Building stable, growing and globally competitive financial markets

Submission to the Financial System Inquiry

31 March 2014

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Executive summary and considerations for the Inquiry

Australia has highly successful financial markets. ASX is optimistic about the opportunity to maintain a stable financial system, support a vibrant domestic economy and develop a growing role for Australia in the Asian region.

Global regulatory and commercial forces are now at work and will affect Australia's financial markets. The impact of these forces needs to be understood and the choices we collectively make must strengthen Australia's ability to compete. In the future, it will be less about the regulatory settings *within* Australia and more about the competitiveness *of* Australia. Financial markets have entered a new phase that requires new skills and clear policy positions.

New global regulations mean scale has become an important driver that influences the decisions of participants and exchanges. This has created 'tension' between the interests of investors and participants. It is in the interest of investors that their risk and their collateral are managed locally under Australian law. International banks and market operators, on the other hand, have an incentive to maximise their scale globally. It is more efficient for them to concentrate all market risk in one location and avoid 'fragmentation' of their economics.

Today, Australia's central financial market infrastructure supports one of the largest equities and derivatives markets in the world. These markets are critical for the funding of economic activity, the banking system and the current account deficit. Having a strong domestic financial market infrastructure is essential if Australia is to maintain control over systemic risk and to secure a seat at the table when global regulations are set.

Having access to a central market infrastructure is a pre-condition to be a financial centre. It attracts liquidity, investment, skills and people. In our region Hong Kong, Japan and Singapore all have central infrastructures and policy makers in these jurisdictions are focused on retaining and strengthening their domestic infrastructures. This can be seen in the choices that they make to manage the changing global environment.

Currently, ASX provides most of Australia's financial market infrastructure. It does this well and is recognised as one of the leading exchange groups in the world. ASX has a deep understanding of financial markets, the drivers of change, and the interests of investors, participants and other stakeholders.

ASX is investing more than $500 million to ensure that Australian investors will continue to have access to a world class and globally competitive market infrastructure. ASX currently has the scale and the financial strength to make the necessary investments.

As a result of the global forces at work, it is important that policy makers make clear and upfront choices about the regulatory controls they need over systemically important financial markets. Moreover, policy makers need to decide to what degree having a central financial infrastructure is important for Australia's position in the Asian region.

The questions that arise are:

> **To what degree must policy makers and regulators have direct control over Australia's systemically important financial markets and infrastructure?**
>
> **Is a central financial market infrastructure important for Australia's ambitions in the region?**

Answering these questions will require policy makers to look 5 to 10 years forward and balance financial stability, competition and market efficiency considerations. The policy outcomes need to be applied consistently to all potential providers of financial market infrastructure.

It needs to be recognised that liquidity can move quickly between financial markets and that it will be difficult to impose controls after markets have shifted. This means that it is important to make the best possible choices upfront rather than through a process of discovery or case-by-case decision making.

ASX believes that there are two long-term choices for Australia's financial markets:

1: Strong domestic market with regional ambitions	2: Australia as a branch of a global market
Domestic mandate for critical market infrastructure • Capital, collateral, core infrastructure in Australia • Applies to all systemically important markets **Level playing field for all competitors** • Comply with location requirements • Comply with Financial Stability Standards **Controls over ASX apply equally to all operators of systemically important infrastructure** • Includes ownership restrictions (15%)	**Open global market** • All participants free to optimise their economics • 'Regulatory equivalence' is only requirement **Regulatory functions may be 'outsourced'** • No location requirements • Reliance on overseas 'equivalent' regulators and insolvency laws to support Australian investors **Level playing field** • Freedom for ASX to locate its operations overseas • No strategic, M&A or ownership restrictions

ASX believes that the first option is the better choice for Australia. It provides greater control over systemic risk and gives the country a better chance to participate in the growth that is available in Asia.

To deliver the first option, location requirements for key financial markets need to be set upfront. The following table shows the current state-of-play, comparing the regulatory guidance with ASX's recommendations.

Financial market	Current guidance on requirements	Recommendation
Domestic equities and equity options	Offshoring restrictions/ Australia	Australia
Domestically traded derivatives (A$ interest rates, index)	Offshoring restrictions/ Australia	Australia
Internationally traded OTC derivatives (A$ interest rate swaps)	No controls	Australia for systemically important institutions
Commodities and energy/electricity	No controls	No controls

The table highlights that good progress has been made for several markets.

ASX agrees with the current regulatory guidance in respect of the domestically traded equity and derivatives markets. Examples are the cash equities and exchange-traded interest rate futures. These markets are material in size, are extensively used by domestic institutions, and are critical to the capital formation, price discovery and risk transfer processes that underpin the proper functioning of the Australian economy.

In relation to third category – the over-the-counter (OTC) A$ interest rate interest rate market – ASX recommends a tightening of the current approach by imposing domestic clearing requirements.

The view of Australia's regulators is that the A$ OTC interest rate market is systemically important. ASX agrees. The A$ OTC market is large with notional turnover of $15 trillion pa, and has a significant involvement from the big four Australian banks – they are estimated to be on one side of approximately 60% of all A$ OTC transactions.

The exchange-traded and OTC markets are converging. Given that both address interest rate risk, the product features of exchange traded and OTC derivatives are converging and liquidity will become more integrated as more of the OTC volume is cleared on an exchange platform. The locations of both markets may over time become the same.

Therefore, there is a strong case to apply location requirements to the OTC market in the same way they are applied to the exchange-traded interest rate market. This is ASX's recommendation.

The ASX recommendations are consistent with the outcomes that can be observed in other large financial markets and currencies – US$, Pound, Euro and Yen. Moreover, they are consistent with the approach of Asian markets and regulators to which the future of Australia is most closely linked.

Australian investors have access to a highly efficient market infrastructure that includes a capability to clear OTC derivatives. The infrastructure has been funded and is fully operational, making implementation of the required regulatory controls possible.

ASX acknowledges that its recommendation in relation to the A$ OTC interest rate market is a departure from the current approach and that some A$ liquidity would be contained within the Australian market as a direct result of regulation. This makes it somewhat more difficult to implement and communicate to stakeholders.

Commodity and energy derivatives markets are smaller in size and currently do not have the ability to materially impact the primary industries that they support. ASX supports the guidance in relation to these markets which is to have no location requirements.

With the confirmation of domestic location requirements for existing financial markets – equities and derivatives – there is a case to remove the specific 15% ownership restriction that is currently applied only to ASX. The 15% limit provided additional protection in an environment where the regulatory settings were less well defined.

Regulators will retain full control of the physical market infrastructure under any ownership scenario, and the normal foreign investment controls continue to apply. Removal of the restrictions would create a level playing field – there are no ownership requirements for any of the overseas operators that are licensed in Australia.

Australia is in the fortunate position that it is successful and internationally competitive. This allows it to make a positive choice about its future in financial markets and the region. ASX submits that now is the time to do so.

