ASIC Consultation 186

Clearing and settlement facilities: International principles and cross-border policy (update to RG 211)

ASX Submission

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Executive Summary

At the time of rejecting the ASX-SGX transaction, the Treasurer indicated that "it is in the national interest for Australia to maintain the ongoing strength and stability of our financial system, and ensure it is well placed to support the Australian economy into the future. It is important that we continue to build Australia's standing as a global financial services centre in Asia to take best advantage of the benefits of our superannuation savings system".

Like the Treasurer, the ASX supports the maintaining and strengthening of Australia's financial system and the development of Australia as a global financial services centre. We have supported the Federal Government's development of a white paper on Australia's position in the 'Asian Century', and we believe that the world-class infrastructure that resides at the ASX and upon which we will continue to build is one of the great strengths of the Australian economy. Our clearing and settlement functions are a core part of ASX's strength.

ASX believes that in any process of determining advice to the Treasurer, ASIC must consider other policies the Government is implementing or considering, including our position in the Asian century.

In addition, ASX believes that, before the Treasurer is asked to make a decision on a licence application from an overseas or domestic clearing house for cash equities listed on ASX, a full assessment of whether the public interest is served, including a cost-benefit analysis, must be undertaken. This assessment needs to engage with all financial sector players including a wide range of market participants as well as the end consumers – namely fund managers, retail investors and public companies. ASIC must engage with these groups to establish whether they would have concerns if clearing took place overseas or, if there needed to be changes to the way the CHESS system or settlement operates, before the Treasurer can consider the public interest implications of granting a second clearing house licence to clear ASX-listed securities. There is no evidence that ASIC has outlined the potential difference in outcomes to end investors or established if they would have concerns if their trades were cleared through an overseas clearing house.

To date there has not been an informed public debate which would enable participants in the market, regulators, political decision-makers and end consumers to fully appreciate the material costs and consequences that would follow from a change to the market structure of clearing. ASX is calling for an open consultation process through public forums on these issues that discuss all the implications.

If Australia is to allow such an important part of our financial sector to be outsourced overseas or, if fundamental changes to the clearing market structure are proposed, ASX believes that everybody should be aware of the costs and benefits, and where this will position Australia in Asia and in the future.

This must be part of ASIC's process in determining an application.

A Significant Gap in the 'Desired Regulatory Outcomes'

ASIC's draft update to RG 211: *Clearing and settlement facilities: Australian and overseas operators* is based on certain "desired regulatory outcomes". ASX believes that there is a significant gap in the list of "desired regulatory outcomes".

ASIC's updated guide is focused on the ability of Australian regulators to conduct regulatory oversight of a facility through foreign equivalence of regulatory regimes and cooperation arrangements with overseas regulators. This does not take into account ASIC's critical role to promote the "confident and informed participation of investors and consumers in the financial system".

There is a significant gap in the list of "desired regulatory outcomes" in relation to the different outcomes that investors will experience if Australian regulators allow clearing or settlement activities to be conducted by an overseas facility. Australian regulators will not have practical jurisdiction and direct influence over facilities which can be operated from other jurisdictions. This is because the laws and insolvency processes of another jurisdiction will be different from those of Australia, something that cannot be solved through regulatory equivalence and cooperation. There is no consideration or suggestion that regard will be had to these matters in ASIC's draft Regulatory Guide. Investors are not likely to be aware of what these differences mean for them.

The regulators need to directly engage with end consumers, namely fund managers, retail investors and public companies, to establish if they would have concerns if clearing took place overseas. Investors should be asked if they would have concerns if these activities moved offshore. The evidence from the USA is that end investors do have concerns if they are asked. ASX's consultation on OTC Derivatives Clearing suggests that the same concerns will be expressed by Australian investors once they understand the potential consequences. Market participants also need to consider potential costs of a dual central counterparty (CCP) structure whether that be under an overseas or domestic licence.

The Treasurer should have regard to these matters as he considers whether the grant of a licence to a particular applicant is in the public interest. The update to RG 211 should set out the range of matters that ASIC will advise the Treasurer as he seeks to address the public interest test.

