



ASX



Driving efficiency in competitive settings for the Australian economy

Submission to the Competition Policy Review

June 2014

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CONTENTS

Contents.....2

Executive Summary3

A policy framework for a competitive Australia.....4

Competition policy principles 5

Regulatory impediments to competition – services markets 7

Competition laws 9

Defining markets..... 9

Self-regulation delivers best outcomes with industry bearing the costs of regulation:
ASX Code of Conduct 10

Administration of competition policy..... 12

Executive Summary

- Competition policy is important to drive an efficient economy, advance Australia's trade and investment agenda and deliver higher living standards for all Australians.
- Increasing globalisation in a number of sectors – through the advance of technology and global regulations – requires a refocussing of the approach to competition policy.
- A modern competition policy needs to address two distinct policy concerns. It needs to look outward, supporting market structures and incentives for businesses to compete globally from Australia, as well as delivering efficiencies to, and protecting, consumers and small business within Australia.
- In the past, competition policy predominantly addressed competition *within* Australia. It now also needs to balance this with a greater focus on the competitiveness *of* Australia. We can be competitive and successful if we recognise what drives our competitiveness and make decisions that support and enhance it.
- As the Issues Paper identifies, it may be appropriate for relatively small countries such as Australia to accept a more concentrated domestic market structure in some sectors than are seen in other larger countries. In financial services, for example, market concentration may enable local service providers to meet global regulatory standards and compete with international organisations that have the benefit of larger scale economies. Alternatively, it may assist the Government achieve other important public policy objectives such as financial stability which may not always be consistent with unrestrained competition.
- Where a more concentrated market is the policy or practical outcome, it is necessary to ensure that local service providers are operating in a way that delivers durable outcomes that are consistent with those that would be expected under a more competitive market structure, and that protect consumers.
- This could be achieved through a range of possible mechanisms including sectoral regulation, regulated pricing or self-regulation. Well-designed self-regulatory structures can be an effective policy tool help drive competitive-type outcomes in more concentrated industries.
- A recent example of efficient self-regulation can be found in the Australian equity market, where ASX is the sole provider of clearing and settlement infrastructure. In 2013, ASX put in place a Code of Practice that commits ASX to:
 - provide transparent and non-discriminatory access to, and pricing of, its clearing and settlement services
 - publish an annual profit and loss statement for the services (including a calculated return on equity)
 - put in place a stakeholder Forum that gives input into the investment program for the services
 - commission independent benchmarking of the costs of the services compared to other financial markets

Taken together, these commitments provide a good illustration of an efficient and best practice solution that provides benefits to end users while retaining the significant network and scale benefits of a single provider.

- Guidelines on the principles of good regulation were set down in the report of the Regulation Taskforce 2006, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (the Bank's report). The report identifies self-regulation as a viable policy option. ASX agrees with this conclusion. ASX submits that in conducting the cost-benefit analysis of alternative regulatory settings it is important to explicitly reference the competitive position of Australia in international markets.

A policy framework for a competitive Australia

ASX welcomes the opportunity that the review of competition policy provides to ensure that Australia has in place a framework and settings for competition policy that facilitates an efficient and internationally competitive Australian economy.

The changing nature of the Australian economy in the twenty years since the last major competition review (the Hilmer review) has been significant; particularly the impact globalisation and technology have had on many sectors of the economy. ASX's perspective on these issues is drawn from our experience of the rapid change that has been seen in financial markets and the financial services sector over this period.

Australia has well-functioning financial markets and punches above its weight amongst its global peers.

The current Financial System Inquiry is providing the opportunity for Government to respond to the challenges and opportunities confronting the financial services sector in the wake of the global financial crisis, and in the context of the significant opportunities Australia has to play a much greater role in delivering financial services to meet growing Asian demand.

ASX believes that the competition policy review will also play an important role in modernising competition policy settings to provide a foundation upon which industries such as financial services can compete in a global market. This is a requisite if Australia is to be well placed to achieve its ambitious trade and investment agenda.

While these forces are present in a number of sectors, and will require a broad-based response through competition laws, this submission will focus on examples from ASX's own experience as a financial services provider to illustrate our points.

In this regard the financial sector is somewhat unique in that global, as much as domestic, regulation is driving market structure and competitive outcomes.

Global regulatory and commercial forces are now at work that will affect the nature, quality and competitiveness of Australia's financial markets. The impact of these forces needs to be understood, and the choices regulators and other stakeholders collectively make, must strengthen Australia's ability to compete if we are to remain amongst the top tier of global markets. This would provide flow-on benefits to the broader economy and living standards over the longer term.

