7.62. Coopers & Lybrand argued in its written submission that it is not realistic for most issuers to seek listing on foreign exchanges and so CHESS tariffs for most issuers are not influenced by natural competition. Mr Davis also suggested that companies listed on ASX with market capitalisation below the top 50 had no suitable alternative to listing on ASX, unless they had the particular attributes that make listing on NASDAQ attractive.

7.63. The Commission recognises that the globalisation of the securities industry has exposed ASX, and with it ASTC, to competition from overseas exchanges. It may be expected that global competition will act as a check on prices for CHESS services. However, the pressure from international competition is not spread uniformly across the market for CHESS services. The prices charged to some sectors of the securities industry for CHESS services are not subject to direct pressures from international competition.

7.64. The Commission also notes that the extent to which international competition acts as a check on overall CHESS prices is in no small part dependent upon the way in which CHESS tariffs are structured. It would be possible for ASTC to set tariffs in such a way that the pressures on prices exerted by global competition was limited to a particular segment of the market. Substantial discounts could be offered in those areas that are directly subject to international competition, for example large transactions by institutional investors, while at the same time prices on small retail transactions could be increased without effecting the international competitiveness of ASX.

7.65. The effect of such a strategy of price differentiation could be to limit the savings associated with CHESS to a particular segment of CHESS users. In so doing, the public benefits of CHESS, particularly in so far as they relate to small investors and issuers, may also be reduced.

7.66. It may be expected that if the trend towards greater internationalisation of the securities industry continues, the benefits that result from global competition may be extended to a larger proportion of investors and issuers. However, at present, global competition does not necessarily provide a check on CHESS tariffs for small investors and for small and medium sized issuers. If small investors wish to invest in publicly listed equities and if medium sized Australian companies wish to list on a stock exchange they have no practical alternative but to participate in CHESS and pay the associated charges.

Domestic competition

7.67. Currently there is little or no competition in the clearing and settlement of securities transactions. Three distinct clearing and settlement systems, CHESS, RITS and Austraclear, service transactions in equities, Commonwealth bonds, and non-government debt securities respectively. The current CHESS arrangements support this lack of competition. As noted in paragraph 7.27 above, brokers are required to clear and settle ASX market transactions in equity securities through CHESS, and the ASTC Board has declared ASX market transactions in debt securities ineligible for clearing and settlement through CHESS. Thus, these current arrangements ensure that ASTC (CHESS) does not face competition in the clearing and settlement of 'on market' equity transactions, and ASTC does not compete with either RITS or Austraclear in the clearing and settlement of debt transactions.

7.68. In 1994 as part of the CHESS phase 1 arrangements, the Commission granted authorisation to the exclusive dealing requirement that brokers clear and settle ASX market transactions in securities through CHESS. At that time most interested parties, including Austraclear, were not concerned about the competitive implications of such a requirement. However, the RBA considered that requiring ASX market transactions in debt securities to be settled through CHESS would be anti-competitive as such transactions would be eligible to be settled through RITS.

7.69. In its 1994 determination the Commission noted that, should the exclusive dealing conduct be authorised, stockbrokers and their clients would have the choice of trading debt securities outside of ASX's market (the vast majority of transactions in debt securities were then, and continue to be, effected outside of ASX's market) and using the facilities of Austraclear or RITS for clearing and settlement; or trading debt securities on ASX's market with clearance and settlement effected through CHESS. That is, there would competition for the provision of trading/clearing/settlement services in respect of debt securities. The Commission concluded that the exclusive dealing requirement would not significantly lessen competition and that the conduct, by ensuring that a large volume of securities transactions are cleared and settled through CHESS, would enhance the operational efficiency of CHESS.

Proposed choice of clearing and settlement facility

7.70. The applicants have advised in respect of the current applications for authorisation that, if required by the Commission, they would alter their Rules to provide brokers with the choice of using the services of an alternative clearing and settlement facility. They also submitted that, should they implement such changes to their Rules, there should be no impediment to ASTC being able to clear and settle debt securities. They advised, however, that the exclusion of debt securities from clearing and settlement through CHESS would not be removed pending resolution of apparent conflicts with the *Inscribed Stock Act*. (The Commission notes that the *Commonwealth Inscribed Stock Act 1911* does not make provision for the electronic transfer of title to Government securities. Thus, even should debt securities be declared 'eligible' by the ASTC Board for clearing and settlement through CHESS, this Act would require amendment before such services could be offered through CHESS in respect of Government securities.)

7.71. Austraclear, and its major shareholder the Commonwealth Bank, opposed the current applications for authorisation to the extent that they prevented or constrained Austraclear's capacity to offer alternative clearing and settlement facilities for equity transactions on ASX.

7.72. Austraclear operates the central securities depositary and the electronic clearing and settlement facility for Australian money market securities, excluding Australian Government securities. Austraclear's system is also licensed to the Reserve Bank of New Zealand, with Austraclear maintaining and upgrading the software. The New Zealand version of the Austraclear system supports an electronic central securities depository for both the New Zealand money market and a segment of the New Zealand Stock Exchange. Approximately one third by value of the shares listed on the New Zealand Stock Exchange are held in the electronic central depository. The New Zealand version of the Austraclear system offers DvP gross settlement in real time for both debt securities and equities held in the central depository.

7.73. Austraclear has expressed a desire to operate a clearing and settlement facility for equity transactions in competition with the CHESS system operated by ASTC and advises that it has the capability to settle equity trades between its members. The Commonwealth Bank also indicated that Austraclear could provide a competitive alternative to ASTC, particularly at the wholesale end of the market. CBA was particularly concerned that competitors, such as Austraclear, be able to offer DvP Real Time Gross Settlement for equity securities so as to fully exploit the efficiency gains that flow from an electronic transfer and settlement system.

7.74. Austraclear, the RBA (who operates RITS), and the SFE (who operates the futures market and provides, through a subsidiary, clearing and settlement services for futures transactions) all supported the proposal that ASX and ASTC amend their rules to allow for greater competition between providers of clearing and settlement services in the securities industry. The RBA also submitted that if the ASX/ASTC Rules mandate the use of CHESS to settle debt securities quoted on ASX, then re-authorisation should only be granted on the basis that debt securities continue to be declared 'excluded securities' under the Rules.

7.75. However, a number of submissions by interested parties expressed concern about the entry of competitors to ASTC. The Chartered Institute of Company Secretaries in Australia argued that, in view of the complexity of the securities industry, the qualifications of new entrants should be strictly appraised. The Institute argued that for security reasons there should be only one entity responsible for the transfer and registration of legal title to equities. For security and efficiency reasons, ANZ Nominees also did not support any change to the existing arrangements that would allow brokers to choose between alternative clearing and settlement service providers.

CHESS as a default

7.76. The applicants argued that, if alternative clearing and settlement facilities are allowed to compete with ASTC, CHESS must be established as the automatic default option for ASX market transactions. Under the applicants' proposal, brokers who wish to use an alternative clearing and settlement facility for a particular transaction would have to notify CHESS and arrange for the transaction to be removed from the CHESS settlement process. If both parties failed to agree on an alternative provider, the transaction would be settled through CHESS.

