



# **Financial Stability Standards Implementation**

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**Market Feedback Statement**

## Table of Contents

<b>Table of Contents</b> .....	<b>2</b>
<b>Executive Summary</b> .....	<b>3</b>
Account Segregation .....	3
Rescheduled Settlements .....	3
<b>Introduction</b> .....	<b>4</b>
Key feedback.....	4
Next steps.....	4
Account Segregation.....	4
Rescheduled settlements.....	7
<b>Attachment A – Responses Received by ASX</b> .....	<b>8</b>
Account Segregation .....	8
Rescheduled settlements .....	9

## Executive Summary

On 29th July 2013 ASX released a Consultation Paper on the implementation of the Reserve Bank of Australia's (RBA's) Financial Stability Standards (FSS). This paper outlined ASX proposals for cash equity market account segregation and liquidity arrangements in the event of a Clearing Participant default.

### Account Segregation

ASX received strong support from the industry to maintain the existing single house account structure. Accordingly ASX has undertaken a further review of current processes to identify and resolve any material shortcomings in the protection of client assets compared to the operation of a client omnibus account structure.

As a result of this review, including engagement with several participants and a systems vendor, ASX intends to implement several changes to the ASX (Clearing and / or Settlement) Operating Rules that will largely strengthen existing market practices and introduce a new process in CHESSE to provide better protection for clients arising from broker sponsored sales.

ASX intends to introduce some rule changes in Q1 2014 and the CHESSE and related rule changes in Q4 2014.

Following consultation with both the RBA and the Australian Securities and Investments Commission (ASIC), ASX has received in-principle agreement from both regulators that these enhancements will achieve materially equivalent protection of client assets to that offered through a client omnibus account.

Providing these enhancements are constructed in a satisfactory form, ASX will not be required to proceed with the client omnibus or Individually Segregated Client Account (ISCA) structures outlined in the ASX Consultation Paper.

### Rescheduled Settlements

There was broad support for ASX's proposed offsetting financing arrangement and, with no alternative suggestions being put forward, ASX intends to proceed with the proposed rule changes in Q1 2014.

## Introduction

On 29<sup>th</sup> July 2013 ASX released a Consultation Paper on the implementation of the RBA's FSS. ASX received 24 submissions and we would like to thank all organisations who prepared a response to the Consultation Paper. We received 17 submissions from Clearing Participants, four submissions from software vendors, two submissions from trade associations and one submission from an exchange market operator.

ASX has placed the 11 non-confidential submissions received on the ASX website. A copy of these submissions can be accessed by following the link below.

[www.asx.com.au/services/clearing/consultation-responses.htm](http://www.asx.com.au/services/clearing/consultation-responses.htm)

A copy of the ASX Consultation Paper can also be accessed through the following link.

[www.asx.com.au/services/clearing/new-regulatory-standards.htm](http://www.asx.com.au/services/clearing/new-regulatory-standards.htm)

In Attachment A we have provided a summary of the responses received to the various questions raised in the Consultation Paper. The feedback provided in Attachment A is based on the questions posed by ASX. It is important to note that some responses did not directly address the questions that were posed. We have tried to incorporate this feedback under the relevant ASX question headings where possible.

Please note that in providing this summary, we have attempted to best reflect the main content received. While we have sought to incorporate all relevant comments, the summary below does not attempt to capture every remark received from respondents.

## Key feedback

The majority of the submissions received expressed strong support for ASX retaining the existing single house account structure. Most respondents thought the existing arrangements provided sufficient protection to clients while a number of submissions argued that ASX should consider enhancing the existing model in order to increase client protection (e.g. changes to client stock delivery arrangements). These enhancements were viewed as a way of addressing any existing client protection shortcomings without requiring a separate account structure for client and house activity.

The proposed client omnibus account was seen by many respondents as a viable second preference while the ISCA proposal was widely viewed as an unsuitable model for the Australian market. The client omnibus account was preferred over ISCA for a number of reasons including the lower estimated build and ongoing operating costs. This model was seen as a way of achieving house and client segregation while minimising netting efficiency losses and expected increases in cash market margin requirements.

