Review of Competition in Clearing Australian Cash Equities

A Consultation Paper by the
Council of Financial Regulators

February 2015

Council of
Financial Regulators

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Consultation Process

Request for feedback and comments

This Consultation Paper seeks stakeholder views on the issues raised by the Council of Financial Regulators (CFR) in relation to competition in clearing of the Australian cash equity market.

Submissions should include the name of your organisation (or your name if the submission is made as an individual) and contact details for the submission, including an email address and contact telephone number where available.

While submissions may be lodged electronically or by post, electronic lodgement is strongly preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and contact details) contained in submissions will be made available to the public on the CFR website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. Any future request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

In addition to seeking submissions, the CFR will be conducting stakeholder consultation meetings during March 2015. Expressions of interest for a stakeholder consultation meeting are invited by **27 February 2015**.

Closing date for submissions: **27 March 2015**

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1. Introduction

On 11 February 2015, the Assistant Treasurer, the Hon Josh Frydenberg MP, announced that the CFR would conduct a review of competition in the clearing of Australian cash equities.[1] This review will be carried out by the Australian Securities and Investments Commission (ASIC), the Reserve Bank of Australia (the Bank) and the Australian Treasury on behalf of the CFR, with the assistance of the Australian Competition and Consumer Commission (ACCC) – collectively, the Agencies.

This follows a review in 2012 in which the Agencies examined the implications of competition in the clearing and settlement of Australian cash equities (the 2012 Review).[2]

In light of stakeholder feedback received during the 2012 Review, the Agencies recommended to the government that a decision on any licence application from a central counterparty (CCP) seeking to compete in the Australian cash equity market be deferred for two years and, in the meantime, that ASX be encouraged to work with industry to develop a Code of Practice.[3] The recommendations of the 2012 Review were endorsed by the government in February 2013.[4]

The Agencies committed to carrying out a review at the end of the two years. With the two-year period due to end in early 2015, this Consultation Paper sets out the scope of the Agencies' review and the issues that will be considered. The review is also consistent with the 2014 Financial System Inquiry's recommendation that the state of competition in the financial sector should be reviewed every three years. Following the consultation process, the Agencies will consider stakeholder submissions and will advise the government of the findings of their review in due course.

2. Background

2.1 Clearing and Settlement of the Australian Cash Equity Market

To date, there has been no competition in the clearing and settlement of ASX-quoted securities (ASX securities). ASX securities are cleared and settled by subsidiaries of the ASX Group – ASX Clear Pty Ltd (ASX Clear) and ASX Settlement Pty Ltd (ASX Settlement), respectively. Although these two entities are legally separate, they are operationally integrated, with clearing and settlement of ASX securities occurring through a shared operating system, CHESS.

Chi-X Australia Pty Ltd (Chi-X) operates a competing trading venue for ASX securities. Trades executed on the Chi-X market are cleared and settled by ASX Clear and ASX Settlement, respectively, using the Trade Acceptance Service (TAS). ASX developed the TAS to allow trades executed on approved market operators' platforms to be submitted to ASX Clear and ASX Settlement. ASX Settlement also provides settlement arrangements for approved listing market operators under the Settlement Facilitation Service (SFS). ASX makes the TAS and SFS available under a published set of contractual terms of service, which specify service levels and include operational and technical requirements.

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1 The announcement is available at <http://jaf.ministers.treasury.gov.au/media-release/006-2015/>.

2 A paper outlining the issues for consideration was issued in June 2012: see CFR (2012), 'Competition in the Clearing and Settlement of the Australian Cash Equity Market: Discussion Paper', June. Available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/Competition-in-the-clearing-and-settlement-of-the-Australian-cash-equity-market>.

3 The CFR's advice on competition in clearing of the cash equity market and the final report of the 2012 Review are available at <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/competition-of-the-cash-equity-market>.

4 The government's response to the Agencies' recommendations is available at <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/022.htm&pageID=&min=wms&Year=&DocType=0>.

2.2 Regulatory Framework

This review will be carried out within the context of the existing regulatory framework for the clearing and settlement of cash equities. Part 7.3 of the *Corporations Act 2001* establishes conditions for the licensing and operation of clearing and settlement (CS) facilities in Australia, and gives ASIC and the Bank joint responsibility for CS facilities.

