Market Structure Partners

RESPONSE TO

Review of Competition in Clearing Australian Cash Equities

A Consultation Paper by the Council of Financial Regulators

February 2015

March 2015

EXECUTIVE SUMMARY

Market Structure Partners, MSP, believes that there is no perfect capital market structure but that all structures must be allowed to evolve over time in order to best serve the market, the economy and the shareholders. Sometimes the interest of these parties are not aligned and require a catalyst for change. MSP is of the view that this is the appropriate time for change in the clearing of the Australian cash equity market.

Our view is that competition would be the best tool as a catalyst for change. Although, economies of scale do need to be considered, we think the market could support at least one alternative clearing entity which would create enough competitive tension. However, we believe that the market will struggle to support competition in the near term. This is because:

1) There is no culture of mutualized risk management in the Australian market. The entry of a competitor that might follow a mutualized risk model would need to help the market adapt to such a model.

2) The ASX currently provides the capital that acts as a default mechanism for the market but there is no transparency about how this figure is calculated or how the costs for the capital deployed are passed on. This makes it extremely hard for participants to assess alternative models.

3) Participants may not have enough capital to support two alternatives at present, or at least not until they have fully understood the implications, costs and efficiencies.

4) Participants are concerned about regulatory costs that may be passed on for oversight of what may initially be a nascent competitor into the market.

This does not mean than competition should be excluded as an option. Competition could bring many improvements to the market but, if a competitor becomes successful and inter-operability is required, it can also bring risks. However, in the short term, transparency and governance at the exchange should be improved and a full analysis of the default fund mechanism and costs should be undertaken. This will either help banks/brokers to fully understand their costs and properly assess competing alternatives or it may suffice to keep one clearing entity in the market that fully serves the needs of the overall market.

INTRODUCTION

Market Structure Partners, MSP, specializes in consulting on topics related to capital markets infrastructure. All team members have many years of professional experience working with many aspects of the capital markets infrastructure across global markets, particularly, but not exclusively, in Europe and the US. They have personally participated in and experienced the many changes of market structure that have had a fundamental impact on those markets and investors. Our response to this consultation is based on a synthesis of our own observations and practical experience working for and with capital markets infrastructures and market participants in a number of different international markets. It also follows on from work that was undertaken by MSP in October 2014 to review the cost of clearing in Australian cash equity markets and benchmark it versus other global markets.[1]

It should be noted that MSP, was paid by ten Australian broking firms to undertake and publish the study that benchmarked Australia's equity clearing costs against other global clearing fees. However this response to the consultation is an independent MSP initiative that has not been discussed with the brokers and no payment has been received for making this response. We believe our experience in other markets may help inform the debate about clearing in Australia.

THE NEED FOR CHANGE IN THE AUSTRALIAN MARKET

The ideal of an exchange has been closely linked to the economic well being of the country and this is strongly correlated with the ownership and governance of the exchange. Many global financial markets have had centuries to evolve but the ownership and governance of the has had to adapt over time to maintain the efficiency of capital markets. The timing of this is critical and each model has its advantages and disadvantages but it is important that the model remains adaptable.

As Western markets have evolved, the owners of the exchanges were traditionally the users who had a vested interest in improving that market and determining its future. However, over time, the dynamics of the local market can change. Typically the investor base will become more sophisticated and the globalisation of markets introduces the ability to expand across borders. At this point, some local stakeholders who are threatened by the market expansion may become more protective about their own interests and try to prevent the market from changing. This can potentially be negative, for example, if they prevent foreign capital from coming to the market with better financing options for the real economy.

In most Western markets, the listing of an exchange has helped to transform the ownership at a critical point in the market's development and provide the right level of flexibility for the exchange to grow. Nonetheless, it is clear from the both historical and current ownership models of exchanges that the for profit model of the exchange owners and the interests of the national market can start to diverge at different times in the lifecycle. Any ownership or governance model may find that at some point it will have to confront a conflict of interest

[1] http://www.marketstructure.co.uk/services/international-transaction-cost-benchmark-review-october-2014/

between a group of shareholders, customers and possibly the national government. Failure to realise the need for change can be detrimental to the market infrastructure itself.

In our view the Australian cash equity clearing model may have reached this point. Specifically MSP understands that the Australian cash equity clearing infrastructure may have suffered from a period of under-investment. The ASX has publically stated that it would consider fee reductions only if it can secure a longer-term monopoly on clearing[2] - this is the classic argument of a monopolist where customers are expected to pay for any improvements and not the shareholders. This argument would not stand up in a freely competitive world where, the shareholders would have to pay for the development to make the product attractive to customers. This stance by the ASX clearly suggests that the Australian market may not be benefitting from improvements and further investment in the clearing model and that the dominance of for profit motivations may be detrimental to the improvement of the market.