Among respondents there was broad support for ASX's proposed offsetting financing arrangement. ASX did not receive any alternative suggestions which would enable the new regulatory requirements to be met.

## Next steps

### Account Segregation

As a result of the feedback received on the account segregation proposals ASX has re-examined the existing single house account structure and the new FSS account segregation requirements.

Substandard 13.2 of the FSS for Central Counterparties states that:

*“A central counterparty should employ an account structure that enables it readily to identify positions of a participant's customers and to segregate related collateral. A central counterparty should maintain customer positions and collateral in individual customer accounts or in omnibus customer accounts, or equivalent”.*

In addition the guidance under this sub-standard (paragraph 13.2.10) states:

*“Under certain circumstances, central counterparties clearing cash markets may be able to achieve materially equivalent protection of customer assets by alternative means. Such alternative arrangements should ensure that: customer positions can be identified in a timely manner; customers will be protected by an alternative mechanism (for example, an investor protection scheme) designed to move customer accounts from the failed or failing participant to another participant in a timely manner; and customer assets can be restored”.*

The FSS therefore facilitate ASX retaining the existing single house account structure in the cash equity market if it can demonstrate that this structure provides materially equivalent protection of client assets compared to one of the proposals (i.e. client omnibus account or ISCA) outlined in the ASX consultation paper. ASX considers that with the appropriate enhancements (discussed later in this paper) the existing structure would provide materially equivalent protection for client assets to a client omnibus account structure.

In respect of the portability of cash positions and segregation of related collateral as specifically contemplated under the above FSS, ASX believes that such portability of cash positions is not practical given the short three day settlement cycle. It is important to note that client collateral is not able to be used for cash market margining.

Following the settlement of a cash equities market transaction the stock is held by the client in either an Issuer Sponsored or Broker Sponsored format. The cash proceeds resulting from a sell transaction is either paid to the client or held in a trust account. For clients with Broker Sponsored holdings, in the event of a Clearing Participant default, these holdings (once a new broker sponsorship agreement has been executed with an alternate Clearing Participant) can be transferred. ASX considers that the focus should therefore be on ensuring the protection of client assets (cash and securities) between the trade and settlement date.

ASX has undertaken a detailed analysis on the existing industry practices, including the ASX Operating Rules and statutory framework around the movement of client stock and cash between the trade and settlement date. While such practices and frameworks provide protections for client assets, ASX considers that in the context of the trade settlement process:

- There is uncertainty around who is the beneficial owner of the stock once it has been transferred from the client into the brokers accumulation account;
- There could be a potential delay between when the stock is transferred into the brokers settlement account (normally on T+2) and when the associated funds are paid to the client or transferred into the Trust account (normally on the afternoon of T+3); and
- There is uncertainty around when client funds (relating to purchases) can be withdrawn from the trust account.

As a result ASX considers that the existing single house account structure can be enhanced through:

- amendments to the ASX (Clear and/or Settlement) Operating Rules to expressly address the above aspects; and
- the introduction of a new process flow (together with the associated rule changes) for clients selling stock that is held broker sponsored to mitigate the amount of stock a broker would have to fund in their settlement account on T+2.

Such enhancements to the existing legal framework are viewed by ASX to achieve materially equivalent protection of client assets to that offered through a client omnibus account. ASX has also consulted with RBA and ASIC on these proposals and both regulators have provided in-principle agreement on the intended enhancements. Providing these enhancements are constructed in a satisfactory form, ASX will not be required to proceed with the client omnibus or ISCA structures contemplated under FSS 13.

*Proposed cash equity market enhancements and new process flow*

ASX is proposing to introduce the following enhancements to the ASX (Clear and/or Settlement) Operating Rules:

- Confirmation that client stock held in the accumulation account is maintained beneficially for the underlying client. This will also require brokers to maintain accurate records of the beneficial holders and to reconcile the records of beneficial holdings against stock in the accumulation account on a daily basis;

**Comment:** Can you please advise ASX if your organisation does not agree with this assumption (e.g. does your organisation fund the client as soon as the stock have been transferred into the accumulation account?).