7.77. The applicants noted that under this proposal, ASX would engage in exclusive dealing conduct (for which it seeks authorisation) because brokers would be required to clear and settle through CHESS unless they agreed otherwise with their counterparty.

7.78. The applicants argued that such a default system is necessary to guarantee settlement. To do otherwise, they argued, is to run the risk that brokers would be unable to agree on which settlement service to use, with the result that a trade on SEATS may fail to be settled.

7.79. When trades are executed through ASX's SEATS trading system, a broker is not free to choose the counterparty broker for a particular trade. In a typical ASX trade through SEATS the counterparty is not known until after the trade has been executed. In his submission, Mr Davis expressed concern that in these circumstances the freedom to agree with the counterparty to opt out of CHESS is illusory. The choice to use an

alternative clearing and settlement facility may only be real when the parties, usually in large trades, already know each other.

7.80. Austraclear argued against the establishment of CHESS as the default. They suggested that it would be better for brokers to agree between themselves, subject to their clients' specific instructions, that all ASX market transactions involving them will be dealt with by a particular clearing and settlement facility, whether it be Austraclear, ASTC or another clearing and settlement facility.

Commission view

7.81. The Commission notes that should Austraclear enter the market for the clearing and settlement of equity transactions, it is probable that it would only compete for large wholesale transactions in the most active company stocks. As with international competition, domestic competition from an entity like Austraclear is, therefore, unlikely to put competitive pressure on ASTC's pricing for CHESS services in relation to small, retail trades. Nevertheless, removal of the exclusive dealing requirement that brokers clear and settle ASX market transactions in securities through CHESS would increase the potential for other clearing and settlement facilities to enter the market. Removal of this requirement is also, in the Commission's view, a necessary first step towards the realisation of a competitive check on the ability of ASTC, in the absence of Articles 59A and 86, to unreasonably increase charges for CHESS services.

7.82. The Commission also notes that a default system as proposed by ASTC would put potential competitors at a disadvantage since ASTC would automatically service those customers who did not actively seek out the counterparty to the transaction and negotiate with them about using an alternative clearing and settlement service provider. It remains unclear under the applicants' proposal how this could be done in an efficient manner. However, the Commission recognises that if brokers are to be given a choice between competing clearing and settlement facilities, there needs to be a default mechanism to ensure that settlement does not fail because brokers are unable to agree on which facility to use.

7.83. Nevertheless, the Commission is concerned that the default mechanism proposed by ASX and ASTC has the potential to operate as a substantial barrier to competition. Under the applicants' proposal, the default could be employed because counterparties are unable to efficiently communicate their desire to clear and settle through an alternative facility, rather than because they are unable to agree on which facility to use. Without an efficient and effective means of communication between counterparties, the default mechanism could seriously undermine the ability of brokers to choose between competing clearing and settlement facilities and so undermine the ability of an alternative clearing and settlement facility to compete with ASTC.

7.84. The Commission is also concerned at the anti-competitive effect of the exclusion by the ASTC Board of ASX market transactions in debt securities from clearing and settlement through CHESS. As noted, this exclusion ensures that ASTC does not compete with either RITS or Austraclear.

7.85. In its draft determination the Commission proposed, should ASTC Articles 59A and/or 86 be removed, to grant authorisation subject to a condition that:

- the applicants alter their Rules to explicitly permit brokers to use the services of a clearing and settlement facility other than that operated by ASTC to clear and settle ASX market transactions.

In addition, to the extent that the applicants could otherwise hinder the entry of a competitor to ASTC in the clearing and settlement of transactions on ASX's market, the Commission intended to include a condition to the authorisation a requirement that:

- the applicants not use any power under their Rules to prevent an entity from competing with ASTC or unreasonably constrain an entity's ability to compete with ASTC in the provision of clearing and settlement services.

The Commission also intended to authorise the proposal that CHESS operate as a default facility where the counterparties to a transaction are unable to agree on which clearing and settlement facility to use, subject to the condition that:

- ASTC and ASX provide a means through which the counterparties to an ASX market transaction can efficiently communicate their desire to have a transaction cleared and settled through an alternative facility.

This latter condition was intended to ensure that the default mechanism only operates when the counterparties are unable to agree on which clearing and settlement facility to use, rather than operating because the counterparties are unable to communicate effectively concerning use of an alternative facility.

7.86. However, in its draft determination the Commission also proposed, should ASTC Articles 59A and/or 86 not be removed, to grant authorisation without these three conditions.

7.87. In addition, in its draft determination the Commission proposed to grant authorisation subject to the condition that the applicants remove the exclusion of debt securities from clearing and settlement through CHESS. It was proposed that this condition would apply whether or not ASTC Articles 59A and/or 86 were removed.

7.88. Following release of the draft determination the RBA advised it supported greater competition in the provision of securities clearing and settlement services provided this 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 consistent with minimising risk in the financial system, which may require such transactions to be settled on a real time basis. However, the RBA was not convinced by the arguments for maintaining CHESS's exclusive right to settle equities prior to demutualisation which was seen as inconsistent with the approach on debt securities. The RBA submitted that the three conditions noted in paragraph 7.85 above should apply whether or not ASTC Articles 59A and/or 86 are removed. At the pre-decision conference ASA also argued that these three conditions should apply whether or not ASTC Articles 59A and/or 86 are removed.

7.89. The Commission has reconsidered this matter. Should the Commission grant authorisation without these three conditions outlined in paragraph 7.85 above, it would be re-authorising the original exclusive dealing conduct - that brokers clear and settle ASX market transactions in securities through CHESS. As a consequence, ASTC (CHESS) would not face the possibility of competition in the clearing and settlement of

'on market' security transactions. The Commission now takes a different view of the effect on competition of this exclusive dealing conduct than its view in 1994 in granting authorisation to the CHESS phase 1 arrangements (when it concluded the conduct would not significantly lessen competition). The anti-competitive nature of the conduct has been highlighted by Austraclear expressing interest in operating a clearing and settlement facility for equity transactions in competition with the CHESS system. This exclusive dealing conduct would act as a substantial barrier to entry for Austraclear or any other potential provider of clearing and settlement facilities for equity transactions.

7.90. The Commission considers that the original exclusive dealing conduct, by ensuring that a large volume of securities transactions are cleared and settled through CHESS, would enhance the operational efficiency of CHESS. As noted, the Commission also considers that ASTC Articles 59A and 86 provide a check on ASTC's power to charge extortionate fees for CHESS services. Consequently, should these Articles remain, the Commission accepts that the efficiency gains resulting from the original exclusive dealing conduct would be likely to result in benefit to the public. (The Commission does not, however, accept that such public benefit would be likely to result in the absence of Articles 59A and 86.) However, the Commission is not satisfied that the public benefit likely to result from this exclusive dealing conduct would outweigh the anti-competitive detriment likely to result from the conduct.

