Competition in the provision of clearing and settlement services

Submission to the Australian Treasury - Exposure Draft Legislation

20 April 2023

Executive Summary

Thank you for the opportunity to submit to the government consultation process on the exposure draft legislation concerning competition in clearing and settlement (CS) services, specifically to amend the *Corporations Act 2001*, the *Competition and Consumer Act 2010* and the *ASIC Act 2001* to facilitate competitive outcomes in the provision of CS services for Australia's financial markets.

We welcome the Government's broader reforms to modernise Australia's financial system, positioning our economy to embrace new economic opportunities and respond to future challenges. As the Treasurer noted in December 2022, it is critical that we ensure we have a financial system that works for consumers, businesses and investors – one that delivers for the Australian economy and the Australian people. After a significant period of instability in the Australian and global economy, competition in CS services should be considered part of a broader suite of measures that are critical to improving the resilience, functioning and stability of financial markets.

It has been clear from reports of the Council of Financial Regulators (CFR) over the last decade and the persistent lack of progress on key reforms, that Australia's regulatory architecture has not kept pace with changes in the market, including the advent of new digital products and services. The CFR reviews dating back to 2012 make clear that there are deficiencies in the current regulatory framework for CS services and in particular in relation to achieving competition in the context of an existing and entrenched monopoly.

We congratulate the government on initiating this process, especially considering the ongoing and significant issues with ASX Limited's existing monopoly position and the impacts of the mismanagement of the replacement of the Clearing House Electronic Subregister System (CHESS).

The draft legislation is a good step to facilitating competition. The policy position to facilitate competition in CS services is not new, with the extensive work that was undertaken by the CFR since 2015. Despite this, a committed competitor has not emerged in Australia. There are other areas for legislative reform and further policy consideration, without which we are unlikely to see meaningful competition emerge in this area. The barrier to competition in the provision of clearing and settlement services has remained prohibitively high due to a number of factors. We will draw them out further in these submissions.

To be successful, it will be important for the proposed legislation to achieve the following: (1) ensuring the legislation keeps pace with regulatory developments in international peers and positions Australia back at the global frontier, (2) ensuring the proposed legislative process and broader policy developments recognise the significant technological innovations that have taken place and are likely to take place, and put in place an architecture that is future facing and fit for purpose, and (3) ensuring the proposed legislation enables the emergence of a new competitor for CS services to demonstrate the

substantive effect of the proposed reforms and a clear departure from the existing monopoly market structure and regime.

Reforms to modernise CS services are urgent and Australia cannot afford to wait for ASX to reveal its post-CHESS plans

We believe the government needs to move ahead with some urgency on these reforms. The ASX recently announced that it will not reveal its alternate solution design for a replacement to CHESS until the December quarter of 2023 - another ~8 months from now. The implementation plan for this design will then be developed with stakeholders over an unspecified time frame. This is too long to wait when we know that there exists genuine alternatives that can, via competition combined with appropriate regulation, bring significant service, cost, stability and risk benefits to financial markets.

As the government would have already seen through the public debate as well as the proceedings before the Parliamentary Joint Committee on Corporations, there is a strong view across the industry – from stockbrokers to share registries, to other market participants and stakeholders – that the CHESS replacement project has been severely compromised, in a large part, due to the ASX's ingrained lack of transparency and poor engagement with the industry that the ASX is meant to support. There is also a clear view that the ASX has irreconcilable conflicts of interest in this project, that it does not have the capability to execute the replacement of CHESS and can no longer be trusted, or relied upon, to deliver the replacement. There is a real sense that recovering this trust will be significantly challenging for ASX in the near, and even, medium term.

Moving on from the current CHESS monopoly service is urgent because the technology that underpins it is becoming obsolete along with the resources (people) that are required for ongoing maintenance and development of the technology. It would be a mistake to rely solely on ASX to deliver a solution to the lack of innovation in CS services. ASX remains in a highly conflicted position and it is highly questionable and doubtful that it has the competence to deliver such a complex project. At best it will lead to a piecemeal of disparate technologies, entrenching monopoly, or at worst, to another aborted project.