ASX encourages the Inquiry to provide its views on how Australia can work more closely with other regional financial centres to ensure that global regulations are tailored to the needs of the Asian region.

ASX encourages the Inquiry to express its views on the location requirements for financial market infrastructure in the context of managing systemic risk and Australia's ambitions in the region.

ASX encourages the Inquiry to express its views on the need for the 15% ownership restriction that applies to ASX under the new and tighter regulatory regime for financial markets.

Australia has successful and world-class financial markets

Key themes

- Australia's financial markets are backed by a growing economy, superannuation sector and world class regulators.
- Australia punches above its weight in financial markets relative to the size of the economy.
- As a result of the strength of the sector, ASX is one of the leading exchange groups in the world.

The Financial System Inquiry provides a timely opportunity to assess Australia's financial system against its ability to meet the needs of Australian business and investors. Previous inquiries have led to significant changes that have positioned Australia well. There is a positive link between a strong and well-functioning financial sector and the 22 years of uninterrupted economic growth that Australia has enjoyed.

The reports of the Campbell and Martin Committees in the early 1980s helped foster the growth of capital markets in Australia. The Wallis Committee in the late 1990s, combined with subsequent reform of the Corporations Act, strengthened the regulatory arrangements for financial services providers.

Other government decisions such as the introduction of compulsory superannuation, privatisations, and the removal of stamp duty on financial securities have contributed to strong growth in Australia's financial markets over the past 30 years.

As economies go through cycles, the stability and the effectiveness of financial markets can be tested. Australia's markets were tested during the GFC and performed very strongly.

The current Inquiry has the opportunity to respond to today's challenges and opportunities. In financial markets the most significant challenges relate to the impact of new global regulations introduced in the aftermath of the GFC. The most significant opportunities involve Australia playing a much greater role in delivering financial services to key Asian markets.

Australia punches above its weight in financial markets

Australia's financial markets bring together a large number of participants, including 6.7 million individual investors[1], the superannuation sector, the funds management industry, domestic and international banks, brokers, traders, financial planners, data and technology providers, and more than 2,000 listed entities.

Australia punches above its weight in financial markets. It is the 12th largest economy in the world[2], yet in the financial markets it operates Australia ranks between 3rd and 8th in the world. While public attention tends to focus on Australia's equity markets, the largest financial markets are the derivatives and foreign exchange markets.

Australia's largest financial markets

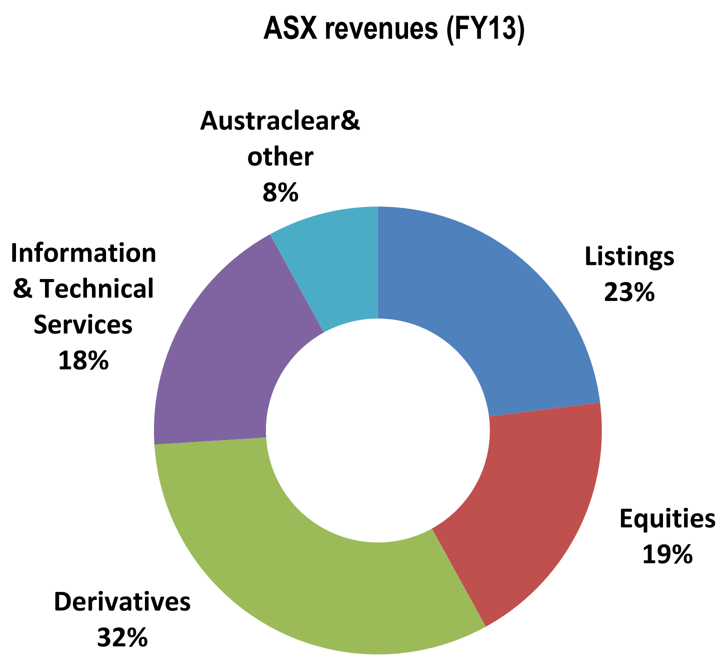
Markets	Key facts
Investments	• Superannuation savings pool of $1.7 trillion[3] • 3rd largest superannuation pool in the world[4]
Listings	• More than 2,000 companies listed with market capitalisation of $1.5 trillion • Over $400 billion capital raised since the start of the GFC, ranking Australia 4th in the world[5]
Equities	• Annual turnover of $1.2 trillion • 8th largest equity market in the world by free-float market capitalisation[6]
Derivatives	• Largest exchange-traded interest rate derivatives market in Asia and top 5 in the world[7] • Largest OTC interest rate swaps market in Asia and top 5 in the world[8]. • Other derivatives markets in domestic electricity and soft commodities
Foreign exchange	• Australian dollar is 5th most traded currency in the world[9] • Held as a reserve currency by a number of central banks.

The only market where Australia underperforms currently is the fixed income market and particularly the corporate bond market. Work is under way to address this through a number of legislative changes that simplify the process of issuing corporate debt securities. It is uncertain if these changes are going far enough. Market activity will decide if more reform and further simplification is needed.

Australia has one of the leading exchange groups in the world

The size and strength of Australia's economy and financial markets has allowed it to develop one of the most successful exchanges in the world.

ASX is multi-asset class and vertically integrated exchange group. This means that ASX operates both equities and derivatives markets, and that it provides a full end-to-end service involving listings, trading, clearing, settlement and depository services. In FY13, ASX had revenues of $617 million.

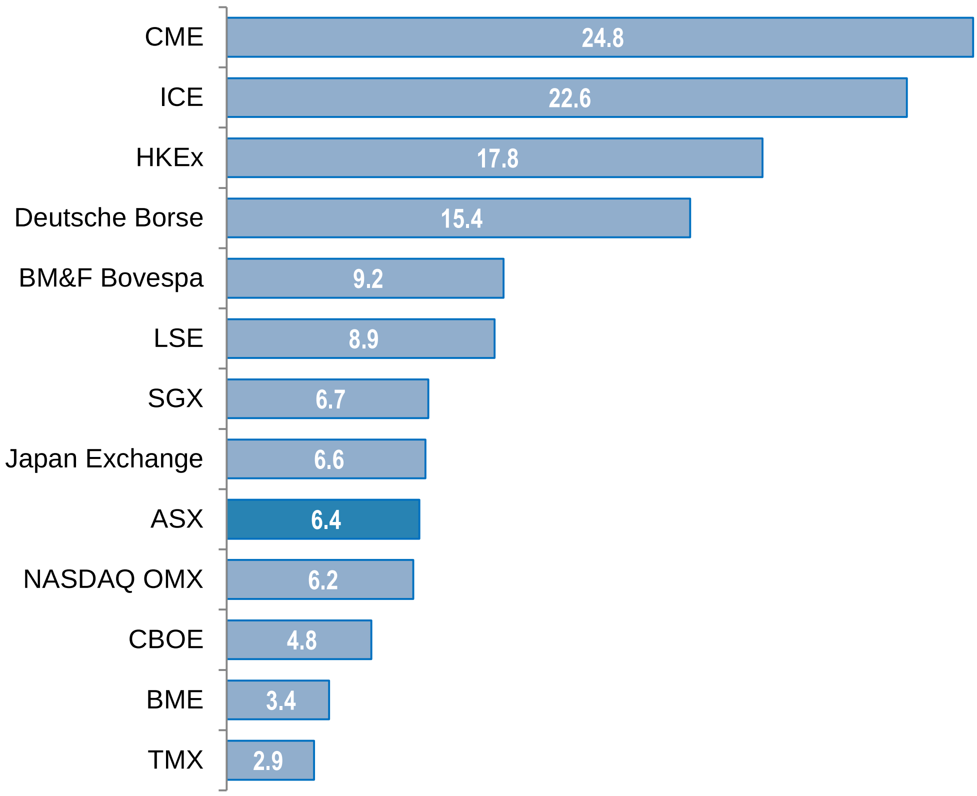


The size and diversity of its revenue streams provide ASX with the financial stability and strength to make large and long-term investments in Australia's financial infrastructure.

