.S. and Canada on a similar agreement was also quite far advanced. These efforts, quite understandably, were abandoned once the extent of the financial crisis became clear, both because regulators had more pressing problems and because of a general aversion toward any policy changes that could appear to loosen regulations on financial sector participants rather than tighten them.

Although the idea of mutual recognition lost a great deal of its appeal for regulators in the immediate aftermath of the financial crisis, the concept remains valid and potentially quite useful since, as noted above, there are significant and wide divergences between some of the regulations that are being developed in a number of jurisdictions. Greater priority needs to be given to achieving mutual recognition on a multilateral as opposed to bilateral basis. This is necessary since the process of achieving bilateral mutual recognition determinations would require a huge amount of resources, take an extended period of time, could be delayed by disputes over latent protectionism and could unduly favour the interests of the larger economies over all other economies. A multilateral approach would also result in a higher level of global consistency between national and regional regulatory policies than would be likely with a bilateral approach.

> *20. Can you suggest any other responses to the issues raised in relation to financial stability*

No comment

5. Competition and Access

As has previously been discussed, there are strong economic reasons to integrate trade execution, clearing, and settlement which can be observed in real world vertical integration arrangements. If one applies a transaction cost economics[8] approach to the analysis one can posit that securities exchanges that execute financial transactions typically exercise considerable ownership control over clearing and settlement when free of regulatory controls. The result is the exercise of market power. The network nature of liquidity means that financial trading faces many of the same challenges and competition issues as other industries, such as telecommunications and electricity, where network effects are also present and more widely debated. In this context it is appropriate to apply the Australian competition regulatory framework to clearing and settlement infrastructure.

5.1. Competition framework

> 21. *Do you have views on the effectiveness of the existing policy and legislative framework in addressing access to ASX Settlement??*

The existing National Access Regime (NAR) under Part IIIA CCA regulatory framework provides appropriate mechanisms for dealing with access issues.

Uncertainty surrounding investment is one of the most difficult issues that policy makers in the access regulation area need to grapple with. Where uncertainty in returns is large the access regime has the potential to impose large dynamic costs. In other words, the greater the uncertainty the greater could be the costs. This, in combination with the possibility of other variables affecting the regulatory outcome such as strategic behaviour and regulatory gaming, mean that the costs and benefits of access decisions are hard to pin down. The Hilmer Committee observed that there is a need for policy makers to tread carefully in this area[9]. Accordingly, access interventions should be limited to where a clear case could be made where the national benefits outweigh the costs. Given the potentially large costs of inappropriate or poorly-applied intervention to facilitate access, the use of access regulation should be confined to situations where significant monopoly power is likely to be present. If regulation is applied to more 'marginal' cases, there is a high probability that the costs of intervention will outweigh the benefits.[10]

In the past concerns have been expressed about the time it took to resolve access issues under the NAR. The amendments which came into effect in July 2010 that were designed to reduce delay, increase certainty for facility owners

[8] Williamson O.E. Transaction Cost Economics: How it works, Where it is headed, De Economist 146, No.1 1998.
[9] Hilmer Report, NCC National Competition Policy 1993
[10] Productivity Commission, 1995, p. 93.

and access seekers, and streamline administrative processes will hopefully ensure that timely access arrangements can be ensured in case of difficulties.

To summarise, access arrangements should where possible be left to commercial negotiation between the parties and intervention only contemplated where there is a clear case that the benefits will outweigh the costs. In the event that intervention is necessary the NAR provisions are likely to be an effective tool.

5.2. Special access arrangements for CHESS & NGF

> 22. *Do you have views on whether transitional or longer term regulatory arrangements would be most appropriate in addressing any potential issues that could emerge in relation to competition and access to ASX Settlement?*

The key component of the ASX Settlement to which access is essential, namely the CHESS System is, as previously mentioned, industry utility infrastructure the development of which was funded by brokers. It is important to note that it differs in character from formerly monopoly public infrastructure that has passed into private ownership, through a privatisation process, as it can be characterised as an industry sponsored utility infrastructure that has continued to be managed on behalf of the industry by ASX Settlement.

Consideration should be given to making specific access provisions for CHESS which takes into account its special industry utility status. In giving consideration to CHESS there is the related issue of access to the National Guarantee Fund which should be dealt with at the same time. In both cases the question of industry participation in their governance should also form part of a public policy consideration.

A key component of European regulations are the provisions for 'non-discriminatory access' to exchange trade data feeds that are included in the current draft of the Markets in Financial Instruments Regulation (MiFIR). MiFIR Art 28 provides the following access rules:

- CCPs must clear financial instruments on a non-discriminatory basis taking into account fees and trading venue.
- A request for access must be submitted to both the CCP and the competent authority. The CCP must provide a written response within three months of accepting or denying access.
- Authorities can only deny a venue access if they believe that granting access would threaten the proper functioning of the market.
- Third country access can only be granted to venues based in third countries that the Commission has deemed to have equivalent supervision and where a reciprocal access arrangement exists.

- The Commission will adopt through Delegated Acts the conditions where access can be denied by a CCP including the volume of transactions, the number of users and other factors that may entail additional risk; and the conditions where access is granted for example, the confidentiality of information provided and the non-discriminatory; and transparent basis of fees and operational requirements regarding margining.

5.3. Transparency

> *23. Can you suggest any other options (regulatory or non regulatory) to address any potential issues that could emerge in relation to competition and access?*

Transparency around the costing of ASX Settlement services would provide benefit for participants regardless of whether there are new entrants to the market.

A clear delineation of clearing and settlement services from trading platform and listing services would be a desirable improvement to market structure as it would allow greater transparency. This would also allow for the possibility of greater user participation in the governance of ASX Settlement. Such a development does not require regulatory intervention at present as the continuing dialogue between the ASX and its users may take it down this path in the future.

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