7.91. The Commission notes that the applicants proposed, if required by the Commission, to alter their Rules to provide brokers with the choice of using the services of clearing and settlement facilities other than CHESS, provided that CHESS be established as the automatic default option for ASX market transactions. The proposal that CHESS operate as a default facility constitutes exclusive dealing conduct. The Commission confirms its view that this modified exclusive dealing conduct should be granted authorisation subject to the conditions outlined in paragraph 7.85 above. The Commission is satisfied that subject to these conditions the modified exclusive dealing conduct would be likely to have little anti-competitive effect but would be likely to result in market efficiencies and benefit to the public as the conduct will ensure that settlement does not fail because brokers are unable to agree on which clearing and settlement facility to use.

7.92. The Commission therefore refuses to authorise the original exclusive dealing conduct - that brokers clear and settle ASX market transactions in securities through CHESS. The Commission grants authorisation to the modified exclusive dealing conduct - that brokers be able to choose to use the services of clearing and settlement facilities other than CHESS provided that CHESS be established as the automatic default option for ASX market transactions - subject to the conditions outlined in paragraph 7.85 above.

7.93. The Commission also requires as a condition of authorisation of the CHESS arrangements that the applicants remove the current exclusion of ASX market transactions in debt securities from clearing and settlement through CHESS. (In imposing this condition the Commission notes that the *Commonwealth Inscribed Stock Act 1911* would require amendment before Government debt securities could be cleared and settled through CHESS.)

Corporations Law impediments to competition

7.94. ASIC has confirmed that as a practical matter no ASTC competitor could provide a facility for the electronic transfer of legal title without amendment to the Corporations Law. Treasury's submission on this issue is noted in paragraphs 6.27 to 6.29 above. Briefly, Treasury advised that the Corporations Law does not confer any exclusive rights on ASTC (the approved SCH under the Law) in relation to the settlement and registration of transactions involving ASX quoted securities and quoted rights. Treasury noted that while ASTC is not a statutory monopoly in relation to securities clearing, its approval as the SCH clearly has significance and legal consequences. In particular, 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.

7.95. In New Zealand the Austraclear system delivers beneficial rather than legal title in respect of securities held in the central depository. ASX and ASTC have suggested that such a beneficial title system could be operated by Austraclear in Australia in competition with ASTC without changes to the Corporations Law.

7.96. In its submission, however, Austraclear emphasised that a settlement system that cannot deliver legal title in one step is substantially inferior to CHESS and could only obtain market acceptance if it could offer significant cost savings. In its submission following release of the Commission's draft determination, Austraclear confirmed its desire to clear and settle equity securities. It has had for some time the ability to provide such services on a beneficial or equitable title basis, however, to do so would place it at a competitive disadvantage to ASTC. Austraclear's preference is for amendments to be made to the Corporations Law to enable it to effectively compete with ASTC on a legal title basis.

7.97. Thus, apart from any barriers to competition in the applicants' Rules, there may be other legal and practical impediments to the entry of competitors to CHESS in the clearing and settlement of equity transactions. As noted in the submissions of ASIC and Treasury, the Corporations law confers market advantages on ASTC as the securities clearing house approved under the Law. ASTC has also referred to apparent problems that settlement of debt securities through CHESS would raise under the *Inscribed Stock Act*. Various legislative changes may therefore be needed to facilitate genuine and fair competition between securities clearing houses.

7.98. In this regard, the Commission notes that Treasury is currently considering changes to the way in which clearing and settlement facilities are regulated under the Corporations Law. In particular, the Corporate Law Economic Reform Program (CLERP) includes a proposal to establish a licensing system for operators of clearing and settlement facilities. Treasury has 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 for consideration by the Government.

7.99. The issue of legislative reform is further discussed in section 8 of this determination. The Commission would, however, support changes to the Corporations Law and other legislation that would facilitate genuine and fair competition between clearing and settlement facilities in the Australian securities industry, and which did

not result in increased risk in the financial system which outweighed the benefits of such increased competition.

Direct price monitoring by the ACCC

7.100. A number of interested parties argued in their submissions that should ASTC be allowed to operate on a dividend paying basis, some regulatory mechanism should be implemented for the ongoing control of tariffs for CHESS services, see the summary of submissions in section 5 of the determination. National Australia Custodian Services, for example, strongly argued that it was unacceptable for a monopoly to operate without being subject to a price justification process. The Australian Shareholders' Association also argued that ASTC's operations should be scrutinised by an independent body while ever ASTC operates in a non-competitive environment.

7.101. The applicants responded by arguing both that ASX and ASTC were subject to competitive pressures from overseas exchanges and that the Commission should be reluctant to play the role of tariffs setter until other safeguards have been shown to fail. The applicants also suggested that if ASTC's tariffs were later shown to have deprived the public of the benefits associated with CHESS, the Commission could revoke the authorisation and grant a fresh authorisation subject to new conditions or the giving of undertakings under section 87B of the Act. The applicants argued that this power of revocation provided an important check on ASTC's power to charge extortionate fees.

7.102. The limited capacity of international competition to provide a check on CHESS tariffs has been discussed above. In addition to competition from overseas exchanges, however, the Commission has also considered the possibility of competition from domestic clearing and settlement facilities. Changes to the ASX and ASTC Rules to remove the barriers to competition in the clearing and settlement of ASX market transactions, which are required as a condition of authorisation, have been discussed above. Legislative changes that may be needed to facilitate competition in the clearing and settlement of ASX market transactions have been noted above and are also discussed in section 8 of this determination.

7.103. At the pre-decision conference a number of interested parties again expressed concern at the lack of external control over CHESS fees. In addition, the Chartered Institute of Company Secretaries and National Australia Custodian Services lodged further written submissions (see section 6 of this determination) on this issue following release of the draft determination. Both submitted the Commission should reconsider the CHESS fee structure and excess profit issue and include a mechanism for regulating CHESS fees. National Australia Custodian suggested the Commission should consider the tariff principles of CREST in the United Kingdom. It provided an extract from a CREST newsletter which advised that CREST was not established to make excess profits. CREST's return to shareholders is fixed and any surplus of revenue over expenditure after making prudent reserves are returned to users as a rebate.

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

7.105. While acknowledging the concern of CHESS users, the Commission remains of the view that, should ASTC be allowed to operate on a dividend paying basis, the existence of a competitive environment is a more efficient mechanism than formal price regulation as a means of ensuring that CHESS tariffs are kept at levels that will enable the public benefits associated with CHESS to be realised. The Commission considers, therefore, that an opportunity should be given to determine whether or not competitive pressures are sufficient to act as a check on CHESS tariffs.

7.106. The Commission notes, however, that some form of formal price regulation may be necessary in the future if it is shown that competitive pressures are not such as to keep CHESS fees at levels that ensure the realisation of the public benefits associated with CHESS, particularly for retail investors and small to medium sized issuers. The Commission also notes that if ASTC's future pricing policy was such that the efficiency gains associated with CHESS were not resulting in a benefit to the public sufficient to outweigh the anti-competitive effect of the CHESS arrangements, the Commission would regard such a policy as changed circumstances justifying review and revocation of authorisation of the CHESS arrangements.

Access to CHESS DvP settlement by ASX competitors

7.107. At the pre-decision conference SFE noted 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 CHESS DvP settlement. 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.

