Safe and Effective Competition in Cash Equity Settlement in Australia

A Consultation Paper by the
Council of Financial Regulators

March 2017

Council of
Financial Regulators

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Consultation Process

Request for Feedback and Comments

This consultation paper seeks stakeholder views on the issues raised by the Council of Financial Regulators (CFR) in relation to competition in the settlement of Australian cash equities.

Submissions should include the name of your organisation (or your name if the submission is made as an individual) and contact details for the submission, including an email address and contact telephone number where available.

While submissions may be lodged electronically or by post, electronic lodgement is strongly preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and contact details) contained in submissions will be made available to the public on the CFR website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain confidential should provide this information marked as such in a separate attachment. Any future request made under the Freedom of Information Act 1982 for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

In addition to seeking submissions, the CFR will be conducting stakeholder consultation meetings during April 2017. Expressions of interest for a stakeholder consultation meeting are invited by 23 March 2017.

Closing date for submissions: **20 April 2017**

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Contents

1. Executive Summary

The Council of Financial Regulators (CFR), in collaboration with the Australian Competition and Consumer Commission (ACCC) (together, the Agencies), completed a review of competition in clearing of Australian cash equities in 2015.[1] Based on the findings of that review, the Agencies made recommendations on necessary policy guidance for safe and effective competition in clearing, which the government endorsed in 2016.[2] Importantly, the review was underpinned by an assumption that the prevailing market structure in settlement (in which there is a sole provider of settlement services) would continue, at least for the foreseeable future. However, the Agencies are aware that technological developments, such as the potential application of distributed ledger technology for clearing and settlement (CS) facilities, may challenge the previous assumptions regarding the future market structure for settlement services.

The purpose of this consultation, therefore, is to explore whether the prospect of competition in the settlement of cash equities in Australia may have increased and to invite feedback on the development of policy guidance for such competition. In this context, competition refers to the situation where trades in the same equity security could be settled in more than one securities settlement facility (SSF). This consultation does not review the policy case for competition in settlement, noting that the government has previously endorsed a position of openness to competition in both clearing and settlement.[3]

The first part of this paper provides an overview of current cash equity settlement arrangements in Australia and identifies three stylised market structures that might emerge following the entrance of a competing SSF. The consideration of possible market models is technology neutral. These models are presented to elicit feedback on the risks and policy issues that may arise under each market structure (and do not imply that any of these structures would be preferred or necessarily acceptable from a regulatory perspective).

The final sections of this paper discuss a number of potential implications for the functioning of markets, financial stability and access. The paper concludes by presenting potential controls for safe and effective competition. In developing these controls the Agencies have had regard to the Minimum Conditions (Clearing), which would be expected to apply to a central counterparty (CCP) if there was competition in clearing. Consequently, the structure of the potential controls envisaged for competition in settlement largely mirrors that of the Minimum Conditions (Clearing).

Nevertheless, the precise risks and policy considerations that arise from the emergence of competition in settlement will depend on the specific proposal of any potential competing SSF. The Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (the Bank) will only be in a position to conduct a detailed risk assessment when a CS facility licence application from a committed competing SSF has been received. An important regulatory consideration for ASIC, from a markets and listed entities perspective, would be any proposal in which the choice of settlement timeframe occurred as part of contract formation on a licensed market. Following the consultation process, the Agencies intend to advise the government on the need for any additional policy guidance.

1 The conclusions and the government's response are available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Review-of-competition-in-clearing-Australian-cash-equities>.
2 Ibid.
3 Ibid.

2. Background to Consultation

2.1 Rationale

On 30 March 2016, the government endorsed the recommendations of a review of competition in clearing Australian cash equities conducted by the Agencies in 2015 (the 2015 Review). These recommendations are set out in the Agencies' report, *Review of Competition in Clearing Australian Cash Equities: Conclusions* (the Conclusions). The government's endorsement of the Agencies' policy stance of openness to competition recognises that the prevailing legislative settings envisage competition, and this position is not under review.

As a result of the recommendations, in October 2016 the CFR 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)).[4] The Regulatory Expectations apply to the Australian Securities Exchange's (ASX) engagement with, and provision of services to, users of its monopoly cash equity CS services, for both ASX-listed and non-ASX-listed securities. The Minimum Conditions (Clearing) establish a set of minimum conditions to ensure safe and effective competition should a competing provider of clearing services emerge.

Together these policy papers 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 Agencies also recommended that the relevant regulators be granted rule-making and arbitration powers to impose requirements on ASX Group's cash equity CS facilities consistent with the Regulatory Expectations and the Minimum Conditions (Clearing). The government has committed to develop and consult on legislative changes in line with these recommendations.

The Regulatory Expectations and the Minimum Conditions (Clearing) were developed with reference to the prevailing market structure in settlement, in which there is a sole provider of settlement services. However, recent technological developments may increase the prospect of competition emerging in settlement. 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 SSFs. The timing of an entry into the market for settlement services in cash equities and the form of any such competing SSF would ultimately be determined by the market.

The purpose of this consultation is to invite feedback on the development of appropriate policy guidance for safe and effective competition in the settlement of cash equities in Australia. Following the consultation process, the Agencies will consider stakeholder submissions and advise the government of the findings in the form of policy guidance.

Similar to the Minimum Conditions (Clearing), the Agencies would expect to periodically review any policy guidance developed for competition in settlement, including in the event of material changes to the operating environment or market structure for these services, such as the emergence of a competing SSF.

