



Level 23, Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000

11 November 2016

Ms Diane Lewis
Senior Manager
Regulatory and Public Policy Unit
ASX Limited
20 Bridge Street
Sydney NSW 2000

By email: diane.lewis@asx.com.au

Dear Ms Lewis

CP: ASX's Replacement of CHES for Equity Post-Trade Services

Chi-X is grateful for the opportunity of providing a submission to the Consultation Paper: ASX's Replacement of CHES for Equity Post-Trade Services: Business Requirements (the CP). Chi-X is also appreciative of your understanding in allowing an extension past the deadline date for submissions.

The need to replace CHES has provided ASX Clear and ASX Settlement with a once in a generation opportunity to change the critical market infrastructure of clearing and settlement in a way that will facilitate the growth and development of Australia's financial markets over the next twenty years. This opportunity is presented when the most dynamic growth globally is taking place in our region.

Unfortunately, the CP indicates that ASX is dedicated to using this once in a generation opportunity to prioritise ASX interests and shareholders over the interests of Australia and all stakeholders in Australia's financial markets.

Chi-X is of the view that ASX must immediately review its proposed management of this critical project and implement appropriate review and governance measures that will address critical flaws in the project that are evidenced in the CP. The failure to do so will put at risk a once in a generation opportunity to deliver critical market infrastructure that serves the interests of all Australians.

The need for ASX to act immediately is apparent from the following.

1. **The need for a Detailed and Objective Review of Existing Clearing and Settlement Systems and Functions:**

ASX has not undertaken a transparent detailed review of the different ASX functions and systems involved in the clearing and settlement processes ASX has imposed on Australia's markets. A transparent and detailed review is an essential pre-requisite to facilitating the full and effective contribution of all stakeholders in Australia's market infrastructure to any ASX proposals.

2. **The Need to Prioritise the Replacement of Outdated and Critical Technology:**

ASX has refused to invest in and replace outdated technology and has instead prioritised developing a prototype of an untried technology provided by a company in which ASX has an invested interest. Chi-X notes that the RBA has stated:

ASX is also encouraged to invest in appropriate contingency arrangements, to ensure the timely implementation of an alternative CHES replacement system should the decision be taken not to proceed with the DLT solution.¹

3. **The Need to Address the Continuing Lack of Any Genuine Consideration of Competition:**

ASX has consistently declined to consult on and develop any measures to implement a genuinely non-discriminatory clearing and settlement service and framework for non-ASX trading platforms. It should be a minimum condition of the CHES replacement programme, and an explicit matter for consultation, that all of the major post trade services offered by the ASX be decoupled from ASX trading infrastructure and that standard interface technology be introduced that applies equally to all trading platforms.

4. **The Need to Address the Cost of and Barrier to Entry posed by the Default Fund:**

ASX has consistently failed to analyse the impact of the default fund on the cost of clearing and its possible use as a barrier to entry.

5. **The Lack of any Substantive Governance Around one of the Most Important Market Infrastructure Projects Undertaken in Australia**

There is an almost total lack of transparent governance around the project and the consultation process. There is no reason for Chi-X to believe that any appropriate priority will be given to matters that enhance Australia's markets. There is evidence

¹ See page 59 of the 2015/2016 RBA Assessment at <http://www.rba.gov.au/payments-and-infrastructure/financial-market-infrastructure/clearing-and-settlement-facilities/assessments/2015-2016/pdf/report-2015-2016.pdf>



that ASX will prioritise ASX interests, whether those interests are those of ASX trading platforms or any of the many other business undertaken within the ASX group. This is also demonstrated in the questions asked in the CP and scope of the consultation being undertaken.

The ASX consultation indicates that ASX is seeking to entrench an ASX way of doing things to retain as much monopoly rent from as many of the different services and functions it provides as possible, to the cost of other stakeholders in Australia's markets.

It is also appropriate to revisit the matters covered in the CP in light of the Government's announcement on 12 October concerning regulatory expectations for conduct in operating cash equity clearing and settlement services.

