5.137. Mr Jakobi was also concerned that the broker sponsorship arrangements invaded his privacy since his sponsoring broker would have access to information about his current shareholding and cash holdings. He also suggested that this information could be used by the sponsoring broker to influence trades for the purpose of creating commissions.

5.138. The Chartered Institute of Company Secretaries in Australia noted that concern had been expressed that 'small shareholders' were overlooked in the submissions in favour of the institutional market makers. However, they noted that on matters relating to the day to day administration of CHESS adequate internal safeguards existed within ASTC to deal with the matters raised.

5.139. The Australian Shareholders' Association believed that brokers were encouraging clients to convert from issuer sponsorship to broker sponsorship and that ASX and the stockbroking industry were biased in promoting broker sponsorship in preference to issuer sponsorship.

5.140. Ms Stoddart suggested that an ombudsman should be appointed to safeguard the interests of small investors.

5.141. Coopers & Lybrand were pleased with the level of cooperation that was achieved in implementing legislative controls to enhance the security of uncertificated issuer sponsored holdings. However, they argued that the actions of some brokers are causing issuers considerable concern, in particular:

- some brokers are refusing to trade securities on behalf of investors unless the investor signs a sponsorship agreement forcing them to become a broker sponsored holder on the CHESS subregister; and
- misleading information is being dispatched by brokers regarding both issuer sponsored and certificated holdings.

5.142. GIO noted that it found issuer sponsorship expensive to implement.

5.143. Commonwealth Securities argued that the recent Rule changes relating to the operation of CHESS holdings and sponsorship agreements need fundamental reconsideration. They were particularly concerned that brokers' sponsorship agreements remained unnecessarily legalistic. They were also concerned that the requirement in Rule 9A.2.5(a) that the broker explain the sponsorship agreement to the sponsored holder is unworkable because it is impossible to know whether the holder has really understood the agreement.

Applicants' response

5.144. The applicants stated that the broker sponsorship arrangements were not intended to and do not have the effect of obliging a client to use a particular broker. They noted that there is nothing to stop a sponsored client placing a 'sell' order with a broker other than the sponsoring broker and arranging for the sponsoring broker to deliver the relevant securities to that broker, provided it is done within the T+5 regime. Equally, a client can place a 'buy' order through a broker other than the sponsoring broker with an instruction to deliver the securities to the sponsoring broker or they could be sponsored by the broker who executed the order.

5.145. It was accepted by the applicants that there is sometimes an embarrassment factor when a sponsored client uses another broker. However, they note that this is not unique to the broking industry. When changing lawyers, doctors or accountants, for example, clients need to obtain their records from their existing professional in order to provide them to the new professional.

5.146. With respect to the submission by Commonwealth Securities, the applicants note that the new Rules relating to brokers' sponsorship agreements introduce greater flexibility into the agreement and do not demand excessively legalistic agreements. Given the fiduciary nature of the sponsorship agreement, the applicants also affirm the need for holders to be fully informed of their rights and obligations.

**Changes to SCH Business Rules**

5.147. In a number of the submissions from large institutional CHESS users and industry bodies, concern was expressed that there had been inadequate industry consultation prior to changes to the SCH Business Rules.

5.148. The Securities Registrars Association of Australia noted that CHESS participants need to be assured that the Rules will not be changed without full and adequate consultation. In their second submission, the Chartered Institute of Company Secretaries in Australia suggested that the consultation process was inadequate both with respect to the limited number of organisations involved and the restricted time given to review what are often complex and extensive Rule changes. The Institute suggested that proposed Rule changes should be distributed to all commercial registries and all issuers who maintain their own registries, in addition to selected professional bodies and others at the discretion of ASTC.

5.149. Commonwealth Securities recommended a general review of the industry consultation process and suggested that all proposed Rule changes should be circulated at least 60 days prior to final consideration by the ASTC board.

5.150. Coopers & Lybrand advised that not all changes to the SCH Business Rules are circulated to the CHESS Business Advisory Committee and often CHESS participants are unaware of proposed changes until they are implemented. They recommended a more formal structure for reviewing proposed Rule changes.

5.151. ANZ Nominees submitted that members of working parties were not always given adequate time to respond to proposed changes to the Rules. They cited one instance where an amendment was distributed to the Rule Review Group on a Friday afternoon, for consideration at a meeting on the morning of the following Monday. They were also concerned about an instance where amendments to the Rules, designed to support the Telstra share offer, where circulated to the Rule Review Group with a directive that circulation be kept to a minimum (the amendments were originally marked 'strictly confidential').

5.152. More generally, BHP's share department argued that the various technical and consultative user groups, which were paramount in the development of CHESS, could encompass broader industry involvement.

Applicants' response

5.153. The applicants noted that there is a necessary trade off between the ability to implement four sets of Rule changes per year and providing extensive consultation to ensure industry acceptance. They also noted that they are operating with a relatively new set of Rules and that operational experience may necessitate that the Rules be modified promptly if ASTC finds that a Rule does not work in the manner originally contemplated.

5.154. It was also noted that ASTC relies on the various industry representatives who are member of the Rule Review Group to circulate the Rules to members of their sector of the industry.

5.155. As a result of concerns expressed about introduction of certain Rules, ASTC has now adopted a policy of circulating details of Rules changes to additional industry groups where feedback from the Rule Review Group indicates that the principles upon which the Rule changes are based may be controversial. The applicants submit that this amended approach is working effectively, although it has introduced time delays.

**Complaints and disciplinary procedures**

5.156. The submissions revealed some concern about the way in which complaints were handled by ASTC. In particular, concern was expressed about a perceived reluctance on the part of ASTC to institute formal proceedings to enforce the SCH Business Rules.

5.157. National Australia Custodian Services expressed dissatisfaction with the way in which a complaint they had lodged with ASTC was handled. The complaint concerned the removal of securities from National Australia Custodian's holding without their authority and in breach of the SCH Business Rules. National Australia Custodian believed that ASTC had failed to purse the complaint adequately, discipline the party involved in the breach and address the shortfalls in the Rules. Other instances of inadequate handling of breaches were also provided. National Australia Custodian submitted that these deficiencies cause a great deal of disquiet because users of CHESS must implicitly trust the SCH Business Rules if the Rules are to provide a secure environment for investment and form the basis for the sound operation of CHESS.

5.158. ANZ Nominees were also concerned about the decision by ASTC not to proceed to the disciplinary tribunal in the above mentioned case of an unauthorised holding adjustment. They argued that this decision does not give participants any real faith in the strength of the Rules.

5.159. In addition, ANZ Nominees raised a concern about the use of ASTC's power to waive the Rules. While recognising that there is an occasional need to issue waivers, they suggested that the practice does not add to the efficiency of the system and has caused a level of uncertainty amongst participants.

5.160. National Australia Custodian Services argued that the complaints process is too cumbersome, particularly where there has been a prima facie Rule breach. In cases where there has been a recognised Rule breach, they suggest that an expedited process should be available for immediate resolution of the matter.

5.161. The Australian Shareholders' Association were concerned that there was no representative of investors on the disciplinary panel.

Applicants' response

5.162. The applicants responded that the extent of ASTC's compliance activities cannot be adequately gauged by reference to the number of formal disciplinary proceedings. They affirmed that ASTC conducts an active compliance and regulation program and has every intention of prosecuting Rule breaches. The applicants' also suggested that the unauthorised holding adjustment referred to by National Custodian was a result of a unique set of circumstances and that ASTC's response could not, therefore, be taken as representative of ASTC's approach to regulation generally.

