

Regulating Price Discovery and Conflicts of Interest in a Multi-Operator Financial Market



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This paper provides ASX's response to ASIC's Consultation Paper 95 and refers to the market operator licence applications currently before ASIC from AXE and LiquidNet. In that paper, in addition to advancing some proposed changes to the regulatory framework, ASIC provided commentary on the views which ASX had expressed in response to ASIC's earlier Consultation Paper 86.

Whilst there were some very significant aspects of ASX's views that have clearly been heeded, ASX has been inaccurately depicted as being against competition. As a result, ASX believes that certain key points raised previously have not been given due consideration. Consequently, ASX restates them, and elaborates upon them, in this submission and anticipates their further consideration by ASIC and the Government. ASX also outlines some serious flaws in the mechanism by which ASIC has, appropriately, attempted to temper the predictable desire of intermediaries in the AXE proposition to conduct as many transactions as possible in execution forums that are not fully accessible to other market participants – something which lessens competition in the price formation process of any Central Limit Order Book (CLOB). The lessening of price formation competition (or the impact on market quality when introducing competition for market services), whilst a key principle in ASIC's original consultation paper, has not been subject to robust scrutiny in ASIC's assessment to date (in terms of measurement criteria or analysis). ASX believes it is important that ASIC develops suitable measures going forward.

If ASIC and the Government do not get these mechanisms right, investors and issuers will suffer through wider bid/offer spreads, higher liquidity search costs and ultimately higher costs of capital. It is the impact on these key stakeholders and not the impact on intermediaries or market operators which should be ASIC's and the Government's primary focus, from a public policy perspective.

In order to help explain the reasoning behind the views expressed in this submission, it is worth describing the environment within which the issue of competition for market services is being considered.

Following its demutualisation in 1998, ASX has transformed itself from a member-owned organisation serving the interests of its intermediary-owners into an efficiently run commercial enterprise operated in the interests of its shareholders (but where intermediaries remain important stakeholders). As markets have evolved from floor based trading to globally distributed electronic platforms, ASX has become familiar with, welcomes, and is constantly faced by, competitive threats from other exchanges and the over-the-counter markets dominated by global investment bank intermediaries. Whilst these threats come in many forms, the most usual are competitive attempts to attract liquidity to alternate execution venues.

ASX defends its competitive position against these threats through the development and ongoing improvement of an efficient execution mechanism made available to the widest possible group of market users. To do so requires the development of new products, the broadening of distribution, the creation of new functionality, and the deployment of new technologies. It also requires the provision of the clearing, settlement and supervisory functions that underpin the integrity of the market. Broadly speaking, ASX earns a return for delivering this service through fees charged for listings and trade execution volumes. Volumes have continued to grow at impressive rates for a number of reasons, including the value proposition of ASX itself. At the same time, one can observe reducing average transaction fees and record transaction fee rebates paid to intermediaries (which are typically retained by broker intermediaries, rather than passed on to investors).

Investors and issuers benefit from this competitive offering through the growth in liquidity and consequential narrowing of bid/offer spreads and the reduction in the costs of capital. These spreads represent the vast majority of the costs of trading in the ASX market. For these reasons, ASX, investors and issuers remain aligned in the long-term development of more efficient marketplaces as each benefit from their creation. In the pursuit of greater efficiency, particularly with respect to large order execution, ASX acknowledges that improvements to existing market micro structure are always desirable (such as changes to ASX crossing rules) where doing so further reduces the overall costs of trading for such large orders.

Intermediaries, whose brokerage fees have declined as access to electronic markets has become easier for investors, are now more dependent on the significant returns they can earn through the provision of liquidity (via their balance sheet). These proprietary trading returns can be made more profitable if bid/offer spreads are widened. One way to achieve this is through the internalisation of order flow, and this can create market inefficiency at the expense of retail and institutional end users who pay in the form of higher overall costs of trading. The AXE proposition supports the

unrestricted internalisation of order flow by intermediaries based on a flawed view of genuine competition. Via its crossing rules, ASX permits the restricted facilitation of large orders away from the CLOB in circumstances where the advantage of reduced market impact costs (or slippage) outweighs the disadvantage of not having subjected those orders to the competitive price formation process of the CLOB. The potential for development of the ASX crossing rules – in addition, or as an alternative, to the complex process of granting multiple licences – has not formed any part of the discussion to date.