The ASX business model is similar to the business model of Asian exchanges such as Singapore, Hong Kong and Japan. The business model is different from most of the exchange models found in the US and Europe. Exchanges such as the London Stock Exchange, NASDAQ and ICE (which now owns the New York Stock Exchange) operate in much larger markets, but have narrower product and/or service footprints.

The differences in the business models matter and can give markets such as Australia a competitive strength which compensates for the lack of absolute scale that some of the larger financial markets offer. ASX is a top ten global exchange group.

Exchange businesses – market capitalisaton (US$ billion, March 2014)



Delivering on the long-term objectives for Australia's financial markets

Key themes

- The GFC reminds us that the long-term stability of financial markets is an overriding objective.
- Australia's financial markets are well placed to support the domestic economy. There is a need to accelerate reforms that diversify sources of funding for SMEs, corporations and infrastructure. The development of a corporate bond market is likely to require more radical simplification of regulations.
- Having a financial market infrastructure is a pre-condition to be a regional financial centre. Australia is well placed to play a bigger role in the region. There is a need for greater regional coordination to ensure that global regulations are tailored to the needs of Asia.

In deciding Australia's future in financial markets there are three key national objectives:

- Ensure the long-term stability of financial markets.
- Support a vibrant and growing domestic economy and wealth creation.
- Play a greater role in the delivery of financial services to the Asian region.

Ensure long-term stability of financial markets

In the aftermath of the GFC, there has been an increased focus on systemic risk and financial stability. Regulators and governments have agreed to change the way financial markets operate. Two key changes stand-out. First, more of the financial risk will be managed on exchange platforms, rather than in the bilateral interbank market. This means that regulators will progressively require that OTC derivatives are cleared by clearing houses. Trading can still take place bilaterally between two counterparties, but the risk has to be transferred to a clearing house as a central counterparty.

Second, regulatory requirements for clearing houses have increased. ASX operates two clearing houses: one for equities and one for exchange-traded and OTC derivatives. Clearing houses that operate in the global derivatives markets now need to hold more capital to support their activities. Australia has adopted the highest global standards. The agreement between global regulators to adopt similar standards is referred to as 'regulatory equivalence'.

The role clearing houses play in managing systemic risk in financial markets

Although largely invisible to market users, clearing and settlement services are critical to the operation of Australia's financial markets. They help reduce counterparty and systemic risk, and provide transaction efficiency and certainty for end investors.

Clearing arrangements in Australia

ASX Clear is the clearing house for all shares, structured products, warrants and ASX equity derivatives.

ASX Clear (Futures) is the clearing house for all major derivatives products, including futures and certain OTC products.

When a trade is completed it is submitted to the clearing house. Once the trade has been accepted, the clearing house becomes the central counterparty to each of the participants. This process is called novation. Rather than being exposed to each other, the participants now each have an exposure to the clearing house. In effect, the clearing house becomes the buyer to every seller and the seller to every buyer.

Clearing houses have sophisticated risk management procedures to manage the significant risks involved in clearing. In addition, the clearing houses ask participants to provide collateral to support their exposures to the clearing house. And finally, the clearing houses are separately capitalised to provide further financial resources in case of a material default.

ASX's clearing houses are regulated under Australian law. ASX holds capital and collateral on-shore.

ASX operates licensed clearing and settlement facilities under the Corporations Act. They must comply with the Financial Stability Standards (FSS) for such facilities overseen by the RBA.

The Australian FSS have been aligned with the global standards. As the provider of Australia's financial market infrastructure, ASX has taken a number of steps to strengthen its risk management practices and improve market efficiency:

- In 2013 ASX completed a $553 million capital raising, with most of the funds being allocated to its two clearing houses. Following the capital raising ASX's derivatives clearing house (ASX Clear (Futures)) meets the highest global capital standards.

- ASX has received regulatory relief from the European and US regulators to offer clearing services to the local bank branches of banks domiciled in those jurisdictions. This is important given the significant role international investment banks play in Australia's financial markets.

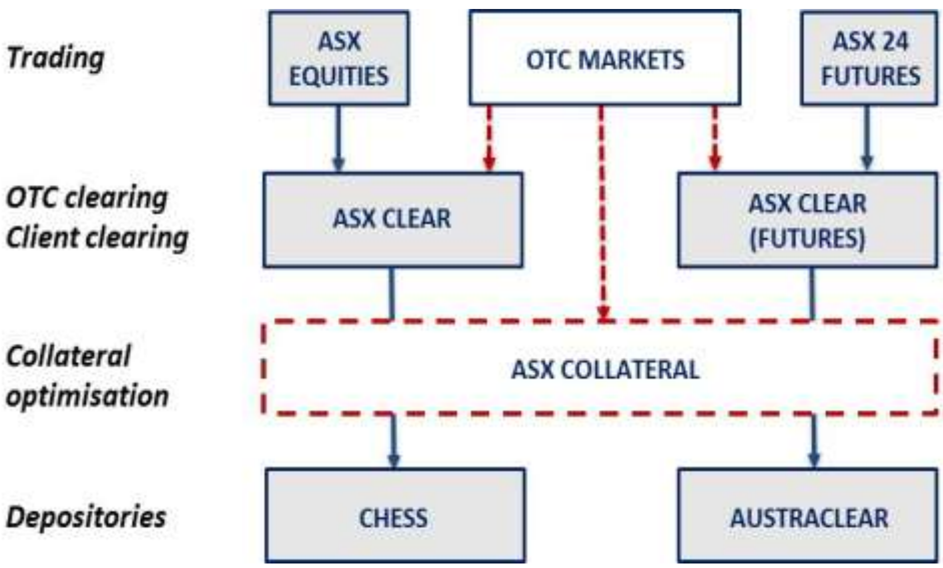
- ASX Clear (Futures) has obtained a long-term credit rating of AA- from Standard & Poor's, with a short-term rating of A1+, further strengthening ASX's position as a world-class financial market based in Australia.

