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**CONSULTATION PAPER – COUNCIL OF FINANCIAL REGULATORS:
COMPETITION IN CLEARING AND SETTLEMENT IN THE AUSTRALIAN
EQUITIES MARKET
SUBMISSION BY STOCKBROKERS ASSOCIATION OF AUSTRALIA**

Preliminary Comments

The Stockbrokers Association of Australia is the peak industry body representing institutional and retail stockbrokers and investment banks in Australia. Our membership includes stockbroking firms across the spectrum, ranging from the largest wholesale investment banks firms to medium-sized firms and down to the smallest retail firms.

The Stockbrokers Association is pleased to provide this submission to Treasury in relation to the Council of Financial Regulators (CFR) Discussion Paper on *Competition in the Clearing and Settlement of the Australian Cash Equities Market - June 2012..*

The Association has a strong commitment to the growth of Australia's markets, particularly the Cash Equities Market, and to fostering Australia's role as a regional financial centre. In this regard, it is critical in our view that a robust regulatory framework is maintained that maintains the balance between fostering innovation and

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competition whilst at the same time maintaining the integrity and high standing of Australia's securities market.

The Association believes that the CFR has identified the correct issues for consideration in relation to potential competition in clearing and settlement in the cash equities market.

The Association has for some time, and in particular, in previous submissions to Treasury in relation to the Review of Financial Market Infrastructure, registered in-principle support for competition, and for the potential for financial benefits, including efficiencies and innovation, that the market stands to gain from competition. In the Association's view, it is important that the regulatory framework does not shut Australia out from these potential benefits.

The Association's in principle support for competition extends to the area of clearing and also potentially to settlement of cash equities.

Having said that, the Association agrees with the conclusion reached by the CFR that there has not been any support that our members have identified for competition in the area of settlement. Our members recognise the effectiveness of Australia's settlement system, and we also agree with the CFR that there are merits in having a single system for establishing title.

Hence, unless compelling reasons can be identified for the introduction of competition in settlement, which we do not presently see, then we agree with the focus of the Discussion Paper on questions relating to competition in clearing.

As regards the potential introduction of competition in clearing, there are three key objectives that must be satisfied before a decision is made to go down this path.

First, the benefits of introducing competition must clearly exceed the costs that would be involved. We have recently seen the introduction of competition in exchange services generating a level of costs which may ultimately prove to outweigh the benefits of market competition. There is little benefit to be gained from introducing competition in clearing if a similar outcome were to arise in this area as well.

It is vital that the regulatory framework which is settled on does not saddle the industry with compliance costs and other cost recovery levies that render the benefits of competition nugatory.

Secondly, introducing clearing competition should assist in furthering the competitive ability of Australia's cash equities market in the region. It is a key government policy objective to further Australia's position as a regional financial centre, and it must be closely evaluated whether this is best done by introducing clearing competition, or

alternatively, whether there might be a case that retaining a single clearing facility may be a better springboard for achieving that outcome.

Thirdly, financial stability and investor confidence are of utmost importance. Investor confidence in cash equities is at a low point as a result of market events over the last five years, not limited to the Global Financial Crisis but also including the rapid increase in complication of market trading. The growth of electronic trading, high frequency trading, multiple markets and dark trading venues may well be affecting the confidence of investors in feeling that it is safe to invest in the cash equities markets.

It is critical that this confidence not be further undermined by any perception that competing clearing facilities will increase systemic risk, or a perception that investors will not be as well protected, or even a perception that operations of the market will simply become too complicated to understand.

Set out below are our specific comments addressing individual Questions in the Discussion Paper. We have not sought to address all of the specific questions, as much would depend on the detail of the competition model being proposed.

FEEDBACK QUESTIONS

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

In principle, yes. There are ample instances of competition having been introduced in overseas markets such as in North America and Europe. There is no reason or particular features of the Australian cash equities market which would prevent competition from being introduced here.

Our conclusion of course is subject to our comments noted in the Preliminary Comments section above. The introduction of competition must be cost effective, and not result in increased cost to market participants.

Close consideration will need to be given to the size and turnover of the Australian cash equities market to ensure that the market is able to carry any increase in cost burden. The degree to which costs including regulatory and compliance costs are not able to be strictly contained could be critical, given that our markets are smaller than the overseas comparisons where competition in clearing is in place.

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?

We refer to our Preliminary Comments above. We agree that there is no call for competition in settlement at the present time. There is familiarity and satisfaction with the CHES system.

The key issues in the Association's view is the safeguarding of ASX's settlement facility and access to it on proper commercial terms. The listed equity market in Australia is highly efficient, and relies on the ASX settlement system to achieve this. The CHES system is a key component of Australia's financial market infrastructure.

