

# FAIR AND EFFECTIVE CLEARING AND SETTLEMENT FACILITIES

The purpose of this document is to articulate how the ASX group interprets its obligation under section 821A(a) of the Corporations Act 2001 (Cth)<sup>1</sup> to do all things necessary, to the extent that it is reasonably practicable to do so, to ensure that the services of each of its licensed clearing and settlement facilities<sup>2</sup> are provided in a **fair and effective** way.<sup>3</sup>

In summary, ASX considers:

<p>An operator of a licensed clearing and settlement facility can be expected to satisfy its obligation under section 821A(a) to do all things necessary, to the extent that it is reasonably practicable to do so, to ensure that its services are provided in a <b>fair and effective</b> way if:</p>	
<ul style="list-style-type: none"> <li>• the rules governing the operation of the facility clearly set out: <ul style="list-style-type: none"> <li>• who can participate in the facility;</li> <li>• the rights and obligations of participants under the rules; and</li> <li>• when a participant can have their participation in the facility suspended or terminated,</li> </ul> <p>and those rules are applied by the operator of the facility consistently and without inappropriate bias.</p> </li> </ul>	<div style="border: 1px solid black; padding: 10px; width: 150px; margin: 0 auto;">FAIR</div>
<ul style="list-style-type: none"> <li>• the facility enables participants to meet their obligations to each other in accordance with the facility's rules and within the timeframes contemplated by the facility's rules.</li> </ul>	<div style="border: 1px solid black; padding: 10px; width: 150px; margin: 0 auto;">EFFECTIVE</div>

## Context

In determining whether the services of a licensed clearing and settlement facility are provided in a fair and effective way, ASX considers it both appropriate and important to have regard to the statutory context in which the obligation under section 821A(a) appears and also to the commercial context in which ASX's licensed clearing and settlement facilities operate.

The statutory context includes the definition of "CS facility"<sup>4</sup> in section 768A(1), that is, a facility<sup>5</sup> that provides a regular mechanism for the parties to transactions relating to financial products to meet obligations to each other that:

- arise from entering into the transactions; and
- are of a kind prescribed by regulations made for these purposes.<sup>6</sup>

By defining a clearing and settlement facility by reference to the commercial functions that the facility performs, section 768A gives colour to whether or not a licensed clearing and settlement facility is providing its services in an "effective" way. It suggests that a licensed clearing and settlement facility will be providing its services in an effective way if it is achieving the commercial ends for which it was designed – that is, allowing the parties to relevant transactions in financial products to meet their obligations to each other.<sup>7</sup>

The statutory context also includes the framework within which the operating rules of a licensed clearing and settlement facility are made, which:

- requires the Minister, before he or she can grant a licence to operate a clearing and settlement facility, to be satisfied that the operator has adequate rules for the facility to ensure, as far as is reasonably practicable, that the facility will be operated in a fair and effective way;<sup>8</sup> and

- empowers the Minister to disallow any change to the operating rules of a licensed market,<sup>9</sup> having regard to whether the change is consistent with the licensee's obligations under the Corporations Act, including in particular its obligation to ensure, as far as is reasonably practicable, that the facility's services are provided in a fair and effective way.<sup>10</sup>

Once an operating rule of a licensed clearing and settlement facility comes into effect, the licensee and each participant in the facility comes under a statutory obligation to comply with the rule.<sup>11</sup>

The commercial context includes the vital role that ASX's licensed clearing and settlement facilities play in facilitating capital flows, reducing risk and promoting stability in the Australian financial system. This vital role is recognised and reinforced by the separate requirement in section 821A(aa) that the operator of a licensed clearing and settlement facility must, to the extent it is reasonably practicable to do so, comply with the Financial Stability Standards determined under section 827D and do all other things necessary to reduce systemic risk.<sup>12</sup> The fact that this obligation appears first in the list of obligations of licensees who operate licensed clearing and settlement facilities in section 821A suggests that it should be regarded as the primary obligation of such licensees and that, to the extent there is any conflict between the obligations in section 821A(aa) and 821A(c), the former should prevail. In turn, this suggests that the enquiry as to whether a licensed clearing and settlement facility is providing its services in a fair and effective way should be answered at the macro, rather than a micro, level by reference to whether the clearing and settlement facility is fairly and effectively performing the functions it is intended to perform from the perspective of participants in the facility generally rather than from the perspective of an individual participant.<sup>13</sup>

### **The meaning of "fair"**

The word "fair" can have many different meanings, depending on the context in which it is used.<sup>14</sup>

In ASX's opinion, in the context of section 821A(a), the word "fair" is used in one (or possibly both) of two senses – 'something that conforms to the applicable rules' (as in a *fair* contest) and/or 'free from bias or injustice' (as in a *fair* decision).<sup>15</sup>

As mentioned previously, once an operating rule of a licensed clearing and settlement facility comes into effect, the facility operator and each participant comes under a statutory obligation to comply with the rule. At that point, it is no longer open to a participant to argue that it should not have to comply with the rule because it is unfair. Hence the enquiry as to whether a licensed clearing and settlement facility is meeting its ongoing obligation to provide its services in a "fair" way is not intended to be a value judgment as to whether its operating rules are fair – that value judgment having already been made by the Minister in deciding to grant a licence to the facility operator with its rules as in force at that time and not to disallow any rule change subsequently<sup>16</sup> – but rather whether its operating rules are being applied in a fair manner (that is, consistently and without inappropriate bias).