7.108. SFE was concerned that SCH Business Rule 7.1 limits transactions that are eligible for DvP settlement to "on market" transactions as defined by ASTC. As a result of transactions on SFE's market not being classified as "on market" transactions and thus being excluded from CHESS DvP settlement, 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 similarly not be able to benefit from the efficiencies of CHESS DvP settlement.

7.109. 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 in respect of the transactions is in place. SFE submitted that this would have efficiency benefits and reduce risk in respect of the transfer of ASX listed securities as well as overcoming the anti-competitive effect of the current Rule.

7.110. At the pre-decision conference, ASA submitted 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, and that ASTC's monopoly underlines ASX's monopoly in equities trading. ASA considered that there needs to be adequate checks on ASTC's monopoly power (it supported the draft determination's checks of authorisation for 5 years only and the Commission's monitoring of changed circumstances and possible revocation of the authorisation). ASA also submitted that

the Commission should require ASTC to make its services available to competitors of ASX, and on no less favourable terms.

7.111. ASTC has confirmed that CHESS DvP settlement is currently limited to transactions that are entitled to the settlement guarantee of the NGF. (The CHESS DvP settlement process and application of the NGF guarantee, as advised by ASTC, are outlined in section 6 of this determination.) ASTC accepted that it may be appropriate in due course to extend the range of transactions that may be settled through CHESS DvP. However, ASTC submitted that there are significant legal policy issues (which are appropriate for consideration under the current CLERP process) as well as practical and technical issues which need to be resolved prior to extending access to CHESS DvP settlement.

7.112. ASTC also noted that SCH Business Rule 7.1 includes a discretionary provision under which SFE Deliverable Share Future contracts could be determined by ASTC to be eligible for CHESS DvP settlement. ASTC considered it inappropriate to use the authorisation process as an indirect way of requiring ASTC to provide access to CHESS DvP without giving it the opportunity of assessing the implications of such access. ASTC also noted that a decision to admit Deliverable Share Futures contracts to CHESS DvP would necessarily involve consideration by ASIC of CHESS-integrity and NGF-guarantee issues, and any related changes to the SCH Business Rules would also require the approval of ASIC and the Treasurer. ASTC submitted that as it has no control over such regulatory processes, it would be inappropriate that authorisation of the CHESS arrangements be made conditional on extending DvP settlement to Deliverable Share Futures, or that any timetable be imposed for determination of this matter.

7.113. 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. 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. However, within the time available ASIC had not been able to come to a definitive conclusion on the issue.

7.114. As noted above under the heading "Domestic competition", the Commission is to impose conditions of authorisation in respect of the CHESS arrangements to ensure that ASTC does not obtain a monopoly in respect of the clearing and settlement of equity securities as a consequence of the applicants' rules. As also noted, Treasury has advised that while the Corporations Law does not provide ASTC with a statutory monopoly in relation to securities clearing, it does confer market advantages on ASTC as the approved securities clearing house under the Law. Treasury advised that such advantages are an unintended consequence of the relevant provisions of the Corporations Law (and the associated ASTC and ASX rules), and will be taken into account in designing, under the CLERP process, the new legislative scheme for financial instruments (including securities and derivatives).

7.115. SFE has forcefully put the point, however, that whilst alternative clearing and settlement providers may be established as a consequence of the Commission's determination (and proposed changes to the legislative scheme), it is likely that ASTC will remain the predominant service provider in view of the significant efficiency benefits of a centralised netting facility in DvP settlement. ASA supports SFE's view, arguing that ASTC is a natural monopoly in regards to the clearing and settlement of equity securities, having advantages as the original supplier of such services over potential competitors.

7.116. Should the views of SFE and ASA prove correct and ASTC maintains a monopoly position in clearing and settlement of equity securities, despite reducing the barriers to entry for potential competitors through changes to the CHESS arrangements and the legislative scheme, abuse by ASTC of its power could cause the Commission to reconsider its authorisation of the CHESS arrangements. As noted above, if ASTC's future pricing policy were such that the efficiency gains associated with CHESS were not resulting in a benefit to the public sufficient to outweigh the anti-competitive effect of the CHESS arrangements, the Commission would review its authorisation of the CHESS arrangements. In addition, should CHESS exhibit natural monopoly characteristics, the provisions of Part 111A of the Trade Practices Act may be relevant to the CHESS access arrangements, including the price of its services[7].

7.117. In any event the Commission, as part of its authorisation of the CHESS arrangements, is obliged to consider the anti-competitive and public benefit consequences of SCH Business Rule 7.1.

7.118. It is clear from SFE's submission that at least some providers of alternative trading facilities, or parties to securities transactions that take place outside of ASX markets, may wish to have access to CHESS DvP settlement. The Commission notes that the current SCH Business Rule 7.1.3(d) provides ASTC with discretion to extend eligibility for CHESS DvP settlement to any class of transaction. The Rule does not include any criteria by which ASTC assesses such eligibility, and there is no avenue of appeal from a decision by ASTC concerning such eligibility.

7.119. The Commission agrees with the submission by SFE that if the organisation seeking approval for a new class of transaction is perceived as a competitor of ASX, it is of little comfort for such approval to be at the discretion of ASX's subsidiary, ASTC. The Commission notes that the current SCH Business Rule 7.1 does limit the types of transaction eligible for access to CHESS DvP settlement, and is of the view that the Rule is anti-competitive despite the discretion which ASTC currently has to extend access to DvP settlement to other transactions.

7.120. The Commission considers that limiting the classes of transaction eligible for CHESS DvP settlement to transactions that are covered by an appropriate guarantee structure, is likely to result in benefit to the public by preserving the integrity of CHESS and by providing protection to investors. ASTC has advised that CHESS DvP

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[7] Under Part 111A of the Act, services may be "declared" by the Minister on the recommendation of the National Competition Council. Following declaration, parties may negotiate access to the services, and access disputes may be determined by the Commission. As an alternative to the declaration process, the service provider may give an access undertaking to the Commission specifying the terms and conditions on which access will be made available to third parties.

settlement is currently limited to transactions that are entitled to the settlement guarantee of the NGF.

7.121. The Commission notes the disagreement between SFE and ASTC as to whether the guarantee structure which supports SFE's Deliverable Share Futures contracts is sufficient, and whether there are appropriate procedures in place to ensure that risks of default are properly attributed to the relevant guarantee mechanism, to admit transactions in this SFE product to CHESS DvP settlement. ASIC has specific responsibility under the Corporations Law for securities market integrity and investor protection issues. In this regard, the Commission notes ASIC's advice 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. In response, SFE pointed out that its proposal would limit the range of parties with access to CHESS DvP to those that have adequate and sufficient guarantee structures in place, such as that of SFECH. SFE noted that both it and SFECH are bodies approved pursuant to relevant provisions of the Corporations Law, and advised it was certain that any outstanding regulatory concerns could be addressed to ASIC's satisfaction.

7.122. It is the absolute discretion that ASTC has under current SCH Business Rule 7.1.3(d) that is of concern to the Commission. As it is currently worded, this Rule could be used in an anti-competitive way to exclude products in competition with ASX products from CHESS DvP settlement, even if such products were covered by an appropriate guarantee structure. In order to grant authorisation in respect of SCH Business Rule 7.1 the Commission needs to be satisfied that the provisions would be likely to result in a benefit to the public and that such benefit would outweigh the anti-competitive detriment to the public likely to result from the provisions. The Commission is not so satisfied.