Whilst the current operating system and policies have historically served the Australian community well, the technological landscape and stakeholder expectations have clearly changed in recent years. The ASX as a single mandate provider is not serving its stakeholders appropriately and greater competition is needed. The deficiencies in the current regulatory framework for financial market infrastructure – previously identified by the CFR, and including the lack of competition in CS services for equities – continue to exist and are beginning to have real consequences with the bungled replacement of the CHESS system.

Moving to greater competition is consistent with approaches taken in comparable international jurisdictions

The Treasury's consultation paper and proposed approach goes some way to adjust current regulatory settings to promote innovation and competition via alternate capabilities and to encourage direct participation from alternate providers with a view to diversifying risk away from a single monopolistic provider. This approach is already being successfully implemented by many international jurisdictions, including the US, Canada, Switzerland and the EU, and has subsequently promoted efficiencies, innovation, lower costs and improved stability and reliability.

We believe competition can improve any marketplace, and that Australia's financial markets will benefit from this critical infrastructure being exposed to normal market competition in line with virtually every other business. Given innovation in the industry and significant advances in technology observed in many markets around the world, the services that CHESS provides can be delivered by other providers within a licensing or regulatory regime that supports access and competition, leading to improved service and efficiency outcomes while preserving stability and reliability. Indeed the reduced reliance on a single monopoly provider of a critical component of the financial markets infrastructure will reduce the risks associated with the system having a single point of failure.

Introducing more competition in CS services will deliver significant benefits to Australians and place us back at the global frontier

We believe the introduction of competition in CS services will deliver substantial benefits to consumers (via their superannuation fund accounts), businesses (via reduced costs of capital) and investors (super funds and other institutional investors). Beyond driving improved outcomes for financial markets stakeholders in Australia, changes to the status quo should also catalyse a genuine opportunity to return Australia to its former position on the global frontier of financial markets technology that it enjoyed 20+ years ago with the introduction of CHESS (at the time a world-leading innovative technology).

The introduction of competition in CS services, and the resultant increase in innovation in financial markets infrastructure technology, will create significant opportunities for Australian service providers to export their technology to other financial markets around the world that seek to move towards leading edge approaches. Australia has been well regarded internationally as a sophisticated financial center, supported by an enormous pool of savings through our superannuation industry, yet critical infrastructure is now lagging behind leading global markets, undermining our reputation as a leading financial center in Asia.

To realise the benefits of competition it will be important that any legislative and policy changes enable and catalyse new entrants into specific segments of the Australian financial markets value chain such as CS services

It is our view that the likelihood of a new entrant setting up in the Australian market to provide end-to-end financial market infrastructure (as the ASX does currently) is unlikely due to the challenges of sustaining multiple competing providers in markets the size of Australia in the trading exchange component of the financial markets value chain. Observers cite the case of Cboe Australia (formerly Chi-X) which since entering the Australian market in 2011 in competition to ASX has after nearly 12 years only achieved a market share of ~20% (ASX having retained ~80% share). We would highlight, however, that despite somewhat modest market share outcomes, Cboe Australia has delivered notable product and service innovations including cost reductions to the Australian financial markets.

We therefore believe that for the government's intended policy of delivering increased levels of competition to have real impact the focus needs to be on spurring competition in currently non-competitive segments of the markets such as CS services. The only way to deliver the genuine benefits of significant improvements in service (in terms of speed, time and quality), cost (in terms of fees and service lines), and stability (in terms of risk and capability) is through enabling and catalysing new entrants. The principal mechanism for investors, consumers and businesses to benefit from these reforms is if there is potential for competition by having the potential to switch providers or change services, not just the mere management and constraints on the controlling tendencies and market power of a legislatively entrenched monopoly. Enabling market forces through genuine competition represents a clear challenge and test for these proposed reforms.

Further refinements are required to the exposure draft legislation to unlock the potential of truly competitive CS services in Australia

In providing our submission, FinClear has asked its legal advisers, Ashurst, to review the proposed draft legislation and collectively, we note some challenges with the current drafting of the proposed legislation given the above.

