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8 April 2015

The Manager
Financial Markets Unit
Corporations and Capital Markets Division
The Treasury

Dear Sir/Madam

CHI-X AUSTRALIA SUBMISSION ON THE CONSULTATION PAPER: REVIEW OF COMPETITION IN CLEARING AUSTRALIAN CASH EQUITIES

Chi-X Australia Pty Ltd (Chi-X) is grateful for the opportunity of providing a submission on the consultation paper issued by the Council of Financial Regulators (CFR) on the Review of Competition in Clearing Australian Cash Equities (the CP).

This is an important moment in the regulation of critical market infrastructure. The outcomes of the CFR's work will need to serve Australia's public interest for many years and in a variety of possible circumstances: the takeover of local exchanges, increased competition from regional operators, developments in global standards on default/resolution, changes in local infrastructure providers and the complete range of economic cycles.

The Goal: Clearing and Settlement that Develops Australia's Markets

Many Australians are impacted by the quality of the services delivered and the fees charged by ASX Clear Pty Ltd (ASX Clear) and ASX Settlement Pty Ltd (ASX Settlement). The clearing and settlement functions are crucial to the well-being and development of Australia's cash equities market and the wider financial services system. Those functions include the essential tasks of market wide risk management and the keeping of records to determine the delivery and payment on every cash equity transaction in Australia.

A regulatory framework for clearing and settlement should enhance and develop Australia's markets. This should be the key driver in the CFR's current deliberations.

Clearing and Settlement in Australia Today

The clearing and settlement fees currently charged by ASX are expensive when globally benchmarked. ASX currently earns an EBITDA margin on clearing revenues of 76.6%. The level of investment by ASX in its core clearing and settlement infrastructure is low and has been for many years.

These monopoly outcomes have occurred notwithstanding that ASX Clear has benefitted from the use, since 2005, of over $71 million in industry funds to subsidise the capital required for the clearing default fund[1].

Addressing these outcomes requires a regulatory framework that ensures the ongoing delivery of a clearing and settlement service that is also focused on the public interest.

ASX Clear and ASX Settlement have had many years to address the monopoly outcomes they have imposed on participants, non-ASX market operators, end investors and wider stakeholders. The current governance/fee/access arrangements and the low level of investment in clearing and settlement infrastructure, provide substantial evidence that ASX self-regulation has failed. Australia is paying a cost for this. In addition to the high fees and back office costs, some Australian markets are experiencing significant declines that are connected to the cost and quality of the clearing and settlement infrastructure[2]:

- from 2010 to 2014, volumes on the ASX equity options market have declined by over 30%[3];
- since September 2013, the volumes, active issuers and issuance on the warrants markets has declined by up to or in excess of 50%;
- global market makers have ceased trading on ASX's local markets notwithstanding that they may have their regional headquarters in Sydney[4].

The need to develop an effective regulatory framework is heightened by regulatory requirements published in March 2014 on requiring any competitive provider to be locally incorporated[5]. This

[1] On 31 March 2005, the Parliamentary Secretary to the Treasurer directed the payment of $71,488,687 from the NGF to ACH. The NGF money came from the interest earned on client accounts held at stockbroking firms and, in some cases, contributions directly by those firms. This money has not been paid out but has remained available for use by ASX since that date. See http://www.segc.com.au/pdf/segc_annual_report_2005.pdf

[2] Each of these outcomes is further discussed in paragraph 3.4.1 of Part A of the submission.

[3] See page 30 of the slide presentation for ASX's 2014 Full Year Results, retrieved on 26 March 2015 from http://www.asx.com.au/documents/asx-news/ASX_Ltd_Full-Year_Results_Presentation_2014.pdf

[4] See *Optiver to cease trading on ASX,* Joyce Moullakis, BRW online publication, published 1 September 2014 and retrieved on 25 March 2015 from http://www.brw.com.au/p/investing/optiver_to_cease_trading_on_asx_dg3rQCSb4kBZfepH14iotI

[5] See http://www.cfr.gov.au/publications/cfr-publications/2014/pdf/app-reg-influence-framework-cross-border-central-counterparties.pdf.

has operated as a barrier to entry and effectively removed the prospect of competition in Australia in the medium term.

What Has Worked Globally

There are many global precedents of a regulatory framework developing and enhancing financial markets through competition or the imposition of formal governance, pricing and access requirements on an incumbent monopoly operator. The formal governance requirements are aimed at ensuring the separation and independence of the clearing and settlement functions as they serve an important public interest, including the facilitation of competition. The policy of Canadian regulators is set out in the following statement by the Ontario Securities Commission:

> *"[T]he Commission **considers the operation of a clearing agency in the public interest to include**, among other things, appropriate governance arrangements, fair access and services to all market participants, adequate management of risk, including systemic risk, and operational reliability, fair and non-discriminatory fees, and **appropriate rules and procedures to foster competition in the Canadian financial markets**."*[6]

The OSC's policy has no doubt played a role in the development of Canada's financial markets: Canada has three cities in the top twenty global financial centres listed in the latest Global Financial Centres Index, Australia has none[7].

In these circumstances, Australia would be setting an unwanted global precedent were it to provide a government guaranteed monopoly in clearing and settlement to ASX in return for continuing self-regulation through the ASX's Code of Conduct and a non-enforceable commitment to address the existing monopoly rents. There is no need to extend the moratorium.