7.123. However, the Commission would be satisfied that SCH Business Rule 7.1 would be likely to result in net public benefit should it be amended so that transactions which satisfy appropriate objective criteria relating to relevant technical, procedural, investor protection, etc issues, are eligible for CHESS DvP settlement; and so that decisions by ASTC in respect of such eligibility are subject to an appropriate appeal mechanism.

7.124. Accordingly, the authorisation that the Commission grants is to be subject to the conditions that:

- SCH Business Rule 7.1 be amended to provide that a transaction is eligible for CHESS DvP settlement if the transaction is of a class of transaction determined by ASTC in accordance with objective criteria to be so eligible, and that any such determination by ASTC is subject to an appeal mechanism; and
- the relevant objective criteria and appeal mechanism are formulated to the Commission's satisfaction by ASTC within three months of the date that this determination comes into force.

7.125. The Commission recognises that any necessary changes to the SCH Business Rules will be subject to the disallowance procedures under the Corporations Law.

Competition among payments providers

7.126. The SCH Business Rules require all CHESS participants to have in place a payments facility with a payments provider. A payment facility is a facility operated by a payments provider on behalf of the participant for the purpose of making and receiving payments in respect of DvP settlement.

7.127. The definition of payments provider that was authorised as part of the second phase of the introduction of CHESS envisioned the appointment of a financial supervisor to approve payments providers. This was part of the mechanism to allow credit unions and building societies to participate as payments providers. The rationale behind such an approval mechanism was to ensure that prospective payments providers, particularly credit unions and building societies, had the financial capacity to meet the indemnity requirements imposed under the Standard Payments Provider Deed (SPPD).

7.128. In its authorisation of the phase 2 arrangements, the Commission noted that it expected ASTC to determine within six months of the phase 2 arrangements being implemented whether or not a financial supervisor was likely to be appointed to undertake the approval process.[8] Using this time frame, the Commission anticipated that when the applicants applied for re-authorisation, there would be around one year's experience of the process of approval of financial institutions' capacity to meet the indemnity requirements needed to participate in DvP settlement. In fact, at the time the applicants submitted their application for re-authorisation in March 1997, a financial supervisor had not been appointed.

7.129. Throughout February, March and April of this year, the applicants distributed a number of proposed amendments to the definition of payments provider. These proposals retained most of the elements of the previous definition of payments provider authorised by the Commission in December 1995. The primary effect of these proposed amendments was to remove the requirement that payments providers be approved by a financial supervisor and to include a requirement that payments providers operate an exchange settlement account in their own name with the Reserve Bank of Australia. These proposed amendments are set out in **Attachment C** to this determination.

7.130. Under the proposed amended definition of payments provider, an entity must:

(i) operate in its own name an Exchange Settlement Account (ESA) with the Reserve Bank of Australia,

(ii) be a bank, building society, credit union or special service provider regulated under the Financial Institutions Code;

(iii) have the operational capacity to authorise and make payments on behalf of and to CHESS participants, and register entries in the CHESS payments Provider User Group for the purpose of discharging its net payments to and from the CHESS bank under the Standard Payments Provider Deed;

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[8] P2, 6.33.

(iv) meet the technical and performance requirements prescribed by ASTC to ensure that the entity does not affect the integrity or orderly operation of CHESS; and

(v) execute a Standard Payments Provider Deed.

7.131. The Standard Payments Provider Deed is a standard form agreement between ASTC, TNSC, APCA and each payments provider. The SPPD enables an electronic link between CHESS and financial institutions to facilitate DvP settlement. The SPPD sets out the obligations of the Payments Provider and the procedures to be followed for electronic funds transfer in DvP. Under the SPPD, a payments provider is required to be:

- a member of the CHESS Payments Provider User Group;
- a member of the Inter-Bank Payments System; and
- a member of APCA, or to have given a non-member undertaking to APCA.

Under the SPPD, each payments provider must fund any loss suffered if a settlement is cancelled as a result of default by that payments provider. The SPPD also sets out a range of circumstances in which ASTC can suspend or terminate payments providers, which are subject to a right of appeal. These circumstances relate to a failure or anticipated failure by a payments provider to fulfil its payment obligations.

7.132. The CHESS Payments Provider User Group is a sub-system within the Inter-Bank Payments System established to enable financial institutions to satisfy the payment obligations of CHESS participants. The Inter-Bank Payment System is a system for transferring value between financial institutions by the debiting and crediting of exchange settlement accounts (or other similar accounts) maintained by the Reserve Bank. Currently, the Reserve Bank Information and Transfer System (RITS) is being used as the Inter-Bank Payments System.

7.133. APCA co-ordinates and manages payments clearing arrangements for each of the clearing systems it has established. Individual institutions are responsible for their own clearing operations, and must conduct their clearing operations in accordance with APCA's rules. APCA currently manages four payments clearing systems: the Australian Paper Clearing System, the Bulk Electronic Clearing System, the Consumer Electronic Clearing System and the High Value Clearing System. The Commission has authorised three of these systems and has issued a draft determination in respect to the Consumer Electronic Clearing System. APCA has three broad categories of membership: share members, participating members and associate members. Participating members of APCA are those providers of payments services who are participants in one of APCA's clearing systems.

7.134. In granting authorisation to the CHESS phase 2 arrangements, the Commission was of the view that:

- the requirement that payment providers be members of APCA or give a non-member undertaking to APCA would have little anti-competitive effect and would be likely to assist the efficiency of DvP settlement given APCA's central role in the self-regulatory payments clearing arrangements and the

importance of the interface between CHESS and the payments system in DvP settlement.

- the requirement that payment providers have an ESA (or other similar account with the RBA) and be members of RITS would limit the number of entities able to provide payment services in CHESS DvP settlement, but these requirements would be likely to result in net public benefit through the reduction of risk in the settlement of securities transactions.
- the requirement that payment providers meet the technical and performance requirements set by ASTC to ensure that the entity does not affect the integrity or orderly operation of CHESS, was appropriate providing that such requirements are objectively set.

The Commission remains of the view that these requirements are likely to result in a net benefit to the public.

7.135. Both the Credit Union Services Corporation (Australia) Ltd (CUSCAL) and the Australian Association of Permanent Building Societies (AAPBS) lodged submissions with the Commission expressing general support for the applicants new proposal for the definition of payments provider.

7.136. However, CUSCAL submitted a number of recommendations to remove institutional bias from the definition of payments provider and to bring the definition of payments provider into line with the process of law reform following the recommendations of the Wallis Report. These submissions are discussed above in section five of this determination.

7.137. The Commission notes that the proposal to require non-bank financial institutions to be approved by a financial supervisor before they could operate as payments providers has proved unworkable.

7.138. The Commission also notes that "operating an exchange settlement account with the RBA in its own name" is the most important limitation in the proposed definition of payments provider. To date only banks and licensed special service providers have been granted access to an ESA or similar account with the RBA.

