Application for authorisation

by

Australian Stock Exchange Limited

and

Options Clearing House Pty Ltd

In respect of clearing of options traded on ASX's Derivatives Market

Authorisation number
A90758

Commissioners
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Summary

On 10 November 2000, the Australian Stock Exchange Limited (ASX) and ASX's wholly owned subsidiary, the Options Clearing House Pty Ltd (OCH), applied for authorisation of third line forcing conduct relating to the clearing of options contracts which are traded on the ASX Derivatives Market. The application was made under section 88(8) of the *Trade Practices Act 1974* (the Act) in respect of conduct which may constitute exclusive dealing under section 47 of the Act.

The applicants are seeking authorisation of the requirement that as a precondition to participation in the ASX Derivatives Market, Trading Participants are to acquire clearing services either directly or indirectly from OCH. They are also seeking authorisation of the requirement that to obtain clearing services from OCH in respect of transactions on the ASX Derivatives Market, organisations must be ASX Clearing Participants and such clearing services are provided on condition that Clearing Participants agree to abide by the ASX Business Rules and procedures in force from time to time.

The Commission authorised these requirements in 1995. Previously, the Commission had authorised similar arrangements since 1976, in relation to the trading of options on the Sydney Stock Exchange Limited.

On 3 August 2001, the Commission issued a draft determination proposing to grant authorisation to the requirement that as a precondition to participation in the ASX Derivatives Market, Trading Participants must obtain clearing services from OCH, as embodied in ASX Business Rules 7.2.1.1 – 7.2.1.3 until one year after the date of Royal Assent of the *Financial Services Reform Act 2001* (FSR Act) or, in the event that the *Financial Services Reform Bill 2001* was not promulgated, for no more than five years. Royal Assent of the FSR Act took place on 27 September 2001.

The Commission also proposed not to grant authorisation to the requirement that an organisation must be an ASX Clearing Participant in order to access OCH clearing services in respect of options transactions on the ASX Derivatives Market, as embodied in ASX Business Rules 10.2.1.1 and 10.2.1.3(b). The Commission invited submissions on this issue, before it issued a final determination.

Following a pre-decision conference on 13 September 2001 and a Regulators' Roundtable on 20 September 2001, the Commission received further submissions from interested parties.

Third line forcing of clearing services

The Commission notes that the requirement that as a precondition of participation on the ASX Derivatives Market, Trading Participants acquire clearing services from OCH, creates a barrier to competition between clearing houses.

In this context, the Commission notes the consensus between regulators at the Roundtable meeting on 20 September 2001 at which the Commonwealth Department of the Treasury (Treasury), the Reserve Bank of Australia (the Reserve Bank) and the

Australian Securities and Investments Commission (ASIC) agreed that barriers to competition between clearing houses should be removed in line with the policy objectives of the FSR Act, although ASIC expressed the view that a decision to allow more than one clearing house to service the one financial market should not be taken until after any problems with the transition to the new regulatory regime have been ironed out. In response to ASIC's concerns, Treasury and the Reserve Bank noted that this issue could be addressed through the licensing provisions of the FSR Act.

The Commission acknowledges that at the present time, before the full implementation of the FSR Act, there appear to be benefits associated with clearing all options contracts traded on markets operated by ASX on a single clearing house. This is largely because of the benefits associated with the OCH assuming the position of central counterparty clearer.

However, the reforms contained in the FSR Act are intended to increase competition by lowering barriers to entry and encouraging new participants to operate competing markets and clearing and settlement facilities.[1] In particular, these reforms will permit (but not require) more than one clearing and settlement facility to handle the clearing and settlement of transactions executed on the one financial product market.[2]

In light of these changes in the regulatory environment, the Commission considers that it would not be appropriate to grant authorisation to the conduct for an extended period of time given that the conduct would not appear to be consistent with the policy objectives of the FSR Act.

The Commission has decided to grant authorisation for twelve months from the date this authorisation comes into force, on the basis that this provides for a reasonable transition period.

Third line forcing of membership in ASX & compliance with ASX Business Rules

In relation to the requirement that an organisation be a Clearing Participant to access OCH clearing services in respect of options transactions on the ASX Derivatives Market, and agree to abide by the ASX Business Rules in place, the Commission considers that this conduct, which assures the enforceability of OCH's business rules until the FSR Act is fully implemented, is likely to result in such a benefit to the public that the conduct should be allowed to take place in the short term.

The Commission has decided to grant authorisation for twelve months from the date this authorisation comes into force, on the basis that this provides for a reasonable transition period.

Scope of authorisation

It is proposed that this authorisation be limited only to cover options which are traded on the ASX Derivatives Market.

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[1] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraph 2.57.
[2] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraph 8.3.

Abbreviations

ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange Limited
Commission	Australian Competition and Consumer Commission
Corporations Act	*Corporations Act 2001*
FSR Act	*Financial Services Reform Act 2001*
NGF	National Guarantee Fund
OCH	Options Clearing House Pty Ltd
Reserve Bank	Reserve Bank of Australia
SDIA	Securities and Derivatives Industry Association
SFE Corporation	SFE Corporation Limited
SSE	Sydney Stock Exchange Limited
The Act	*Trade Practices Act 1974*
Treasury	Commonwealth Department of the Treasury

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1. Introduction

1.1 On 10 November 2000, the Australian Stock Exchange Limited (ASX) and the Options Clearing House Pty Limited (OCH) lodged an application for authorisation, A90758, with the Australian Competition and Consumer Commission (the Commission) under section 88(8) of the *Trade Practices Act 1974* (the Act)[3], in respect of conduct that constitutes, or may constitute, exclusive dealing. The conduct concerns clearing procedures on the OCH.

1.2 The arrangements the subject of this application are embodied in ASX Business Rules. ASX Business Rule 7.2.1.1 provides that only Trading Participants are entitled to enter into options transactions on the ASX Derivatives Market. A derivatives Trading Participant must be either:

- an ASX Participating Organisation, in which case they must also be a Clearing Participant or obtain services from a Clearing Participant; or
- a Registered Independent Options Trader, in which case they must obtain clearing services from a Clearing Participant.

1.3 In effect, Trading Participants on the ASX must clear options traded on the ASX Derivatives Market through a Clearing Participant of the OCH.

1.4 ASX Business Rule 10.2.1.3(b) requires that Clearing Participants agree to comply with the ASX Business Rules and Procedures and any directions from either the ASX or OCH. An organisation wishing to obtain clearing services directly from OCH in respect of transactions on the ASX Derivatives Market must be recognised as a Clearing Participant. The applicants highlighted that this does not mean that OCH is limited to providing clearing house services to the ASX Derivatives Market. In effect, to be admitted as a Clearing Participant, an applicant must apply to the ASX to be admitted as a Clearing Participant, and must agree to comply at all times with the Rules, Procedures, practices, directions, decisions and requirements of the Exchange and the Clearing House.

