

Manager  
Banking and Capital Markets Regulation Unit  
Financial System and Services Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

March 28 2015

Dear Sirs,

## **REVIEW OF COMPETITION IN CLEARING AUSTRALIAN CASH EQUITIES**

This letter provides the submission of LCH.Clearnet Ltd (“LCH.Clearnet”) to the CFR’s Review of Competition in Clearing Australian Cash Equities.

LCH.Clearnet is a subsidiary of the LCH.Clearnet Group, one of the world’s leading clearing house groups, which services major international exchanges and platforms, as well as a range of over-the-counter (“OTC”) markets. It clears a broad range of asset classes including cash equities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps, bonds, repos, and foreign exchange derivatives. The Group’s central clearing counterparties (“CCPs”) have over 190 clearing members and over 600 clients across 22 countries.

LCH.Clearnet was the first non-Australian CCP to be granted an Australian Clearing and Settlement Facility Licence and is currently providing clearing services for OTC interest rate swaps (“IRS”) to a number of major Authorised Deposit-taking Institutions through its SwapClear service. LCH.Clearnet is also licenced in Australia to clear for the FEX commodities and energy exchange. LCH.Clearnet is supervised directly by both ASIC and the RBA. In addition to its Australian licence, LCH.Clearnet Ltd is regulated in the EU, Norway, Switzerland, the US, Singapore, Quebec and Ontario. LCH.Clearnet SA is regulated in the EU and the US. LCH.Clearnet LLC is regulated in the US, and has applied for recognition in the EU.

### **Introduction**

LCH.Clearnet believes that the moratorium on competition in cash equity clearing in Australia should be lifted and competing CCPs should be allowed to enter the market. In principle LCH.Clearnet is ready to provide competitive equity clearing in Australia using its global offering and expertise to provide innovative services. As the world’s largest open, horizontal CCP, LCH.Clearnet can bring new expertise, experience and connectivity to Australia’s financial markets. Recent adoption of the LCH.Clearnet SwapClear platform is

evidence of the confidence Australian banks and their clients have in LCH.Clearnet's risk management. Membership enables them to gain direct access to global liquidity pools in all major currencies, realise optimal netting efficiencies and enjoy value-added services such as trade compression. Where we have provided clearing services elsewhere, these have been followed by lower charges, faster innovation and enhanced capacity. ASX, as we understand it, seeks to attract overseas entities to list on its markets. More generally, our belief is that the Australian government wants to ensure that its markets are open. Enabling access to a global infrastructure will support this objective. Many exchange-traded products, such as ETFs and ETPs are developed by global asset managers for distribution to a global market, which would be facilitated by access to a global CCP.

The advantages of competition in the clearing sector should never result in a reduction in risk management standards. It is a fundamental belief at LCH.Clearnet that CCPs should never differentiate themselves by compromising on risk management standards as this could lead to potentially catastrophic consequences in the event of a significant default. LCH.Clearnet operates its clearing services at a prudent level of risk, calibrated to exceed any regulatory minimum and international market standards such as CPMI-IOSCO's PFMI (Principles for Financial Market Infrastructures).

However, we believe that the requirement that a CCP must be an Australian incorporated entity if it provides services which are considered to be "systemically important" with a "strong domestic connection" in Australia – e.g. cash equities – has the effect of creating a barrier to market entry, stifling competition and preventing the realisation of potential efficiency gains. The costs inherent in establishing a new CCP, including the requirement to put in place its default/guarantee fund, and the loss of potential netting and collateral efficiencies that would be available if a CCP clearing cash equities on other (international) markets, would in our view make the venture commercially unattractive.

However, even smaller European markets such as Switzerland and Norway have embraced clearing competition and this has enabled participants to realise significant savings. Enabling LCH.Clearnet to clear directly for additional markets in Australia subject to the supervision of Australian regulators could benefit the market by increasing financial stability, bringing innovation and lowering fees for Australian firms. This has already been enabled for OTC IRS through the approval of LCH.Clearnet's SwapClear service in accordance with the CFR's policy. However, maintaining a requirement for CCPs to domestically incorporate for other activities denies them further such benefits. Moreover, it runs the risk in the longer term of fragmenting trading as developments in Asia create more efficient international trading hubs that will eventually trade and clear Australian cash equities.