There are a number of tools that can be used to try to effect change. It is important to note that markets have to continue to evolve and when a change of ownership or governance model is considered, the longer term consequences of that change also needs to be thought through, and some flexibility needs to be introduced to allow the ownership or control structure to develop again in the future.

Any ownership or governance model may find that at some point it will have to confront a conflict of interest between a group of shareholders, customers and possibly the national government. Failure to realise the need for change can be detrimental to the exchange or market infrastructure itself and may need intervention. Two examples are given below:

New York Stock Exchange: Failure to change	Deutsche Börse: Government Intervention
NYSE thrived for hundreds of years and was the most famous Wall Street institution but was ultimately held back from change in the 1990's by legacy members, known as specialists, who owned the exchange and wanted to preserve lucrative privileges that had become out-dated in a modern electronic market place. New electronic platforms in the US such as ARCA, BRUT and INET had started to provide more efficient price formation, which attracted increasing flow. Ultimately, the privately owned NYSE merged with a new entrant, ARCA, and through a reverse IPO became a publicly owned, for profit company with a ready made electronic order book. One could argue that the changes were made too late, as NYSE, previously the world's most famous exchanges was recently bought by a more flexible competitor, ICE, which was only established 16 years ago.	In the early 1990's the German market was increasingly losing competitiveness to London. For example, the German Bund Future was only traded on the LIFFE Exchange in London and equity trading had started to migrate to London, which saw the greatest inflows of capital coming into Europe. German local members were reluctant to change the existing exchange structure as it served to protect their interests, even though the German government wished to have the Bund future trading in Germany. A national program was launched (Financial Promotion Act, 4. Finanzmarktförderungsgesetz of 2002) between government, regulator, banks, brokers and exchanges to create a national Champion: Deutsche Börse. Deutsche Börse succeeded in migrating Bund and equity trading and clearing back to Germany and became a European exchange powerhouse. A decade later it is struggling to grow after a merger with NYSE Euronext was denied by European competition authorities.

[2] 9 March 2015, www.asx.com.au/asxpdf/20150309/pdf/42x4l270b9wp8v.pdf, http://www.globalcustodian.com/au/news/news_article.aspx?id=2147490050

FEEDBACK TO SPECIFIC QUESTIONS

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

MSP's view is that clearing is the greatest enabler in any market. Although, not a perfect model, a utility clearing model can serve the market well and allows competition to flourish at both the trading and settlement end of the value chain where it does not impact risk management models. However, few markets have managed to preserve a utility model - the US is the most notable example – and utility models still need the flexibility to change over time. Once a vertical exchange structure is listed, it becomes hard to create a utility model in clearing as the value of the clearing entity is very hard to assess – the exchange will price it high because of the monopoly pricing it can extract but the future utility will be valued much lower because it is aiming to keeping pricing low.

Where utilities do not exist, competition helps improve the market and is the preferred stance of MSP but competition can mean many things and needs to be viewed in two ways:

1. Competition for the market i.e. CCPs compete to connect to new trading platforms

2. Competition within the market i.e. CCPs compete to offer better services to customers

1. Competition for the market i.e. CCPs compete to connect to new trading platforms

It should be noted that competition for the market was a very important enabler in Europe where many emerging trading platforms were not able to connect to the incumbent clearing houses. BATS-Chi-X is now the largest exchange in Europe but when it started, none of the existing equities CCPs had an appetite to provide services to a new entrant. For example LCH.Clearnet required a very substantial payment to develop a trade feed (a practice mirrored by ASX with the TAS) and offered a 'time to market' that had no relation to the readiness of the trading platform and could have been detrimental to its launch. Eurex meanwhile was prepared to offer services on non-German securities only so that the platforms could not compete in its domestic market. No CCP was prepared to offer price competition, claiming the pricing was 'agnostic' to platform.

Ultimately, Fortis Bank set up a new CCP, EMCF. This created the first direct competition in the market. EuroCCP, another new central counterparty followed EMCF into the market. EMCF and EuroCCP have now merged (EuroCCP N.V.).

Now competing CCPs in Europe are far more eager to support new and/or additional markets introduced by platforms in order to defend/increase their market share and their overall service offerings to customers. For example, LCH.Clearnet proactively added the Spanish and Nasdaq OMX markets to their offering when EuroCCP N.V. gained access to the LSE trade feed which would challenge their domestic clearing capabilities Practically, the concept of payment for a Trade Acceptance Feed is becoming a distant memory as CCPs vie in a competitive world for new business in the current market.