Attachment one to this submission provides further details on why ASX must immediately review its proposed management of the CHES replacement project and is referenced to each of the five critical matters listed above. **Attachment two** contains answers to the questions asked in the CP.

I hope this submission assists in your important work on the replacement of Australia's most critical financial market infrastructure.

Please do not hesitate to contact me if you have any queries.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Michael James'.

Chi-X Australia Pty Ltd

Attachment One

1. The Review of the Role of Clearing, Settlement, Issuer Administration, Asset Registration and Reference Data

There are many different integrated components in ASX's technology and operational systems, including those that contribute to clearing, settlement and issuer administration services.

The lack of transparency on how these systems operate and what options may exist for some of the processes they perform, means that the consultation currently being undertaken is inappropriately narrow and opaque.

ASX has used the opportunity of being, over many years, the sole infrastructure provider in almost all aspects of Australia's regulated financial market infrastructure, to extend its proprietary reach over as much of that infrastructure as possible. The areas of market infrastructure in which ASX currently has a dominant position and which may impact on clearing and settlement functions, include:

- (i) Reference data;
- (ii) Issuer administration;
- (iii) Asset holdings;
- (iv) Processing of corporate actions;
- (v) Default;
- (vi) Message protocols and mechanisms;
- (vii) Clearing; and
- (viii) Settlement.

It is therefore essential that an end to end review ASX's clearing and settlement services, including those functions listed above, be conducted to facilitate the effective contribution of all stakeholders in Australia's markets to the replacement of CHES in a way that develops and advances Australia's markets².

The ASX Schedule of Fees for clearing, settlement and issuer administration services is eleven pages long and contains over 100 separate charging points or fee products. This demonstrates the many different systems and operations imposed on Australia by the ASX way of operating

² For an outline of the basic principles that should be met in a consultation as significant as that relating to the replacement of Australia's key financial market infrastructure, see, for example, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/492132/20160111_Consultation_principles_final.pdf

its clearing and settlement functions. The ASX Schedule can be benchmarked against global clearing providers who have a handful of fees listed in a two page schedule. ASX may provide many more services but it is precisely because of this that a detailed review is required of each of those services to ensure that any CHES replacement does not simply reproduce an opaque vertically integrated mass of different services and systems that operate to provide an opaque service with myriad charges to Australia's investment community.

2. CHES replacement and Digital Ledger Technology

ASX is to be commended for exploring innovative solutions for market infrastructure issues. However it is not clear to Chi-X why the consultation on the replacement of outdated critical market infrastructure gives such priority to the DLT process.

In September 2014 the RBA stated:

The transition to global messaging standards will be pursued as part of a broader project to replace the CHES clearing and settlement system; this is expected to be implemented within the next three to four years.

In March 2015 the ASX stated:

"A decision in relation to ASX's cash equities clearing and settlement infrastructure will be made when there is regulatory certainty around the market structure for cash market clearing."

In September 2015 the RBA stated:

The Bank views the replacement of the CHES clearing and settlement system as an important element of this project [the group wide technology transformation project].... The Bank is examining prioritisation decisions, resourcing challenges, interdependencies with day-to-day business-as-usual processes, and potential change-management issues associated with ASX's technology transformation project. This includes ensuring that investment in the replacement of CHES is appropriately prioritised.

In September 2016 the RBA stated:

ASX is also encouraged to invest in appropriate contingency arrangements, to ensure the timely implementation of an alternative CHES replacement system should the decision be taken not to proceed with the DLT solution.

Prioritising the development of a blockchain prototype to enable a decision to be made at the end of 2017 on whether that prototype can be further developed as a replacement for CHES, raises queries over whether appropriate priority is being given to the replacement of CHES. In particular, Chi-X is surprised at the lack of consultation on any appropriate contingency arrangements.

3. Competition

The CP states:

ASX is proposing that the following key business functions currently provided by CHESSE will continue to be supported by the new system that replaces CHESSE:

.....

Non-discriminatory access by AMOs: all AMOs, including ASX-affiliated AMOs, will be provided with non discriminatory access to clearing, settlement and issuer administration arrangements under the new system. As all AMOs will access these arrangements in the same way, the existing Trade Acceptance Service for AMOs other than ASX will no longer be required.