1.5 This authorisation application is essentially designed to replace an existing authorisation of the same conduct, which was granted in 1995, and which expired on 16 November 2000.

1.6 Prior to this, in 1976 the Commission granted authorisation to the Sydney Stock Exchange Limited (SSE) and the OCH in respect of third line forcing requirements that all options transactions negotiated on the Australian Options Market be registered with and cleared through the OCH. In 1987 there was an amalgamation of the SSE with all the state exchanges, to form the ASX.

1.7 On 15 November 2000, the Commission issued the parties with interim authorisation for the period during which the merits of the application were assessed. The interim authorisation will cease operation on the date this determination comes into force.

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[3] The application has also been considered as an application under the Competition Code.

1.8 The Commission issued a draft determination on 3 August 2001 proposing to grant authorisation to the third line forcing of clearing services for a period of one year from the date of Royal Assent of the *Financial Services Reform Act 2001* (FSR Act). The Commission did not propose to grant authorisation to the third line forcing of membership requirements.

1.9 A pre-decision conference was requested by ASX and was held on 13 September 2001 in Sydney. A record of the conference is on the Commission's public register. An outline of the main issues raised at the conference is at Section 6 of this determination.

1.10 A Regulators' Roundtable was held on 20 September 2001 in Canberra. A record of this meeting is on the Commission's public register. An outline of the main issues discussed at the meeting is at Section 6 of this determination.

2. Background to the application

The ASX and the OCH

2.1 The ASX operates, among other things, a securities market. This securities market consists of an equities market, and a derivatives market (the ASX Derivatives Market), which is governed by the ASX Business Rules. The ASX Derivatives Market facilitates transactions in a range of derivative contracts approved by the Exchange from time to time, including options and share ratio contracts. The applicants have indicated that share ratio contracts are, however, no longer traded.

2.2 An option is a contract which conveys a right, but not an obligation, to buy (a call option) or to sell (a put option) an underlying security at a predetermined price, typically, before or after a specified time.

2.3 The OCH is a wholly owned subsidiary of the ASX. The OCH currently provides clearing services in respect of trades made on the ASX Derivatives Market.

Trading and clearing in a derivatives market

2.4 The clearing function can be described as the process of calculating the obligation of a participant to make payments or deliver securities. It also usually involves assessing the availability of funds and securities in preparation for settlement of the transaction. Clearing systems may either operate on a gross settlement (that is, a transaction by transaction) basis (such as RITS and Austraclear), or on a net settlement basis (such as CHESS, the OCH and the clearing house operated by the SFE Clearing Corporation Pty Ltd), where net obligations arising from trades and open contracts are calculated at the end of each day.

2.5 The process of trading in derivatives differs from trading on securities markets, as participants do not buy or sell a physical instrument. Rather, in a derivatives market, the exchange sets the contracts (this is called the "contract series") that participants can trade, and when a trade occurs, a buyer takes a "bought position" and the seller takes a "sold position". The contract is registered with the clearing house, and through the novation process, the clearing house becomes the counterparty to both the buyer and the seller (the clearing house becomes the buyer to each seller and the seller to each buyer). If the buyer then wishes to exit the market, then he/she can enter into another transaction on the market in the same contract series with any buyer who is willing. On execution of this trade, the original buyer will have a "sold position" in the same contract in which he/she previously had a "bought position". As these positions are in respect of the same contract, the positions are set off against each other.

2.6 Once an options contract is registered with the OCH, the responsibility for performance of the contract is taken over by the OCH, which adopts the position of a central counterparty clearer. In doing so, the OCH guarantees

performance of the contract to the relevant Clearing Participant in whose name the contract is registered. In order to be able to fulfil this guarantee of performance, the OCH engages in various risk management activities, such as continually monitoring the financial position of Clearing Participants, price movements, and the number of open positions held by Clearing Participants. The OCH also administers a system of margining, which is a risk management technique central to the role and operation of the clearing house.

2.7 When an options contract is initially registered with the OCH, the relevant Clearing Participants are required to pay the OCH an initial margin. Each day the OCH calls from each Clearing Participant whose position has been adversely affected by the previous day's price movements an amount, or margin, equal to the decline in the value of that Participant's open position. At the same time, the margins of Clearing Participants whose positions have improved because of price fluctuations will be in credit.

The Financial Services Reform Act 2001

2.8 The regulatory environment for financial services is subject to considerable change with the passage of the FSR Act. The three key elements of the regime embodied in the FSR Act are:

- product disclosure;
- licensing and conduct of financial services providers; and
- licensing of financial markets and clearing and settlement facilities.

2.9 The FSR Act will commence on 11 March 2002. The reforms contained in the FSR Act are intended to increase competition by lowering barriers to entry and encouraging new participants to operate competing markets and clearing and settlement facilities.[4] In particular, these reforms will permit (but not require) more than one clearing and settlement facility to handle the clearing and settlement of transactions executed on the one financial product market.[5] Additionally, and of specific relevance to the present authorisation application, the FSR Act will address the current inconsistency between Chapters 7 and 8 of the *Corporations Act 2001* (Corporations Act) whereby Chapter 8 of the Corporations Act independently recognises a futures clearing house with its own set of business rules while Chapter 7 of the Corporations Act does not provide equivalent recognition for securities clearing houses (other than those dealing with Securities Clearing House, operator of the CHESS system).

Transition to the Financial Services Reform Act 2001

2.10 The *Financial Services Reform (Consequential Provisions) Act 2001* provides for the transition to the new regulatory regime for the financial services industry outlined in the FSR Act. According to the Explanatory Memorandum of the

[4] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraph 2.57.
[5] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraph 8.3.

Financial Services Reform (Consequential Provisions) Bill 2001, the transitional provisions are divided into two categories:

- Those dealing with the application of the FSR Act to different groups of people. In many circumstances, existing participants will be able to choose the time, during the two-year transitional period, at which the Financial Services Reform regime will begin to apply to them by 'opting in'.
- Those dealing with how a person moves from any one of the existing regulatory regimes into the Financial Services Reform regime. Relevant issues here are, for example, the extent to and way in which conduct undertaken under a former regime is recognised under the Financial Services Reform regime. The FSR Act does not set out the specific rules dealing with these situations but instead provides for regulation making powers and powers for the Australian Securities and Investments Commission (ASIC) to make such rules. These transitional provisions relate to the licensing of trading and clearing and settlement functions.

2.11 The *Financial Services Reform (Consequential Provisions) Act 2001* also contains other consequential amendments to a range of Commonwealth legislation as a result of the provisions contained in the FSR Act.

3. The application

3.1 Application A90758 was lodged under section 88(8) of the Act in respect of conduct that constitutes or may constitute exclusive dealing pursuant to section 47 of the Act.

