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

A Policy Statement by the
Council of Financial Regulators

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Background

On 30 March 2016, the Government endorsed the recommendations of a review of competition in clearing Australian cash equities carried out by the Council of Financial Regulators (CFR) and the Australian Competition and Consumer Commission (ACCC) – together, the Agencies – in the first half of 2015. These recommendations are set out in the Agencies' report, *Review of Competition in Clearing Australian Cash Equities: Conclusions* (the Conclusions), published at the time of the Government's announcement.[1]

With the Government's endorsement of the Agencies' recommendations, a policy stance of openness to competition has been confirmed. This stance recognises prevailing legislative settings that are accommodative of competition, as well as the potential benefits of competitive discipline. At the same time, the Conclusions acknowledge that competition in clearing could have cost, risk and efficiency implications for the functioning of markets, financial stability and access for unaffiliated market operators and clearing and settlement (CS) facilities. Accordingly, the Conclusions recommend legislative changes to facilitate a set of minimum conditions for safe and effective competition in cash equity clearing (Minimum Conditions (Clearing)).

As a first step, the Agencies have undertaken to set out the Minimum Conditions (Clearing) in a publicly stated policy. This document fulfils this commitment. The Conclusions recommend that the Minimum Conditions (Clearing) cover the following: (i) adequate regulatory arrangements; (ii) appropriate safeguards in the settlement process; (iii) access to settlement infrastructure on non-discriminatory, transparent, fair and reasonable terms; and (iv) appropriate interoperability arrangements between competing cash equity central counterparties (CCPs). The Minimum Conditions (Clearing) have been developed with reference to the prevailing market structure in settlement – in which there is a sole provider of settlement services. Nevertheless, the statutory framework (Part 7.3 of the *Corporations Act 2001*) applies to both clearing and settlement and recent rapid advances in technological developments may increase the prospect of competition emerging. The Agencies will consider the need for specific policy guidance to be issued in respect of settlement facilities.

The Minimum Conditions (Clearing) aim to give potential entrants 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, 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 (Clearing).

Some aspects of the Minimum Conditions (Clearing) are not enforceable under the existing regulatory framework (such as requirements for materially equivalent settlement arrangements and the establishment of interoperability). The Agencies will therefore work with Government to implement legislative changes that would:

- allow the relevant regulators to implement and enforce the Minimum Conditions (Clearing) through the use of a rule-making power if and when a competitor emerged
- grant the ACCC power to arbitrate disputes regarding access to services licensed under Part 7.3 of the Corporations Act. In the context of the current settlement market structure, this would ensure that any competing CCP was able to access ASX's settlement infrastructure on fair,

[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>.

transparent and non-discriminatory basis with terms and conditions, including price, which are fair and reasonable.

Given the importance of the Minimum Conditions (Clearing) in ensuring that competition did not adversely affect financial stability or effective market functioning, ASIC and the Bank would be unable to advise in favour of a licence application until these measures had been implemented. The Agencies accept that this process could take some time. 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.

The proposed legislative framework to implement the Minimum Conditions (Clearing) 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. It is envisaged that the new legislation would set the scope of the rule-making powers and the circumstances in which these powers could be used. The accompanying Explanatory Memorandum could provide further guidance on the nature of specific requirements that might be imposed through the use of these powers. In the case of interoperability, for instance, the rules would be likely to include such details as the criteria against which a CCP would be obliged to consider an access request from a competitor (and the acceptable grounds for rejecting such a request), the required scope and operational functionality of a link, and the timeframe on which a request that met the criteria should be granted.

Certain of the Minimum Conditions (Clearing) would need to be further supported by operational changes and, once implemented, would rely on other aspects of the regulatory framework. In the case of interoperability, for example, the rule-making power would establish and enforce the access requirement; once in place, the relevant regulators would monitor the operation of the link and the management of risks arising from the link under existing powers. The Bank would need to elaborate additional guidance to the *Financial Stability Standard for Central Counterparties* (CCP Standards) that deals with the management of risks arising from interoperable links.[2] At the same time, the Agencies would clarify arrangements for the regulatory oversight of matters such as default management and CCP recovery in a multi-CCP environment.