In line with the Minimum Conditions (Clearing), ASIC and the Bank would be unable to recommend that the Minister grants a licence to a prospective competing SSF until the legislative amendments have been implemented. It is anticipated that those legislative changes would be included in the same legislative package relating to clearing. However, ASIC and the Bank would engage with any potential entrant in the interim and commence consideration of a licence application, should one emerge.

4 Available at <http://www.cfr.gov.au/media-releases/2016/mr-16-02.html>.

Questions

1. Has the emergence of competition in cash equities settlement become more likely than it was considered during the 2015 Review? Please elaborate on your answer.

2.2 Scope of this consultation

In its response to the 2015 Review, the government announced that it 'will consider any clearing or settlement facility licence applications on their merits as they arise' (after taking account of the CFR recommendations).[5] As previously stated, this position is not under review.

The scope of this consultation is the settlement of listed cash equities in Australia, and specifically the situation where trades in the same equity security can be settled in more than one SSF. In this context, the term 'settlement' is taken to refer to the transfer of securities in exchange for payment (i.e. the delivery-versus-payment process). This definition of settlement is consistent with the definition of a CS facility in the Corporations Act and the Bank's *Financial Stability Standards* (FSS).[6,7]

The Agencies are aware that there are a number of services that are ancillary to settlement services. While the Agencies are open to hearing feedback on issues concerning such ancillary services (and have included some specific questions in this paper to guide the discussion), these services are not the primary focus of this consultation. The Agencies also recognise that there are other means to settle financial obligations, for non-listed securities, other than through an SSF. Although the Agencies continue to monitor developments in the settlement of non-listed securities, this is beyond the scope of this paper.

2.3 Regulatory framework

Part 7.3 of the Corporations Act establishes conditions for the licensing and operation of CS facilities in Australia, and gives ASIC and the Bank responsibility for the regulation of CS facilities.

- The Bank is responsible for determining financial stability standards for licensed CS facilities and assessing compliance by those facilities with those standards and their obligation to do all other things necessary to reduce systemic risk, to the extent that it is reasonably practicable to do so.
- ASIC is responsible for ensuring CS facilities comply with other obligations under the Corporations Act, including to the extent that it is reasonably practicable to do so, to do all things necessary to ensure that the facility's services are provided in a fair and effective way.

ASIC and the Bank also provide advice to the Minister on any CS facility licence application. The Corporations Act specifies a number of matters that must be considered by the Minister in granting a CS facility licence, including whether granting the licence would be in the public interest.[8]

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5 Details of the 2015 Review and the recommendations that were endorsed by the government are available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Review-of-competition-in-clearing-Australian-cash-equities>.

6 Section 768A(1) of the Corporations Act states that 'a CS facility is a facility that provides a regular mechanism for the parties to transactions relating to financial products to meet obligations to each other that . . . arise from entering into the transactions.' Available at <http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s768a.html>

7 The Financial Stability Standard for Securities Settlement Facilities defines a securities settlement facility as a 'CS facility operated by an Australian CS facility licensee that enables its participants to transfer title to or other interests in securities, typically in return for payment.' Available at <http://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/standards/financial-stability-standards.html>.

8 The Minister (with the advice of ASIC and, on certain issues, the Bank) has formal responsibility for various matters under Part 7.3 of the Corporations Act, including granting, varying, suspending or cancelling a CS facility licence, granting exemptions from the requirement to hold a CS facility licence and making directions about the operation of a CS facility.

The application of the CFR's framework for ensuring that ASIC and the Bank retain sufficient regulatory influence over cross-border CS facilities operating in Australia is also relevant for a prospective competing CCP or SSF that is based overseas or foreign owned. This graduated framework imposes additional requirements on cross-border CS facilities proportional to the materiality of domestic participation, their systemic importance to Australia, and the strength of their connection to the domestic financial system or real economy.[9]

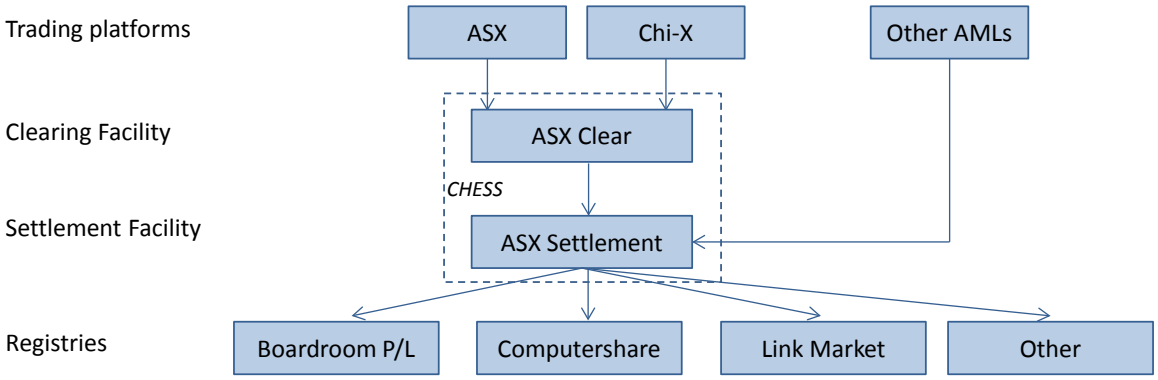
Finally, the ACCC is responsible for promoting competition and fair trading in the Australian economy under the *Competition and Consumer Act 2010*.