A New Framework to Develop Australia's Markets

Part A of the submission outlines a regulatory framework for the clearing of cash equities that will develop and enhance Australia's markets. The proposed framework includes measures that have been used elsewhere to address an enduring and fundamental feature of a monopoly clearing and settlement model: sometimes the self-interest of a self-regulated monopoly provider does not serve the public interest and external regulation is required.

The Corporations Act contemplates that licence conditions may need to be imposed on a clearing and settlement facility to address changes such as those that have taken place recently in Australia's financial market infrastructure[8]. In these circumstances, Chi-X is of the view that it is

[6] See pages 1-2 of the Consolidated Recognition Order of the Canadian Depository for Securities Limited and CDS Clearing and Depository Services Inc., retrieved on 25 March from https://www.osc.gov.on.ca/documents/en/Marketplaces/cds_20150306_unofficial-consolidated-cds.pdf .

[7] See http://www.longfinance.net/images/GFCI17_23March2015.pdf

[8] See sections 825A and 821A of the Corporations Act.

essential for the development of Australia's markets that licence conditions are imposed on ASX Clear and ASX Settlement to:

(i) require the following governance arrangements:

(a) the boards to be independent of the wider ASX Group board and include members representing participants and alternate market operators;

(b) the separation of staff and non-staff resources from those of the wider ASX Group so that the public interest responsibilities can be fulfilled without the inherent and substantial conflicts that currently exist;

(c) incentives being provided to staff to foster competition and fulfil the other public interest responsibilities of clearing and settlement;

(ii) impose a fee regime based on that found in comparable markets and which:

(a) initially sets fees at the levels announced by ASX on 9 March 2015[9];

(b) only allows fee increases if there is a significant change in circumstances;

(c) addresses cross subsidisation so that accounts and revenues are properly separated;

(d) is subject to an annual independent review; and

(e) requires the board to report annually on how it has balanced a return on capital against appropriate levels of costs, including those arising from investment in infrastructure, services and risk management; and

(iii) in lieu of a mandated access regime under the Competition and Consumer Act, requires:

(a) structural separation of ASX Clear and ASX settlement systems and staff.

(b) the prompt notification to the CFR of any request for access;

(c) the resolution of any such request within 60 days; and

(d) a reporting to the CFR on how the application was managed.

Additional reform of the wider regulatory framework may be necessary to accompany these conditions. For example, there are different views on the extent to which a company director has a duty to recognise the interests of non-shareholder stakeholders. There are however, quite

[9] See http://www.asx.com.au/documents/investor-relations/ASX_Clearing_Fees.pdf

broad powers within the existing framework and Chi-X would be happy to engage with the CFR on any additional measures that may be required in order to implement the reforms outlined above and that have been successfully implemented in other common law jurisdictions.

Part B of the submission also provides the view of Chi-X on each question in the consultation paper.

We hope this submission is of assistance in your important task.

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

Yours faithfully

Chi-X Australia

PART A

A NEW REGULATORY FRAMEWORK TO DEVELOP AUSTRALIA'S MARKETS

1. Introduction

1.1.1 This part of the Chi-X submission outlines:

(i) ten key features of the current framework for the clearing and settlement of cash equities in Australia;

(ii) the consequences for Australia's financial markets of the framework outlined in (i);

(iii) suggested regulatory reforms to address the consequences in (ii) and develop Australia's markets.

1.1.2 Throughout this submission references are made collectively to "clearing and settlement" and "ASX Clear and ASX Settlement". Clearing and settlement are two distinct services but operationally the two services are intertwined within the ASX business model. The lack of transparency on operations, systems and cost centres makes it difficult to externally analyse the extent of this overlap and the impact it may have on regulatory reform[10]. There are different considerations that must be taken into account when considering the contestability of, respectively, the clearing and settlement functions, and there is an argument that settlement is a natural monopoly function. This submission is primarily directed at a framework that is necessary to address the absence of competition for both clearing and settlement and hence the reforms suggested herein are directed at both functions.

2. The Current Framework – Ten Key Features

2.1.1 The following are ten key features of clearing and settlement in Australia.

I. ASX Clear and ASX Settlement are members of a for profit publicly listed corporate group that has a monopoly over the clearing and settlement of all Australia's exchange traded markets. As a consequence all ASX staff and directors currently have obligations to deliver optimal monopoly outcomes for ASX shareholders and are obliged to act in pursuit of these goals.

II. Competition in cash equities clearing is unlikely in the near to medium term. Regulators require a central counterparty (CCP) in ASX listed equities to be "domestically incorporated", which operates as a barrier to entry and results in a

[10] For example, the ASX's Clearing House Electronic Sub-register System, or CHESS, was initially developed and is still used as a settlement system. However CHESS is also the principal technology system used by ASX to support its clearing functions.

competing provider being unable to leverage a cross border business model. This has removed the possibility of competition to ASX from the only providers to have expressed a viable interest in competing in the Australian market.

III. The fees charged by ASX for CCP services are expensive. Different reports have stated:

- "[ASX is] at the high end of the range for fees charged for CCP services" [11];
- "Clearing and settlement costs in Australia are high when benchmarked across other global markets"[12].

IV. ASX's investment in modernising its core clearing and settlement infrastructure has been low over a period of many years and so the systems are now dated, inefficient and in need of a technology overhaul.

V. ASX Clear earns an EBITDA margin of 76.6% on its clearing revenues and 71.2% on its settlement revenues[13].

VI. There is little external transparency on ASX Clear cost centres, sources of capital and staff incentives.

VII. Trading Participants on ASX and Chi-X are captive customers who must use ASX clearing services.

VIII. Market Operators competing with the ASX trading businesses are also captive customers of ASX Clear and must use the dated systems and obtain the approval of ASX Clear for any product development, even though the development and enhancement may compete with other ASX non-clearing businesses.