To the extent possible, the relevant regulators would offer a prospective competitor guidance on potential specific requirements through bilateral discussions prior to submission of a licence application, but detailed specific requirements would not be articulated or implemented until such time as a committed competitor emerged or was likely to emerge. The Agencies recognise that the rule-making process and the need to make operational arrangements to support a multi-CCP environment would defer the commencement of operations by a competitor. However, to implement the rules and require that operational changes be made in advance would lead to redundant industry investment and regulatory cost should a competitor fail to emerge. This is particularly important given that the rules will deal with matters such as interoperability and materially equivalent settlement arrangements between the emerging competitor and incumbent CCP, which could be costly to establish.

Accordingly, ASX would not be required to make up-front operational changes to accommodate competition until such time as a competing CCP committed to entry. However, at the same time, the technological design of ASX's CS infrastructure should not raise barriers to the potential future implementation of interoperability or access to settlement arrangements by a competing CCP.

2 The Bank's CCP Standards are available at <http://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/standards/central-counterparties/2012/>.

This statement should be read alongside the analysis on the costs and benefits of competition detailed in the Conclusions. Since the Minimum Conditions (Clearing) have been developed in the context of a market structure in which the settlement of cash equities is monopolistic, the statement also refers to the *Regulatory Expectations for Conduct in Operating Cash Equity Clearing and Settlement Services in Australia* (Regulatory Expectations).[3] The Regulatory Expectations would, for instance, govern the terms of access to ASX Settlement, ASX's securities settlement facility for cash equities.

The Agencies also expect to review the Minimum Conditions (Clearing) periodically, including in the event of material changes to the operating environment or market structure for these services, such as the emergence of a competing settlement facility.

Minimum Conditions for Safe and Effective Competition

The Minimum Conditions (Clearing) relate to the following.

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.

Each of the Minimum Conditions (Clearing) 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 joint regulatory responsibility for supervising CS facility licensees. The Bank is responsible for ensuring that CS facilities comply with the CCP Standards and take any other steps necessary to reduce systemic risk. The CCP Standards are aligned with the financial stability-related requirements of the CPMI-IOSCO *Principles for Financial Market*

3 The Regulatory Expectations are available at <http://www.cfr.gov.au/publications/cfr-publications/2016/regulatory-expectations-policy-statement/>.

Infrastructure (PFMI), which establish an international benchmark for the risk management and operational standards of CS facilities.[4] 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).[5]

Equivalent application of these oversight standards across competing CCPs 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 standards, including cost-cutting measures and product development processes.

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

If a new entrant CCP was seeking to leverage existing capabilities in overseas cash equity markets ASIC and the Bank's supervisory approach would be guided by the CFR's Regulatory Influence Framework.[6] 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.

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 additional guidance on the Regulatory Influence Framework, the threshold for application of this requirement would be likely to be set at a relatively low level for any CCP seeking to clear ASX securities. The Agencies consider this to be an integral part of the Minimum Conditions (Clearing), at least until ASIC and the Bank are comfortable with the arrangements for cross-border coordination and management of FMI recovery and resolution.[7] The precise threshold for the requirement would be discussed and agreed with a prospective competitor in order to provide the entrant with sufficient certainty to support business plans and investment decisions. The threshold would also be made transparent to market participants, market operators and ASX, to ensure that all stakeholders had the necessary information to formulate business plans with certainty.

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

Since a commercially driven exit of a CCP in a competitive environment could disrupt activity in the segment of market activity that it cleared, the Agencies see a case to include measures aimed at mitigating such market disruption within the Minimum Conditions (Clearing).

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4 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>

5 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/>

6 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>. Guidance on the application of this framework in the case of CCPs is available at <http://www.cfr.gov.au/publications/cfr-publications/2014/pdf/app-reg-influence-framework-cross-border-central-counterparties.pdf>

7 The international work on recovery and resolution of FMIs is currently ongoing. Domestically, in February 2015, the government released a consultation paper on legislative proposals to establish a special resolution regime for FMIs in Australia, available at <http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Resolution-regime-for-financial-market-infrastructures>. The CFR's response to this consultation was published in November 2015. This is available at <http://www.cfr.gov.au/publications/cfr-publications/2015/resolution-regime-financial-market/>.

In particular, all competing CCPs – including the incumbent and any new entrants – would 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 operating expenses for the duration of the notice period, calculated on a rolling basis, as well as clearly articulated wind-down plans which would be discussed with ASIC and the Bank.

The Agencies acknowledge that the conditions stated here are more stringent than the requirements for orderly wind-down envisaged in the CCP Standards; Standard 14 on general business risk requires that 'at a minimum, a CCP 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 Agencies consider this difference to be appropriate, as this condition is intended to provide for a planned exit for commercial reasons, while the Standard 14 seeks to protect against exit due to the crystallisation of business risk.