3.2 The ASX and OCH seek authorisation of the requirement that as a precondition to participation in the ASX Derivatives Market, Trading Participants are to acquire clearing services either directly or indirectly from OCH. This requirement is embodied in ASX Business Rule 7.2.1.1 which provides that only Trading Participants are entitled to enter into options transactions on the ASX Derivatives Market. A derivatives Trading Participant must be either :

- an ASX Participating Organisation, in which case they must also be a Clearing Participant or obtain services from a Clearing Participant; or
- a Registered Independent Options Trader, in which case they must obtain clearing services from a Clearing Participant.

3.3 The applicants are also seeking authorisation of the requirement that to obtain clearing services from OCH in respect of transactions on the ASX Derivatives Market, organisations must be ASX Clearing Participants and such clearing services are provided on condition that Clearing Participants agree to abide by the ASX Business Rules and procedures in force from time to time. This requirement is embodied in ASX Business Rule 10.2.1.3(b) which requires that Clearing Participants agree to comply with the ASX Business Rules and Procedures and any directions from either the ASX or OCH. An organisation wishing to obtain clearing services directly from OCH in respect of transactions on the ASX Derivatives Market must be recognised as a Clearing Participant. The applicants highlighted that this does not mean that OCH is limited to providing clearing house services to the ASX Derivatives Market.

4. The statutory tests

4.1 This application was made under section 88(8) of the Act in respect of exclusive dealing (third line forcing) conduct. The Act provides that the Commission shall only grant authorisation if the applicant satisfies the relevant test in section 90(8) of the Act.

4.2 Section 90(8) provides that the Commission shall grant authorisation under section 88(8) only if it is satisfied, in all the circumstances, that the third line forcing conduct would result, or be likely to result, in such a benefit to the public that the conduct should be allowed to take place.

4.3 In practice, this test involves assessing in all the circumstances, the likely public benefits and likely public detriment constituted by any lessening of competition resulting from the conduct, and weighing the two to determine which is the greater.

4.4 Should the public benefits or expected public benefits outweigh the anti-competitive detriment, the Commission may grant authorisation or grant authorisation subject to conditions.

4.5 The Commission is unable to grant authorisation if it is unlikely that the arrangements will result in a benefit to the public, or any likely public benefit will not outweigh the likely anti-competitive detriment. In refusing authorisation, the Commission may indicate to the applicant how the application could be constructed to change the balance of detriment and public benefit so that the authorisation may be granted.

4.6 Section 88(10) provides that an authorisation application may be expressed to apply to or in relation to another person who subsequently becomes a party to the contract, arrangement or understanding, at a time after it is made or arrived at, or after an authorisation is granted.

5. Submissions

5.1 The Commission sought submissions on the application from a range of interested parties, including the Reserve Bank of Australia (Reserve Bank), ASIC, the SFE Corporation Limited (SFE Corporation), the Securities and Derivatives Industry Association (SDIA), the Australian Financial Markets Association and the Commonwealth Department of the Treasury (Treasury).

5.2 In addition to the submission of the applicants, written submissions were received from the ASIC, the Reserve Bank, SDIA and the SFE Corporation.

Submission from applicants

5.3 The applicants asserted that the conduct for which they are seeking authorisation forms part of the regulatory framework necessary to ensure the financial integrity and efficiency of the ASX Derivatives Market, as well as facilitating the effective prudential supervision of those participating in the trading and clearing of options transactions entered into on that market.

5.4 The applicants stated that the financial integrity of the market is best facilitated by requiring that all contracts for such derivative instruments be registered with a central clearing house. They stated that to provide participants in derivatives markets with the ability to choose the clearing house they wish to use reduces the efficiency of the underlying market, and increases risks in the clearing and settlement system. This would ultimately increase the risks for investors, and increase indirect costs on market participants.

5.5 In their submission, the applicants stated that they support competition in the provision of clearing services whereby clearing houses offer exclusive services to a number of exchanges.

5.6 In expressing support for competition amongst clearing houses, the applicants drew a distinction between two potential levels of competition in this area. Firstly, the applicants referred to competition in which multiple clearing houses compete in the provision of clearing services to the one exchange, and market participants nominate a preferred clearing house to clear and settle particular transactions. Secondly, the applicants referred to competition in which clearing houses compete to provide exclusive clearing services to multiple markets (for example, OCH supplying clearing services to the ASX Derivatives Market and to the ASX Futures Exchange).

5.7 In regard to the first situation, in which multiple clearing houses provide clearing services to one market, the applicants submitted that under the existing framework, this model is inappropriate for the derivatives market, due to the additional risks inherent in such markets, and the central role played by the clearing house in monitoring and managing those risks. The applicants asserted that under the current framework, those risks could not be managed as efficiently or as cost effectively if multiple clearing houses cleared the one

market. The applicants stated that it was not aware of any example in Australia or overseas where a derivatives market uses multiple clearing houses.

5.8 The applicants submitted that in the absence of some mechanism for transferring both open positions in a contract to an agreed clearing house, the existence of multiple clearing houses in a derivatives market would result in the formation of pools of liquidity. The applicants stated that it is essential for risk management purposes that both sides of a contract are cleared through the one clearing house. It claimed that liquidity on a market would be illusory if only a portion of the open positions in a given instrument are registered with a particular clearing house. This is because such a situation would mean that any market participant seeking to close out a contract would be able to do so only if the other side of the contract was agreeable to registering their side of the contract with the same clearing house.

5.9 The applicants were of the view that the presence of multiple clearing houses would significantly increase the costs imposed upon clearing participants. They stated that if multiple clearing houses did exist, then in order to minimise difficulties, it would be necessary for all clearing participants to be members of each clearing house, or alternatively, it would be necessary for them to attempt to find a mechanism whereby positions could be efficiently transferred to an agreed clearing house. The applicants were of the view this would involve substantial costs, and may result in a number of current clearing participants withdrawing from the market, hence reducing the level of competition amongst clearing participants. The applicants estimated that the costs of joining multiple clearing houses would be in the order of several hundred thousand dollars per clearing participant, not inclusive of the additional requirements of many clearing houses to contribute to a clearing house guarantee fund. The applicants considered it to be unlikely that the entry of new clearing houses would reduce clearing costs per transaction so as to outweigh the substantial costs of establishment and ongoing operation. They considered that therefore, even in the event that market participants could choose between multiple clearing houses, it is unlikely that there would be sufficient demand from clearing participants to warrant the use of more than one clearing house.

5.10 In addition, the applicants identified that if clearing participants held open positions in various clearing houses, then market risk would be increased, which could create additional risk for the respective clearing houses. The applicants predicted that this added risk would cause clearing houses to increase margin requirements, which would constitute additional costs and inefficiencies for the underlying markets being served by those clearing houses.

5.11 The second potential level of competition identified by the applicants concerns a clearing house providing exclusive services to multiple markets. The applicants stated that they actively support this model for derivatives markets, as evidenced by the arrangements which OCH entered into with the Australian Derivatives Exchange Ltd in 2000, and the arrangements it has recently entered into with the ASX Futures Exchange.