On the surface, connectivity to the incumbent clearinghouse is less of a problem in Australia. However, it could still prevent innovative products from emerging as participants do not want to share knowledge with their main competitor. Additionally the competing platform may have no control over time to market.

<u>2. Competition within the market i.e. CCPs compete to offer better services to customers</u>

We address competition within the market in the next section.

We acknowledge that competition is unlikely to be introduced in Australia with immediate effect and so address other ways to improve the market effectiveness in the Monopoly section.

Competition

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

In MSP's experience, competition has brought 1) a significant reduction in cost for clearing members and 2) also improved clearing models.

However, it should be noted that in Europe competition has the potential to bring about more significant reduction in costs than may be expected in a single homogenous market the size of Australia. The motivation for competition in Europe also has similarities and differences to that of the Australian market. Overall customers in both markets want to see a decrease in price, and an improvement in service, but participants in Europe also have to deal with the complexities of a clearinghouse in each individual market or pay clearing fees to third parties to manage clearing on their behalf. Competition has helped to create multi market clearing houses that benefit participants with significant cross border business and enable them to achieve significant volume discounts whilst dealing with less interfaces. Competition was effectively created to drive consolidation of the market rather than to expand it but, as explained above, new clearing houses had to be created in order to commence such change.

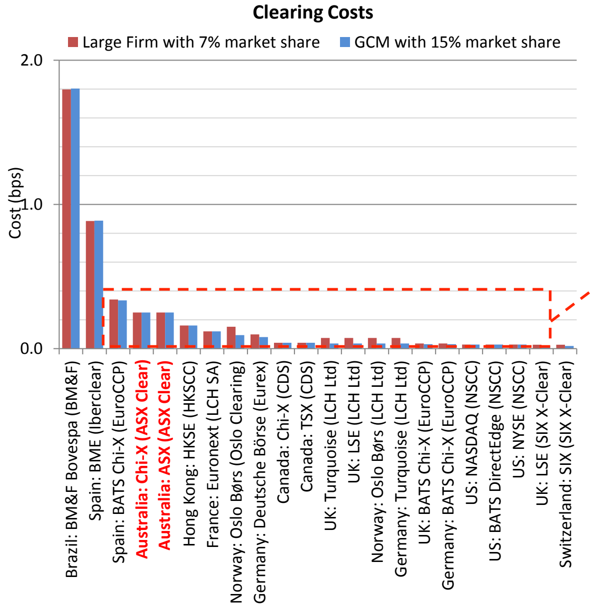
1. **<u>Costs</u>**

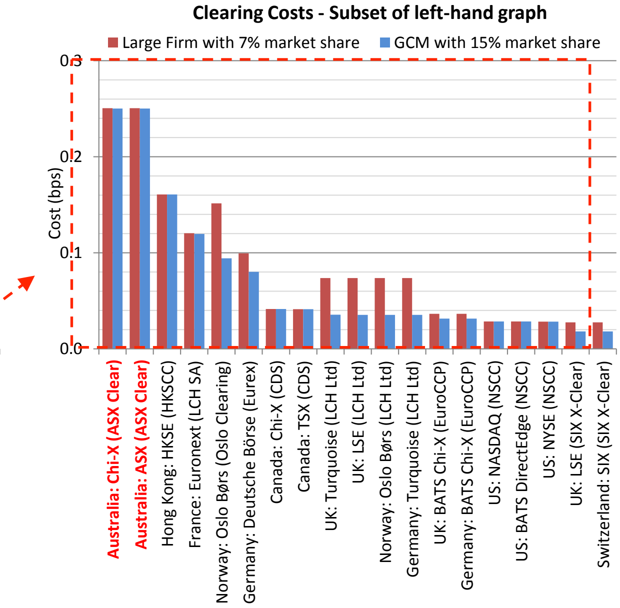
Nonetheless, even taking into account the different economies of scale, we still believe that clearing costs in Australia can be reduced and have documented this in our International Transaction Cost Benchmarking Review of October 2014[3], an extract (in italics) of which is presented below. We acknowledge that the cost of providing capital for the default fund is not taken into consideration because, as noted elsewhere in this report, there is no transparency about how this is calculated and apportioned to participants.

