

# Fair and Effective Clearing and Settlement Facilities



The purpose of this document is to articulate how the ASX group interprets its obligation under section 821A(a) of the Corporations Act 2001 (Cth)<sup>1</sup> to do all things necessary, to the extent that it is reasonably practicable to do so, to ensure that the services of each of its licensed clearing and settlement facilities are provided in a **fair and effective** way.<sup>2</sup>

## ASIC guidance

The primary guidance the Australian Securities and Investments Commission (“ASIC”) has given in relation to section 821A(a) appears in the following passage of ASIC Regulatory Guide 211 *Clearing and settlement facilities: Australian and overseas operators* (December 2012) (“RG 211”):<sup>3</sup>

### ***“Is your CS facility<sup>4</sup> operating in a fair and effective way?”***

*Another key responsibility as a CS facility licensee is that you must do all things necessary to ensure that your facility’s services are provided in a fair and effective way, to the extent that it is reasonably practicable to do so: s821A(a).*

*We interpret the phrase using the ordinary meanings of the words ‘fair’ and ‘effective’. Whether an operator is complying with this obligation will be assessed on a case-by-case basis, taking into account the particular circumstances of the facility’s operation, and having regard to the regulatory outcomes in Table 1 [the desired regulatory outcomes sought to be achieved by the regulation of CS facilities under the Corporations Act].<sup>5</sup>*

*The obligation to ‘do all things necessary’ is qualified by the phrase ‘to the extent that it is reasonably practicable to do so’. In other words, you must do everything reasonably practicable to ensure that the CS facility’s services are provided in a fair and effective way.*

*Cost by itself will not make any action ‘not reasonably practicable’, unless the cost is manifestly excessive or unreasonable when compared to the regulatory outcomes sought.”*

ASX agrees with ASIC’s guidance above. ASX would observe, however, that ASIC has not specifically stated the meaning it ascribes to the terms “fair” and “effective”, beyond saying they have their ordinary meaning. In the absence of specific guidance from ASIC on this issue, ASX believes it is helpful for it to articulate how it interprets these words in the context in which they are used in section 821A(a).

## Context

In determining whether the services of a licensed clearing and settlement facility are provided in a fair and effective way, ASX considers it both appropriate and important to have regard to the statutory context in which the obligation under section 821A(a) appears and also to the commercial context in which ASX’s licensed clearing and settlement facilities operate.

The statutory context includes the definition of “CS facility” in section 768A(1), that is, a facility<sup>6</sup> 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; and
- are of a kind prescribed by regulations made for these purposes.<sup>7</sup>

By defining a clearing and settlement facility by reference to the commercial functions that the facility performs, section 768A gives colour to whether or not a licensed clearing and settlement facility is providing its services in an “effective” way. It suggests that a licensed clearing and settlement facility will be providing its services in an effective way if it is achieving the commercial ends for which it was designed – that is, allowing the parties to relevant transactions in financial products to meet their obligations to each other.<sup>8</sup>

The statutory context also includes the framework within which the operating rules of a licensed clearing and settlement facility are made, which:

- requires the Minister, before he or she can grant a licence to operate a clearing and settlement facility, to be satisfied that the operator has adequate rules for the facility to ensure, as far as is reasonably practicable, that the facility will be operated in a fair and effective way;<sup>9</sup> and
- empowers the Minister to disallow any change to the operating rules of a licensed market,<sup>10</sup> having regard to whether the change is consistent with the licensee's obligations under the Corporations Act, including in particular its obligation to ensure, as far as is reasonably practicable, that the facility's services are provided in a fair and effective way.<sup>11</sup>

Once an operating rule of a licensed clearing and settlement facility comes into effect, the licensee and each participant in the facility comes under a statutory obligation to comply with the rule.<sup>12</sup>

The commercial context includes the systemically important role that ASX's licensed clearing and settlement facilities play in facilitating capital flows, reducing risk and promoting stability in the Australian financial system. This important role is recognised and reinforced by the separate requirement in section 821A(aa) that the operator of a licensed clearing and settlement facility must, to the extent it is reasonably practicable to do so, comply with the Financial Stability Standards determined under section 827D and do all other things necessary to reduce systemic risk.<sup>13</sup> The fact that this obligation appears first in the list of obligations of licensees who operate licensed clearing and settlement facilities in section 821A suggests that it should be regarded as one of their most important obligations. In turn, this suggests that the enquiry as to whether ASX is meeting its obligations under section 821A(a) in relation to its licensed clearing and settlement facilities should be answered at a systemic level, by reference to whether those clearing and settlement facilities are operating fairly and effectively from the perspective of participants in those facilities generally, rather than from the perspective of an individual participant.<sup>14</sup>