7.139. In the case of special service providers, the Commission notes that the RBA uses the term "settlement account". CUSCAL advises, however, that the RBA accepts that settlement accounts operated by special service providers are the same as an ESA operated by a bank. In this regard, the Commission has evaluated the applicants' proposed requirement that payments providers operate an ESA with the RBA to include similar settlement accounts operated by NBFIs.

7.140. The Commission would not accept the applicants' proposal if any technical difference between the terms 'exchange settlement account' and 'settlement account' was used to exclude NBFIs from operating as payments providers.

7.141. On the matter of settlement facilities, the Wallis Inquiry's general recommendation was that the RBA should continue to determine the right to hold an ESA on the basis of clear and open guidelines determined by the Payments System

Board and that there should be no presumption that banks and special service providers would be the only holders of settlement facilities.[9] The Inquiry also recommended that the Payments System Board should provide clearing and settlement approval to all deposit taking institutions with a banking authorisation and to other institutions and entities subject to their meeting appropriate prudential guidelines.[10]

7.142. The Commission recognises that the integrity of the CHESS clearing and settlement system rests on the prudential soundness of participating payments providers that are responsible for the final settlement of financial obligations arising from the clearing of transactions through CHESS. The Commission also notes that the RBA's current and proposed role in respect of the provision of ESAs or similar accounts is consistent with its responsibility for managing the liquidity and stability of the financial system.

7.143. Limiting participation in CHESS as a payments provider to entities that operate an ESA or similar settlement account with the RBA in its own name provides a means for ensuring that payments providers fulfil objective prudential requirements necessary to ensure the stability and integrity of the CHESS clearing and settlement system.

7.144. The Commission notes, however, that the proposed definition of payments provider not only specifies that an entity must operate an ESA in its own name, but also be an institution of a specific type. The applicants have been advised that the Commission would be concerned if the list of institutions within the proposed definition of payments provider excluded, without justification, an entity that either now or in the future (for example, following the implementation of the Wallis recommendations) is able to operate an ESA or similar account in its own name. One way of ensuring this does not occur would be to remove the references to specific types of institutions from the proposed definition.

7.145. The Commission intends, therefore, to grant authorisation subject to the condition that the proposed payments provider criterion that an entity must maintain an ESA or similar settlement account with the RBA in its own name not be further qualified so as to exclude particular types of institutions with such settlement facilities.

7.146. The Commission also accepts the proposed removal of provision (e) from the current definition of payments provider and the proposed removal of the phrase "either directly or in the case of a building society or credit union, via its nominated bank or special service provider" in parenthesis in provision (b)(iii) of the definition.

7.147. The Commission notes CUSCAL's advice that under section 866 of the Corporations Law, and corresponding provisions in the ASX Business Rules, brokers are required to operate their trust accounts with a bank. CUSCAL argues that these provisions would need to be changed before non-bank deposit taking institutions can fully participate in CHESS. CUSCAL also advised that it had taken up the issue of amendment of section 866 with the Treasury. The Commission has since been advised by Treasury that section 866 has been amended, with the words 'approved deposit taking institution' being substituted for the word 'bank'. The Commission notes ASTC's

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9 *Financial System Inquiry Final Report*, March 1997, recommendation 73.

10 *Financial System Inquiry Final Report*, March 1997, recommendation 77.

recent advice that the relevant ASX Business Rules will be amended to accord with the amendment to section 866 of the Corporations Law, however, there is presently an embargo on all ASX rule changes until after demutualisation in October 1998.

Brokers and NBPs

7.148. The Rules governing the operation of CHESS effect the relative positions of brokers and NBPs in the provision of investment services by way of sponsoring holdings on the CHESS subregister.

7.149. The CHESS arrangements impose limitations and obligations specific to NBPs. In the absence of coverage by the National Guarantee Fund (NGF), NBPs are required to lodge a performance bond of at least $250,000. NBPs are also unable to convert securities from a certificated subregister to the CHESS subregister without recourse to the Registry. In practice this means that it takes an NBP longer than a broker to convert securities. The rationale behind this limitation is to provide additional protection for investors in the absence of coverage by the NGF.

7.150. In addition, only a limited class of entities subject to regulation, such as banks, insurance companies and trustee companies,[11] are permitted to sponsor holdings, as NBPs, on the CHESS subregister. While these restrictions are likely to lessen competition for the provision of sponsorship services, the Commission accepts that these restrictions are needed to protect investors and are in the public interest. The Commission also notes that it has received no submissions from parties who wish to act as NBPs but are excluded by these provisions.

7.151. National Australia Custodian Services expressed concern that Rule 10.21.1 discriminated against NBPs by only allowing parties to remove a scheduled settlement in the circumstances set out in the Rule if at least one party to the transaction is a broker. In response the applicants' noted that by moving settlement cut off to 10:30am on the day of settlement, the period of time during which participants were exposed to the risks associated with their clients becoming insolvent was now only a matter of hours. ASTC's response appears to answer the substantive concerns raised by National Australia Custodian. In addition, the Commission notes that ASTC intends to schedule this Rule for review in September 1998.

7.152. The Commission also notes that the tariff for brokers to broker transactions is $1.10 while the tariff for transactions between a broker and a NBP is $1.60. While Commonwealth Securities Ltd noted this inconsistency, the Commission did not receive any submissions from NBPs arguing that this substantially effected their competitive position.

7.153. The applicants advised that since September 1994, the number of NBPs has substantially increased, from 46 to 70, while the number of brokers has remained largely static. This strongly suggests that the competitive position of NBPs has not being adversely effected by the CHESS arrangements. The Commission recognises that the additional obligations and limitations imposed on NBPs, which are designed to ensure the protection of investors, are in the public interest.

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[11] For a complete list of these regulated entities, see SCH Business Rule 9A.3.2 outlined above in section three of this determination at paragraph 3.42.

7.154. Were ASTC to use its powers under the Rules, including the power to set tariffs, to substantially effect the competitive position of NBPs, the Commission may regard this as changed circumstances justifying revocation of this authorisation under section 91 of the *Trade Practices Act*.

7.155. In addition, the Commission notes that it did not receive any submissions from brokers expressing concern that the CHESS arrangements adversely effect the ability of small brokers to compete with large broking houses.

Small investors' concerns

Broker sponsorship

7.156. Only brokers and NBPs, as CHESS participants, have direct access to the electronic transfer and settlement facilities of CHESS. Brokers and certain NBPs may control sponsored holdings of securities on the CHESS subregister in the name of another person (the sponsored holder, or owner, of the securities), provided there is a current sponsorship agreement in place. Under such an agreement, the sponsoring broker or NBP is appointed to provide transfer and settlement services as agent for the sponsored client in relation to the sponsored holding of securities.

7.157. A number of small investors expressed concern that brokers' sponsorship agreements stifled competition between brokers by tying investors to one broker. The Commission notes, however, that the Rules are not designed and do not have the effect of tying investors to the sponsoring broker.

7.158. Having entered into a sponsorship arrangement with a broker in relation to a particular parcel of shares, there is nothing in the Rules that prevents an investor trading in those or other shares though another broker. In addition, investors are able to change the broker sponsoring a specific parcel of shares, provided they have settled all accounts with the original sponsoring broker.

