Building stable, growing and globally competitive financial markets

Submission responding to the FSI Interim Report

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ASX

Contacts
For general enquiries, please contact:

Mr Gary Hobourn
Senior Economic Analyst,
Regulatory & Public Policy
T 02 9227 0930
E gary.hobourn@asx.com.au

Media enquiries, please contact:

Mr Matthew Gibbs
General Manager, Media and
Communications
T 02 9227 0218
E matthew.gibbs@asx.com.au

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Executive summary

The Committee's Interim Report reflects the extensive consultation undertaken to date and its observations and conclusions are practical. ASX's submission responds to the Committee's request for information and focuses on four of the key areas identified in the Interim Report which can enhance the foundations of Australia's financial system.

Funding economic activity

ASX supports a bolder reform agenda to stimulate the domestic corporate bond market. Changes before Parliament support this objective but more can be done. Australia's strong continuous disclosure regime provides the opportunity to remove the prospectus requirement for a listed company which is issuing senior corporate debt. A cleansing notice, which is the mechanism for equity rights issues, and a simple fact sheet are appropriate regulatory safeguards for plain vanilla corporate bonds, and particularly those that meet the criteria set out in the Simple Corporate Bonds Bill. This reform would significantly simplify the corporate bond issuance process and reduce costs for issuers as well as making it easier for investors to understand the product they are buying. Section 2 provides more detail on how this could work.

The Committee also asked for views on several equity capital raising matters:

- Second Boards. ASX has conducted market-wide reviews of whether there is an opportunity in the Australian context for a second board. They have consistently found that there is no significant demand from listed companies or investors for a second board. The existing framework which requires small companies to meet most of the same high standards that apply to larger companies works well. Moreover, there is room for differentiation within a single board. For example, in 2013 ASX introduced changes that improve the capital raising flexibility specifically for small and mid-cap companies that was well received by the sector.
- Mandated pro-rata offers. The flexibility of Australia's capital raising regime is highly valued by listed companies and investors. The existing capital raising regime strikes the right balance, providing boards with flexibility to tailor a capital raising to their specific circumstances. Australia is one of the leading markets in the world in this respect. Mandating a single pro-rata method would impact hardest on smaller companies, which rely heavily on placements, and companies of all sizes during periods of high volatility.
- Crowdfunding. ASX supports initiatives to give start-up businesses access to crowdfunding within a regulatory framework that licenses crowdfunding portals and sets limits on the amounts that may be raised. ASX also supports government initiatives to make venture capital investment and share schemes more attractive, as well as tax measures directed at commercialisation of intellectual property and capital investment in certain sectors e.g. mining exploration.

Competition in the financial system

Competitive processes and outcomes can drive greater product and service innovation and lower costs for customers. The Competition Policy Review has recognised that a concentrated market structure does not preclude competitive dynamics. Moreover, competition policy has to recognise that some industries – including financial markets – are increasingly subject to international competitive forces. As a result, there needs to be a greater focus on the competitiveness *of* Australia, as opposed to the regulatory settings *within* Australia.

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Regulators face trade-offs between market stability, investor protection, market efficiency and competition. They may conclude that the best outcome for Australia is to have a more concentrated market structure with stronger and better capitalised institutions, a continued investment in domestic market infrastructure and a greater ability to comply with global regulations. These outcomes may result in a better long-term competitive position for the country.

The trade-offs are particularly important for clearing and settlement services that rely on a central Financial Market Infrastructure (FMI). If the services access infrastructure that is based overseas, it is highly likely that the outcome is irreversible with Australia relying permanently on overseas regulators and legal systems.

If a concentrated market structure is the outcome, policymakers may decide that measures are needed to provide confidence that the outcomes are consistent with competitive market dynamics. Whenever possible, industry-led arrangements should be preferred, as they can provide the most efficient solution. The costs of industry-led regulation are borne by the users and not the wider community.

Equity market clearing and settlement is an example where an industry-led Code of Practice has delivered tangible outcomes in transparency of performance reporting, access to infrastructure and pricing. Moreover, a stakeholder Forum established under the Code has been effective in defining the investment priorities for the FMI. The Code requires external benchmarking of services. A recent benchmarking report commissioned under the Code found that "the costs of post-trading services in Australia are in line with the costs of similar services provided in financial centres of comparable size."

Appropriate regulatory arrangements

ASX supports the endorsement of the Council for Financial Regulators (CFR) as the appropriate body to advise the Government on issues that affect the stability of financial markets and Australia's critical market infrastructure.

ASX, as an important regulated entity, has no current concerns with the regulatory structure or its interactions with CFR, or its two main regulators ASIC and the RBA. ASX does not see a case for urgent or significant change in the way CFR operates.

To date, CFR has operated as a relatively informal structure that brings together the RBA, ASIC, APRA and Treasury. The current membership arrangements have worked well. When necessary, other agencies such as the ACCC, AUSTRAC and the ATO can be invited to participate in CFR deliberations or to separately advise the Government. When the CFR was considering the market structure for cash equities clearing and settlement, the ACCC provided input.

