

Safe and Effective Competition in Cash Equity Settlement in Australia: Response to Consultation

A Response to Consultation by the
Council of Financial Regulators

September 2017

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1. Introduction and Background

In March 2016, the Government endorsed the recommendations of a 2015 review of competition in clearing cash equities in Australia (the Review), conducted by the Council of Financial Regulators (CFR) in collaboration with the Australian Competition and Consumer Commission (ACCC) (together, the Agencies).¹ In October 2016 the Agencies released two policy statements: *Regulatory Expectations for Conduct in Operating Cash Equity Clearing and Settlement Services in Australia* (Regulatory Expectations); and *Minimum Conditions for Safe and Effective Competition in Cash Equity Clearing in Australia* (Minimum Conditions (Clearing)).²

These policy statements were developed based on the assumption that the prevailing market structure in settlement (in which ASX Settlement Pty Limited (ASX Settlement) is the sole provider of settlement services) would continue, at least for the foreseeable future. However, the Agencies are aware that industry developments (such as the emergence of new technologies) may challenge the previous assumptions regarding the future market structure for settlement services. In addition, the statutory framework (Part 7.3 of the *Corporations Act 2001* (Corporations Act)) applies to both clearing and settlement. This has prompted the Agencies to consider the need for specific policy guidance in respect of competing securities settlement facilities (SSFs).³

In March 2017, the Agencies released the consultation paper: *Safe and Effective Competition in Cash Equity Settlement in Australia* (the Consultation Paper), which sought views on whether the prospect of competition in the settlement of cash equities in Australia may have increased, and invited feedback on the development of policy guidance for such competition.⁴ The Consultation Paper did not review the policy case for competition in settlement, noting that the Government has endorsed a position of openness to competition.⁵

The Consultation Paper defined settlement as the transfer of securities in exchange for payment (i.e. the delivery-versus-payment (DvP) process). The paper also acknowledged that there are a range of services that are ancillary to settlement, and sought feedback on the contestability of these services. The Consultation Paper discussed a number of potential implications of competition in settlement, including for the efficient functioning of markets, financial stability and access. It also presented some potential controls to support safe and effective competition, should it emerge. In developing these potential controls, the Agencies had regard to the structure of the Minimum Conditions (Clearing).

1 See *Review of Competition in Clearing Australian Cash Equities: Conclusions, A Report by the Council of Financial Regulators*, June 2015 available at: <<http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Review-of-competition-in-clearing-Australian-cash-equities>>.

2 The Regulatory Expectations apply to the Australian Securities Exchange's (ASX) engagement with, and provision of services to, users of its monopoly cash equity clearing and settlement services, for both ASX-listed and non-ASX-listed securities. The Minimum Conditions (Clearing) establish a set of minimum conditions to support safe and effective competition should a competing provider of clearing services emerge. These policy statements establish a flexible policy framework so that if competition in clearing were to emerge, the Minimum Conditions (Clearing) would apply while the Regulatory Expectations would continue to apply to the provision of ASX's ongoing monopoly settlement service. The policy statements are available at: <<http://www.cfr.gov.au/media-releases/2016/mr-16-02.html>>.

3 The Agencies' consideration of the need for specific policy guidance was limited to the circumstance when trades in the same listed cash equity security could be settled in more than one SSF. The Agencies did not consider the need for policy guidance on the potential emergence of competition in the settlement of other listed or unlisted products.

4 The Consultation Paper is available at: <<https://www.cfr.gov.au/publications/consultations/safe-and-effective-competition-in-cash-equity-settlement-in-australia/pdf/consultation-paper.pdf>>.

5 The media release announcing the Government's openness to competition is available at: <<http://sjm.ministers.treasury.gov.au/media-release/034-2016/>>.

This response to consultation summarises the key feedback from stakeholders (Section 2) and the Agencies' views on how this feedback should be addressed within the policy framework (Section 3). Where a summary of industry feedback is provided, the views presented are those of industry.