9 See CFR (2012), 'Ensuring Appropriate Influence for Australian Regulators over Cross-border Clearing and Settlement Facilities', July. Available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/%202012/cross-border-clearing>. Also see CFR (2014), 'Application of the Regulatory Influence Framework for Cross-border Central Counterparties', March. Available at <http://www.cfr.gov.au/publications/cfr-publications/2014/application-of-the-regulatory-influence-framework-for-cross-border-central-counterparties/>.

3. Current Cash Equity Settlement Arrangements

Securities settlement refers to the completion of a trade, wherein the seller transfers securities to the buyer and the buyer transfers money to the seller. Settlement of all exchange traded and reported cash equity trades in Australia is conducted by ASX Settlement Pty Limited (ASX Settlement) (Figure 1).[10] ASX Settlement provides settlement services for equities traded on Australian Market Licensees (AMLs) such as ASX (ASX Trade) and Chi-X Australia Pty Ltd. ASX Settlement also provides settlement services for transactions in non-ASX-listed securities undertaken on trading platforms operated by other AMLs, such as Sydney Stock Exchange Limited, the National Stock Exchange of Australia Limited and IR Plus Securities Exchange Limited (formerly SIM Venture Securities Exchange).

Figure 1: Current Market Structure



Settlement for Australian cash equities is conducted using ASX Settlement's Clearing House Electronic Sub-register System (CHESS). CHESS is linked to a number of securities registries, including Boardroom Pty Limited, Computershare Limited and Link Market Services Limited. These registries are appointed by an issuer to maintain a record of securities ownership for that company. The complete register for a company's securities is made up of the combined holdings registered on both CHESS and the issuer-sponsored sub-registers. Investors can choose to register the legal title to the securities they hold on either of these sub-registers, though in order to settle a market trade, the settlement participant will need to deliver/receive the securities via CHESS.[11]

ASX Settlement offers delivery-versus-payment (DvP) settlement on a Model 3 basis. That is, the transfer of ownership of the securities is linked to the payment in such a way as to ensure that delivery occurs if and only if the corresponding payment occurs. DvP Model 3 involves settling both securities and funds on a net basis in a batch at the end of the processing cycle. For trades cleared through ASX Clear Pty Limited (ASX Clear), settlement currently occurs two business days after the trade takes place (T+2 settlement).[12] Other trades, such as off-market trades, can be settled in the same batch as trades cleared through ASX Clear.

The Agencies note that there are a range of services that are ancillary to settlement, such as asset registration, safekeeping, issuer services (e.g. corporate actions) and investor services, and that the provision of these services may be contestable. ASX Settlement currently provides several of these services. As a further example, in conjunction with various registries, ASX Settlement helps manage the ownership integrity of securities by sending daily messages to the registries regarding the

10 For simplicity, clearing and settlement participants, including custodians, have not been included in Figures 1–3. Furthermore, the term 'AML' is used for convenience; this does not preclude any other form of off-market trades, such as trades reported to an AML from broker crossing platforms/dark pools or from over-the-counter (OTC) trades.

11 To be registered on CHESS, an investor must either be a registered ASX Settlement participant or sign a sponsorship agreement with a registered participant.

12 For more detailed information on the settlement process, see Appendix A2.1 of the Bank's *2015/16 Assessment of ASX Clearing and Settlement Facilities*. Available at <http://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/assessments/2015-2016/pdf/appendix-a2.1-asx-settlement.pdf>.

ownership status of CHESS holdings for securities held in its sub-register. ASX Settlement may also facilitate the transfer of securities in the primary market (following an initial public offer) and/or in the secondary market. These ancillary services go beyond those that the Agencies would consider addressing in any potential guidance related to competition in settlement (as noted in sub-section 2.2).

Questions

2. What, if any, are the existing barriers to entry for a competing SSF in Australia? For example, are settlement services contestable without the additional provision of ancillary services? Are there other factors or particular market features that increase barriers to entry for a competing SSF?

3. What, if any, are the existing barriers to competition in the provision of ancillary services? How would competition in settlement impact upon the provision of ancillary services? For example, would you expect this to increase the prospect of competition in ancillary services?

4. Would the entry of a competing SSF have an impact on Australia's electronic sub-register system (i.e. the broker-sponsored and issuer-sponsored model)?

4. Competition in Settlement

As a starting point for considering possible policy guidance, the Agencies have considered how competition in settlement for Australian cash equities might emerge. There are examples of competition in settlement of cash equities in New Zealand and India (see 'Box A: Examples of Competition in Settlement' for details). As there are only a limited number of examples, the Agencies have identified three stylised market structures to help inform the analysis of the implications of competition in settlement of cash equities emerging in Australia.

These stylised structures represent the following scenarios:

- Competition in settlement, with all trades cleared through a single CCP (sub-section 4.1)
- Competition in settlement, where not all trades are cleared (sub-section 4.2)
- Competition in both clearing and settlement (sub-section 4.3)

These stylised market structures illustrate how market players might interact and the types of risks and policy questions that could arise under each structure. However, the precise links that would be required between market players, as well as the risks and policy considerations under each market structure, cannot be determined prior to the emergence of a committed competitor with a specific proposal.