- The Bank is responsible for ensuring that CS facilities comply with the Financial Stability Standards (FSS) that it has determined, and take any other steps necessary to reduce systemic risk.
- ASIC is responsible for ensuring CS facilities comply with other obligations under the Corporations Act, including for the fair and effective provision of services.

ASIC and the Bank also provide advice to the Minister on any CS facility licence application. The Corporations Act specifies a number of matters that must be considered by the Minister in granting a CS facility licence, including whether granting the licence would be in the public interest.

For a prospective competing CCP that was overseas based or foreign owned, the application of the CFR's framework for ensuring that ASIC and the Bank retain sufficient regulatory influence over cross-border CS facilities operating in Australia is also relevant. This graduated framework imposes additional requirements on cross-border CS facilities proportional to the materiality of domestic participation, their systemic importance to Australia, and the strength of their connection to the domestic financial system or real economy.[5]

In addition, under the Corporations Act, domestic CS facilities are subject to a 15 per cent limit on any individual controlling interest. The Minister may approve an application for a variation of the limit if the acquisition is in the national interest.[6] The 2014 Financial System Inquiry recommended that, once the current reforms to cross-border regulation of financial market infrastructure were complete, the government should remove market ownership restrictions from the Corporations Act.[7]

Finally, the ACCC is responsible for promoting competition and fair trading in the Australian economy under the *Competition and Consumer Act 2010*.

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5 See CFR (2012), 'Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities', July. Available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/%202012/cross-border-clearing>. Also see CFR (2014), 'Application of the Regulatory Influence Framework for Cross-border Central Counterparties', March. Available at <http://www.cfr.gov.au/publications/cfr-publications/2014/application-of-the-regulatory-influence-framework-for-cross-border-central-counterparties/>.

6 In April 2011, for example, the government prohibited the acquisition of ASX by Singapore Exchange Limited, citing that the acquisition would be contrary to the national interest. See <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/030.htm&pageID=003&min=wms&Year=&DocType>.

7 See Commonwealth of Australia (2014), *Financial System Inquiry Final Report* (D Murray, Chair), Canberra, Recommendation 44. Available at <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf>.

2.3 Initial Consultation and Review

Given the prevailing legislative settings, the Agencies' 2012 Review took openness to competition in clearing cash equities as the starting point for its analysis. While the 2012 Review also considered the contestability of securities settlement, it was generally agreed that there may be less scope for competition in relation to settlement than in relation to clearing; accordingly, the Agencies' analysis assumed that ASX would remain the sole provider of core securities settlement services. An industry consultation sought feedback from stakeholders on the potential implications of competition in clearing for the Agencies' responsibilities, as well as possible policy responses that might be necessary to ensure that competition could occur in a safe and effective way. In addition to providing useful input on these matters, many stakeholders also expressed views on the broader case for competition.

A number of respondents to the Agencies' consultation in 2012 were strongly in favour of competition in clearing cash equities. They identified several principal benefits, including: lower clearing fees; increased innovation and user responsiveness; support for competition in trading through improved terms of access for alternative trading platforms; and other flow-on effects arising from reduced frictional costs of participating in the market.

Other respondents, however, were less convinced that competition in clearing would deliver a net benefit. Several stakeholders argued that due to the size of the Australian cash equity market, economies of scale could not be realised if competition emerged, and the aggregate savings from a reduction in clearing fees were unlikely to be substantial. Concerns were also raised about the operational costs of adjusting to a multi-CCP environment, as well as a potential increase in regulatory costs. The balance of feedback in 2012 was that it was not then the appropriate time for changes that would impose further costs on the industry, particularly given prevailing market conditions and the substantial structural and regulatory change that was already underway. Accordingly, the Agencies recommended that a decision be deferred for two years on any licence application from a CCP seeking to compete in the clearing of Australian cash equities.

