Minimum Conditions for Safe and Effective Competition in Cash Equity Settlement in Australia

A Policy Statement by the
Council of Financial Regulators

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Background

In March 2016, the Government endorsed the recommendations of a review of competition in clearing cash equities in Australia carried out by the Council of Financial Regulators (CFR) and the Australian Competition and Consumer Commission (ACCC) – together, the Agencies. Importantly, the Government's endorsement included a policy stance of openness to competition. The conclusions from that review are set out in the Agencies' report, *Review of Competition in Clearing Australian Cash Equities: Conclusions* (the Conclusions).[1]

As per the recommendations from the Conclusions, the CFR released two policy statements in October 2016: *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* (the Minimum Conditions (Clearing)).[2]

These policy statements were developed with reference to the prevailing market structure in settlement – in which there is a sole provider of settlement services. However, the Agencies considered it appropriate to explore the prospect of competition emerging in settlement and the need for additional policy guidance to support safe and effective competition, should it emerge.

For this purpose, the Agencies released a consultation paper on Safe and Effective Competition in Cash Equity Settlement in Australia in March 2017.[3] The Agencies also met with a number of interested parties to discuss their views on the prospect of competition and the need for policy guidance.

Feedback received from stakeholders during consultation acknowledged that the prospect of competition in settlement had increased, but also highlighted some of the barriers to entry, as well as some potential risks, cost and efficiency implications of competition in settlement.[4]

Accordingly, to address the identified barriers and risks, the Agencies have undertaken to set out Minimum Conditions for Safe and Effective Competition in Cash Equity Settlement in Australia (Minimum Conditions (Settlement)). The Minimum Conditions (Settlement) apply when the same equity security can be settled in more than one Security Settlement Facility (SSF).

The Minimum Conditions (Settlement) aim to give prospective providers of settlement services sufficient clarity as to the measures that the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (the Bank) would require be taken before they could advise in favour of a licence application. This should assist in establishing the business case for any competing provider. In addition to meeting existing licensing requirements under the *Corporations Act 2001* (the Corporations Act), any licence applicant would be expected to demonstrate that it could viably provide services in this market in a manner consistent with the Minimum Conditions (Settlement).

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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 The Minimum Conditions (Clearing) is available at < https://www.cfr.gov.au/publications/cfr-publications/2016/minimum-conditions-safe-effective-cash-equity/pdf/policy-statement.pdf>; The Regulatory Expectations are available at <https://www.cfr.gov.au/publications/cfr-publications/2016/regulatory-expectations-policy-statement/pdf/policy-statement.pdf>.

3 The consultation is available at <https://www.cfr.gov.au/publications/consultations/safe-and-effective-competition-in-cash-equity-settlement-in-australia/index.html>.

4 A more detailed summary of the feedback received is available in the Agencies' report: Safe and Effective Competition in Cash Equity Settlement in Australia: Response to Consultation, available at <https://www.cfr.gov.au/publications/cfr-publications/2017/safe-effective-competition-response/pdf/response-to-consultation.pdf>.

Some aspects of the Minimum Conditions (Settlement) are not enforceable under the existing regulatory framework (such as access by a competing clearing and settlement (CS) facility on transparent, non-discriminatory, and fair and reasonable terms). Nevertheless, the Agencies expect that service providers of settlement services will operate in a manner that is consistent with the Minimum Conditions (Settlement).

The Agencies will work with the Government to fully implement the Minimum Conditions (Settlement) through legislative changes. It is proposed that the legislative changes will include provisions that:

- allow the relevant regulators to implement and enforce the Minimum Conditions (Settlement) through the use of a rule-making power; and
- grant the ACCC power to arbitrate disputes regarding access to services (including data).

The proposed legislative framework to implement in full the Minimum Conditions (Settlement) would set out the relevant high-level requirements, leaving the relevant regulators to impose any specific obligations at a later stage through the use of the rule-making powers.

Given the importance of the Minimum Conditions (Settlement) in ensuring that competition does not adversely affect financial stability or effective market functioning, ASIC and the Bank would be unable to advise in favour of a licence application from a potential competitor until these legislative measures had been implemented. Consistent with the position of openness to competition, however, ASIC and the Bank would be prepared to engage with any potential entrant in the interim and commence consideration of a licence application, should one be submitted. In the event that a committed competitor submits an application for a CS facility licence, consistent with past practice, a public consultation on the potential effects of the applicant's services on the market may be conducted by the relevant agency, in order to ensure that any potential risks have been adequately dealt with by stakeholders and the regulators.

To the extent possible, ASIC, in consultation with the Bank, would offer guidance to a prospective competitor on potential specific requirements before the submission of a licence application. However, detailed specific requirements would not be articulated or implemented until such time as a committed competitor emerged, or was likely to emerge.

Accordingly, ASX may not be required to make operational changes to accommodate competition until such time as a competing SSF committed to entry. However, at the same time, the technological design of ASX's CS infrastructure should not raise barriers to entry or otherwise seek to frustrate access to data or services that are necessary for the provision of settlement services by a competing service provider. ASIC and the ACCC have a particularly strong interest in this outcome being delivered.

The Agencies expect to review the Minimum Conditions (Settlement) periodically, including in the event of material changes to the operating environment or market structure for these services.

Minimum Conditions for Safe and Effective Competition in Settlement

The Minimum Conditions (Settlement) relate to the following.

1. Adequate regulatory arrangements:
    (a) Rigorous oversight against the Financial Stability 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 and associated commitments
    (d) Appropriate arrangements for certainty of securities transfer and administration.

2. Access on transparent, non-discriminatory, and fair and reasonable terms.
3. Appropriate links between competing SSFs.
4. Appropriate regulatory arrangements for oversight of Primary and Secondary Markets.

