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7 November 2014

Ms Janine Ryan  
General Manager  
Office of General Counsel  
ASX Limited  
20 Bridge Street  
Sydney NSW 2000

Dear Ms Ryan

**ASX Consultation Paper: Central Counterparty Recovery**

Chi-X Australia Pty Ltd (Chi-X) is grateful to ASX for the opportunity of providing a submission on the above consultation paper (CP). Chi-X operates a licenced market in the trading of ASX listed equity market products and the comments in this submission are primarily addressed to issues that may be raised in respect of ASX Clear.

Chi-X commends ASX for engaging publicly in this CP on the recovery processes to be implemented by the ASX CCPs, but is of the view that enhanced governance arrangements at those CCPs must be part of any meaningful analysis of recovery arrangements. In particular it is not clear to Chi-X how it may be appropriate to charge clearing participants with the cost and obligations of a recovery regime and yet not provide those participants with ongoing transparency and input to the key aspects of that regime, including the composition, size and replenishment of the funds to be used in the default waterfall. The remainder of this submission outlines material in support of this key concern.

Chi-X is also of the view that once ASX refines its thinking on the recovery proposals, any transfer of risk from ASX shareholders to clearing participants should be detailed in a further consultation paper that also:

- (i) outlines any revised policy for the payment of dividends to ASX shareholders that properly recognises the risk that will now be carried by participants; and
- (ii) enables clearing participants to better understand any costs/savings (for example, savings through reduced clearing fees) that may flow from the new risks they will carry.

This submission is segmented as follows:

1. CCP Governance, including participant representation and the structural separation of ASX's CCP's from other parts of its business;
2. calculating the true cost and source of funding of the ASX resources in the default waterfall;
3. issues raised by mandatory participant replenishment.

### **1. Governance, including structural separation and participant representation**

Chi-X is of the view that the governance at ASX Clear, including the transparent and substantive structural separation of ASX Clear from the other components of the ASX Group, must be enhanced before the recovery and resolution processes at ASX Clear can be settled. As Paul Tucker, formerly Deputy Governor of the Bank of England<sup>1</sup>, has stated:

*Where a CCP is part of a vertically integrated group centred on an exchange, the CCP's risk managers must be appropriately insulated from the commercial imperatives that these days can all too easily dominate profit-maximising strategies of the boards of publicly quoted groups. Strong user representation – meaning senior risk managers and others from clearing members – is essential given the mutualisation of risk. Independent directors on boards and risk committees are important too.<sup>2</sup>*

Chi-X is of the view that in the case of ASX Clear, the principles outlined by Mr Tucker are appropriate and require strong user representation and insulation of clearing risk management processes from the wider activities of the ASX Group. At present these requirements are clearly not satisfied at ASX as:

- (i) clearing activities at ASX are often resourced by persons engaged at ASX that have clear fiduciary and other obligations to other parts of the ASX group;
- (ii) there is a lack of genuine user representation in the determination of the risk management process - Chi-X acknowledges the steps taken by ASX to incorporate user representation in the Forum and various committees established pursuant to the Code on Clearing and Settlement, however the Forum and committees are still run and managed by ASX persons with fiduciary and other obligations to the wider ASX Group. Chi-X is of the view that the experience with

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<sup>1</sup> Paul Tucker was formerly Deputy Governor, Financial Stability, Bank of England and also Chairman of the Basel Committee on Payment and Settlement Systems (CPSS)

<sup>2</sup> Central Counterparties in evolving capital markets: safety, recovery and resolution, retrieved on 3 November 2014 from <http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech650.pdf>

respect to the publication of separate reports on the benchmarking of clearing costs bear out the inadequacies in the current user representation on the Forum<sup>3</sup>;

- (iii) under current arrangements, ASX Clear is proposing to use a static fund (consisting of what ASX describes as ASX own funds, although it is not clear that this description is accurate – see section 2), that if set at an excessive level imposes an excessive cost on participants<sup>4</sup> and if set at an insufficient level, may impose the cost of any default or a burden of replenishment upon participants<sup>5</sup>.

A strong and effective governance process, including transparent and substantive structural separation, will also be important in managing the risks posed to ASX Clear by the other parts of the ASX Group. For example, losses among ASX group companies may impact on the ability of ASX Clear to re-capitalise any funds that may be called on in the recovery process.

## **2. Transparency on the cost and sources of the ASX Resources in the default waterfall**

The default waterfall shown on page 19 of the CP outlines a series of funded pools, some of which are described as ‘ASX funded pools’, that will be used in the recovery process. The Oxera report states that a likely reason for ASX being at the high end of the range for fees charged for CCP services is that ASX has more of its own funds at risk than other CCPs<sup>6</sup>. The Oxera report states that “the benefit to CCP users of ASX’s commitment to the default fund is conservatively estimated at between 0.04bp and 0.07bp”<sup>7</sup>.

While the fees paid for clearing services do not directly fund the ASX ‘own fund’ pools that are to be used in the waterfall, there is clearly a link between the relatively high rate of those fees and the ASX’s ability to use the “own funds” for the waterfall pools.

Chi-X is of the view that if Oxera has submitted on behalf of ASX that clearing fees are not expensive because the ASX own funds represent a benefit to users of between 0.04bp and 0.07bp, then that amount should, at a minimum, be incorporated into any analysis of the risk management that forms part of the recovery process.