IX. Australia's clearing systems are based on technology and protocols that are proprietary to ASX and unique to Australia.

X. ASX Clear and ASX Settlement staff and non-staff resources are co-mingled with those of other ASX businesses, including those that compete with ASX Clear customers[14].

[11] See the overview on page 3 of *Global cost benchmarking of cash equity clearing and settlement services* a report by Oxera commissioned by ASX Clear and ASX Settlement and is accessible at http://www.asx.com.au/cs/documents/Global_cost_benchmarking_of_cash_equity_clearing__settlement_services_Final_20Jun14.pdf

[12] See the executive summary on page 8 of the report *International Transaction Cost Benchmarking Review* retrieved on 25 March 2015 from http://www.marketstructure.co.uk/wp-content/uploads/Market-Structure-Partners-International-Transaction-Cost-Benchmark-Review-October-2014-Final-Windows-Version.pdf

[13] See the ASX's Management Income Statements for Cash Market Clearing and Cash Market Settlement for the 2014 calendar year, retrieved on 25 March 2015 from http://www.asx.com.au/cs/financial-statements.htm .

3. The Current Framework - Consequences

3.1.1 In keeping with the fundamentally important and far reaching functions clearing and settlement providers fulfil, the key features of Australia's clearing and settlement infrastructure have wide ranging consequences. Unfortunately many of them are negative.

3.2 Consequences: Key Features I to V

3.2.1 The nature of ASX as a for profit, publicly listed monopoly provider of clearing and settlement has resulted in ASX resources being used to raise prices and lower costs in order to extract a monopoly rent. While the different reports on the benchmarking of ASX fees differ in some respects, it is clear that Australian cash equity markets have expensive fees and remarkably low investment in core infrastructure. This outcome is reflected in the EBITDA margins for clearing and settlement revenues. Australia is paying a monopoly rent on its clearing and settlement services and has done for many years.

3.2.2 The expensive fees and low investment in core infrastructure systems have a negative impact on the relative attraction of Australia's cash equities markets as a place to do business. ASX has also lagged global standards in the introduction of some of the basic risk measures: for example, margins have been used in other global jurisdictions to manage risk in cash equities clearing since at least 1995, but were not collected on this basis in Australia until June 2013.

3.2.3 The lack of investment by ASX in clearing and settlement systems has also resulted in additional expense being incurred by market operators, participants and end investors to:

(i) build trading and back office systems that have to work with the ASX's dated clearing and settlement systems (see also section 3.3 below);

(ii) comply with dated settlement practices – for example, the mandated method of communication by ASX Settlement to end investors is the post.

3.2.4 The lack of competition in clearing means that ASX currently has no externally imposed incentive to fulfil the public interest responsibilities of a clearing and settlement operator. The internal incentives are dominated by the obligations of ASX staff and board directors to deliver monopoly outcomes that best serve the interests of ASX shareholders. The interests of ASX shareholders may overlap or coincide with the public interest, but the overwhelming evidence provided by the current fees, lack of investment in infrastructure and access to alternate operators, is that in many cases it does not.

[14] See pages numbered 82-83 in the RBA's 2013/14 Assessment of ASX Clearing and Settlement Facilities, retrieved on 265 March 2015 from http://www.rba.gov.au/payments-system/clearing-settlement/assessments/2013-2014/pdf/report-2013-2014.pdf

3.3 Consequences: Key Features VI-X

3.3.1 The captive customer base of ASX Clear and ASX Settlement and the use of clearing and settlement systems that are proprietary to ASX results in Australian users paying a cost for clearing and settlement services that is not always immediately apparent. This results in the following negative consequences:

(i) the isolation of Australia on technology grounds;

(ii) Australia's participants and market operators being unable to use global technology and protocols when interacting with ASX clearing/settlement systems[15];

(iii) the need for expensive bespoke Australian back office systems that decrease the relative attraction of Australia as a place to do business; and

(iv) a long, expensive and drawn out process being required for any new market development that has to interact with that dated proprietary technology.

3.3.2 The co-mingling of ASX resources impedes developments by captive market operators seeking to compete with the ASX:

(i) ASX Clear and ASX Settlement "rely in the delivery of their services on group-wide operational and compliance resources that reside in ASX Operations Pty Limited, which is a wholly owned subsidiary of ASX Limited"[16]. Hence there is no identifiable non-conflicted "team" within ASX Clear that may be used by non-ASX operators[17].

(ii) ASX Clear systems are integrally intertwined with those used by ASX trading platforms so that the ASX Clear service to ASX platforms is guaranteed to be more facilitative of ASX business development than that offered to non-ASX platforms: providing a service to a non-ASX platform requires ASX Clear to first "untangle" the systems used to provide a clearing service for a non-ASX product and may result in ASX Clear charging non-ASX operators for trading services.

(iii) A bureaucratic process is required to initiate and identify the right people to work on a project and the systems they need to work on, resulting in significant delays and additional cost on the projects of non-ASX operators.

[15] For example participants are required to incur the expense of connecting to the globally unique user interface of the ASX's CHESS system.