Each of the minimum conditions identified above is considered in greater detail in the remainder of this policy statement.

1. Adequate Regulatory Arrangements

(a) Rigorous oversight against the Financial Stability Standards and other requirements under the Corporations Act

The Corporations Act gives ASIC and the Bank responsibility for the regulation of CS facility licensees. 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. The Bank's *Financial Stability Standards for Securities Settlement Facilities* (SSF Standards) are aligned with the financial stability-related requirements of the CPMI-IOSCO Principles for Financial Market Infrastructure (PFMI), which establish an international benchmark for the risk management and operational standards of CS facilities.[5] ASIC is responsible for ensuring CS facilities comply with other obligations under the Corporations Act, as elaborated in ASIC's Regulatory Guide 211: Clearing and Settlement Facilities: Australian and Overseas Operators (RG211).[6]

The Bank and ASIC consider that equivalent application of the regulatory framework across competing SSFs should limit any scope for competition on the basis of less onerous risk controls, such that the market continues to function in a safe and effective manner.

Application of the existing regulatory framework for CS facilities in a multi-SSF environment is also expected to be sufficient to address any additional risks to central counterparties, for example 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 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.[7] This is a framework for ensuring that Australian regulators have sufficient influence over overseas providers of CS services in the Australian market to support domestic policy objectives.

One measure under the Regulatory Influence Framework, which would apply primarily where a CS facility was both systemically important in Australia and had a strong domestic connection, is the requirement to incorporate locally and seek a domestic CS facility licence. As articulated in the Regulatory Influence Framework, a competing SSF that settles Australian securities would almost certainly have a strong domestic connection as it would operate in a primarily domestic market, perhaps with a high level of domestic retail participation. The Agencies consider this to be an

5 The PFMI, published by the Committee on Payment and Settlement Systems (now known as the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions is available at <http://www.bis.org/cpmi/info_pfmi.htm>.
The SSF Standards is available at <http://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/standards/securities-settlement-facilities/2012/>.

6 ASIC's Regulatory Guide 211 is available at <http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-211-clearing-and-settlement-facilities-australian-and-overseas-operators/>.

7 The CFR's framework for ensuring appropriate influence over cross-border clearing and settlement facilities (the Regulatory Influence Framework) is available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2012/cross-border-clearing>.

integral part of the Minimum Conditions (Settlement), at least until ASIC and the Bank are comfortable with the arrangements for cross-border coordination and management of financial market infrastructure recovery and resolution.

(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 Minimum Conditions (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 before 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 SSF Standards; Standard 12 on general business risk requires that 'at a minimum, a securities settlement facility should hold, or have legally certain access to, liquid net assets funded by equity equal to at least six months of current operating expenses'. The Bank considers this difference to be appropriate, as this condition is intended to provide for a planned exit for commercial reasons, while SSF Standard 12 seeks to protect against exit due to the crystallisation of business risk.

(d) Appropriate arrangements for certainty of securities transfer and administration

Each SSF, in compliance with the Corporations Act, will have its own operating rules reflecting the settlement facility service it operates and other services it provides. The operating rules of a SSF, along with the operating rules of the listing market for the issuer, may govern the registration of legal title to, and in some cases administration of, securities in respect of which the SSF provides settlement services. Where there are competing SSFs, a registry acting on behalf of an issuer may be subject to requirements imposed by more than one SSF. For example, there may be circumstances under which registries, acting on behalf of issuers, receive instructions from competing SSFs relating to the same listed security. The registry will need to determine how to prioritise those instructions and ensure the resulting change of title to the securities is legally certain, which may be challenging in situations where the registry is not able to comply with, or reconcile the requirements imposed on it by, competing SSFs.

Accordingly, the Agencies consider that, in the event of a competing SSF emerging, there is a case for the relevant agency to have the ability, if required, to put in place regulatory arrangements to support certain aspects of the legal relationship between competing SSFs, registries and issuers. Such regulatory arrangements might involve prescribing protocols, rules or regulations setting out common principles for the transfer, registration and administration of securities.

2. Access on Transparent, Non-discriminatory, and Fair and Reasonable Terms

To address concerns regarding access to services (including data) necessary for the provision of settlement services by a competing SSF, the Agencies consider it appropriate that CS service providers be required to facilitate access to services (including data) on a transparent and non-discriminatory basis with terms and conditions, including price, that are fair and reasonable. For example, ASX is expected to comply with this requirement with respect to providing services (including data) necessary for the provision of settlement services by a competing service provider, and vice versa.

This is consistent with the Regulatory Expectations, which deal with access to the incumbent service provider's monopoly CS services. The relevant provisions in the Regulatory Expectations explicitly address access on transparent, non-discriminatory, and fair and reasonable terms should a

competing provider of settlement services emerge. Additionally, following the proposed legislative changes as previously noted, the ACCC will have the power to arbitrate disputes in relation to price and/or non-price terms and conditions of access to data and services where negotiations guided by the Regulatory Expectations fail.

3. Appropriate Links between Competing SSFs

Further to the requirement for transparent, non-discriminatory, and fair and reasonable access, in order to facilitate market functioning in a structure with competing 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. It would also be necessary to have a process in place to prevent the risk of the same security holding being used multiple times during settlement.

4. Appropriate Regulatory Arrangements for Oversight of Primary and Secondary Markets

Any SSF proposing to provide settlement services that will offer a choice in settlement timeframe, should be aware that 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 and/or 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 SSF. Such proposals would require significant analysis to be undertaken by ASIC on the potential market impacts. A prospective provider of settlement services that seeks to offer such services should undertake bilateral dialogues with ASIC early in the development of its proposal.