Deferring competition, however, would continue a de facto monopoly in cash equity clearing. This could lead to price or non-price distortions that compromised the effective delivery of this service to the market. In the meantime, therefore, the Agencies recommended that ASX develop a *Code of Practice for Clearing and Settlement of Cash Equities in Australia* (the Code). The intent of this recommendation was to address industry concerns, while preserving the prospect of competition and/or further regulation in the future. The Agencies further recommended revisiting the matter at the end of the two years. The current review fulfils this commitment.

The recommendations of the 2012 Review were endorsed by the government in February 2013, and the Code was issued in August 2013. ASX recently carried out a review of the Code and, in December 2014, issued a consultation paper seeking feedback on a number of changes to the Code.[8]

[8] The Consultation Paper is available at <http://www.asx.com.au/documents/public-consultations/ASX_Consultation_Paper_-_Operational_Improvements_to_the_Code_of_Practice_-_Dec_2014.PDF>.

3. Policy Approaches

Consistent with the commitment to review the prospect of granting a licence to a competing CCP, or of pursuing alternative regulatory outcomes, the Agencies are seeking stakeholder feedback on prospective policy approaches.

For consultation purposes, the Agencies have identified two broad policy approaches that could be considered. The Agencies are also open to stakeholder feedback on alternative policy approaches to those outlined below. As in the 2012 Review, the scope of the current review is competition in clearing. However, given the interdependencies between clearing and settlement functions, the Agencies acknowledge that there are likely to be some implications for the design, operation and organisation of equity settlement that would also need to be considered.

The policy approaches to competition in clearing that have been identified by the Agencies are, broadly:

- *Competition.* Lift the moratorium on competition in the clearing of Australian cash equities, either immediately or after a further defined period.
- *Monopoly.* Establish an effective monopoly by recommending that competition in the clearing of Australian cash equities be deferred indefinitely, implementing one of three approaches to regulate the activities of ASX's cash equity CS facilities.
  - *Self-regulation.* As per the current arrangements, retain a Code of Practice as a formal commitment to the industry.
  - *Partial regulation.* Retain a Code of Practice, and strengthen some specific aspects through regulatory action.
  - *Full regulation.* Regulate all functions of ASX's cash equity CS facilities as a monopoly service.

The Agencies will examine the benefits and costs associated with each of these policy approaches, and how these benefits and costs might be distributed across stakeholders. The Agencies will also consider whether any ancillary policy or legislative measures would be necessary to ensure the continued safe and effective functioning of clearing and settlement in the Australian cash equity market.

The Agencies further recognise that these policy approaches could be pursued either independently or in combination. For instance, even if a policy approach in favour of competition were adopted, in the absence of imminent entry of a competing provider, it might be desirable to retain the Code or impose other measures to govern the activities of ASX's cash equity CS facilities.

This analysis, together with feedback from stakeholders, will form the basis for the Agencies' recommendations to the government on how to approach any future application from a competing CCP in this market.

The following sections outline some of the issues that will be taken into consideration during the upcoming review. Stakeholders are invited to submit their views on the issues discussed and any other relevant issues.

3.1 Stakeholder Feedback – Policy Approaches

The Agencies are seeking feedback on the following questions:

1. Which policy approach would you prefer, and why?
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.
3. Are there any other overarching issues that should be taken into consideration?

4. Competition

The first policy approach identified by the Agencies is to lift the moratorium on competition in the clearing of Australian cash equities, either immediately or after a further defined period. As a matter of principle, the Agencies remain open to competition in clearing. The existing regulatory framework envisages competition between multiple providers of clearing and settlement services; this is reflected in the broadly stated licence criteria, which are intended to be sufficiently flexible to accommodate different market structures. Taking a broader financial system perspective, the 2014 Financial System Inquiry noted that competition was 'the cornerstone of a well-functioning financial system' and was a generally preferred mechanism for achieving efficient, resilient and fair outcomes.[9]

4.1 Objectives of Competition

The benefits of competition have been observed in a number of related markets in Australia and overseas. A study of the European market revealed that clearing fees fell by between 7 and 59 per cent across European CCPs, on a per transaction value basis, over the period between 2006 and 2009 when competition in clearing first emerged.[10] Competition in clearing could similarly encourage increased innovation and investment in clearing and settlement infrastructure to meet the evolving needs of stakeholders. The introduction of competition in the trading of Australian cash equities, for instance, has encouraged ASX to reduce trading fees, upgrade to new trading platforms, increase trading capacity and execution speeds, and develop new trading products.

