Shortening the Settlement Cycle in Australia: Transitioning to T+2 for Cash Equities

Consultation Paper

25 February 2014

Invitation to comment

ASX is seeking submissions on this consultation paper by Monday, 7 April 2014. Submissions should be sent to:

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Regulatory & Public Policy ASX Limited
20 Bridge Street Sydney NSW 2000

Attention: Ms Diane Lewis – Senior Manager, Regulatory & Public Policy

ASX prefers to receive submissions in electronic form. Submissions not marked as 'confidential' will be made publicly available on ASX's website.

If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly in your submission.

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Executive Summary

ASX is consulting on the introduction of T+2 settlement for cash market trades in Australia. The consultation seeks to obtain feedback on the size of the benefits, industry-readiness, an achievable timeframe and the issues that need to be addressed to facilitate the transition to T+2. Today, T+2 operates in a number of markets, including Germany and Hong Kong, and will shortly be introduced throughout Europe.

The broad-based benefits of shortening the settlement cycle for cash equities in Australia have been widely recognised by participants and other industry stakeholders. The growing global interest is being driven by the evolution of payments systems, dematerialised security holdings, improvements in trade affirmation and the over-arching desire to reduce risk in the settlement of a trade.

Shortening the settlement cycle by one business day is expected to deliver broad-based benefits by:

- reducing counterparty risk for individual investors, participants and the central counterparty, resulting in reduced systemic risk for the market as a whole
- reducing the regulatory capital required to be held by market participants to mitigate risk
- standardising regional and global settlement practices
- driving greater post-trade operational and process efficiency and associated cost savings.

ASX has estimated the following potential capital and margin savings for the industry from the introduction of T+2:

- had the T+2 settlement cycle been in place from June 2012 to December 2013, daily cash market margins for the total market would generally have been 20-30% lower, producing an estimated reduction of $30-$40 million in total margin payments with a consequent saving in funding costs for the industry. On a daily basis, individual clearing participant margin changes vary widely from relatively small increases on some occasions to reductions of over $10 million for some larger clearing participants. In over 90% of cases, participants' daily cash market margins were reduced
- clearing participants, especially those clearing institutional business, could expect a reduction in their liquid capital requirements, in so far as they relate to cash equities, of between 10% and 20%. It is estimated that the total liquid capital requirement for the industry as a whole could potentially be reduced by between $60 million and $120 million.

In addition, ASX has received feedback from participants indicating that they expect a reduction in their counterparty credit risk exposure to end clients. A reduction in counterparty risk for investors may also deliver the additional benefits of freeing credit, which could lead to higher turnover and increased trading capacity.

The reduction in aggregate counterparty risk exposure for the central counterparty and resulting reduction in systemic risk expected from the introduction of a T+2 settlement cycle also provides the opportunity for ASX Clear to review with the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) the $250 million of paid-in capital that ASX provides for clearing participant default management. A reduction in these resources held by ASX Clear would provide the opportunity for ASX Clear to reduce the clearing fee for cash equities.

ASX would need to make changes to CHESS to enable a T+2 settlement cycle. While this would not be a major project for ASX, we recognise that the transition to, and implementation of, a T+2 settlement cycle will impact market participants in different ways. One of the objectives of this consultation is to ensure that the industry as a whole appreciates these impacts and develops an industry-wide approach to the management of a transition to T+2.

If market participants and other industry stakeholders confirm their support for the introduction of a T+2 settlement cycle in the near term, ASX expects that most of the preparation for transition to a shorter settlement cycle will be undertaken in 2015. During this period, a CHESS replacement project (which will be subject to a separate consultation process) will be underway. The T+2 and the CHESS replacement initiatives will be run in parallel, with no dependency between them.

ASX is now seeking industry feedback on whether the introduction of T+2 in the first quarter of 2016 (calendar year) is feasible and supported, or whether an earlier implementation is considered achievable and should be targeted.

What needs to be in place for T+2

This consultation also seeks feedback on the preparedness of industry and validation of the key preconditions required to move to a T+2 settlement cycle for cash equities in Australia, in particular, the relative importance of:

- achieving higher rates of same day trade affirmation
- improving matching and settlement efficiency
- accelerated clearance of retail funds
- managing the potential for increased settlement failure through changing the settlement batch cut-off time or the introduction of alternative mechanisms for dealing with late settlements.
- the sequencing of an Australian T+2 implementation with European or other major markets

The settlement failure rate for cash equities in Australia is extremely low, with an average daily settlement failure rate of 0.339% over the December 2013 quarter. ASX is of the view that transitioning to a T+2 settlement cycle should not lead to a significantly increased risk of settlement failure.

ASX is proposing that any additional settlement failure fees received during the first 12 months of implementation will be set aside in a separate pool of funds to undertake customer and investor education.

Introduction

Strong Industry Support for T+2

1. The Forum and the Business Committee - advisory forums consisting of senior representatives from industry which were established under the ASX Code of Practice for Cash Equities in Australia - have expressed strong support for the introduction of a T+2 settlement cycle for cash equities. This topic has been given the highest priority in the Forum and the Business Committee work program over the next 18 months.

2. In addition to the discussions in the Forum and the Business Committee, ASX has engaged with a number of retail and institutional participants, and other industry stakeholders including custodians and system vendors, informally seeking feedback on the introduction of T+2 in the Australian market. The feedback received in those discussions has provided strong support for ASX to undertake a formal consultation process regarding the introduction of a T+2 settlement cycle.