- ASX has launched new clearing services for the OTC derivatives markets, initially focusing on transactions between individual banks (referred to as a 'dealer-to-dealer' service). By mid-2014 the clearing service will be extended to include client clearing, which will provide important new protections to investors. Client clearing allows the positions and the collateral of individual investors to be separately identified from all other users.

- ASX has invested in a new collateral management service that provides attractive collateral cost savings to market participants. ASX's vertically integrated business model and ownership of the securities depositories (Austraclear for fixed income securities and CHESS for equities) allow it to develop sophisticated collateral management services.

The investments made by ASX mean that Australian investors and participants have access to a world-class service that gives them the ability to manage their risk and collateral under Australian law. The chart below provides an overview of the ASX infrastructure that will largely be in place by the end of 2014.

ASX is building a world-class financial market infrastructure



While an important focus is on the derivatives markets where global regulations have the greatest impact, ASX is also investing in the domestic equities market. In June 2013, ASX introduced cash market margining as a way of enhancing the risk management controls in the equities market. In addition, ASX is currently examining how the Australian market can reduce the standard equity market settlement cycle from three days (T+3) to two days (T+2).

Support a vibrant and growing domestic economy and wealth creation

Australia's financial markets have been highly effective over the last 30 years. They helped fund the mining investment boom, generated strong growth in personal wealth and came through the test of the GFC with flying colours.

Stability and growth are not mutually exclusive objectives. Since the start of the GFC, ASX-listed companies have raised over $400 billion in new capital, making Australia one of the most effective capital markets in the world during a period of economic stress.

ASX and its clients and regulators continue to develop the services, systems and listing rule framework to strengthen Australia's position as an attractive market to list and raise capital. Over the last two years ASX has:

- Released clearer, more detailed guidance to help companies understand and comply with their continuous disclosure obligations. ASX also updated the disclosure requirements for reserves and resources in the mining and oil and gas industries.

- Reduced the standard timetable for traditional rights issues from 26 to 19 business days, making such offers a more attractive tool for companies to use to raise capital.

- Improved the flexibility for small and mid-cap companies to raise capital, and implemented a new Equity Research Scheme that provides funding to create research coverage of small and mid-cap companies.

- Started quoting Australian Government bonds on the exchange. This makes a new asset class available to retail investors and is an important step in the development of a domestic corporate bond market.

It will be critically important that Australia diversifies the funding options available for companies beyond equity and bank debt, and broadens the range of financial assets available for superannuation funds and private investors. The size of the superannuation savings pool already exceeds the market capitalisation of the Australian equity market, and the size of the supply/demand imbalance is expected to grow over the next 5 to 10 years.

Some changes are already planned to broaden funding and investment options:

- The Government is simplifying disclosure requirements for some types of corporate bonds to encourage greater issuance. ASX has developed a framework to quote corporate bonds on the exchange, giving retail investors access to a new asset class.

  While these reforms are welcome it is possible that further simplification is needed to make the Australian bond market genuinely competitive with bank funding and overseas bond markets that are being used by Australian corporations. Australia should reference the US markets, as well as progress made in New Zealand. Australia has a flexible and efficient regime to issue equity; the ability to issue senior debt should be no harder or more involved, particularly for well-established investment grade listed companies.

- ASX is looking to make it easier for Australian investors to access international equities that are not directly listed in Australia. This can be achieved by quoting Unsponsored Depository Receipts (UDRs) of a range of international equities on the ASX market. This would bring greater diversity to the Australian market, allowing funds and sophisticated investors to invest in international equities locally, rather than having to do so overseas. ASX will engage with ASIC on the appropriate safeguards for this service offering.

In addition, ASX supports:

- A renewed focus by Commonwealth and State Governments on privatising government businesses as a way to generate funds to re-invest in national infrastructure.
- The issuance of 20 to 30 year Commonwealth government debt to create a 'risk-free' benchmark for corporate bonds and infrastructure financing.
- Providing investment incentives for 'greenfield' mining exploration. ASX believes that the investment incentive model could be extended to other industries in which Australia has strong potential, such as biotech and life sciences. This would allow research and intellectual property to be commercialised locally.
- The creation of new ways to finance innovation, start-up businesses and commercialisation of research and intellectual property. This includes innovative forms of financing, such as crowdfunding.

ASX is aware that there are impediments that limit the investment by superannuation funds in longer dated corporate bonds and infrastructure assets. These could be structural in the way the super industry operates or based on specific regulations. An example of a structural issue is the ability of fund members to receive a lump sum to the full value of their assets rather than being asked to maintain a reasonable annuity income stream, and the lack of annuity providers. An example of a specific regulation is the requirement that fund members should be able to switch funds within three days, which creates a more significant liquidity requirement. These issues, and others, need to be addressed.

In relation to broadening distribution of financial investment products, ASX recently launched an innovative new managed funds service called mFund, which allows investors to buy and sell (apply for and redeem) units in unlisted managed funds through their normal online broker platform in much the same way they buy and sell shares. The mFund service creates significant automation of existing paper based processes, opens up new distribution channels for fund managers and provides a wider range of convenient investment options for consumers. Some 60 foundation partners are working with ASX on this innovation.

Action in all of these areas will broaden the sources of funding available within the economy, accelerate investment in critical economic infrastructure and provide investors with new long-term investment opportunities. They will also create jobs and growth, which are key objectives of the upcoming Brisbane G20 meeting.

Play a greater role in the delivery of financial services to the Asian region

The 2009 report by the Australian Financial Centre Forum, *Australia as a Financial Centre: Building on our Strengths* (the Johnson Report), provided a good overview of the opportunity for Australia to play a greater role in financial services in the Asian region. A competitive Australian financial market, supported by a strong financial infrastructure, is an important enabler for this strategy.

The report was predicated on the fact that Australia is situated close to the fastest growing region in the world and has arguably the most efficient and competitive 'full service' financial sector in the Asia-Pacific region. The report identified opportunities for Australia to export funds management, offshore banking and Islamic finance services to the region.

The prospects for growth in the region are material:

- It has been estimated that if it retains its current growth rates, Asia by 2050 will account for around 50% of the world's GDP and China alone will account for 20%[10].
- There are currently around 500 million people in the Asian middle-class and this is expected to grow to 1.7 billion people by 2020 and as high as 3 billion people by 2030[11]. This demographic will drive an increased demand for financial and investment services.

- As countries such as China open up their financial systems, investors will require greater sophistication of instruments in which to invest and hedge their risk exposures.

- A report released by ANZ[12] on 24 March 2014 highlights the opportunities posed by the rapid growth of Asian markets, with the total Asian financial system expected to more than double its share of global activity to around 50%. This will reflect rapid growth across all market sectors, including debt, equity, and foreign exchange.

Some progress has been made on the implementation of the Johnson Report, but it is fair to say that it has been slow. While Australia has a strong trading relationship with Asia, sending 70% of its exports to the region and sourcing 45% of its imports from the region[13], the investment links with the region are not as strong. Foreign direct investment (FDI) into the region accounts for 31% of Australia's total outflows while inbound FDI accounts for 28% of the total. In terms of portfolio investment flows the relationship is even weaker, with outbound flows making up only 14% of the total and inbound flows making up 16% of the total[14].

