



**GBST**

**Capital Markets**

## **GBST Response**

**Financial Stability  
Standards – The Way  
Forward**

**2 September 2013**

**GBST**

Level 4, 410 Ann Street  
Brisbane QLD 4000  
Australia

**Website:** <http://www.gbst.com>

**Phone:** +61 7 3331 5555

**Fax:** +61 7 3839 7783

# Contents

Q1: Which method do you prefer and why? .....	1
Q2: Should any other alternatives be considered? .....	3
Q3: Are there any other factors that should be taken into account? .....	4
Q4: Are there any other impacts or benefits of either model on Clearing Participants or their clients that should be taken into consideration? .....	4
Q5: What, if any, would be the implementation impact on Clearing Participants?.....	4
Q6: Should Clearing Participants be able to offer any of the options outlined to their clients? .....	4
Q7: Do you believe a gross margin client omnibus account structure should be considered in order to facilitate margin pass-through? .....	4
Q8 Under the ISCA proposal, do you believe that final settlement should occur on a per client account basis or as one single settlement across all clients? .....	4
Q9: Are there any comments on the proposal, especially on the operational impact? ....	5
Q10: Are there any other changes required to the Clearing Participant/client arrangements to facilitate the operation of the offsetting transaction arrangements? .....	5
Q11: Are there any suggestions for alternatives that achieve the same regulatory requirement, particularly drawing on overseas experience? .....	5

## Q1: Which method do you prefer and why?

*Option 1 – Retention of the Existing Structure would be the preferred option if allowed under the Financial Stability Standards.*

The current model delivers an extremely high level of investor protection when considered in conjunction with ASIC market rules and corporations' law on trust account protection of client money. The National Guarantee Fund provides an additional level of protection of investor interests. GBST back office systems already provide for segregation of selling client securities up to the point where they are moved to the CHESSE settlement entrepot for delivery on the relevant settlement day; this movement triggers crediting funds to the client trust account balance. Likewise buying client funds are held in trust until final delivery of the relevant securities has been actioned. Under this model the client assets are always clearly identified as such until the offsetting leg of the settlement has been completed (i.e. trust funds credited to selling clients, stock delivered to buying clients).

The retention of the existing model would also minimise the additional costs to the industry and investors.

*Option 2 – If the existing model is not acceptable to regulators the use of segregated house and client omnibus structures would be the next best alternative.*

The existing settlement system requires that participants support multiple entrepots to segregate securities subject to foreign ownership restrictions; as such existing systems typically support the use of multiple entrepots and associated payment facilities. Option 2 will, however, require separate management of settlements for each entrepot thus increasing the operational cost of processing settlements in addition to reducing netting efficiency and increasing margin requirements. For retail brokers with negligible house trading the impact would be reduced.

The key issue with this model is the attribution of each market execution to the correct processing stream (i.e. house or client) for clearing and settlement. Ideally this would be specified on the trade notifications received from markets and the CCP (as specified in the discussion document). It is likely, however, that some mechanism will be required to allow brokers to change the designation of particular executions and potentially parts of executions prior to the netting of obligations.

A key part of processing the clearing and settlement of market executions is ensuring that internal broker back office system records exactly match those maintained by the CCP; as such the splitting of market executions between house and client accounts must be final and unambiguous when netting occurs. Any difference between internal and CCP records will result in settlement failures at the omnibus level leading to higher failure rates for the market as a whole.

Current practices in the institutional broking segment currently include:

- Aggregation of orders from client and house sources into a single market order with subsequent executions allocated across the underlying orders as required

- Use of price averaging (e.g. VWAP) techniques which book multiple executions to a suspense account from which allocations are done at prices nominated during the booking process. Under this model there may be profit or loss generated due to differences between booked prices and the prices on the source executions. A side effect of this method is to remove any direct linkage between market executions and client transactions.

These practices result in a situation where the attribution of a specific execution to single category is not possible due to the “many to many” relationship between market executions and client side allocations. Splitting of executions based on gross values allocated to the different categories based on client side allocations is also not possible due to possible price variances in the booking process.

Possible solutions to this issue include:

- Treating executions tagged as “Both” as house obligations – this would result in client obligations being combined with house obligations and would totally negate the protections which the new FS standards are meant to provide. Brokers would have an incentive to treat all market side obligations as “house” and thus retain the current highly efficient model unless specifically prevented via business rules (e.g. no dual entry DVP settlements allowed against a house settlement entrepot)
- Split processing of executions into the 3 streams of Client, House & Both and require brokers to perform a post-trade “allocation” of each “Both” execution into one of the other categories before COB on T+1. The splitting process would require controls to ensure that the total value and units in the “both” category was attributed appropriately. This model would still result in some mingling of house and client assets as an exact split based on whole executions would not be feasible; it would, however, be less than that under previous option. For the allocation process to accurately reflect the actual split the ability to split an execution into house and client components would be required; this would greatly increase the scale and costs of modifications to both the CCPs CHES system and brokers’ back office systems.
- Account for all executions as one category at capture and then split based on client side allocations. The main benefit of this proposal would be to ensure that the values and units settled through the client omnibus would accurately reflect actual client obligations. It would, however, involve very significant changes to CHES and broker systems as well as new business rules and procedures to support new a CHES workflow to capture allocations. As with the previous option the problem of splitting specific executions or alternatively creating new transactions to reflect client side allocations would have to be addressed.