The current AMO access regime does not provide non-discriminatory access to all AMOs and it is incorrect for the CP to state that this is a key business function currently provided by CHESSE.

The discriminatory service provided by ASX Clear and ASX Settlement is recognised in the terms of the TAS, which do not prohibit ASX providing a discriminatory service to non-ASX AMOs. The TAS states that non-ASX AMOs will receive a “comparable service” from ASX Clear and ASX Settlement. The nature of clearing and settlement services is that very small differences in services can dictate the winner of competing exchanges engaging in a “winner takes all” competition. There are many instances of discrimination in the clearing and settlement services Chi-X has received since its market launch:

- (i) Chi-X accesses ASX clearing and settlement system through a bespoke technology system that ensures Chi-X receives a different service to ASX trading Platforms – transparency on the differences generated by this inherent discrimination has never been provided;
- (ii) Chi-X is subject to an onerous, lengthy and one sided set of legal terms that are not applied equally to competing ASX trading platforms³. There are over 30 obligations imposed upon Chi-X in the operational standards appended to these terms and only four imposed on ASX Clear and ASX Settlement, notwithstanding that the terms relate to services provided by ASX to Chi-X;
- (iii) ASX traded warrants are able to be settled on terms other than T+2 while Chi-X warrants are not;

³ In this context, Chi-X notes that the initial ASX draft of the TAS expressly allowed ASX Clear to discriminate between ASX Limited and Chi-X so long as the discrimination was not “unreasonable”. Allowable discrimination was determined by taking into account the differences between ASX Limited and Chi-X: - see the Legal Terms for 28 January 2010 at http://www.asx.com.au/documents/professionals/tas_att_1_legal_terms_20100128.pdf . These terms remained in the draft TAS until January 2011, despite repeated objections prior to that date from Chi-X.

- (iv) ASX Trading product developments are dealt with in an integrated business development process with ASX Clear staff while Chi-X developments must occur on an arm's length basis;
- (v) The permitted number of decimal places for ASX and Chi-X trading reports has favoured ASX products;
- (vi) ASX trading and clearing fees can and have been bundled in opaque structures to enable the extraction of maximum rents that are then unbundled to enable drastic fee cuts in ASX business that become subject to competition;
- (vii) An ASX Clear "opting out of crossing services" has been promoted exclusively to ASX participants and not offered to non-ASX AMOs as a service.

The Ontario Securities Commission has stated, with reference to regulating its sole provider of clearing and settlement systems: “

*[T]he Commission considers the operation of a clearing agency in the public interest to include, among other things, appropriate governance arrangements, fair access and services to all market participants, adequate management of risk, including systemic risk, and operational reliability, fair and non-discriminatory fees, **and appropriate rules and procedures to foster competition in the Canadian financial markets.**”*

In these circumstances, ASX should, without delay, remove the legal terms currently applied to non-ASX AMOs and replace them with a standard set of terms for all AMOs, irrespective of whether they are located within the ASX group. The new terms should explicitly state that ASX and non-ASX AMOs will receive the same services and be subject to the same legal framework except to the extent transparently identified by ASX in consultation with AMOs and the appropriate regulatory authorities.

4. The Impact of Cost of the Default Fund on the Cost of Clearing

On 31 March 2005, the Parliamentary Secretary to the Treasurer directed the payment of \$71,488,687 from the NGF to ACH. The NGF money came from the interest earned on client accounts held at stockbroking firms and, in some cases, contributions directly by those firms. This money has not been paid out but has remained available for use by ASX since that date. See http://www.segc.com.au/pdf/segc_annual_report_2005.pdf . Interest on these funds has not been made available for the default fund and it is also possible that ASX has been charging participants for the use of these funds.

The default fund operates as a barrier to entry for any competing clearing provider. The fund operated by ASX has benefitted from participant funds. In these circumstances the end to end detailed review of the clearing and settlement process, undertaken as part of the CHES replacement project, should include a review of the default fund and:

- (i) the costs of capital charged to participants in respect of the fund;

- (ii) the use of the funds by ASX and any possible revenue gains that could be used to further develop clearing and settlement functions;
- (iii) the barriers to entry posed by having a fund used by one clearing/settlement operator.