3. The Information Paper 'Introducing T+2 for the Australian Equities Market' released jointly by the Stockbrokers Association of Australia and GBST on 30 January 2014 suggests further support for a T+2 settlement cycle on the basis that significant investments in clearing and settlement systems are not required, and because of the risk reduction and capital optimisation benefits expected to result from its implementation[1]. The Information Paper highlights the benefits of:

    - a shortened settlement cycle for retail investors and brokers
    - lower costs for brokers servicing retail customers of moving towards electronic methods of notifying and confirming transactions, and settling cash
    - greater take-up of integrated payments, such as real-time cash management trust accounts
    - implementing straight-through processing for institutional markets and the adoption of electronic trade confirmation systems, which will be key to achieving timely settlement in a T+2 settlement cycle.

International Shift to a T+2 Settlement Cycle Underway

4. In addition to the expected capital and margin savings for market participants, there are other benefits of moving to a T+2 settlement cycle for cash equities in Australia which will be delivered through adopting a standardised settlement cycle and aligning with global best practice. In recent discussions, a number of participants have recognised the global move towards shortened settlement cycles and have acknowledged the importance of international harmonisation in this area.

5. As the diagram on the next page shows, there are a number of developed and emerging markets in Asia, Europe and elsewhere in the world that already operate under a T+2 settlement cycle, including Hong Kong, India, Taiwan, Korea, Germany, Turkey, Bulgaria, Russia, Jordan, Egypt, Chile and Venezuela. Markets in the member states of the European Union are in the process of transitioning to a standardised T+2 settlement cycle in response to a European Commission requirement for T+2 to be implemented by 1 January 2015 under the Central Securities Depository Regulation. A number of markets have announced an implementation date in October 2014 ahead of the new European Union requirement becoming effective.

6. US markets are also giving consideration to the move to a T+2 settlement cycle. Depository Trust and Clearing Corporation (DTCC) commissioned the Boston Consulting Group to undertake an independent cost benefit analysis of shortening the settlement cycle for US equities and corporate and municipal bonds. It is understood that the US industry is working through what is a feasible timeframe for the transition to T+2 given the need for significant domestic changes to be implemented, including the migration away from physical securities in the US market, before a T+2 settlement cycle can be introduced.

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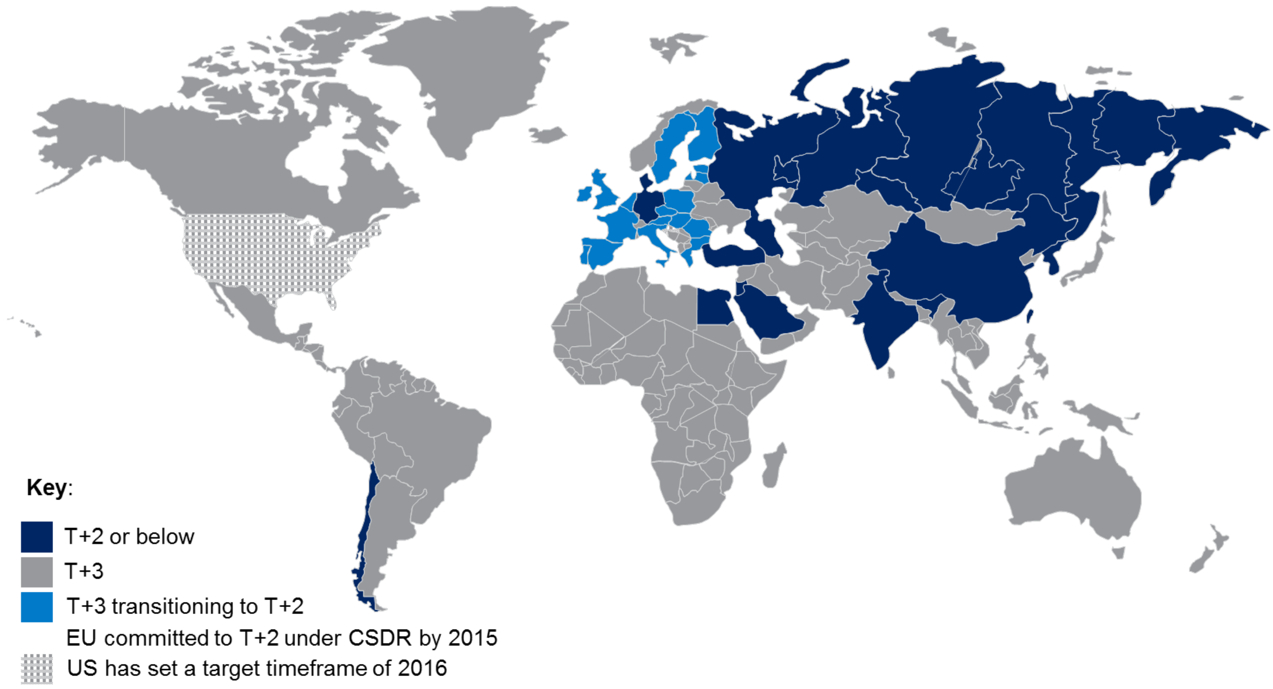
[1] A copy of the information paper 'Introducing T+2 for the Australian Equities Market' released jointly by the Stockbrokers Association of Australian and GBST on 30 January 2014 is available here.

Markets Operating under a T+2 Settlement Cycle



Source: World Federation of Exchanges

Current Settlement Arrangements in Australia

7. Settlement of Australian cash equity market trades is effected by CHESS (Clearing House Electronic Sub-register System), an electronic name on register system. Cash equity securities include shares, warrants, units of listed trusts, ETFs, CDIs, unsecured notes, convertible notes, and AGBs and other interest rate securities. ASX currently operates a trade date plus three Business Days (T+3) settlement discipline for securities transactions. Under a T+3 settlement cycle, the seller has an obligation to deliver "sold" securities on the third business day after the transaction, and the buyer has an obligation to pay for those securities on that same day.