[16] See page 82 of the 2013/14 Assessment of the ASX Clearing and Settlement Facilities, retrieved on 25 March 2015 from http://www.rba.gov.au/payments-system/clearing-settlement/assessments/2013-2014/pdf/report-2013-2014.pdf

[17] See paragraphs 168-169 of http://download.asic.gov.au/media/1344638/rep401-published-28-July-2014.pdf

3.3.3 The lack of transparency in the ASX cost centres, pricing models and resource allocation results in it being enormously difficult, if not impossible, for ASX customers to (i) objectively benchmark the fees they are being charged and/or to (ii) negotiate a pricing model that may deliver outcomes more focused on building/developing a market. As ASX customers are captive they have little negotiating power: ASX pricing can be and is delivered unilaterally as a *fait accompli*.

3.4 The Cost to Australia's Markets

3.4.1 The consequences outlined in sections 3.2 and 3.3 above, also apply to the equity options and warrants markets where Australia's expensive and dated clearing and settlement infrastructure has contributed to a stark decline in the quality of those markets. The ASX slide presentation for the 2014 Full Year Results records that from 2010 to 2014, the number of contracts traded on the ASX equity options market decreased from 16,639,000 to 11,634,000, a decrease of over 30%[18]. The Australian warrants market has also seen a decline in active issuers, issuance and volumes: in September 2013 there were seven active issuers and 5,651 'live' warrants on issue, currently there are four active issuers and approximately 3,000 'live' warrants on issue. Significant global market makers have ceased trading on ASX markets notwithstanding that they may have their regional headquarters located in Sydney[19].

3.4.2 There is clear and substantial evidence that the current framework for the clearing and settlement infrastructure does not facilitate the development of Australia's regulated markets. The CP marks a seminal moment at which this can be addressed and corrected.

4. Key Features and Consequences: The Need for Regulatory Reform

4.1.1 Regulatory reform is required to address the wide ranging negative consequences of Australia's existing clearing and settlement infrastructure. The evidence to date, including that outlined above, is that this reform cannot be achieved by ASX self-regulation: externally imposed requirements and incentives are necessary to ensure ASX fulfils the public interest responsibilities of a clearing and settlement operator and to deliver the outcomes that would be achieved if competition was introduced.

4.1.2 Chi-X is of the view that the measures the CFR should impose include:

(i) governance reforms at ASX Clear and ASX Settlement, including the structural and operational separation of clearing and settlement systems and resources within the ASX group;

[18] See page 30 of the presentation retrieved on 26 March 2015 from http://www.asx.com.au/documents/asx-news/ASX_Ltd_Full-Year_Results_Presentation_2014.pdf

[19] See *Optiver to cease trading on ASX,* Joyce Moullakis, BRW online publication, published 1 September 2014 and retrieved on 25 March 2015 from http://www.brw.com.au/p/investing/optiver_to_cease_trading_on_asx_dg3rQCSb4kBZfepH14iotI

(ii) the regulation of clearing and settlement fees through an ongoing framework that prevents the continuation of the current monopoly pricing model;

(iii) the regulation of access to ASX clearing and settlement systems intended to foster competition in and develop Australia's markets.

4.1.3 Chi-X notes that under section 825A of the Corporations Act a Minister may impose conditions on the licence of a clearing/settlement facility to address changes such as those which have occurred in Australia's financial market infrastructure. Licence conditions, or their equivalent, have been used elsewhere to implement the reforms that are now required in Australia. The measures listed in paragraph 4.1.2 are therefore discussed below in the context of licence conditions that could be imposed to implement these important reforms.

5. The Need for Regulatory Reform: Governance

5.1.1 The governance models at ASX Compliance and the Canadian Depository for Securities (CDS) provide useful precedents on board independence, industry representation and the facilitation of staff separation at a subsidiary within a corporate group that has interests or goals that may conflict with those of the subsidiary. The Canadian regulators have imposed requirements on CDS in the areas of governance, fees and access in a recognition order. The same outcomes can be achieved in the Australian regulatory framework through the imposition of conditions in the licences of ASX Clear and ASX Settlement.

5.1.2 The CDS recognition order[20]:

(i) requires CDS to act in the public interest;

(ii) states that the responsibilities of the board of directors includes the fulfilment of the public interest responsibility of CDS;

(iii) requires the board to report at least annually to the regulator on how it has fulfilled its public interest responsibility;

(iv) imposes governance arrangements designed to fulfil CDS's public interest requirements and to balance the interests of the different customers and stakeholders of clearing and settlement;

(v) requires one director on the board to be a representative of a market operator unaffiliated with Maple (ie the equivalent of ASX in this scenario) and at least 33% of the board to be representatives of participants.

[20] An unofficial consolidated copy of the CDS Recognition Order is accessible in pdf form at https://www.osc.gov.on.ca/documents/en/Marketplaces/cds_20150306_unofficial-consolidated-cds.pdf

5.1.3 The ASX Compliance Board charter requires:

(i) the Chair of the Board not be a director of ASX Limited;

(ii) the ASX Compliance Board to review the performance of the executive head of ASX Compliance and inform the Remuneration Committee of that review;

(iii) the executive head of ASX Compliance to report to the ASX Compliance Board on matters relating to the compliance services provided to the other members of the ASX Group.

5.1.4 The principles that underlie the CDS and ASX Compliance measures suggest that the important public interest functions of ASX Clear and ASX Settlement are best served by a regulatory framework that:

(i) requires the boards of ASX Clear and ASX Settlement to:

(a) act in the public interest;

(b) be independent of the ASX Corporate Group;

(c) have an independent Chair who does not sit on other ASX boards;

(d) review the performance and have input to the remuneration of the executive heads of ASX Clear and ASX Settlement;

(e) report annually on how ASX Clear and ASX Settlement have fulfilled their public interest responsibilities;

(f) consist of representatives of non-ASX market operators and participants.