5.163. The applicants suggest that frequently complaints arise from a lack of understanding of CHESS, rather than a problem with CHESS or a broker. In these instances, the appropriate response is to provide additional information.

5.164. The applicants also noted that the Rules provide for an expedited disciplinary procedure, through which the ASTC board my penalise CHESS participants issuers who contravene the Rules.

5.165. In a further submission lodged with the Commission in March 1998, the applicants advised that four matters have now been dealt with by the disciplinary tribunal. In all four cases the tribunal judged that there had been a breach of the Rules. The penalty imposed in all four cases was that details of the parties' breach was published to the securities industry. In one case, an additional penalty of $1,000 was imposed. Two other matters are pending before the disciplinary tribunal.

**Limitations on ASTC's liability**

5.166. National Australia Custodian Services expressed dissatisfaction with the way in which Rules 1.10.8 and 1.12.8 seek to limit ASTC's liability to persons suffering damages as a result of action done in the performance of a function on behalf of ASTC to situations where a lack of good faith can be shown. This contrasts with the very high standards of accuracy, timeliness, solvency, etc. which are required of all participants and supported by a number of sanctions. National Australia Custodian argued that to ensure the maintenance of the high standards essential to the reliability and integrity of the system, the same levels of liability that apply to participants should apply to ASTC. They also suggested that ASTC has not identified any public benefit arising out of these limitations of liability and that the protection afforded by these Rules will not save costs for anyone other than ASTC.

Applicants' response

5.167. The applicants responded that it is appropriate to exclude liability in cases were SCH and its employees act in good faith and in purported performance of a function imposed by the SCH Business Rules.

**Rule 10.24.1**

5.168. Rule 10.24.1 provides a means for removing a scheduled settlement if both parties act for the same third party and that third party becomes externally administered before settlement date. The Rule is currently limited to on market transactions between a brokers and an NBP. National Australia Custodian Services submitted that the operation of this Rule should be extended to apply to transfers between two NBPs and off-market transactions.

Applicants' response

5.169. ASTC responded to this submission by reviewing Rule 10.24.1. In a submission to the Commission in March 1998, the applicants argued that the importance of this Rule was significantly reduced when settlement cut off was moved from the 'end of day' on the day before settlement to 10:30am on the day of settlement. This substantially reduced the period of time during which participants were exposed to the risks associated with their clients becoming insolvent after settlement cut off but before actual settlement.

5.170. The applicants also advise that they are considering scheduling the Rule for review in September 1998.

**Pledging**

5.171. In a certificated regime, share certificates could be used as security for a loan. By requiring the surrender of share certificates, the lender could prevent the transfer of title to the relevant shares. National Australia Custodian Services expressed concern that ASTC has not made adequate arrangements for the use of securities as security for credit in an uncertified environment. They suggests that the operation of the holding lock mechanism currently available in CHESS be extended to provide for pledges of securities.

Applicants' response

5.172. The applicants advise that the approach most frequently used by financiers to enable the pledging of securities in CHESS is to require the borrower to be sponsored by a CHESS participant nominated by the lender or to transfer the relevant securities into the name of a nominee stipulated by the lender. The applicants argue that the existing arrangements provide the most efficient way of pledging and that both borrowers and lenders are better off in CHESS than they are in a certificated environment.

5.173. The applicants also advised that discussions with representatives of the Law Council of Australia indicated that using a subposition or holding lock facility may create additional legal problems. In particular, the applicants' indicated that there were problems caused by the operation of section 262 of the Corporations Law which requires charges on the property of a company to be registered. Under section 262(1)(g) of the Corporations Law, "a charge created in whole or in part by the deposit of a document of title to the marketable security" is exempt from the requirement under section 262 to register the charge.

5.174. CHESS approved securities held in a subposition or holding lock facility do not come under this exemption. If the charge is not registered, therefore, it will be defeated by a registered charge. The applicants' indicated that until securities held in a subposition or holding lock facility are exempted from the requirement to register the charge, it is unlikely that lenders would use either the subposition or holding lock options.

**Tied membership**

5.175. The Sydney Futures Exchange (SFE) requested that, in respect of transactions between brokers in quoted securities and quoted rights using CHESS, that the following be incorporated into the determination:

1. the authorised conduct only applies to ASX market transactions;
2. there exists no limitations on brokers using other settlement facilities for transactions other than ASX market transactions; and
3. there is no mandatory requirement that off market transactions in quoted securities and quoted rights be settled through CHESS.

**Third party forcing arrangements in respect of debt securities**

5.176. The Reserve Bank of Australia submitted that the third party forcing arrangements in respect of debt securities presently quoted on ASX and settled via RITS or Austraclear should be removed. Failing this, re-authorisation should be granted on the basis that debt securities continue to be declared 'excluded securities' as is currently the case.

Applicants' response

5.177. The applicants firmly argued that there should be no barrier to ASTC providing clearing and settlement facilities for all Australian money market securities and debt securities generally, including Commonwealth Government debt securities, for which transaction settlement is currently handled by the Reserve Bank's RITS system. Since ASTC and ASX are content for competition in the clearing and settlement of equities, they should be permitted to compete with the existing clearing and settlement facility for business in debt securities quoted on ASX.

5.178. Nevertheless, in their November submission, the applicants confirmed that Commonwealth Government Securities will not be removed from the Excluded Security list, pending resolution of apparent conflicts with the *Commonwealth Inscribed Stock Act 1911.*

**Time limit on any authorisation**

5.179. Colonial State Bank submitted that there should be no time limit on any authorisation granted by the Commission given the amounts invested by ASX and other parties in the development of CHESS. GIO also supported authorisation without a time limit because the continuation of CHESS was now central to the competitiveness and credibility of the Australian securities market.

5.180. National Australia Custodian Services suggested that, given the major changes being proposed to the structure of ASX, authorisation only be granted for two years and be reviewed bi-annually until such time as the CHESS operation has been sufficiently tightened that a lengthier authorisation could be granted. An authorisation without a time limit should only be granted when a demutualised ASX has earned the right by its conduct.

5.181. Commonwealth Securities, The Australian Shareholders' Association, Ernst & Young Registry Services and Ms Stoddart argued for a time limitation of three years or less.

Applicants' response

5.182. The applicants noted that the Commission has in the part granted open ended authorisations, including one for the APCA Bulk Electronic Clearing System.[5] The applicants argued that a fixed period authorisation creates uncertainty among users and may have the undesirable effect of creating a lack of commitment to use CHESS.

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5 (1994) ATPR (Com) 50-164.

# 6. Pre-decision conference and submissions received following the draft determination

## Pre-decision conference

6.1. On 18 June 1998 the Commission issued a draft determination proposing, subject to any pre-decision conference pursuant to section 90A of the Act that might be requested, to grant conditional authorisation in respect of the CHESS arrangements and conduct the subject of the applications.

6.2. A pre-decision conference was requested by the Sydney Futures Exchange Limited (SFE). The conference was held on 9 July 1998. A record of the conference has been placed on the Commission's public register of applications for authorisation. The main issues raised are outlined below.

### Transactions eligible for DvP settlement through CHESS

6.3. SFE submitted that whilst alternative clearing and settlement providers may be established as a result of the Commission's determination, it is unlikely that they will capture sufficient market share to threaten the predominance of ASTC's DvP settlement process. SFE advised that there are significant economies associated with the DvP process whereby CHESS participants net their equity and payment obligations on a given settlement day. It argued that for netting to be efficient there can be only one centralised netting facility.