In line with this, the Agencies have published the *Minimum Conditions for Safe and Effective Competition in Cash Equity Settlement in Australia* (Minimum Conditions (Settlement)), which provide a set of controls for competition in settlement of cash equities in Australia.⁶ Similar to the Minimum Conditions (Clearing), the Agencies would expect to periodically review the Minimum Conditions (Settlement), including in the event of material changes to the operating environment or market structure, such as the emergence of a competing SSF. In light of this work, the Agencies have also reviewed the Regulatory Expectations and Minimum Conditions (Clearing) and made some minor consequential changes to ensure consistency of the language used across the policy statements.

2. Overview of Consultation Responses

The Agencies received 13 written responses to the Consultation Paper and held nine bilateral meetings with stakeholders. These stakeholders included licensed market operators, brokers, custodians, prospective providers of settlement services, share registries and industry bodies.

Stakeholder feedback to the consultation focussed on four main themes:

- the likelihood of competition in settlement (and the associated potential risks and costs);
- competition in services ancillary to settlement;
- existing barriers to entry (including access to services (including data)); and
- the proposed controls to support safe and effective competition should it emerge.

These four themes are discussed further below.

2.1 Likelihood of Competition in Settlement

Most stakeholders agreed that the prospect of competition in settlement has increased since the Agencies completed the Review in 2015. A majority of respondents attributed this to developments in technology, in particular, the emergence of distributed ledger technology.

Almost all stakeholders were concerned about the potential risks and inefficiencies that could arise from a market structure with competing SSFs. For example, some stakeholders expressed concerns regarding the duplication of effort required to process and reconcile information across multiple SSFs. Other concerns related to the additional costs and risks of connecting to more than one SSF.

Most responses also suggested that the potential for shortened settlement cycles and, particularly, differing settlement cycles across competing SSFs may increase operational risks and costs.⁷ Approximately half of the respondents questioned whether potential benefits of competition, such as lower prices, would be outweighed by additional costs associated with increased complexity. However, almost half felt that competition was desirable provided adequate regulatory safeguards were in place.

6 The Minimum Conditions (Settlement) are available at <<https://www.cfr.gov.au/publications/cfr-publications/2017/minimum-conditions-safe-effective-competition/pdf/policy-statement.pdf>>.

7 The risks arising from real-time settlement and the optionality of shorter settlement timeframes are not unique to a market structure with competing SSFs, but would also arise in the event that a single SSF sought to offer such optionality. The concerns expressed by stakeholders related to market fragmentation as a result of these differing timeframes and are discussed further in section 2.4.

Some responses indicated it was possible competition would emerge for a subset of settlement services. This may include the DvP settlement function of title transfer or other Clearing House Electronic Sub-register System (CHES) services which occur in connection with this function, including corporate actions processing, sub-registry services and payment facilitation.

2.2 Competition in Ancillary Services

The Consultation Paper noted that there are a number of services ancillary to settlement, such as asset registration, safekeeping, issuer services (e.g. corporate actions) and investor services. The respondents provided a range of comments on these services, especially on their contestability and the interdependence with a DvP settlement service. Most respondents believed a competing SSF would need to provide at least some ancillary services in order to effectively provide a DvP settlement service. However, some suggested that as long as a competing SSF had access to the data held on the CHES sub-register (or its replacement), it could effectively provide DvP settlement without also providing ancillary services.⁸

Some respondents noted that the range of ancillary services provided by ASX Settlement on a monopoly basis is limited, and that many ancillary services are already offered through the registries on a competitive basis. There were mixed views on whether competition has been beneficial for the provision of ancillary services. For example, several submissions noted that each of the registries use different processes and systems and that this results in some inefficiencies due to a lack of standardisation and automation (e.g. corporate actions processing). On the other hand, other stakeholders felt that competition among the registries had encouraged innovation – a primary example being the provision of securities holding statements in electronic form. At the same time, some submissions noted that competitive pressures had led to pricing benefits for certain services offered by the registries.

Some stakeholders noted that ASX's ongoing issuance of securities holding statements in hard copy was evidence of a lack of innovation. Some stakeholders also considered the fees charged for these statements to be excessive.

Several responses argued that, in order to improve the provision of ancillary services, promoting competition in ancillary services independently of competition in DvP settlement should be a priority.