(ii) ensure the complete operational separation of ASX Clear and ASX Settlement staff so that they can fulfil the public interest clearing and settlement functions without the inherent and substantial conflicts that arise if they are engaged by a single services entity such as ASX Operations Pty Ltd that provides services to ASX trading businesses;

(iii) provides incentives to ASX Clear and ASX Settlement staff to foster competition in Australia's markets and fulfil the public interest responsibilities of clearing and settlement.

6. The Need for Regulatory Reform: Fees

6.1.1 The CDS recognition order proactively regulates prices and the evidence outlined in sections 2 and 3 above (globally high fees notwithstanding no or minimal investment in

core infrastructure and services) provides evidence that such regulation is required in Australia. The measures in the CDS recognition order include:

(i) Fee increases are not allowed unless there is a significant change in circumstances (paragraph 2 of Appendix B), cannot be amended by CDS unilaterally and must go through a rule amendment process governed by CDS Participant Rules and the Recognition Order requirements of CDS's regulators. The amendment process is transparent to participants by virtue of Participant Committees as well public consultation periods.

(ii) Maple is required to share 50% of any increase in annual revenue on clearing and other core CDS services with Participants.

(iii) There are provisions on cross subsidisation that require the CDS to properly "silo" financial accounts relating to the business and revenue (paragraph 8 of the Terms and Conditions).

(iv) Any rebates provided by CDS have to be platform neutral (paragraph 7.2 of the Terms and Conditions).

(v) There is a meaningful and periodic independent review of pricing (paragraph 7.9 of the Terms and Conditions).

6.1.2 In these circumstances, Chi-X is of the view that the fee regime announced by ASX on 9 March 2015, should be a regulated "ground zero" fee regime imposed immediately and then subject to requirements similar to those in the CDS recognition order listed above. Further measures that may serve the public interest responsibilities of ASX Clear and ASX Settlement include:

(i) The ASX Clear Schedule of Fees could be benchmarked to those global entities that clear for multiple markets (eg LCH, Eurex).

(ii) The Board could report annually on how it has balanced a return on capital against appropriate levels of costs, investment, risk management and the appropriate allocation of capital. To this end there should be:

(a) published cover 1/cover 2 calculations, as appropriate, on a periodic (quarterly) basis demonstrating adequate stress testing to ascertain the appropriate level of cover for the default fund;

(b) confirmation that no return on capital is required for the original NGF funds donated to ASX ($71.5 million) and accrued compounded interest on this

sum ($40 million) should also be included in the Restricted Capital Reserve[21];

(c) the return on capital should be based upon a reasonable target on the capital required from the default fund under the applicable Cover 1/Cover 2 requirements less the Restricted Capital Reserve.

6.1.3 These numbers should be recalibrated upon the introduction of T+2 settlement.

7. The Need for Regulatory Reform: Access

7.1.1 The recitals to the CDS recognition order state that a clearing and settlement function operating in the public interest will have appropriate rules and procedures to foster competition in financial markets[22]. The access provisions in the CDS recognition order require CDS to:

(i) accept clearing of trades in securities on a non-discriminatory basis regardless of the marketplace of execution[23];

(ii) promptly notify the regulator upon receipt of any application for access[24];

(iii) complete the granting or denial of access within 60 days and promptly notify the regulator of any applications that are outstanding for more than that period and the reasons for the delay[25];

(iv) not impose any burden on competition that is not reasonably necessary or appropriate[26].

7.1.2 Chi-X is of the view that even these measures would not, if implemented locally, usefully address the public interest in fostering competition in Australia unless and until the structural and operational separation of ASX Clear and ASX Settlement takes place. As

[21] See footnote 1 above.
[22] The recital states: "..the Commission considers the operation of a clearing agency in the public interest to include, among other things, appropriate governance arrangements, fair access and services to all market participants, adequate management of risk, including systemic risk, and operational reliability, fair and non-discriminatory fees, and appropriate rules and procedures to foster competition in the Canadian financial markets", retrieved on 24 March 2015 from https://www.osc.gov.on.ca/documents/en/Marketplaces/cds_20150306_unofficial-consolidated-cds.pd
[23] See paragraph 6.3 of the Terms and Conditions on page 10 of the CDS Recognition Order, retrieved on 25 March 2015 from https://www.osc.gov.on.ca/documents/en/Marketplaces/cds_20150306_unofficial-consolidated-cds.pdf
[24] ibid paragraph 6.4
[25] ibid paragraph 6.5
[26] ibid paragraph 6.2(b)

outlined in paragraphs 2.1.1 (key feature X) and 3.3.2 above, the co-mingling of staff and non-staff resources guarantees effective discrimination in the access of non ASX market operators to ASX Clear and ASX Settlement.

7.1.3 In these circumstances, an appropriate regulatory framework for access to ASX Clear and ASX Settlement may require:

(i) structural and operational separation of ASX Clear and ASX Settlement resources from the other parts of the ASX Group;

(ii) a regulation requirement in licence conditions or elsewhere for ASX Clear and ASX Settlement to:

(a) structure its systems and resources so that it can and does accept clearing of trades in securities on a non-discriminatory basis that is platform neutral;

(b) promptly notify the CFR and ACCC of any request for access to its systems;

(c) progress and finalise the request for access within a specified time period, say 60 days, and promptly notify the CFR and ACCC of any applications that are outstanding for more than that period and the reasons for the delay;

(d) not impose any burden on competition that is not reasonably necessary or appropriate; and

(e) report annually on how it has fulfilled the public interest in fostering competition.