6.4. SFE was concerned that SCH Business Rule 7.1 limits transactions that are eligible for DvP settlement to "on market" transactions. For example, transactions associated with option settlement and exercise on the ASX Derivatives (ASXD) market are classified as "on market" transactions, whereas similar transactions on SFE's market are not. Without the ability to participate in the DvP process, SFE advised that it is at a distinct competitive disadvantage in relation to its Deliverable Share Futures contract compared to the similar ASXD product, the Low Exercise Price Option contract. Further, any alternative market provider that represents competition to ASX would also not be able to benefit from the efficiencies of ASTC's DvP netting process.

6.5. SFE acknowledged that it could be argued, in support of Rule 7.1, that without a guarantee structure such as the National Guarantee Fund (NGF) for transactions facilitated by ASX brokers, the DvP process will not work. However, the obligation to give delivery pursuant to a Deliverable Share Futures contract is guaranteed by SFE Clearing House (SFECH) and is supported by its $150 million financial backing.

6.6. SFE submitted that Rule 7.1 should be redrafted so that any class of transaction that involves two CHESS participants, be they NPBs or brokers, can not be excluded from DvP settlement so long as an appropriate guarantee structure is in place. This would have efficiency benefits as well as overcoming the anti-competitive effect of the current Rule.

6.7. ASTC advised that SFE's submission must be considered in the context of the legal and regulatory framework which governs CHESS DvP settlement, and the procedural arrangements for settlement (ie, the framework provided by Section 7 of the SCH Business Rules and the provisions of Part 7.10 Division 6B of the Corporations Law). It confirmed that CHESS DvP settlement is currently limited to transactions that are entitled to the settlement guarantee of the NGF.

6.8. ASTC accepted that it may be appropriate in due course to extend the range of transactions that may be settled through CHESS DvP. It submitted, however, that there are sound legal and regulatory reasons which support the current scope. In ASTC's view, any commingling of a broader range of transactions will require amendment of the Corporations Law and determination of an appropriate set of rules and procedures to ensure that risks of default are properly attributed to the relevant guarantee mechanism.

6.9. ASTC's written submission provided at the conference sets out the CHESS transaction netting arrangements. On market transactions between ASX brokers are subject to contractual novation and netting (under Section 7 of the SCH Business Rules) involving a subsidiary of ASTC, TNS Clearing Pty Ltd (TNSC); whereas transactions between brokers and NBPs are not. The netting of all settlement obligations (broker/broker and broker/NBP) scheduled for DvP settlement on a day is implemented for administrative convenience. However, the individual broker/NBP obligations that are 'administratively netted' retain their contractual identity.

6.10. During the daily settlement process, the system gives effect to administrative netting arrangements by calculating the number of securities due to be transferred out of each participant's holding to fulfil its net obligations on that day. Where there is a shortfall one or more of the instructions going forward for DvP settlement will be failed until the holding no longer has a securities shortfall. Any knock-on consequences for other participants are resolved through an iterative process. The system then calculates the net amount due to be paid to or received from each participant's payment facility for that day. Following confirmation from participants' payment providers that payment obligations for each participant will be met, the DvP settlement obligations are 'locked in'. Upon advice that relevant payments have been effected through the Reserve Bank's real time gross settlement system, CHESS proceeds to effect the transfer of securities and the settlement process finishes.

6.11. Should a payment provider decline to authorise an amount to be paid out by a participant in that day's settlement, the system will fail additional settlement instructions, further securities shortfalls may arise and the process must proceed iteratively until such shortfalls are resolved.

6.12. As a consequence of a broker payment obligation not being authorised, net broker settlement instructions (ie, netted obligations between the broker and TNSC) may be candidates for failing. In such an event, TNSC may, within limits, have recourse to its "at call" facility to fund the payment shortfall and thereby avoid the flow-on failure of other transactions. This "at call" facility is secured by TNSC's rights against the NGF under Part 7.10, Division 6B, of the Corporations Law.

6.13. ASTC advise that the effect of these arrangements is that a broker's capital always stands between a NBP and the NGF. For example, if a payment authorisation for a NBP was refused, the effect of failing settlement transactions between that NBP

and brokers is that the brokers' payment obligations for that day will increase and ultimately the brokers will be called upon to fund the corresponding amounts for the market side settlements on that day. If a broker then defaults on its increased payment obligations, the TNSC at call facility, and hence the NGF, comes into play.

6.14. Division 6B is framed on the basis that the contract completion protection of the NGF applies to transactions that are reportable to the ASX. ASTC submits that there are sound equitable reasons for this. The NGF drew its seed assets from the fidelity funds of the six State stock exchanges which merged to form the ASX in 1987, it has since grown through interest earnings and through arrangements under which moneys held in trust by brokers may be lodged with ASX for investment. ASTC notes that in 1995 the government regulatory authorities considered the regulations of deliverable share futures under Section 72A of the Corporations Law and confirmed the current philosophy for NGF coverage (ie, such coverage does not apply in relation to transfer of shares between the parties to a deliverable share futures contract).

6.15. ASTC submits that it would be premature and inappropriate for the ACCC to run ahead of the Treasury's consideration of current distinctions between securities and futures regulations in the context of the Corporate Law Economic Reform Program (CLERP) by granting SFE's request to mingle the two settlement and guarantee regimes at this time. It further submits that the ACCC is not the appropriate body to determine either whether SFECH has a guarantee structure appropriate for meshing with that of ASTC, or whether it is appropriate to extend access to CHESS DvP settlement beyond the current limits. There are significant legislative policy, practical and technical issues which need to be resolved in order to facilitate such access.

**Other issues**

6.16. The Australian Shareholders Association (ASA) noted that ASTC is both a legal monopoly under the Corporations Law and a natural monopoly in regards to the supply of clearing and settlement services for equity securities. There needs to be adequate checks on ASTC's monopoly power. ASA considers that neither competition for ASX from overseas exchanges nor competition for ASTC from Austraclear in clearing and settlement would provide effective checks, particularly in respect of retail investor transactions. ASA considers that the ACCC had overestimated the effectiveness of ASTC Articles 59A and 86. Article 59A provides only that directors are "authorised to" act in the interests of the securities industry generally. The Article hasn't had any great effect but ASA nevertheless supports its retention. Article 86 does not prevent ASTC distributing profits to ASX. ASA supports the removal of Article 86 to make the distribution of profit transparent. ASA also considers that conditions 3, 4 and 5 of the draft determination should be retained whether or not Articles 59A or 86 are removed; supports the proposed 5 year time limit on authorisation and ACCC's monitoring of changed circumstances; and argued for an additional condition of authorisation - that ASTC make its services available to others on terms no less favourable than those available to ASX.

6.17. Interested parties also raised a number of issues that had been previously raised in written submission to the Commission, including - ASTC's charges have been too high, it has been accumulating excess profits, what will be done with these excess profits following demutualisation, and concern that there are no external controls over ASTC's costs and pricing.

## Submission received following the draft determination

6.18. A number of interested parties lodged submissions prior to the pre-decision conference.

6.19. CUSCAL advised that the draft determination addressed its main concerns but noted that amendment of Section 866 of the Corporations Law, which requires a broker to open and maintain a trust account with a bank and which may obstruct principles of institutional and competitive neutrality in CHESS, remains a matter for resolution.

6.20. Austraclear confirmed its desire to clear and settle equity securities, and advised that it has had for some time the ability to provide such services on an "equitable title" basis. However, Austraclear considers (for the reasons given in its submission dated 17 December 1997) that for it to do so would place it at a competitive disadvantage to ASTC. Accordingly, Austraclear's preference is for amendments to be made to the Corporations Law and other relevant legislation to enable it to effectively compete with ASTC on a "legal title" basis.