5.12 The applicants acknowledged that all these cases involve third line forcing conduct. They asserted that in the context of derivatives markets, it is necessary to have a framework which involves exclusive dealing arrangements for certain periods of time. This is due to the fact that not having a central counterparty clearer in a derivatives market would be detrimental to the efficiency and regulation of the underlying market.

5.13 The applicants stated that in the absence of authorisation of the particular conduct, ASX initiatives to develop new products to be traded on the ASX Derivatives Market would be adversely affected. The applicants explained that this is because there may not be a market for those instruments where the ASX is not able to guarantee appropriate and cost effective risk management and margining procedures which are available through the use of a central clearing house.

5.14 The ASX and OCH are also seeking authorisation of a requirement that an organisation must be an ASX Clearing Participant in order to access OCH clearing services in respect of options transactions on the ASX Derivatives Market. The effect of this requirement is that Clearing Participants of the OCH must be members of the ASX. The applicants claim that this is necessary because, in order to ensure that market participants do not take counterparty risk on each other, options entered into on the ASX Derivatives Market are novated to the OCH, and the OCH, in turn, requires that counterparties to novated contracts are Clearing Participants.

5.15 The applicants stated that this requirement by OCH ensures that the counterparties meet certain minimum standards in respect of having sufficient financial and organisational resources to meet their contractual obligations to the OCH, and it seeks to ensure that such organisations are contractually bound by the regulatory framework constituted by the ASX Business Rules. This protects the financial integrity of the ASX Derivatives Market. The applicants claim that it also allows the OCH to discharge its obligations to the ASX as ASX's clearing house. It also enables the ASX to satisfy its statutory obligations to maintain fair and orderly markets.

Submissions from interested parties

Australian Securities and Investments Commission

5.16 ASIC lodged a submission expressing support for the applicants' authorisation application. ASIC stated that it believed that there was significant public benefit in allowing the current arrangements to continue in the short term.

5.17 ASIC considered that the current arrangements for ASX and OCH should be allowed to continue until they have completed their transition under the FSR Act, and the relevant financial markets have the opportunity to develop a workable model that permits clearing and settlement services for licensed derivatives markets to be provided by third parties unrelated to market providers.

5.18 ASIC stated that it remains of the view that clearing arrangements under which participants in a licensed derivatives market have the choice as to who they would use to clear their transactions is likely to be detrimental to the efficiency and regulation of the derivatives market.

5.19 ASIC noted that novation to a central counterparty enhances the liquidity in each market by allowing participants to deal without the need to assess the creditworthiness of counterparties, or accept credit risk from counterparties whose identity is unknown until after the contracts are made.

5.20 ASIC stated that trading participants already have a choice as to which clearing participant to use. If there was also a choice of clearing houses, the practical effect would be that there would be no central counterparty. Rather, there would be a number of "central counterparties" each of whom would need to manage the risks of exposure to common clearing participants, who may in turn participate in more than one derivatives market.

5.21 ASIC stated that risk management, reporting of trades and supervision of clearing participants in more than one clearing house would require a significant degree of cooperation between the clearing houses and the market operator, because no one entity would have access to the total exposure a trading or clearing participant may have to the market. ASIC was of the view that the practical difficulties which would have to be overcome in achieving the necessary degree of cooperation would be likely to increase risks to investors, and pose a threat to the integrity of the clearing and settlement systems.

Reserve Bank of Australia

5.22 The Reserve Bank considered that the applicants had not made a sufficiently strong case for continuing to allow a clearing house to require its members to be a member of a related exchange. The Reserve Bank highlighted that the provision of exchange and central counterparty services are quite separate functions, and do not require exclusive arrangements between related entities in order to operate efficiently and safely.

5.23 The Reserve Bank stated that central counterparty clearing system membership requirements should be based on objective criteria which aim to ensure that members are able to fulfil their contractual obligations in an objective and efficient manner, and do not expose the central counterparty to unacceptable risk. Where these contractual obligations require the delivery of a particular security or other asset, the trade to give effect to this obligation should be able to be done on an appropriately regulated exchange or on an over-the-counter market, rather than one owned by the same entity which owns the clearing house. The Reserve Bank stated that membership of a financial market exchange should be based on objective criteria which reflect the exchange's legitimate interest in ensuring that trades on its markets are settled efficiently and safely.

5.24 On the issue of third line forcing of clearing services, the Reserve Bank considered that it may be appropriate for an exchange to nominate a default

clearing and settlement system for efficiency reasons, and it may be appropriate for an exchange to have details of its trading members' overall position, to enable it to perform its market oversight function. However it stated that these objectives could be met without identifying a specific related central counterparty through which all members must clear their trades.

Securities and Derivatives Industry Association

5.25 The SDIA is the national industry body representing stockbroking firms in Australia. SDIA has over 65 member organisations, and represents over 95% of the stockbroking firms in Australia.

5.26 The SDIA lodged a submission in support of the authorisation application. It saw benefits in restricting trading participants in the ASX to clearing through the OCH, in terms of better management of counterparty risk and prudential standards. The SDIA considered that these benefits would outweigh any adverse price impact on users.

5.27 However the SDIA stated that it may be appropriate to review the policy again in the future, if there are significant changes in the domestic clearing and settlement environment.

SFE Corporation Limited

5.28 The SFE Corporation expressed support for the Commission's authorisation of the ASX's requirement that Trading Participants acquire clearing services from OCH as a precondition of participation in the ASX Derivatives Market. The SFE Corporation was of the view that in the absence of third line forcing, there would not be any viable replacement rules in the circumstances.

5.29 In respect of the requirement that to obtain clearing services from OCH in respect of transactions on the ASX Derivatives Market, organisations must be ASX Clearing Participants and such clearing services are provided on the condition that Clearing Participants agree to abide by the ASX Business Rules in place at the time, the SFE Corporation highlighted that it has demonstrated that it is viable to effect a complete separation of the exchange and clearing house rules. The SFE Corporation claimed that whether this is necessary depends on whether there are any ASX Business Rules which should not be imposed upon ASX Clearing Participants. The SFE Corporation stated that it did not know whether this was the case or not.

6. Draft determination, pre-decision conference, Regulators' Roundtable and subsequent submissions

Draft determination

6.1 On 3 August 2001, the Commission issued a draft determination proposing, subject to any pre-decision conference, to:

- Grant authorisation to the requirement that as a precondition to participation in the ASX Derivatives Market, Trading Participants must obtain clearing services from OCH, as embodied in ASX Business Rules 7.2.1.1 – 7.2.1.3.

- In the event that the *Financial Services Reform Bill 2001* is promulgated, grant authorisation until one year after the date of Royal Assent, on the basis that this provides for a reasonable transition period. In any event, the Commission proposed to grant authorisation for a period of no more than five years.

- Limit the authorisation to only cover options which are traded on the ASX Derivatives Market.