ASX is progressively connecting its infrastructure to other markets. This will improve the access of international investors to Australia's financial markets and recognises that the Australian economy and its financial markets are connected to major trading partners and financial centres. Some of the specific initiatives include:

- ASX's liquid and well regulated market is attractive for Asian companies to list, particularly from China. ASX is taking a conservative approach to this opportunity to ensure that the quality and reputation of Australia's financial markets is not put at risk.

- ASX is looking to increase the opportunity for Australian investors to invest in international equities that are not directly listed in Australia through the launch of Unsponsored Depository Receipts (UDRs).

- ASX has connected its proprietary data network (ASX Net Global) to the networks of Singapore, London and Chicago. This gives traders in those markets seamless access to Australia using existing high speed data networks and, in the future, may assist Australian investors to connect directly to foreign markets.

- ASX is developing a collateral management solution for the Australian market that will provide attractive collateral cost savings for market participants. The ASX solution is the same as the one in place at Deutsche Borse in Europe and those being developed by Singapore and Canada. Over time, the objective is to allow the use of collateral in different depositories to support financial transactions, thus creating cross border efficiencies for global banks.

- ASX has leveraged its existing Austraclear infrastructure to establish, in partnership with the Bank of China, a Renminbi settlement service allowing Australian companies to efficiently take or make payments with their Chinese trading partners. The service provides the foundation for expanding the scope and connectivity of Australia's financial markets with China and could be a precursor to the development of a new range of investment products.

Improve coordination with other Asian financial centres

The global regulations that have emerged post-GFC have been based on addressing problems that emerged from, and were concentrated in, the US and Europe.

There are growing signs that these regulatory responses may be having unintended consequences for many countries in the Asian region, impeding their ability to develop their financial markets (eg derivative markets to support risk management) and to provide funding for key parts of their economies (eg small and medium sized companies).

ASX believes that the following three steps would assist acceleration of the Australia's integration with Asia and the development of stronger regional markets:

- Implementation of free trade agreements with our largest trading partners that open up the services sector. ASX welcomes the progress that has recently been made.

- A renewed focus on the implementation of the Johnson Report recommendations, including oversight on progress from an ongoing 'task force'. One option would be to allocate this task to the Financial Sector Advisory Council. The Council could also provide oversight of the implementation of other recommendations of the Inquiry.

- Greater coordination between policy makers and regulators in the major regional financial centres – Australia, Japan, China, Hong Kong and Singapore – work together to ensure that global regulations are tailored to the needs of the region.

Increase focus on the competitiveness *of* Australia

Key themes

- The domestic equity market is well regulated. The settings are appropriate.
- Global regulatory changes are now impacting on Australia, particularly in the derivatives markets and the central risk management infrastructure of the country. These regulations are changing the financial system competitiveness *of* entire countries, requiring a shift in focus from policy makers and regulators.
- Scale matters if countries are to be competitive in the new world of global regulations. Australia today has scale.
- We cannot 'cherry pick' and set the rules for individual markets, products or licences in a piecemeal fashion. The policy framework has to be defined clearly and upfront for all financial markets.
- Outsourcing of risk management to another jurisdiction should be supported by legally enforceable recovery mechanisms. These do not currently exist and will not exist for some time.

The domestic equity market is well managed and the settings are appropriate

Over recent years, the main focus of policy makers and regulators has been on the market structure of the domestic equity market. In 2011 competition was introduced in Australia's equity market and Chi-X started offering markets in ASX-listed securities.

Since the introduction of competition in the equity market, ASIC has put in place new regulations that try to manage the challenges that come with having multiple exchanges and a more fragmented market place. These challenges include an increase in high frequency trading and dark pools, which make it more difficult for large investors to find liquidity and execute their orders. Today, there are at least 20 'venues' where fund managers can trade major ASX-listed securities[15]: two exchanges and 18 crossing systems/dark pools.

ASIC has done a good job in regulating a more fragmented equity market. Australia is regularly referred to as one of the leading markets when it comes to practical and effective equity market regulation.

ASX has adjusted well to the new competitive environment, cutting its fees to intermediaries, investing in a new and fast growing technical services business and getting closer to its customers.

The net benefit to the wider economy and end investors, however, is less clear. One way to illustrate this is by looking at the revenues involved in exchange competition. Today, the total revenue pool that ASX and Chi-X compete over is no more than $35 to $40 million per annum – that's it for the entire Australian economy. This represents less than 4% of the total fees that investors pay to execute their trades. Since fragmentation increases the total cost of execution for larger investors, it is not surprising that investors have not been publicly promoting exchange competition as delivering a material net benefit to them. ASX is encouraged by the initiative of Australian regulators to increasingly reach out to end investors when it comes to designing market structures and regulation.

The experiment with equity market competition contains some interesting lessons. The main one ASX points to is the caution regulators should exercise in transplanting market structures and regulations from the US and Europe. Australia is a significantly smaller market, which means that the negative impacts of fragmentation may be relatively larger.

Australia has learnt from the equities trading experience. In 2012 the Council of Financial Regulators (the Council) reviewed the market structure for equities clearing and settlement. These services are currently provided by ASX.

The Council recommended that the Government postpone the consideration of any new clearing licences for two years, as the business case was not sufficiently attractive[16]. The Government accepted the recommendation.

In response to that decision, ASX implemented a Code of Practice for its equity clearing and settlement services that allows its clients and other stakeholders to provide input into its investment program. The Code cements ASX's commitment to transparent and non-discriminatory pricing, and provides for non-discriminatory access to its platforms.

The Code is working well and is leading to changes in the way ASX manages its platform. For example, ASX is currently consulting on the benefits of moving from a T+3 settlement cycle for cash equities to T+2. This was identified as a priority by industry stakeholders.

In early 2015 the Council will conduct a further review of the Code and of the clearing and settlement market structure. ASX will ask for a longer term decision as it needs to make significant investments in its clearing and settlement platform. Given that the returns on equity from equities clearing and settlement are modest at 11% and 18% respectively, the size and timing of any investment will be influenced by the future market structure.

Global regulations in derivatives markets require policy makers to re-focus

The changes to Australia's equity market can be managed locally without direct reference to global regulations. The market and competition are largely local.

Over the last three years, the emphasis has shifted from local equity markets to global derivatives markets. Following the GFC and the collapses of Lehman Brothers and MF Global, regulators have put in place new and tighter requirements for banks and exchanges that operate in the derivatives markets. These new rules have been developed with the larger and more 'sophisticated' US and European markets in mind and are not necessarily as relevant to markets in our region which have not experienced the same problems.

The impact of the GFC on the functioning of Australia's financial markets was relatively limited. While major banks strengthened their balance sheets and the Government temporarily provided funding and deposit guarantees, there were no major bank failures that required Government-funded bailouts as were experienced in other markets.