Furthermore, as discussed above, a commercially driven exit of a CCP could disrupt activity in the segment of market activity that it cleared. Such disruption could also arise if an existing provider scaled back its activities due to increased costs (e.g. if its exposures became concentrated in less liquid products). The Agencies would therefore work with the CCPs and relevant market operators to establish *ex ante* contingency arrangements to ensure the continued provision of clearing services for less liquid securities in the event that the incumbent CCP for those securities exited the market or reappraised its provision of those services.

(d) Appropriate arrangements for regulatory oversight in a multi-CCP environment

The Agencies do not see a strong case for a material change in ASIC and the Bank's supervisory responsibilities in a multi-CCP environment. This view is consistent with the idea that participant oversight is central to a CCP's risk management activities, given the proprietary risk exposure that a CCP assumes to its participants.

However, a more fragmented view of participants in a multi-CCP environment could disrupt arrangements for monitoring and managing clearing risk, including perhaps most notably in default management. As part of the Minimum Conditions (Clearing), the Agencies would clarify arrangements for regulatory oversight, particularly in relation to default management and CCP recovery, at such time as a committed competitor emerged.

Competition in clearing could also give rise to adverse selection in both products and participants. For instance, a competing CCP may be motivated to only offer clearing services in the most liquid securities or to structure their business so as to favour larger participants over smaller participants. This could lead to the fragmentation of the market along the lines of liquidity, with potential implications for the profile of exposures to be managed by each CCP. If a competing CCP were to emerge, the Agencies might consider steps to mitigate these effects, such as through closer oversight of product and participant scope; it is acknowledged, however, that there could be practical challenges in implementing such steps.

2. Appropriate safeguards in the settlement process

The entry of a competing cash equity CCP would have implications for the design, operation and organisation of the settlement model. Any changes to the existing settlement arrangements could potentially give rise to additional costs, as well as financial and operational risks. In light of this, the Agencies see a case to set minimum conditions around the design of the settlement model for a multi-CCP environment. As far as possible, the new model would need to preserve the efficiencies of the prevailing settlement model in a single-CCP environment, while affording materially equivalent

priority to a competing CCP. It should also minimise financial interdependencies between CCPs in the settlement process and facilitate appropriate default management actions.

3. Access to ASX Settlement on fair, transparent and non-discriminatory terms

In the absence of an alternative provider of cash equity settlement services emerging, any new cash equity CCP would require access to the vertically integrated incumbent settlement facility, ASX Settlement. To the extent that it remains the sole provider of cash equity settlement services, ASX Settlement would be required to facilitate the provision of access to its cash equity settlement infrastructure on a fair, transparent and non-discriminatory basis with terms and conditions, including price, that are fair and reasonable.

The Regulatory Expectations, outlined by the Agencies in a separate policy statement, deal with access to monopoly clearing and settlement services. The relevant provisions in the Regulatory Expectations explicitly address access on fair, transparent and non-discriminatory terms; these provisions would also apply to ASX Settlement's provision of clearing and settlement services to a competing CCP for cash equities under the Minimum Conditions (Clearing). Additionally, the ACCC will have the power to arbitrate disputes in relation to price and/or non-price terms and conditions of access where negotiations guided by the Regulatory Expectations fail.

4. Appropriate interoperability arrangements between competing CCPs

Interoperability has been identified as a potentially effective mechanism for ensuring that the benefits of competition are realised while mitigating some of the adverse implications, including market fragmentation and increased operational costs for participants. Based on analysis summarised in the Conclusions, the Agencies consider that a requirement to establish appropriate interoperability arrangements between cash equity CCPs, prior to a competing CCP commencing operations, would be a necessary condition to support competition.

Given commercial and operational considerations, the incumbent CCP may have little incentive to voluntarily develop interoperability arrangements with a new entrant. 'Open access' obligations or other regulatory measures may therefore need to be imposed to facilitate the establishment of fair and effective interoperability between the incumbent CCP and any new CCP seeking to enter the Australian cash equity market.

The Agencies also acknowledge that interoperability may give rise to additional complexities and risks. Should a competing CCP emerge, an effective risk management framework for interoperability arrangements would need to be put in place in order to mitigate these incremental risks. Specifically, the Bank would need to issue additional guidance to clarify how the requirements under CCP Standard 19 (FMI Links) should be met for the purpose of establishing safe and effective interoperable links.