- Not grant authorisation to the requirement that an organisation must be an ASX Clearing Participant in order to access OCH clearing services in respect of options transactions on the ASX Derivatives Market, as embodied in ASX Business Rules 10.2.1.1 and 10.2.1.3(b). The Commission invited submissions on this issue before it issued a final determination.

Further submission by the applicant

6.2 A further written submission (a copy of which is on the public register) was provided to the Commission by the applicant in response to the Commission's draft determination and to support the arguments raised by the applicant at the pre-decision conference. The main points are outlined below.

Third line forcing of clearing services - period of authorisation

6.3 ASX expressed concern regarding the Commission's proposal to authorise the third line forcing of clearing services for a period of one year after the date of Royal Assent of the FSR Act.

6.4 ASX submitted that:

- Under the transitional arrangements to the new Financial Services Reform regime, operators of existing markets and clearing and settlement facilities will obtain transitional licences to afford time to complete their transition to the new regulatory framework. In most cases, the transitional licences will expire at the end of two years from the commencement of the FSR Act or when the licensee applies to vary the terms of the licence, whichever occurs first.

- ASX is conducting a significant review of its business to identify and implement any changes necessary to comply with the FSR Act. ASX anticipates that it will require the full two year period available under its transitional licence to complete the review.
- If the conduct were only authorised for a period of twelve months from the date that the FSR Act is proclaimed, ASX and OCH would need to make significant changes that could, it was argued, result in them losing their transitional licences and force both organisations to prematurely complete their transition to the Financial Services Reform regime.

6.5 In this context, ASX sought authorisation of the conduct for a period of 2 years from:

- the date of commencement of the FSR Act; or
- the date on which ASX and OCH complete their transition to the FSR Act, whichever occurs first.

6.6 In its submission, ASX noted that ASIC is of the view that authorisation should be granted until ASX and OCH have completed their transition to the new regulatory framework.

Third line forcing of membership in ASX and compliance with ASX Business Rules

6.7 ASX expressed concern regarding the Commission's proposal not to authorise the requirement that Clearing Participants must be ASX Participating Organisations and agree to comply with the ASX Business Rules in order to access clearing services provided by OCH.

6.8 ASX submitted that:

- While Chapter 8 of the Corporations Act independently recognises a futures clearing house with its own set of business rules, there is no equivalent provision in Chapter 7 of the Corporations Act for securities clearing houses other than those dealing with the Securities Clearing House (operator of the CHESS system). This means that while SFE Corporation can separate its exchange and clearing rules, there is currently no process for OCH to seek formal recognition or approval as a securities or options clearing house with its own independent business rules. This anomaly will be addressed by the FSR Act.
- ASX Business Rules have statutory recognition under the Corporations Act and can be enforced by ASIC, ASX, participants and investors under the Corporations Act.
- In order for the derivatives clearing rules to be recognised at law, and be enforceable, it is necessary therefore for the rules to be included in the ASX Business Rules.
- If the Commission fails to authorise this conduct, OCH would need to establish its own business rules but such rules would not be recognised or enforceable under the existing Corporations Act.

- It is necessary for the derivatives clearing rules to form part of the ASX Business Rules so that the investor protection function of the National Guarantee Fund (NGF) remains available to OCH clearing participants and their clients. If OCH were required to have its own separate rules, the protection of the NGF would be lost.

6.9 In this context, ASX sought authorisation of the conduct for a period of 2 years from:

- the date of commencement of the FSR Act; or
- the date on which ASX and OCH complete their transition to the FSR Act, whichever occurs first.

Pre-decision conference

6.10 ASX requested a conference, which was held on 13 September 2001 in Sydney and attended by ASX, ASIC, SFE Corporation and Treasury. A record of the conference has been placed on the Commission's public register. The main issues raised at the conference are noted below.

6.11 **ASX** expressed concern regarding the Commission's proposal to:

- authorise the third line forcing of clearing services for a period of one year after the date of Royal Assent of the FSR Act; and
- not authorise the requirement that Clearing Participants must be ASX Participating Organisations and agree to comply with the ASX Business Rules in order to access clearing services provided by OCH.

6.12 In respect of third line forcing of clearing services, ASX considers that an authorisation period of less than two years could adversely affect ASX's operations by imposing a premature transition to the new regulatory regime without the benefit of a proper and detailed analysis.

6.13 ASX argued that should the Commission not grant authorisation to third line forcing of membership in ASX and compliance with ASX Business Rules, and OCH be required to establish its own business rules, OCH's business rules would not be recognised or enforceable under the existing Corporations Act and trading activity in the options market would not be guaranteed by the NGF.

6.14 **ASIC** advised that its position remained consistent with the stance outlined in its submission of 10 September 2001. In summary, this submission argued that the current arrangements between OCH and ASX promote the objectives of investor protection and integrity of clearing and settlement facilities and so should be allowed to continue during the transition period under the FSR Act.

6.15 **SFE Corporation** explained that it was interested to ensure a consistent approach to similar issues affecting similar markets. SFE Corporation noted that it has severed the links between its exchange and clearing rules.

6.16 **Treasury** supported the Commission's proposal to grant authorisation to the third line forcing of clearing services for a period of one year after the date of Royal Assent of the FSR Act. Treasury noted that the rigidities in the NGF would be lessened after March 2002 and advised that it hadn't envisioned any great impositions on ASX during the transitional period to the new regulatory regime.

Regulators' Roundtable

6.17 On 20 September 2001 representatives of the Commission, the Reserve Bank, ASIC and Treasury attended a roundtable meeting to discuss financial market clearing arrangements. This roundtable discussion dealt with issues that are relevant to the Commission's consideration of the ASX and SFE Corporation authorisation applications currently before it and consequently, a record of this meeting has been placed on the Commission's public register. The main issues discussed at the roundtable are noted below.

6.17.1 The meeting identified a consensus among Treasury, the Reserve Bank and ASIC that the barriers to competition between clearing houses should be removed in line with the policy objectives of the FSR Act, although ASIC expressed the view that a decision to allow more than one clearing house to service the one financial market should not be taken until after any problems with the transition to the new regulatory regime have been ironed out. Treasury and the Reserve Bank noted that these practical problems could be worked out through the licensing process and, in particular, by using the power to impose conditions on licences.

6.17.2 Treasury and the Reserve Bank accepted that the Commission's proposal to authorise the third line forcing of clearing services for a further 12 months provided a workable transition period. Treasury also advised that the Commission's proposed 12 month authorisation period is not inconsistent with the FSR Act.

6.17.3 Treasury and ASIC clarified some regulatory concerns with the Commission's proposal not to authorise the third line forcing requirement that OCH's clearers must be members of the ASX. Treasury and ASIC advised that these concerns only arise during the transition period under the Financial Services Reform regime. Treasury and the Reserve Bank expressed the view that this problem could be resolved by authorising the arrangements for a period of one year, during which OCH could apply to become a licensed options clearing house. Once OCH is licensed under the Financial Services Reform regime, there is no regulatory need for OCH's clearers to be members of ASX.