### **The meaning of "fair"**

The word "fair" can have many different meanings, depending on the context in which it is used.<sup>15</sup>

In ASX's opinion, in the context of section 821A(a), the word "fair" is used in one (or possibly both) of two senses – "something that conforms to the applicable rules" (as in a *fair* contest) and/or "free from bias or injustice" (as in a *fair* decision).<sup>16</sup>

As mentioned previously, once an operating rule of a licensed clearing and settlement facility comes into effect, the facility operator and each participant comes under a statutory obligation to comply with the rule. At that point, it is no longer open to a participant to argue that it should not have to comply with the rule because it is unfair. Hence the enquiry as to whether a licensed clearing and settlement facility is meeting its ongoing obligation to provide its services in a "fair" way is not intended to be a value judgment as to whether its operating rules are fair – that value judgment has already been made by the Minister in deciding to grant a licence to the facility operator with its rules as in force at that time and not to disallow any rule change subsequently<sup>17</sup> – but rather whether its operating rules are being applied in a fair manner (that is, consistently and without inappropriate bias).

ASX considers that a licensed clearing and settlement facility is likely to meet its obligation to provide its services in a fair way if the rules governing the operation of the facility clearly set out:

- the criteria and process for someone to become a participant in the facility;
- the rights and obligations of the operator and participants under the rules;
- when participants can have their participation in the facility suspended or terminated,

and those rules are applied by the operator of the facility consistently and without inappropriate bias.<sup>18</sup>

This is not to say that the operator of a licensed clearing and settlement facility must treat all participants equally in all circumstances. Plainly, a licensed clearing and settlement facility can still meet its obligation of fairness, even though it may provide for different categories of participants with different rights and obligations under the rules, or charge different fees to, or call different risk margins from, participants who deal in different products or who have different risk profiles.

Fairness requires a level playing field and that participants in like circumstances are treated in like manner, rather than that all participants in all circumstances are treated equally.

### **The meaning of “effective”**

In ASX’s opinion, the word “effective” is used in section 821A(a) in the sense of “adequate to accomplish a purpose” or “producing the intended or expected result”.<sup>19</sup>

ASX considers that a licensed clearing and settlement facility is likely to meet its obligation to provide its services in an effective way if:

- the facility operates in a manner that enables participants to meet their clearing and settlement obligations to the facility and to each other in accordance with the facility’s rules; and
- the facility’s clearing and settlement systems are secure, reliable and have sufficient capacity to handle reasonably foreseeable peak levels of transactions.

### **Balancing fairness and effectiveness**

The phrase “fair and effective” is a composite phrase of two potentially conflicting elements. It is conceivable, for example, that something could be fair but not effective, or effective but not fair. It is also conceivable that something could affect different participants differently – that is, something might be fair to some participants but unfair to others, or effective for some participants but not for others.

Judicial guidance on how to interpret another composite phrase – the obligation of financial service licensees to provide their services “efficiently, honestly and fairly”<sup>20</sup> – suggests that to meet its obligations under section 821A(a), the operator of a licensed clearing and settlement facility must provide its services in a fair way having regard to the dictates of effectiveness, and in an effective way having regard to the dictates of fairness.<sup>21</sup>

Regulatory guidance on how to interpret another composite phrase – the obligation of financial market licensees to ensure that their market is “fair, orderly and transparent”<sup>22</sup> – is to similar effect. It suggests that if there is a conflict between the elements of the phrase, the licensee is expected to strike an appropriate balance between the demands of each element<sup>23</sup> – in the context of section 821A(a) between the obligation to provide services in a fair way and the obligation to provide services in an effective way.<sup>24</sup>

ASX would add that, in its view, the appropriate balance between fairness and effectiveness is one which has regard to the systemically important role that ASX’s clearing and settlement facilities play in the Australian financial system. ASX considers that the test in section 821A(a) should be biased towards an outcome that achieves fairness from the perspective of participants generally and effectiveness from the perspective of the clearing and settlement facility as a whole rather than an outcome that delivers fairness to an individual participant at the expense of the effectiveness of the facility.

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<sup>1</sup> Referred to in this paper as the “Corporations Act”. Unless otherwise stated, references to sections are to sections of the Corporations Act.