3 http://www.marketstructure.co.uk/services/international-transaction-cost-benchmark-review-october-2014/

COST OF CLEARING IN DIFFERENT MARKETS

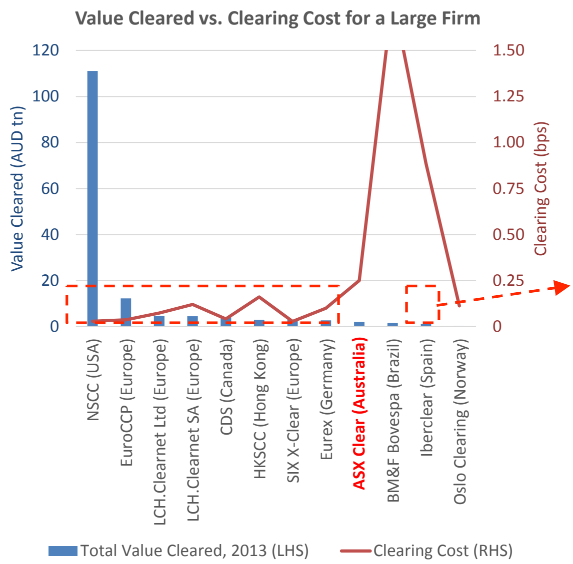
Overall Australian clearing costs appear high. The graphs below compare the cost of clearing for a large firm, with 7% market share, against a GCM that has 15% market share across different markets.

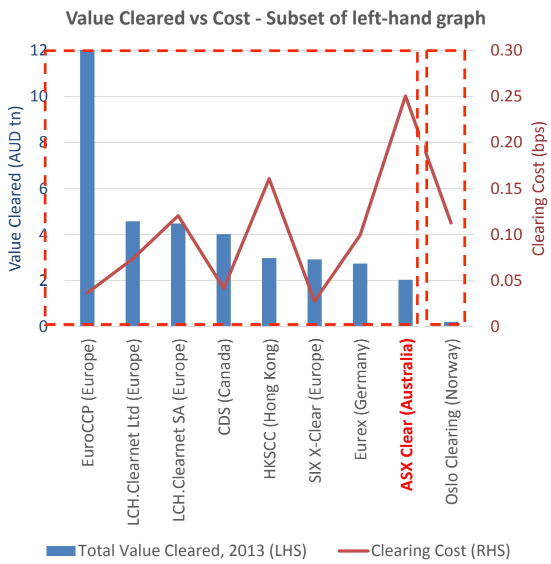




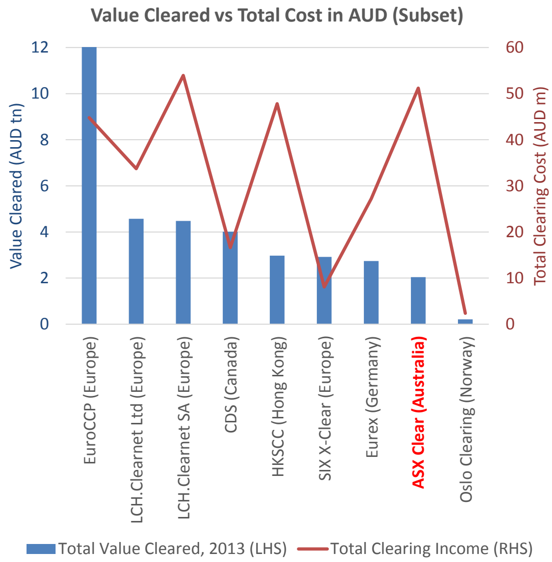
Value Cleared vs. Clearing Cost

Although there is an argument that Australia cannot achieve similar economies of scale to Europe, even when compared with peers of a similar value cleared to the Australian market, such as SIX Xclear, Eurex, Canada and HKSCC, the average cost of clearing in Australia is considerably higher. In addition, the graphs demonstrate that a market such as Oslo which has much lower values cleared than Australia has a lower average clearing cost. Norway has recently opened the clearing market to competition, with LCH.Clearnet coming online earlier this year.