In the future, it will be less about the regulatory settings *within* Australia and more about the competitiveness of Australia if the living standards of Australians' are to continue to grow. This principle should guide not just financial sector regulatory objectives but should also be reflected in a more general updating of the competition policy framework.

When, and how, Australia applies new global financial regulations will have a significant influence on providers of financial market infrastructure and will mean that scale becomes an important factor driving decisions of participants and exchanges. It will directly affect market structures, business models and competitive dynamics. These rules will drive international banks and market operators to maximise their scale globally as it is more efficient for them to concentrate all market risk in one location and avoid 'fragmentation' of their economics.

Having a strong domestic financial market is essential to underpin the growth potential of Australia. Australia also needs strong domestic financial infrastructure if local authorities are to maintain control over systemic risk and to secure a seat at the table when global regulations are set. It is a pre-condition to be a financial centre. Policy makers need to decide to what degree having a central financial infrastructure is important to service the Australian economy and to enhance Australia's position in the Asian region.

Achieving this important policy objective requires significant investment to ensure that Australian investors will continue to have access to a world-class and globally competitive market infrastructure. Competition policy arrangements need to allow operators to have the scale and the financial strength to make the necessary investments.

For example, the substantial investments made by ASX (including \$500 million in its post-trade infrastructure in 2013) mean that Australian investors and participants have access to a world-class service that gives them the ability to manage their risk and collateral under Australian law. Given the relatively modest scale of the Australian market (even though we rank in the top ten by many market measures) such an investment could only be made because of the business model ASX operates within.

The ASX business model (horizontal and vertical integration across a range of products and services) is similar to the business model of Asian exchanges such as Singapore, Hong Kong and Japan. The business model is different from most of the exchange models found in the US and Europe. Exchanges such as the London Stock Exchange, NASDAQ and ICE (which now owns the New York Stock Exchange) operate in much larger markets, but have narrower product and/or service footprints.

The differences in the business models matter and can give smaller markets such as Australia a competitive strength which compensates for the lack of absolute scale that some of the larger financial market infrastructure providers can offer. ASX is a top ten global exchange group.

As a result of the global forces at work, it is important that policy makers make clear and upfront choices about the regulatory controls they need over systemically important financial markets and to govern competition within the sector.

While industry specific regulations have an important role to play, competition policy settings must also align to support growth, innovation and competitiveness of Australian industry.

ASX's comments in response to the Issues Paper will focus on competition policy principles (Chapter 1), restrictions on competition (Chapter 2), and competition laws (Chapter 5) as these are the areas that most directly impact on our sector and business.

Competition policy principles

The broad competition policy principles set out at the time of the Hilmer review appear to be as appropriate now as they were at the time. In particular, the needs to limit the anti-competitive conduct of firms and to only restrict competition if the benefit to the community outweighs the cost. The ability of Australian firms to compete globally will be a key factor that can drive the long-term living standards of Australians.

Australia's key markets are relatively concentrated (in comparison to other larger economies), in part due to Australia's relatively small population and geographic position. ASX agrees with the view expressed in the Issues Paper that "concentrated markets are not a concern if market participants are operating in a way that delivers durable and competitive outcomes."

However, if a lack of competition in a market does raise concerns about the ability of a firm to exercise market power then it is appropriate for the government, in the public interest, to regulate the conduct of that firm to limit adverse impacts on consumers.

Competition policy has traditionally had a strong (almost exclusive) focus on domestic markets. But as the Issues Paper notes, the impact of technology and other factors have made many markets more global in nature. ASX believes the financial services sector provides a clear case study of these forces.

Technological and communications advances have seen the cost of entry of smaller operators (and market participants) drop significantly and as a consequence new service providers have emerged. Given the highly regulated nature of this sector this development has presented challenges for financial sector regulators to determine if a more fragmented market provides net benefits to end consumers.

There has been significant innovation in trading strategies as competition has brought with it a fragmentation of liquidity pools. The changed market dynamics have also driven incumbent exchanges to consider cross-border mergers to seek to build scale given the economics of the business (high fixed costs and low marginal costs).

More recently, regulatory action to drive a significant portion of off-market derivatives activity through centralised market infrastructure traditionally supplied by regulated clearing houses and exchanges to enhance financial market stability, has disrupted long-standing business models of exchanges and market participants. The economics of such centralised infrastructure are such that it is likely that only one service provider will operate in each small to medium-sized market (including Australia).