In addition to increased innovation and investment in clearing and settlement infrastructure, competition in clearing could also encourage greater responsiveness to users' demands to meet the evolving needs of the industry. Furthermore, by providing an alternative to the incumbent CCP, competition in clearing could improve the terms of access for competing market operators, allowing the benefits of competition in trading to be more fully realised. Under the current arrangements, with no competition in clearing, ASX could under some circumstances hinder competition in related markets, such as the trading of cash equities.

4.2 Implications for Market Efficiency and Financial Stability

As identified in the 2012 Review, competition in clearing Australian cash equities could also have cost, risk and efficiency implications for the functioning of markets, financial stability and access.

- *Market functioning.* Competition between CCPs could affect the functioning of the market for ASX securities, with potential inefficiencies arising from the loss of netting offsets (un-netting), liquidity fragmentation and duplication of operational costs. Also, in the absence of interoperability between competing CCPs (see Section 4.4), there is the potential for increased costs for all market participants in connecting to all trading and clearing venues to achieve best execution, irrespective of the private benefits they could derive from competition.
- *Financial stability.* Competition in clearing could result in a 'race to the bottom' between CCPs on risk management standards, although this is unlikely in the current regulatory environment. Competition may, however, increase the likelihood of market disruption arising from the entry and exit of CCPs, as well as potential risk and uncertainty during the transition between providers. Risks could also arise from the settlement arrangements in a multi-CCP environment, including from financial interdependencies between CCPs within the settlement

[9] Commonwealth of Australia (2014), *Financial System Inquiry Final Report* (D Murray, Chair), Canberra, p 238. Available at <http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf>.

[10] Oxera (2011), 'Monitoring Prices, Costs and Volumes of Trading and Post-trading Services', May. Available at <http://ec.europa.eu/internal_market/financial-markets/docs/clearing/2011_oxera_study_en.pdf>.

process. If competition were to emerge from offshore-based CCPs, regulators would also need to ensure they had sufficient influence over these clearing services in order to meet their regulatory objectives. More generally, consideration would need to be given as to whether additional regulatory arrangements were necessary to effectively oversee a multi-CCP environment in the cash equity market, and how such arrangements would be funded.

- *Access.* Alternative trading platforms for ASX securities require access to the ASX cash equity CS facilities. Given the existing market structure, competition in clearing could lead to an 'essential facilities' scenario in relation to settlement services. That is, assuming that there remained a single provider of equity settlement services, any competing CCP would need effective access to the vertically integrated settlement facility, ASX Settlement.

4.3 Minimum Conditions for Safe and Effective Competition

The final report of the 2012 Review (the 2012 Report) set out actions that might need to be taken, should competition emerge, to address the potential implications for stability and the effective functioning of markets. These actions were cast in terms of 'minimum conditions' for safe and effective competition.

- *Adequate regulatory arrangements.* These are that:
  - all facilities should be overseen against the Bank's FSS and the Corporations Act
  - the CFR's framework for regulatory influence over cross-border CS facilities should be applied, including that beyond a certain threshold market share a competing overseas CCP for Australian cash equities would need to incorporate domestically and become domestically licensed
  - *ex ante* wind-down plans should also be established to facilitate any commercially driven exit from the market.
- *Appropriate safeguards in the settlement process.* The cash equity settlement model in a multi-CCP environment should seek to maintain existing efficiencies, while affording materially equivalent priority to trades cleared through a competing CCP, minimising financial interdependencies between the CCPs in the settlement process, and facilitating appropriate default management actions.
- *Access to existing settlement infrastructure on non-discriminatory and transparent commercial terms.* Access to the vertically integrated incumbent settlement facility, ASX Settlement, would need to be attainable by a competing CCP on non-discriminatory and commercial terms.