Subsequent submissions from interested parties

6.18 Written submissions (copies of which are on the public register) were provided to the Commission by ASIC, the Reserve Bank, SFE Corporation and Treasury.

Australian Securities and Investments Commission

6.19 In its submission, ASIC recognises that it is possible for there to be multiple clearers for a market, although it considers that such an approach will require detailed consideration of various measures to ensure the integrity of the market, such as the need for effective information sharing arrangements between clearers, and between the market operator and each clearer. ASIC notes that these potential complications would not be present in the alternative model of clearers competing to provide all the clearing and settlement for a market in a contestable environment.

6.20 ASIC considers that until the FSR Act is fully implemented and market participants have brought themselves fully within the new regime, continuing market integrity requires that the business rules of OCH remain subject to Ministerial disallowance. Maintaining the requirement for membership of ASX by participants of OCH ensures that the business rules of OCH remain subject to Ministerial disallowance prior to the full implementation of the FSR Act.

6.21 ASIC noted that it is unable to say definitively whether any market operator will need the full, two year, period to complete the transition to the new regulatory regime.

Reserve Bank of Australia

6.22 The Reserve Bank restated its view that the provision of exchange and central counterparty clearing services are quite separate functions and do not require exclusive arrangements between related entities to operate efficiently and safely. The Reserve Bank believes that the provision of clearing and exchange services should be contestable although it does not envisage that market pressures will result in an extended period in which two central counterparty clearers serve a single market.

6.23 Although the Reserve Bank does not believe that the case has been made for reauthorising the third line forcing of related services by the ASX, it does consider that it is desirable to avoid regulatory uncertainty before the commencement of the FSR Act. In particular, the Reserve Bank notes the importance of ensuring regulatory coverage of OCH by the Minister and ASIC. For these reasons, the Reserve Bank does not object to the Commission reauthorising the third line forcing conduct of ASX for a short period of time.

SFE Corporation Limited

6.24 SFE Corporation submits that the issues raised by ASX's application for authorisation of third line forcing conduct in respect of clearing services and membership services are similar to the issues raised by SFE Corporation's applications for authorisation (A90756 and A90757) of third line forcing conduct relating to the operation and membership of the SFE Clearing Corporation Pty Ltd and in respect of the clearing of futures traded on markets operated by the SFE Corporation. SFE Corporation is concerned that the

Commission adopt a consistent position in relation to its assessment of the ASX and SFE Corporation applications for authorisation. Additionally, SFE Corporation considers that this consistent approach should be extended to the Commission's assessment of the notifications (N90875 and N90876) lodged by ASX Futures Exchange Pty Limited and OCH concerning third line forcing conduct in respect of clearing services and membership services pertaining to ASX's proposed futures market.

6.25 SFE Corporation considers that the Commission:

- should not authorise the requirement that an organisation must be an ASX Clearing Participant in order to access OCH clearing services in respect of options transactions on the ASX Derivatives Market; and
- should authorise the requirement that as a precondition to participation in the ASX Derivatives market, Trading Participants must obtain clearing services from OCH, for a period of twelve months from the date of Royal Assent of the FSR Act.

6.26 SFE Corporation noted that the FSR Act may not result in the trades effected on a particular market being clearing through multiple clearing and settlement facilities and suggested that the Commission identify the core features that should be present in any alternative structure upon cessation of the authorisation.

Treasury

6.27 The main points raised in Treasury's submission are outlined below.

- At the time of commencement of the FSR Act, the Minister will be required to issue OCH with a clearing and settlement facility licence with effect from the commencement of the FSR Act. The licence will refer only to OCH's regulated activities but will not prevent OCH from continuing to provide clearing house facilities for options contracts.
- From the commencement of the FSR Act, OCH will have the advantage of a transition period during which it must bring its services in relation to options contracts onto the licence. The transition period expires either two years after commencement or when the clearing and settlement facility licensee seeks to amend a condition on its licence, whichever occurs first.
- OCH will not be required to undertake major changes. The required changes relate to the need to bring the options contracts within the regulatory fold and compliance with section 822A of the Corporations Act.

6.28 Treasury submitted that ASX has participated in the development of the reforms, and been aware of the impact of the reforms on its operations, for several years.

6.29 Treasury is of the view that the barriers to competition between clearing houses should be removed in line with the policy objectives of the FSR Act. Treasury considers that issues of practicality, risk and integrity related to more than one

clearing house providing services in relation to transactions on the one market in the same financial products could be worked out through the licensing process.

6.30 While Treasury acknowledges that the operation of more than one clearing house in the one market may not be considered by the industry to be a long term solution, it is of the view that it is desirable to allow market forces to operate, rather than regulators imposing an anti-competitive model.

6.31 Treasury supports:

- authorisation of the third line forcing of clearing services for twelve months from Royal Assent of the FSR Act and does not consider this period to be inconsistent with the transition period provided by the *Financial Services Reform (Consequential Provisions) Act 2001*; and
- authorisation of the third line forcing requirement that OCH's clearers must be members of ASX for twelve months from Royal Assent of the FSR Act.

7. Commission evaluation

7.1 The Commission's evaluation of this application is made in accordance with the statutory test as set out in section 4 of this determination.

7.2 The exclusive dealing conduct the subject of the application relates to clearing house services in respect of options traded on the ASX Derivatives Market. The applicants describe the conduct as:

- ASX requiring, as a precondition of participation in the ASX Derivatives Market, Trading Participants to acquire clearing services either directly or indirectly from OCH; and

- the requirement that to obtain clearing services from OCH in respect of transactions on the ASX Derivatives Market, organisations must be ASX Clearing Participants and such clearing services are provided on condition that Clearing Participants agree to abide by the ASX Business Rules and procedures in force from time to time.

7.3 The applicants sought authorisation for the above arrangements in respect of options as well as share ratio contracts traded on the ASX Derivatives Market. However in their submission, the applicants stated that share ratio contracts are no longer traded on the ASX Derivatives Market. The Commission considers that it is therefore not necessary or relevant to grant authorisation to cover share ratio contracts as well.

Requirement that as a precondition to participation in the ASX Derivatives Market, Trading Participants obtain clearing services from OCH

7.4 The Commission notes that one of the effects of the third line forcing conduct is to create a barrier that prevents other clearing service providers from providing clearing services in respect of options traded on the ASX Derivatives Market in competition with OCH.

7.5 In authorising this third line forcing conduct in 1995 (and prior to that, in relation to the SSE and the OCH), the Commission accepted that the conduct was likely to result in such a public benefit that the conduct should be allowed to take place.

7.6 The benefits associated with a requirement that all options traded on the ASX Derivatives Market be cleared through the one clearing house arises fundamentally out of the nature of clearing services associated with the clearing of *derivative products*, such as options.