6.21. The Chartered Institute of Company Secretaries advised it supports CHESS and the efficiencies it delivers. However, the Institute was concerned about the lack of control of CHESS fees under a demutualisation environment, did not agree with arguments that competition from overseas exchanges and the Commission's power to revoke authorisation provide adequate control, and supported the inclusion of an appropriate mechanism for regulating CHESS fees.

6.22. The Reserve Bank of Australia (RBA) supported amendment of the definition of payments provider to allow the participation of a wider range of financial institutions in CHESS. The RBA advised that it also encouraged greater competition between providers of securities markets clearing and settlement services in a manner which is consistent with minimising risk in the financial system. It therefore supported removal of the exclusion of debt securities from CHESS, provided CHESS applies risk control measures appropriate to the amounts being settled (which may require such transactions to be settled on a real time basis). Noting that it may be only academic if demutualisation goes ahead, the RBA was not convinced by the arguments for maintaining CHESS's exclusive right to settle equities prior to demutualisation. This was seen as inconsistent with the decision on debt securities and conducive to greater competition if conditions 3, 4 and 5 of the draft determination applied whether or not Articles 59A and/or 86 are removed.

6.23. The Australian Securities & Investments Commission (ASIC) confirmed its previous advice that ASTC's capacity to distribute profits, should ASTC Articles 59A and 86 be removed, may prejudice its performance of regulatory responsibilities under the Corporations Law. However, ASIC considers there are adequate mechanisms available under the Corporations Law to add to the regulatory regime so that it applies clear regulatory standards to ASTC and assure continuing compliance with those standards. ASIC agreed with the Commission's view that in the event the Articles remain there exist sufficient checks to minimise the perceived risks.

6.24. ASIC advised that it had no problem in principle with the proposal that the market for clearing equity transactions be opened to competition, among other things by permitting brokers to use clearing systems other that CHESS. However, ASIC was concerned to ensure that this step would not involve increased risk for investors, or a

lessening of the overall integrity provided by the current arrangements. ASIC referred to its previous submissions and confirmed that as a practical matter no ASTC competitor could provide a facility for the transfer of legal title without amendment to the Corporations Law. It noted that until the legislation envisaged in CLERP Paper No 6 is effective, it is unlikely that full competition for the clearing and settlement of ASX traded securities will be achieved.

6.25. Following the pre-decision conference, additional submissions were received.

*Interested parties*

6.26. A submission from National Australia Custodian Services expanded on the issue of the CHESS fee structure which it (and others) had raised at the conference. It noted that CHESS pricing based on 9 000 transactions per day when, with changes in the market, on average 20 000 transactions per day are being processed, has provided ASTC with a very health profit. National Australia Custodian considered there has to be a major concern when ASTC, with its monopoly in equity clearing and settlement, is proposing to change its Articles to allow dividends to be paid. It submitted that the Commission should reconsider the CHESS fee structure and excess profit issue in reaching its final determination, possibly along the lines of the tariff principles of CREST in the United Kingdom.

6.27. The Treasury (Commonwealth) noted that subsection 779B(1) of Part 7.2A of the Corporations Law empowers the Minister to approve a body as the SCH, subsection 779B(4) provides that only one approval can be in force at any one time, and that ASTC was subsequently approved as the SCH. It also noted that subsection 779B(4) has apparently been interpreted as conferring a "monopoly" over the clearing and settlement of equity securities on ASTC, but advised that this was not its intended effect. The intention of section 779B was not to license the SCH to do that which would otherwise be prohibited, but to provide a legislative framework specifically tailored to the particular circumstances and needs of the body that would be the ASX's clearing house.

6.28. Treasury advised that Part 7.2A does not confer any exclusive rights on the ASTC in relation to the activities contemplated by section 779B, namely "settlement of transactions involving quoted securities or quoted rights" or the "registration of quoted securities or quoted rights". While ASTC is therefore not a statutory monopoly in relation to securities clearing, its approval as the SCH does clearly have significance and legal consequences. Treasury notes that the provisions of Part 7.13 of the Corporations Law, which relate to the concept of non-certificated holdings and paperless transfers of "SCH-regulated transfers", are also relevant. The Law leaves to the SCH rules to determine what is an "SCH-regulated transfer" and to identify how and when a proper SCH transfer is effected to pass legal title by electronic means. Thus, if another clearing and settlement service provider such as Austraclear wished to provide a facility for the electronic transfer and registration of legal title to securities, similar amendments to those afforded SCH-regulated transfers in Part 7.13 may be necessary.

6.29. Treasury noted that the operation of the relevant provisions of the Corporations Law (and the associated ASTC and ASX rules) could in hindsight be seen as resulting in the unintended consequence of providing ASTC with some market advantage. It advised that the circumstances and matters raised through the authorisation process will be taken into account in designing, under the CLERP process, the new legislative

provisions ultimately considered by the Government. It is envisaged that the new legislative scheme would commence no earlier that 1 July 1999.

6.30. SFE made a further submission on the issues it had raised, and on matters raised in ASTC's submission, at the conference.

6.31. SFE advised that in 1995 the government regulatory authorities considered the applicability of the investor protection regimes of ASTC and SFECH under the circumstances in which futures contracts became contracts for the sale and purchase of ASX listed securities which must be transferred to their rightful owner. Under these circumstances there was no need for the NGF to cover the transfer of shares where the transfer is attributable to a futures transaction as there was already in place an adequate investor protection mechanism at the SFECH. SFE submitted that the Deliverable Share Futures regulations clearly indicate the demarcation in relation to the use of the NGF thereby removing this as a potential issue with respect to CHESS DvP settlement.

6.32. SFE noted ASTC's comment that the guarantee provided by SFECH does not extend to the guarantees of completion of broker/client contracts that are provided by the NGF. SFE submitted that at some stage the futures contract becomes nothing more than a transfer of ASX listed securities like any other such transfer and therefore should be treated no differently. It submitted that if there are circumstances, no matter how unlikely, which result in some form of residual liability on the part of the NGF then it would appear reasonable given the statutory purposes of the fund to stand behind transfers of shares under CHESS for the fund to act accordingly.

6.33. SFE noted that even if amendments to the Corporations Law were necessary (as argued by ASTC, but which SFE submitted has not been demonstrated) to extend the range of transactions that may be settled through CHESS DvP, the ASTC rules would still need to be modified. This raises the question as to why such a change can not take place sooner rather than later. It remains SFE's contention that there are no sound legal and/or regulatory reasons as to why transactions, such as those contemplated for Deliverable Share Futures, can not be settled through CHESS DvP.

6.34. SFE submitted that the issue of the appropriateness or otherwise of the use of NGF funds in relation to Deliverable Share Futures contracts overlooks two important features inherent in the CHESS system. Firstly, the NGF is already in place and may be called upon in respect of certain unlikely events which may entail transfers which may have originated as futures contracts since 1996, and secondly, the use of DvP settlement should reduce the operational risk and the potential for fraud, defalcation or misdirection with respect to the transfer of ASX listed securities.

6.35. SFE advised that without access to CHESS DvP settlement, it has had to design a settlement procedure for Deliverable Share Futures which although as robust and as complete as possible nonetheless lies outside of the more efficient CHESS DvP system (which allows netting of securities and payment obligations). The resulting inefficiency represents a real transaction cost to participants and discourages their participation in the market for Deliverable Share Futures. SFE argued that the CHESS DvP system is anti-competitive and it need not be were it to allow DvP settlement to be utilised by those entities which have in place an appropriate guarantee structure. It submitted that this is an appropriate issue for determination by the Commission.