Box A: Examples of Competition in Settlement

New Zealand has two SSFs for cash equities trades. All listed equities traded on the New Zealand Stock Exchange (NZX) must be settled in New Zealand Clearing and Depository Corporation Limited (NZCDC), which is a wholly owned subsidiary of NZX. Equities listed on the NZX market that are traded off-market may be settled in either NZCDC or NZClear, which is owned and operated by the Reserve Bank of New Zealand. Settlement in NZCDC occurs in batches (DvP Model 3) on a T+2 basis, while settlement in NZClear occurs in real-time. Another distinction is that while trades settled by NZCDC are centrally cleared, no CCP is involved in trades settled by NZClear. The two SSFs use two different depositories, which are linked to allow for the real-time transfer of securities. There is no direct link between the two SSFs.

There is also some competition between SSFs in India. The two main stock exchanges, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE), trade the same equities; almost all companies listed on NSE are also listed on BSE. Each exchange has an affiliate that acts as both CCP and SSF. The exchange on which a trade is executed determines where it is cleared and settled. There are also two securities depositories in India, with both of the combined clearing and settlement entities linked to both depositories. Most companies connect to both depositories and investors choose the depository in which to hold their securities. Settlement occurs on a T+2 basis in two independent batches, one for each clearing and settlement entity, with both depositories involved in both batches. The distinct set up of India's CCPs, SSFs and depositories as silos limits the applicability of the Indian model to the market structures that could emerge in the Australian context.

Competition does exist between the International Central Securities Depositories (ICSDs), such as Euroclear, Clearstream and SIX Securities Services. However, competition in settlement is generally limited to financial products other than cash equities. Although the ICSDs settle cash equities, typically the securities of a particular company are only registered in the one ICSD. Therefore, this model has limited applicability to the Agencies' analysis of the risks associated with competition in the settlement of cash equities in Australia.

So that any policy guidance that might be developed is sufficiently robust and technology neutral, the consideration of possible market structures is not confined to a particular type of technology. Further, the stylised models are presented to elicit stakeholder feedback on the risks and policy issues that

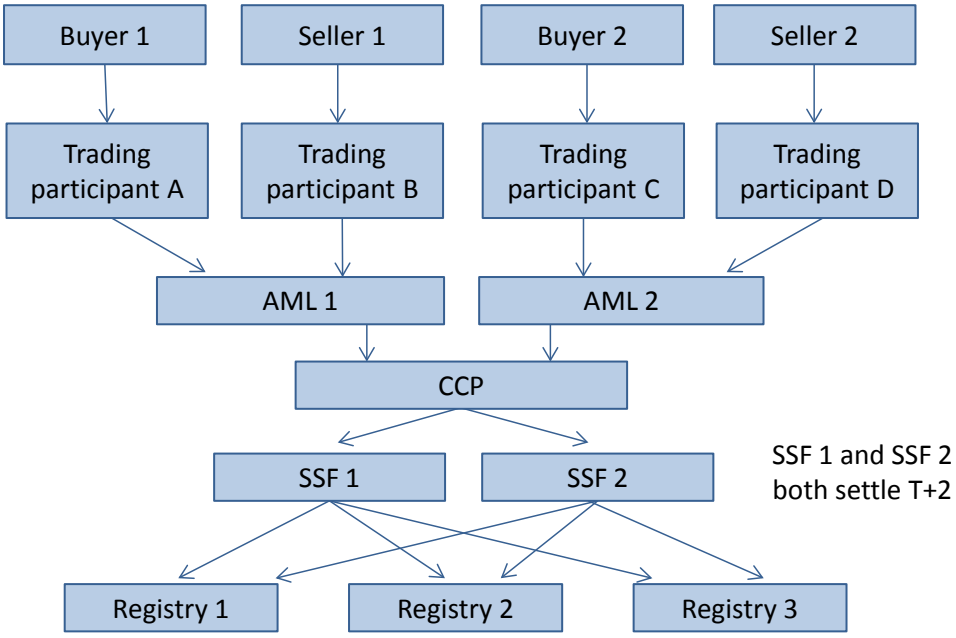
might arise under each market structure; presentation of the models does not imply that these market structures would be preferred or acceptable from a regulatory perspective.

For simplicity, each model in this paper considers two AML holders, both trading the same equities. Each model also assumes that the prevailing registry arrangements in Australia, as described in section 3, would remain unchanged, notwithstanding that some operational changes may be needed within registries to facilitate multiple SSFs. For illustrative purposes, certain assumptions have been made about the timing of settlement (and consequently the possible DvP model) and the positioning and number of the various links between the facilities. These assumptions should not be interpreted as a regulatory requirement or, as noted above, regulatory approval for such arrangements.

4.1 Without competition in clearing

The model set out in Figure 2 represents the smallest incremental change to the current structure of the market for clearing and settlement of cash equities in Australia. In this model, all trades are centrally cleared through a single CCP, and both SSFs settle on T+2. The CCP has direct links/access to both SSFs, as do the registries. The fact that the CCP links to both SSFs would allow a single trade between a buyer and a seller to settle across different SSFs.

Figure 2: Competition in Settlement without Competition in Clearing



With two SSFs, a link or process is necessary to allow securities to move between SSFs, so that settlement may occur in either SSF. The nature of such a link will depend on the exact proposal from an emerging competing SSF; it is possible that this process could occur at the registry level or directly between the SSFs (since the nature of this link will depend on the specifics of any application, for simplicity, this link is not shown in Figure 2). With two SSFs, it would be necessary to ensure that controls are in place to prevent multiple use of the same security during settlement.