7.1.4 A mandated access regime under the Consumer and Competition Act may ensure fair and non-discriminatory access is provided to non-ASX market operators. Chi-X is of the view that such a regime should be developed and implemented if the measures outlined above do not result in a sufficient separation of the clearing and settlement resources and systems within the ASX group. In the absence of this separation, a mandated access regime may be the only effective regulatory measure for ensuring the public interest responsibilities of the clearing and settlement operator are fulfilled.

PART B: CONSULTATION QUESTION

Consultation Paper Question	Chi-X Response
Policy Approaches	
Q1. Which policy approach would you prefer, and why?	Chi-X is of the view that the local incorporation requirement for an applicant seeking to clear cash equities, has resulted in the lack of any realistic prospect of competition in the near to medium term. Therefore the preferred policy approach is to impose firm, transparently monitored and objectively measured regulatory requirements that require ASX Clear and ASX Settlement to: (i) deliver the outcomes that would be achieved if competition were present; (ii) fulfil their public interest responsibilities; (iii) foster competition in Australia's financial markets; (iv) structurally and operationally separate its key staff and non-staff resources from the wider ASX Corporate Group.
Q2. Are there alternative policy approaches to those outlined in this paper that you think should be considered by the Agencies? If so, please provide details. **?**	Part A of this submission outlines the view of Chi-X that it is appropriate to impose licence conditions on ASX Clear and ASX Settlement that: (i) require the following governance arrangements: (a) the boards to be independent of the wider ASX Group Board and include members representing participants and alternate market operators; (b) the separation of staff and non-staff resources from those of the

Consultation Paper Question	Chi-X Response
	wider ASX group so that the public interest responsibilities can be fulfilled without the inherent and substantial conflicts that currently exist; (c) incentives being provided to staff to foster competition and fulfil the other public interest responsibilities of clearing and settlement; (ii) impose a fee regime based on that found in comparable markets and which: (a) initially sets fees at the levels announced by ASX on 9 March 2015[27]; (b) only allows fee increases if there is a significant change in circumstances; (c) addresses cross subsidisation so that accounts and revenues are properly separated; (d) is subject to an annual independent review; and (e) requires the board to report annually on how it has balanced a return on capital against appropriate levels of costs, including those arising from investment in infrastructure, services and risk management; and (iii) in lieu of a mandated access regime under the Competition and Consumer Act, requires:

[27] See http://www.asx.com.au/documents/investor-relations/ASX_Clearing_Fees.pdf

Consultation Paper Question	Chi-X Response
	(a) structural separation of ASX Clear and ASX settlement systems and staff. (b) the prompt notification to the CFR of any request for access; (c) the resolution of any such request within 60 days; and (d) a reporting to the CFR on how the application was managed. .
Q3. . Are there any other overarching issues that should be taken into consideration?	The key features of the clearing and settlement infrastructure in Australia are outlined in section 2 of Part A and are: I. ASX is a for profit publicly listed corporate group that has a monopoly over the clearing and settlement functions. II. Competition in cash equities clearing is unlikely in the near to medium term. III. The fees charged by ASX for CCP services are expensive. IV. ASX's investment in modernising its core clearing and settlement infrastructure has been low over a period of many years. V. ASX Clear earns an EBITDA margin of 76.6% on its clearing revenues and 71.2% on its settlement revenues[28].

[28] See the ASX's Management Income Statements for Cash Market Clearing and Cash Market Settlement for the 2014 calendar year, retrieved on 25 March 2015 from http://www.asx.com.au/cs/financial-statements.htm .

Consultation Paper Question	Chi-X Response
	VI. There is little external transparency on ASX Clear cost centres, sources of capital and staff incentives. VII. Trading Participants on ASX and Chi-X are captive customers who must use ASX clearing services. VIII. Market Operators competing with the ASX trading businesses are also captive customers of ASX Clear. IX. Australia's clearing systems are based on technology and protocols that are proprietary to ASX and unique to Australia. X. ASX Clear and ASX Settlement staff and non-staff resources are co-mingled with those of other ASX businesses, including those that compete with ASX Clear customers. The consequences of these key features are outlined in section 3 of Part A and Chi-X is of the view that the CFR should take these into account when aiming to develop a regulatory framework that will develop Australia's markets and serve the public interest over the next 5 to ten years.
Competition	
Q4. What particular benefits would you expect to arise from competition in the clearing of Australian cash equities? What level of fee reduction, or specific innovation in product offerings or service enhancements would you expect to arise? Please share any relevant	There many benefits of competition in clearing and they include: (i) lower fees; (ii) more efficient and less costly back office systems that leverage more globally integrated clearing and settlement providers;

Consultation Paper Question	Chi-X Response
experiences from overseas or in related markets.	(iii) the cross border integration of clearing and settlement systems that would facilitate the growth and development of Australia's markets; (iv) the development of non-cash equity markets connected to cash equities clearing including derivatives markets; (v) a more competitive environment for the development of market infrastructure; (vi) a more dynamic environment delivered by the increased customer focus and delivery of competing firms; (vii) an increased market wide resiliency and removal of "single points of failure" as a consequence of having multiple providers of critical infrastructure.
Q5. What costs or other impediments might you expect that you, and the industry as a whole, may incur if competition in clearing emerged? Please provide a description of the nature of these costs and any relevant estimates?	As outlined elsewhere in this submission, local regulatory requirements have resulted in competition in clearing being unlikely in the near to medium term. Therefore the clearing model that may develop in Australia, if competition is introduced, will be determined by a number of matters that are not currently clear. They include the practical application of the existing statutory framework, which is largely principles based and does not prescribe specific outcomes or requirements. For example, the costs of competition are fundamentally impacted by the CFR's local incorporation requirement, which is not part of the statutory framework but prescription provided by the CFR. Another example of the way costs may be determined by the regulatory framework is the nature of the default fund that a competing CCP may be required to maintain. Given the reality of the local incorporation requirement, Chi-X has not applied the business models of a prospective competitive provider to the Australian