The Agencies acknowledged in the 2012 Report that implementing these minimum conditions could have implications for the magnitude of any net benefits from competition in clearing. It could also affect the commercial decisions of potential entrants around the economic viability of entering the Australian market, and the nature of any competing services that may emerge. The minimum conditions could also entail costs to other stakeholders, including market participants and end users, and may require a relatively long lead time for implementation.

4.4 Interoperability

The 2012 Report noted that beyond the minimum conditions referred to above, the case for regulatory intervention to facilitate interoperability would need to be considered further. An interoperability link between two CCPs allows participants of one CCP to execute centrally cleared trades with participants of the other CCP. Interoperability has been identified as a means of mitigating some costs associated with a multi-CCP environment, including the un-netting of CCP exposures, liquidity fragmentation, and the duplication of operational costs. Interoperability could also reduce the likelihood of material changes in the participation structure of the market. This, in turn, could support competition at both the trading and clearing levels. Should competition in clearing cash equities emerge, alternative market operators would be likely to seek an interoperable link between ASX Clear and the competing CCP.

However, interoperability may introduce additional complexities and potential financial stability risks, primarily since it gives rise to direct financial exposures between the interoperating CCPs. In light of this, the Bank's FSS establish a number of risk management conditions for interoperability arrangements, including the requirement that financial exposures between competing CCPs be appropriately collateralised.

The implementation of interoperability could also require a long lead time and involve significant set-up costs. Furthermore, an incumbent CCP generally has little incentive to establish links that would facilitate competition; it may therefore be difficult to establish interoperability arrangements under mutually acceptable commercial terms without regulatory intervention.

The implications for best execution obligations in an environment with interoperable CCPs would also need to be examined. In a multi-CCP environment without interoperability, best execution obligations would require participants either to establish the capability to clear through all CCPs, or else demonstrate that best execution was achieved under their existing arrangements. While the best execution rules contemplate competition in clearing, additional guidance could be required to clarify how the obligations would apply in an environment with interoperable CCPs.

4.5 Interim Arrangements

Establishing a competing CCP would require considerable time and up-front investment from both the entrant CCP and market participants. If the moratorium on competition was lifted, it could be some time before a competing CCP actually entered the market. Consideration should therefore be given to whether any transitional measures would be required until such time as competition emerged.

As an alternative policy approach, the Agencies could also consider the prospect of extending the moratorium on competition in clearing for a further defined period. This could be appropriate, for instance, if the balance of feedback received from stakeholders in the review revealed that the industry was in favour of competition but, as in 2012, was not yet ready for the associated changes to the market structure.

If the moratorium were lifted – either immediately following this review or after a further period – any further recommendations on allowing a competing CCP to enter the Australian cash equity market would be provided as part of the Agencies' advice to the Minister on a specific CCP licence application.

4.6 Stakeholder Feedback – Competition

The Agencies are seeking feedback on the following questions on the first prospective policy approach:

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.

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?

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.

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)?

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?[11]

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? 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?

   (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?

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

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

[11] The options discussed in Section 5 of this Consultation Paper for regulating a combined clearing and settlement monopoly are also relevant to regulating a settlement monopoly.

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?

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)?

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?

5. Monopoly

An alternative policy approach would be to establish an effective monopoly by recommending that competition in the clearing of Australian cash equities be deferred indefinitely. At the same time, measures would be introduced to address stakeholder concerns that may be associated with a monopoly in clearing services.

- *Self-regulation.* As per the current arrangements, retain a Code of Practice as a formal commitment to the industry.
- *Partial regulation.* Retain a Code of Practice, and strengthen some specific aspects through regulatory action.
- *Full regulation.* Regulate all functions of ASX's cash equity CS facilities as a monopoly service.

Where there is a monopoly in clearing Australian cash equities, alternative market operators would have no choice of clearing service provider; this could lead to price or non-price distortions that compromised the effective delivery of this service to the market. Furthermore, where a vertically integrated firm supplies a monopoly service to a related market in which that firm also competes, it may have an incentive and ability to foreclose competition, or discriminate in the provision of its service to competing firms in that related market. The existing market structure for ASX securities may be such an 'essential facilities' scenario, since access to ASX's post-trade services would be necessary for alternative market operators to compete effectively with ASX in securities trading.