To support you in improving the legislation, we submit the following specific changes to the exposure draft legislation for your consideration:

1. *Definition of CS services*

   As currently drafted, there are a number of issues with this definition:

   - It is not clear from this definition that the term extends to services provided by the licensed CS facility service itself (as the definition only refers to services which require

"access" to the facility, presumably services provided by competitors or users). If the purpose is to make rules to regulate the licensed CS facility's activities, conduct or governance, the focus should be on the *service to which access is required* rather than the service which can only be provided if access is granted.

- We query whether the focus solely on "access" is the right approach. Competition may not require or involve "access" to the facility or data at all, but rather the provision of services by a third party of competing services.

- The definition is potentially confusing in the way it assumes that the CS services require access. It may be better to refer to the services by reference to persons who provide the CS services requiring access.

- Limiting the definition to services which can *only* be provided with access to the licensed facility or its data sets quite a high bar – a licensed CS facility which wishes to challenge the validity of a rule may argue that the particular service is not one which can only be provided with access; it may be that a service can be provided without access, but in an inefficient way, or at a price which is not competitive with the incumbent licensee.

2. *Timing for making CS services rules*

We understand that ASIC may not may CS services rules until such time as a committed competitor emerge. If this is the case, we have two concerns with this:

- If the purpose of the legislation is to give ASIC greater powers to regulate the incumbent licensees, then what benefit is there in ASIC's powers being utilised only when competition emerges. ASIC should exercise these powers now – for example to facilitate better and more efficient access to clearing and settlement services from ASX, *even if competition for clearing and settlement services does not emerge*.

- Waiting for competition to emerge risks leaving it too late in the process. It does not provide sufficient certainty for a service provider to be able to gain relevant access required to provide its service. From the perspective of an entrant, there is significant time and costs that will need to be invested in the project. The process for the competitor to itself obtain a CS facility licence to operate is significant in and of itself. The engagement with the incumbent facilities with regards to potential access and relevant arrangements would also be significant in and of itself (as was the experience of Cboe Australia with seeking access to ASX Clear and ASX Settlement). If, in addition to these barriers, the competitor is expected to further engage on the CS services rules which is subject to public consultation, this could substantially affect its time and costs.

- In our view, ASIC should, in connection with the making of the legislation, release draft CS services rules which pre-emptively cover matters that it considers need to be addressed to facilitate competition (e.g. those which are covered in the Minimum Conditions for Safe and Effective Competition in Cash Equity Clearing /Settlement in Australia and the Regulatory Expectations, as articulated by CFR). The rules, as initially

made, could contain the basic framework to provide any potential competitor with some certainty. As the relevant competitive offering develops, those rules could be further amended to accommodate any specific aspects of the CS service which should be addressed.

3. Access regime

We have the following comments on the access dispute arbitration regime of the draft legislation:

- As the EM notes (at paragraph 1.68), the proposed framework for resolving access disputes has some parallels to Part IIIA of the Competition and Consumer Act 2010 (Cth). However, these parallels are at a high level only and the regime for CS services is bespoke, particularly in respect of the factors that the Australian Competition and Consumer Commission (**ACCC**) must take into account in making an arbitral determination. While this is appropriate, access seekers and CS service providers will not be able to reasonably predict how the framework will operate until some arbitrations proceed to a final determination under the framework. In contrast, requiring the ACCC to publish guidelines on how it intends to approach arbitrations may promote more effective and productive negotiations between parties prior to resorting to arbitration.

- In the interests of ensuring timely and cost-effective dispute resolution, it may be appropriate that the arbitration determinations of the ACCC are only subject to judicial review, not merits review. Nonetheless, this approach also highlights the need to ensure there is clear, prospective guidance for access seekers and CS service providers as to how the ACCC will conduct its arbitrations.

- The determination of the price of access is likely to be critical in any arbitration brought under the proposed framework. Given this, it is unclear why the pricing principles stated in section 153ZER(3) are not mandatory considerations for the ACCC (at least as far as they may practicably apply to a particular dispute).