If the market continues to support market orders and executions which are not clearly identified as either client or house (i.e. it supports a “both” category) it will require a process to split the ambiguous transactions into their relevant category; this process is likely to be complex, costly and subject to error which will result in at least a partial negation of the protections which the standards are claimed to provide.

If option 2 is implemented it should be on the basis of a single PID with separate client and house omnibus accounts. This structure will minimise the operational overhead of managing multiple settlements as movements of stock between entrepots for settlement preparation

purposes will be simplified as they will be done on a single entry demand basis (i.e. using 001 messages) rather than requiring dual entry movements (i.e. using 105 messages). It will also minimise additional costs if the current charge exemption for movements between entrepots is retained. Recent changes to business rules already allow a single clearing participant to operate multiple PIDs if they choose to do so.

*Option 3 – Individual Segregated Client Accounts is not considered as a viable option.*

The changes to the industry required to fundamentally change the structure and practices used for cash market settlements would be very high compared to the improvement in investor protection. The Australian market has a highly efficient model where, particularly in the retail market, client exposure to brokers is limited to the duration of the settlement cycle (i.e. a maximum of 4 business days). Outside of this timeframe client assets are typically held externally in either CHESSE sponsored or Issuer Sponsored holdings (for stock) or external bank or CMT accounts (for cash). These measures taken together with existing protections for client funds and holdings have historically delivered a very high level of client protection. The confusion and disruption arising from the implementation of a totally different model would likely reduce rather than improve investor protection.

The costs of implementation would be very high as it would require very significant redevelopment of existing broker systems and CHESSE; the costs of these developments could lead to a further reduction in the number of brokers offering services to retail investors with a resulting reduction in competition in this market. The costs of implementation would ultimately have to be passed back to investors.

## **Q2: Should any other alternatives be considered?**

Given the likely costs of implementing the proposed changes will be significant the actual benefit to investor protection should be more clearly defined before changes are mandated.

Many of the issues raised by regulators as justification for the proposed changes such as portability and margin segregation and pass through have extremely limited application to the cash market. Whilst appropriate for derivatives markets where transactions are open for a significant timeframe and clients provide margins to cover their exposure the cash market has fundamental differences which greatly reduce the benefits arising from these measures.

If investor protection in the event of a broker default is the prime concern, mandating how such a situation would be handled to maximise investor protection should be considered. For example the fundamental protection of client money is provided by the trust account regulations; in a situation of default what entity would be responsible for freezing the account and managing the distribution of funds? Whilst the CCP has the ability to liquidate its exposure to the defaulting participant and holds margin against this event what access should they have to assets held in broker entrepot accounts when doing so; if a separate client omnibus is used or accurate records of client beneficial ownership are available should the CCP have access to these assets when liquidating their exposure? If they do have access who is then responsible for distributing the proceeds to the underlying clients? Which entity would be responsible for transferring client sponsored holdings to either issuer sponsored holdings or another sponsor; what time frame would apply (i.e. how long would client assets be tied up in the liquidation process)?

Clarity on these issues backed up by appropriate business rules, legislation and compliance monitoring would seem to offer more protection to investors than a theoretical “portability” model which could not be applied in a timely fashion compared to the settlement cycle. Likewise the costs of collecting, managing and refunding client margins for a 4 day cycle are likely to be far more than the costs of funding a net margin requirement as per the current situation.

**Q3: Are there any other factors that should be taken into account?**

The cost to the industry compared to the actual realisable (not theoretical) benefits to investor protection should be a primary consideration.

**Q4: Are there any other impacts or benefits of either model on Clearing Participants or their clients that should be taken into consideration?**

See above.

**Q5: What, if any, would be the implementation impact on Clearing Participants?**

Any change in the existing methods and practices will incur a cost to the industry which will ultimately be passed back to investors as either increased charges or reduced returns to broker and ASX shareholders. Under the proposed dual omnibus model there will be costs incurred for system upgrades by both the CCP and participants. Participants will also face additional costs through a requirement to duplicate the settlement management process. The actual costs will vary by participant based on the complexity of their business and the level of principal trading they undertake.

**Q6: Should Clearing Participants be able to offer any of the options outlined to their clients?**

Ideally all brokers would operate on a level playing field as far as investor protection is concerned (i.e. all should support the mandated minimum requirements). Giving the ability to brokers to allow clients to choose their desired model would make investor protection an area of competition between brokers. If a broker is allowed to offer differing levels of protection it is unclear how this could be disclosed in a comprehensive way so clients could make an informed choice. The ongoing issues arising from provision of Product Disclosure documents and statements of advice would be further complicated if they had to be extended to also providing clarity on comparative methods of providing investor protection.

**Q7: Do you believe a gross margin client omnibus account structure should be considered in order to facilitate margin pass-through?**

No – see comments on margins in Q2.

**Q8 Under the ISCA proposal, do you believe that final settlement should occur on a per client account basis or as one single settlement across all clients?**

The ISCA proposal should not be considered on any basis due to costs of implementation and disruption to the industry.

**Q9: Are there any comments on the proposal, especially on the operational impact?**

If there will be no changes to CHESSESS messaging and broker systems are not required to actually record and process REPO trades the operational impact should be nil.

**Q10: Are there any other changes required to the Clearing Participant/client arrangements to facilitate the operation of the offsetting transaction arrangements?**

None identified – clients would not typically be aware of current re-scheduling processing so a purely rule based change should not have any impact.

**Q11: Are there any suggestions for alternatives that achieve the same regulatory requirement, particularly drawing on overseas experience?**

No