The only direct impact was the collapse of MF Global, an intermediary in the Australian futures market that operated in a number of countries and was an important participant in the Australian grains market. When MF Global collapsed some market users discovered that under the agreements they had in place the collateral they had given MF Global to cover their risk had been transferred overseas. It took a year for end users to recover their collateral.

The MF Global experience was important for some end users and the grains market, but relatively small overall given the size of Australia's financial markets. Nevertheless, it illustrated the importance of understanding and deciding where risk should be managed on behalf of investors. If risk is managed overseas it adds a new source of systemic risk and reduces the options available to recover moneys if a crisis unfolds.

Outsourcing of risk management should be supported by legally enforceable treaties between countries and central banks, including an assessment of the ability of the country to which risk is transferred to cover the financial obligations in the event of a material default. These arrangements do not currently exist.

The new regulations that govern derivatives markets are fundamentally changing the way these markets operate:

- The derivatives markets are Australia's largest financial markets and carry the greatest risk. They account for approximately 30% of ASX revenues and 74% of the default risk capital that ASX allocates to its clearing operations. In addition, ASX holds approximately $3.7 billion in cash collateral each day to support its management of default risk in the derivatives market.

- Derivatives markets have a significant connection to the real economy. The largest derivatives markets are interest rate futures and interest rate swaps. These markets support the funding of the economy by the banking sector and corporations, define the benchmark yield curve for debt instruments and help manage the significant risks involved in Australia's reliance on offshore funding.

- The largest participants in Australia's derivatives markets are global investment banks. They need to comply with new regulations in every market in which they operate and look to optimise their economics globally.

- Given that ASX deals with the branches of US and European banks it needs to comply with the various regulatory standards that apply to those markets. The main impact has been on capital. European regulators have increased the capital standards for clearing houses that clear derivatives, and ASX has increased the capital allocation to its derivatives clearing house.

The new global regulatory environment has created 'tension' between the interests of investors and global banks:

- The lowest risk solution for Australian investors is for risk to be managed in Australia, under the supervision of Australian regulators and with capital and collateral held on-shore under Australian law.

- Global banks, on the other hand, have a commercial incentive to optimise their business economics. It may be in their interest to centralise risk in a single offshore location to provide scale and reduce the amount of capital they need to hold and the amount of collateral they need to post to the central clearing house.

  For the global investment banks, 'fragmentation' of clearing locations is less efficient. In setting their objectives they do not necessarily have regard to the systemic risk of individual financial markets or to specific needs of Australian investors. This is not criticism of the banks; it is recognition of their individual financial drivers.

ASX is investing in clearing and risk management solutions that aim to deliver on both objectives. That is, the ASX infrastructure will provide the highest level of protection to investors under Australian law *and* should be efficient for the global banks.

There are clear trade-offs to be made by Governments and regulators on where risk, capital and collateral should be managed. It should not be left to chance when it involves currency and interest rate markets as large as Australia's that are critical to the nation's economic interests.

Scale matters in managing risk; one cannot 'cherry pick'

Clearing houses require scale to manage risk in a cost-effective manner. The larger they are, the greater the diversification between individual counterparties and trading positions. Scale not only delivers the normal cost efficiencies that come with the use of technology, it also allows for more efficient use of capital and collateral.

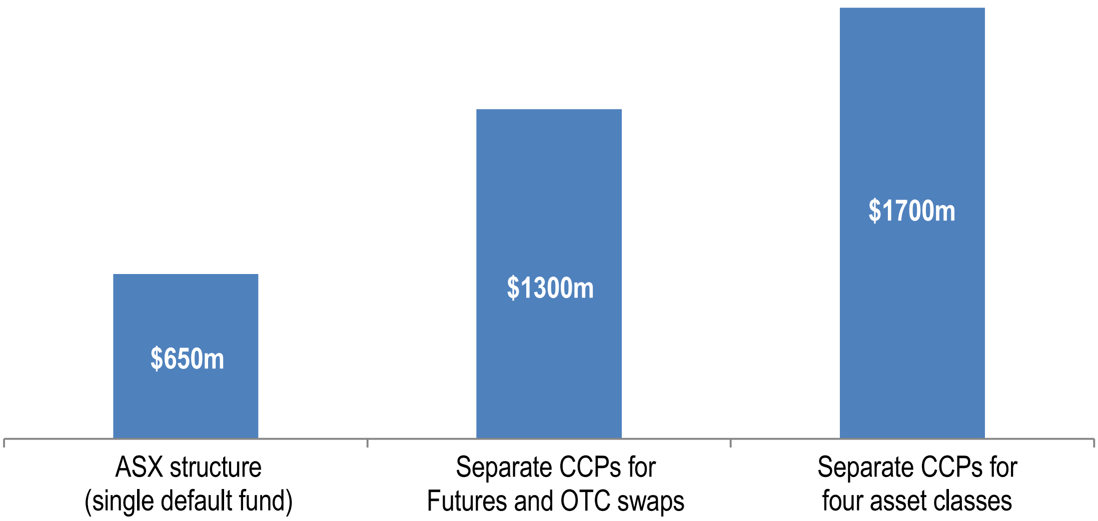
Australia has a large derivatives market with sufficient scale to have a competitive clearing house. As noted earlier, ASX's derivatives clearing house is world-class: it is well-capitalised, complies with rigorous Australian regulatory requirements, has been accredited by other jurisdictions, and has an investment grade credit rating.

Using the same clearing house for multiple derivatives products helps ASX achieve sufficient scale to provide a cost effective clearing solution for all products. Smaller volume products, such as OTC interest rate swaps, electricity futures and grain futures are supported by the overall scale and diversity of the clearing house.

The scale of ASX's derivatives clearing house is derived largely from interest rate futures. Interest rate futures account for around 90% of derivatives turnover and more than 70% of ASX derivatives revenue.

One way to illustrate the benefits of this approach is to look at the capital needed to support the clearing house (see following chart). In total, for all derivatives products that are cleared through ASX Clear (Futures), $650 million of capital is required. By diversifying the risks in a single clearing house ASX is able to create scale. If it were to develop separate clearing houses for interest rate products, equity products, electricity, and other commodities the capital requirements in aggregate could increase to as much $1.7 billion. This could not be funded locally on an economic basis.