Hence, if a decision were taken to rule out the prospect of competition in the clearing of cash equities, the following issues would need to be considered: how to give effect to the monopoly; whether regulation of the monopoly would be required; and, if so, the scope and form of such regulation.

5.1 Mechanism to Give Effect to a Monopoly

The existing regulatory regime envisages competition between multiple providers of clearing and settlement services, which is reflected in the broadly stated licence criteria. ASX's current monopoly on cash equity clearing and settlement services is implemented through the transitional measure of a moratorium on competition in clearing of the Australian cash equity market. If a decision were made to preclude competition in the clearing of cash equities, the various alternative options for implementing this would need to be considered.

5.2 Scope of Regulation

To address issues surrounding the governance, access and pricing of the ASX cash market clearing and settlement services, the Agencies will consider a number of key matters relating to the potential scope of any regulatory arrangements that might be required. In particular, in a regulatory setting, the Agencies would need to determine which particular functions and services should be regulated, and in what manner. Regulatory arrangements might need to be put in place not only to govern access to ASX's cash equity clearing and settlement infrastructure, but also the pricing of those services. The structure and ownership of ASX would also need to be taken into account. Furthermore, the Agencies would have to consider whether ASX had sufficient incentive to continue innovating and developing its clearing and settlement infrastructure in the absence of any regulatory intervention.

Finally, the Agencies would need to determine whether, under a regulatory approach, both ASX Clear and ASX Settlement should be regulated as monopoly businesses, or if regulating only one of these services would be sufficient to deliver the desired outcomes.

In considering these issues, the Agencies will examine a number of instances internationally where CS facilities have been subject to specific regulatory arrangements. Arrangements utilised in overseas markets, such as the conditions imposed on the Maple Group in Canada and the regulation of Singaporean CS facilities by the Monetary Authority of Singapore, could serve as useful precedents in determining settings that might be relevant in the Australian context.

5.3 Self-regulation

One policy approach is to retain the current arrangements, under which ASX is self-governed by its commitments to the industry under a Code of Practice.

In response to the recommendations made by the Agencies in their 2012 Report, ASX released the Code on 9 August 2013.[12] The Code commits ASX to enhancing user engagement through the establishment of an advisory Forum and supporting Business Committee, and to maintaining transparent and non-discriminatory pricing of, and terms of access to, its cash equity clearing and settlement services.

By establishing a formal and transparent commitment to the industry, it was envisaged that the Code would go some way towards delivering outcomes similar to those that might be expected in a competitive setting, thereby addressing many of the issues that stakeholders had raised in consultation about a monopoly in clearing services.

5.3.1 Implementation and Effectiveness of the Code

A review of the implementation and effectiveness of, and ASX's adherence to, the Code in accordance with the Agencies' recommendations is an essential element of consideration of this policy approach.

ASX has undertaken a number of initiatives in accordance with its commitments under the Code.

- *User engagement.* The Forum and Business Committee have provided input on the development of clearing and settlement services infrastructure to the ASX Clear and ASX Settlement Boards. In particular, the Forum and Business Committee have identified and progressed two key strategic initiatives: a move from a three-day to a two-day settlement cycle for cash equities; and adoption of global messaging standards, which will be pursued as part of a broader CHESS system replacement project.
- *Pricing.* ASX has released a cost allocation and transfer pricing policy, and begun to publish management accounts for its cash market clearing and settlement businesses. ASX also commissioned the economic consultancy firm Oxera to conduct a global cost benchmarking study, with the Forum and Business Committee providing input on the scope and methodology of this review. Oxera's final report, released in June 2014, concluded that ASX's cash equity clearing and settlement costs were broadly in line with those in markets of comparable size.[13]

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[12] The Code of Practice is available at <http://www.asx.com.au/cs/documents/Code_of_Practice_9Aug13.pdf>. The consultation paper and ASX's response are available at <http://www.asx.com.au/cs/documents/consultation_paper_TAS_and_SFS_23Jan14.pdf> and <http://www.asx.com.au/cs/documents/TAS_and_SFS_Consultation_Outcomes_-_ASX_Response_to_Feedback.PDF>, respectively.