2.3 Barriers to Entry – Access to Services (including data)

A large majority of stakeholders raised concerns over perceived barriers to entry for a competing SSF. The two main themes across the submissions centred on access to the data in the CHES sub-register and concerns around ASX's vertically integrated market structure. Some respondents also noted practical and commercial considerations such as the small scale of the Australian cash equities market and the significant costs of developing a settlement system.

Almost all respondents expressed the view that, for competition in settlement to be effective, any competing SSF would need to be able to access data in the CHES sub-register or its replacement (e.g. holder identification and securities holdings data).⁹ Access to other ASX monopoly services deemed necessary for competition was also mentioned by a majority of stakeholders. This may be required, for

8 Most corporate actions are currently performed by the registries and facilitated by access to information contained in the CHES sub-register. Examples of corporate actions performed by registries include dividend payments, rights issues, share buy backs and capital reconstructions. The Agencies acknowledge that the ASX project to replace CHES may impact competition in clearing and settlement. This is provided for in the Regulatory Expectations.

9 The listed cash equities supply chain begins with the issuer-requested registration of a cash equity on an approved listing market and continues through the trading, clearing and/or settlement functions, ending with the final registration of the (new) owner of the cash equity on the CHES sub-register (which subsequently updates the registries' records).

example, to ensure legal certainty of settlement. Such services may include securities conversions and transfers between the CHES and issuer sub-registries, and the issuance of CHES holding statements.

Some respondents also argued that the data currently held in the CHES sub-register should be provided by an independent utility service, in order to better facilitate competition across the Australian cash equities market. Some respondents suggested that settlement services more broadly (including DvP settlement) should be provided by an industry utility.

A second theme that emerged from a majority of the responses was concern around the current interdependency of the ASX Group's vertically integrated structure, which provides listing, clearing, settlement, CHES sub-registry and other ancillary services. These submissions argued that this structure inhibited competition and encourages anti-competitive behaviour.

One submission suggested that, to facilitate genuine competition, the ASX Group should be operated as distinct functional entities (e.g. one for each of trading, clearing, settlement, registration) to address concerns around its vertically integrated structure.

2.4 Proposed Controls to Support Safe and Effective Competition

Stakeholder feedback generally supported the policy controls proposed in the Consultation Paper to support fair and effective competition in settlement. However, some respondents also argued the controls may need to go further. The majority of submissions commented that establishing appropriate links between competing SSFs would be required for effective competition. Some respondents argued that any policy guidance needs to make appropriate arrangements for a set of common principles for SSF rule-making, for instance to ensure certainty and integrity of legal title.

There were mixed opinions on whether new policy is needed to deal with default management where, for example, a defaulting entity may be a settlement participant in competing SSFs. While some respondents thought it was important that regulators be involved, some instead considered default management to be primarily the responsibility of the central counterparty. Some of the submissions highlighted the difficulty in determining 'fair and reasonable pricing', and one wanted explicit regulatory oversight of pricing. Another also specifically suggested a review of ASX's pricing policies for non-Clearing and Settlement services.

The Consultation Paper asked for feedback about the potential effects of a competing SSF providing the choice of settlement timeframe and/or SSF as part of contract formation on a licensed market. Specifically, the Australian Securities and Investments Commission (ASIC) had concerns that this model may fragment market liquidity (e.g. from retail investors, institutional investors and proprietary traders), based on preferences of settlement timeframe, and/or SSF. A majority of submissions agreed with this concern.

More broadly, some stakeholders suggested that real-time settlement may only be particularly beneficial for retail clients (who typically pre-deliver securities and cash to their broker before placing orders). Stakeholders also broadly accepted that institutional clients (particularly overseas clients) would prefer a longer settlement cycle due to their trade netting and settlement matching needs. In contrast, one stakeholder thought that, although fragmentation of liquidity is more likely in a competitive post-trade environment, technology could overcome this problem with improved reporting and system interoperability.

There were also some different views over whether settlement timeframes and changes to other market infrastructure arrangements should move on a whole-of-market basis or in a more fragmented manner driven by individual SSFs. In a similar vein, there were differing views over which entities in the investment chain should make the choice of which SSF to use and, potentially, the resultant settlement period.