6.36. ASIC provided comments on SFE's submission. As a general principle, ASIC supported the proposition that access to CHESS DvP should not be narrowly restricted, provided that opening the system to a broader range of parties does not increase risk to investors or to the integrity of the clearing and settlement system. ASIC noted that there may be some problems, relating to both investor protection and system integrity, with a proposal immediately to broaden in a major way the range of parties that can take advantage of the DvP process. Some problems have their origin in the current legislative scheme which was devised to support and is confined to the current CHESS arrangements.

6.37. ASIC advised the DvP process involves novation of contracts to TNSC and that access to the NGF is limited to transactions involving ASX brokers. ASIC advised it has not had the opportunity to examine thoroughly the ramifications of a change to the risk exposure of TNSC, should an NBP with access to DvP fail to settle, for the overall integrity of the system. ASIC also considered it would be undesirable at this stage potentially to alter the risk exposure of investors who deal in deliverable share futures without full analysis of all the implications for them.

6.38. ASIC noted it may be that only legislative reform of the kind contemplated by CLERP Paper No 6 can resolve the quite complicated issues involved in an adequate way and therefore achieve the principle espoused in SFE's submission. Within the time available ASIC had not been able to come to a definitive conclusion on this issue.

*ASTC*

6.39. ASTC responded to SFE's further submission. ASTC noted that SCH Business Rule 7.1.3 includes a discretionary provision under which Deliverable Share Future contracts could be determined to be eligible for DvP settlement in CHESS. If SFE were to approach ASTC directly with a request for inclusion of Deliverable Share Futures settlement in DvP, with details of any necessary rule changes and guarantee fund cover, ASTC could deal with the matter. It agreed to assess any such application on its merits. ASTC considered it inappropriate to use the authorisation process as an indirect way of requiring it to provide access to DvP without giving ASTC the opportunity of assessing the implications of providing such access. ASTC would need to assess whether participation criteria for NPBs need to be more restrictive, and any amendments may need authorisation by the Commission.

6.40. ASTC noted that a decision to admit Deliverable Share Futures to CHESS DvP will necessarily involve ASIC which will need to be convinced that the provision of access will not affect the integrity of CHESS or have unfavourable consequences for the NGF. If such access required changes to the SCH Business Rules such changes will also require the approval of ASIC and the Treasurer. ASTC submitted that as provision of access to DvP will involve processes over which ASTC has no control (eg, discussions and agreement with ASIC) it is inappropriate that authorisation of the Rules be made on the condition that access to DvP be extended to settlement of Deliverable Share Futures, or that any timetable be imposed in relation to a determination of this matter.

6.41. ASTC responded to the further submission by National Australia Custodian Services by referring to its previous submissions on the issue of CHESS tariffs. ASTC acknowledged that the level of CHESS fees would be kept under scrutiny to ensure the realisation of the public benefits associated with CHESS, particularly for retail investors and small to medium sized issuers.

# 7. Commission evaluation

**Introduction**

7.1. The Commission's evaluation of the applications is made in accordance with the relevant statutory tests, which are paraphrased in section 4 of this determination. In general terms, the Commission is required to determine whether the Rules and associated conduct for which the applicants have sought authorisation is likely to result in a benefit to the public that is sufficient to outweigh any likely anti-competitive detriment resulting from the relevant Rules and associated conduct.

7.2. The Rules for which authorisation is sought govern participation in and the operation of CHESS. These Rules enable ASTC and ASX to exclude individuals and organisations from participating directly in the electronic transfer and settlement of securities transactions through CHESS. The current Rules also enable ASX to require all brokers and all issuers listed on ASX to acquire services from ASTC, irrespective of the price charged by ASTC for those services. In addition, the Rules require ASTC to provide its services only in relation to companies admitted to ASX's official list.

7.3. The Rules also enable ASTC to require all CHESS participants to acquire services from a recognised payments provider. The Rules and the SPPD, to which APCA is a party, enable the exclusion or suspension of payments providers who do not meet certain requirements. These requirements include membership of APCA (or the giving of a non-member undertaking) as well as membership of the Inter-Bank Payments System and the CHESS Payments Provider User Group.

7.4. The benefits associated with the CHESS arrangements are primarily in the form of efficiency gains in the clearing and settlement of securities transactions. The Commission notes the following efficiencies in particular:

- the reduction of delays achieved by the removal of paper certificates from the transfer and settlement system;
- the effective elimination of any delay between settlement and registration;
- the increased security resulting from the introduction of DvP settlement; and
- the capacity to move to a T+3 settlement regime.

The Commission also notes that Australia has a high ranking on GSCS Benchmark's settlement index. This index provides a comparison of the settlement efficiency of major equities markets based on the cost to market participants of failed trades.

7.5. Under the CHESS arrangements, certain CHESS services are forced on issuers and brokers and, in practice, on NBPs. The price that ASTC charges for such services is, therefore, a key factor in determining the extent to which CHESS users generally, rather than ASTC and ASX, benefit from these efficiency gains. High CHESS fees would mean that ASX and ASTC would derive the primary benefit from these efficiency gains, rather than CHESS users generally and, through them, the public at large.

7.6. The existence of adequate checks and balances to protect CHESS users from the introduction of extortionate compulsory fees is, therefore, a particularly important factor in the Commission's evaluation.

7.7. Four different types of checks and balances on the power of ASTC to charge extortionate fees have been considered:

(i) Articles 59A and 86 of ASTC's Articles of Association,

(ii) competition from overseas exchanges,

(iii) competition from domestic providers of clearing and settlement services; and

(iv) direct price monitoring by the ACCC.

7.8. By establishing the framework of Rules that govern the exchange and settlement of ASX listed securities, the CHESS arrangements have the capacity to effect the competitive positions of a range of players within the securities industry, including brokers, NBPs, financial institutions that wish to act as payments providers and third parties who provide registry services to companies, as well as directly effecting the registry arrangements of companies listed on ASX.

7.9. The most obvious effect of the CHESS arrangements is to make holding share certificates less attractive than maintaining uncertificated share holdings. This has effects both on investors who hold paper certificates and companies that maintain certificated share registries. However, these comparative disadvantages simply reflect the greater efficiencies associated with an uncertificated registration and settlement regime.

7.10. Nevertheless, the CHESS arrangements also have the potential to cause a range of anti-competitive effects that are of concern to the Commission. Four matters of particular importance in this evaluation are:

1. The CHESS arrangements, as they currently stand, have the effect of excluding potential competitors from providing clearing and settlement services to brokers trading on ASX's markets.

2. The current exclusion, by ASTC, of debt securities from clearing and settlement through CHESS which ensures that ASTC does not compete with either RITS or Austraclear in the clearing and settlement of such securities.

3. Access to CHESS DvP settlement is limited to "on market" transactions as defined by ASTC, with the effect that transactions on trading facilities that are in competition with ASX are excluded from the efficiencies of such settlement.

4. The criteria for recognition as a payments provider should not raise unnecessary barriers to the provision of payment facilities to CHESS participants, and in particular should not prevent competition between banks and NBFIs for such business.

Other areas of particular concern raised by interested parties and considered in this evaluation include:

5. The effect of the CHESS arrangements on the relative positions of brokers and NBPs in the provision of investment services by way of sponsoring holdings on the CHESS subregister.

6. The effect of the CHESS arrangements on small investors and the capacity for the issuer sponsorship arrangements to provide investors with an alternative to sponsorship by a broker or a NBP.

