

Application of the Regulatory Expectations for Conduct in Operating Cash Equity Clearing and Settlement Services in Australia

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Introduction

In October 2016, the Council of Financial Regulators (CFR) and the Australian Competition and Consumer Commission (ACCC) (together, the Agencies) released the *Regulatory Expectations for Conduct in Operating Cash Equity Clearing and Settlement Services in Australia* (Regulatory Expectations). The Regulatory Expectations were revised in September 2017.¹

The Regulatory Expectations are intended to support the long-term interests of the Australian market by delivering outcomes that are consistent with those that might be expected in a competitive environment. In particular, the Regulatory Expectations seek to ensure that ASX remains responsive to users' evolving needs and provides access to its monopoly cash equity clearing and settlement (CS) services on a transparent and non-discriminatory basis with terms and conditions, including pricing, that are fair and reasonable.

The Regulatory Expectations take a largely principles-based approach to describing the conduct expected of ASX as a monopoly provider of cash equity CS services. This ensures that the Regulatory Expectations can be applied broadly as ASX's services and the needs of its users evolve. However, in some cases the application of these broad principles to specific circumstances may be unclear. The CFR and the ACCC have therefore determined that it is appropriate to provide additional guidance on how the Regulatory Expectations apply in certain specific circumstances, in the *Application of the Regulatory Expectations for Conduct in Operating Cash Equity Clearing and Settlement Services in Australia* (the Applications). The first such set of circumstances concerns access to clearing services by a licensed listing market that is unaffiliated with ASX.

The Agencies expect ASX to comply with the Applications. Certain users of ASX's CS services, such as listing markets, are also expected to comply with the Applications, where necessary to complement actions expected of ASX and in accordance with the user's broader regulatory obligations.

The Agencies may also amend or add to the Applications to provide guidance that addresses any future scenarios or developments in the operation of cash equity CS services in Australia.

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Summary of the Regulatory Expectations

The Regulatory Expectations apply to ASX's engagement with, and provision of services to, users of its monopoly cash equity CS services for both ASX-listed and non-ASX-listed securities. Users are broadly defined to include participants of the ASX clearing and settlement facilities; end users; unaffiliated market operators, central counterparties (CCP) and settlement facilities; technology service providers; and other relevant stakeholders such as share registries.

The Regulatory Expectations cover:

1. User input into governance;
2. Transparent, non-discriminatory, and fair and reasonable pricing of CS services; and

¹ Available at <<https://www.cfr.gov.au/publications/policy-statements-and-other-reports/2016/regulatory-expectations-policy-statement/pdf/policy-statement.pdf>>.

3. Commercial, transparent and non-discriminatory access to CS services – service levels, information handling and confidentiality.

Should a committed competitor emerge for any aspect of ASX's cash equity CS services, the Agencies will review and make any necessary changes to the scope of the Regulatory Expectations. The Agencies also expect to review the Regulatory Expectations periodically, including to assess the ongoing appropriateness of the Regulatory Expectations and their effectiveness in delivering the intended outcomes. If the Agencies determine that the Regulatory Expectations require revision, the Agencies may also revise the Applications.

ASX is expected to act in accordance with the Regulatory Expectations. The Agencies acknowledge that the Regulatory Expectations are not legally enforceable under the existing legislative framework. The government has committed to pursue legislative changes that would grant the relevant regulators the power to make enforceable rules consistent with the Regulatory Expectations if these expectations were either not being met or were not delivering the intended outcomes.² These powers would be held in reserve and would be expected to be used only in the event of a material deviation from the Regulatory Expectations or where ASX's conduct was generating undesirable outcomes for the market.

Summary of the Applications

Principles applicable to the clearing of Australian listed securities (Schedule 1)

ASX Clear acts as the CCP for trades in ASX-listed securities. The Regulatory Expectations set out that ASX should also offer access to its cash equity CS services (including CCP services) on commercial, transparent and non-discriminatory terms to listing markets that are not operated by ASX. However, there is potential for ASX Clear and an alternative listing market operator to disagree on whether the listing and clearing of a particular security poses an acceptable risk, or complies with regulatory obligations or system requirements. It is important that any such disagreement is resolved in a manner consistent with the Regulatory Expectations, as well as the broader regulatory obligations of ASX Clear and the listing market operator.

The Agencies have developed principles that aim to provide further guidance on access to ASX Clear's CCP services in circumstances where the licensed listing market that is seeking access is not affiliated with ASX Group (the Open Access Principles). The Open Access Principles are set out in Schedule 1.

The Agencies determined it was important to provide greater clarity on the respective scope of the listing market licensing and CS facility regulatory framework regimes, and their interaction with the Regulatory Expectations.

The Open Access Principles have therefore been designed so that issues relating to the clearing of listed securities are dealt with under the CS facility regulatory framework, while issues relating to listing markets are dealt with under the listing market regulatory framework. The Open Access Principles also seek to ensure that all securities listed on a single trading board are subject to the same clearing and settlement arrangements, and that adequate risk management arrangements are in place to accommodate clearing of markets that list less liquid securities.

² Available at <<http://ministers.treasury.gov.au/ministers/scott-morrison-2015/media-releases/turnbull-government-open-competition-share-clearance>>.