8. Securities transactions routinely settle on a net basis in a single daily batch cycle. Batch settlement starts at 10.30am each business day and generally completes at around 11.30am. It involves the determination of each participant's net funds and security delivery obligations, and the net funds obligations of all participants' banks. Funds settlement occurs across the Exchange Settlement Accounts of those payment providers in the RBA's Information and Transfer System (RITS). Once completed, this triggers the movement of securities from delivering to receiving settlement participants within CHESS. These multilateral payment netting arrangements, which are key to the settlement efficiency of the system, are approved and protected under the Payment Systems and Netting Act.

9. CHESS effects the settlement by transferring the title or legal ownership of the securities while simultaneously facilitating the transfer of money for those securities between participants via their respective banks.

10. The last time there was a change to the settlement cycle in Australian was in 1999. Improvements in electronic banking, post-trade processes and the underlying technology facilitated the move at that time from T+5 to a T+3 settlement cycle. The transition management during the cross-over period from T+5 to T+3 was effective, resulting in the smooth implementation of T+3 without disruption to the functioning of the market.

Benefits of Shortening the Settlement Cycle to T+2

11. The global financial crisis has highlighted the need to improve risk mitigation and efficiency in post-trade processing. The importance of managing counterparty risk exposure has been brought into sharper focus for participants, regulators and policymakers and is now better appreciated by the end users of financial markets.

12. There is now widespread agreement that shortening the settlement cycle by a business day to T+2 should deliver significant benefits for the industry by:

- reducing counterparty risk for individual investors, participants and the central counterparty, which results in reduced systemic risk for the market as a whole
- reducing the regulatory capital required to be held by participants to mitigate risk
- driving greater post-trade operational/process efficiency and associated cost savings.

Reduction in Risk

13. At any point in time, the introduction of a T+2 settlement cycle will reduce the number and duration of unsettled clearing house novated transactions and also clearing participants' related non-novated settlements including bilateral off-market trades, security transfers and securities lending and borrowing transactions. The exposure from the unsettled transactions for individual participants is likely to be lower and this will reduce participants' exposure to default by their clients (counterparty credit risk). The reduction in aggregate counterparty risk exposure for the central counterparty expected from the introduction of a T+2 settlement cycle will also reduce systemic risk for all market users.

14. The reduction in the number of outstanding novated transactions expected from the introduction of a T+2 settlement cycle has the potential to lead to a meaningful reduction in cash market margin requirements for clearing participants. Participants are also expected to see reduced liquid capital requirements (the magnitude of the expected reductions in liquid capital requirements will vary from participant to participant depending on their business model).

15. A number of clearing participants anticipate that a reduction in counterparty credit risk will also deliver the additional benefits of freeing credit, which could lead to higher turnover and increased trading capacity of end clients. ASX has estimated that the reduction in the cash market margining risk margin has the potential to lead to an average reduction in capital based position limits usage across clearing participants of 5-10%.

Cash Market Margin Savings for Participants

16. In June 2013, ASX commenced the calling of margin from clearing participants on an end-of-day basis as a way of enhancing the risk management controls of ASX Clear, and thereby achieving a reduction in systemic risk. Clearing participants are subject to a daily cash market margin which requires clearing participants to collateralise against risk exposures they generate through novated trading activity.

17. In the event of a default, the clearing house will close out the defaulting clearing participant's net novated settlement obligations and, if needed, use the margin contributions of the defaulting clearing participant as a first line of defence to meet any shortfalls from close out.

18. Transactions that are not novated are excluded from the cash market margin calculations, for example, cash market transactions involving the same clearing participant (crossings) which are not novated, matched non-novated DvP transactions, and IPOs and placements which are yet to commence official quotation on the official list.

19. ASX estimates that had the T+2 settlement cycle been in place from the introduction of cash market margining in June 2012 until December 2013, daily cash market margin requirements for the total market would generally have been 20-30% lower, producing an estimated reduction of $30-$40 million in total margin payments with a consequent saving in funding costs for the industry.

20. On a daily basis, individual clearing participant margin changes due to a settlement period reduction vary widely from relatively small increases on some occasions to reductions of over $10 million for some larger clearing participants. In over 90% of cases, participants' daily cash market margins will be reduced and over the whole period of the analysis, over 90% of clearing participants are forecast to see a reduction of between 20% and 30% in their average daily cash market margin requirements once T+2 is implemented.

Liquid Capital Requirement Savings for Participants

21. ASX Clear Operating Rules require equity clearing participants to meet the risk-based capital requirements[2] based on prescribed risk measurement calculations and ratios that measure a participant's financial stability. The requirements are intended to cover all of the risk of a participant's business including principal trading, securities lending, general operations and large exposures. The capital liquidity requirements are classified into two distinct components: a measure of each participant's liquid capital and also a measure of risk in each organisation (total risk requirement (TRR)). At all times, a participant must have sufficient liquid capital to cover its TRR. As a buffer to help ensure compliance, the ratio between the liquid capital value and the TRR must be greater than 1.2 to 1.

22. Two major contributors to the total risk requirement are measurements of counterparty and operational risk. Both are expected to fall as a result of the reduced number of unsettled transactions resulting from the introduction of a T+2 settlement cycle for cash equities.