Furthermore, the first EU Commission equivalence decision in October 2014 included Australia. Under this arrangement it is possible for Australian-domiciled CCPs, subject to their home regulation and supervision, to apply for recognition to offer clearing services to EU clearing members. This analysis was conducted on an outcomes-based assessment and the principle of equivalence in regulatory regimes would provide, in return,

the ability of EU CCPs to provide clearing services to Australian members without the need for local incorporation. LCH.Clearnet believes that the CFR's review should conclude that the EU's equivalence assessment should be developed so that EU CCPs can offer cash equity clearing in Australia.

LCH.Clearnet has demonstrated a strong commitment and willingness to adhere to the high standards of Australia's clearing regulatory regime without being domestically incorporated. Through the license we hold in relation to the FEX and SwapClear services, we are subject to the RBA's Financial Stability Standards in addition to ASIC's requirements. We have also demonstrated our commitment to Australia in practical ways by setting up a local office, joining the local payments and securities settlement infrastructures, increasing our staff presence, and establishing a local User Group.

The recent Financial Systems Inquiry stated that policy settings in the Australian financial system "do not focus on the benefits of competition and innovation". We believe that the right balance between stability and competition can be achieved by allowing a strong, locally-regulated though foreign-incorporated CCP to offer cash equities clearing services in Australia. That is contingent on the Australian regulators being satisfied with the home oversight and risk management regimes, as has already been proven and implemented in OTC derivative markets, and the agreement of cross-border resolution arrangements. We are aware that the Australian authorities have cooperation arrangements with at least the UK authorities, the European Securities and Markets Authority ("ESMA"<sup>1</sup>), and the CFTC<sup>2</sup> and also that the RBA is a member of the supervisory college established for the oversight of LCH.Clearnet's SwapClear service. We would welcome the opportunity to discuss how these arrangements could be enhanced, if it was helpful to the CFR.

LCH.Clearnet has many years' experience in providing competitive clearing services in Europe in a multi-currency, multi-platform, multi-market, multi-CCP environment. This has brought significant benefits to market users while maintaining the highest prudential standards. Our service and experience is described below, following which we answer the CFR's questions.

### **LCH.Clearnet's cash equities clearing service "EquityClear"**

LCH.Clearnet has been clearing cash equities in the UK since 1995, initially for the Tradepoint exchange. In 2001, it commenced clearing of trades executed on the London Stock Exchange's SETS platform and now clears cash equities executed on the following venues:

#### Primary Exchanges

London Stock Exchange

SIX Swiss Exchange

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<sup>1</sup> <http://www.esma.europa.eu/content/ESMA-ASIC-RBA-MOU-European-central-counterparties>

<sup>2</sup> <http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/cftc-rba-asic-clearingmou06051.pdf>

BATS Chi-X Europe  
Oslo Børs

MTFs

Turquoise MTF  
AQUIS Exchange  
Equiduct  
Burgundy MTF

OTC

Traiana

The EquityClear services clears cash equities issued in 17 different countries and settlement is enabled in 19 separate CSDs and ICSDs. In 2014 the service cleared 726m trade sides. The clearing service is platform-neutral, with the same user access criteria and tariff applied in relation to trades executed on all venues. Trades for all venues are incorporated into a single margin calculation enabling collateral efficiencies, and there is full settlement netting offered across trades executed on all venues

### **Structure and Governance of EquityClear**

The EquityClear service is platform-neutral i.e. no favourable treatment is afforded to any venue operator by virtue of any shareholding or other relationship with LCH.Clearnet Ltd. Access by new venues, and product and service enhancement initiatives for existing venues, are assessed by LCH.Clearnet with primary reference to the revenue economics and viability of the desired product or venue enhancements.