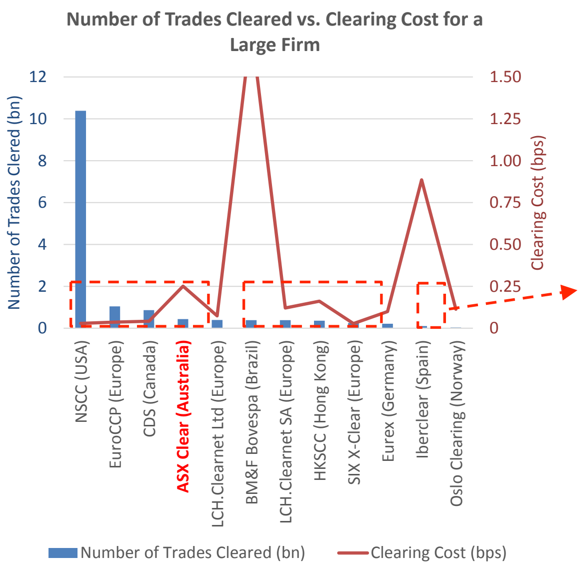


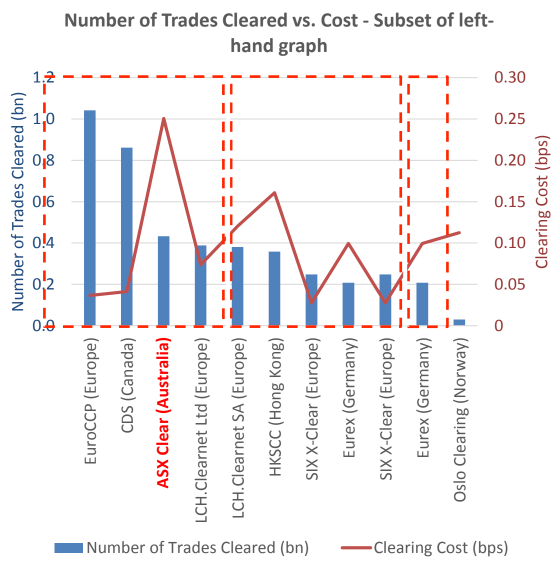
The following graph shows the AUD equivalent of the basis point costs above. These AUD costs represent the total cost of clearing, across all intermediaries in each market, if all of those intermediaries were large firms on average (e.g. 7% market share). Generally smaller firms have higher clearing costs, while a larger GCM may have lower costs, and therefore changing the assumption of market participants would have the effect of increasing or lowering costs in each market respectively. Overall this shows the total cost that a CCP is potentially extracting from market participants compared to the value that is cleared. Compared to similar size markets such as Eurex and SIX X-Clear, ASX is extracting significantly more income. In Hong Kong, which is a similarly dominant market, the value cleared is slightly higher and the income extracted is slightly lower. LCH extracts a similar amount of income but clears a greater value and, as previously stated, the costs at LCH are over-stated in order to make a fairer comparison with Australia.



Number of Trades Cleared vs. Clearing Cost

In terms of the number of trades cleared, BM&F Bovespa, HKSCC, and ASX Clear have greater economies of scale than some of their peers; however, clearing costs are higher than their peers.





As well as reducing direct costs, different pricing models have evolved between competing CCPs. This can benefit different types of firms but helps move the market to a user pays model. MSP considers developments in pricing as innovation. Examples include:

- Differences in membership categories (tiered membership fees).
- Nuances in the rate cards. Some customer types, e.g. HFT clearers may gravitate towards one CCP whereas a different customer type may gravitate towards a competing CCP.
- Increased range of acceptable collateral.
- More transparent pricing for handling different types of collateral (costs for assets are much higher than cash).
- Haircut differences – significant differences between rates of return on cash/collateral.
- More transparent pricing regime for fines and delivery failures.
- Access to Central Bank money versus Commercial Bank money.
- Different accounting / charging policies within firms mean that different CCP models may be beneficial e.g. Default fund costs may be taken at a corporate level, IM cash/assets and fees at a business/desk level

2. **<u>Improvements in Market Models</u>**

In addition to the proposed changes in cost, competition could introduce different ways of managing and mutualizing risk across the market. As noted in our report of 22 October 2014[4], the risk management and default waterfall model in Australia, managed by ASX Clear, is unusual compared to other global markets. We believe this model is a significant barrier to creating competition because of the unusual culture that this has created i.e. where participants and the government rely on the ASX for the default fund but there is no transparency over the model and the associated costs. A number of changes could be brought about by competition:

- In most other markets, after the funds of the defaulting participant are used, there is a default fund where the risk is shared between the non-defaulting market participants. ASX Clear has no default fund shared between market participants and instead puts it own funds (AUD250mn) in place of a mutualised default fund or one that shares risk.
- Well-managed default funds do not have to be static. Some CCPs offer dynamic management of the default fund by reassessing contributions based on risk profiles. This improves collateral management and costs for the market. It was stated in the Oxera Report[5] that the Oxera calculations for the cost of financing the default fund assume that AUD250m is the optimum fund size and that this remains constant. However, there was neither supporting material to this, nor an explanation as to how this cost is passed to participants. If this sum is larger than required then this model imposes unnecessary costs on participants and shareholders. Currently ASX clearing members pay a charge without any clear justification as to the size of the default fund and the cost apportioned to them:

[4] http://www.marketstructure.co.uk/services/international-transaction-cost-benchmark-review-october-2014/

[5] June 2014: Oxera - "Global cost benchmarking of cash equity clearing and settlement services"