23. While it is difficult to estimate the impact on the liquid capital requirements from a move to a T+2 we have undertaken analysis based on the data that ASX can access. ASX estimates that participants could expect a reduction in their liquid capital requirements, in so far as they relate to cash equities, of between 10% and 20% depending on the amount of netting present in any participant portfolio of transactions and the speed at which payments from clients are received. Clearers of institutional business are likely to see the largest reductions. Retail brokers are expected to realise significantly smaller reductions depending on the level of client sponsorship and the use of real-time cash management trust accounts.

24. For the industry as a whole, ASX estimates that there is the potential to reduce total liquid capital requirements by between $60 million and $120 million with the implementation of T+2.

Capital Considerations for the Central Counterparty (ASX Clear)

25. ASX Clear faces counterparty credit risk exposure to clearing participants on novated transactions for the duration of the settlement cycle.

26. The expected reduction in aggregate counterparty risk exposure for the central counterparty and resulting reduction in systemic risk from the introduction of a T+2 settlement cycle provides the opportunity for ASX Clear to review the $250 million of paid-in capital that ASX provides for the purpose of the clearing house default fund. This amount of paid-in capital held by ASX Clear is determined under the Financial Stability Standards, in particular the requirement under Standard 4.4 to maintain sufficient financial resources to cover "*the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure for the central counterparty in extreme but plausible market conditions.*"

27. Any change to the regulatory capital held by ASX Clear is subject to regulatory clearance. ASX Management intends to engage with the RBA and the ASIC on the introduction of a T+2 settlement cycle, including the potential to reduce the financial resources held by ASX Clear.

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[2] Some participants, for example approved deposit taking institutions (ADIs), are subject to other regulatory risk regimes and are typically exempt from ASX Clear Operating Rule requirements.

28. A reduction in the paid-in capital held by ASX Clear would provide the opportunity for ASX Clear to reduce the clearing fee for cash equities.

Consultation Questions

Q1 Do you agree with the expected benefits from the introduction of a T+2 settlement cycle for cash equities? If so, please outline the key benefits to your organisation.

Q2 What level of reductions in cash market margin and liquid capital requirements do you expect for your organisation from the introduction of a T+2 settlement cycle? Please indicate if you wish this information to remain confidential to ASX and the regulators, RBA and ASIC.

Q3 Do you expect the costs associated with the implementation of T+2 to be relatively small, moderate or significant for your organisation? Can you provide a cost range for your implementation of T+2?

Q4 Do you consider that the potential net benefits expected from the introduction of a T+2 settlement cycle for cash equities warrants its introduction in the near term? If so, do you consider that:

a. an implementation date in Q1 2016 should be targeted?

b. an earlier implementation date in 2015 is feasible for all industry participants and should be considered? If so, what implementation timing do you think should be targeted?

c. sequencing the transition to a T+2 settlement cycle with other markets is important, noting that EU member states will be required to operate a T+2 settlement cycle from January 2015?

Key Elements in Facilitating the Introduction of a T+2 Settlement Cycle

29. A number of commentators on the benefits of shortening the settlement cycle have noted the increase in operational efficiency in post-trade processing that will need to be put in place to facilitate a move to a T+2 settlement cycle[3].

30. This consultation seeks feedback on the preparedness of industry and any key preconditions required to move to a T+2 settlement cycle for cash equities in Australia, in particular, the importance of:

- achieving higher rates of same day affirmation
- improving matching and settlement efficiency
- accelerated clearance of retail funds
- changing the settlement batch cut-off time.

Same Day Affirmation

31. Achieving higher rates of same day affirmation (SDA) has been identified as an important precondition to ensure that settlement failures do not increase with the introduction of a T+2 settlement cycle. This will accelerate the post-trade process and leaves enough time to identify and address any errors and mismatches before trades are due to settle.

32. SDA is achieved when the trade affirmation process is completed on the day of the trade. Trade affirmation is a critical post-trade process, which involves the verification of the trade details between the institutional investment manager and the broker before the trade can be settled.

[3] The Boston Consulting Group, 'Cost benefit analysis of shortening the settlement cycle', October 2012 paper and the Omgeo 'The road to shorter settlement cycles: Creating a trade date environment in the US and across the global markets', March 2013 paper discuss the operational efficiencies in post-trade processing that will be driven by the introduction of shorter settlement cycles.

33. There are four key stages to the process for affirming trades:

- notice of execution by the broker
- transmission of allocation details by the investment manager
- confirmation of those details by the broker
- affirmation by the investment manager.

34. Automated trade verification (using electronic systems to match the trade details either locally or centrally) provides a means to achieve timely trade affirmation and facilitate higher rates of SDA.

35. Central trade verification and matching allows the process from an institutional broker to be progressed independently of the investment manager. As a result of removing the dependency on sequencing in the trade verification process, centralised matching enables trades to be automatically matched within compressed time frames and allows firms to focus solely on exceptions.

36. The extent to which the trade verification process is automated by participants, custodians and the buy-side firms varies. Some or all of these trade verification processes can be conducted manually by phone, fax or email.

37. A 2010 study conducted by Omgeo on SDA found that:

- there was a direct correlation between SDA and shortening settlement cycles
- SDA leads to greater settlement efficiency, which was demonstrated by settlement efficiency in countries with SDA rates of over 90% – India, Taiwan, Hong Kong, Japan, Singapore and Korea – being on average 26% higher than in countries with SDA scores of less than 70% – Brazil, Italy, South Africa and the United States
- Asian markets lead the way and have the highest SDA rates (a regional average of 94%), with the Americas the lowest (53.8% average). Australia was found to be lagging in the region with an SDA rate of 70%. In Europe, SDA rates were found to be consistently in the mid 80% range
- central trade matching increases SDA rates. Centrally matched trades were found to more likely to be affirmed on the day the trade was executed (average SDA of 86.5%) against locally matched trades (average SDA of 66.6%)[4].