If both SSFs in this model settle on T+2 in separate batches, settlement may not occur simultaneously at both SSFs.[13] The CCP will therefore have to manage the risks associated with this timing mismatch, however long or short, for individual trades or batches of trades that are split across SSFs. It is likely that the CCP will need additional liquidity and may need securities lending arrangements to facilitate sequential settlement across the two SSFs. However, the exact nature of the risks will depend on the

13 This would mean, for example, that for a single trade that was settled across different SSFs, the two legs of the novated trade (i.e. the trade between the buyer and the CCP, and the offsetting trade between the CCP and the seller) would not settle simultaneously.

specifics of the operating models of the two competing SSFs, including settlement duration and the DvP model used.

With more than one SSF, there is also the risk of some 'un-netting' of trades during the settlement process if some trades (or legs of trades) settle in one SSF but fail to settle in the other. In the event that a clearing participant default occurred following such 'un-netting', the CCP may face larger than expected exposures. The CCP will need to manage this risk, possibly by collecting additional margin to cover the risk of default on obligations that have been 'un-netted' during settlement. This risk of 'un-netting' is not unique to a market structure with multiple SSFs; CCPs that connect to an SSF that settles on a DvP Model 1 basis (i.e. gross settlement on a trade-by-trade basis) faces similar risks.

Questions

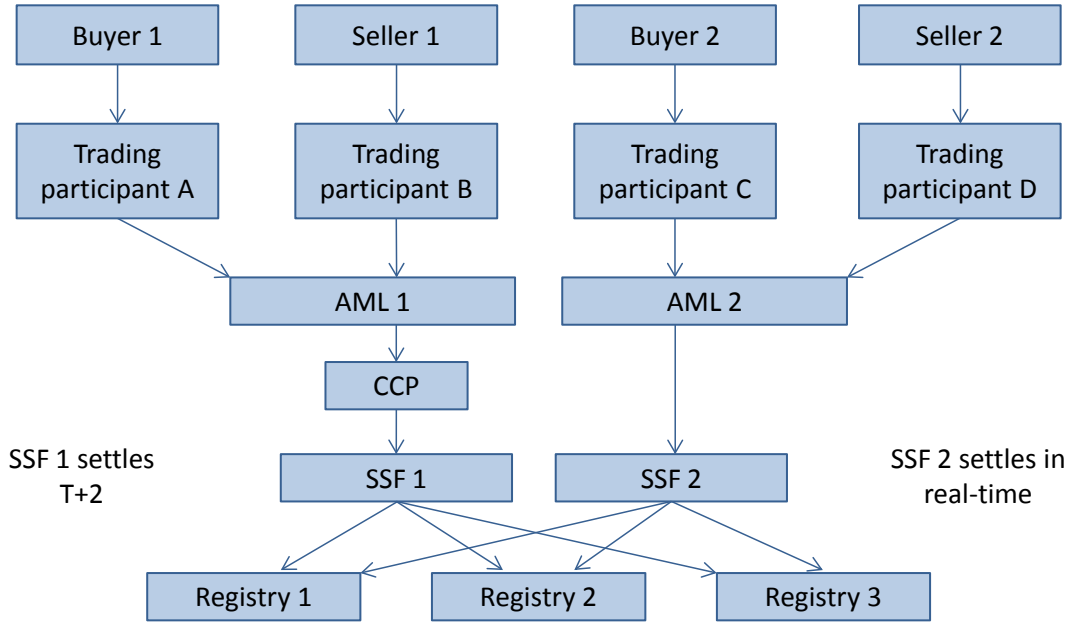
5. Do you agree with the risks highlighted in the discussion of this model? What other risks, related to links or otherwise, or to the broader efficiency, stability or functioning of the Australian cash equities market, could arise from the model of competition in settlement described in Figure 2?

6. How would the risks change with different settlement timing and/or methods in the two SSFs? For example, consider situations in which both SSFs settle on a gross trade-by-trade basis (DvP Model 1), or in independent batches (DvP Model 3), or if the SSFs use different settlement methods.

4.2 Where not all trades are cleared

In Figure 3, one SSF settles centrally cleared trades on T+2 while the other offers real-time settlement of trades that are not centrally cleared. In this model, the CCP only has links/access to the SSF that settles on T+2.[14]

Figure 3: Competition in Settlement where not all trades are cleared



The Agencies have assumed that, in this model, the choice of trading platform determines the SSF used (though preferences around settlement timing and whether trades are centrally cleared may in fact determine the choice of trading platform). Consequently, a buyer and seller must use the same trading platform and SSF, and so there is no mismatch in settlement timing in this model.

14 The Agencies acknowledge that variations of this model could alternatively present options for each AML to access each SSF or that one or both SSFs could offer both T+2 and real-time settlement.

Similar to the previous model, some link or process to allow securities to settle in either SSF is presumed necessary, as is a process to prevent multiple use of the same security during settlement. However, this model also raises a different set of risks and policy issues that require consideration. One potential outcome of this model is that trading liquidity may fragment between AMLs based on the settlement instructions (i.e. T+2 or real-time). This may exacerbate any security price differentials between the AMLs. As trades on AML 2 are not centrally cleared, this model also raises policy questions around whether central clearing should be required for all on-market (anonymous) trades and/or whether all trading participants should be provided with the option of central-clearing, irrespective of the AML they use. The precise nature of the risks and the requirements necessary to manage those risks will depend on the specific market structure that emerges, including the settlement timing (and DvP model) used by each SSF.

Questions

7. What do you see as the risks, related to links or otherwise, or to the broader efficiency, stability or functioning of the Australian cash equities market, that could arise from the model of competition in settlement described in Figure 3?