It is essential that the availability of, or continued efficiency of, the CHES system to be maintained, and not be reliant on any issue arising from a change of control of ASX, or of changes to the commitment to maintaining the system or funding its ongoing development.

Questions of access to CHES including by competing exchange market operators must satisfy Australian Competition laws.

Effect of fragmentation on participants

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

Yes

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?

Some members have raised with the Association similar concern to that raised in the Discussion Paper in relation to mid to small cap stocks.

The concern is that the cost of clearing in that mid to small cap sector could be impacted should competing clearer(s) focus on securing profits that may be available in clearing more liquid stocks only. Some members consider that there is a real possibility that the cost of clearing mid to small cap companies could well rise in that event.

The listed equity market is now more vital than ever for mid to small cap companies. As this sector of the market finds it increasingly difficult to secure

funding through traditional forms of borrowing for expansion, exploration, research and development , and so on, all of which are vital to Australia's economic growth, the sector is highly reliant on the equities market to support the raising of funds through new issues.

This has been reflected in the attempts by ASX to facilitate capital raising in this sector. It is important that positive initiatives are not undermined by any adverse developments, such as increased transaction costs in the secondary market, which may follow if clearing costs for this sector were to be impacted adversely by selective competition in clearing. An efficient secondary market is vital to the effective operation of the primary market for capital raising.

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

There is widespread comment to the effect that investor confidence in the cash equities market has fallen. Whilst this is likely to be the result of the fall in the value of equities as a consequence of the Global Financial Crisis, it is also suggested that confidence has been impacted by the rapid increase in transaction speed, the use of algorithms and High Frequency Trading strategies. Falling investor confidence has been highlighted globally, and not just in relation to the Australian markets.

Whilst these issues fall to be addressed by regulators separately, the question of falling investor confidence is relevant to the issues under consideration here on the basis that the introduction of competition in cash equities clearing would need to be managed in a way that does not further impact on investor confidence.

Investors must feel that their fund are safe from systemic risk, and that there is no increase in risk of exposure to counterparties or failure of a CCP and that margins and collateral are accessible when required.

In the context of investor confidence, the question of a suitable guarantee fund for investors needs to be considered. Certain claims might properly fall within the intended scope of the existing National Guarantee Fund, and others may not. The extent to which the NGF does or does not apply should be resolved at the outset, having regard to the limited amount in the Fund. Any gaps should be covered by suitable alternative investor protection.

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?

Competition has the potential to deliver positive benefits in terms of innovation. It is also hoped that one benefit of competition would be to drive a reduction in transaction costs through lower clearing fees.

The Australian cash equities market has demonstrated the tendency to be extremely competitive. There is always the possibility that extreme levels of competition in clearing could manifest itself through lowering standards to attract flow. This could potentially be in standards of conduct, risk management requirements, or required margin or collateral requirements.

Where any of these are lowered to the point that they were to create levels of financial risk that were unacceptable, then we would look to the relevant regulators to ensure that standards were imposed that ensured that financial stability and investor protection were not jeopardized.

Whilst the Association does not support regulation for regulation's sake, and is keen to ensure that any new regulatory requirements only be introduced if they satisfy a robust cost benefit analysis, we would expect that relevant regulators should be given the powers necessary to ensure that the clearing of cash equities was not weakened by reckless competition, if that were to occur.

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

We believe that the exit of CCP's could have the potential to destabilise the cash equities market. Competing CCP's, being commercial operations, could be expected to reassess their commitment to remaining in this market if commercial objectives were not being met. It is extremely important both for the stability of the equities market, and also for investor confidence, that CCPs did not exit from the market at short notice. There would need to be firm conditions imposed on the relevant licence to manage any exit in an orderly fashion.

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

A critical factor for financial stability and for investor protection are satisfactory controls over the availability of collateral, margins, investor funds and other relevant financial liquid capital.

In our previous Submission on Financial Market Infrastructure, we noted that there may be a tension between potential CCPs seeking to achieve efficiencies on a global scale, especially in relation to the utilization of funds including netting, the use of global IT and other system infrastructure, and the need for the availability of funds to be safeguarded in this jurisdiction when access to the funds is needed.

Recent events has illustrated the danger that funds transferred offshore may be come caught by offshore legal or insolvency rules and may be not be accessible locally when required, unless robust requirements are put in place to ensure that this does not arise.

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

Please see the comments in our answer to Question 12 above.

We would be happy to discuss any issues relating to this matter at your convenience. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3207 or email pstepek@stockbrokers.org.au .

Yours sincerely,



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