ASX's experience in dealing with the CFR is that it is an effective forum that has served the Australian market well, both during the GFC and subsequently as reforms have been implemented. It has given policy guidance that supports the ongoing strength and stability of Australia's financial markets and had the flexibility to reach out to end users of market infrastructure as it formulates its advice to Government. In exercising its judgment CFR has been able to take account of the trade-offs between market stability, competition and efficiency. In relation to market structure, while the Government retains responsibility for the national interest, CFR has established a role as an important advisory forum.

ASX believes that the composition of CFR is appropriate and provides a strong focus on the principal role of the regulators in ensuring that Australia has a stable and well regulated financial services industry. ASX recognises that it may be

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helpful to formalise the role of CFR, so long as this does not blur the lines of responsibility of individual regulators, reduce flexibility or create the need for a large bureaucracy. On balance, ASX's preference would be to retain the current model.

International integration

There is a rapidly shrinking window of opportunity for Australia to integrate more fully with countries in the region as they continue their transitions towards more market-based financing. Moreover, global regulations are having a significant impact on the banking sector and financial markets. ASX has observed a growing trend of offshore participants trading directly into Australia and existing participants offshoring critical back-office activities.

Australia needs to commit to a deeper and more focused engagement with the region if it is to play a major role in financial services in the region. The recent successful conclusion of several free trade agreements are important steps forward. ASX considers China as a significant opportunity for Australia's financial services sector.

In addition, several policy initiatives have been under way for some time following an initial panel review (i.e. the Johnson Review). Despite the significant value of the ideas, progress remains slow. ASX believes that this is in part due to the absence of an ongoing 'force' that drives the necessary changes. ASX recommends that the work does not end with a review but is assigned to a body, such as the Financial Sector Advisory Council (FSAC) which can track progress, be a bridge between industry and government, and anticipate the next wave of opportunities. FSAC brings together the Government and a broad range of business representatives. It may require a secretariat and changes to its composition to fulfil an expanded role.

Depending on the outcomes of the Financial System Inquiry, a reconstituted FSAC could play a useful role as an ongoing forum to discuss the implementation of measures the Government adopts from the Committee's final recommendations.

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1. Introduction

The observations and options in the Committee's Interim Report acknowledge the significant changes in the financial system since the Wallis Committee and highlight the challenges and opportunities facing the system. Addressing the challenges is critical to maintaining an effective, efficient and internationally competitive sector that fosters resilient financial institutions and innovative and stable capital markets to drive stronger economic growth.

ASX's submission focuses on four of the key areas identified: funding (equity and debt) economic activity; competition in the financial system; appropriate regulatory arrangements; and international integration.

2. Funding economic activity

The Interim Report raised three topics related to capital raising that ASX would like to comment on: the need for a well-developed corporate bond market; changes to equity capital raising mechanisms; and crowd-sourced equity funding.

The need for a well-developed corporate bond market

Australia has an opportunity to develop the corporate bond market in a more meaningful way, simplify the issue process, significantly reduce the costs for issuers, and provide appropriate information for investors to make investment decisions.

The expected passage of the Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014 and the extension of that framework to facilitate depository interests, are important first steps to make corporate bonds available to retail investors. ASX supports and encourages these developments.

The next step is to leverage Australia's strong and well regarded disclosure framework to allow listed issuers that are already subject to continuous disclosure requirements to issue 'simple' bonds directly to retail investors without the need for a prospectus. A cleansing notice can be used to confirm to regulators that disclosure requirements have been met, in the same way that it does for rights issues. Investors can also be provided with a term sheet with key features of the bond issue and access to a simple information statement on corporate bonds, which forms part of a broader education program.

Benefits of an exchange-based retail corporate bond market

The development of a deeper and more liquid exchange-traded retail corporate bond market will:

- diversify and reduce volatility in Australia's savings pool by allowing retail investors to broaden their investments beyond equities and into a fixed income asset class;
- reduce Australia's reliance on offshore funding and exposure to movements in foreign exchange rates by mobilising greater domestic savings for investment in local infrastructure and corporate expansion; and
- contribute to the stability and efficiency of the financial system.

There is broad support for the development of an exchange-traded retail corporate bond market, as evidenced in the initial submissions to the Financial System Inquiry.

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Making bonds available to retail clients on an exchange provides liquidity and transparency of both the traded price of the bond and transaction fees payable by investors. It addresses concerns about the lack of disclosure of fees on OTC bond markets[1] and addresses potential conflicts of interest of the product provider. Further, it ensures familiarity, confidence and security for retail investors in accessing the market with the investment process, clearing and settlement being the same as for other investments, such as shares, traded on exchange.