<sup>2</sup> Operators of licensed clearing and settlement facilities also have separate obligations under section 821A (among other things):

- to the extent that it is reasonably practicable to do so, to comply with the Financial Stability Standards determined under section 827D and to do all other things necessary to reduce systemic risk (section 821A(aa));

- to have adequate arrangements for supervising the facility, including arrangements for:
  - handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the facility's services are provided in a fair and effective way; and
  - enforcing compliance with the facility's operating rules (section 821A(c));
- to have sufficient resources (including financial, technological and human resources) to operate the facility properly and for the required supervisory arrangements to be provided (section 821A(d)); and
- to take all reasonable steps to ensure that no disqualified individual becomes, or remains, involved in the licensee (section 821A(h)).

<sup>3</sup> RG 211, at paragraphs 178-181.

<sup>4</sup> The Corporations Act uses the contraction "CS facility" to refer to a clearing and settlement facility. A CS facility may provide clearing services only, settlement services only or both clearing and settlement services.

<sup>5</sup> ASX does not read the reference to Table 1 in this passage as meaning that ASIC considers that a CS facility must meet all of the desired outcomes in Table 1 to be "fair and effective". Table 1 of RG 211 lists the following desired regulatory outcomes sought to be achieved by the regulation of CS facilities under the Corporations Act:

- *CS facility stability*: the regular mechanism provided by the facility operates reliably and the risk of failing is minimised, so that:
  - existing and potential facility users can be confident that it will be available in the future; and
  - the risk of existing and potential facility users, operators of markets or other CS facilities being adversely affected by any failure of the facility is also minimised.
- *Clearing and settlement process*: the clearing and settlement process is transparent so that participants:
  - understand their obligations and the operation of the facility; and
  - can identify, understand and evaluate the financial risks and costs associated with their participation in the facility.Also, users of a CS facility are confident that the facility operates fairly and that settlement obligations will be met in a timely manner. For example, participants:
  - promptly and properly settle their obligations; and
  - comply with the law and the facility's operating rules.
- *Facility and participant supervision*: the facility and its participants are properly supervised by the operator so that breaches of the law or the facility's operating rules are likely to be detected and disciplined. As a result:
  - participants and existing and potential facility users have confidence in the operation of the facility;
  - participants and facility users are not disadvantaged by breaches of the facility's operating rules; and
  - the facility has a good reputation.

Further, facility supervision is not compromised by:

- conflicts between the facility operator's duties and its commercial interests;
- the influence of a major shareholder;
- the involvement of unfit individuals in the management of the facility operator; or
- the facility operator's lack of resources.
- *Risk management*: risks relating to default and other risks, including systemic risk, counterparty risk, market risk, liquidity risk and operational risk, are anticipated and appropriately dealt with, so that:
  - participants and existing and potential facility users can be confident that the clearing and settlement obligations will be met promptly and properly in case of a participant default;
  - the risk of operators of markets, participants of the CS facility or other CS facilities being adversely affected by a participant default will be minimised; and
  - systemic risk to the Australian financial system is reduced.

The desired regulatory outcomes in Table 1 plainly reference a broader range of statutory obligations than just section 821A(a). These include the statutory obligations in sections 821A(aa), (c), (d) and (h) mentioned in note 2 above.

<sup>6</sup> "Facility" is not defined in the Corporations Act. ASIC has expressed the view that a "facility" includes any form of technology or physical infrastructure (see ASIC Regulatory Guide 172 *Financial markets: Domestic and overseas operators* (May 2018) ("RG 172"), at paragraph 30). This is consistent with the decision in *Carrageen Currency Corporations Pty Ltd v Corporate Affairs Commission (NSW)* (1986) 11 ACLR 298, 312-3.

<sup>7</sup> Corporations Regulation 7.1.09 prescribes for the purposes of this paragraph obligations that arise from a contract to transfer securities, managed investment products, foreign exchange contracts and certain other types of financial products or to acquire or provide derivatives. Section 768A gives as examples of facilities that fall within this definition: (1) a facility that provides a

regular mechanism for stockbrokers to pay for the shares they buy and to be paid for the shares they sell, and for records of those transactions to be processed to facilitate registration of the new ownership of the shares; and (2) a facility that provides a regular mechanism for registering trades in derivatives on a futures market and that enables the calculation of payments that market participants owe by way of margins.

<sup>8</sup> ASX therefore would not regard the fact that another licensed CS facility may be affected by circumstances that cause it to be operating in an unfair or ineffective manner, or that it has halted processing in response to, or to avoid, that occurring, of itself to be relevant to assessing whether an ASX licensed CS facility is providing its services in a fair and effective way. The latter issue would have to be assessed by reference to the particular circumstances affecting the ASX facility and any direct or indirect impact that the circumstances affecting the other licensed CS facility is having on the ASX licensed CS facility.