Global operators are seeking to expand their geographic footprint to service the needs of larger multinational investment banks operating in a number of jurisdictions. This has the potential to significantly change the nature of how such services are supplied in the future, particularly whether they are provided in the local market or remotely from one or more larger financial centres. Local providers are constrained in offering the same lower costs, driven by the economies of scale that large international infrastructure providers can offer.

The regulatory implications of such an outcome are best considered by financial sector regulators. However, the increasing globalisation of some sectors of the economy has significant implications for framing discussion about the definition of markets and measures of market concentration in the competition law.

The fundamental elements of the national competition policy need to be framed in a way that explicitly includes a mechanism for the competition authorities to be able to consider the international competitiveness of Australia in their market analysis.

This need to address both the competitiveness of Australia while still protecting consumers and small business from unacceptable market conduct may require a different institutional structure. Enhancing Australia's competitiveness requires a commitment to best practice regulation and ensuring that competition policy settings do not unnecessarily impede the flexibility and scale of business structures necessary to be globally competitive.

Regulatory impediments to competition – services markets

ASX and some other financial market infrastructure providers operate in a highly regulated environment. This reflects the important role financial markets (and the infrastructure servicing them) play in facilitating the financial flows that help fund Australian business, and which provide a transparent and efficient mechanism for Australians to invest their savings in a wide range of financial products.

Operators of financial markets and clearing and settlement facilities, such as ASX, are subject to requirements under the *Corporations Act* and other legislative requirements in relation to licensing and business conduct. Changes to the operating rules governing access to, and activities within, the market/facility are subject to Ministerial disallowance after rigorous scrutiny by financial regulators and public consultation with interested parties.

The main financial regulators - the Australian Securities and Investments Commission (ASIC) and the Reserve Bank of Australia (RBA) - also conduct annual assessments of licensees' compliance with their regulatory obligations.

These requirements are rigorous and may be seen by some as an impediment to new entrants. However, the regulatory arrangements serve important public policy purposes including enhancing financial stability, efficiency and investor protection. Granting licences (or providing exemptions from a licensing requirement) to operate critical financial market infrastructure need to be made after a thorough analysis on the impact this would have on the overall financial system.

The Banks Report to the Prime Minister and the Treasurer sets out guidelines on the principles of good regulation.

Extract from *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*

Principles of good regulatory process

In the Taskforce's view, good regulatory process requires governments to apply the following six principles:

- Governments should not act to address 'problems' through regulation unless a case for action has been clearly established. This should include evaluating and explaining why existing measures are not sufficient to deal with the issue.
- A range of feasible policy options — including self-regulatory and co-regulatory approaches — need to be assessed within a cost-benefit framework (including analysis of compliance costs and, where relevant, risk).
- Only the option that generates the greatest net benefit for the community, taking into account all the impacts, should be adopted.
- Effective guidance should be provided to regulators and regulated parties to ensure that the policy intent of the regulation is clear, as well as what is needed to be compliant.
- Mechanisms such as sunset clauses or periodic reviews need to be built in to legislation to ensure that regulation remains relevant and effective over time.
- There needs to be effective consultation with regulated parties at the key stages of regulation-making and administration.

These principles acknowledge that self-regulation can be an appropriate policy response. A cost-benefit analysis of alternative regulatory options and overall regulatory settings needs to explicitly reference the impact of choices on the international competitiveness of Australian businesses in global markets.

In its submission to the Financial System Inquiry, ASIC has suggested that its statutory objectives should be explicitly extended to "formally consider the effect of its decision making on competition." It argues that this would drive a greater focus on the long-term benefits for the end users of the financial system and help ensure that its approach to regulation considered market-wide effects more explicitly. ASIC note that such a change would be consistent with the existing regulatory objectives of the Australian Prudential Regulation Authority (APRA). Further, it believes the change would not have any implications for the role of the Australian Competition and Consumer Commission (ACCC) in administering and enforcing the *Competition and Consumer Act 2010* and related legislation as it relates to the financial sector.

ASX does not have any particular issues with the proposal given that ASIC explicitly states in its submission to the Inquiry that:

pursuit of this [competition] objective would not take precedence over ASIC's other objectives. Rather, it would enhance them, by recognising the importance of competition in encouraging commercial certainty, efficiency, consumer confidence and the development of the economy. We think that this is a vital step in the development of Australia as a centre of financial excellence and a regional financial hub.