Foundations for the development of the market

Since May 2013, retail investors have been able to purchase Australian Government Bonds (AGBs) on exchange. The initiative underscored the necessity for any retail market to have a strong base – this being provided by the government bond yield curve. This development also pioneered an innovative approach by the Australian Government and ASX which provides retail access to wholesale issued bonds. The wholesale bonds are traded in retail-sized parcels by way of depository interests and there is a simple disclosure regime whereby investors are provided with clear information on the key features of the bonds. All the AGBs on issue are quoted on ASX and able to be bought and sold as depository interests by retail investors, cleared and settled through CHESS. As at 1 July 2014, retail investors held approximately 500,000 depository interests valued at around $65 million.

The Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014 is another important development. The Bill contains two key elements:

1. a simplified disclosure regime for simple bonds issued by companies already subject to a continuous disclosure regime and traded on an exchange; and
2. support for the extension of the depository interest framework to corporate bonds to allow bonds in the wholesale market to be offered to retail investors.

Parallel trading of wholesale and retail bonds facilitates a continuous flow of securities from the wholesale to the retail market to meet retail demand. This provides access to a broader range of bonds for retail investors. It also provides significant efficiencies to issuers as they are not required to have separate wholesale and retail offers of securities. However, further changes are required to ensure that regulatory requirements that affect the parallel trading of simple corporate bonds in wholesale and retail markets can be satisfied[2]. ASX urges the Government to implement these further changes as soon as possible, so that the full benefits of the Simple Corporate Bonds Bill can be realised.

Opportunity for more fundamental reform

While the introduction of the Simple Corporate Bonds Bill is an important first step, more fundamental reform is needed to promote an active and sustainable exchange-traded retail bond market.

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[1] See a summary of this issue in the US in 'Bond Fee Disclosures Sought by SEC to End a 38 year Debate', by Lisa Abramowicz and Dave Michaels, Bloomberg, 17 July, 2014 http://www.bloomberg.com/news/2014-07-16/bond-fee-disclosures-sought-by-sec-to-end-38-year-debate.html
[2] Explanatory Memorandum, Corporations Amendment (Simple Corporate Bonds and Other Measures) Bill 2014, para 1.28.

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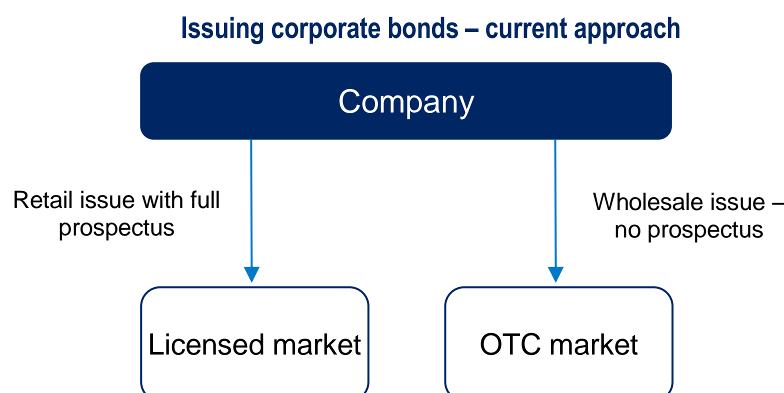
Listed issuers, already subject to continuous disclosure requirements, should be able to issue bonds to retail investors without a prospectus. These issuers are subject to a continuous (and periodic) disclosure regime where all information which may affect the price of their securities must be disclosed to the market. They can already issue further shares by way of a rights issue without a prospectus, provided they issue a cleansing notice. That notice states that they have complied with their continuous disclosure requirements and set out any information not disclosed which would reasonably be required by investors.[3]

The removal of the prospectus requirement might eventually extend to exchange-traded bonds of all listed companies, but the initial focus could be limited to bonds issued by investment grade companies. The definitions in the Simple Corporate Bonds Bill could be used, covering eligible bonds that:

- are quoted on a prescribed financial market requiring continuous disclosure;
- are denominated in Australian dollars;
- have a maturity length of no more than 15 years;
- have a fixed or floating rate of return, that cannot be reduced, paid periodically by the bond issuer;
- are not convertible to any other form of security;
- cannot be subordinated to debts to unsecured creditors;
- are not able to be converted into any other type of security; and
- have a minimum issue of $50 million.

This approach embraces the principle that issuing corporate bonds should be no more difficult than issuing new shares – in fact there is a strong case that it should be simpler. The bonds have a defined rate of return and term, and carry less risk as bondholders rank ahead of shareholders in the event of a winding up. The information which is relevant to investors relates to the issuer's ability to repay the debt, rather than the performance of the company and is already available to the market under the continuous disclosure regime. A prospectus does not provide additional information for investors on the issuer's ability to repay the debt.

Issuing corporate bonds – current approach



[3] Corporations Act 2011, s708AA.

