



Manager, Financial Markets Unit
Corporation & Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600
Australia

10 August 2012

Dear Sirs

Competition in the clearing & settlement of the Australian cash equity market

This letter provides the response of the LCH.Clearnet Group ("LCH.Clearnet") the Council of Financial Regulators' Consultation Paper on "Competition in the clearing and settlement of the Australian cash equity market".

LCH.Clearnet is the world's leading clearing house group, serving major international exchanges and platforms, as well as a range of OTC markets. It clears a broad range of asset classes including: securities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps and bonds and repos; and works closely with market participants and exchanges to identify and develop clearing services for new asset classes.

2. Competition in clearing and settlement

Q1. Do you agree that clearing of ASX securities is contestable?

LCH.Clearnet Ltd ("LCH") has a clearing service, EquityClear, that has supported the clearing of cash equities since 2001. Since 2009, EquityClear has been interoperable with other CCPs on multiple exchanges including London Stock Exchange, SIX Swiss Exchange and more recently Multi-lateral Trading Facilities including, Turquoise, BATs and Chi-X Europe. During this time LCH has built considerable expertise and successfully managed the default of members including most recently, MF Global Ltd. LCH has been at the forefront of developing practices and procedures for the management of interoperable clearing services for a variety of markets in the EEA of size and constitution similar to the ASX market. LCH firmly believes that clearing of ASX securities is contestable and that the benefits of competitive clearing highlighted in this paper can be delivered efficiently and safely to the market for ASX securities.

Q2. Do you agree that there is no evident demand for competition in the settlement of ASX securities? If so, do you have any views on whether price or non-price issues could emerge in relation to ASX's settlement facility?

LCH.Clearnet Limited Aldgate House, 33 Aldgate High Street, London EC3N 1EA
Tel: +44 (0)20 7426 7000 Fax: +44 (0)20 7426 7001 www.lchclearnet.com
LCH.Clearnet Group Limited | LCH.Clearnet Limited | LCH.Clearnet SA

Whilst LCH has no comment on the demand for competition in settlement of ASX securities, LCH would like to draw attention to the fact that were ASX to move from having a current monopoly on clearing and settlement services, to competing on clearing but retaining a monopoly on settlement services, unless strict price controls are in place, the incumbent may seek to recoup the loss of clearing revenue through an increase in settlement fees, thus negating the benefits of interoperable CCPs. Hence LCH would seek a firm commitment from regulatory authorities to ensure that, in the instance of a single settlement facility in an interoperable clearing environment, there would be sufficient safeguards to ensure that the owner of the facility, who may also be a competing CCP:

- i) Provides open, non-discriminatory and fair access to all CCP users;
- ii) Cannot arbitrarily increase or maintain Settlement service prices such as to prevent a barrier to entry for a CCP and/or negate the cost benefits of competitive clearing.

4. Market functioning

Q3. Have the Agencies identified the right issues around fragmentation?

With respect to the concerns outlined in the paper on the fragmentation of less liquid securities, LCH has not seen any empirical evidence from its European interoperability experience to support this concern. In Europe, there is a range of trading facilities from Recognised Investment Exchanges to Multi-lateral Trading Facilities which operate different types of CLOB facilities that are targeted at different types of market participants. These may range from large secondary trading markets to dark books for institutional investors to block trading facilities. The existence of multiple venues does not of itself decrease liquidity but facilitates different trading needs from a variety of market participants. Indeed it could be arguable that the existence of multiple types of facilities increases “on-exchange” liquidity, as the need for Over-The-Counter, non-cleared cash equities trading decreases and moves “on-exchange”.

Q4. Do you have views on whether particular product or participation segments of the market for ASX securities would be affected in the event that competition in clearing emerged?

From the European experience, LCH believe that fears on decreasing liquidity and increasing volatility are misplaced. Since the introduction of interoperability, the volatility and liquidity of small cap segments of the market have shown no correlation to interoperable CCP volumes. In LCH’s experience, Clearing Members are incentivised to move all their cash equities clearing to a single CCP, this includes clearing of liquid and illiquid securities to gain the reduced cost benefit as well as the margining and collateral benefits.

The risk highlighted in S4.1.1 concerning CCPs left to manage exposures in less liquid securities only arise in the presumption that not all trading venues are open to all CCPs.

Q5. Are there any other factors related to the effective functioning of the market for ASX securities that should be considered?

Q6. Do you have views on the stability and effectiveness of interoperability in other jurisdictions? Should interoperability between competing CCPs be encouraged in Australia?

Answers to Q5 & Q6. As stated, LCH has extensive experience servicing trading venues in an interoperable environment. LCH and other participating CCPs have developed arrangements in the “peer-to-peer” interoperability model as mentioned in the paper. This model involves CCPs becoming participants of each other and margin flowing in both directions. LCH have found that this arrangement allows the most efficient management of risk and does not compromise the ability for LCH as CCP to determine the correct risk margining framework to be applied to exposure held by other CCPs. LCH believe that for risk management purposes this is superior to the “Senior/Junior” member model as this ensures that risk standards are maintained across all CCPs. The “Senior/Junior” introduces the risk that there is a single dependency on the risk management standards of the “Senior” CCP. It may also be inconsistent with regulatory requirements that all CCPs are at all times fully collateralised.

Q7. Can you suggest any other responses to the issues raised in relation to market functioning?

LCH believe interoperability in European markets have delivered substantial benefits to all market participants in lowering their transaction costs and delivering settlement and collateral netting benefits.

5. Financial stability

Q8. Do you consider that there is a risk of a race to the bottom on risk control standards in the event that competition in clearing emerged?