Consultation Paper Question	Chi-X Response
	infrastructure requirements in order to determine the answers to this question but is willing to engage with the CFR further if the CFR is of the view that, taking into account the local incorporation requirement, some clearing models are more likely than others
Q6. What are your views on the specific risks that competition in clearing could pose to market functioning and financial system stability? Do you think the 'minimum conditions' identified by the Agencies would be appropriate to both promote competition and protect the stability and effective functioning of securities markets? Are there any other conditions that should be considered or other issues that the minimum conditions should seek to address? Please describe these.	As outlined in the answer to question 5, the risks that may arise will depend on the model that develops. Chi-X is of the view that: • the current minimum conditions proposed are not appropriate • the CFR should not try and anticipate a proposed clearing/settlement model that may be employed by a future applicant for a clearing licence as it is difficult to foresee where markets may develop regionally/globally and the case for clearing cash equities on a cross border basis may be fundamentally different in the years to come. • the CFR should not unnecessarily fetter its discretion to consider any future application for a clearing licence. Chi-X is willing to engage further with the CFR further on this question if the CFR is of the view that, taking into account the local incorporation requirement, some clearing models are more likely than others.
Q7 What changes, if any, would be necessary to effectively oversee a multi-CCP environment in the cash equity market (e.g. additional regulatory arrangements)?	In keeping with the answers to questions 5 and 6, the necessary changes to oversee a multi-CCP environment will depend on the clearing model that develops. As outlined above, Chi-X is willing to engage further with the CFR on this question if the CFR is of the view that, taking into account the local incorporation requirement, some clearing models are more likely than others.

Consultation Paper Question	Chi-X Response
Q8. Is there likely to remain a single provider of equity settlement services, either in the short or long term? Should competition in clearing emerge, what implications might this have for the design of the equity settlement facility, the cost of equity settlement services, access to equity settlement for the competing CCP, and future investment in the settlement infrastructure? Would the Code be sufficient to achieve access to equity settlement on appropriate terms, or would an alternative regulatory approach be necessary?	Chi-X is of the view that when considering what would be an appropriate regulatory framework for clearing and settlement in Australia, it would be appropriate for the CFR to work on the basis that a single provider of equity settlement services is likely. The nature of clearing and settlement services today means that initial steps need to be taken to separate the systems, resources and governance of the clearing and settlement functions within the ASX Group. The implications that competition in clearing may have for the settlement facility will depend on the competition model that evolves and the practical application of the principles based regulatory regime. Chi-X is of the view that Europe provides a useful precedent for how the well managed interaction of multiple CCPs with settlement providers can enhance market development.
Q9. If competition in clearing emerged, should interoperability between CCPs be encouraged in Australia? (a) How might competition in clearing affect the organisation and conduct of your operations? In the absence of interoperability, would you expect to establish connections to multiple trading platforms and CCPs? If so, would implications such as this diminish the commercial attraction of competition between CCPs? (b) With interoperability in place, would you expect to consolidate clearing in a single CCP? How would this decision be affected by best execution obligations? What effect would interoperability have on the costs that you may expect to incur from competition in clearing?	Chi-X is strongly of the view that interoperability should be mandated if competition emerges. As has been demonstrated in Europe, competition with mandated interoperability delivers a number of benefits for participants, investors and wider stakeholders. Those measures are repeatedly supported by the participant and investor communities in Europe. The answers to the remaining inquiries in this question are, as is stated elsewhere, dependent on the clearing model that evolves if competition is introduced and Chi-X is willing to engage further on this questions if the CFR is of the view that, taking into account the local incorporation requirement, some clearing models are more likely than others.

Consultation Paper Question	Chi-X Response
(c) What actions might the Agencies need to take (in addition to the requirements around management of financial exposures between interoperating CCPs specified in the Bank's FSS) in order to ensure that interoperability did not introduce additional financial stability risks? Would 'open access' obligations need to be imposed to facilitate interoperable links? (d) What are your views on the stability and effectiveness of interoperability between CCPs in other jurisdictions?	
Q10. If the moratorium were lifted, would you expect a competing CCP to seek entry to the Australian market in the near future, noting the 'minimum conditions' set out in the Agencies' 2012 Report (refer to Section 4.3)? If competition were permitted but no competing CCP entered the market, at least for a time, should transitional regulatory measures (such as the existing Code) remain in place until such time as competition did emerge?	Chi-X is strongly of the view that the moratorium should be lifted as it is not appropriate, on a number of levels, for a government to guarantee a monopoly to a for profit publicly listed company. In those countries where the clearing/settlement infrastructure has evolved to provide a monopoly, it is often the case that the local authorities, rather than enshrine the monopoly, have implemented regulations to ensure the public responsibilities of the clearing and settlement providers are fulfilled and/or the provider is an industry owned utility. Australia would be damage its reputation globally if, in the current circumstances, it provided a government mandated monopoly on the clearing and settlement functions. Chi-X is of the view that the regulatory measures outlined in Part A of this submission should be implemented to address the wide ranging negative impacts of the existing clearing and settlement infrastructure.