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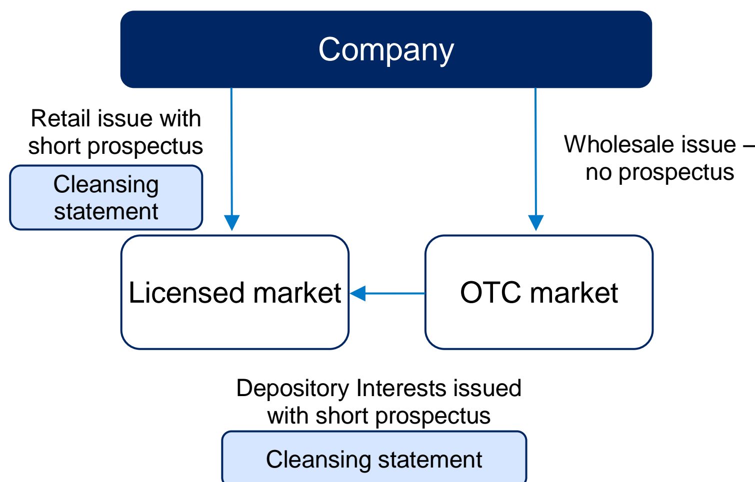
Issuing corporate bonds – legislation before Parliament and further reform (shaded boxes)



Removing the prospectus requirement makes the process for issuing retail bonds similar to that for wholesale bonds. When combined with the use of depository interests to facilitate the parallel trading of wholesale and retail bonds the reforms could make it significantly easier and less costly for companies to issue corporate bonds to the Australian retail market. For investors, simple corporate bonds are relatively easy to understand.

Other jurisdictions have undertaken reforms, similar to those in Australia, to encourage the issue of ongoing series of corporate bonds.

Reforms are being implemented in New Zealand, which is introducing a new short Product Disclosure Statement for bonds (and shares). There is an exemption for additional tranches of quoted bonds, whereby the issuer is simply required to issue a cleansing notice, published on the licensed market website, confirming compliance with continuous disclosure and financial reporting obligations. From 1 December 2014 this streamlined approach will be extended to bonds with different terms to the original tranche of securities.

The United States also offers a simplified process for issuing bonds whereby seasoned issuers that meet certain eligibility requirements can use a 'base' prospectus updated for each issue by a short-form registration statement. The base prospectus can be updated from time to time by identified SEC disclosures. This permits speed to market and minimal costs for additional bond issues.

Disclosure process under a 'no prospectus' regime	
Issuer	• Complies with continuous disclosure • Gives cleansing notice to confirm disclosure obligations met • Issues corporate bonds (initially limited to simple corporate bonds)
Investor	• Receives term sheet from issuer • Access to information statement on corporate bonds • Broader education program on corporate bonds

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A cleansing notice confirms compliance with continuous disclosure requirements as they relate to the issue of bonds and sets out any undisclosed information which would reasonably be required by investors in relation to the bond issue. Such a process allows the corporate treasury function of an issuer to coordinate the issue of corporate bonds, subject to the usual board delegations. This compares to a prospectus which requires formal board approval for each issue of securities.

Investors can be provided with a term sheet setting out the key terms of the bond issue and access to an information statement, providing clear information on corporate bonds, including (where relevant) an explanation of the nature of depository interests and how to acquire them. This simple disclosure regime is already used for AGBs and a similar approach is appropriate for corporate bonds. A broader education program can also be developed to support investor understanding of retail bonds. The AGB website and the section of the ASX website dealing with AGBs are good examples of how such an education program can be developed.[4]

Maintaining an efficient, flexible and fair equity raising regime

ASX has been at the forefront globally in developing a flexible capital raising rule framework that caters for the capital needs of a diverse range of companies at all stages of their growth within a single market structure.

Differentiated market structure – small and mid-cap sector

The Committee sought views on the need for a differentiated market structure (i.e. second board) catering specifically for smaller companies that might improve their access to finance.

ASX allows very small (including start-ups with no financial history) and very large companies (with well-established financial histories) to list under largely the same listing rule framework. This includes identical prospectus and continuous disclosure requirements but with flexibility as to how they comply with some corporate governance standards. The ASX 'brand' as a venue to list remains strong, with an average of two new listings a week in financial year 2014 raising a total of $27 billion in IPO capital.

When ASX has consulted stakeholders (most recently in 2005 and 2011) about their views on a second board there has been no real demand from either companies or investors. There are alternative licensed listing markets in Australia which have targeted small companies. But they have not attracted a significant number of listings, confirming the limited demand for a differentiated market.

ASX's single 'hybrid' market provides a more sustainable model over the medium-term for smaller companies to raise capital, in contrast to experience overseas where second/venture boards tend to go through boom-bust cycles.

[4] See http://australiangovernmentbonds.gov.au/ and http://www.asx.com.au/products/bonds/exchange-traded-agbs.htm.

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For a second board to be successful, it usually requires separate (lower) admission requirements (e.g. initial prospectuses and ongoing disclosure standards) possibly combined with different trading microstructure (e.g. market makers, periodic auctions). Companies have indicated to ASX that they believe that this leads to a perception they are 'second rate'. The feedback to ASX has been that higher listing standards, while more onerous, provide investors with more confidence in governance and disclosure, which in turn can lower a company's cost of capital.