Schedule 1 – Open Access Principles for a licensed listing market seeking access to ASX Clear

These principles are intended to apply in respect of the clearing of Australian listed securities only. They are not intended to cover (directly or by analogy) other situations, such as the ASX central counterparties' (CCPs) clearing of derivatives. The principles are ordered for logical flow and the order does not reflect their relative regulatory significance. The principles should be read in the context of the *Regulatory Expectations for Conduct in Operating Cash Equity Clearing and Settlement Services in Australia*.³

1. Each listing market is responsible for maintaining and enforcing high quality listing standards which support fair, orderly and transparent markets.
2. Each listing market should meet ASIC's listing principles (the Listing Principles).⁴
3. Not all listed securities have to be cleared, although all securities markets need to have adequate clearing and settlement arrangements.
4. Open access: ASX Clear should facilitate access to its cash equity CCP services by a competing listing market on non-discriminatory, transparent, fair and reasonable terms.
5. All listed securities on a single trading board should have the same clearing and settlement arrangements. That is, all securities on a single board should either be cleared or not cleared. ASIC's policy position is that different clearing and settlement arrangements should not be a source of bifurcation to a single board.
 - (a) This is distinct from having another board with different clearing and settlement arrangements. ASIC is not opposed to a market opting for different boards with different clearing and settlement arrangements.
6. CCP discretion not to clear contracts: ASX Clear should have the discretion not to clear certain cash market securities; however, liquidity thresholds for securities should not be a consideration in exercising this discretion (the direct credit risk from illiquid securities can be managed via other mechanisms, see Principles 8 and 9 below, although indirect risks may remain). It is expected that the use of this discretion not to clear a certain security is the exception rather than the norm. Consistent with this, the acceptable considerations for not clearing certain securities are:
 - (a) contract specifications are inconsistent with ASX's clearing and settlement systems, for example, the security is certificated;
 - (b) valid concerns with the legality or legitimacy of the issued security, for example, there are fraud concerns relating to the business of the issuer. Legality or legitimacy of the issued security would be of concern where the Listing Principles for admission criteria⁵ 'robust governance' or 'legitimate intent to access capital market' have not been met;
 - (c) the risk the security poses is unacceptable after discussion with:

3 Available at <<https://www.cfr.gov.au/publications/policy-statements-and-other-reports/2016/regulatory-expectations-policy-statement/pdf/policy-statement.pdf>>.

4 The Listing Principles are set out in Appendix 1 of ASIC Regulatory Guide 172: *Financial markets: Domestic and overseas operators*. Available at <<https://download.asic.gov.au/media/4720076/rg172-published-4-may-2018.pdf>>.

5 The Listing Principles specifically address admission criteria.

- i. ASIC as the listed market regulator; or
- ii. if the risk would have an adverse material impact on ASX Clear's compliance with the Financial Stability Standards and obligation to do all other things necessary to reduce systemic risk, the RBA,⁶ or

(d) any other considerations agreed to be acceptable by ASIC and the RBA.

Should ASX Clear have concerns under 6(a) or 6(b), it should raise the concerns with the listing market in the first instance. ASX Clear is not responsible for assessing compliance with the listing market's listing rules. The listing market should be given the opportunity to make the necessary enquiries to enable it to assess the validity of the concerns and, where applicable, take appropriate action in accordance with its licence obligations under the Corporations Act and Principles 1 and 2. In the event that the listing market and CCP have differing views on whether the concerns related to 6(b) are valid, and cannot resolve these on a timely basis, ASIC should be notified as the listing market regulator. After considering concerns raised under 6(b), ASIC will discuss with the RBA whether any of ASX Clear's concerns raised under 6(b) are relevant to risk management considerations under 6(c).

7. Contemporaneous and equivalent treatment of listed markets: If ASX Clear declines to clear certain securities due to one of the considerations under Principle 6, then any ASX-listed securities affected by the same consideration should be removed from clearing at the same time (i.e. contemporaneously). Any procedures that ASX Clear implements with respect to its discretion not to clear certain securities under Principle 6 should not differentiate between listing markets. They should apply equally to all markets cleared by ASX Clear.
8. Margin methodology – mitigating credit risk from participants that clear illiquid securities: ASX Clear is obliged as a licensed clearing and settlement facility that operates a CCP to impose margin requirements to mitigate the potential credit risk it has in the event of the default of a clearing participant. It has the right to charge reasonable margin add-ons based on liquidity metrics and to impose a longer margin period of risk. ASX Clear could also calibrate margin to the credit risk associated with clearing illiquid securities, which in extreme cases may be as high as 100 per cent. ASX Clear should consult on any changes to its margining of cash market equities to better capture risks associated with market liquidity. ASX Clear should not apply different margin methodology and models based solely on the identity of the listing market of a security (i.e. the margin methodology should be non-discriminatory).
9. Cash settlement of illiquid securities: To ensure that ASX Clear is able to close out its exposure to a defaulting participant with positions in an illiquid security, it would be appropriate for ASX Clear to have in place a rule allowing it to cash settle securities positions that it is unable to trade out of within a designated period. The rule should determine an appropriate price at which settlement would take place, which would have regard to the most recent settlement price. This price would determine the maximum exposure of ASX Clear to an illiquid security in the event of a participant default.

⁶ An example of an 'adverse material impact' of the type described would be where the RBA has assessed that addressing the risk in a defined timeline is required for ASX Clear to fully observe one or more Financial Stability Standards (i.e. it has resulted in ASX Clear being rated 'broadly observed' or below for such standards).