- Requiring that when client stock is transferred from the accumulation account into the settlement account, funds representing the sale proceeds (net of brokerage) must be paid into the trust account operated by the Participant or paid out to the client on the same day that the stock is transferred (e.g. before banking closes); and
- Confirming that funds covering client purchases can only be withdrawn from the trust account operated by the Participant following the registration of the associated stock into the clients' name (i.e. the attribution of the stock to the client's Participant Sponsored Holding or Issuer Sponsored Holding).

**Comment:** Can you please advise ASX if your organisation does not follow the above process and withdraws client funds from the Trust account prior to the registration of the associated stock into the client's name.

ASX is also proposing to introduce the following new process flow for Broker Sponsored selling clients in an attempt to reduce the amount of stock that a broker has to fund in their settlement account on T+2.

- ASX is proposing that following the execution of the selling client's transaction a broker would send a message to CHES to lock the number of securities relating to the sale which are held in the client's Participant Sponsored Holding (this may be a new message or we may look to adapt an existing message such as the 105). This would differ to the current arrangements where client Broker Sponsored stock is delivered into the brokers accumulation account;
- Provided that the client has sufficient securities on their Participant Sponsored Holding, CHES would send a confirmation message back to the broker;
- Cancellation messages would also be available in order to enable the broker to cancel, re-book and contra transactions;
- On the morning of T+3 at 10.30am the securities would be transferred from the client Participant Sponsored Holding into the brokers settlement account ready for use through the CHES batch process;
- As part of the CHES batch process the funding obligations would be split into two components:
  - A payment representing the sum of all "locked" Broker Sponsored stock transactions would be paid to the brokers payment provider for deposit into the brokers trust account; and
  - A second obligation (pay or receive) will be required to cover the remaining CHES obligations.

ASX (Clear and/or Settlement) Operating rules will also be implemented to support the above process and payment flows. Changes are also expected to be required to the Standard Payment Provider Deed entered into by all Payment Providers who provide Payment Facilities to satisfy payment obligations on behalf of Participants.

The above process will be a mandatory requirement for all client Broker Sponsored sales i.e. where the securities relating to the sale are held in the client's Participant Sponsored Holding. This will ensure that only client Issuer Sponsored stock will be required to be processed through the brokers accumulation account into the brokers settlement account.

ASX is proposing the following timetable for the roll out of these enhancements:

#### Quarter 1 2014

- Introduce changes to the ASX (Clear and/or Settlement) Operating Rules to confirm that:
  - client stock held in the accumulation account is maintained beneficially for the underlying client (together with corresponding reconciliation requirements); and
  - funds covering client purchases can only be withdrawn from the trust account following the registration of the associated stock into the clients' name.

#### Quarter 4 2014

- Introduce the new processing flows for broker sponsored sell transaction into the November 2014 CHES release; and
- Introduce changes to the ASX (Clear and/or Settlement) Operating Rules to:
  - support the above new processing and payment flows; and
  - require that when client stock is transferred from the accumulation account to the settlement account (or directly into the settlement account) it must be funded into trust or paid out to the client on the same day that the stock is transferred (e.g. before banking closes).

### Rescheduled settlements

ASX intends to make the required rulebook changes in order to implement the proposed offsetting financing arrangement as outlined in the ASX consultation paper. Our intention is that the offsetting transaction arrangement will be transacted between ASX Clear and affected non-defaulting Clearing Participants.

A minority of responses to the Consultation Paper noted that the proposed offsetting financing arrangement may raise tax or accounting implications for Clearing Participants. ASX will consider these concerns in more detail when defining the required rule enhancements to support this process (expected to be introduced in Q1 2014).

ASX would welcome any comments on the above issues. In addition if any Participant would like to have a bilateral meeting with ASX to discuss any of the above proposed solutions in more detail then please contact Joshua Everson on +612 9227 0233 or [joshua.everson@asx.com.au](mailto:joshua.everson@asx.com.au).