Given the lack of observed demand for a second board, ASX has focused on other initiatives tailored to assisting small listed companies. For example, in 2013 ASX introduced rules that make it easier for small and mid-cap companies (below the ASX300 and with a market capitalisation below $300 million) to raise capital during the year, subject to approval at their Annual General Meeting. In the first two years around 1,300 shareholder approvals were sought by companies at their annual meetings. In addition, ASX has launched an equity research scheme to assist those companies who would not normally attract analyst attention by making basic information on them more widely available.

Secondary capital raisings

The Committee asked if secondary capital raising requirements should be modified to mandate certain pro-rata entitlement offers to reduce the dilution of some (particularly retail) shareholders from placements or if that would reduce the ability of companies to raise capital during periods of stock market stress.

The flexibility of Australia's equity capital raising regime served Australia well during the GFC, as it provides choice for boards in determining the most appropriate capital raising mechanism in their particular circumstances. This is particularly important given the range of companies listed on ASX - from large multinational companies to very small, highly speculative companies that can have very different needs for new capital.

During the GFC, Australian companies raised almost $400 billion in new equity, ranking Australia in the top four globally in absolute dollar terms and number one when related to the size of the market. When the equity market needed to be there to support the real economy, it was. The flexibility with which equity raisings are conducted should therefore not be constrained. It is the role of the board to consider all options available to it.

When raising equity boards consider a range of factors: the size and urgency of the funding required, the market conditions at the time of the raising, the risk associated with an unsuccessful raising, the overall cost of capital associated with the option chosen, the costs and availability of alternate sources of funding, the availability of underwriting support, and the interests of all existing and potential shareholders. The weight attached to each of these factors will be different across different companies and at different points of time.

A traditional renounceable rights issue, made on equal terms to all shareholders, is the 'fairest' option if equal participation is the overriding objective. However, the length of time to complete an offer leaves some residual execution risk that can make this an unattractive option if the capital is required urgently in volatile market conditions. In contrast, a placement can raise issues of shareholder dilution if not accompanied by a separate retail offer, but can usually be completed more quickly and at a lower cost.

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While a few stakeholder groups have periodically called for narrowing the range of options available to boards, often suggesting that a single capital raising mechanism be prescribed (usually a renounceable rights issue), this would constrain the options available to companies. It would increase the economic risks for the issuers and their shareholders. While these limitations would be most problematic during periods of high volatility it would also affect the overall ability of some, particularly small, companies to raise capital.

Small companies rely more heavily on placements given the nature of their share registers which make pro-rata fund raising from a relatively small number of existing shareholders more challenging. For these companies mandating a single pro-rata issue type will significantly restrict their ability to raise capital.

The capital raising environment has not been static and the flexibility in the system has facilitated innovation.

Traditional (renounceable and non-renounceable) rights issues are conducted according to a detailed timetable prescribed in the ASX Listing Rules. This timetable was reduced significantly from 26 days to 19 days in April 2014. Placements can be conducted overnight or during a two-day trading halt.

ASX has examined the scope to reduce the rights timetable further. The increasing electronic distribution of information may facilitate a shorter timetable, particularly where there are also improvements in payment arrangements. Cheques remain a significant means of payment for rights issues and require a number of days to clear. The inability of broker cash management trust accounts to interact with BPAY systems also limits their ability to facilitate faster funds transfer. Improvements to the payments system to facilitate real-time retail payments with close-to-immediate funds available to the recipient would be a major development that could transform the ability to achieve a reduced rights timetable. Such reforms are unlikely before the end of 2016 at the earliest.

Innovation has also taken the form of the creation of a range of ‘accelerated’ rights issues that reduce the market risk faced by the issuer by completing a large part of the funding from institutional investors upfront, while maintaining the ability of retail investors to participate on similar terms. ASX conducted a $553 million equity issue in 2013 that used such a structure and it was received well by both large and small shareholders.

Crowd-sourced equity funding and start-up companies

Encouraging new innovative funding sources can facilitate a range of emerging businesses and technologies which often have relatively modest capital needs. Crowd-sourced equity funding is still an embryonic funding mechanism and it is not clear how many potential issuers in Australia may be attracted to it. However, given the firms most likely to use it are also those who have the least access to traditional funding sources, it is important that a supportive regime for crowd-sourcing is developed if it is to grow.

The Corporations and Markets Advisory Committee (CAMAC) recommended developing a self-contained statutory and compliance structure for crowd funding that provides an appropriate degree of investor protection given the nature of such funding (i.e. a large number of very small investments). The capital raising provisions of the Corporations Act were designed for substantive capital raising activities and their compliance costs may be prohibitive for small capital raisings.

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The CAMAC proposals were well targeted and should be considered by Government, including:

- setting caps on the amount of money companies can raise through this mechanism and how much investors can invest, both in one issuer and in aggregate;
- developing disclosure requirements that provide sufficient information for investors but are not unduly burdensome on issuers; and
- requiring funding portals to be licensed and placing obligations on them to operate in a professional manner.