38. Omgeo Benchmark Analytics from December 2013 has demonstrated higher SDA rates for central matching with a rate of 81% for Australia, 91% for Germany, 94% for Hong Kong and the US still lagging with a rate of 69%.

39. Given the research indicates that achieving SDA rates of over 90% is important in delivering greater settlement efficiency and lower rates of settlement failure, increasing SDA rates in the Australian market will be important in transitioning to T+2. A high degree of automation in the trade affirmation process remains the key to delivering higher SDA rates. The greater degree of automation in post-trade processing is also expected to deliver significant operational cost savings for individual firms.

[4] Omgeo, 'Mitigating Operational Risk and Increasing Settlement Efficiency through Same Day Affirmation (SDA)', 2010.

Consultation Questions

Q5 To what extent do you currently utilise an automated centralised trade matching system? Please indicate which system you use.

Q6 What percentage of trades are verified manually by your organisation? If you use manual verification processes, what is the main reason for doing so?

Q7 What is the percentage of trades where affirmation is completed on T+0?

Q8 What are the main reasons for failure to achieve SDA?

Q9 In what timeframe could your organisation be reasonably expected to achieve an SDA rate of over 90%?

Q10 What is the expected investment required for your organisation to implement a T+2 settlement cycle? Do you agree the changes required to implement a T+2 settlement cycle are largely configuration and behavioural changes rather than wholesale system changes?

Institutional Settlement Instruction Matching

40. Following trade affirmation, instructions are released for settlement by the counterparties to the trade. Typically, settlement instructions should be pre-matched prior to T+3. There are a number of reasons for settlement failure, including:

- inaccurate settlement instructions
- lack of available borrows or a failure to receive stock for onward delivery
- deliberate failure by the counterparties as it may be cheaper to fail and pay the penalty rather than borrow stock for short periods.

41. According to research undertaken by Omgeo, inaccurate settlement instructions are often cited as the primary reason for settlement failure (as a result of using manual settlement instruction processes)[5].

42. ASX has undertaken a preliminary analysis of the time at which both the preliminary settlement instructions are released and matching concludes under the current settlement regime in Australia, with a view to understanding the implications of shortening the settlement cycle by a business day.

43. The analysis found that around 70% of settlement instructions were matched before 1pm on T+2. This is positive given the market operates under a T+3 settlement cycle. However, under a T+2 settlement cycle it would be expected that the matching of settlement instructions would largely need to be achieved on T+1. The analysis found that while a large number of settlement instructions had been sent out (DvP MT101 settlement messages) for matching by T+1, only a small number of settlement instructions (14%) had been matched by T+1.

44. The table below sets out the timing and cumulative percentage of settlement instructions that had been sent out compared to that which had been matched over December 2013 to January 2014.

DVP MT101 Settlement Messages	T+3	T+2	T+1	T
First side instructions sent out	100%	98%	65%	18%
Instruction matched by counterpart	99.7%	93%	14%	4%

[5] Omgeo 'The road to shorter settlement cycles: Creating a trade date environment in the US and across the global markets', March 2013

45. The introduction of a T+2 settlement cycle will need to be accompanied by a compression in the timing of issuing and matching settlement instructions. This will require a significant majority of settlement instructions to be matched by T+1.

Consultation Questions

Q11 Please indicate the most significant reason for a delay in the release of settlement instructions to the market?

Q12 What are the key reasons for delaying the matching of settlement instructions until late in the afternoon of T+2 or in the morning of T+3?

Q13 Are investor location and time zone differences the main driver for delayed settlement instruction matching? Please indicate the main jurisdictions where delays are common.

Q14 Should the ASX require continued publication of settlement instructions so that they cannot be removed after initial publication and potentially delay the opportunity to match settlement instructions?

Q15 Should the ASX consider enriching message information to facilitate more timely settlement instruction matching?

Accelerated Clearance of Retail Funding

46. The introduction of a T+2 settlement cycle may lead to increased risk exposure for participants that continue to accept client payment via cheques, BPAY and transfers into brokers accounts, as these payment methods may not deliver cleared funds in time for settlement on T+2. It is likely that a T+2 settlement cycle will lead to participants moving away from allowing these payment methods by retail clients, as the participant would be required to fund the transaction until the client's funds are cleared.

47. A number of participants have indicated that a move to a T+2 settlement cycle will lead to a greater drive towards participant-initiated payment methods, such as, linked cash management trust accounts, together with straight-through processing of retail customer trades and confirmation processes.

48. The introduction of improvements to the payments system to facilitate real-time retail payments with close-to-immediate funds available to the recipient, which are expected to be implemented in 2016, will address the issue of delayed cleared funds associated with some electronic payment methods.

Changes to be Implemented by ASX

49. While not significant, ASX will need to make technology changes to CHESS to implement a T+2 settlement cycle. In addition, ASX will need to put in place transition management arrangements for the cross-over period from T+3 to T+2. ASX proposes to take a similar approach to the transition management of the cross-over period from T+3 to T+2 to that adopted for the well managed transition from T+5 to T+3 in February 1999.

50. The ASX Trade release on 8 February 2014 introduced the necessary change to facilitate T+2 settlement for "special markets" quoted under the reduced timetables for corporate actions, which will be effective from 14 April 2014[6]. Accordingly, no change to the ASX Trade trading platform is expected.