## Attachment A – Responses Received by ASX

### Account Segregation

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

17 of the submissions received argued that the existing account segregation arrangements should be retained while six respondents supported the client omnibus account structure. One submission expressed support for the ISCA proposal.

Many submissions noted that there were already a number of cash equity market protections in place (e.g. client money trust arrangements). Some Clearing Participants argued that the existing structure should be retained because any client protection benefit from moving to a client omnibus or ISCA structure would be relatively minor in comparison to the significant build and ongoing administration costs.

The client omnibus model outlined by ASX was widely viewed as more favourable than the ISCA proposal. The key benefits of the client omnibus account over the ISCA included lower build and ongoing administration costs and lower cash market margin requirements through greater netting availability under the client omnibus account structure.

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

The alternative options put forward included a market move to T+2 settlement as a way of reducing the length of any client exposure. Some responses suggested that ASX should review the rules on the timing of the transfer of client stock into Clearing Participant accumulation and settlement accounts. One respondent suggested that ASX should consider using enhanced CHESS messaging as a way of increasing client protection for stock sellers.

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

Many submissions argued that, if the existing account structure could not be retained, ASX should seek to mandate the client omnibus account structure. This approach was broadly supported because it would ensure that all Clearing Participants operated on a level playing field, avoiding any unnecessary industry fragmentation.

A large number of respondents suggested that ASX would need to provide further guidance on what activities should be designated as either house or client activity if the market were to transition to a client omnibus or ISCA model. Many respondents also noted that these proposals would require significant time for development and testing.

There was broadly equal support for house/client designation at the trade level and house/client designation through two Clearing Participant PIDs. Respondents supporting designation at the trade level generally thought that this was the 'cleanest' way for Clearing Participants to make the required designation. Some submissions noted that Clearing Participants may not necessarily know the origin of an order at the time a trade occurred and as a result ASX would need to allow post trade adjustments. The two Clearing Participant PIDs option was broadly seen as the quickest and lowest cost mechanism for making the required designation although this option could result in increased market transparency of house positions.

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

Most submissions noted that the ASX proposal would result in increased Clearing Participant costs in the form of IT upgrades, staff training and additional administration costs. A number of responses outlined that any benefit from improved client protection would need to outweigh the additional costs imposed on Clearing Participants.



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

Respondents noted that the client omnibus and ISCA proposals would result in additional messages in order to enable settlement. Some submissions suggested that settlement fails could also increase. Additional administration and technology costs, and increased staff training were also noted.

A minority of respondents suggested that there may also be client communication and re-documentation costs.

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

There was strong support for the final ASX solution to be mandated because of the concern that client choice could lead to industry fragmentation. A minority of respondents suggested that, while there should be a default client omnibus account, clients could have a choice of either opting into an ISCA (for greater client protection) or opting into the existing single house account (for administrative purposes such as stock borrowing and lending activity).

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

A large majority of respondents did not support the use of gross margining under the client omnibus account structure. A number of issues were raised with this option including the expected significant development cost, increases in administration and funding costs, and concerns that the pass-through of client margins would not be practical.

**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 overwhelming majority of respondents did not support the ISCA model as a potential cash equity market solution. Most respondents outlined that, if the ISCA proposal were to be mandated, a single settlement for all client trades should be adopted.

## Rescheduled settlements

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

Respondents broadly supported the ASX proposal. A minority of respondents expressed concern that the ASX proposal would create operational and financial challenges for Clearing Participants without any market benefit. Some suggested that books and records would need to be updated and manual processing required in the unlikely event that the offsetting financing transaction was used. One bank respondent suggested that the ASX solution should be subject to a master netting arrangement in order to increase the capital efficiency of any possible transactions.

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

A significant majority of respondents thought that the ASX proposal would not require additional changes to Clearing Participant or client arrangements. One respondent suggested that the new proposal could have different legal ramifications and regulatory capital impacts compared with the existing ability for ASX to reschedule transactions.

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

ASX did not receive any alternative suggestions which would allow the new regulatory requirements to be met.