- The draft legislation also provides limited guidance on what appropriate non-price terms and conditions for access to CS services may be, consequently leaving significant discretion to the ACCC as arbitrator in this regard. Unlike Part IIIA, there is no provision for CS service providers to develop an access undertaking with such terms and conditions. In finalising this framework, it should be considered whether the CS services rules developed by ASIC will provide sufficient guidance on what appropriate non-price terms and conditions may be.

- Generally, a fixed outer time limit on the ACCC's determinations in arbitrations should promote the timely resolution of disputes. However, it is unlikely to be satisfactory that the ACCC's failure to issue a final determination within the expected period results in a deemed determination that the status quo prevails – this would tend to serve the interests of a monopoly provider of services. An alternative may be to give each party a

right to require that the Commission nonetheless issue a determination as soon as practicable after the expected period ends.

- The robust right to request information during negotiations is welcome, but it is unclear why it should extend to a right for a CS service provider (which is likely to be the beneficiary of information asymmetry vis-à-vis access seekers) to request any information from an access seeker that is "reasonable". The prospect of responding to such requests may have a chilling effect on access seekers' willingness to use the legislated framework for negotiation. If there are particular categories of information that a CS service provider should be able to request from an access seeker, these should be stated expressly and exhaustively in the legislation or regulations.

In addition to the specific improvements of the draft legislation that we have provided above, there are a range of other aspects of the Australian regulatory regime which have, to date, contributed to the failure of a committed competitor to emerge. We discuss these below:

4. Application of the Financial Stability Standards

- An alternative CS facility will, from the outset, require a CS facility licence. The application process is lengthy and involves very significant engagement with ASIC and the RBA. Time and cost are generally two factors which factor heavily into whether a potential competitor emerges as a "committed competitor".

- The most significant aspect of a CS facility licence application process is to demonstrate compliance with the Financial Stability Standards, which are comprehensive and onerous. We understand that, in practice, the RBA applies a materiality and monetary threshold in determining whether those Standards would apply from the outset. However, the stated policy position of CFR is that "equivalent application of the regulatory framework across competing [CS facilities] should limit any scope for competition on the basis of less onerous risk controls"[1].

- To provide certainty to any potential competitor, we would recommend the RBA articulate on a formal basis the relevant thresholds or considerations for applying (or disapplying) the Financial Stability Standards to newly established CS facilities and the process for "graduating" to comply with the Standards as and when that is required. A more formalised framework for applying the standards on a proportional basis to new, small, emerging operators would be helpful.

5. Transfer of title under Part 7.11 of the Corporations Act

- One of the most significant barriers to a competitor emerging to operate a settlement facility with respect to cash equities is the entrenchment of ASX Settlement (i.e. CHESS) as the only person (as the *prescribed CS* facility) which can transfer title via electronic

[1] See 1(a) at page 3 of *Minimum Conditions for Safe and Effective Competition in Cash Equity Settlement in Australia*, dated September 2017.

messages. More specifically, this is the effect of Division 4 of Part 7.11 and Regulations made under these provisions.

- There are two distinct regimes which can apply under Part 7.11 – Division 3 and Division 4. The detailed operative provisions of these two Divisions are contained in the Corporations Regulations, briefly described below.

  - Division 3 governs the transfer of securities *otherwise than through a prescribed CS facility*.

    The Division 3 transfer regime is a relatively "simple" regime to facilitate the transfer of title as between transferors and transferees, without the involvement of a CS facility. It is primarily targeted at "off-market transfers" between contracting counterparties. The language used in Division 3 is directed primarily at paper based transfers – that is, the "traditional form" instrument of transfer.

    The language of Division 3 is sufficiently broad to cover transfers by way of electronic message. The definition of "transfer document" specifically accommodates this.[2] In essence, Division 3 contemplates that a transfer (whether it is paper based or electronic message) will be a "sufficient transfer" if it contains the mandatory statutory content.[3] If the transfer is a "sufficient transfer", then the issuing company will be bound to recognise that transfer and the Listing Rules would require the company to process the transfer.[4] Despite the recognition of execution by electronic message, the mechanics required to comply with Division 3, when applied in practice, are less efficient then the mechanics recognised in Division 4.

