9 September 2013

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Dear Mr Everson

Financial Stability Standards Implementation – The Way Forward

Thank you for the opportunity to comment on ASX's Consultation Paper *Financial Stability Standards Implementation – The Way Forward – Cash Equity Market Account Segregation and Portability, and Rescheduled Settlements* (the *Consultation Paper)*.

The implementation of the RBA's Financial Stability Standards for Financial Market Infrastructure by the ASX requires a detailed review of the risks around settlement for cash products and the potential benefits and costs of changing the prevailing arrangements.

Our members have reviewed the Consultation Paper and its options and have provided the following thematic responses.

General regulatory environment

Regulatory change driven both locally and globally continues to create pressures on the industry in relation to costs, resources, operations and information systems. Implementation of any of the proposed changes will contribute to this increased pressure. We note this would especially be the case for the proposals involving Individually Segregated Client Accounts (ISCA).

We note that any of the proposed changes will increase margin costs to clearing participants, reduce netting efficiencies and result in an increased number of settlements and that these will likely be absorbed by clearing participants. They may over time lead to increased investor costs as clearing participants seek to recover the

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revenue impact. As a result any proposal needs to carefully consider the costs and benefits to both clearing participants and end clients before being implemented.

Need for a response

The risks associated with cash equities settlement with a central clearing house and appropriately capitalised clearing participants following appropriate procedures are low. Cash equity margining further reduces these already low risks.

There is widely held concern that in seeking to eliminate all risks the diminishing returns will result in the costs outweighing the benefits.

We understand that the risks that the Financial Stability Standards seek to address are associated with the netting of positions (and hence margins) between house and client positions and between client positions in the event of insolvency of a clearing participant.

To address these risks in a proportionate way it is important to recognise the differences between different settlement arrangements with different categories of clients. Participants have indicated that over 90% of institutional trades are settled by Delivery *vs* Payment (DvP) during the 10.30 am batch settlement process.

The DvP process largely removes settlement risk even in the event of a default of a clearing participant as clients stay either long stock or long cash (held by themselves or their custodian) until the batch process runs. Each client will therefore already have effectively segregated and ring-fenced their assets from the clearing participant in the event of insolvency of the clearing participant. After the batch process they are either long cash or long stock and the settlement is completed.

Given the prevalence of the DvP basis for this category of clients the benefits of separating out trades into a client omnibus account would not justify the associated costs and increases in margin.

Retail broker or issuer-sponsored clients in comparison may be required to deliver stock early or otherwise leave themselves with some small risk. The net batch settlement method free of payment (FOP), while more convenient for retail clients, does have a certain higher degree (though still small) of associated risk than the DvP process.

It is certainly possible that this risk may be decreased through the implementation of a client omnibus account. Having a separate client entrepot settlement and accumulation account may help protect against risks associated with a clearing participant default for the retail broker or issuer sponsored client.

However, these risks may be better and more proportionately addressed with more benefit and less cost by introducing rules that prevent participants from bringing in stock for settlement prior to the settlement date. Introducing separate accounts, when rule changes may more effectively address these risks, may be excessive.

With regard to client cash we note that proper practices on the part of brokers in handling client money derive from the cash segregation requirements already created by the Corporations Act, whereby cash must be locked up in trust prior to and following settlement. As such, client exposure to clearing participant default is already mitigated. The same applies where stock is registered in the name of the client under their own individual HIN, hence retaining legal title.

AFMA members are of the view that maintenance of the current arrangements with an investigation of rule changes for retail (or non-DvP) stock movements is the optimal outcome from a cost benefit perspective. Whichever outcome is decided a single mandated solution should be determined by the broker as being the appropriate approach to take with respect to its clients.

That is clients should not be given the option to select whether their funds are held in the institutional-only principal and client comingled accounts or the client segregated account for retail clients (if this option is selected), rather the broker will designate which of the options it has elected to follow and ensure that the client is provided with sufficient information to understand the effect of this decision. If the status quo is maintained, given the limited benefits of change then there should not be an option for brokers to offer ISCA or client only accounts.

While client choice is in general a good aim and should be supported, given the significant costs associated with implementing such a system the potential benefits of client choice are outweighed by the costs to the industry and ultimately investors.

Individually Segregated Client Accounts

Although an ISCA model is used in some markets for derivative transactions it is not appropriate for cash equities as it comprehensively fails the cost benefit test.

This model's administration load would introduce a high level of operational risk and have the potential to increase failed trades within the market with very little benefit for the Clearing Participant or client. Cash Market Margining obligations would also be increased for the Clearing Participant under these arrangements. We do not see any merit in relation to the pass-through of Cash Market Margining to clients, as it is impractical for Clearing Participants to pass the margining requirements on within the standard settlement cycle particularly with regard to offshore clients.

The industry is strongly opposed to the ISCA model.

Increased settlement volumes and charges

Any of the proposed changes will increase settlement volumes. If settlement fees remain unchanged there will be an attendant increase in costs to the Clearing Participant and revenues to the ASX. We request that the ASX review and adjust its charges such that these changes will be settlement cost neutral to the industry.

The industry has welcomed ASX's indications in this regard and would support formalising this commitment prior to any implementation.

Alternative proposals - Rescheduled settlements

Notwithstanding the position which Market Participants have taken with respect to the proposals, there is general support of change to rescheduled settlements which is viewed as being consistent with international best practice.

T+2 settlement

To reduce the capital requirements of Cash Market Margining and to reflect improvements in technology that have occurred over time, clearing market participants encourage the further investigation of a move to a T + 2 settlement cycle.

Such a move could be accompanied by a move of the batch settlements to later in the day to better coordinate with clients in Asia.

T+2 settlement could be a viable alternative to additional segregation proposals as it will mitigate the period of exposure to a clearing participant default and associated settlement and mark-to-market risks.

Conclusion

With a short settlement cycle, in comparison to longer dated OTC derivatives, any risks of clearing participant default to clients are minimal, particularly taking into account other factors such as ASX regulatory capital requirements, client money laws, registered title and cash margining. Members are of the view that any benefits to clients of segregation are minimal and are outweighed by implementation and ongoing costs and impact to resources at a time when the industry is already under significant pressure to reduce costs whilst implementing several other costly and resource intensive regulatory reforms.

We thank the ASX for its comprehensive stakeholder engagement process which has included multiple meetings, a workshop and direct feedback from ASX staff.

Yours sincerely

Damian Jeffree
Lead Director Markets