7.7 In this regard, the Commission notes that it did not accept the need for similar third line forcing of clearing services in relation to equities traded on ASX's equities market. Accordingly, in its 1998 CHESS determination, the Commission determined not to authorise such arrangements.

7.8 The Commission acknowledges that in the existing regulatory environment, and given the existing risk management structures, there appear to be benefits associated with clearing all options contracts traded on the ASX Derivatives Market on a single clearing house. This is largely because of the benefits associated with the OCH assuming the position of central counterparty clearer. The use of a single clearing house also enables the operation of the system of margins, which is central to the effective management of risk by the OCH. This system ultimately enhances the financial integrity of the options markets operated by the ASX, which the Commission has accepted in the past, and continues to accept, is a public benefit.

7.9 However the Commission is of the view that there is no reason that the central counterparty clearer through which an exchange's trades are cleared must be owned by the same entity that owns the exchange. On this point, the Commission notes the concerns raised by the Reserve Bank in its submission. This view is also supported in the submission lodged by ASIC.

7.10 At the time the Commission issued its draft determination, the passage or possible timing of the implementation of the FSR Act were not certain. The Commission considered that granting authorisation of the third line forcing of clearing services for a period of one year from the date of Royal Assent of the FSR Act provided the ASX with a reasonable period in which to adapt its operations in accordance with the new regulatory regime while enabling a re-assessment of these issues once the effects and implications of the FSR Act are known.

7.11 Royal Assent of the FSR Act took place on 27 September 2001 and it is now apparent that the FSR Act will significantly change the nature of the regulatory environment for Exchanges and Clearing Houses. The reforms contained in the FSR Act are intended to increase competition by lowering barriers to entry and encouraging new participants to operate competing markets and clearing and settlement facilities.[6] In particular, these reforms will permit (but not require) more than one clearing and settlement facility to handle the clearing and settlement of transactions executed on the one financial product market.[7]

7.12 At the Regulators' Roundtable on 20 September 2001, Treasury, the Reserve Bank and ASIC agreed that the barriers to competition between clearing houses should be removed in line with the policy objectives of the FSR Act.

7.13 At the Roundtable meeting, ASIC expressed the view that a decision to allow more than one clearing house to service the one financial market should not be taken until after any problems with the transition to the new regulatory regime have been ironed out. ASIC also expressed this view in its submission and expressed concern that risk management, reporting of trades and supervision of clearing participants in more than one clearing house would require a significant degree of cooperation between the clearing houses and the market operator,

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[6] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraph 2.57.
[7] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraph 8.3.

when no one entity would have access to the total exposure a trading or clearing participant may have to the market.

7.14 In response to ASIC's concerns, Treasury and the Reserve Bank noted at the Roundtable meeting that these issues could be addressed through the licensing provisions of the FSR Act and, in particular, through the use of the Minister's power to impose conditions on licences.

7.15 In light of the view of Treasury and the Reserve Bank, the Commission considers that the concerns raised by ASIC are most appropriately dealt with through the licensing provisions of the FSR Act, rather than by the Commission authorising third line forcing conduct by market operators that may create a barrier to competition inconsistent with the policy objectives of the FSR Act. The Commission notes that the FSR Act prescribes that at the time a licence is granted, the Minister may impose conditions on the licence to address matters other than those relating to the particular facility that the licensee is permitted to operate and the class or classes of financial products in respect of which the facility can provide services.[8]

7.16 The Commission notes that authorisation of third line forcing of clearing services would appear contrary to the competitive environment envisioned by the FSR Act. In short, should authorisation of third line forcing of clearing services in respect of ASX's Derivatives Market be allowed to continue in the long term, it would constitute a barrier to competition between clearing houses and so create an impediment to the FSR Act reform.

7.17 On the other hand, authorisation of this conduct in the short term is likely to promote an orderly transition to the new regulatory regime and the Commission is of the view that authorisation of this conduct would appear to generate net public benefit in the short term.

Authorisation period

7.18 ASX has submitted that authorisation should be granted for two years, to coincide with the two year transition period to the FSR Act.

7.19 In this regard, the Commission notes the views of:

- **Treasury**, indicating that an authorisation period of twelve months would not operate in a manner which is inconsistent with the FSR Act;
- **ASIC**, indicating that it considers that the current arrangements for ASX and OCH should be permitted to continue until they have completed their transition under the proposed new legislative framework, and financial market participants have had the opportunity to develop a workable model that permits clearing and settlement services for licensed derivatives markets to be provided by third parties unrelated to market providers; and

[8] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraphs, 8.45, 8.46 and 8.48.

- **Reserve Bank**, indicating that it is not opposed to an authorisation period of 12 months.

7.20 ASIC, the Reserve Bank and Treasury consider that while authorisation will have the positive effect of promoting an orderly transition to the new regulatory regime, once the FSR Act has commenced, authorisation of third line forcing of clearing services for a longer period of time would appear contrary to the competitive environment envisioned by the FSR Act. In essence, the submissions received from ASIC, the Reserve Bank and Treasury indicate that while these regulators do not object to authorisation being granted for a period of time, it is not necessary that this period of time coincide with the two year transition period to the FSR Act. In light of the views held by regulators, the Commission considers that an authorisation period of twelve months is appropriate and will not adversely effect ASX's transition under the new regulatory regime.

7.21 In the draft determination, the Commission considered that the twelve month authorisation period should commence from the date of Royal Assent of the FSR Act. Royal Assent of the FSR Act took place on 27 September 2001. Given the time expired since the FSR Act received Royal Assent, the Commission considers that it is appropriate to grant authorisation for a period of 12 months from the date this determination comes into force.

Requirement that an organisation be a Clearing Participant in order to access OCH clearing services in respect of options transactions on the ASX Derivatives Market

7.22 This conduct restricts OCH to supplying its clearing house services in respect of transactions made on the ASX Derivatives Market only to ASX Clearing Participants who comply with the ASX Business Rules, including rules governing membership of ASX, disciplinary and other rules.

7.23 The applicants contend that this allows OCH to ensure that Clearing Participants meet certain minimum standards, and that such organisations are contractually bound by the regulatory framework constituted by the ASX Business Rules. Pursuant to the requirements in these rules, it is necessary for Clearing Participants to demonstrate that they have sufficient financial and organisational resources to meet their contractual obligations to the clearing house.

7.24 The Commission accepts that participation in the Options Clearing House should be restricted according to criteria that aim to ensure that Participants are able to fulfil their contractual obligations in an effective manner and do not expose the central counterparty to unacceptable risks. However, the Commission notes that trading on ASX's derivatives market is a separate activity from clearing those transactions through ASX's Options Clearing House. The membership, disciplinary and other rules necessary to ensure the efficient, honest, fair and orderly operation of a derivatives exchange are not

necessarily the same as the membership, disciplinary and other rules required to ensure the efficient and orderly operation of a derivatives clearing house.

