PROPOSALS FOR THE INTRODUCTION OF NATIONAL CONTINUOUS NET SETTLEMENT

A paper under this title has been prepared by the Australian Associated Stock Exchanges. The following extracts have been selected to explain the working of the system, and the approval of A.A.S.E. to their publication is gratefully acknowledged.

OBJECTS OF NET SETTLEMENT

Continuous net settlement may be described as a system for netting each Broker's transactions, both buys and sells in various stocks, to provide his net position over an agreed period, with all other Brokers, so that each Broker is required only to deliver or receive the difference in his net position, in place of the present Trade-for-Trade delivery and settlement.

The basic objectives of this system will therefore benefit Brokers by -

(i) Reducing the amount of scrip processed in a Broker's office. Simulated exercises have indicated that 50% of Broker/Broker market transactions will be netted out using a one day netting cycle, rising to 75% by using a five day cycle.

(ii) Relieving the Broker of the necessity for keeping detailed accounts for Broker/Broker transactions with the attendant problem of reaching agreement on open lines. In short, the objective is to limit the accounting and scrip processing functions of a Broker in respect of market transactions, to client transactions only. Within this framework, it is therefore most important that the terms of a transaction be defined as being a market transaction with anyone who is not a member of the A.A.S.E. Market transactions on a Broker's own account or on behalf of overseas Brokers are client transactions within this definition.

By maintaining daily continuous balances in market transactions, the present costly reconciliation system will be eliminated.

(iii) By reducing the number of open lines through netting, the number of adjustments presently required will be reduced.

(iv) Providing a speedier settlement of market transactions.

(v) Making it possible to consolidate clients orders for the purpose of operating on the Trading Floor.

In addition to these basic objectives and benefits, there are flow on benefits in the areas of -

(i) Statistics and market information - by having all information from all A.A.S.E. Stock Exchanges centrally collected.

(ii) Share Registrars - by reducing the volume of share registrations.

(iii) Clients - by enabling investors to have shares registered into their name more promptly, and by removing from traders a considerable amount of document processing at present associated with their transactions.

Experiences of overseas Stock Exchanges where net settlement is in operation - Johannesberg, Montreal and Toronto, Mid West and Pacific Coast, Paris and Frankfurt - indicate that these benefits are real and enables the Broker to make more efficient use of capital, personnel and securities.
WHAT IT INVOLVES

Clearing House

Obviously trade-for-trade settlement will be replaced by net settlement of outstanding transactions only. This means that it will not be possible for Brokers to deliver direct to the netted trades, as this will be a combination of a number of other Brokers. A new agency must therefore be involved, that is, a Clearing House, which receives from and delivers to Member Firms based on the Netted trades that have been calculated at the end of each netting period.

Common Settlement Price

It will be appreciated that in any one stock, the individual trades that are the subject of netting operations will have taken place at varying prices. It is a principle of the system that -

(i) Brokers can not settle netted trades direct with each other, and
(ii) Deliveries and receipts (which overall match on quantity) must also match on value

It follows that a common denominator at which all Brokers positions are valued and settled, must be introduced to make the concept of scrip netting feasible. This common denominator is known as the common settlement price. There are a number of possible alternatives to be considered in selecting a common price, all of which have arguments for and against. The cumulative weighted average on open lines method has been selected because -

(i) It will ensure the maximum amount of smoothing, that is, the least fluctuation between the traded prices and the settlement prices compared with any other method of pricing.
(ii) It is least vulnerable to exploitation.
(iii) It is quite practical for a local netting system as well as National Netting.
(iv) It is in fact the net aggregation result of trades after taking into consideration volume and value of trades less deliveries.
(v) It will require the minimum amount of financing from Members for its operation, compared with any other method of market to market pricing.

Netting Cycle

A netting cycle is necessary for the completion of accounting functions and the calculation of Common Settlement Prices. In order to reap maximum benefit from scrip netting it is proposed that the netting cycle period should be based on the business week, that is five working days, unless public holidays occur. This period has been selected as the most suitable for a netting cycle because -

(i) It is a natural period.
(ii) It provides a reasonable time for settlement.
(iii) Exercises have revealed that in a period of light trading, the number of deliveries would have been reduced by 70% and in a period of heavy trading by 85%.
(iv) A netting period of five days will give Brokers the opportunity to so organise their scrip that significant value adjustments to the Common Settlement Price at the end of a netting period can be avoided or minimised.
(v) In times of extended heavy trading the whole of the weekend is available for processing to ensure that the system is always up-to-date.
DELIVERY AND SETTLEMENT

Continuous Netting

With a continuous netting system, net positions not settled in a netting period are carried forward to a subsequent netting period to form part of a new net. The position therefore, is a net on net. A netting cycle is necessary as there needs to be a clear definition between netting periods to determine Common Settlement Price.

Contra Adjustments for Common Settlement Price

The adjustment of the net value of all trades to a Common Settlement Price at the end of a Netting Cycle provides, in certain circumstances, an incentive to a net seller to deliver, and a net buyer to receive.

When the common settlement price is higher than the trade price, the selling broker will pay to the Clearing House the difference between the two prices. In other words, if a sale takes place at $1.00 and the common settlement price is $1.05, the selling broker will be required to pay to the buying broker, 5¢ per share (via the Clearing House).

Conversely, the buying broker will be required to pay the difference when the common settlement price is lower than the trade price. This has the effect of creating continuing relationship between transaction and settlement prices. The monies paid/received, in addition to maintaining continuous balances, will actually be part payments or credited back upon settlement.

If the system, for example, were defined so that transactions fall due for delivery in the second weekly period after the week of trade, and that they are subject to adjustment to a Common Price only at that time, any financial impact on Brokers would be minimised. However, for the reasons that-

(i) There must be incentives and penalties for Brokers not to let their position get out of hand or inconvenience other Brokers;
(ii) The Clearing House will not initially be holding Buffer Stocks;
(iii) The financing of the Clearing House should be kept to a minimum,

it is proposed that -

(i) Common Settlement Price adjustments (calculated at revised weighted average prices) will be payable at the end of each Netting period. The sum total of these adjustments is redeemable on delivery/receipt.

(ii) Selling Brokers will be penalised for failure to deliver.

(iii) Buying Brokers will be required to accept delivery.

Simulated exercises that have been, and are in the course of being carried out, show that, in the application of the Common Settlement Price, there is a smoothing effect of netting all stocks and all trades.

Delivery Period

Deliveries in respect of the net position at the end of a netting period are due immediately, and may be made at any time during the next netting period, either by the Broker to the Clearing House, or the Clearing House to the Broker, but having due regard to trades subsequent to netting period on which the deliveries are made.

Delivery may be for sales transacted during a netting period, but only to the limit of the current short position. Settlement Price will be the Common Price established for the previous cycle.