7. The existence of adequate complaints and disciplinary procedures and the existence of adequate procedures to enable industry consultation prior to changes to the SCH Business Rules.

The Commission has also considered:

8. The relationship between the responsibilities of the ACCC and the ASC in regard to the subject matter of these applications and reforms to the Corporations Law and other legislation that would facilitate competition between providers of clearing and settlement services.

9. The imposition of a time limit on this authorisation.

**Issues arising from the Commission's previous authorisation of the CHESS arrangements.**

7.11. The proposed demutualisation of ASX and the proposal to remove Articles 59A and 86 from ASTC's Articles of Association have required the Commission to fundamentally reconsider the basis on which the Commission's previous authorisations were granted. Nevertheless, it remains appropriate to note a number of issues arising from the Commission's previous authorisations of the CHESS arrangements.

7.12. In its authorisation of the CHESS phase 1 arrangements, the Commission set out a list of matters which, at the time, it believed would be of particular importance in any future re-authorisation of CHESS. These matters were:

(i) improvement in the efficiency of the registration and transfer of securities as a consequence of the introduction of phase 1 of the CHESS arrangements;

(ii) whether tariffs for CHESS services and facilities had been set on ASTC's proposed 'not for profit' or 'cost plus' basis;

(iii) whether ASTC's board includes persons drawn from across the range of groups within the securities industry;

(iv) whether ASTC's board had established and maintained effective communications with all relevant sectors of the securities industry (including both private and institutional investors, and professional share registries) so that they have an opportunity to contribute to the efficient and effective operation of the CHESS system;

(v) whether consideration and pursuit of complaints against CHESS users by the board has been adequate and appropriate;

(vi) whether the board's initiation and pursuit of disciplinary proceedings, and its appointment of persons to the disciplinary panel, has been adequate and appropriate;

(vii) whether the various appeal arrangements, and the disciplinary arrangements, have operated efficiently and effectively and with the necessary degree of independence and fairness;

(viii) whether ASTC's notices requiring access to a CHESS user's records contained information on the general nature of the matter under consideration; and

(ix) that ASTC's use of its audit power has not been used to discriminate against the provision of issuer sponsored subregistry services.

7.13. Subject to the concerns raised in this evaluation, the applicants' have addressed these issues in general terms to the satisfaction of the Commission. The Commission's concerns in respect of the assumptions that underpin ASTC's current 'cost plus development' policy for setting CHESS tariffs are discussed below at paragraphs 7.52 to 7.56.

7.14. In its evaluation of the CHESS phase 2 arrangements, the Commission also raised a number of matters which, at the time, it believed would be of importance in any future re-authorisation of CHESS. These matters primarily concerned the process for determining the capacity of building societies and credit unions to meet the indemnity obligations contained in the Standard Payment Providers Deed (SPPD) as a prerequisite for participation in the CHESS arrangements as a payments provider. The applicants' most recent proposals relating to the definition of payments provider appear to have resolved many of these issuers. The remaining issues of concern are discussed below at paragraph 7.144.

**New Rules included in the current applications**

*CUFS*

7.15. These applications also include new Rules to accommodate the introduction of CHESS Units of Foreign Securities (CUFS). These Rules were given interim authorisation in June 1996.

7.16. CUFS are units of beneficial ownership in foreign securities. Legal title to the securities is held by a depositary entity known as the depositary nominee. When buying and selling CUFS, only beneficial ownership is transferred. CUFS enable the transfer and settlement through CHESS of ASX transactions in securities of companies listed on ASX but domiciled in countries that do not recognise uncertificated holdings or the electronic transfer of legal title.

7.17. The Rules relating to CUFS have been outlined above in section three of this determination.

7.18. The Commission accepts that these new Rules create further efficiency gains by extending the benefits of CHESS, particularly DvP settlement, to foreign securities that would otherwise be excluded from the CHESS arrangements.

*The new Rules in sections 9A and 11 of the SCH Business Rules*

7.19. Included in these applications are new Rules covering brokers' sponsorship arrangements (section 9A) and the establishment of a holder record lock in the event of

the death or bankruptcy of a holder (section 11). These Rules were given interim authorisation by the Commission in June 1997.

7.20. With regard to the new section 9A provisions, the Rules governing brokers' sponsorship agreements are now contained in the SCH Business Rules along with the Rules governing NBPs' sponsorship agreements, rather than being contained in the ASX Business Rules. This enables a more cohesive regime for governing broker and NBP sponsorship agreements. While introducing greater flexibility into brokers' sponsorship agreements, the Commission notes that these changes appear to retain most of the protections afforded to investors under the earlier arrangements.

7.21. The Rules relating to brokers' sponsorship agreements are outlined above in section three of this determination at paragraphs 3.41 to 3.51. Specific issues raised by interested parties concerning sponsorship arrangements are discussed below at paragraphs 7.156 to 7.163.

7.22. With respect to the changes to section 11 of the Rules, these new Rules are designed to avoid the inefficiencies that resulted from the death or bankruptcy of a holder. The old Rules required the recertification, and so removal from CHESS, of a CHESS holding upon the death or bankruptcy of a holder. The new Rules enable the creation of a holder record lock that restricts the movement of securities into or out of the holding, while ownership of the securities is being determined. The Rules relating to the creation of a holder record lock in the event of the death or bankruptcy of a holder are outlined above in section three of this determination at paragraphs 3.72 to 3.74.

7.23. The Commission notes that these changes were in part made in response to concerns expressed by CHESS participants and that these changes enhance the efficient operation of CHESS.

**ASTC's dominant position and the pricing of CHESS services**

7.24. While the CHESS arrangements create the potential for considerable public benefits through efficiency gains, the extent to which these potential benefits are realised is largely dependent upon the price that ASTC charges for CHESS services.

7.25. ASTC currently provides CHESS related services to three different classes of customers:

(i) brokers,

(ii) non-broker participants; and

(iii) issuers.

The main services supplied by CHESS are clearing and settlement services to brokers and NBPs and registry services to issuers. The applicants advise that at present about 65% of the processing fee revenue of ASTC is derived from services supplied to brokers, 25% from services to issuers, and 10% from services to NBPs.

7.26. The Rules currently compel brokers and issuers to acquire CHESS services, irrespective of the price ASTC charges for those services.

7.27. Under the CHESS Phase 1 arrangements ASX and ASTC sought and were granted authorisation, in June 1994, for a requirement that all brokers acquire clearing,

settlement, and registration services from ASTC in respect of transactions between brokers in quoted securities and quoted rights effected through an ASX market. (ASX and ASTC have again sought authorisation for this requirement.) However, transactions in debt securities on ASX's market have to date been declared by the ASTC Board as 'ineligible' for clearing and settlement through CHESS, so that in practice only ASX market transactions in equity securities are required to be cleared and settled through CHESS. In respect of such transactions, brokers may therefore be required to use ASTC's CHESS services irrespective of the price charged by ASTC. At present the tariff for broker to broker DvP settlement is $1.10 payable by each broker. The tariff for broker to NBP DvP settlement is $1.60 payable on both sides of the trade. There is a minimum charge of $2,000 per annum for CHESS services to brokers and NBP.

7.28. The Commission did not receive any submissions from brokers expressing concern about the cost of CHESS services. The Commission notes, however, that the report by PA Consulting Group commissioned by ASX registered concern by brokers that CHESS fees did not provide good value for money.