Investors Unaware of Implications of Offshore Clearing

Investors are not necessarily aware of how clearing works but they do rely on its critical functions. The experience of the defaults of Lehman Brothers and MF Global shows that investors are not aware of the way Australian and foreign insolvency law can affect rights to their collateral or margin money. The different outcomes impact investors most directly if a clearing facility becomes insolvent. In that situation, Australian investors would expect the insolvency processes of Australian law to apply to a facility operating in Australia. This is particularly relevant as investors may not be aware that clearing is being undertaken offshore.

Australian investors are entitled to expect that when a CS licence application is being assessed full consideration will be given to these issues. The outcomes can be very different for investors when an overseas facility operates without a domestic licence and is not subject to Australian law. Australian insolvency laws do not necessarily apply to an overseas facility unless it establishes an Australian subsidiary, holds capital and collateral within the jurisdiction, and conducts key operations here. Foreign insolvency laws may have different objectives, or give priorities to different parties, or even preference foreign systems or investors outside Australia. Australian investors affected by the default of MF Global are still waiting for resolution of their entitlements close to a year after the events that lead to the insolvency of an overseas futures clearing participant which had been exempted from the requirement to operate under an Australian financial services licence.

The courts of this country will either have no jurisdiction or no practical jurisdiction over an overseas licensee. Non-compliance is not limited to insolvency. Revoking the licence may not be of any comfort to those adversely affected by the actions of the licensee or the (overseas) regulators. This problem needs to be solved before any approval of an application from an overseas clearer is contemplated.

Australian Regulators Must Have Powers to Preserve Financial Stability

Any change to the structure of clearing and settlement will increase operational risk. In the more serious circumstance of a failure of a CCP there needs to be clear and unambiguous step-in arrangements for Australian regulatory authorities to ensure the continuous operation of the facility and to protect the interests of the facility's customers and Australia's financial stability. Effective cross-border resolution arrangements remain elusive and new cooperative arrangements are un-tested from a practical perspective. If Government financial support or recapitalisation is required, Australian investors using a foreign facility will rely on a foreign government to protect their interests. Equivalence does not guarantee this.

Profound Implications Merit a Proper Cost-Benefit Analysis

ASX has stated the case for a proper cost-benefit analysis to be conducted before a decision is made to change the structure of clearing in Australia[i]. ASX's view is that a high burden of proof needs to be satisfied before major changes are made to how Australia's financial markets operate. This is particularly the case where any additional risk is to be measured against the modest gross benefits that may emerge through lower facility fees. In the case of equity clearing competition the assumed gross benefits are no more than $12.5-25.0 million a year. ASX analysis has estimated that the potential costs of a dual CCP structure could be as high as $30 million per annum and will more than offset these gross benefits.

When a licence application is made by a domestic or an overseas clearing and settlement facility, the Corporations Act[ii] provides that the Minister must have regard to whether it is in the public interest to grant a licence and any other matters that the Treasurer considers relevant. ASX believes that in these circumstances the public interest requires that a proper cost-benefit analysis is conducted that answers four simple questions:

- Will there be clear benefits for end consumers – that is, fund managers, retail investors and public companies?
- Will stakeholders be well informed about the risks and confident the controls are sufficient? Will investors understand the different outcomes and risks that they accept particularly if key elements of clearing are conducted offshore?
- Can regulators give a positive assurance that there is no increased (systemic and operational) risk and that they will be able to manage the risks to Australian markets and investors if something goes wrong, particularly if it goes wrong overseas?
- Does the change help Australia's game plan as a country – in this case, does it help our ambitions to become a regional financial centre in the Asian century?

Australia in the Asian Century

Given the importance of the Federal Government's white paper 'Australia in the Asian Century', it would seem prudent for regulators to marry decisions on clearing competition with this significant strategic policy paper. The ASX infrastructure is critically important to the long-term productive capacity of the Australian economy and how we position ourselves in the Asian region.

Only three other countries have exchanges like ASX - Germany, Canada and Brazil. No country in Asia has exactly the same model as ASX, and this is a real strength for Australia in the region.

In regard to Canada, it has reversed market fragmentation and undertaken the Maple transaction which gives Canada greater strength globally.