5. Consultation Governance

There is no incentive on ASX to replace the existing CHES and CHES-related systems and functions with systems/operations that prioritise the interests of Australia's markets over those of ASX shareholders. There is evidence that ASX has delivered low quality high cost services over many years that have extracted monopoly rents from market participants while inflicting significant damage on Australia's markets.

In these circumstances, ASX should prioritise the development of an enhanced governance process surrounding its consultation and review of the CHES replacement project. That process should establish a project board that:

- (i) is required to act in the public interest;
- (ii) has members each of whom has an expressly stated responsibility to fulfil the public interest responsibility of the project;
- (iii) is required to report at least quarterly to the Council of Financial Regulators on how it has fulfilled its public interest responsibility;
- (iv) imposes governance arrangements intended to fulfil public interest requirements and to balance the interests of the different customers and stakeholders of clearing and settlement;
- (v) requires one board member to be a representative of a market operator unaffiliated with the ASX; and
- (vi) at least 33% of the board to be representatives of participants.

The need for this governance is evidenced in guiding principles listed on page 6 of the Consultation Paper where ASX has stated that the guiding principles for the replacement of CHES are to operate for the benefit of investors and issuers: two of the biggest customers for CHES, market operators (including those at ASX) are not mentioned.

The decision of ASX on its guiding principles stands in stark contrast to the priority given to participants and competing market operators in the guiding principles applied by Canadian regulators to the monopoly clearing and depository service in that country.

Attachment Two

Response to Consultation Questions

Q1. Are there any other key business functions provided by CHESSE that have not been identified in this paper that should be supported by the system that replaces CHESSE? Explain the importance and value of any such business functions to you.

Chi-X is of the view that a transparent end to end review of the clearing and settlement services provided by ASX. That review should include an examination of the following ASX functions in order to facilitate the effective review of the many integrated ASX systems and operations relating to clearing and settlement:

- (i) Reference data;
- (ii) Issuer administration;
- (iii) Asset holdings;
- (iv) Processing of corporate actions;
- (v) Default;
- (vi) Message protocols and mechanisms;
- (vii) Clearing; and
- (viii) Settlement.

This review should be conducted with a goal of ensuring that:

- (a) all ASX post trade systems and operations are decoupled from ASX trading systems and functions; and
- (b) a standard interface technology is introduced to be applied equally for all trading platforms, whether or not they are members of the ASX group.

Q2. What are your views on ASX implementing only a limited suite of business function and service enhancements in the replacement of CHESSE, In order to minimise risk and disruption to the market?

This question is loaded toward minimising enhancements by indicating that to do otherwise will increase risks and market disruption and should be rephrased in a way that facilitates an effective contribution from all stakeholders.

The ASX should conduct a transparent end to end review of the matters referenced in the answer to question 1 and embark upon an appropriate consultation after that time rather than ask consultation questions that are loaded to maintaining an ASX paradigm.

Q3. What are your views on each of the potential business functions and service enhancements identified in the paper for implementation with the replacement of CHES?

As an overarching comment, Chi-X is of the view that there should be a detailed review of all clearing, settlement, issuer administration and asset holding systems and operations to facilitate the appropriate scrutiny of and effective contribution to the consultation process by all stakeholders. This review would cover each of the matters listed and many more.

Access to a Second CCP

Chi-X is of the view that barriers to entry for a second CCP should be included in the end to end review outlined in the answer to question 1.

Legal name on title through settlement and remove the need for a settlement accumulation HIN.

Chi-X is of the view that an end to end review should cover the options relating to legal names on title and settlement accumulation HINs, including those that may be more globally aligned.

Settlement Period of Choice

Chi-X is of the view that an end to end review would facilitate a full cost benefit analysis of this issue.

Default Fund

Chi-X is of the view that the impact of the default fund on the cost of clearing and its possible use as a barrier to entry should be covered in any CHES replacement project.