2.5 Other Issues

A number of other issues were raised by stakeholders:

- Almost half of the submissions made comments related to the CHESSE replacement project. For instance, there were some concerns the CHESSE replacement project will further entrench the monopolistic vertically integrated structure currently in place.
- One stakeholder called for the Agencies to expand the scope of the current consultation to include an end-to-end review of competition throughout the equities market (from listing, through trading, clearing and settlement, to registration).
- Some submissions commented on current registry arrangements, for example, noting the costly nature of the fragmented sub-register system. In addition, one respondent argued to change the Australian 'name-on-register' model to a central securities depository model) – although other submissions supported the current model.
- Some respondents expressed concerns that the Corporations Act and *Corporations Regulations 2001* (Regulations) need to be amended to allow the licensing of an entrant SSF given the legacy references to ASX Settlement and Transfer Corporation Pty Limited or ASTC (the former name of ASX Settlement) in these instruments.
- Some respondents were concerned about the perceived suggestion in the Consultation Paper that the Agencies were considering the mandatory imposition of clearing for all markets. The Agencies would like to make clear that they do not propose to impose mandatory clearing requirements for listed securities over and above existing regulatory obligations for the clearing and settlement of these securities.
- One submission suggested that licence conditions be imposed on ASX to enforce compliance with the Regulatory Expectations and the Minimum Conditions or, failing this, fast tracking the legislative amendments recommended to the Government, in order to grant rule-making and arbitration powers to the relevant Agencies.

3. Response to Consultation Feedback

Given strong stakeholder support for the development of policy guidance on the possible emergence of competition in settlement, the Agencies have decided to extend the existing policy framework for competition in clearing. Consequently, the Agencies have published the Minimum Conditions (Settlement), to support safe and effective competition in the settlement of cash equities, should it emerge.

Relatedly, as a result of the substantive feedback from stakeholders, the Agencies also reviewed the Regulatory Expectations and Minimum Conditions (Clearing) to assess whether any consequential changes were required to address the potential emergence of a competing SSF. Minimal changes were made to these policy statements, including noting the increased likelihood of competition in settlement.

Similar to the Minimum Conditions (Clearing), the Minimum Conditions (Settlement) aim to give prospective providers of settlement services sufficient clarity as to the measures that ASIC and the Reserve Bank of Australia would require be taken before they could advise in favour of a licence application.

The Minimum Conditions (Settlement) build off the controls proposed in the Consultation Paper. In response to consultation feedback, the Agencies have amended the controls as initially proposed, to incorporate a clarification and two additions, as follows:

- *Access on transparent, non-discriminatory, and fair and reasonable terms:* The Agencies acknowledge that in order to offer safe and effective settlement services, competing SSFs are likely to require access to the data of other Clearing and Settlement (CS) facilities. The Minimum Conditions (Settlement) specifically address stakeholder concerns about access to certain data necessary for the provision of settlement services by a competing SSF. CS service providers will be required to facilitate access to their respective services (including data) on a transparent and non-discriminatory basis, with terms and conditions, including price, that are fair and reasonable. The Agencies note that the Government is implementing legislative changes that will grant the ACCC power to arbitrate disputes about the terms of access, including pricing. The Agencies recognise that certain ancillary services are necessary to support the provision of DvP settlement. Those ancillary services necessary to DvP settlement will ultimately be a function of each SSF's business model, and may change over time (including due to ASX's CHES replacement project).
- *Appropriate arrangements for certainty of securities transfer and administration:* An additional control has been included to address concerns regarding certainty of securities transfer and administration. There may be circumstances under which registries, acting on behalf of issuers, receive conflicting instructions from competing SSFs, related to the same listed security. The registry will need to determine how to prioritise those instructions to ensure the resulting change of title to the securities is legally certain. Accordingly, the Agencies consider there is a case, if required, for regulatory arrangements to support certain aspects of the legal relationship between competing SSFs, registries and issuers.
- *Appropriate regulatory arrangements for oversight of primary and secondary markets:* This additional control recognises ASIC's strong regulatory interest in the potential impact on price formation, liquidity and fragmentation in markets where there is a choice offered between settlement timeframes at the point of trade execution. The purpose of the control is to alert potential entrant SSFs that including a choice of settlement timeframe in their business case may have implications for any CS facility licence application. ASIC would therefore have a regulatory role in any proposal in which the choice of settlement timeframe and/or SSF might have potential market impacts.