8. How would the risks change with different settlement timing/methods in the two SSFs? For example, consider situations in which both SSFs settle on a gross trade-by-trade basis (DvP Model 1), or in independent batches (DvP Model 3), or if the SSFs use different settlement methods.

9. Should central clearing of all trades executed on an anonymous basis be mandatory – regardless of where they trade – or should central clearing be optional? That is, should all AML holders be required to link to at least one CCP? Does your response change depending on the settlement method or timing of each of the SSFs?

4.3 Competition in both clearing and settlement

A third possible model is one with competition in both clearing and settlement; that is, with multiple CCPs and multiple SSFs. Many of the risks and policy questions arising in the previous models may also be relevant in this case.

If competition in both clearing and settlement were to emerge, in addition to the application of the Minimum Conditions (Clearing) (See 'Box B: Minimum Conditions (Clearing)') any policy guidance developed with respect to competition in settlement would also apply. The Minimum Conditions (Clearing) require, among other things, that there be appropriate interoperability arrangements between competing cash equities CCPs. In a market in which there are interoperating CCPs, settlement by these CCPs using multiple SSFs may extend the financial interdependencies between the CCPs. This is because any mismatch in the timing of settlement across the SSFs could extend the duration of the exposure between the two CCPs. The requirement in the Minimum Conditions (Clearing) that there be appropriate safeguards in the settlement process in the case of competition in clearing, notably that financial interdependencies between competing CCPs in the settlement process should be minimised, would be of particular relevance in the event that interoperating CCPs settled across multiple SSFs.

Box B: Minimum Conditions (Clearing)

1. Adequate regulatory arrangements. These should include:
   (a) rigorous supervision against the CCP Standards and other requirements under the Corporations Act
   (b) application of the CFR's framework for regulatory influence over cross-border CS facilities
   (c) ex ante wind-down plans
   (d) appropriate arrangements for regulatory oversight in a multi-CCP environment.
2. Appropriate safeguards in the settlement process. The cash equity settlement model applied in a multi-CCP environment should seek as far as possible to preserve the efficiencies of the prevailing settlement model at the time a competitor emerged, while:
   (a) affording materially equivalent priority to trades novated to a competing CCP
   (b) minimising financial interdependencies between competing CCPs in the settlement process
   (c) facilitating appropriate default management actions.
3. Access to the securities settlement infrastructure on non-discriminatory, transparent, fair and reasonable terms.
4. Appropriate interoperability arrangements between competing cash equity CCPs.

Questions

10. What (if any) are the additional risks in a market in which there is competition in clearing as well as settlement, including to the broader efficiency, stability or functioning of the Australian cash equities market? To what extent are these risks addressed by the Minimum Conditions (Clearing)?

11. What kind of safeguards in the settlement process would be necessary to minimise financial interdependencies between competing CCPs in the settlement process? For example, do you think that interoperating CCPs should be required to settle trades between themselves as quickly as possible? If so, what would be required to allow this to happen?

12. In each of the three market structures described, at what point do you consider it most likely that the choice of SSF would be made (e.g. at the AML level or by the trading participant)?

13. Are there other models of competition in settlement, or adaptations of the described models, that the Agencies should consider? If so, what are the risks to safe and effective competition in (clearing and) settlement and what kinds of safeguards could be put in place to mitigate them?

5. Implications for Market Efficiency and Financial Stability

The models discussed above illustrate that competition in settlement of cash equities in Australia may have implications for the functioning of markets and for financial stability. Issues concerning access to certain existing facilities may also need to be addressed in order to facilitate effective competition.

5.1 Primary and secondary market functioning

Should a competing SSF wish to provide settlement services with a choice in settlement timeframe, this may have implications for the functioning of any licensed financial market for which it is permitted to settle trades and for the participants and investors that use the market. There may also be implications for the listed entities and the transactions they conduct.

It is important to note that ASIC would have a regulatory role in any proposal in which the choice of settlement timeframe, including situations where there is an option to settle on a real-time basis and to select the settlement facility, occurred as part of contract formation on a licensed financial market. Such a proposal may raise significant policy considerations in respect of price formation, liquidity and fragmentation in the markets for securities settled by the respective competing settlement facilities. For example, it may fragment the type of liquidity (e.g. from retail investors, institutional investors, proprietary traders) based on preferences of settlement timeframe, it may exacerbate any differential in security prices between the relevant markets and it may have implications for market participants' fulfilment of best execution duties to clients. Real-time or mismatched settlement periods may also raise policy considerations in relation to how corporate actions are conducted. Such proposals would therefore require significant analysis to be undertaken on the potential market impacts by ASIC. A CS facility or entrant who wished to offer such services should undertake bilateral dialogues with ASIC early in the development of its proposal. To assist ASIC in an early exploration of these market considerations, the Agencies have included a question below.

Questions

14. Would the emergence of a competing SSF, providing differing settlement timeframe(s) and/or settlement models, potentially impact:

a) price formation, liquidity and fragmentation in the trading of securities settled in this way; and/or

b) listed entities' obligations regarding the way they conduct corporate actions?

Please elaborate on your answer.

5.2 Financial stability

As discussed in section 4, competition in settlement could create additional interdependencies between market infrastructures, whether financial or operational, which would need to be managed. More generally, competition in settlement could increase incentives to cut costs, which could adversely affect risk management. Competition in settlement may also increase the likelihood of disruption arising from the entry and exit of SSFs, as well as potential risk and uncertainty during the transition between settlement facilities.