7.29. The ASX Listing Rules require all issuers listed on ASX to irrevocably authorise ASTC to establish and administer CHESS subregisters for the issuers' quoted securities and quoted rights on ASX. (This requirement was also granted authorisation in June 1994 as part of the CHESS Phase 1 arrangements. ASX and ASTC are again seeking authorisation for this requirement.) ASTC charges an annual operating tariff of five percent of the listing fee. ASTC also charges issuers for a range of CHESS services, for example, $1.20 for providing a routine current holding statement for sponsored holders. If they wish to gain the benefits of raising capital on the ASX exchange, issuers have no choice but to purchase services from ASTC.

7.30. In their November submission, the applicants advised that many of the services supplied by commercial registries are similar to those provided by CHESS. The applicants noted that if ASTC did not charge less than commercial registries for like services, it would be a clear indication that ASTC was exploiting the obligations imposed on issuers to operate a CHESS subregister. They also accepted that this would constitute 'changed circumstances' warranting consideration by the Commission of revocation of the authorisation.

7.31. In this regard the Commission also notes the concern raised by Ernst & Young Registry Services that ASTC could use its power to change the SCH Business Rules in a way that could reduce the economic viability of registry service providers. Registry services are discussed below at paragraphs 7.167 to 7.174.

7.32. While brokers and issuers are compelled to use CHESS services, NBPs are not required to settle their transactions though CHESS. The applicants argued that the concerns raised by NBPs about the cost of CHESS services were not, therefore, justified since NBPs could choose not to use CHESS if the costs of CHESS services became unreasonable.

7.33. In response, National Australia Custodian Services argued that the benefits of CHESS, in particular DvP settlement, were such that they had no choice but to use CHESS. They also noted that transactions involving an issuer sponsored subregister are subject to considerable delays and require a signed paper transfer request. Given the substantial daily transaction volumes of large custodians, National Australia

Custodian argued that large custodians would be unable to operate effectively if they conducted their business using issuer sponsored subregisters. In practice, therefore, many NBPs are compelled to use CHESS.

7.34. The Commission notes that the exclusive dealing arrangements between ASTC and ASX requiring all ASX brokers and issuers to acquire CHESS services and the requirement in practice for NBPs to acquire CHESS services gives ASTC considerable power to charge unreasonable fees for CHESS services.

**Articles 59A and 86 and the demutualisation of ASX**

7.35. The applicants' have asked the Commission to evaluate the applications on the basis that ASX is demutualised and Articles 59A and 86 of ASTC's Articles of Association are removed. In the Commission's previous authorisations of the CHESS arrangements, Articles 59A and 86 were taken as the primary check on ASTC's power to charge extortionate fees for CHESS services. The applicants' proposal to remove these Articles, combined with the demutualisation of ASX, fundamentally alters the basis on which these previous authorisations were granted.

7.36. In their original application for phase 1 of CHESS, the applicants argued that it was precisely by operating CHESS on the basis that it would not provide a commercial return on equity capital, that CHESS would minimise the operational costs of the securities industry, enhance the liquidity and efficiency of the stock market, and for this reason, be in the public interest.[6]

7.37. The effect of Article 86 is to prohibit ASTC from paying dividends or otherwise transferring income to its owner, ASX. Within the context of the demutualisation of ASX, the proposed removal of Article 86 from ASTC's Articles of Association means that the applicants can no longer rely on such assurances to support the public benefit arguments in their applications for re-authorisation.

7.38. In addition, the proposed removal of Article 86 means that the applicants cannot rely on past tariff levels to support their arguments for re-authorisation. Since past tariffs were set using the 'costs plus redevelopment' assumption, they cannot be used as a clear indicator of how ASTC will set CHESS tariffs in the future when it is operating on a for profit basis paying dividends to its shareholder, ASX.

7.39. In their submission, the applicants noted that it would be difficult for ASX to run as an effective commercial enterprise where one of its key operating subsidiaries is unable to distribute to ASX any profits which it earned. In this regard, the Commission notes that in the financial year ended 30 June 1997, ASX's after tax consolidated operating surplus of $15.67m included ASTC's after tax consolidated operating surplus of $11m. ASTC contributed over 70% of ASX's surplus. These figures indicate that the revenue gained by ASTC's operation of CHESS has the potential to provide a substantial, even the major, source of profits for a demutualised ASX. It may be expected, therefore, that the need to ensure the profitability of a demutualised ASX will have a direct impact on the way in which ASTC sets CHESS tariffs.

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[6] See P1, 2.28 and 7.20. References to the Commission's previous authorisations of phase 1 and phase 2 of the CHESS arrangements are cited as P1 and P2 respectively followed by the relevant paragraph number.

7.40. In relation to the original authorisation of phase 1 of CHESS, concern was expressed that CHESS would be operated primarily in the interests of ASX rather than in the interests of the securities industry generally. In its determination, the Commission put considerable reliance on the capacity of ASTC's board to act, independently of ASX, as a check on the level of tariffs charged by ASTC. To this end, the Commission was particularly concerned that ASTC's board include representatives from a wide range of sectors within the securities industry to ensure that the interests of the securities industry were adequately represented. In addition, authorisation was granted subject to the condition that ASTC's Articles of Association contain provisions authorising members of ASTC's board to act in the interests of the securities industry generally, including investors. Article 59A was inserted accordingly. Article 59A permits ASTC's directors to act in the interests of the securities industry generally, which is defined to include the interests of investors.

7.41. Within the context of demutualisation, it can be expected that commercial considerations will play an increasingly important role in determining the composition of ASTC's board. The Commission notes that ASTC's directors are drawn from a wide range of sectors in the securities industry. The Commission also recognises that industry representation on ASTC's board is of commercial benefit to ASTC because it facilitates industry acceptance of ASTC's operations and enables ASTC to anticipate the likely effect of changes to CHESS. Nevertheless, the Commission is mindful of the fact that the need for commercial expertise rather than the need for adequate industry representation may well play a key role in determining future board appointments.

7.42. The combination of the demutualisation of the ASX and the removal of Articles 86 and 59A means that ASTC's board will be obliged to optimise profits for ASTC and its shareholder, ASX. Tariffs will need to be set accordingly. With respect to optional services, the applicants have expressed a desire to set prices at a level that reflects what the market will bear.

7.43. Despite these changes, the applicants argued that there remain sufficient checks and balances to ensure that ASTC will not exploit the legal protection afforded by authorisation to charge unreasonably high fees for CHESS services. In particular, they argued that competitive pressures will ensure that CHESS fees are kept at reasonable levels.

7.44. The applicants also suggested that the commercial interests of ASTC and ASX, operating in a highly competitive international market, are closely aligned with the interests of the securities industry as a whole.

7.45. The Commission received a number of submissions arguing against the removal of Articles 59A and 86, particularly from small investors and providers of registry services. There was a high level of concern that, in the absence of these Articles, ASTC would be able to exploit its position by charging extortionate fees for its services. Ernst & Young Registry Services also noted that, in the absence of Article 59A, the board may be unable to take action in the interests of the securities industry generally if such action imposed costs on ASTC. On the other hand, at the pre-decision conference the ASA expressed the view that Articles 59A and 86 had not been effective, as Article 59A provides only that directors are "authorised to" act in the interests of the securities industry generally and Article 86 does not prevent ASTC distributing profits to ASX through various methods of inter-company transfer. The ASA considered that Article

59A should be retained, but that Article 86 should be removed to make distribution of ASTC's profit transparent.