Regarding stakeholder feedback on default management arrangements, the Agencies' expectation is that application of the existing regulatory framework for CS facilities in a multi-SSF environment should be sufficient to address any additional risks.

Stakeholder feedback suggests it is possible that competition could emerge from either a competing full service SSF or from a facility which provides a select number of settlement services only. In the latter case, the Regulatory Expectations will continue to apply to the remaining subset of monopoly CS services. Complementing this, the Minimum Conditions (Settlement) will apply to the contested settlement services.

3.1 Other Issues

As noted above, stakeholders also raised several broader points in their responses to the consultation. The Agencies' responses are outlined below.

- *Appropriate market structure for settlement services:* Consistent with the conclusions drawn from the Review, the Agencies consider that the most appropriate market structure for SSF services should be determined by the market. Comments related to current registry arrangements were considered by the Agencies but remain outside the scope of the policy aims of the consultation.
- *Broader review on competition in listed cash equities markets:* The Agencies' view is that a broader end-to-end review on competition in listed cash equities markets (i.e. from listing through trading, clearing and settlement, to registration), is not in the scope of the current consultation. ASIC has completed significant work on the structure of cash equity markets in Australia, including the development and implementation of ASIC rules to preserve market integrity following the

introduction of competition between market operators. ASIC's policy work in cash equity market structure, including competition, is ongoing. This work, together with the Agencies' published policy framework for competition in clearing and the proposed Minimum Conditions (Settlement) effectively establishes a policy framework for safe and effective competition in the listing, trading, clearing and settlement of cash market equities in Australia. ASIC and the ACCC will discuss stakeholder feedback relevant to the equity market structure in Australia, and the potential for future policy collaboration on competition.

- Data access issues for settlement services: In its consideration of data access issues, the Agencies were mindful of the recently released Productivity Commission Inquiry Report on Data Availability and Use.¹⁰ The Agencies will give consideration to the investor and market infrastructure data implications with respect to future developments in the Government's data policy.
- Productivity Commission Inquiry: The Productivity Commission is also currently conducting a broader inquiry into competition in the Australian financial system, having released a consultation paper on 6 July 2017. The Productivity Commission has announced its intention to avoid overlap with other active reviews. The Agencies will engage with the Productivity Commission on the CFR's established policy framework on competition in clearing and settlement for Australian cash equities and the Government's announced reform package.
- CHES replacement project: The Agencies acknowledge that ASX's CHES replacement project may have a significant impact on the market, and may interact with the issues discussed in the Consultation Paper. The Regulatory Expectations, which apply to ASX's engagement and provision of services to users of its monopoly cash equity CS services, establish the Agencies' expectation that ASX will provide commercial, transparent and non-discriminatory access to its monopoly CS services.
- References in the Act and Corporations Regulations to ASX Settlement and Transfer Corporation Pty Ltd: Treasury will consider changes to amend legacy references (such as ASTC) in the Corporations Act and Regulations as part of the development of draft legislation to implement the Government's announced reform package.

4. Next Steps

Along with this response to consultation, the Agencies have concurrently published the Minimum Conditions (Settlement), consequential amendments to the Regulatory Expectations and the Minimum Conditions (Clearing).

The Agencies will work with the Government on the development of draft legislation to fully implement the policies set out in the Regulatory Expectations, the Minimum Conditions (Clearing) and the Minimum Conditions (Settlement). The draft legislation will incorporate changes to the Corporations Act to implement rule-making powers for the relevant Agencies and an arbitration power for the ACCC.

As noted above, the Agencies will engage with the Productivity Commission on the Government's announced reform package to regulate both the ongoing provision of ASX's monopoly CS facilities services for Australian cash equities, and the potential emergence of competition in these services.

¹⁰ The Productivity Commission's Inquiry Report on Data Availability and Use is available at: <http://www.pc.gov.au/inquiries/completed/data-access/report>.