5.3 Access

Alternative SSFs for listed securities may require access to the incumbent CCP's trade data. In a market structure with a single CCP (Figure 2), competition in the provision of T+2 settlement services could lead to an ‘essential facilities’ scenario. That is, assuming that there remains a single vertically integrated CCP, any competing provider of T+2 settlement services would need effective access to the

CCP's trade data. The Agencies note that this may be less of an issue for a competing SSF providing real-time settlement of trades. However, depending on the structure of the market, such an SSF may still require access to the incumbent CS facilities.

6. Controls for Safe and Effective Competition

The discussion in sections 4 and 5 illustrates that there a number of potential implications from competition in settlement for the functioning of markets, financial stability and access. The nature of some of these implications suggests that certain controls may be necessary to ensure that any competition in settlement of cash equities in Australia is safe and effective. This section proposes a possible set of such controls. In developing these controls, the Agencies have had reference to the Minimum Conditions (Clearing), which would apply if there was competition in clearing. Consequently, the structure of the controls largely mirrors that of the Minimum Conditions (Clearing).

However, the precise risks and policy considerations that arise from competition in settlement will depend on the specific proposal of any potential competing SSF. A detailed risk assessment will only occur once ASIC and the Bank have received a CS facility licence application from a committed competing SSF.

6.1 Adequate regulatory arrangements

(a) Rigorous oversight against the FSS and other requirements under the Corporations Act

Equivalent application of the regulatory framework (as set out in sub-section 2.3) across competing SSFs should be sufficient to limit any scope for competition on the basis of less onerous risk controls, and thereby ensure that the market continues to function in a safe and effective manner. The Agencies nevertheless acknowledge the need for close vigilance at the margins of the FSS and the relevant sections of the Corporations Act, and in particular section 821A, including cost-cutting measures and product development processes.

Application of the existing regulatory framework to CCPs in a multi-SSF environment is also expected to be sufficient to address any additional risks to CCPs from mismatches in timing of settlement across SSFs and 'un-netting' of trades during the settlement process.

(b) Application of the CFR's framework for regulatory influence over cross-border CS facilities

If a new entrant SSF was seeking to leverage existing capabilities in overseas markets, ASIC and the Bank's supervisory approach would be guided by the CFR's Regulatory Influence Framework. This is a framework for ensuring that Australian regulators have sufficient influence over overseas providers of clearing and settlement services in the Australian market to support domestic policy objectives.

(c) Ex ante wind-down plans and associated commitments

Since a commercially driven exit of an SSF in a competitive environment could disrupt activity in the segment of market activity that it settled, the Agencies see a case to include measures aimed at mitigating such market disruption within the controls for safe and effective competition in settlement.

In particular, all competing SSFs – including the incumbent and any new entrants – could be required to commit *ex ante* to a notice period of at least one year prior to any planned exit from the market. This should be supported by ring-fenced capital sufficient to cover any operating expenses for the duration of the notice period, as well as clearly articulated wind-down plans. Similar to the Minimum Conditions (Clearing), this condition would be more stringent than the requirements for orderly wind-down envisaged in the FSS. The Agencies consider this difference to be appropriate, as this condition is intended to provide for a planned exit for commercial reasons, while the relevant standard in the FSS seeks to protect against exit due to the crystallisation of business risk.

Questions

15. Do you agree with the analysis of the regulatory arrangements described above, and that this is necessary to ensure fair and effective competition in the settlement of cash equities in Australia? If not, please explain why not and if you consider there to be other issues, please also include these in your answer.

16. Would there be a need for coordination of default management arrangements across competing SSFs in the event of a participant default? Who should be responsible for such arrangements?

6.2 Access on fair, transparent and non-discriminatory terms

As previously noted, a new entrant SSF could face a number of 'essential facilities' scenarios:

- *Access to a single CCP's trade data by SSFs:* Alternative SSFs for listed securities may require access to the incumbent's CCP. That is, assuming that there remains a single vertically integrated CCP, any competing provider of T+2 settlement services would need effective access to the CCP's trade data. The Agencies note that this may be less of an issue for a competing SSF providing real-time settlement of trades.
- *Access between the competing SSFs:* Subject to the model, competing SSFs should be able to interface, to enable the safe and efficient transfer of securities for settlement of trades. The Agencies note that this could be achieved by technological interoperability or a link between SSFs.
- *Access between registries and SSFs:* Under the prevailing registry arrangements in Australia an SSF is expected to interface with each of the registries. The Agencies consider that this would necessarily continue.

To address concerns regarding 'essential facilities', the Agencies consider it appropriate that the incumbent CS facilities would be required to facilitate the provision of access to its services on a fair, transparent and non-discriminatory basis with terms and conditions, including price, that are fair and reasonable. The Agencies note that this is consistent with the Regulatory Expectations, which apply to ASX's conduct in operating its cash equity clearing and settlement services while it remains the sole provider of each of these services (see sub-section 2.1 of this paper for further background).

Questions

17. Do you agree with the scope of the access considerations above? If not, please explain why not and if you consider there to be other issues, please also include these in your answer.

6.3 Appropriate links between competing SSFs

Further to the question of fair, transparent and non-discriminatory access, in order to facilitate market functioning in a structure with multiple SSFs, the Agencies are of the view that it would be necessary to ensure that securities can be accessed by and moved between all of the SSFs. The nature of this link will depend on the particular model; for example it is possible that this process could occur at the registry level or directly between the SSFs. It would also be necessary to have a process in place to prevent the risk of the same securities being used multiple times during settlement.