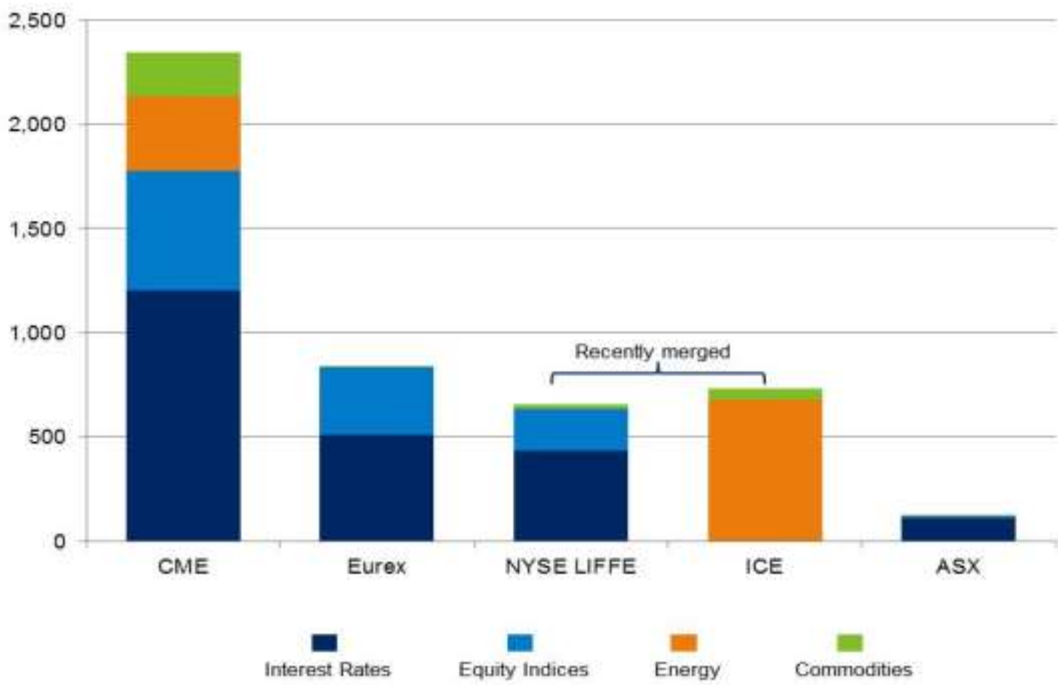
ASX Clear (Futures) default fund - current structures and consequences of fragmentation



The reverse logic is also true: if significant derivatives volumes were lost from the clearing operations in Australia, the loss of scale may make the service offering uneconomic over time.

Australia's derivatives markets are large by Asian standards, where they are still in the early stage of development, but still significantly smaller than the derivatives markets in the US and Europe, as is shown in the following chart.

Exchange-traded derivatives volume 2013 (contracts, million)



The aggregate scale that comes from the interest rate futures market and the ‘co-mingling’ of derivative products provide important strengths that allow a medium-sized market like Australia to be competitive and have a national infrastructure. This means that regulators cannot afford to make decisions about the clearing arrangements for individual products without considering the implications this may have for the whole of Australia’s market infrastructure. Dilution of the existing scale will weaken Australia’s global competitiveness.

In other words, regulators cannot allow the ‘cherry picking’ of segments *within* the market without focussing on the flow-on impacts on the overall efficiency and competitive position *of* Australia.

Clarity and certainty can now be provided for market infrastructure

Key themes

- Policy makers have to decide how important it is to have critical infrastructure in Australia, or to what degree they are comfortable to ‘outsource’ risk management to a foreign jurisdiction.
- The Government and regulators have to make a choice between 1) a strong market infrastructure in Australia, or 2) a global level playing field that would allow ASX to move its infrastructure overseas.
- The regulatory settings, and particularly the location requirements for systemically important infrastructure, will to a considerable degree determine which of the two outcomes will emerge.
- ASX is making specific recommendations on the location requirements for each systemically important market.
- ASX’s recommendations align Australia with the outcomes observed in Asian markets.

Market regulation seeks to balance the stability of the financial system with the policy objectives of promoting competition and efficiency. In the case of the regulations that impact national financial market infrastructure, the trade-offs go beyond Australia’s borders. Therefore questions that arise are:

To what degree must policy makers and regulators have direct control over Australia’s systemically important financial markets and infrastructure?

Is a central financial market infrastructure important for Australia’s ambitions in the region?

Given the importance of the ASX infrastructure to Australia’s financial markets and the rapidly evolving global regulatory environment, it is important that maximum clarity and certainty are given on the regulatory requirements.

The two strategic choices available to Australia

ASX recognises that there will always be trade-offs that need to be made between stability, competition and market efficiency. There are two strategic long-term choices for Australia:

1: Strong domestic market with regional ambitions	2: Australia as a branch of a global market
Domestic mandate for critical market infrastructure • Capital, collateral, core infrastructure in Australia • Applies to all systemically important markets **Level playing field for all competitors** • Comply with location requirements • Comply with Financial Stability Standards **Controls over ASX apply equally to all operators of systemically important infrastructure** • Includes ownership restrictions (15%)	**Open global market** • All participants free to optimise their economics • ‘Regulatory equivalence’ is only requirement **Regulatory functions may be ‘outsourced’** • No location requirements • Reliance on overseas ‘equivalent’ regulators and insolvency laws to support Australian investors **Level playing field** • Freedom for ASX to locate its operations overseas • No strategic, M&A or ownership restrictions

ASX believes it is important that Australia continues to have a strong domestic market infrastructure and that this is consistent with the economic policy objectives of the Government.

However, it is also important to present the alternative scenario. This case would be considered just as legitimate by some, but creates a very different long-term outcome for Australia.

If regulators and the Government confirm that there will be no onshore location requirements for the largest financial markets, then ASX should also be released from its current restrictions. Under this scenario no domestic location requirements would apply to ASX, and it would be free to locate its infrastructure in any jurisdiction that is considered 'regulatory equivalent'. This includes North America, Europe and several markets in Asia. This way, ASX is free to optimise its economics, lower its cost base or achieve greater scale.

In addition, ASX would be able to combine its operations with those of other exchanges. The only conditions would be that any potential partners are located in 'regulatory equivalent' locations, and normal FIRB approvals as needed.

It is important to make a clear choice between the two options, and not end up with a 'hybrid' that is not globally competitive. That outcome would not be in the national interest. A 'hybrid' solution can only work if ASX has no restrictions. In other words, unless a clear choice is made, ASX must be released of its obligations and constraints.

For regulators, this scenario would mean that they would explicitly acknowledge that they are happy to rely on the oversight of overseas 'equivalent' regulators, and that Australia will rely on the offshore recovery processes and insolvency laws to look after Australian investors if a crisis were to unfold.

ASX is not advocating the second path (i.e. no onshore location requirements) as it would increase systemic risk and limit the growth opportunities available. Nevertheless, ASX believes it is important to clearly articulate the choices.

Current and recommended location requirements

To deliver the first option that was presented in the previous section, location requirements for key financial markets need to be set upfront. The following table shows the current state-of-play.

Financial market	Current guidance on requirements	Recommendation
Domestic equities and equity options	Offshoring restrictions/ Australia	Australia
Domestically traded derivatives (A$ interest rates, index)	Offshoring restrictions/ Australia	Australia
Internationally traded OTC derivatives (A$ interest rate swaps)	No controls	Australia for systemically important institutions
Commodities and energy/electricity	No controls	No controls

The table highlights that good progress has been made for several markets.