51. To implement a T+2 settlement cycle, ASX needs to introduce consequential changes across its rulebooks - ASX Operating Rules, ASX Listing Rules, ASX Clear Operating Rules and the ASX Settlement Operating Rules. ASX will also need to change the clearing and settlement specification and procedure documentation, for example, the CHESS External Interface Specification (EIS) and the ASX Settlement Procedure Guidelines (APG), in addition to related changes to the CHESS database.

[6] The reduced timetables for corporate actions, which incorporate a 3 business day 'ex period' and will be effective from 14 April 2014, are available here.

Management of Settlement Risk

Management of Settlement Risk

52. The settlement failure rate for cash equities in Australia is extremely low, with an average daily settlement failure rate of 0.339% over the December 2013 quarter. The high level of settlement efficiency in Australia is demonstrated by both average daily settlement completion rate of 99.7%, and the fact that 77.8% of settlements which failed on T+3 were completed by T+4. Ninety three percent of the settlements that failed on T+3 over Q4 2013 involved securities outside the top 50 ASX-listed securities.

53. Given the extremely low settlement failure rate in Australia and the advancements in technology and post-trade processes, ASX is of the view that transitioning to a T+2 settlement cycle should not lead to a significantly increased risk of settlement failure. That being said, ASX does recognise that in the short-term the transition from a T+3 to a T+2 settlement cycle could lead to an increase in the number of failed settlement obligations as a result of a shorter timeframe for client instructions and matching settlement obligations.

54. In the context to moving to a T+2 settlement cycle, ASX has reviewed the arrangements it has in place for the management of settlement risk. ASX considers that the key elements of its settlement disciplinary regime – financial penalties for failed settlement, an automatic close-out requirement on T+5 and the potential for serious cases of settlement delays to be referred to ASX's Disciplinary Tribunal – continue to provide appropriate incentives to promote timely settlement and support market efficiency.

55. Under the ASX settlement disciplinary regime, participants that fail to 'deliver' securities on the scheduled settlement date are levied with a daily fine. The current fine is 0.1% of the trade value outstanding, with a floor of $100 and a cap of $5,000. ASX is not proposing to increase the financial penalties with the introduction of a T+2 settlement cycle.

56. The ASX Settlement Operating Rules require that a settlement participant must close-out settlement shortfalls that remain after batch settlement on T+5 by purchasing or borrowing the securities needed to complete settlement. With the introduction of a T+2 settlement cycle, ASX is proposing to change the ASX Settlement Operating Rules so that settlement disciplinary milestones are also reduced by 1 business day (that is, financial penalties will be levied for settlement fails on T+2 and the automatic close-out requirement applies for settlement shortfalls that remain after batch settlement on T+4).

57. In recognition of the industry transition required to implement a T+2 settlement cycle, ASX is proposing that any additional settlement failure fees received during the first 12 months of implementation will be used to undertake customer and investor education.

Settlement Catch Cut-Off Time

58. The Business Committee and a number of individual participants have asked ASX to consider delaying settlement batch cut-off past the existing 10.30am deadline to early afternoon as a way of facilitating the move to a T+2 settlement cycle and to help minimise settlement failure. Participants have indicated that a later settlement batch cut-off would better accommodate late instructions on settlement day and provide for greater alignment with time zones in Asia.

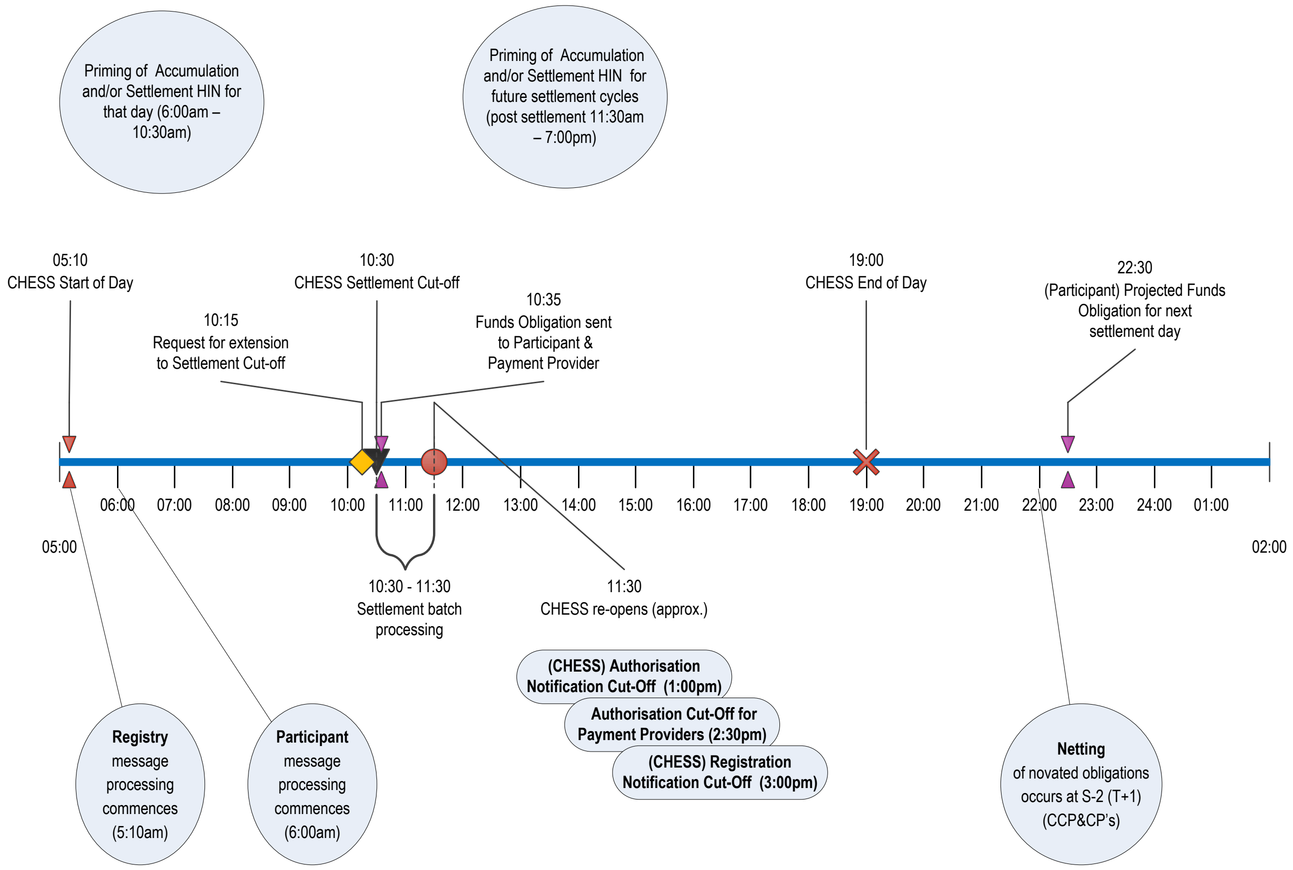
59. ASX has given preliminary consideration to delaying the settlement batch cut-off to 11.30am, 12.00pm and 1.00pm. ASX does not consider delaying the batch cut-off to 1.00pm is a feasible option as it would compress the time available for the management of a potential default and lead to increased risk in managing such events.