7.159. Nevertheless, the Commission notes that some investors appear to be inadequately informed about their ability to change sponsoring brokers. To ensure that the CHESS arrangements do not have the practical effect of limiting competition between brokers, brokers who mislead investors about their rights in this respect should be dealt with under ASX's disciplinary procedures. ASX and ASTC should also continue to ensure that information provided to investors clearly indicates the rights of investors to trade through the broker of their choice and to change sponsoring brokers.

7.160. Commonwealth Securities Ltd objected to the requirement that brokers ensure that the sponsored holder understand the sponsorship agreement. Commonwealth Securities also argued that the sponsorship agreements are too legalistic.

7.161. This aspect of the Rules relating to sponsorship agreements appears to have little if any anti-competitive effect and results in benefits to the public. The Commission agrees with the applicants' response that, given the fiduciary nature of the sponsorship agreement, holders need to be fully informed of their rights. Moreover, the Rules do not appear to require excessively legalistic agreements, particularly given the increased flexibility introduced by the new section 3A of the Rules.

Issuer sponsorship

7.162. A number of small investors suggested that ASX was not doing enough to encourage issuer sponsored subregisters, which enable investors to maintain uncertificated shareholdings without entering into a sponsorship agreement with a broker or NBP. The Australian Shareholders Association as well as Coopers & Lybrand were also concerned that some brokers were forcing investors to convert from issuer sponsorship to broker sponsorship.

7.163. The Rules submitted for authorisation enable investors to hold securities by means of issuer sponsorship as an alternative to sponsorship by a broker or NBP. If this is to provide investors with a real alternative to sponsorship by a broker or NBP, it is important that investors are aware of the option of holding shares by means of issuer sponsorship. It is important therefore that brokers who mislead investors about their ability to maintain shareholdings on issuer sponsored subregisters are disciplined appropriately. It is also important that general information provided to investors about holding ASX listed equities by ASX and ASTC contains information about the possibility of holding shares by means of issuer sponsorship.

7.164. In a submission lodged with the Commission in February 1998, the applicants advised that shares representing 62% of the total value of ASX market capitalisation are held in uncertificated form on the CHESS subregister. When uncertificated holdings on issuer sponsored subregisters are added to this, ASX estimates that 80% of the total market capitalisation is already held in uncertificated form.

7.165. It may be expected that certificated registers will ultimately be phased out. ASX is currently circulating a draft Listing Rule to interested parties that would require issuers to be fully uncertificated by the end of 1998. Investors will then have a clear choice between maintaining their holding by means of issuer sponsorship and maintaining their holding by means of broker or NBP sponsorship.

7.166. In response to concerns raised in the initial authorisation of phase 1 of CHESS, the applicants advise that ASTC's audit power has not been used to discriminate against the provision of issuer sponsored subregistry services. The Commission has not received any submissions from interested parties suggesting otherwise.

Registry service providers

7.167. The Commission received submissions from Coopers & Lybrand Securities Registration Services and Ernst & Young Registry Services. A number of their concerns have been discussion in the previous section regarding misleading statements by brokers about issuer sponsorship.

7.168. In addition, Coopers & Lybrand noted that while brokers appear to have derived significant benefits from the introduction of CHESS as a result of reduced costs through reductions in back-office staff numbers, issuers do not appear to have enjoyed any obvious cost savings. This is shown by the applicants' own feedback from users submitted in attachment M to the application.

7.169. Coopers & Lybrand argued that for the majority of issuers, maintaining an issuers sponsored subregister is more expensive than maintaining a certificated share register. This is because issuer sponsorship involves an ongoing obligation on the part

of the issuer to send out, potentially monthly, statements. With a certificated register, issuers are only required to issue share certificates when shares are purchased. The volume of statements required to be sent out to shareholders is, therefore, greater in an uncertificated environment than in a certificated environment.

7.170. Coopers & Lybrand argued that it is important that tariffs for issuer sponsored and CHESS transactions are comparable to ensure fair competition between the two types of holdings.

7.171. Ernst & Young Registry Services also expressed concern that CHESS may be used to reduce the economic viability of registry service providers. In particular, Ernst & Young were concerned that ASTC would use its Rule making power to encroach on the market traditionally serviced by registry service providers.

7.172. The Commission notes that ASTC has considerable power to effect the ability of professional share registries to provide registry services to issuers on a competitive basis. The Commission also notes that in addition to the mandatory services that ASTC provides to issuers, ASTC also provides optional services in direct competition with professional share registries.

7.173. The CHESS arrangements and in particular CHESS tariffs must not be structured in a way that artificially directs or encourages investors to hold securities in the CHESS subregister as opposed to the issuer sponsored subregister. Any such tariff structure would be anti-competitive and in the Commission's view could not be justified on efficiency or other public benefit grounds.

7.174. If the CHESS arrangements, including CHESS tariffs, are used to undermine the capacity of registry services to compete with ASTC, the Commission would regard this as "changed circumstances" which may lead to the revocation of this authorisation.

Other relevant issues raised by interested parties

7.175. A number of other matters relevant to the Commission's task of weighing the public benefits and the anti-competitive effects arising from the CHESS arrangements were raised by interested parties in their submissions.

Complaints, disciplinary and appeal procedures

7.176. In its draft determination in respect of the authorisation of the second phase of the CHESS arrangements, the Commission expressed concern that, at that time, CHESS participants had no right of appeal against a decision by ASTC's board to suspend, restrict or terminate their participation in CHESS under Rule 19.2. The Commission also expressed concern that a payments provider suspended or terminated under clause 15 of the Standard Payments Provider Deed did not have a right of appeal. Authorisation of the phase two arrangements was granted on the basis that the applicants would provide CHESS participants and payments providers with a right of appeal in these circumstances.

7.177. The Commission notes that the Rules now contain a right of appeal for CHESS participants whose participation is suspended, restricted or terminated under Rule 19.2 and that clause 17 of the SPPD now contains a right of appeal for payments providers that are suspended or terminated under clause 15 of the SPPD.

7.178. Submissions from interested parties 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. The applicants' responded by noting that their compliance activities included an active compliance and regulation program as well as formal disciplinary proceedings.

7.179. The effective operation of the disciplinary provisions needed to ensure the integrity of the SCH Business Rules are an important factor in determining the public benefit and anti-competitive effects of these Rules. Any benefit associated with the Rules is dependent upon the Rules being complied with. It is also important that the Rules are not enforced in an anti-competitive manner.

7.180. When the applicants first lodged their main submission in March 1997, only one matter had been listed for hearing before the disciplinary tribunal in the life of the CHESS arrangements. This matter was ultimately discontinued. 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 within the securities industry. In one case, an additional penalty of $1,000 was imposed. Two other matters are pending before the disciplinary tribunal.

7.181. The Commission recognises that compliance education programs provide an important means for achieving compliance with the Rules, particularly in respect of new and detailed provisions. However, appropriate enforcement action is also important if the public benefits associated with the authorised Rules are to be realised. The recently completed disciplinary proceedings appear to allay earlier fears that the disciplinary arrangements were not being utilised.