- This is not the experience at most other CCPs, which recalculate the default fund requirement daily and adjust periodically (e.g. quarterly) to reflect market risk and ensure the right level of funding. The default fund for cash instruments is typically 3-5% of Initial Margin, IM.
- There is no mention in Oxera's report of other instruments cleared at ASX which may have a different risk profile and more impact on the AUD250mn fund. Other CCPs may ring fence non cash equity instruments and show their impact on the default fund.
- ASX's model where risk is not mutualised amongst participants could lead to a higher risk profile and a higher cost of financing for the organisation which may then be passed onto participants or the shareholders. However this could be offset by savings on collateral posted because it is less at risk.
- Risk calibration is therefore extremely important. If there is very high confidence that the default funds or shareholder funds will not be used, this creates over collateralisation for market participants which comes at additional cost. However, if confidence is low then the participants may be under-collateralised and other funds may be more at risk.
- The current model with a static fund of AUD250 may not be the optimum size for the business that is being cleared.

- ASX does not segregate client funds. However this can reduce/increase costs depending on the user perspective.

A competitor could bring multiple improvements in these areas.

The diagram below highlights how ASX's model is different from standard CCP models and indicates that a competing model could introduce improvements. The diagram covers default prevention and default management. It does not show resolution management.

		Oxera Ref 4.1.1	ASX Clear	Standard CCP model
Pre-default	Membership criteria		✔	✔
	Eligible collateral		✔	✔
	Investment/liquidity/sett risk mgmt		✔	✔
	Concentration risk mgmt		✔	✔
Funded	Initial margin	Tier 1a	✔ 99%	✔ 99% (IOSCO)
	Default fund - defaulter	Tier 1b	✗	✔ variable
	CCP capital (skin in the game)	Tier 2	✔ AUD250m	✔ 25% (EMIR)
	Default fund – non-defaulters	Tier 3	✗	✔ c.3-5% of IM
Unfunded	Unfunded default fund contributions (assessment)	Tier 4	✔	✔
	Additional CCP capital	Tier 4	✔	✔

Source: *Market Structure Partners*

Acknowledging how automated trading impacts risk management is also important. The term high frequency trading, HFT, is not easily defined and has been used globally to scaremonger in the industry. However, automated trading is unlikely to disappear and is a part of industry evolution that should not be ignored. It is a clear fact that as institutional asset managers and brokers communicate electronically, their trading behaviour changes and will continue to do so as asset managers increase in size and sophistication, and undergo fee pressure that pushes them to passive trading models.

The emergence of proprietary traders, whose presence is a by-product of these changes, is also attributed to increased data dissemination, transparency in the markets and fee models that incentivise liquidity. Whilst some elements of the micro structure can be flexed to control the amount of automated trading in the market, it will not go away and should not be presented as negative to the market. A recent study by the Bank of England suggests that HFT activity is information-based and so does not generally contribute to undue price pressure and price dislocations.[6]

It is therefore important that rather than ignore the increase in automated trading, risk management practices move to accommodate it and ensure risk is managed in the appropriate timescales. Competition in Europe has seen real time risk management practices in Europe change. During a set of interviews as part of a project with market participants in 2012, MSP found that competing CCPs in Europe offered to deliver risk position information to customers between 6 times a day down to every 15 minutes. (This improvement has continued. For example EuroCCP currently say they offer this service 'real' time). For customers that deal with a higher percentage of automated trades, CCPs that provide as near to real time risk management as possible are important and competition is likely to continue to increase responsiveness to the real time risk management requirements.

CCPs have also improved collateral management services by increasing the ability to handle more types of collateral for participants. (e.g. Eurex now accepts over 25,000 ISINs).

More specific examples of competitive service offerings would be EuroCCP's power of attorney to instruct agent banks on behalf of participants that eliminated unmatched and failed trades.

A Note on Consolidation

In our view, competition may be a transition phase to the next stage of market evolution. In Europe, EuroCCP and EMCF have already consolidated and we expect further consolidation, although with a lack of regulation mandating inter-operability between all clearing houses, it is not a level playing field. We believe that Australia cannot support a large number of clearing houses, but the presence of an alternative may be enough to migrate to a new model under a single entity with different governance and control.

6 http://www.bankofengland.co.uk/research/Pages/workingpapers/2015/wp523.aspx

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?**

We see a macro and micro element to this debate.

On a macro level domestic participants are concerned by the regulatory cost recovery mechanism. Recent experience of the direct cost recovery for nascent competition in trading services has left participants wary of further cost allocation / recovery.