ASX agrees that it is important that regulatory arrangements should be assessed against criteria including commercial certainty and development of the economy. Bodies such as the Productivity Commission and the Office of Best Practice Regulation have played an important role in shining light on the impact of regulation on sectors of the economy.

The Uhrig review (2003) proposed that the Commonwealth establish an Inspector General of Regulation to provide active oversight of regulators and to ensure they are held accountable for the impacts of their regulatory interventions. The Business Council of Australia in its *Action Plan for Prosperity* (2013) made a similar suggestion. ASX can see merit in establishing a 'competition advocate' within Government whose role would be to focus on how regulatory decisions impact on the competitiveness of Australian businesses.

In some circumstances, considering regulatory initiatives may require the regulator to balance possible trade-offs between financial stability and competition. While the two goals are not necessarily inconsistent, it may be that regulatory arrangements designed to enhance market stability may act as an impediment to some possible new entrants. In such cases there needs to be an assessment of the net benefits of any change, i.e. the potential economic benefits of enhanced stability against the potential costs associated with less competition between service providers.

There needs to be a process whereby the views of end-users of these intermediary services are captured and given appropriate weight in determining policy outcomes. It should be acknowledged that regulators have become more proactive in gathering such views as part of their analysis of the issues.

The overriding principle from a competition policy perspective should be that all providers of a similar service should be subject to the same regulatory obligations to ensure a level playing field. Applying the same rules of the game to all providers in the market cannot be considered to be an unnecessary impediment to competition; in fact it is a necessary requirement to ensure an even playing field.

Competition laws

Defining markets

The key test for whether the *Competition and Consumer Act 2010* is applicable in specific cases is whether the alleged conduct has the purpose and/or effect of lessening competition in a market, or of preventing or deterring competitive conduct.

This requires a definition of what constitutes 'a market'. As noted above, traditionally this has been that a market is limited to markets located within Australia, while recognising that competition can also reflect imports of goods or services delivered from outside of Australia.

Over recent years, the main focus of financial market policy makers and regulators has been on the market structure of the domestic equity market, an area in which ASX operates. Competition was introduced into Australia's equity market with Chi-X offering trading in ASX-listed securities in 2011. There had previously only been some limited competition for the listing of companies by small regional exchanges.

The experiment with equity market competition contained some interesting lessons for regulators and other key stakeholders. One significant lesson is the caution regulators should exercise when considering transplanting market structures and regulations from the US and Europe. Australia is a significantly smaller market, which means that the negative impacts of fragmentation may be relatively larger.

It is clear that some exchange-related fees have fallen and that there has been some innovation in service provision since competition was introduced. However, it is less clear that end-consumers have seen any net benefits from the change given increased operational, compliance and regulatory costs for market participants as well as the impact on trading efficiency of fragmented liquidity.

In 2012 the Council of Financial Regulators (the Council) reviewed the market structure for equities clearing and settlement. These services are currently provided solely by ASX. The Council recommended that the Government postpone the consideration of any new clearing licences for two years, as the business case was not sufficiently attractive at that time based on feedback from market participants. The Government accepted the recommendation.

The Council is likely to conduct a further review of the Code and of the clearing and settlement market structure in 2015. ASX will ask for a longer term decision as it needs to make significant investments in its clearing and settlement platform. These investment decisions will be heavily influenced by the future market structure as the returns on equity from equities clearing (11%) and settlement (18%) are relatively modest given the capital intensive nature of these investments. The annual costs to the Australian economy of cash equity clearing is \$42 million and for settlement \$40m, based on ASX's FY13 financial accounts.

As noted earlier, competition in the provision of listing, trading and clearing services is increasingly becoming globalised. If a market is 'global' then the competitiveness of Australia should be as important a consideration as the competitiveness of individual domestic operators. That does not mean that the latter objective is unimportant, just that it needs to be considered in the context of the overarching objective of raising the living standards of all Australians.

If markets are global then regulators need to lift their sights to consider how decisions will impact on the ability of Australia to compete globally.

That may mean that Australia is willing to accept a more concentrated domestic market structure than in some other countries. In such cases, rather than focussing on domestic market structure issues it may be more appropriate to focus on monitoring market outcomes and ensuring that appropriate conduct rules are in place so that any entity which benefits from such a concentrated structure is not able to exploit that position to the detriment of consumers.