  - Division 4 governs the transfer of securities through a "prescribed CS facility". The significance of Division 4 is that it provides statutory recognition to the transfer of title, by providing that a transfer is valid and effective if effected in accordance with the operating rules of the prescribed CS facility.[5] The operating rules have the force of law.[6] The relevant regulations also provide statutory force to the obligation of the issuer to accept the transfer.[7] Among the key protections in the Division 4 regime are the following:

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[2] See definition of "transfer document" in section 1073B; which includes electronic message.

[3] The mandatory statutory content is: (a) transferor, (b) transferee, (c) quantity, (d) description of securities, (e) class, (f) whether fully paid, (g) identifying the relevant register, (h) transfer ID, and (i) the broker's stamp (if applicable).

[4] ASX Listing Rule 8.10. We note that the Listing Rules specifically distinguish "paper-based transfer documents", which is likely to reference the relevant forms that must be completed in respect of a Division 3 transfer (even though Division 3 also clearly contemplate electronic messages).

[5] Corporations Act, section 1074D.

[6] Corporations Regulation 7.11.24.

[7] Corporations Regulation 7.11.36.

- A provision which has the effect that a client is taken to have authorised a participant to effect a transfer by the participant in accordance with the operating rules.

- Certain warranties are deemed to have been given in respect of a proper transfer – ie, that the transferor was legally entitled or authorised to transfer the product, the transfer was effected, and the participant was authorised to make the transfer.

- More comprehensive indemnities where the transfer was not effected or where there was no authority to transfer the products.

- The ability for the prescribed CS facility to assume that the operating rules has been complied with in respect of the transfer.

- Express provision to the effect that the issuer must not refuse or fail to register a proper transfer under Division 4.

o On their face, the provisions in the Corporations Act are drafted in terms which accommodate more than one prescribed CS facility. However, the regulations under Division 4, which provide the operative content, warranties and indemnities, are drafted in terms which refer to "ASTC"[8] as the "prescribed CS facility". In other words, without amended, or equivalent, regulations, these provisions could not apply to any other CS facility.

- Clearly, if other CS facilities were to seek to have the benefit and protections under Division 4, this would require amendments to the regulations. This could be done by way of amendments to Division 4 to remove specific references to ASTC, or alternatively the creation of a new division which would enable regulations to be specifically tailored to the relevant settlement facility if required.

6. Issuer constitutions

- The position of the listed company issuers is important, as their constituent documents, and the ASX Listing Rules, also govern the transfer of title to securities. Most constitutions of listed companies would be drafted in terms which recognise that title may be transferred in any way permitted under the Corporations Act. However, as to valid methods of transfer, we expect those constitutions would commonly specifically reference the ASX Settlement Rules, or otherwise contemplate paper-based instruments of transfer that must be delivered to the company or its registrar.

- To the extent that an issuer's constitution could not facilitate electronic settlement through an alternative facility, solutions should be considered to potentially resolve this issue without requiring issuers to amend their constitution (which would hinder the

[8] This is the term used to identify ASX Settlement.

uptake of utilising alternative facilities). For example, considerations could be given to legislative amendments with deeming provisions which would apply despite company constitutions which might otherwise only recognise ASX Settlement transfers.

7. Compensation arrangements

- Some of the NGF coverage provisions in Part 7.5 of the Corporations Regulations specifically apply to include separate claims for transfers through ASX Settlement (i.e. "ASTC regulated transfers"), and for transfers other than through ASX Settlement.
- We anticipate that there may be technical elements of the drafting which may require closer consideration and potentially amendment to reflect transfers through other settlement facilities.

As we have outlined a number of times in this submission, for the objective of the legislation to be achieved and greater competition to be delivered with the benefits of market forces more can be done as set out above to enable and catalyse the emergence of new entrants and genuine providers.