If Australia wishes to change the market infrastructure there are some costs, such as regulation and supervision, that may initially need to be borne by the government in order to facilitate the desired national market structure. In much the same way as the government is prepared to invest in other long term infrastructure initiatives. The 'payback' may not be immediate, but the long term health of the market is assured by the framework laid out in policies set in place today.

Competition between CCPs in Europe commenced with a competition model of 'by the market' (platform). i.e. Each market platform remained aligned with a single CCP (A many markets to one CCP arrangement / many : 1). This had the impact of dual default funds etc. Whilst this sounds inefficient, it needs to be considered in conjunction with the materiality and proportionality of a nascent market. It is only once you start to have material market share that the inefficiency of a multiple CCP model becomes material.

Inter-operability introduced the concept of a competition model of 'for the market' (Participant). This enabled each market participant to choose which CCP, down to market segment, to use. (Many markets to many CCP arrangement / many : many).

On a micro level, how Australia views the implementation of competition will be a critical in determining the costs to the industry; a 'big bang' approach for interoperability or a phased approach of competing CCPs by market.

Additionally, best execution requirements will be important. If the broker must factor in all elements of the execution including clearing AND hence must be connected to all clearing houses then they will have to invest in technology to make the appropriate calculations. The level of discretion extended in determining best execution could have an impact on the growth of a competing CCP. (In Europe, the broker creates a best execution policy that they must abide by but they do not have to have access to every clearing house. However, as competition has increased, asset managers have increasingly demanded to better understand execution and how it is achieved.)

Market Participants typically find useful forums via vendor working groups to effectively manage the costs of new functionality effectively.

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.**

The consultation paper raises a concern that there may be a race to the bottom in risk management models. However, this assumes that the current ASX model is superior to any other models. It is likely that competition will actually introduce improvements and raise standards rather than create a race to the bottom.

However, if inter-operability is mandated then there are risks between clearinghouses and default funds that need to be accommodated.

The importance of non discriminatory access to the settlement system is not to be underestimated. The CHESS net batch settlement system should allow equivalent priority to settlement messages from competing CCPs.

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)?**

It is worth noting that inter-operability currently works only between CCPs in European markets that have voluntarily agreed to inter-operate. There is no precedent regulation to mandate interoperability between clearing houses, although "open access" between exchanges and clearing houses has been introduced as a concept in the MiFIR/MiFID II regulation in Europe.

It is difficult to imagine that the ASX would willingly interoperate with a competitor so it is anticipated some regulatory incentive would be required at the point that interoperability becomes important.

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?**

Economy of scale would imply that a single settlement service will be the prevailing model for the Australian market at present. Recognizing the nature of the services provided by CHESS, from sub-registry functions to asset servicing and corporate actions, the complexity of competition would be impractical for market users to take advantage of given the current size of the domestic market. However, as the market continues to evolve and we see further commoditization of the settlement processes (e.g. the decoupling of the DvP process from asset servicing) there may be more scope for competition in domestic settlement at a later point. It should be noted that regulation The Central Securities Depository Regulation, CSDR[7], is being introduced in Europe to create competition between depositories.

The emergence of new trading platforms in Australia is evidence of the markets continued evolution. A next logical step would be competition in clearing. As such, any development of the settlement system should be robust enough to allow the inclusion of settlement messages from multiple sources (on an equal basis).

The current vertical structure of ASX is susceptible to the prioritization of vested interests. Governance would have to greatly reinforced to offer true commercial independence. The Code, in its existing form would not meet this objective in the view of MSP.

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

The nature of interoperability depends on the nature of competition.

It has been noted several internationally active participants (e.g. Optiver and IMC) in the equity options market have exited the Australian market (citing the high costs imposed by ASX)[8]. In the case that a new entrant wanted to introduce a new market segment and vertical silo for equity options only this could become the new defacto. There may be no pressing need for interoperability.

The answer to interoperability lies in the materiality of the positions and the correlation / offset of the risk profile of those positions. It is noted that the tenure of equities contracts (moving to T+2) is substantially shorter that the tenure of derivatives contracts.

In the event of direct competition for identical underlying contracts then the point of materiality for interoperability is likely to happen sooner, i.e. Initially, a new entrant is likely to have minimal market share and the opportunity costs of using multiple CCPs are likely to be minimal. Over time, and as market share becomes more evenly distributed across CCPs the economic case for interoperability increases.

(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?

7 http://ec.europa.eu/finance/financial-markets/central_securities_depositories/index_en.htm

8 http://www.brw.com.au/p/investing/optiver_to_cease_trading_on_asx_dg3rQCSb4kBZfepH14iotI

(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?

The implications and risks around interoperability are correctly raised.