ASX agrees with the current regulatory guidance in respect of the domestic cash equity, interest rate derivative and equity derivative markets. These markets are material in size, are extensively used by domestic institutions, and are critical to the capital formation, price discovery and risk transfer processes that underpin the proper functioning of the Australian economy. Therefore, they must have domestic location requirements.

ASX also agrees with the guidance for commodity and energy markets. These are smaller in size and currently do not have the ability to materially impact the primary industries that they support. They do not require domestic location requirements.

The comparison between the current guidance and the recommendations shows that there is one outstanding issue in relation to A$ over-the-counter interest rate derivatives. This issue is material.

ASX proposes a tightening of current practice for A$ OTC derivatives

The current settings for the A$ OTC interest rate market are based on two assumptions:

- The A$ OTC interest rate market is systemically important. ASX agrees. The A$ OTC market is large with notional turnover of $15 trillion per annum and is critically connected to the large banks and the financial system.
- The A$ OTC interest rate market has no strong domestic connection. ASX believes that this is not correct.

Australian regulators first considered the appropriate regulatory settings for the clearing of A$ OTC interest rate market back in 2011. At the time, global regulations had not been finalised or implemented, and the insights into the workings of the various exchange traded and OTC markets, and their connections, were less well established.

Today, we know more. Part of our knowledge comes from the work done by ASX and its clients in 2012 during the design of the Australian OTC clearing solution. This solution is now fully operational.

Our current understanding suggests that there is a strong domestic connection, and that this connection will strengthen as OTC and exchange traded markets converge. The strong domestic connection of the A$ OTC interest rate market is supported by the following observations:

- The A$ OTC interest rate market is closely linked to the Australian banking system. In 2012, approximately 60% of notional amount outstanding (i.e. open risk) had a domestic Australian bank on one side of the transaction. This will not have changed materially since 2012.
- There is a direct connection between the OTC and exchange trade interest rate markets. Market feedback suggests that for the dealer market about 80% to 90% of transactions are executed on an exchange for physical (EFP) basis. That is, the ASX bond or bank bill futures contracts are used as a simultaneous hedge and underlying price basis for the OTC transaction.
- Exchange-traded and OTC markets are converging. Given that they both address interest rate risk it is likely that product features of exchange-traded and OTC derivatives will continue to converge and liquidity will become more integrated as more of the OTC volume is cleared on an exchange platform. The locations of both markets may over time become the same. This should be considered when setting requirements.
- The Australian time zone is important for the A$ interest rate markets. Approximately 70% of ASX interest rate futures activity occurs in the normal ASX day session.

The above observations suggest that the A$ OTC interest rate market is both systemically important and has a strong domestic connection. Moreover, with the exchange-traded and OTC markets converging, this suggests that the regulatory requirements for the two markets should be the same.

The outcome that ASX recommends is consistent with the outcomes we are likely to observe in other major markets. US$ swaps that involve US-based end investors will most likely be cleared in the US under a client clearing solution. Euro and British Pound swaps will most likely be cleared in Europe under the capital standards that Europe itself has imposed on global markets.

Japan has implemented regulations that ensure that Yen swaps that involve systemically important institutions are cleared in Japan. Regulators in Hong Kong have expressed the view that regulations may need to be tailored for the circumstances that prevail in Asia (which are different from those in the US and Europe) and will be implemented locally.

The ASX proposal for domestic location requirements where trades involve at least one 'Australian person' has few downsides or practical difficulties. There may be apparent policy 'conflicts' between markets that adopt similar requirements; for example Australia and the US if both countries have requirements around systemically important 'persons'. In practice, these conflicts will have a modest impact on some global participants and the economic impact of market 'fragmentation' is very limited. The ASX domestic service has been developed with support from participants and is efficient for A$ products.

It is true that the ASX proposal does not have the same scale efficiency as could be achieved by having a single clearing house in one location servicing all global markets. The offsetting benefit is that the infrastructure, capital and collateral are under the direct control of Australia's regulators and policy makers. Moreover, the additional capital requirements that flow from having a domestic service have already been met, largely by ASX.

Moreover, ASX is considering linkages between exchanges that may improve the efficiency of clearing solutions in an environment where multiple location requirements exist across the globe. Such linkages could allow the two legs of swap transactions to be cleared in the respective home markets, with the exchanges managing the 'link'. Solutions like this become more viable if a mandate is in place. The market will continue to develop ideas that can create greater efficiencies and be economically viable.

Australian investors have access to a highly efficient infrastructure. Since 2013 this infrastructure includes a capability to clear OTC derivatives. The infrastructure has been funded and is fully operational, making implementation of the required regulatory controls possible.

ASX acknowledges that its recommendation in relation to the A$ OTC interest rate market is a departure from the current approach and that some A$ liquidity would be contained within the Australian market as a direct result of regulation. This makes it somewhat more difficult to implement.

ASX suggests that this initial approach to the requirements for the A$ OTC interest rate market should apply for a period of at least five years. This is consistent with a normal investment horizon for infrastructure and will allow the new global regulations in each major market to settle down. At the end of five years, regulators will have much greater insights into the shape and convergence of financial markets. At that point the Council of Financial Regulators would conduct a further review.

Review the need for the 15% ownership limit that applies to ASX

The Corporations Act currently states that there is a 15% ownership limit for ASX. This limit provides the Government with additional control over systemically important infrastructure.

The 15% limit originates from a time when the regulatory settings were not as well defined. This is now being addressed and the requirements described in this document provide regulators with direct control over the national financial market infrastructure. The final components of the control framework (including requirements for 'recovery and resolution') will be put to Parliament in the near future.

Once all regulations have been implemented there is a case to remove the 15% ownership limit. Regulators will retain full control of the physical market infrastructure under any ownership scenario, and the normal foreign investment controls continue to apply. It would create a level playing field – there are no ownership requirements for any of the overseas operators that are licensed in Australia.

Financial markets carry very significant risk. This means that there will always be trade-offs that need to be made between stability, competition and market efficiency. Australia is in the fortunate position that it can make a positive choice about its future in financial markets

ASX submits that now is the time to do so.

Sydney, 31 March 2014

Endnotes

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[2] International Monetary Fund, World Economic Outlook Database

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[5] World Federation of Exchanges

[6] S&P Dow Jones, 'S&P Global Equities Indices Monthly Update', February 2014

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[9] Bank for International Settlements, Triennial Central Bank Survey 2013 (September 2013)

[10] Asian Development Bank, 2011, 'Asia 2050: Realizing the Asian Century '

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[13] ABS Cat No 5368.0, International Trade in Goods and Services

[14] ABS Cat No 5352.0, International Investment Position, Australia, Supplementary Statistics

[15] See http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/List-of-crossing-systems-registered-with-ASIC

[16] "… it is acknowledged that now may not be the appropriate time for changes that will have further cost implications for industry, especially given current market conditions and existing pressures on participants to cut costs" - letter from the Council of Financial Regulators to the Treasurer, 18 December 2012