In addition to crowd-sourced funding, the Government can support start-up companies by:

- making changes to the tax arrangements for stock options that currently penalise start-up companies;
- providing tax incentives for the commercialisation of Australian intellectual property in Australia; and
- providing tax incentives for investors capital intensive sectors which can take a number of years to generate positive earnings. A good example is the Exploration Development Initiative, a tax credit to attract capital to mining companies that conduct risky exploration activity.

3. Competition in the financial system

Framework for competition

Competition can be an important driver of lower costs for consumers and innovation in the provision of new products and services. ASX agrees with the Committee that considering measures to promote competition in the financial services sector must be balanced against any impact they have on other policy objectives including systemic stability and investor protection.

The Competition Policy (Harper) Review issues paper identified that it may be appropriate for relatively small countries such as Australia to accept a more concentrated domestic market structure in some sectors than is accepted in larger countries.

That applies in financial services where a relatively concentrated market structure enables local service providers to meet global regulatory standards and compete with larger offshore organisations that can offer lower prices by accessing larger scale economies. A more concentrated sector may also assist the management of systemic stability, which may not always be consistent with unrestrained competition, provided 'too big to fail' concerns can be addressed.

In its submission to the Harper Review ASX noted that a modern approach to competition policy needs to consider competitive forces beyond Australia's borders. There is a need to support market structures that allow businesses to compete globally from Australia, while ensuring that they deliver efficiencies to consumers and small business within Australia.

Competition is rapidly globalising in financial markets. Convergence in global regulatory standards is an important driver of this. The longer term competitiveness of Australia needs to be directly considered in assessing the outcomes that policymakers want to achieve.

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This is particularly relevant in relation to clearing and settlement services that rely on Financial Market Infrastructure (FMI). If the services access infrastructure that is based overseas it is likely to be a permanent move with little prospect for a reversal of the outcome even if regulators desire this.

As the Committee observed, new entrants providing FMI services are more likely to come from foreign-based facilities extending their business footprint to Australia rather than a new local start-up facilities. This raises regulatory issues when services and risk management are likely to be conducted offshore.

This is why, in practice, around the world most markets are generally serviced by one provider of central FMI services located and regulated in its home jurisdiction. The one exception is Europe where the authorities have promoted competition between facilities to break down national barriers within the EU and spur the development of a pan-European market. Even within Europe there is regulatory tension, with the European Central Bank looking to restrict centralised clearing of Euro-denominated OTC derivatives to facilities located within the Eurozone, thereby excluding facilities domiciled in the UK. The UK government is taking legal action in an attempt to avoid this outcome.

Where a more concentrated market is the policy or practical outcome, authorities may need to put in place conduct rules that ensure that service providers deliver outcomes similar to those that might be expected under a more competitive market structure.

In Australia, post-trade facilities already have licence obligations under the Corporations Act to provide 'fair and effective' services and access to the infrastructure. ASX also has experience in developing, in consultation with industry, a Code of Practice for cash equities clearing and settlement following the Government's decision to delay the granting of any licences for alternative clearing houses for a period of at least two years.

The commitments under the Code of Practice show that industry-led, self-regulatory frameworks can deliver outcomes similar to those in a market which has more providers. These commitments include:

- providing transparent and non-discriminatory access to, and pricing of, ASX's clearing and settlement services;
- publishing annual profit and loss statements for the services (including a calculated return on equity);
- establishing a stakeholder Forum that provides meaningful user engagement with the boards of the ASX facilities in developing investment priorities; and
- commissioning independent benchmarking of the costs of the services in Australia compared to other financial markets.

The Code has produced tangible outcomes in the first 12 months of operation including endorsement of a move to a T+2 settlement cycle. In financial year 2015 ASX will engage with Forum members on the requirements for the next generation settlement system (the replacement of CHESS).

Australia has greater transparency in the pricing of these services than other markets with the publication of audited accounts for ASX Clear and ASX Settlement and a comprehensive global cost benchmarking report by Oxera Consulting.

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The Oxera benchmarking report[5] stated that the "overall conclusion is that when taking into account the scale of trading, the costs of post-trading services in Australia are in line with the costs of similar services provided in financial centres of a comparable size." They also found that when the costs of equities trading are included in the analysis Australia was amongst the lowest cost jurisdictions.

Ensuring the appropriate regulatory safeguards are in place

The Committee noted that two separate regulatory processes are currently in place that will set the framework for competition in trading and post-trading services in key Australian markets.

Market licensing

ASX supports the Treasury market licensing review. The review provides the opportunity for a much needed modernisation to reflect the significant changes that have occurred since the Wallis Committee established the existing arrangements. Changes in technology and the lowering of barriers to entry have prompted an explosion in the range of execution venues for ASX-listed securities and other systemically significant financial products. The current licensing framework has not kept pace with these developments. A robust licensing regime is an important regulatory control to provide transparency to regulators and confidence to investors.