Brazil has looked at other markets which have implemented competition, including our own, and rejected it.

Graduated Approach to Regulation has Serious Flaws

ASX does not agree that a graduated approach is an appropriate way of imposing regulatory standards on foreign CS facilities servicing important Australian markets. Such an approach is both inconsistent with a public interest test and practically difficult to implement:

- The graduated approach to licensing is not consistent with a public interest test, particularly when the CS facility being licensed is servicing a systemically important market (for example, cash equities). In such a circumstance the public interest goes well beyond the interests of CS facility operators and their users to encompass the broader community. This public interest cannot be met by deferring a proper consideration of the potential differences in risks, outcomes and concerns of end investors until an overseas clearer has built a substantial market presence. It is the systemic significance of the market being serviced and not the size of the individual facility which should drive regulatory policy settings, particularly the need for domestic licensing and location requirements and consistent application across all facilities from day one. This reflects the real macroeconomic effects that can result from financial disruptions in these markets. A public interest test must place a premium on financial stability in any assessment. Linking regulatory standards to the market share of a facility fails this test, particularly as it is not possible before a facility even begins operation to anticipate what level of activity it may achieve in a relatively short period of time.
- ASX's analysis shows that the higher market costs of a dual CCP structure appear even at a modest 9 per cent share for a second facility. This makes a graduated approach uneconomic.

- In practical terms, the ability of regulators to impose regulatory settings once a business model has grown to a certain size is very difficult, complex and potentially disruptive to the market. Experience with changes to the market structure in equities trading suggests that regulation 'after the fact' is difficult, if not impossible. A year after competition in equities trading commenced, important issues around dark execution and high frequency trading remain unresolved. What this means is that appropriate regulatory controls may never be implemented if an overseas clearing facility becomes systemically important.

- A graduated approach does not create a level playing field, leaving ASX exposed to 'ad hoc' decision-making in relation to its infrastructure and opportunities to move this offshore.

ASX submits that considerations of the public interest, informed by a substantive cost-benefit analysis and with input from key stakeholders through a public consultation process (which may require active reaching out to ensure all affected parties are made aware of the implications of different outcomes), should be undertaken before further consideration is given to specific changes to market structure in clearing and settlement and the licensing of new facilities.

Appendix 1 sets out ASX's responses to the ASIC questions in CP 186.

[i] See http://www.asxgroup.com.au/media/Competition_in_the_clearing_and_settlement_of_the_Australian_cash_equity_market.PDF.

[ii] Section 827A (2) (g).

Appendix 1 – Detailed Responses to ASIC Questions

CPSS–IOSCO Principles for financial market infrastructure: Implementing the Principles

ASIC Proposal	ASX Response
B1 Propose the following amendments to RG 211: a) change references from 'the CPSS–IOSCO Recommendations' to 'the CPSS–IOSCO Principles for financial market infrastructures' and 'the CPSS–IOSCO Principles'. b) add the following sentences to existing RG 211.145: When framing our advice to the Minister about granting you a licence, we will consider: … (d) whether you comply with the Principles relevant to ASIC's regulatory remit. When we assess a licence application to give advice to the Minister as to whether you comply with the CPSS–IOSCO Principles, we will take into account the CPSS–IOSCO Disclosure framework for financial market infrastructures and the CPSS–IOSCO Assessment methodology for the principles for FMIs and the responsibilities of authorities.	ASX agrees with the proposed approach to amend RG 211 to adopt the CPSS-IOSCO principles for financial market infrastructure, specifically the disclosure framework and assessment methodology. It is important that the licensing of CS facilities, which provide critical post-trade services to Australian markets and the investors that deal in them, have confidence in Australia's post-trade infrastructure. From ASX's position as a licensed clearing and settlement facility operator the proposed redrafting of RG 211 does not appear to raise issues for our compliance with the licence obligations. CP 186 notes that a decision was taken not to provide detailed guidance in the amended RG 211 on the application of the CPSS-IOSCO principles, given such guidance it contained in that document. However, we would expect that should ASIC be contemplating revising its existing approach, for example to the annual assessment process, that these would be subject to a separate consultation. That is the approach the RBA has taken with its implementation of the financial stability aspects of the global standards.
B2 We propose to take into account the CPSS–IOSCO disclosure framework and assessment methodology in considering whether the CS facility meets the Principles.	ASX has been an advocate of CS facility transparency and we strongly support the efforts of global regulators to enhance FMI disclosure through the disclosure principles. We believe transparency is particularly important as it enables customers to understand the risks inherent in the use of the FMI's services. ASX sees clear public benefits from authorities being transparent in their findings from the annual assessment reviews. They provide a means of disclosing very detailed information on FMI operations and, as such, can be a useful mechanism for educating the public on these important issues. The assessment methodology needs to recognise that Australian regulators retain an ability to impose super-equivalent requirements (over and above the global standards) on FMIs operating in the domestic market if they deem it necessary in the context of the size and character of Australian markets. Where Australian regulators choose to impose requirements over and above the CPSS-IOSCO standards then these should be applied equally to both domestic and foreign-licensed CS facilities. The process is not clear that the two regulatory agencies will undertake with regards to the ongoing assessment of licensed facilities against the12 CPSS-IOSCO Principles for FMIs, where responsibility is split between ASIC and the RBA. It is important that an efficient annual assessment process is established that does not involve multiple assessments against the same principles and that it is clear which agency will be the lead agency for the purpose of the oversight of these shared principles.