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<sup>3</sup> Compare the reports: (a) *Global cost benchmarking of cash equity clearing and settlement services*, prepared for ASX Clear Pty Ltd and ASX Settlement Pty Ltd by Oxera Consulting LLP, retrieved on 5 November 2014 from [http://www.asx.com.au/cs/documents/Global\\_cost\\_benchmarking\\_of\\_cash\\_equity\\_clearing\\_settlement\\_services\\_Final\\_20Jun14.pdf](http://www.asx.com.au/cs/documents/Global_cost_benchmarking_of_cash_equity_clearing_settlement_services_Final_20Jun14.pdf) (the Oxera report) and (b) *International Transaction Cost Benchmarking Review*, Market Structure Partners, October 2014, commissioned by a group of 10 Australian clearing participants who have significant market share in the Australian market, retrieved on 5 November 2014 from <http://www.marketstructure.co.uk/wp-content/uploads/Market-Structure-Partners-International-Transaction-Cost-Benchmark-Review-October-2014-Final-Windows-Version.pdf> (the MSP report).

<sup>4</sup> See the link between clearing fees and the default fund that is made in the Oxera report and is set out in section 2 of this submission. See also the comments in the third row of the table on page 71 of the MSP Report.

<sup>5</sup> See section 3 of this submission.

<sup>6</sup> See the overview on page 3 (not numbered) of the Oxera report.

<sup>7</sup> See page 11 (not numbered) of the Oxera report. See also the discussion on pages numbered 54 and 62 in the Oxera report.



Chi-X is also of the view that ASX should be transparent on the source of the funds used for each of the waterfall pools. The ASX Annual Report for 2005 states:

*On 31 March 2005, ASX's wholly-owned subsidiary Australian Clearing House Pty Limited (ACH) received \$71.5 million from the National Guarantee Fund (NGF) as provided for under Section 891A of the Corporations Act 2001 (the Act). This amount, in addition to a further \$38.5 million retained by ACH, is held in cash and liquid securities to provide capital backing for ASX's clearing business and to meet the Reserve Bank of Australia's Financial Stability Standard for Central Counterparties.<sup>8</sup>*

The Explanatory Statement for the Parliamentary Secretary's decision under section 891A and the accompanying regulations, make clear that the default funds for ASX Clear came from NGF funds<sup>9</sup>, which were in turn made up of contributions from members of the ASX/the State Stock Exchanges<sup>10</sup>.

In these circumstances, Chi-X is of the view that a more thorough cost benefit analysis needs to be undertaken of the levels in the default waterfall. Further, greater transparency needs to be provided on the source and nature of the waterfall funds to enable effective user input to the recovery and resolution regime.

### **3. Mandatory participant replenishment**

Chi-X is concerned that the proposals for mandatory replenishment outlined in the report do not properly consider or cost the alternatives to and varieties of mandatory replenishment. For example:

- (i) is it possible to allow ASX Clear to default in respect of cash equity trading and have its business assumed by another entity?
- (ii) could the option of a mutualised default fund operated by and for (shareholder) participants complement mandatory replenishment?
- (iii) is it appropriate to enable the appointment of an independent management team to address any governance concerns (eg that mandatory replenishment is being used

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<sup>8</sup> See the Directors Report contained on page 49 of the ASX Annual Report for 2005, retrieved on 5 November 2014 from [http://www.asx.com.au/documents/investor-relations/annual\\_report\\_2005.pdf](http://www.asx.com.au/documents/investor-relations/annual_report_2005.pdf).

<sup>9</sup> See the Explanatory Statement for Select Legislative Instrument 2005 No. 38 retrieved on 5 November 2014 from <http://www.comlaw.gov.au/Details/F2005L00717/Explanatory%20Statement/Text>.

<sup>10</sup> Under section 92 of the Securities Industry Act 1975, members of the State Stock Exchanges/ASX were required to pay to the NGF (i) a minimum of \$500 upon application for membership and (ii) an annual payments of \$100. The sums so paid to the SEGC were held on trust for the benefit of persons who suffered loss arising from, among other things, clearing or settlement default. See also pages 19-20 of the AFMA submission on the Treasury Review of Financial Market Infrastructure, retrieved on 5 November 2014 from <http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/Consultations/2011/Review%20of%20Financial%20Market%20Infrastructure%20Regulation/Submissions/AFMA.ashx>

as a means by which participants bail out ASX shareholders and the wider ASX Group)?

- (iv) the circumstances in which an assessment call may be made on clearing participants is not outlined in sufficient detail for the proposals to be properly considered.

Chi-X accepts that the CP is seeking feedback on the straw man proposals (eg question G5 expressly asks for information on the impact of the straw man recovery proposals on the regulatory capital cost of clearing), but considers that the issues and options outlined above should be fully analysed as part of a revised consultation paper. This is particularly important if participants are required to agree to mandatory replenishment being formally implemented as part of the waterfall in ASX Clear rules.

Moving to mandated participant replenishment of a default fund that is currently ASX funded, also involves a transfer of risk from ASX and ASX shareholders to participants. It will also introduce an additional default risk for participants as a default fund of insufficient size will now require replenishment by participants. Chi-X is of the view that any transfer or introduction of risk created by mandatory replenishment must be transparently analysed and costed for the benefit of all stakeholders.

## **Conclusions**

Each of the preceding segments of this submission is linked in demonstrating how the recovery regime at ASX Clear would benefit on an ex ante and ex post basis from enhanced governance, including greater ongoing user representation and structural separation. It also highlights further issues raised by the transfer of risk, from ASX shareholders to clearing participants, which may result from a recovery regime that implements the straw man proposals outlined in the CP.

Chi-X is hopeful that this submission assists ASX in the important task of developing and implementing a recovery regime for ASX CCPs.

Please do not hesitate to contact us if you have any queries.

Yours sincerely



Chi-X Australia Pty Ltd