60. A delay of the settlement batch cut-off to 11.30am or 12.00pm may be possible and should be subject to consultation. Delaying the batch cut-off to12.00pm would also likely require regulatory approval. While extending the batch cut-off time could be beneficial in terms of providing more time for participants to mitigate against settlement failure and achieving better alignment with Asian markets, these potential benefits need to be considered in the context of the other implications of extending the settlement batch cut-off, including:

    - compressing the timeframe between batch cut-off and authorisation cut-off time for payment providers

- compressing the timeframe between batch cut-off and ASX Settlement authorisation notification cut-off time
- a 12.00pm batch cut-off is likely to require the amendment of payment provider deeds, with the ASX Settlement authorisation notification cut-off potentially being delayed to 1.15pm, the payment provider authorisation cut-off time potentially being delayed to 2.45pm and a registration cut-off being delayed to 3.15pm
- compressing the timeframe for participants to manage matters (for example, technical), which may impact the authorisation of funding obligations and potentially increase the probability of a settlement failure or default event
- compressing the timeframe for ASX to manage a CHESS payment default situation and perform default back-out procedures
- delaying participant back office processing related to post-settlement activity, for example, allocation of securities or funds to clients.

61. The diagram below provides a representation of the timeline of the existing deadlines for the current settlement batch cut-off process for participants, payment providers and ASX.



Alternative mechanisms for dealing with late settlements

Within the current settlement cycle, settlement participants may be required to manage settlements after the settlement batch has completed on T+3. Some of these late settlements may be the result of late instructions associated with international customers or inaccurate settlement instructions. These late settlements are typically effected by moving securities free-of-payment through CHESS while moving cash separately (e.g. EFT or via ASX Group's other settlement facility, Austraclear). This is largely an operational and manual process and carries additional counterparty risk as the process is not completed on a DvP basis.

In the transition to a T+2 settlement cycle, there is the potential for an increased number of such late settlements. Rather than continue to manage these late settlements in the way described above, there is an alternative for settlement participants to use CHESS's existing Real-Time Gross Settlement (RTGS) functionality to ensure that these settlements successfully complete through DvP on settlement date.

Another alternative to address this issue would be to schedule an additional settlement batch later in the day. This would provide another point during the settlement day to achieve net settlement of funds and securities. To maintain the liquidity and administrative efficiencies delivered through a single daily settlement batch it will be important to consider what types of settlements would be eligible for the additional settlement batch. Further to this the timing of the additional batch will need to take into account the implications of a payment failure at this point given the compressed time to manage such an event. This option would also involve much more significant changes to CHESS functionality than those envisaged to implement a change to a T+2 settlement cycle while maintaining the current batch arrangements.

Consultation Questions

Q16 Do you think that the introduction of a T+2 settlement cycle is feasible with the existing 10.30am settlement batch cut-off? Please state reasons for your view. If you act on behalf of foreign investors, please indicate the percentage of current trading volumes executed by foreign clients in Asian, US and European time zones.

Q17 What are the main internal processes and procedural changes that your organisation would need to introduce to ensure T+2 and batch cut-off settlement deadlines are met? If you do not think moving to a T+2 settlement cycle is feasible with the existing 10.30am settlement batch cut-off, do you think delaying settlement batch cut-off to 11.30am or 12.00pm would provide sufficient additional time to assist in facilitating timely settlement? If so, would the benefits exceed the cost of the flow-on impacts (for example, the likely need to change payment provider deeds and delaying the ASX settlement authorisation notification, payment provider authorisation, and registration cut-off times, together with delaying participant back office processing related to post settlement activity)?

Q18 What are the main internal processes and procedural changes that your organisation would need to introduce to ensure later batch cut-off settlement can be supported, including internal funding arrangements and operational resource availability?