[13] See Oxera (2014), 'Global Cost Benchmarking of Cash Equity Clearing and Settlement Services', June. Available at <http://www.asx.com.au/cs/documents/Global_cost_benchmarking_of_cash_equity_clearing__settlement_services_Final_20Jun14.pdf>.

- *Access.* Following industry consultation, ASX has made a number of enhancements to the service-level and information-handling standards established under the TAS and SFS. ASX also waived the annual TAS service fee, and undertook a technical review of the TAS to confirm material equivalence with the services performed for trades executed on the ASX market.

Additionally, ASX has made some changes to address stakeholder concerns around confidentiality and conflicts of interest arising from its group structure. In particular, ASX recently restructured its Clearing and Settlement Boards to reduce the number of common directors between its CS facilities and ASX Limited, and adopted a policy that a majority of its directors must be independent. ASX also enhanced its information-handling procedures, which form part of wider arrangements that ASX has in place to address potential conflicts of interest.

ASX has carried out an internal review and engaged an independent external auditor to review the operation of the Code; both reviews concluded that ASX has been in broad compliance with its obligations under the Code.[14] In December 2014, ASX issued a consultation paper seeking feedback on a number of operational improvements to the Code. The proposals include: changes to the governance arrangements which give greater prominence to the Business Committee; carrying out the cost benchmarking review every two years, rather than annually; and focusing the external annual review of the Code on the core commitments.[15]

5.3.2 Strengthening the Code

Despite the actions taken under the Code, however, some stakeholders have queried whether the current arrangements are sufficient to deliver the desired outcomes. Reflecting some of the issues raised, the Agencies will consider a number of areas in which the Code could potentially be strengthened.

- *Governance arrangements.* The Agencies will examine the effectiveness and influence of the Forum, and the role of the Business Committee, giving consideration as necessary to whether some refinement to the composition and organisation of these arrangements is necessary. The Agencies will also look more broadly at ASX's governance arrangements, including the composition and independence of the Clearing and Settlement Boards.
- *Pricing.* The Agencies will consider whether arrangements under the Code for pricing transparency and international benchmarking are sufficient to promote efficient outcomes, or whether there is a case to strengthen such arrangements with pricing commitments or caps.
- *Access.* The Agencies will consider the scope of requirements for non-discriminatory access and whether these should be extended beyond the existing agreements, including in the case of non-ASX securities. Arrangements for information handling within ASX and responsiveness to requests for access will be closely examined.
- *Accountability.* The Agencies will also consider whether any aspects of the Code should be subject to extended accountability commitments, such as processes for certifying adherence to the Code or reporting and addressing any breaches.

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[14] The internal review is available at <http://www.asx.com.au/cs/documents/Code_of_Practice_Internal_Review_Report_-_21_August_2014.PDF>. The external review is available at <http://www.asx.com.au/cs/documents/PwC_Code_of_Practice_External_Review_Report.PDF>.

[15] The Consultation Paper is available at <http://www.asx.com.au/documents/public-consultations/ASX_Consultation_Paper_-_Operational_Improvements_to_the_Code_of_Practice_-_Dec_2014.PDF>.

5.4 Partial Regulation

The Agencies have also identified 'partial' regulation as an alternative to the self-regulatory approach discussed above. One possibility under this approach could be to strengthen, via regulatory means, the existing Code by mandating specific aspects of particular concern to stakeholders.

For example, while acknowledging the complexities of regulating ASX in these areas, the Agencies may consider the merits of more formalised regulatory oversight of fee models, fee changes and internal cost allocation and transfer pricing arrangements. The Agencies will also consider whether any aspects of the Code should be subject to more formal regulatory enforcement mechanisms.

5.5 Full Regulation

As noted in the 2012 Report, in principle, it would be preferable for ASX and any competing market operators requiring access to ASX's cash equity CS facilities to arrange mutually acceptable access terms through commercial negotiations. However, the Agencies recognise that regulatory outcomes have been sought under similar circumstances in other industries. The appropriate form of regulation depends on the extent of the incumbent service provider's market power and vertical integration, as well as factors such as the number of service seekers and historical practice.

The Agencies note various approaches within the existing legal and policy framework to address access to nationally significant infrastructure facilities through full statutory regulation.