Q4. Would you expect the business functions and service enhancements identified in the paper to provide a net benefit to your organisation, and if so, how would you categorise the significance of the net benefit -small / medium / large? If possible, please provide a quantification of any net benefit.

Chi-X is of the view that the overwhelming theme to the ASX proposals in the CP is to entrench as many as possible of the existing ASX products in the clearing, settlement, issuer administration and asset holding areas so that it can continue to extract as much monopoly rent from as many of the related products as possible, to the cost of other stakeholders in Australia's market.

Q5. Are there other business functions and service enhancements that are consistent with ASX's guiding principles that have not been identified and which you think should be considered as part of the replacement of CHES?

Chi-X is of the view that proper consideration of and responses to this question can only be provided after a thorough end to end review of existing processes and future needs, as outline din the answer to question 1. That end to end review should include consideration of the current market for clearing participants in Australia.

Q6. Are there any non-functional requirements or connectivity models you would like ASX to consider for the replacement of CHES??

It is important for the CHES replacement project to transparently consult on and: consider non-functional requirements and connectivity models in the following areas:

- (a) all of the major post trade services offered by the ASX should be decoupled from ASX trading infrastructure
- (b) standard interface technology should be introduced that applies equally to all trading platforms
- (c) services provided to market operators should be conducted on the same basis for both ASX and non-ASX market operators.

Q7. Would you expect the adoption of ISO 20022 messaging standards to provide a net benefit to your organisation? If so, how would you categorise the significance of the net benefit –small / medium / large?

If possible, please provide a quantification of the expected costs and benefits of the implementation of ISO 20022 messaging standards.

Market operators have been advised that they will not be using an ISO200022 interface to CHESS but will be asked to use a FIX based interface to be defined by ASX. This is not covered in the CP. It does not seem practical to Chi-X for a consultation on the adoption of ISO 20022 to be considered without including the messaging that will apply to AMOs.

Having said that, Chi-X is of the view that the migration to ISO20022 standards is a necessary improvement for the Australian market to increase efficiencies, competitiveness and work towards international alignment and integration.

Chi-X notes that adoption of internationally accepted messaging standards alongside the renewal of CHESS was recommended in ASIC's and the Bank's 2014 joint assessment of the ASX CS facilities against the PFMI's.

Q8. How important is it to your organisation that ASX continues to support CHESS messaging for a period of time to allow for your organisation's transition to ISO 20022 standards?

Chi-X is of the view that it is appropriate for ASX to develop an approach to transition arrangements in consultation with participants and industry organisations.

Q9. ASX currently supplies and supports two client-side CHESS messaging gateways –CHESS PC and CHESS Access. Are you a user of either of these services? If so, which gateway do you use?

Not applicable to Chi-X.

Q10. If you are a user of CHESS PC or CHESS Access, would you be seeking continuation of this gateway service from ASX (for either CHESS or ISO 20022 message suites)?

Not applicable to Chi-X.

Q11. Does your organisation have the capability to support and migrate to ISO 20022 messaging now? If yes, what business categories do you use? If your organisation does not currently have this capability, does it have plans to implement it in the near to medium term?

Chi-X has the capacity to support and migrate to ISO 20022 messaging.

Q12. If ASX was to mandate the use of ISO 20022 securities messaging, how long would your organisation need to migrate to ISO 20022?

Chi-X could migrate to ISO 20022 within six months, subject to:

- (a) a detailed technical specification being produced after a minimum 6 month period of consultation with industry;
- (b) the business and processing models being aligned with global processes.

Q13. Do you have a preference about the approach to the implementation of ISO 20022 messaging- for example, a big bang approach or per business function or other?

Chi-X is of the view that it would make sense for AMOs to be the first to migrate to the new messaging format, followed by participants after an initial bedding down process.

Q14. Does your organisation have a preference for the network used for ISO 20022 messages-for example, SWIFTNet, ASX Net or other?

Chi-X is of the view that it is appropriate for all ASX and non-ASX AMOs to connect directly to CHES (or the CHES replacement) without an intervening network being in place.