7.182. The Commission is concerned, however, that the move to operate CHESS on a for profit basis does not effect either the degree of industry representation on the disciplinary panel or effect the independence of the disciplinary and appeal tribunals. If the benefits to the securities industry associated with CHESS are undermined because the Rules are not adequately enforced or are enforced in an anti-competitive manner, the Commission will regard this as "changed circumstances" which may lead to the revocation of this authorisation.

Changes to the SCH Business Rules

7.183. A number of submissions by large institutional CHESS users and industry bodies expressed concern that there had been inadequate industry consultation prior to changes to the SCH Business Rules.

7.184. The Commission recognises that there is a necessary trade off between providing extensive consultation to ensure industry acceptance of Rule changes and the need to ensure that, when necessary, the Rules are changed in a timely manner to enable the efficient operation of CHESS.

7.185. The Commission also notes that ASTC has adopted a policy of circulating details of Rules to the CHESS Business Advisory Committee (CBAC) as well as the Sydney and Melbourne settlement advisory groups where feedback from the Rule Review Group

indicates that the principles upon which the Rules changes are based may be controversial. The applicants advise that CBAC comprises some 20 representatives from various sectors of the securities industry.

7.186. The Commission considers that this increased level of consultation is appropriate. It would be concerned, however, if the move to operate CHESS on a for profit basis should result in an erosion of the degree of industry consultation prior to changes to the SCH Business Rules.

Other matter raised by interested parties

7.187. National Australia Custodian Services expressed dissatisfaction with the way in which the SCH Business Rules limit ASTC's liability.

7.188. Under the SCH Business Rules, neither SCH nor its employees are liable for damages that result from actions performed in good faith and in performance of functions imposed by the SCH Business Rules. While the Commission notes the concern expressed by National Australia Custodian, these arrangements do not appear to operate in a way that undermines the public benefits associated with CHESS. In particular, the Commission notes that no evidence has been submitted by interested parties to suggest that ASTC has used the arrangements limiting ASTC's liability in a way that unreasonably shields ASTC from liability for its actions.

7.189. National Australia Custodian Services also expressed concern that ASTC has not made adequate arrangements for the use of securities as security for credit in an uncertified environment.

7.190. Under the current arrangements, to enable uncertificated CHESS approved securities to be used as security for a loan, financiers commonly require borrowers either to have their securities 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. Financiers feel obliged to notify the Commission in respect of possible third line forcing conduct involved in such arrangements. In this regard, the Commission notes that it has received notifications from a number of major Australian banks and other providers of finance.

7.191. National Australia Custodian Services suggested that the pledging arrangements could be made more efficient if the operation of the holding lock mechanism currently available in CHESS was extended to facilitate the pledging of CHESS approved securities.

7.192. In response the applicants' advised that the Law Council of Australia has indicated that there are legal problems associated with using a subposition or holding lock facility to enable the pledging of CHESS approved securities. 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.

7.193. CHESS approved securities held in a subposition or holding lock facility would 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 would be fruitless for lenders to pursue either the subposition or holding lock options.

7.194. Should there be sufficient demand for an alternative to the current pledging arrangements for uncertificated securities, the Commission would expect ASTC to pursue the necessary amendments to section 262 of the Corporations Law, and to extend the subposition or holding lock facilities to enable their use for the pledging of CHESS approved securities.

Time Limit

7.195. The applicants argued that there should be no time limit on any authorisation granted by the Commission. They suggested that such a time limit would subject the CHESS arrangements to an unacceptable degree of uncertainty. In addition, they suggested that the Commission's power to revoke the authorisation if circumstances change provides a sufficient safeguard.

7.196. While the Commission received submissions from Colonial State Bank and GIO arguing that no time limit be imposed, the Commission also received a number of submissions strongly arguing for the imposition of a time limit of two or three years.

7.197. The Commission notes that the applications have a been lodged during a period of radical change in the securities industry, including the proposed demutualisation of ASX and the proposal to operate ASTC on a for profit and dividend paying basis.

7.198. As discussed above, if Articles 59A and 86 are removed, the Commission is of the view that competition, both from overseas stock exchanges competing with ASX and ASTC operating as a single competitive unit, and possibly competition between ASTC and other domestic clearing and settlement facilities such as Austraclear, has the potential to provide the most efficient way of ensuring that CHESS tariffs are kept at a level that will enable to public benefits of CHESS to be realised. However the actual effect on CHESS tariffs of operating CHESS on a for profit basis in a competitive environment remains uncertain.

7.199. If Articles 59A and 86 are not removed, the Commission proposes to authorise the CHESS arrangements without requiring changes to the ASTC and ASX Rules to permit competition in the clearing and settlement of 'on market' transactions. However, should CHESS continue to be operated on a non-dividend paying basis, the Commission would be concerned to ensure that the accumulated operating surplus at the end of the initial seven year cycle were significantly above the amount required to update or replace the CHESS facilities.

7.200. In these circumstances, the Commission is of the view that it would be inappropriate for it to grant an authorisation with no time limit.

7.201. The Commission proposes to grant authorisation for a period of five years.

7.202. Should the applicants wish to retain the benefits of authorisation beyond five years, they will need to lodge a new application for authorisation with the Commission.

8. Clearing and settlement of financial market transactions

8.1. The current lack of competition in the clearing and settlement of securities transactions, the barriers to competition resulting from the current CHESS arrangements, and that legislative amendments may be necessary to facilitate effective competition between clearing and settlement facilities in the securities industries, has been noted above (see paragraphs 7.67 to 7.99).

8.2. The Commission intends to require ASX and ASTC, as conditions of authorisation of the CHESS arrangements, to amend the arrangements to enable competition in the clearing and settlement of ASX market transactions in equity and debt securities (see paragraphs 7.92 and 7.93 above). The Commission has also noted in section 7 above that it would support legislative changes, subject to considerations of financial risk and market integrity, that would facilitate effective competition in the clearing and settlement of securities transactions.

8.3. This section contains a general discussion of the financial markets and the clearing and settlement facilities that service those markets. The current level of regulation is briefly noted as are a number of the regulatory reforms proposed under the Government's Corporate Law Economic Reform Program (CLERP). Some general observations on competition in the financial markets, and particularly competition for the provision of clearing and settlement services and the impact of current regulation, are also made. Much of the background information in this section on the financial markets and their regulation is sourced from CLERP Paper No.6 ,"Financial Markets and Investment Products - promoting competition, financial innovation and investment". References to CLERP within the section are, unless otherwise stated, references to CLERP Paper No.6.

8.4. Finally, the section contains a brief outline of clearing and settlement facilities that service the financial markets in the US and UK.

Financial markets

8.5. Australian financial markets perform a fundamental economic function by facilitating the allocation of savings and resources to their most productive uses. The financial markets include equity, bond, derivatives and debt markets. Service providers in the financial markets include organisations which provide market facilities for the trading of financial instruments, clearing and settlement facilities and intermediaries who provide a range of broking and advising services. Foreign investors, institutions and fund managers are key users of the financial markets while private retail investors remain an important investment group.

8.6. A summary of total market turnover for exchange-traded and over the counter (OTC) markets is contained in the following table.