ASIC Proposal	ASX Response
B3 We intend to amend RG 211 by the end of 2012 and propose that the amendments will take effect immediately from that time.	ASX has not yet determined what transitional arrangements would be necessary for the ASX Group entities which currently hold CS licences (ASX Clear, ASX Clear (Futures), ASX Settlement and Austraclear) to be in a position to comply with expectations outlined in the amended RG 211, particularly those related to the revised Financial Stability Standards. We note that Australia's approach to implementing the systemic stability principles through amendments to the RBA's Financial Stability Standards is still the subject of a separate consultation process.

Proposed amendments to RG 211: Cross-border CS facilities

ASIC Proposal	ASX Response
C1 We propose to amend RG 211 to put in place measures and build on existing ASIC guidance to ensure there is appropriate regulatory influence over cross-border CS facilities as envisaged under the Council's framework.	ASX notes that CP 186 states that the matters dealt with do not cover proposed legislative changes to ensure Australian regulators have appropriate influence over cross-border CS facilities. We assume further amendments to RG 211 may be made subject to those legislative changes. ASX acknowledges that the guidance in RG 211 is designed to cover a wide range of CS arrangements for different products, market structures, and investor participation. Each situation may require a different solution depending on the particular circumstances. However (as noted in the covering submission) ASX believes it is important that both wholesale and retail investors are clearly informed about the different outcomes they may face when their domestic broker/clearer is dealing with a CS facility that does not operate under the conditions of a domestic licence. There are a range of steps that can be taken to educate and inform investors. This includes early engagement by regulators with key stakeholders in the process of considering whether to approve a licence application or to apply conditions to that licence. This will ensure the Minister is fully informed of the full range of stakeholder views. RG 211 anticipates that in some circumstances, determined on a case-by-case basis, a public consultation on a licence application might be contemplated to gain stakeholder views. These circumstances include where a new CS facility may have a regulatory impact on existing licensed CS facilities; affect the reputation of Australia as a financial centre; has certain features (eg size or likely facility users); or may have an impact on Australian investors and the Australian financial system.
We propose to: a) clarify that if a CS facility is systemically important with a strong domestic connection, ASIC would ordinarily recommend that the applicant should apply for a domestic operator licence. We propose to include guidance in RG 211 on the indicative factors we may take into consideration to determine if a CS facility has a strong domestic connection and is systemically important;	ASX believes that a systemically important CS facility or a facility with a domestic connection should be required to have a domestic CS licence. ASX does not, however, support the 'graduated' licence approach which forms the foundation of the regulatory framework for foreign FMI operators. The revisions to RG 211 include a range of indicative factors that are "neither exhaustive nor determinative" which might be considered in determining whether a foreign facility is required to have a domestic operator licence. While none of the criteria are controversial in and of themselves, it is the weighting applied to each factor that will determine the ultimate regulatory outcome. ASX would argue that the interests of users of the facility should be paramount in the Minister's decision on approving a licence application, the nature of that licence and any conditions attached to that licence.