Q19 Would extending the CHESS system start or end of day times assist with achieving timely settlement in a T+2 settlement cycle? For example, would it assist with off-shore processing?

Q20 What are the key drivers for settlement failure? Is the lack of access to stock borrowing arrangements or availability of stock a significant driver for failed delivery?

Q21 Please indicate whether you believe the continuation of the current regime and the automatic close-out requirement will provide the appropriate incentives for timely settlement in aT+2 environment.

Q22 Should the current close-out regime be changed to settlement date +1 (T+4) instead of settlement date +2 (T+5) with the introduction of a shortened settlement cycle?

Q23 Do you think further consideration should be given to using CHESS's existing RTGS functionality to manage late settlements? What would your organisation need to do to use CHESS's existing RTGS functionality? What would your payment provider need to do to use CHESS's existing RTGS functionality?

Q24 Do you think further consideration should be given to running an additional settlement batch to manage late settlements? How do you expect an additional settlement batch would impact your organisation, including the potential cost impact

Q25 If running an additional settlement batch introduces material additional costs or regulatory considerations for industry stakeholders or the ASX, would this change your response?

Consultation Questions Continued

Q26 Do you have other suggestions for addressing late settlements? Are you able to quantify whether late settlements are a significant issue for you? In your view, is the current mechanism – moving securities free-of-payment through CHESS while moving cash separately – sufficient?

Q27 What role do you think that investor education can play in minimising the potential for increased settlement failure following the introduction of a T+2 settlement cycle? Do you think there is merit in ASX working with the industry to undertake investor education in relation to the transition to T+2?

Other Key Implications of Introducing a T+2 Settlement Cycle

Corporate Actions

62. From 14 April 2014, the ex period for all corporate actions (including reorganisations of capital that are effected by way of a security consolidation or split) will be reduced from 5 business days to 3 business days[7]. The 3 business day ex period is being introduced as part of a broader initiative to reduce the standard timetables for rights issues. Stakeholders involved in the consultation process for reducing the timetables for rights issues also indicated the importance of the ex period in corporate actions being aligned with the settlement cycle.

63. To facilitate the creation of special markets following the introduction of a 3 business day ex period, ASX will adopt a T+2 settlement cycle for special markets from 14 April 2014. This means that participants will be able to request that a special market be set up for 1 business day on the 'ex date', with trades in the special market settling on a T+2 basis by the record date.

64. With the introduction of a T+2 settlement cycle, ASX proposes to further reduce the ex period for all corporate actions and applicable reorganisations of capital by a business day to ensure it is aligned with the T+2 settlement cycle (that is, a 2 business day ex period will be implemented). To facilitate special markets in a T+2 settlement environment, ASX also proposes to adopt a T+1 settlement cycle for special markets to allow trading in special markets to be settled by the record date of the relevant corporate action.

Trade Netting

65. Trade netting is a process whereby the CHESS system minimises the number of counterparty settlement obligations for each settlement day. This is achieved by aggregating each clearing participant's individual settlement obligations by security. These aggregated obligations are then offset to produce a single net settlement position by security.

66. Trade netting is performed by CHESS at the end of the second business day prior to the settlement date (T+1 under the current settlement regime).

67. With the introduction of a T+2 settlement cycle, ASX is proposing that trade netting continues to occur at the end of the second business day prior to the settlement date, that is, it is proposed that trade netting be brought forward by a business day to the end of the business day T+0.

68. The key benefit in keeping the same CHESS trade netting timeframe, that is, settlement date minus two business days, is to allow the netted settlement obligation positions to be available to all participants one day prior to settlement rather than the morning of settlement.

[7] The reduced timetables for rights issues and other corporate actions moving to a 3 business day ex period are available here.

69. Bringing the trade netting process forward to the end of the day on trade date will reduce the window for trade cancellations. However, following the introduction of order thresholds and extreme cancellation range policies for cash equities under the Market Integrity Rules, the number of trade cancellations facilitated by ASX Trading Operations has been significantly reduced. These types of trade cancellations, which are small in number, should be cancelled on the day of trade execution.

Securities Lending

70. The introduction of a T+2 settlement cycle will compress the time for the recall of securities out on loan. The reduced timeframe for securities to be recalled and delivered in time for settlement on T+2 may require the introduction of procedural changes and greater automation.

New Zealand & Dual Listed Securities

71. A number of participants have raised with ASX the importance of standardised settlement cycles in the Australian and New Zealand markets on the basis of the significant amount of trading on the ASX market by New Zealand investors and the large number of dual listed companies on ASX and NZX.

72. NZX currently operates a T+3 settlement cycle for cash equities and is yet to announce its intention with respect to shortening its settlement cycle. ASX will seek to engage with NZX on this matter during the consultation process.

Consultation Questions

Q28 Are there particular corporate action events for which the adoption of a T+2 ex period creates significant difficulties?

Q29 Do you think that a T+1 settlement cycle is achievable to facilitate trading in special markets?

Q30 Do you support the same approach to the timing of trade netting being taken in a T+2 settlement cycle (that is, settlement date minus two business days (T+0) to allow the netted settlement obligation positions to be available to all participants one day prior to settlement)?

Q31 Will there be significant impacts for your organisation if trade netting was to occur on T+0 if a T+2 settlement cycle is introduced?

Q32 Do you expect a significant impact to securities lending activity due to the introduction of a shortened settlement cycle? If so, please outline the expected impact?

Q33 Are there any significant additional client or business risks that have not been identified in this paper?