To manage and prioritise initiatives there is a two step process:

- i) All proposed enhancements are reviewed in Quarterly Product Advisory Groups which are constituted of Clearing Members only. PAG members are requested to prioritise initiatives to determine the EquityClear product development schedule.
- ii) All proposed enhancements are subject to the same LCH.Clearnet New Product Approval Process and LCH.Clearnet Risk Governance approval as required. Decisions on new products are scrutinised for their risk impact and costs and benefits.

### **Competitive tension drives innovation**

In a competitive, interoperating environment the key to EquityClear's success has been to deliver a low-cost, value-add service to LCH.Clearnet's Clearing Members who are the primary source of revenue. An essential aspect of this is to benchmark ourselves on a monthly basis against competitors with which we operate and ensure that EquityClear is delivering the best-in-class risk solutions, netting and reporting services, as well as

settlement services. Failure to do so would result in loss of revenue as Clearing Members choose those CCPs who provide better, safer and more efficient solutions for their business. Moreover, the potential for other clearing services, whether provided by new ventures or by existing CCPs broadening their offerings, provides a constant further competitive pressure.

Philip Lowe, Deputy Governor of the RBA in his Sydney Institute speech on 12 March 2014 addressed it succinctly when identifying competition as one of 5 key policy areas for innovation:

*“The way in which we promote competition in our markets, for it is often competition, or the threat of it, that is the driver of innovation<sup>3</sup>.”*

### **Interoperability**

LCH.Clearnet believes that meaningful competition in the Australian cash equities market can only be delivered through choice of CCP. Choice of CCP, in addition to choice of venue, will allow firms to choose the lowest and most efficient end-to-end transaction costs for their clients and enable best execution. Choice of CCP especially if it concerns the same trading platform may require interoperability to maximise efficiencies for members, i.e. the ability of each clearing member to choose their CCP independently from the choices made by other clearing members. Further detail on interoperability is available on the LCH.Clearnet website<sup>4</sup>.

Contrary to the statement in the Consultation that interoperability “could affect the functioning of the market ... with potential inefficiencies arising from the loss of netting offsets” there would typically be *no* loss of offsets (as a clearing member would naturally move the clearing of *all* of its activity to one CCP or another and not split its portfolio). Moreover, in a structure where interoperating CCPs provide services to multiple trading venues (and a CCP that is not owned by a trading venue has the incentive to maximise the number of venues it serves), netting of positions traded across different venues would be enabled.

### **Observed impact of clearing competition: impact on clearing fees**

In all interoperable European markets the cost of clearing has been significantly reduced as already documented in reports by Oxera<sup>5</sup> and Market Structure Partners<sup>6</sup>. Most recently in Norway, since the introduction of LCH.Clearnet on Oslo Børs, members of both Oslo Clearing and LCH.Clearnet have seen a 20-50% reduction in clearing fees in 2014.

<sup>3</sup> <http://www.rba.gov.au/speeches/2014/sp-dg-120314.html>

<sup>4</sup> <http://www.lchclearnet.com/asset-classes/equities/london-stock-exchange/equityclear>

<sup>5</sup> <http://www.oxera.com/Latest-Thinking/Publications/Reports/2011/Monitoring-prices,-costs-and-volumes-of-trading-an.aspx>

<sup>6</sup> <http://www.marketstructure.co.uk/services/international-transaction-cost-benchmark-review-october-2014/>

## Responses to the CFR's specific questions

### Policy Approaches

*1. Which policy approach would you prefer, and why?*

We believe strongly that competition is the best policy approach for the reasons outlined in the rest of this response. Only through competition can the Australian cash equities market realise the potential efficiencies than are observed in Europe.

*2. Are there alternative policy approaches to those outlined in this paper that you think should be considered by the Agencies? If so, please provide details.*

We have not identified any alternative approaches.

*3. Are there any other overarching issues that should be taken into consideration?*

We have not identified any other overarching issues.