FinClear has demonstrated and deployed the distributed ledger technology that can modernise CS services which shows how Australia can head back to the global frontier

FinClear has delivered a proven settlement system using distributed ledger technology. While this is currently at a smaller scale to the system that the ASX seeks to introduce, we are confident that our system could scale successfully.

Our product - FCX - serves private unlisted markets, supporting unlisted companies and start-ups with their capital raising as well as digitising their cap-table. FCX provides atomic (real time) settlement based on distributed ledger technology (DLT), where shares and cash are represented as tokens, and enables title of both to pass at the instant of the trade. Our exchange capability, if approved by ASIC, will also allow investors in unlisted companies to trade private shares in a safe way, at faster speeds than a post trade cycle on the ASX, and for those transactions to be settled atomically.

FCX and its capability is at the global frontier and demonstrates Australia's continued potential to innovate and to lead global financial markets. The underlying technology behind FCX is already being implemented by many international banks, corporates and exchanges/clearing houses. In the US, the Depository Trust and Clearing Corporation (DTCC) is piloting a new DLT based settlement platform to allow for atomic settlement of equity transactions. Switzerland has also explored the use of DLT through its integration of tokenised assets and central bank money on the SIX Digital Exchange (SDX). Meanwhile, Canada has been exploring the use of DLT to enable atomic settlement of TSX-listed equities.

The uptake of this technology, via distributed ledger and smart contract capability, in leading global financial markets demonstrates that heritage infrastructure currently used to underpin CHESS will be displaced over time. We refer the reader to the article published in The Australian on 24th November 2022 (FinClear shows ASX its technology can create a new settlement system).

Regulatory reforms and decision-making can help to capture the potential of these disruptive technologies

FCX represents the type of service Australia should be implementing in a discrete, or 'sandbox', environment to show the markets that there are different, functioning, highly effective capabilities already available without all the significant regulatory burden, time and costs upfront. FCX in its current form would, most likely, already qualify for the pilot programs sponsored by the EU and UK regulators.

In the regulation of *markets*, ASIC has a two tiered approach which enables it to take a proportionate approach to the obligations it puts on market operators, as compared to, say the ASX. However, there is no such proportionate approach to CS, where ASX maintains a monopoly. We should have a system which supports a sensible and proportionate approach to new platforms which provide for atomic settlement. We should not have the efficiencies of electronic transfer of legal title to securities be limited to ASX Settlement, as is presently the case in the Corporations Regulations. This is outdated and stifles investment in both private and public market infrastructure that could deliver electronic and atomic settlement. This must be reformed.

FCX currently has a licence application before ASIC to operate a market, to enable investors of private unlisted companies or funds to trade the relevant products. Our licence application also contemplates that our platform will provide atomic (instant) settlement of these trades. We would hope to find sensible and proportionate ways to facilitate this type of innovation, without the need for FCX to be approved *separately* as a CS facility. We are satisfied that our solution provides a safe, reliable and robust mechanism for the trades to be settled atomically – however if we, and others like us, also need to be regulated as CS facilities, innovation in this area will be stifled, if not eliminated.

A measured proportionate response (such as an exemption from the CS facility regime) would enable and encourage alternate capabilities via a discrete/ring fenced implementation that can over time be more broadly implemented if the market and regulators believe it is useful.

Reform as the catalyst of Australia's return to global leadership in financial markets infrastructure

Australia can lead the way in financial technology and the government has the tools to consider different ways to deliver services to the market currently being managed by CHESS.

We believe it is critical that regulators ensure the Australian financial market remains competitive, ensuring there is continued investment and innovation leading to ongoing improvements in service levels as well as a reduction of charges and fees that impact all Australians (through their superannuation funds).

Thank you for the opportunity to submit to the Treasury process. FinClear will continue to engage positively and constructively with regulators on this issue and we would welcome the opportunity for an ongoing dialogue with the Government to ensure that one lost decade without competition in CS services does not become two.

Finally, please see attached to this submission some recent research work commissioned by Finclear, but conducted independently, by the Mandala Group.

Should you need further assistance in this matter I can be contacted on david.ferrall@finclear.com.au

Kind regards

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