7.25 At the time the draft determination was issued, the Commission was not convinced on the basis of the evidence before it that there is public benefit in requiring participation in ASX's Option Clearing House to be restricted to participants that are members of the ASX and comply with the ASX's Business Rules in circumstances where those ASX Business Rules contain provisions that may not be directly relevant to ensuring the efficient and orderly operation of the clearing house.

7.26 In this regard, the Commission noted that the SFE Corporation has recently amended its clearing arrangements so that participants of the SFE Corporation's clearing house no longer need to be admitted as either a full participant or associate participant of the SFE Corporation. To ensure appropriate regulation of its clearing participants, the membership, disciplinary and other rules necessary to ensure the efficient and orderly operation of the SFE Corporation's clearing house were removed from the SFE Corporation's rules and incorporated into the by-laws of the clearing house.

7.27 The Commission noted that a decision not to grant authorisation for this aspect of the application may also require ASX to amend its rules.

7.28 The Commission invited submissions on this issue before issuing this final determination.

7.29 Submissions addressing this issue were received from:

- **ASX**, indicating that there is currently no mechanism in the Corporations Act to independently recognise an options clearing house with its own set of business rules. Should the Commission fail to authorise this conduct, any OCH business rules would not be recognised or enforceable under the existing Corporations Act. The FSR Act will address this gap in the Corporations Act.
- **SFE Corporation**, indicating that the Commission should not authorise the requirement that an organisation must be an ASX Clearing Participant in order to access OCH clearing services in respect of options transactions on the ASX Derivatives Market. SFE Corporation considers that the Commission should adopt a consistent approach in relation to its assessment of the ASX and SFE Corporation applications for authorisation.
- **ASIC**, indicating that should the Commission decide to refuse authorisation to third line forcing of membership arrangements, there will be a period prior to the full implementation of the FSR Act where options clearing rules are not subject to regulation under the Corporations Act.
- **Reserve Bank**, indicating that it is undesirable to generate regulatory uncertainty prior to the commencement of the FSR Act.

- **Treasury**, indicating that after the FSR Act has commenced, the enforceability of OCH's business rules will not be an issue once ASX obtains a licence for OCH.

7.30 On balance, the Commission is of the view that there would appear to be public benefit in assuring the enforceability of OCH's business rules both prior to the commencement of the FSR Act and for a period of time before its full implementation. The Commission considers that an authorisation period of twelve months from the date this determination comes into force is appropriate. ASIC, the Reserve Bank and Treasury support an authorisation period of twelve months. ASX can avoid any problems with the enforceability of OCH's business rules by gaining a licence within the twelve month period.

Summary of the Commission's assessment

7.31 The arrangements for which authorisation has been sought have the potential to restrict competition, in particular, by potentially stifling the entry of new clearing and settlement facilities, and by restricting participation in the ASX's Options Clearing House.

Third line forcing of clearing services

7.32 Given the existing regulatory environment, and in the absence of alternative risk management structures, the Commission accepts that the requirement that as a precondition of participation on the ASX Derivatives Market, Trading Participants acquire clearing services from OCH, is likely to result in such a benefit to the public that the proposed conduct should be allowed to take place in the short term.

7.33 In this regard, the Commission notes that the conduct facilitates a system of margining which is utilised by the OCH as a risk management measure and thereby facilitates the provision by OCH of a guarantee of performance of the contracts traded on ASX's derivatives market. This enhances the security of options transactions on the ASX's derivatives market which, in turn, enhances client protection and the stable operation of an important financial market.

7.34 The Commission notes that authorising this conduct creates a barrier to competition. However, in the short term authorisation of this conduct is likely to promote an orderly transition to the new regulatory regime under the FSR Act.

7.35 The reforms contained in the FSR Act are intended to increase competition by lowering barriers to entry and encouraging new participants to operate competing markets and clearing and settlement facilities.[9] In particular, these reforms will permit (but not require) more than one clearing and settlement

[9] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraph 2.57.

facility to handle the clearing and settlement of transactions executed on the one financial product market.[10]

7.36 The Commission has decided to grant authorisation for twelve months from the date this determination comes into force, on the basis that this provides for a reasonable transition period. Authorisation of these arrangements for a longer period of time may create an impediment to the FSR Act reforms.

Third line forcing of membership in ASX and compliance with ASX Business Rules

7.37 In relation to the requirement that an organisation be a Clearing Participant to access OCH clearing services in respect of options transactions on the ASX Derivatives Market, and agree to abide by the ASX Business Rules in place, the Commission considers that this conduct, which assures the enforceability of OCH's business rules until the FSR Act is fully implemented, is likely to result in such a benefit to the public that the conduct should be allowed to take place in the short term.

7.38 The Commission has decided to grant authorisation for one year from the date this determination comes into force, on the basis that this provides for a reasonable transition period.

Scope of authorisation

7.39 It is proposed that this authorisation be limited only to cover options which are traded on the ASX Derivatives Market.

[10] Explanatory Memorandum to the *Financial Services Reform Bill 2001*, paragraph 8.3.

8. Determination

8.1 For the reasons outlined in section 7 of this determination, the Commission concludes that in all the circumstances, the third line forcing of clearing services and the third line forcing of membership in ASX and compliance with ASX Business Rules are likely to result in such a benefit to the public that the conduct should be allowed to take place for a twelve month transition period.

8.2 Therefore under section 88(8) of the Act and the Competition Code, the Commission grants authorisation, for a period of one year from the date that this determination comes into force, in relation to:

- the requirement that as a precondition to participation in the ASX Derivatives Market, Trading Participants must obtain clearing services from OCH, as embodied in ASX Business Rules 7.2.1.1 – 7.2.1.3; and
- the requirement that an organisation must be an ASX Clearing Participant in order to access OCH clearing services in respect of options transactions on the ASX Derivatives Market, as embodied in ASX Business Rules 10.2.1.1 and 10.2.1.3(b).

8.3 The authorisation that the Commission grants will also apply to persons who become parties to the ASX's Business Rules after the authorisation is granted.

8.4 This authorisation is subject to any application to the Australian Competition Tribunal (the Tribunal) for its review.

8.5 This determination is made on 14 November 2001. If no application for review is made to the Tribunal in accordance with section 101 of the Act, it will come into force on 5 December 2001.

8.6 If an application for review is made to the Tribunal, the determination will come into force:

- where an application is not withdrawn – on the day on which the Tribunal makes a determination on the review; or
- where an application is withdrawn – on the day on which the application is withdrawn.

8.7 The interim authorisation granted by the Commission on 15 November 2000 is hereby revoked and substituted with an interim authorisation granted in the same terms and subject to the same conditions as this authorisation until such time as this determination comes into force, or until such further order is made by the Tribunal.

8.8 The authorisation that the Commission grants in respect of A90758 is to remain in force until one year after the date this determination comes into force.