ASIC Proposal	ASX Response
	For example, in the case of equity markets where there is significant participation by retail investors, there would seem to be a strong case for a CS facility to be located in Australia and subject to primary regulation by Australian authorities. Where such a facility is required to comply with the domestic licence requirements many of the potential different outcomes for users are reduced or removed. We note that the Council of Financial Regulators': *Supplementary Paper to the Review of Financial Market Infrastructure Regulation* indicated that "in some circumstances, for instance if a trading platform served by an offshore CS facility had a high degree of retail participation, retail consumer protection concerns or market integrity considerations might nevertheless lead ASIC to recommend that the facility apply for a domestic licence and thereby submit to primary regulation by the Regulators." When a licence is granted to operate a CS facility in Australia is the optimal point to clearly establish the regulatory framework under which the facility is expected to operate. Any other arrangements necessarily involve uncertainty for the facility operator and its customers. The practical application of such an approach as thresholds are reached is also problematic given the possible cost, complexity, and disruption involved and the associated resistance likely from affected interests. An analogy could be drawn with the regulation of dark pools and HFT where an initial accommodative stance saw a growth in activity that now makes it more difficult to subsequently wind back. ASX believes that the regulatory approach to considering licence applications from foreign operators must adequately address the need to inform investors of the potential operational complexities and jurisdictional issues that may arise from their involvement with a facility that may not be located in Australia or regulated under domestic licence obligations. We believe there is a need for the regulatory agencies to take a pro-active role in educating this wider customer group as they are ultimately the users of these facilities. Ensuring users have sufficient information on these issues should be supplemented with the ability for investors to choose the nature of their clearing arrangements. In particular they should have the opportunity to decide if they wish their post-trade processing to be conducted by a facility located outside of Australia and not under the full requirements of an Australian domestic licence. It is clear from the MF Global incident that the regulatory and legal differences associated with dealing with a foreign operator of, or foreign participant in, a clearing or settlement facility can be difficult for even sophisticated market participants to understand. This is not to diminish the importance of considering carefully the systemic and operational risks flowing from an increasingly complex structure for post-trade services. This complexity increases as the number of licensed facilities rises, so the regulatory authorities need to be mindful of the overall impact on Australian markets and investors not just the incremental impact of each individual facility.

ASIC Proposal	ASX Response
b) amend existing RG 211.148, which lists the examples of circumstances where we may advise the Minister to impose conditions, to include the following examples: (i) facilitating ASIC's ability to conduct periodic and/or activity-based reviews to determine if there has been changes that mean that a domestic licence and a domestic legal presence should be required; (ii) requiring the CS facility to report to ASIC regularly on its overseas activities and presence; (iii) requiring the CS facility to establish a domestic operational presence, either with respect to human resources or other aspects of their operations, for either all or part of their functions; and (iv) requiring a CS facility to set controls around how they deal with outsourcing of critical functions (e.g. core risk management function);	As noted in C1(a) above, ASX believes that there are some circumstances where a foreign CS facility should be required to have a domestic licence. Subject to that caveat, ASX believes the addition of four further examples of possible conditions that might be imposed on a CS facility licensee all seem reasonable. In addition, ASX believes the example of potential conditions imposed by the Minister should be expanded to include the domestic location of capital and collateral held by the facility.
c) amend existing RG 211.152(a) to include an expectation that a CS facility licence application will include detailed information about whether any operations are performed overseas;	ASX agrees that regulators should be aware where critical CS facility operations are performed outside Australia.
d) insert a new paragraph under existing RG 211.204 to state that specific licence conditions may be imposed to ensure appropriate influence by ASIC over cross-border CS facilities;	ASX agrees that regulators should have the appropriate influence over cross-border facilities. However, in a financial crisis the interests of Australian investors and markets would not be as high a priority for a foreign clearing facility and its home regulators as the impacts in its home jurisdiction. As such, at times when the cooperation between regulatory authorities is most crucial it might be most difficult for Australian authorities to influence the outcomes for Australian investors.
e) insert a new paragraph under existing RG 211.206 to provide an example of additional conditions that may be required to achieve regulatory outcomes in the circumstance of a domestic CS facility seeking to move or offshore some operations overseas or an overseas CS facility that is systemically important with a strong domestic connection;	As noted in C1(a) above, ASX believes that there are some circumstances where a foreign CS facility should be required to have a domestic licence. ASX agrees that ASIC should have the ability to apply such conditions. In circumstances where there are two or more CS facilities competing in providing services to the same market there should be competitive neutral outcomes. That is, what one facility is allowed to do in terms of outsourcing or offshoring should be available to all facilities.
f) amend existing RG 211.215 to provide an example that we may require, through a cooperative agreement with a CS facility licensee, that information is included in the licensee's annual report about whether any operations have been moved or outsourced overseas;	ASX agrees that such material should be contained in the annual report where it involves critical operational functions related to the provision of the facility's services. We would expect that such information should also be made available through the annual assessment report process.