Questions

18. Do you agree that the controls and safeguards described above, in combination with the Minimum Conditions (Clearing), are adequate to mitigate the risks that may emerge with competition in settlement and to ensure such competition is safe and effective?

a) If not, please describe any additional controls or safeguards that you believe are necessary and explain why.

b) Are any of the proposed controls unnecessary? If so, please explain.

19. Do you agree that securities should be able to be moved between competing SSFs (e.g. via a link or a bridge between the SSFs, or possibly at the registry level) or do you envisage other ways for efficient settlement to be achieved?

7. Next Steps

This consultation paper seeks stakeholder feedback on the risks of competition in the settlement of Australian cash equities, and the proposed controls for safe and effective competition. The Agencies intend to meet with interested stakeholders during the consultation period.

Following the consultation process, the Agencies will consider the stakeholder submissions and intend to report to the government by mid-2017. The development of any additional policy guidance on competition in settlement would inform the work to draft legislation to implement the government's response to the 2015 Review. With this is mind, the Agencies invite submissions from stakeholders by the deadline of 20 April 2017.

Appendix A: Consultation Questions

2. Background to Consultation

2.1 Rationale

1. Has the emergence of competition in cash equities settlement become more likely than it was considered during the 2015 Review? Please elaborate on your answer.

3. Current Cash Equity Settlement Arrangements

2. What, if any, are the existing barriers to entry for a competing SSF in Australia? For example, are settlement services contestable without the additional provision of ancillary services? Are there other factors or particular market features that increase barriers to entry for a competing SSF?

3. What, if any, are the existing barriers to competition in the provision of ancillary services? How would competition in settlement impact upon the provision of ancillary services? For example, would you expect this to increase the prospect of competition in ancillary services?

4. Would the entry of a competing SSF have an impact on Australia's electronic sub-register system (i.e. the broker-sponsored and issuer-sponsored model)?

4. Competition in Settlement

4.1 Without competition in clearing

5. Do you agree with the risks highlighted in the discussion of this model? What other risks, related to links or otherwise, or to the broader efficiency, stability or functioning of the Australian cash equities market, could arise from the model of competition in settlement described in Figure 2?

6. How would the risks change with different settlement timing and/or methods in the two SSFs? For example, consider situations in which both SSFs settle on a gross trade-by-trade basis (DvP Model 1), or in independent batches (DvP Model 3), or if the SSFs use different settlement methods.

4.2 Where not all trades are cleared

7. What do you see as the risks, related to links or otherwise, or to the broader efficiency, stability or functioning of the Australian cash equities market, that could arise from the model of competition in settlement described in Figure 3?

8. How would the risks change with different settlement timing/methods in the two SSFs? For example, consider situations in which both SSFs settle on a gross trade-by-trade basis (DvP Model 1), or in independent batches (DvP Model 3), or if the SSFs use different settlement methods.

9. Should central clearing of all trades executed on an anonymous basis be mandatory – regardless of where they trade – or should central clearing be optional? That is, should all AML holders be required to link to at least one CCP? Does your response change depending on the settlement method or timing of each of the SSFs?

4.3 Competition in clearing and settlement

10. What (if any) are the additional risks in a market in which there is competition in clearing as well as settlement, including to the broader efficiency, stability or functioning of the Australian cash equities market? To what extent are these risks addressed by the Minimum Conditions (Clearing)?

11. What kind of safeguards in the settlement process would be necessary to minimise financial interdependencies between competing CCPs in the settlement process? For example, do you think that interoperating CCPs should be required to settle trades between themselves as quickly as possible? If so, what would be required to allow this to happen?

12. In each of the three market structures described, at what point do you consider it most likely that the choice of SSF would be made (e.g. at the AML level or by the trading participant)?

13. Are there other models of competition in settlement, or adaptations of the described models, that the Agencies should consider? If so, what are the risks to safe and effective competition in (clearing and) settlement and what kinds of safeguards could be put in place to mitigate them?

5. Implications for Market Efficiency and Financial Stability

5.1 Listed market functioning

14. Would the emergence of a competing SSF, providing differing settlement timeframe(s) and/or settlement models, potentially impact:

a) price formation, liquidity and fragmentation in the trading of securities settled in this way; and/or

b) listed entities' obligations regarding the way they conduct corporate actions?

Please elaborate on your answer.

6. Controls for Safe and Effective Competition

6.1 Adequate regulatory arrangements

15. Do you agree with the analysis of the regulatory arrangement described in 6.1, and that this is necessary to ensure fair and effective competition in the settlement of cash equities in Australia? If not, please explain why not and if you consider there to be other issues, please also include these in your answer.

16. Would there be a need for coordination of default management arrangements across competing SSFs in the event of a participant default? Who should be responsible for such arrangements?

6.2 Access on fair, transparent and non-discriminatory terms

17. Do you agree with the scope of the access considerations described in 6.2? If not, please explain why not and if you consider there to be other issues, please also include these in your answer.

6.3 Appropriate links between competing SSFs

18. Do you agree that the controls and safeguards described above, in combination with the Minimum Conditions (Clearing), are adequate to mitigate the risks that may emerge with competition in settlement, and to ensure such competition is safe and effective?

a) If not, please describe any additional controls or safeguards that you believe are necessary and explain why?

b) Are any of the proposed controls unnecessary? If so, please explain.

19. Do you agree that securities should be able to be moved between competing SSFs (e.g. via a link or a bridge between the SSFs, or possibly at the registry level) or do you envisage other ways for efficient settlement to be achieved?