For instance, Part IIIA of the Competition and Consumer Act establishes the National Access Regime. This provides a mechanism by which firms can gain access to services provided by nationally significant infrastructure facilities, where access is necessary for competition in a dependent market. Access could be obtained through: a declaration; a state or territory regime certified as an 'effective' access regime; or an access undertaking. If the Minister were to declare the service, access disputes could then be arbitrated by ACCC under Part IIIA. An owner of an infrastructure facility could also submit an access undertaking which, if accepted by the ACCC, would set the terms and conditions of access. Pricing may or may not be determined up front in an access undertaking.

A number of direct policy approaches would also be available if there were found to be impediments to accessing ASX's post-trade facilities on commercially acceptable terms. The following examples draw on previous experience and do not seek to represent an exhaustive list.

- Arrangements such as providing for a 'deemed declaration' or making a decision to mandate the submission of an access undertaking could be employed.[16] ASX could, for example, be required to submit an access undertaking as a condition of its cash equity CS facility licences.
- The government could devise an industry-specific access regime separate to the generic National Access Regime.[17]
- Part IVB of the Competition and Consumer Act provides for 'industry codes of conduct', though these codes must be prescribed under the Act's regulations.
- The government could also require structural separation of a vertically integrated monopoly service from the potentially competitive services. The 2009 Australian Government report, *Australia as a Financial Centre: Building on Our Strengths*, suggested examining the case for

[16] For example, section 192 (now repealed) of the *Airports Act 1996* was enacted to provide for 'deemed declaration' as a transitional measure in the context of the privatisation of a number of airports.

[17] Examples of these include regimes for the telecommunications (Part XIC of the Competition and Consumer Act), electricity (the National Electricity Law and Rules) and gas industries (the National Gas Law and Rules).

clearing and settlement to become industry owned and funded services.[18] The 2014 Financial System Inquiry also noted that vertical integration has the potential to limit the benefits of competition and should be proactively monitored.

- The pricing of ASX's cash equity clearing and settlement services could be subject to surveillance under Part VIIA of the Competition and Consumer Act.

It is, however, important to consider the full implications of a regulatory approach. While regulation of ASX's post-trade services could simplify the market structure and address some key stakeholder concerns, it could also have adverse implications. For instance, any competition-driven innovation and efficiency in clearing and settlement services would be lost under such an approach since the threat of competition would be removed.

5.6 Stakeholder Feedback – Monopoly

The Agencies are seeking feedback on the following questions on the second prospective policy approach, as well as specific feedback on the implementation and effectiveness of, and ASX's adherence to, the Code:

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?
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
    (b) the responsiveness of ASX to the issues raised by the Forum and Business Committee
    (c) the composition of ASX's Boards.
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.
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

[18] Australian Financial Centre Forum (2009), *Australia as a Financial Centre: Building on our Strengths*, Final Report, November. Available at <http://cache.treasury.gov.au/treasury/afcf/content/final_report/downloads/AFCF_Building_on_Our_Strengths_Report.pdf>.

(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?

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.

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?

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?

6. Next Steps

This Consultation Paper seeks stakeholder feedback on the general issues and consultation questions posed in relation to competition in the clearing of Australian cash equities.

The Agencies intend to meet with interested stakeholders during the consultation period. Submissions and expressions of interest in meeting with representatives of the Agencies should be directed to the Australian Treasury, using the contact details at the beginning of this paper.

Following the consultation process, the Agencies will consider the stakeholder submissions and will report to the government in due course.

Appendix: Consultation Questions

Policy Approaches

1. Which policy approach would you prefer, and why?
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.
3. Are there any other overarching issues that should be taken into consideration?

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.
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?
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.
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)?
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?[19]
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? 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?
    (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

[19] The options discussed in Section 5 of this Consultation Paper for regulating a combined clearing and settlement monopoly are also relevant to regulating a settlement monopoly.

risks? Would 'open access' obligations need to be imposed to facilitate interoperable links?

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

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?

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)?

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?

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?

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

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

    (c) the composition of ASX's Boards.

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.

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?

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.

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?

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?