Consultation Paper Question	Chi-X Response
11. If the moratorium on competition were to be lifted, would the threat of competition be sufficiently credible to encourage ASX to retain and adhere to the Code, or would the Code need to be mandated (see Section 5.4)?	Chi-X is of the view that competition is unlikely in the near to medium term for the reasons outlined elsewhere. This is the case irrespective of whether or not the moratorium is lifted. Chi-X is of the view that the regulatory measures outlined in Part A of this submission should be implemented to address the wide ranging negative impacts of the ASX's clearing and settlement infrastructure.
12. Would you support an extension to the moratorium on competition in clearing? If so, why? What time period would be appropriate before the industry was ready for competition in clearing to emerge?	No, extending the moratorium would see Australia setting a global precedent where there is no need to do so and it is not appropriate for a government to guarantee a monopoly to a profit driven publicly listed company. It would damage the reputation of Australia globally.
Monopoly	
Q13. If competition in the clearing of Australian cash equities were to be deferred indefinitely, what form of regulation may be necessary? Would a self-regulatory regime under the Code be sufficient to deliver the benefits of competition in clearing, or would some other form of regulation be necessary?	Chi-X is of the view that competition is unlikely in the near to medium term for Australia's markets and there is no need for the CFR of government to declare or otherwise announce that it is to be deferred indefinitely. In Part A of this submission Chi-X outlines evidence that ASX self-regulation, under the current Code of Conduct and otherwise, has failed. Part A also outlines a regulatory framework that would work to deliver the benefits of competition while ASX Clear and ASX Settlement remain monopoly providers.
14. How effective are the governance arrangements under the Code? For example, please expand upon the following: (a) the effectiveness of the Forum and Business Committee (b) the responsiveness of ASX to the issues	(a) Benchmarking the governance arrangements under the Code against the measures in the CDS recognition order indicates that the Code has been ineffective and compromised by its failure to incorporate serving the public interest and fostering competition. The Code has not delivered any meaningful fee reductions, investment by

Consultation Paper Question	Chi-X Response
raised by the Forum and Business Committee (c) the composition of ASX's Boards.	ASX in core infrastructure or structural and operational changes intended to serve the public interest and foster competition. This is evidence that the Code has been ineffective. The Forum and Business Committee could be effective vehicles for stakeholder representation if complemented by the regulatory reforms outline in Part A of this submission. (b) The lack of responsiveness of the ASX to the Forum and Business Committees was evidenced by the vast majority of Forum member firms agreeing to fund a separate report on the benchmarking of ASX fees. (c) The composition of the ASX's boards is covered in Part A of this submission.
15. How effective are the current pricing arrangements? For example, please expand upon the following: (a) the level of transparency of pricing, revenues and costs associated with ASX's cash equity clearing and settlement services (b) the cost allocation policies adopted by ASX (c) whether pricing is comparable with overseas clearing and settlement services.	ASX currently extracts monopoly rents from its clearing and settlement services. The current pricing arrangements are therefore ineffective. Chi-X notes that: (a) the co-mingling of ASX resources and lack of transparency on cost centres, sources of capital and staff incentives make it difficult to objectively assess the cost of ASX Clear and ASX Settlement services (hence the need for multiple hundred page reports to benchmark the fees globally); (b) the cost allocation policies adopted by ASX are not clear and potentially undermined by its price regime announcement on 9 March 2015; (c) the ASX's fees for clearing and settlement are expensive when benchmarked globally (see the reports referenced in footnotes 6 and 7 above) .

Consultation Paper Question	Chi-X Response
16. How effective are the access provisions under the Code? For example, please expand upon the following: (a) the adequacy of existing access provisions to support competition in trading of ASX-securities (b) whether the scope of access provisions should be expanded beyond ASX securities (c) whether the information-handling standards implemented under the Code are sufficient to support innovation, by mitigating potential conflicts of interest for ASX staff and management (d) whether any further commitments are required to improve necessary access to ASX's clearing and settlement facilities by alternative market, and listing market, operators. If so, what measures are required?	The current operational structure of ASX Clear and ASX Settlement, including that relating to staff and non-staff resources, entrenches and ensures discrimination against non-ASX trading platform. Please see Part A of the submission.
17. In general, how effective do you think the Code has been in addressing the issues identified by stakeholders in the 2012 Review? Do you think a Code of Practice is an effective mechanism for delivering outcomes similar to those that might be expected under competition? Please share your experience in relation to the operation of the Code.	The self-regulatory nature of the Code is fatally compromised by the matters outlined in sections 2-3 of Part A of the submission. .
18. Are there any other issues that the Code should seek to address? What steps, if any,	The Code is an ineffective tool on its own. It requires the regulatory reforms outlined in section 4-7 of Part A of this submission if the underlying issues are to

Consultation Paper Question	Chi-X Response
should be taken to strengthen the arrangements under the Code in order to realise the benefits of a competitive market? Are formal enforcement mechanisms or extended accountability commitments necessary?	be addressed.
19. If you think that another form of regulation would be necessary: (a) What would be the appropriate scope of such regulation? Should both ASX Clear and ASX Settlement be regulated? (b) What aspects of each service should be regulated (e.g. pricing, access, structure, ownership, infrastructure development)? (c) Would the measures available under the existing legislative and policy framework be sufficient for this purpose? If not, what new regulation or legislation might be necessary?	The regulatory reforms necessary to address the negative impacts of the current clearing and settlement infrastructure in Australia are outlined in sections 4-7 of Part A of this submission.