Such conduct-based policy approaches would include access regimes (in the case of critical infrastructure) and/or codes of conduct.

ASX has direct experience with having regulatory obligations to provide 'fair and effective' access to its infrastructure through its licence obligations under the *Corporations Act*. Such regulatory requirements need to be considered when contemplating the application of the broader access regimes through the *Competition and Consumer Act*.

Self-regulation delivers best outcomes with industry bearing the costs of regulation: ASX Code of Conduct

ASX's experience is that an industry code of conduct can play an important role in delivering competitive outcomes where the scale of the Australian market may not support multiple service providers.

In consultation with industry stakeholders and Australian regulators, ASX developed a Code of Practice for the clearing and settlement of cash equities in Australia that commenced operation on 9 August 2013. This followed a Government decision to delay the granting of any licences for alternate clearing houses for cash market equities for a period of at least two years.

ASX has put this Code in place to increase transparency and accessibility in the provision of clearing and settlement services for cash equities in Australia and to formalise avenues for regular and meaningful user engagement.

The structure of the ASX Group (vertically and horizontally integrated) allows for the efficient delivery of a wide-range of services to users. In pricing those services, ASX is committed to the principles of transparency (including published management accounts) and non-discriminatory pricing to all customers and potential users.

ASX is working with its customers and other industry stakeholders in the provision and ongoing development of clearing and settlement services to ensure that the needs of users are met and that these services are aligned with global standards.

Code of Practice for the clearing and settlement of cash equities in Australia¹

Purpose of the Code

ASX has put this Code in place to increase transparency and accessibility in the provision of clearing and settlement services for cash equities in Australia and to formalise avenues for regular and meaningful user engagement.

This Code builds on the principles contained in the Customer Charter of ASX in which ASX commits to:

- work with customers to deliver products and services that meet their needs and that provide them with choice
- support Australia's aspiration to be globally competitive and become one of the leading financial centres in the Asia Pacific region
- make its products and services available on a non-discriminatory basis and on reasonable commercial terms
- manage its businesses and operations on a commercial basis to benefit its customers and provide appropriate returns to ASX shareholders
- recognise its role as a provider of critical financial infrastructure to the Australian financial markets, and make the necessary investments to ensure it can fulfil this role and provide confidence to market participants, investors and regulators
- run its operations in compliance with all legal and regulatory obligations
- maintain conflict handling arrangements that provide assurance and transparency about the way ASX conducts its business.

An advisory forum was established to allow ASX's clearing and settlement participants, and a wide range of other industry stakeholders that are users of ASX's clearing and settlement services, to provide the Boards of ASX Clear and ASX Settlement with user input on the ongoing development of cash market clearing and settlement infrastructure and services.

In the short time since its commencement, the Code has produced tangible outcomes. Australia has greater transparency in the pricing of these services than other markets with the publication of audited accounts and the commissioning of a comprehensive global cost benchmarking report. ASX is also working with industry to reduce the settlement cycle from three days to two days.

As a commitment under the Code, ASX Clear and ASX Settlement commissioned Oxera Consulting (Oxera), a leading independent European economics consultancy, to benchmark the costs of using ASX's cash equity post-trading (clearing

¹ A copy of the Code can be found at: http://www.asx.com.au/cs/documents/Code_of_Practice_9Aug13.pdf

and settlement) services against the costs of using the services provided by other financial market infrastructure providers (FMIs). The Oxera benchmarking report² concludes that “the costs of post-trading services in Australia are in line with the costs of similar services provided in financial centres of comparable size.”

The overall conclusion from the analysis was that the fees charged by ASX for post-trading services — of 0.3 to 0.6 basis points (bps) relative to the value traded for institutional investors, and 0.9 to 2.0bps for retail investors — are within the range that FMIs of a comparable size charge to investors with the same trading characteristics. In relation to the nine FMIs that charge separately for clearing and settlement services, ASX is at the lower end of the range for fees charged for settlement services and at the higher end for fees charged for clearing services.

Administration of competition policy

As noted above, financial services, particularly financial market infrastructure services, are highly regulated. This involves close monitoring by ASIC and the RBA of licensing and market conduct regulation. It is important that these regulators maintain clear thinking when setting policy that influence market structures, maintain financial stability and protect investors. It is also important that policy settings are applied equally to all firms providing the same services and do not create an uneven playing field.

² The full Oxera report can be found at: <http://www.asx.com.au/cs/international-cost-comparisons.htm>