ASX considers that a licensed clearing and settlement facility is likely to meet its obligation to provide its services in a fair way if the rules governing the operation of the facility clearly set out:

- the criteria and process for someone to become a participant in the facility;
- the rights and obligations of participants under the rules;
- when a participant can have their participation in the facility suspended or terminated,

and those rules are applied by the operator of the facility consistently and without inappropriate bias.<sup>17</sup>

This is not to say that the operator of a licensed clearing and settlement facility must treat all participants equally in all circumstances. Plainly, a licensed clearing and settlement facility can still meet its obligation of fairness, even though it may provide for different categories of participants with different rights and obligations under the rules, or charge different fees to, or call different risk collateral margins from, participants who deal in different products or who have different risk profiles.

Fairness requires a level playing field and that participants in like circumstances are treated in like manner, rather than that all participants in all circumstances are treated equally.

## The meaning of “effective”

In ASX’s opinion, the word “effective” is used in section 821A(a) in the sense of ‘adequate to accomplish a purpose’ or ‘producing the intended or expected result’.<sup>18</sup>

ASX considers that a licensed clearing and settlement facility is likely to meet its obligation to provide its services in an effective way if the facility enables participants to meet their obligations to each other in accordance with the facility’s rules and within the timeframes contemplated by the facility’s rules.

## Balancing fairness and effectiveness

The phrase “fair and effective” is a composite phrase of two potentially conflicting elements. It is conceivable, for example, that something could be fair but not effective, or effective but not fair. It is also conceivable that something could affect different participants differently – that is, something might be fair to some participants but unfair to others, or effective for some participants but not for others.

The issues at play here are well illustrated by the observations of Young J in *Story v National Companies and Securities Commission*<sup>19</sup> when interpreting another composite phrase – the obligation of financial service licensees<sup>20</sup> to provide their services “efficiently, honestly and fairly”:

“Thus I turn to the phrase “efficiently, honestly and fairly”. In one sense it is impossible to carry out all three tasks concurrently. To illustrate, a police officer may very well be most efficient in control of crime if he just shot every suspected criminal on sight. It would save a lot of time in arresting, preparing for trial, trying and convicting the offender. However, that would hardly be fair. Likewise a judge could get through his list most efficiently by finding for the plaintiff or the defendant as a matter of course, or declining to listen to counsel, but again that would hardly be the most fair way to proceed. Considerations of this nature incline my mind to think that the group of words “efficiently, honestly and fairly” must be read as a compendious indication meaning a person who goes about their duties efficiently having regard to the dictates of honesty and fairness, honestly having regard to the dictates of efficiency and fairness, and fairly having regard to the dictates of efficiency and honesty ... ”

Applying a similar approach to section 821A(a), this would suggest that to meet its obligation under that section, the operator of a licensed clearing and settlement facility must provide its services in a fair way having regard to the dictates of effectiveness, and in an effective way having regard to the dictates of fairness.

Regulatory guidance as to how to interpret another composite phrase – the obligation of financial market licensees to ensure that their market is “fair, orderly and transparent”<sup>21</sup> – is to similar effect. It suggests that if there is a conflict between the elements of the phrase, the licensee is expected to strike an appropriate balance between the demands of each element<sup>22</sup> – in this context between the obligation to provide services in a fair way and the obligation to provide services in an effective way.<sup>23</sup>

ASX believes that the appropriate balance between fairness and effectiveness is one which has regard to the important role that ASX’s clearing and settlement facilities play in the Australian financial system. ASX considers that the test in section 821A(a) should be biased towards an outcome that achieves fairness from the perspective of participants generally and effectiveness from the perspective of the licensed clearing and settlement facility as a whole rather than an outcome that delivers fairness to an individual participant at the expense of the effectiveness of the facility.

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<sup>1</sup> Referred to as the “Corporations Act”. Unless otherwise stated, references to sections are to sections of the Corporations Act.

<sup>2</sup> The Corporations Act uses the contraction “CS facility” to refer to a licensed clearing and settlement facility. A CS facility may provide clearing services only, settlement services only or both licensed CS services.

<sup>3</sup> Operators of licensed CS facilities also have separate obligations under section 821A (among other things):

- to the extent that it is reasonably practicable to do so, to comply with the Financial Stability Standards determined under section 827D and to do all other things necessary to reduce systemic risk (section 821A(aa));
- to have adequate arrangements for supervising the facility, including arrangements for:

- handling conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the facility's services are provided in a fair and effective way; and
- enforcing compliance with the facility's operating rules (section 821A(c)); and
- to have sufficient resources (including financial, technological and human resources) to operate the facility properly and for the required supervisory arrangements to be provided (section 821A(d)).

<sup>4</sup> See note 2 above.