### Competition

*4. What particular benefits would you expect to arise from competition in the clearing of Australian cash equities? What level of fee reduction, or specific innovation in product offerings or service enhancements would you expect to arise? Please share any relevant experiences from overseas or in related markets.*

### Fee levels

Specific fee levels are hard to estimate in the absence of necessary information on the precise nature of any regulatory requirements to be placed on LCH.Clearnet that would impact set-up and running costs, and indications of likely take-up from users. However we are confident that fee levels would be competitive and in the region of the cheapest tariff currently available from ASX Clear. Member firms who are also members of LCH.Clearnet would be able to benefit from connectivity and collateral efficiencies in international markets. This would be then be supplemented by the benefits accruing from other service enhancements and innovations that LCH.Clearnet can offer.

### Segregated Client Account Structures

LCH.Clearnet can offer the Australian market a choice of net omnibus, gross omnibus and completely segregated individual accounts at the CCP (Individual Segregated Accounts or "ISAs"). ISAs provide segregation not only at the clearing account but also at the settlement level so there is no commingling of settlements between house and client

accounts. This is a standard feature available to GCMs and their clients and one that we believe would be a welcome innovation in Australia.

#### GCM Risk Management Tools

In Europe, competition has driven, for example, both LCH.Clearnet and EuroCCP to improve their services to clearing members to enable them to better manage the risks arising from provision of GCM clearing services to their clients. Both EuroCCP and LCH.Clearnet Ltd have been developing competing offerings that provide enhanced trade and position controls on trading participant activity. This is evidence that, contrary to the CFR's warning that competition between CCPs could result in a 'race to the bottom', we are in fact seeing a 'race to the top' to provide innovative risk and CCP services. We believe there is scope to introduce similar innovations in Australia.

#### Value-added settlement services

The end-to-end post trade process is of course composed primarily of both the clearing service provided by CCPs and the settlement service provided by CSDs. CCPs are able to provide functionality to clearing firms that enable them to optimise their settlement processes at the CSDs thereby increasing the efficiency of the overall post-trade process and overcome possible deficiencies in the settlement process. This is another area where the introduction of competing CCPs drives efficiencies as CCPs use their technology and scale to provide automated and straight-through-processing solutions for market participants, and where benefits could be brought to the Australian market.

*5. What costs or other impediments might you expect that you, and the industry as a whole, may incur if competition in clearing emerged? Please provide a description of the nature of these costs and any relevant estimates?*

This question for participants, and therefore we do not comment.

*6. What are your views on the specific risks that competition in clearing could pose to market functioning and financial system stability? Do you think the 'minimum conditions' identified by the Agencies would be appropriate to both promote competition and protect the stability and effective functioning of securities markets? Are there any other conditions that should be considered or other issues that the minimum conditions should seek to address? Please describe these.*

We believe that the 'minimum conditions' identified in section 4.3 of the Consultation are appropriate – with the exception of the need to incorporate domestically beyond a certain threshold market share. We believe that this will serve only to prevent the entry of a competitor as the costs of establishing a separate CCP will be prohibitively expensive. We do not believe that there necessarily needs to be "a relatively long lead time for implementation" as the European experience has shown how these can be resolved. As previously mentioned, the EU Commission's equivalence decision in relation to Australia

provides a policy structure that enables the provision of CCP services by Australian CCPs in the EU without the necessity to incorporate locally, and we would welcome an arrangement in Australia that enables the same outcome.

*7. What changes, if any, would be necessary to effectively oversee a multi-CCP environment in the cash equity market (e.g. additional regulatory arrangements)?*

In 2013, ESMA published Interoperability Guidelines<sup>7</sup> outlining its view of how national supervisory authorities within the EU should supervise interoperability arrangements. We believe that a similar set of Guidelines could be introduced in Australia, adapted as appropriate for local conditions.