*ASC's regulatory responsibilities*

7.46. While the applicants' have asked the Commission to evaluate the applications on the basis that Articles 59A and 86 are removed, the Commission notes that the removal of these Articles must be approved by the Minister under the regulatory regime established under Part 7.2A of the Corporations Law. In its submission, the ASC noted that Articles 59A and 86 were part of the legal and regulatory framework required to support the CHESS arrangements. Removal of these Articles would raise a range of issues about the appropriate regulatory framework needed to ensure investor protection and market integrity in relation to the clearing and settlement of securities in Australia. The effect of the applicants' proposal was to remove the protection afforded to investors by these Articles while at the same time permitting ASTC to retain the advantages conferred by the Corporations Law on ASTC as the approved securities clearing house. In the view of the ASC, these advantages are considerable. The ASC noted that both it and the Minister will need to ensure that mechanisms are put in place to safeguard the regulatory functions of SCH to ensure that the interests of issuers, participants and investors are protected.

7.47. ASIC (formerly ASC), in its submission lodged following release of the Commission's draft determination, advised that should Articles 59A and/or 86 be removed there are adequate mechanisms available under the Corporations Law to add to the regulatory regime so that it applies clear regulatory standards to ASTC and assure continuing compliance with those standards. ASIC advised that it was discussing those mechanisms with ASTC and expected to resolve the issue before dealing formally with the proposal to remove Articles 59A and 86.

7.48. However, the timing of the re-authorisation process means that the Commission must reach its determination before the ASIC and the Minister have had a chance to formally consider the removal of Articles 59A and 86. In this regard, the Commission notes that its determination should in no way be taken to pre-judge ASIC's and the Minister's own consideration under the Corporations Law of the investor protection and market integrity issues arising from the proposed removal of these Articles. The public benefit and anti-competitive tests applied by the Commission under the *Trade Practices Act* are distinct from the tests applied by the ASIC and the Minister.

7.49. It is necessary, therefore, for the Commission to evaluate the applications both on the basis that Articles 59A and 86 are removed from ASTC's Articles of Association with the approval of the ASIC and the Minister and on the basis that their removal is disallowed by the Minister.

*Articles 59A and 86 retained*

7.50. As indicated above, the existence of adequate checks and balances to protect CHESS users from the introduction of extortionate compulsory fees is a particularly important factor in the Commission's evaluation. In the Commission's previous authorisation of the CHESS arrangements, Articles 59A and 86 were taken to provide important checks and balances in this respect. In particular, operating CHESS on the basis that it would not provide a commercial return to its shareholder, ASX, removes

much of the financial incentive to exploit ASTC's dominant position in the market by charging unreasonable fees for CHESS services.

7.51. The Commission notes the view of ASA expressed at the pre-decision conference that the Commission had overestimated the importance of Articles 59A and 86, and that these articles had been relatively ineffective. However, the Commission also received a number of submissions, particularly from small investors and providers of registry services, arguing against the removal of Articles 59A and 86 on the grounds that, in the absence of these Articles, ASTC would be able to exploit its position by charging extortionate fees for its services. The Commission also notes that ASIC considers Articles 59A and 86 contribute to ASTC's performance of its regulatory responsibilities under the Corporations Law. The Commission therefore remains of the view that the retention of Articles 59A and 86 would allay many of its concerns in respect of the need for adequate checks on ASTC's power to charge extortionate compulsory fees.

7.52. However, the Commission has concerns regarding the forecast of 9 000 transactions per day which underpins ASTC's current 'cost plus redevelopment' pricing policy. A number of interested parties noted that the actual number of transactions per day on ASX's market is well over 20 000. GIO in particular argued that ASTC's assumption was grossly conservative given the recent reduction in stamp duty charges and the massive increase in share ownership following the privatisation of major businesses such as the Commonwealth Bank. This issue was also raised by a number of interested parties at the pre-decision conference.

7.53. The applicants' responded by noting that this forecast is based upon an assumption that the securities industry goes through a seven year boom bust cycle. The applicants' argued that until the market cycle had been completed they were unable to make an informed assessment of the accuracy of their pricing assumption of 9 000 transactions per day.

7.54. The Commission notes that ASX's market appears to be going through a period of sustained high activity. The Commission also recognises that ASTC's pricing policy must take into account the cyclical nature of the securities industry. However, in the Commission's view, following the listing of major Australian corporations such as the Commonwealth Bank and Telstra, the base level of market activity may be higher than that originally anticipated by ASX and ASTC.

7.55. The Commission would be concerned if ASTC's pricing policy was based on a serious understatement of the average number of transaction per day over a seven year cycle. In particular, the Commission notes that CHESS tariffs could be set at unreasonably high levels not only through increases in CHESS tariffs, but also should CHESS tariffs not be reduced to reflect a sustained increase in the average number transactions per day.

7.56. Should Articles 59A and 86 remain, it would be necessary for ASTC to reconsider the assumptions about the average number of transactions per day over the current seven year cycle. It does appear that the company may well be accumulating operating surpluses at levels above that required to cover its costs plus the redevelopment of CHESS after seven years of operation. As noted, however, Article 86 prevents ASTC distributing any excess operating surplus to its owner, ASX. The issue of what ASTC is to do with the excess operating surplus it has accumulated to date was also raised at the

pre-decision conference. The Commission notes ASTC's submission dated 30 June 1997 on this issue when it advised that tariffs have been set on the basis of cost, a development reserve requirement and a price stabilisation requirement. ASTC advised that the development reserve is for the future development of CHESS and there is no intention to use the reserve other than for the development of CHESS, eg, it is not intended that ASX have access to the development reserve.

*Articles 59A and 86 removed*

7.57. As noted above, should Articles 59A and 86 be removed, the ASTC board will be obliged to adopt a tariff policy that would optimise profits for its owner, ASX. Under such a scenario, the Commission is of the view that the existence of a competitive environment has the potential to provide the most efficient mechanism for ensuring that CHESS tariffs are kept at levels that will enable the public benefits associated with CHESS to be realised. In this regard, the primary question at issue is whether there are sufficient competitive pressures to act as a check on CHESS tariffs. Both global competition and the possibility of domestic competition are discussed below under the relevant headings.

**Global Competition**

7.58. The applicants argued that there are sufficient competitive pressures from international exchanges to act as a check on CHESS tariffs. Australian companies seeking to raise capital can list on international exchanges and international companies can list on ASX. Large institutional investors are also able to choose to invest in the market that will give them the greatest return for the least cost. The applicants argued that as a result both ASX and Australian brokers are in competition with exchanges and brokers in other countries.

7.59. In support of these claims about the international character of the securities industry, the applicants noted that all but two of the top 20 companies listed on ASX, which account for approximately 60 per cent of market turnover, are listed on overseas exchanges. They also noted that a number of Australian technology and mining companies have listed on overseas exchanges.

7.60. The applicants argued that global competition acts as a constraint on ASTC's ability to charge high tariffs and earn disproportionately large profits. If CHESS tariffs were to reach a level that rendered listing on ASX, or investing in ASX listed securities, uncompetitive with overseas exchanges, then business would move overseas. The resulting reduction in the number of transactions would have a negative effect on ASTC's capacity to raise income through fees charged for CHESS services. According to the applicants, it is therefore not in ASTC's commercial interests to increase CHESS tariffs to unreasonable levels.

7.61. In response to these arguments, a number of interested parties, both in written submissions and at the pre-decision conference, questioned the effectiveness of global competition to provide sufficient competitive pressures to ensure that CHESS tariffs do not become unreasonably inflated. Commonwealth Securities and Ernst & Young Registry Services, for example, argued in their written submissions that retail investors cannot move their business to overseas exchanges. Mr Davis speculated that ASTC could double or treble CHESS charges on small, retail trades without causing a loss of business to the exchange.