<sup>5</sup> ASIC defines a "facility" as any form of infrastructure and says that this definition is consistent with the decision in *Carrageen Currency Corporations Pty Ltd v Corporate Affairs Commission (NSW)* (1986) 11 ACLR 298, 312-3. (see ASIC Regulatory Guide 172 *Australian market licences: Australian operators*, at paragraphs 17 and 30).

<sup>6</sup> Corporations Regulation 7.1.09 prescribes for the purposes of this paragraph obligations that arise from a contract to purchase securities, managed investment products and derivatives. Section 768A gives as examples of facilities that fall within this definition: (1) a facility that provides a regular mechanism for stockbrokers to pay for the shares they buy and to be paid for the shares they sell, and for records of those transactions to be processed to facilitate registration of the new ownership of the shares; and (2) a facility that provides a regular mechanism for registering trades in derivatives on a futures market and that enables the calculation of payments that market participants owe by way of margins.

<sup>7</sup> ASX therefore would not regard the fact that another licensed CS facility may be affected by circumstances that cause it to be operating in an unfair or ineffective manner, or that it has halted processing in response to, or to avoid, that occurring, to be relevant factors in assessing whether an ASX licensed CS facility is providing its services in a fair and effective way. The latter issue would have to be assessed by reference to the particular circumstances affecting the ASX facility.

<sup>8</sup> Section 824B(1)(c).

<sup>9</sup> Before it can change its operating rules, a clearing and settlement facility operator must lodge written notice of the change with ASIC under section 822D. The Minister can disallow the change within 28 days of that lodgement under section 822E.

<sup>10</sup> Section 822E.

<sup>11</sup> Section 822B and 822C. Although, in the case of the licensee, this is subject to any discretion that the operating rules may afford to the licensee in terms of granting a waiver or exemption from, or not enforcing, a particular rule. Any such discretion is one that would have to be exercised by the licensee "fairly", as that term is defined later in this Guidance Note.

<sup>12</sup> ASX notes that despite section 821A(aa) having been drafted in a way to impose separate obligations on a licensed CS facility, to the extent that it is reasonably practicable to do so, both to comply with the Financial Stability Standards and to do all *other* things necessary to reduce systemic risk, the Financial Stability Standards and the measures thereunder comprehensively cover matters relevant to the assessment of systemic risk.

<sup>13</sup> ASX therefore would not regard a short term loss of connectivity to one of its clearing and settlement facilities by an individual participant or a group of participants as rendering the services of that facility unfair or ineffective.

<sup>14</sup> The Macquarie Dictionary (2006) lists 22, and Dictionary.com lists over 30, different meanings for the word "fair".

<sup>15</sup> See the Macquarie Dictionary (2006) at page 420.

<sup>16</sup> See the discussion of the Minister's powers under sections 824B(1)(c) and 822E in the text at notes 8 and 10 above.

<sup>17</sup> ASX considers that this view of the meaning of "fair" is supported by the decision in *Transmarket Trading Pty Limited v Sydney Futures Exchange Limited*: [2010] FCA 534, concerning the obligation of a market operator under in section 792A(a) to ensure that its market is fair, orderly and transparent. In that context, Perram J observed (at paragraph 95) that the notion of fairness in section 792A(a):

"relates to a state of affairs in which all market participants are placed in an equal position such that there is level playing field."

This formulation of fairness was accepted and applied by the ASX Disciplinary Tribunal in *ASX Compliance Pty Ltd and Timber Hill Australia Pty Ltd* (15 December 2010) Matter No. 2009018 & 2009026, at paragraph 5.14.1. That decision was affirmed on appeal by the ASX Appeal Tribunal (2 May 2011).

<sup>18</sup> See the Macquarie Dictionary (2006) at page 378.

<sup>19</sup> (1988) 13 NSWLR 661, at 672.

<sup>20</sup> Section 912(1)(a).

<sup>21</sup> Section 792A(a).

<sup>22</sup> See ASIC Regulatory Guide 172 *Australian market licences: Australian operators*, at paragraph 83.

<sup>23</sup> The inclusion in section 821A(a) of the qualification "to the extent that it is reasonably practicable to do so" also lends support to this construction. In this regard, the Explanatory Memorandum for the Financial Services Reform Bill (2002), which enacted both section 792A(a) and 821A(a), made the following observations (at paragraph 7.38) about the obligation of a market operator under section 792A(a) to ensure that its market is fair, orderly and transparent:

In interpreting the phrase 'fairness, orderliness and transparency', it is desirable that all the words in the phrase be considered together. One word taken out of context may lead to a course of action which conflicts with the other words in the phrase. Thus, transparency may on occasions be in conflict with liquidity, yet liquidity is needed for an orderly market. The tensions between the three words need to be resolved sensibly, so that an appropriate balance is struck between the demands of different market participants. This is specifically acknowledged in the clause 'to the extent that those objectives are consistent with one another'.

The phrase 'to the extent that those objectives are consistent with one another' was replaced in the final form of section 792A by the phrase 'to the extent that it is reasonably practicable to do so'.