It would also be necessary to ensure that there is non-discriminatory access by CCPs to trades executed on the ASX market and for CCPs and their users to the CHESSE system to ensure competition on an equal basis to ASX Clear. These should cover at least settlement costs, settlement functionality, and equal CCP prioritisation in the CHESSE batch cycle.

*8. Is there likely to remain a single provider of equity settlement services, either in the short or long term? Should competition in clearing emerge, what implications might this have for the design of the equity settlement facility, the cost of equity settlement services, access to equity settlement for the competing CCP, and future investment in the settlement infrastructure? Would the Code be sufficient to achieve access to equity settlement on appropriate terms, or would an alternative regulatory approach be necessary?*

We believe that in the short term at least there will remain a single provider of settlement services. See our comments above at 7 for further regulatory controls on equal access to settlement.

*9. If competition in clearing emerged, should interoperability between CCPs be encouraged in Australia?*

Yes, as this will provide the best basis for CCP competition and enable the realisation of efficiencies and innovations in clearing as described in the Introduction.

*(a) How might competition in clearing affect the organisation and conduct of your operations? In the absence of interoperability, would you expect to establish connections to multiple trading platforms and CCPs? If so, would implications such as this diminish the commercial attraction of competition between CCPs?*

This question is addressed to market participants.

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<sup>7</sup> <http://www.esma.europa.eu/news/ESMA-publishes-guidelines-interoperability-arrangements>

*(b) With interoperability in place, would you expect to consolidate clearing in a single CCP? How would this decision be affected by best execution obligations? What effect would interoperability have on the costs that you may expect to incur from competition in clearing?*

This question is addressed to market participants.

*(c) What actions might the Agencies need to take (in addition to the requirements around management of financial exposures between interoperating CCPs specified in the Bank's FSS) in order to ensure that interoperability did not introduce additional financial stability risks? Would 'open access' obligations need to be imposed to facilitate interoperable links?*

We believe that open access obligations would be needed to ensure that interoperability did not introduce additional financial stability risks. See our recommendation at 7 above.

*(d) What are your views on the stability and effectiveness of interoperability between CCPs in other jurisdictions?*

Interoperability has been a feature of the European equity market structure for over ten years and has proved resilient and robust. There has been no adverse effect on financial stability in Europe throughout that period which included the default of Lehman Brothers and the failure of many other financial institutions.

*10. If the moratorium were lifted, would you expect a competing CCP to seek entry to the Australian market in the near future, noting the 'minimum conditions' set out in the Agencies' 2012 Report (refer to Section 4.3)? If competition were permitted but no competing CCP entered the market, at least for a time, should transitional regulatory measures (such as the existing Code) remain in place until such time as competition did emerge?*

As stated above, we believe that the domestic location requirement prevents a competing CCP from entering the Australian market in the near future. We do not comment on what transitional regulatory measures would be appropriate in that circumstance, believing this is a matter on which market participants are best placed to comment. However, we do support the introduction of a policy framework to allow competitive clearing into the Australian market in a manner that would not be frustrated by undue barriers or obstacles to entry.

*11. If the moratorium on competition were to be lifted, would the threat of competition be sufficiently credible to encourage ASX to retain and adhere to the Code, or would the Code need to be mandated (see Section 5.4)?*

We have no comment on the likely behaviour of ASX.

*12. Would you support an extension to the moratorium on competition in clearing? If so, why? What time period would be appropriate before the industry was ready for competition in clearing to emerge?*

We do not support an extension to the moratorium on competition in clearing. There are already commercial and regulatory barriers to the emergence of competition, we do not believe these should be reinforced by legislative barriers.

Monopoly

We do not comment on qq. 13-19 beyond the points set out above.

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We hope that the CFR finds this submission useful and we look forward to engaging further as policies are developed. Please do not hesitate to contact me at [rory.cunningham@lchclearnet.com](mailto:rory.cunningham@lchclearnet.com) regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours faithfully



**Rory Cunningham**  
**Director, Asia Pacific Compliance & Asia-Pacific Regulatory Affairs**