Competition in cash equity clearing and settlement

As noted earlier, the then Government made a decision in February 2012 to defer licensing additional equity clearing houses for at least two years.

In the Interim Report the Committee noted that the CFR has made recommendations on the regulatory requirements that should apply to offshore provision of systemically significant FMI services. ASX agrees that the CFR agencies are the appropriate bodies to advise the Government on the regulatory framework necessary to balance the different public policy objectives impacted by such market developments.

4. Appropriate regulatory arrangements

The need for strong, independent and accountable regulators

ASX agrees with the Committee that the regulatory framework for financial services operates well in Australia.

Given the substantial post-GFC changes to regulation it is timely to take stock of the cumulative effect of these changes to ensure that, when looked at in totality, they produce efficient and effective regulatory outcomes that are conducive to growing our markets and supporting strong economic growth. Higher standards to enhance systemic stability have increased business costs. Their impact on the provision of finance and management of financial risks needs to be monitored.

[5] The full Oxera report can be found at: http://www.asx.com.au/cs/international-cost-comparisons.htm

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It is also necessary to ensure that individual regulator's mandates are clear and well-targeted to achieving the priorities government have set for them. These mandates should be accompanied by robust accountability frameworks that ensure effective transparency in arrangements and effective oversight of implementation.

Oversight by the responsible Minister combined with Parliamentary scrutiny play a critical role in providing external accountability of the regulatory agencies. This could be supplemented by periodic regulatory audits, say by the Office of Best Practice Regulation, to report to government and the broader public on whether the regulatory framework is delivering effective outcomes, as well as identifying areas for improvement. High degrees of transparency into the policy development and enforcement processes enhance public confidence in the regulators' performance.

The Committee noted that regulators might benefit from having more autonomous funding models, including greater use of industry cost-recovery. While this may be tempting it risks reduced control and accountability as industry has (rightfully) no practical influence over the budgets of regulators. Check and balances need to be in place to ensure that regulators maintain the stability of the financial system *and* deliver process efficiencies *and* support the growth of the sector domestically and in the region.

Ensuring appropriate and effective coordination between regulators

ASX has two primary regulators (ASIC and the RBA), as well as having direct contacts with Treasury (in its role as a policy adviser to the Government) and to a lesser extent APRA (as the regulator of some of ASX's largest participants). There is an intersection of responsibilities, particularly with regards to clearing and settlement facilities where ASIC has responsibility for licencing facilities while the RBA is responsible for financial stability.

The informal CFR process which provides *whole-of-regulator* advice to government on matters that cut across different regulatory responsibilities works well and contrasts favourably to some other jurisdictions, where 'competition' between regulators has led to regulatory overlaps or inconsistencies.

CFR has demonstrated a good grasp of the trade-offs that are necessary to develop well-rounded regulatory frameworks that will impact across a range of policy objectives.

The existing core membership of CFR appears appropriate as it brings together the agencies responsible for macroeconomic and microeconomic policy (Treasury); systemic stability and prudential regulation (RBA and APRA); and market integrity and investor protection (ASIC). Where necessary other agencies, such as the ACCC, AUSTRAC and the ATO can be invited participate in CFR deliberations or to advise the government separately.

There may be some benefit from government providing a more formalised foundation for CFR given the important function it plays, defining its role as a central adviser to Government where policy settings may impact on a range of differing, and sometimes conflicting, policy objectives. In doing this, it would be important to avoid any blurring of the clear lines of responsibility of individual regulators or the creation of a large bureaucracy.

On balance, ASX's preference would be to retain the current model. It is not broken.

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Regulatory mandates

There is no strong case for a significant structural realignment of regulator mandates. For example, the Committee noted that some stakeholders raised the option of splitting the consumer activities and market supervision activities (FMI and participant licensing and oversight) into separate bodies. ASX notes the Committee's observation that this may lead to duplication, issues of boundary definition, and the need for any new body to develop relevant financial services expertise.

The Committee observed that more could be done to strengthen competition considerations in regulatory decision-making. It is always important to distinguish between competitive dynamics in a market and the impact of competitive dynamics on individual companies. ASX believes that the CFR is the appropriate body to identify and advise government on policy trade-offs that may need to be made between measures to enable new entrants and policy objectives that seek to establish and maintain a competitive dynamic.

5. International integration

Integration with Asian markets should be a priority for Australia

Australia has a well-capitalised, sophisticated, profitable, and well regulated financial sector. However, Australia's financial services sector remains largely a domestic industry. It has linkages to the region through trade financing flows, inward investment in the resources sector, outward investment of superannuation monies, and the activities of foreign banks in Australia. Direct investment in the region by Australian financial services firms remains relatively modest.