ASIC Proposal	ASX Response
g) insert a new paragraph under existing RG 211.215 stating that we would expect a domestic CS facility licence holder to speak to us about any intention to move or outsource critical functions overseas so that we can understand any potential regulatory impact and ensure any necessary measures are put in place; and	ASX agrees that regulators should be informed by a CS facility about any intention to move or outsource critical functions overseas to determine if there is any regulatory impact. In order to ensure competitive neutrality this requirement should also apply to offshore clearing and settlement licence holders.
h) amend Examples 4 and 6 in Table 2 of RG 211.	Given the recent consultation on competition in clearing and settlement of the cash equities market we would have thought it timely (and appropriate) to include a specific example related to cash equities clearing. With the regulatory approach along the lines of the description in the recent CoFR supplementary paper (see answer to C1(a) above).
C2 We intend to amend RG 211 by the end of 2012 and propose that the amendments will take effect immediately from that time.	ASX is not aware of any transitional arrangements that would be required for its CS licensed facilities.

RBA's financial stability standards: Consequential changes to take into account proposed revised financial stability standards

ASIC Proposal	ASX Response
D1 We propose to make the following amendments to existing RG 211: a) update references to RBA's financial stability standards in existing RG 211.165 and RG 211.166;	ASX agrees.
b) amend existing RG 211.108 to update the factors RBA will take into account in assessing sufficient equivalence of the home regulatory regime as it applies to the overseas CS facility, in relation to the degree of protection from systemic risk to include observed outcomes relative to those in Australia, as reflected in an initial assessment of CS facilities operating under the relevant overseas regime;	ASX agrees. ASX notes that it is ASIC's intention to make subsequent revisions to RG 211, for the purposes of consistency, should the current RBA consultation process result in changes to the Financial Stability Standards.
c) amend existing RG 211.165 to reflect that the new level of exemption from the financial stability standards for Securities Settlement Facilities issued by the RBA is proposed by the RBA to be $200 million; and	ASX has no in-principle objection to raising the small-size market criterion for determining whether a settlement facility should be eligible for an exemption from the obligation to comply with the RBA's Financial Stability Standards (FSS). However, if that settlement facility is operating in a systemically significant market (even if it only settles a small portion of total activity in that market) it should not be eligible for an exemption from the FSS.

ASIC Proposal	ASX Response
d) remove the exemption from existing RG 211.166 that states: An overseas CSF licensee that operates a central counterparty is exempt from complying with this standard if certain conditions are met, including: a) compliance with the home regulatory regime's requirements relating to financial stability; and b) having in place satisfactory arrangements to provide additional information to the RBA as required.	ASX agrees.
D2 We intend to amend RG 211 by the end of 2012 and propose that the amendments will take effect from that time.	ASX has not yet determined what transitional arrangements would be necessary for the ASX Group entities which currently hold CS licences (ASX Clear, ASX Clear (Futures), ASX Settlement and Austraclear) to be in a position to comply with expectations outlined in the amended RG 211, particularly those related to the revised Financial Stability Standards. This will be done when the standards are finalised.