<sup>9</sup> Section 824B(1)(c).

<sup>10</sup> Before it can change its operating rules, a clearing and settlement facility operator must lodge written notice of the change with ASIC under section 822D. The Minister can disallow the change within 28 days of that lodgement under section 822E.

<sup>11</sup> Section 822E.

<sup>12</sup> Section 822B and 822C. Although, in the case of the licensee, this is subject to any discretion that the operating rules may afford to the licensee in terms of granting a waiver or exemption from, or not enforcing, a particular rule. Any such discretion is one that would have to be exercised by the licensee “fairly”, as that term is defined later in this Guidance Note.

<sup>13</sup> ASX notes that despite section 821A(aa) having been drafted in a way to impose separate obligations on a licensed CS facility, to the extent that it is reasonably practicable to do so, both to comply with the Financial Stability Standards and to do all *other* things necessary to reduce systemic risk, the Financial Stability Standards and the measures thereunder comprehensively cover matters relevant to the assessment of systemic risk.

<sup>14</sup> ASX therefore would not regard a short term loss of connectivity to one of its clearing and settlement facilities by an individual participant or a group of participants as rendering the services of that facility unfair or ineffective.

<sup>15</sup> The Macquarie Dictionary (2006) lists 22, and Dictionary.com lists over 30, different meanings for the word “fair”.

<sup>16</sup> See the Macquarie Dictionary (2006) at page 420.

<sup>17</sup> See the discussion of the Minister’s powers under sections 824B(1)(c) and 822E in the text at notes 9 and 11 above.

<sup>18</sup> ASX considers that this view of the meaning of “fair” is supported by the decision in *Transmarket Trading Pty Limited v Sydney Futures Exchange Limited*: [2010] FCA 534, concerning the obligation of a market operator under in section 792A(a) to ensure that its market is fair, orderly and transparent. In that context, Perram J observed (at paragraph 95) that the notion of fairness in section 792A(a):

*“relates to a state of affairs in which all market participants are placed in an equal position such that there is level playing field.”*

This formulation of fairness was accepted and applied by the ASX Disciplinary Tribunal in *ASX Compliance Pty Ltd and Timber Hill Australia Pty Ltd* (15 December 2010) Matter No. 2009018 & 2009026, at paragraph 5.14.1. That decision was affirmed on appeal by the ASX Appeal Tribunal (2 May 2011).

<sup>19</sup> See the Macquarie Dictionary (2006) at page 378.

<sup>20</sup> Section 912(1)(a).

<sup>21</sup> *Story v National Companies and Securities Commission* (1988) 13 NSWLR 661. The following observations of Young J, at 672, are a good illustration of the issues at play here:

*“Thus I turn to the phrase “efficiently, honestly and fairly”. In one sense it is impossible to carry out all three tasks concurrently. To illustrate, a police officer may very well be most efficient in control of crime if he just shot every suspected criminal on sight. It would save a lot of time in arresting, preparing for trial, trying and convicting the offender. However, that would hardly be fair. Likewise a judge could get through his list most efficiently by finding for the plaintiff or the defendant as a matter of course, or declining to listen to counsel, but again that would hardly be the most fair way to proceed. Considerations of this nature incline my mind to think that the group of words “efficiently, honestly and fairly” must be read as a compendious indication meaning a person who goes about their duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness, and fairly having regard to the dictates of efficiency and honesty ...”*

<sup>22</sup> Section 792A(a).

<sup>23</sup> See RG 172, at paragraph 73.

<sup>24</sup> The inclusion in section 821A(a) of the qualification “to the extent that it is reasonably practicable to do so” also lends support to this construction. In this regard, the Explanatory Memorandum for the Financial Services Reform Bill (2002), which enacted both section 792A(a) and 821A(a), made the following observations (at paragraph 7.38) about the obligation of a market operator under section 792A(a) to ensure that its market is fair, orderly and transparent:

*“In interpreting the phrase ‘fairness, orderliness and transparency’, it is desirable that all the words in the phrase be considered together. One word taken out of context may lead to a course of action which conflicts with the other words in the phrase. Thus, transparency may on occasions be in conflict with liquidity, yet liquidity is needed for an orderly market. The tensions*

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*between the three words need to be resolved sensibly, so that an appropriate balance is struck between the demands of different market participants. This is specifically acknowledged in the clause 'to the extent that those objectives are consistent with one another'."*

The phrase "to the extent that those objectives are consistent with one another" was replaced in the final form of section 792A by the phrase "to the extent that it is reasonably practicable to do so".