This domestic focus is evident in Australia's capital markets: the financial products traded, cleared and settled in Australia are largely Australian dollar denominated. This is in contrast to major financial centres such as London or New York, where capital is raised, trade flows are facilitated, and risk is managed by a much greater proportion of market users that originate from outside the local market.

A strategy of greater integration with regional markets is an important policy objective for the long-term prosperity of Australia. This requires arrangements that facilitate servicing customers on a regional basis as well as creating sufficient scale and long-term relevance in all facets of financial markets (capital formation, trading liquidity, post-trade processing and capital efficiency) so that Australian businesses are internationally competitive.

There is a shrinking window of opportunity for Australia to integrate more fully with the region. Australia's skills and relative size allow us to participate as a true partner. However this requires the right domestic policy settings and investments, as well as a deeper and more focused engagement in our region.

Australia cannot take too long to decide which path to take as global regulations are rapidly shaping the direction of markets around the world and potential partners in the region make their choices.

It is important that government works with industry, as happens in other major financial sectors such as Singapore and Hong Kong, to market Australia's skills and expertise in financial services/capital markets throughout Asia.

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This will require action on a number of fronts:

- working through regional forums, or bilaterally to encourage common and appropriately high regulatory standards across the region, for example, mutual recognition of regulatory standards and cooperation between regulators;
- pursing bilateral free trade and double tax agreements to reduce barriers to market access in financial services;
- ensuring Australia has the appropriate financial market infrastructure to connect to the region; and
- removing unnecessary ownership restrictions (e.g. the 15% limit on a single beneficial shareholding in ASX without the Treasurer's approval, subject to non-disallowance in the Parliament) and relying on normal foreign investment processes. If the right regulatory protections are in place, ownership of financial institutions and infrastructure should not raise additional concerns.

China is gradually transitioning towards a more internationally open and market-based financial sector. The gradual steps towards opening up to cross-border flows of capital, such as allowing the issuance of Renminbi denominated bonds and deposits, has initially been facilitated through the gateway of Hong Kong. More recently other financial centres have been positioning to be early conduits to facilitate the broader use of the Renminbi as an international currency.

The recently established ASX-Bank of China Renminbi settlement service allows customers to conduct high-value electronic cash transfers in real-time, through the Austraclear infrastructure, in the same way they do for Australian dollars. This service is a step towards forging closer financial links with China and its importance will grow when the Chinese Government designates an official clearing bank in Australia, bringing liquidity to Renminbi denominated transactions.

The deepening of the relationship with China highlights the potential benefits where government and business work closely together to achieve a common goal. For example, Australia should be working actively to become part of China's RMB Qualifying Foreign Intuitional Investor program which has already been achieved by a number of other jurisdictions.

Compliance with global standards in an Australian context

There has been a significant focus by policymakers in G20 economies on reforms designed to strengthen financial system stability through earlier identification of risks; ensuring systemically significant financial institutions employ robust risk management processes; and providing regulators with the appropriate tools to deal effectively with crisis situations.

While the structural problems exposed by the GFC did not originate in Australia (or the Asian region), the international rules, driven by European and US regulators, have impacted negatively on Asian economies which are at different levels of financial development. Such outcomes can have the effect of favouring European or US markets competitively.

This presents challenges to all Australian regulators to work closely with regional bodies to promote the interests of our region in the policy debates. This will also require regulators to work closely with business to achieve mutual recognition with Australia's major partners and to ensure that Australia's capital markets remain internationally competitive.

In adopting global regulatory principles and applying them to Australia we should make sure that while we remain in broad step with the rest of the world. Australia should not impose a competitive disadvantage on our own financial institutions by applying these principles ahead of other jurisdictions or by being too prescriptive and not giving due weight to the structure and scale of the domestic market and local conditions. Ensuring regular dialogue between business and government as

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proposals are being developed will assist in delivering that outcome. When we benchmark our market structure arrangements we should also place greater emphasis on the Asian region rather than seeking line by line alignment with the US and European models which have very different characteristics to our own.

There is a good understanding of the importance of this and good engagement by regulatory agencies with local stakeholders.

Advancing Australia's agenda

Australia needs to commit to a deeper and more focused engagement with the region if it is to play a major role in financial services in the region. The recent successful conclusion of several free trade agreements are important steps forward. ASX considers China as a significant opportunity for Australia's financial services sector.

In addition, several policy initiatives have been under way for some time following an initial panel review (i.e. the Johnson Review). Despite the significant value of the ideas, progress remains slow. ASX believes that this is in part due to the absence of an ongoing 'force' that drives the necessary changes. ASX recommends that the work does not end with a review but is assigned to a body, such as the Financial Sector Advisory Council (FSAC) which can track progress, be a bridge between industry and government, and anticipate the next wave of opportunities. FSAC brings together the Government and a broad range of business representatives. It may require a secretariat and changes to its composition to fulfil an expanded role.

Depending on the outcomes of the Financial System Inquiry, a reconstituted FSAC could play a useful role as an ongoing forum to discuss the implementation of measures the Government adopts from the Committee's final recommendations.

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