It is also noted that in times of market stress or outage competing CCPs provide diversity, i.e. they add resilience to the market through the removal of a single point of failure.

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?

Given the current constraints on the ability of local participants to invest in competition along with the prevailing market conditions and volumes (wallet size) a 'near future' entrant is not anticipated.

That said, markets continue to evolve (e.g. IEX in the US) and the technology and other associated costs of entry continue to fall.

It is also noted that market participants very much like 'the threat' of competition. To not lift the moratorium would remove this lever from the market users whilst providing the incumbent with the certainty of a continuing monopoly. The more transparency the participants have over the clearing costs and how the cost of the default fund is allocated to them, they may be more able to understand the real positives and negatives of competition.

The Code should remain in place, and enforced, until such time as competition emerges (or so long as the current market structure remains in place). As mentioned previously, the TAS fees should, at the very least continue to be waived and ultimately abolished. In the event that a new entrant did emerge, based on European experiences, a new CCP would accept a trade feed at notional cost (limited to leased lines and other required technical connectivity etc.).

The Australian market should continue to follow best international practice (G30, CPSS-IOSCO) and move towards a T+2 settlement cycle. (Irrespective of the code). This should further reduce the cost of capital required in the default fund.

Greater transparency is required on the accounts and operations of the ASX CCP(s). This includes the mechanics of any internal transfer pricing. It also includes further debate and transparency around the funding and default mechanism of the Clearing Default fund. It is only when participants understand this that they can assess the true cost of competition.

Governance arrangements need to be strengthened. Market participants should have confidence that the CCP is working for the market with the same emphasis as its shareholders. A shareholders agreement may have to be put in place between the clearing subsidiary of ASX and the main exchange in order to protect the interests of participants.

Until competition emerges the current 15% equity ownership restriction should remain in place (to prevent any dominant shareholder extracting a monopoly rent from the users of the CCPs services).

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)?

In our experience codes are not enough to incentivize a change in behaviour and are not easily monitored. In 2006, the European Commission created a Code of Conduct between Exchanges to improve the cost management practices and relationships with the market stakeholders. The Code did not succeed in changing exchange behavior but did introduce a trend towards increasing transparency. It was only the introduction of competition between trading platforms that changed behaviour because new platforms were forced to create alternative clearing and settlement solutions.

However, clearing and settlement have continued to be an issue in Europe. The Open Access clause in Article 28 of MiFIR II[9] is the first time that regulation is mandating change but it will not begin to be implemented until 2017. During all that time, vertical exchanges that have no incentive to inter-operate have continued to ring fence their clearing operations and, as a result, full economies of scale cannot be harnessed.

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

No.

If competition is not possible now, it should not be excluded in the future and further efforts need to be made to encourage the ASX to make investment on a continual basis and to work with the stakeholders of the market.

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[9] http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm

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?**

We would advocate a metric, based on agreed transparency, that caps the revenues that can be extracted from the market. The pricing model should become increasingly transparent and move towards a 'user pays based on services consumed' model.

In our experience with a number of exchanges in a similar position to that of ASX, codes and self regulation are not easily enforceable or easily monitored and are inappropriate to manage a monopoly. User Committees are usually toothless and there is little way of enforcing their requests. We cannot comment on the individual experience of the users in the market but know that it took considerable time and effort, using industry organisations in Europe to try to make a difference and enforce change.

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

We note that the ASX Forum of twenty two (22) members include a comprehensive cross section of stakeholders. This may make it difficult to achieve consensus and hamper its effectiveness. It also creates an effective mechanism for the exchange to ignore the issues of any one group of stakeholders. We have seen this repeatedly in markets where the exchange uses the excuse that it must look after the interests of all of the participants, even those that do not directly pay its fees. Ultimately the market will sort this out through the vale chain and focus should be on those who are bearing the greatest costs.

It is noted that some of the 22 members represent bodies that are not direct fee paying participants of ASX Clear and that the industry organization includes the exchange as a member which makes it harder to act as a lobbying organistion.

(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

We believe one of the most important areas to be addressed is the size of the default fund and whether or not a more dynamic calculation should be imposed, showing users what element of their charges apply to the capital in the default fund.

(b) the cost allocation policies adopted by ASX

Without greater transparency for participants around any transfer pricing it is difficult to monitor the profitability and independence of the relevant subsidiary.

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

As mentioned previously, based on our International Transaction Cost Benchmarking Review of October 2014, we believe that domestic pricing is greater than that available in other comparable markets. We acknowledge that the cost of the providing capital in the default fund is not included but without further transparency from the ASX on these costs, it is impossible to clarify.