Q9. Are you aware of such a race to the bottom in other jurisdictions in which competition in clearing has emerged? What risk control standards have been impacted and how?

Answer to Q8 & Q9: As an established CCP which has been clearing Equities since 2001, LCH has a comprehensive world class risk management (recognised Clearing House of the year 2011 and 2012 by Risk Magazine). LCH charges both initial margin on all trades unlike the ASX and has a comprehensive default waterfall. This has enabled LCH to manage several defaults of Clearing Members. Regulators must ensure that CCP entrants have sufficient experience and margin requirements. Adequate regulatory requirements on CCP capitalisation and risk standard as outlined in EMIR legislation (Article 16) will mitigate any commercial pressures to lower risk standards.

Q10. Do you have views on the risks that the exit of CCPs could pose to financial stability?

LCH fully support that necessary exit requirements are imposed on CCPs to mitigate exit risks. It has taken steps to limit the contagion risk between its services by instituting separate default funds for different services and by introducing loss-sharing arrangements for OTC businesses. It will be fully engaged in the current CPSS-IOSCO consultation on recovery and resolution of CCPs.

Q11. Do you have comments on the issues identified around access to ASX Settlement and settlement arrangements for non-ASX CCPs more generally?

LCH believes the settlement model should be based on CCPs having responsibility for settlement accounts at ASX Clear. These accounts may be operated on behalf of the CCP by a settlement agent. To mitigate the operational risk of failure of a settlement agent, a CCP may put into place dual arrangements with settlement agents as a backup. To ensure equal access and avoid the back-out risk identified, CCP accounts should rank equally for settlement in the CHES batch and supports the s5.2.3 proposal for “materially equivalent settlement arrangements”, this will ensure that ASX does not gain an unfair advantage and reduce back-out risk.

Q12. Are there any other factors related to financial stability that should be considered?

LCH has no comment

Q13. To what extent do you consider that application of risk-management standards consistent with the CPSS-IOSCO Principles for financial market infrastructures would mitigate the risk of a race to the bottom?

LCH fully supports the requirement for CCPs to be in compliance with international risk management standards such as CPSS-IOSCO. Proliferation of competition should not result in sub-standard risk controls. However this is dependent on robust and vigilant supervision and enforcement by global supervisors of these standards. In general we would welcome a levelling-up of standards e.g. to the “cover two” principle in force in Europe under EMIR.

Q14. To what extent do you consider that exit plans and ex ante commitments would mitigate the risk of instability in the event of the exit of a competing CCP?

LCH agrees that ex ante commitments and exit plans would mitigate any risk of instability.

Q15. Do you have views on what ex ante commitments might be reasonable and how these might be imposed without creating barriers to entry?

LCH fully supports UK RIEs’ Ex ante requirements. We believe the six months’ wind-down time period as defined under CPSS-IOSCO is appropriate provided CCPs have in place robust plans.

Q16. To what extent do you consider that location requirements could help to mitigate the risk of diminished regulatory influence and control in the event that an overseas-based CCP provided clearing services for ASX securities?

Q17. Do you have views on what location requirements – and other measures to enhance regulatory control and influence – might be reasonable in the case of clearing ASX securities and how these might be imposed without creating unnecessary impediments to entry?

Answer to Q16 & Q17: LCH believes that in order to provide a cost effective service, location requirements should not be so onerous as to disadvantage an overseas CCP vis-à-vis the incumbent. As a global clearing house servicing multiple jurisdictions – both in terms of members and trading venues – over multiple timezones, LCH demonstrates that it can service its members and clients in co-operation with multiple regulatory regimes, given effective supervisory co-operation.

LCH believe that location requirements should be commensurate with the size of risk that is undertaken and agrees it must be applied flexibly, proportionally and in a graduated basis.

Q18. Do you have views on what would constitute appropriate settlement arrangements for non-ASX CCPs?

See answer to Q11

Q19. Do you have views on what would constitute a reasonable basis for co-operation with overseas regulators?

LCH has no comment

Q20. Can you suggest any other responses to the issues raised in relation to financial stability?

LCH has no comment

Q21. Do you have views on the effectiveness of the existing policy and legislative framework in addressing access to ASX Settlement?

LCH has no comment

Q22. Do you have views on whether transitional or longer term regulatory arrangements would be most appropriate in addressing any potential issues that could emerge in relation to competition and access to ASX Settlement?

LCH believes that transparent, non-discriminatory rules should be set in place to allow the introduction of interoperability. LCH believes that the development of transitional arrangements and/or a regulatory framework should not provide an opportunity for delay and hence an undue advantage to the incumbent CCP – ASX Ltd. A clear, defined timetable for regulatory arrangements should be set to provide clarity to market participants. In the absence of orderly and prompt direction, Australian market participants will continue to face high costs and barriers to efficiencies.

Q23. Can you suggest any other options (regulatory or non-regulatory) to address any potential issues that could emerge in relation to competition and access?



Access must not allow ASX to claw back lost revenues by setting a barrier to entry through pricing of its Settlement services to equivalent CCPs.

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We urge the Council to consider these arguments carefully. No CCP is more concerned about the safety of the world's financial markets than LCH.Clearnet and our history fully bears this out. The prospect of ensuring a safe, and efficient and Australian financial system does, in our view, depend on facilitating competition in the ways we have described in this response.

Yours faithfully

A handwritten signature in blue ink, appearing to read "Alberto Pravettoni", written over a horizontal line.

Alberto Pravettoni

Chief Executive Officer Repo and Exchanges