Other parties, such as LiquidNet, seek to further reduce transaction costs through the reduction of slippage in relation to large orders, and also offer anonymity for institutional investors seeking to avoid visibility by the intermediaries who have traditionally provided them with access and liquidity. This desire for anonymity is a clear indication that investors have concerns regarding the motives and actions of intermediaries when executing large orders. It should cause ASIC to consider whether relaxing the controls placed on intermediaries to execute in a non-transparent mechanism is an appropriate course of action from a public policy point of view.

The distinction between the LiquidNet and AXE proposition has not been fully examined in the consultation process, nor have the different risks to market quality and integrity been identified or discussed. The LiquidNet proposal, in which no intermediary proprietary trading occurs, does not present the same conflicts as the AXE proposition, in which intermediaries trade their principal account against their clients. To ignore this distinction indicates a misunderstanding of the issues at a most fundamental level. Undertaking complex market re-design that facilitates the preservation of wider bid/offer spreads to the benefit of intermediaries is neither desirable nor necessary to achieve the legitimate objective of reducing slippage to the benefit of investors and issuers (a diametrically opposed objective to that of the intermediaries). This can be achieved through changes to ASX crossing rules and could more simply facilitate the types of innovation proposed by LiquidNet, without raising the plethora of public policy complexities embedded in the AXE application.

Finally, some service providers, such as IRESS, seek to provide new technologies to enable investors to efficiently search for liquidity across multiple dark and transparent liquidity pools. Whilst technology certainly reduces these liquidity search costs, nevertheless these costs and added complexities are borne by the investors whose intermediaries are required to use these new technologies to ensure best execution. Such service providers and intermediaries are incentivised to promote the perceived benefits of multiple platforms because it is within this environment that they are able to add value to the liquidity search process and charge fees for doing so – even if the benefits to the investors in terms of bid/offer spreads are unproven, unclear, or potentially negative. This is analogous to the efforts of floor traders to claim there were liquidity benefits to the complex and impenetrable (from an investor perspective) open outcry trading process. This was because they could add value in that environment to end users, (who, since electronic trading, have benefited from the efficiency and enhanced liquidity of the CLOB).

It is important to understand these factors when considering the prudence and practicalities of granting a licence to a potential market operator and self-regulator that will be part-owned by intermediaries, using a governance model discarded in Australia many years ago as being sub-optimal. It is also important to understand these risks and the motives of all parties when considering the virtues of competition for market services designed (for the most part) to reduce ASX transaction fees, which are a minute fraction of the overall costs of trading, against the risks of widening bid/offer spreads, increasing liquidity search costs, and increasing intermediary returns (the vast majority of the costs of trading).

ASIC has a public policy obligation to understand and consider these factors if it is to be in a position to measure (as ASIC's second principle implies) whether there would be a diminution of market quality and integrity under a multi-operator framework. The proponents of the AXE proposition wish to disproportionately focus the debate on the benefits of competition for exchange fees and the extent to which this may affect ASX - and this is a legitimate debate to have. However, it is also legitimate (probably more so) to debate the conflicts faced by intermediaries wishing to internalise order flow at the expense of investors and issuers – something that has not had adequate scrutiny in the consultation process thus far.

With this background in mind, ASX believes that a range of controls must be in place prior to the granting of licences to facilitate competition for market services. Market events of the early weeks of January 2008 ought to serve as a salutary lesson about the public policy significance of what is at stake in any process of market micro structure redesign involving fundamental issues of transparency, investor protection, regulatory consistency, conflicts of interest and an appropriate legislative framework. This ought not to be interpreted as a negative or anti-competitive statement, but rather as an

unambiguous statement to the effect that the public policy case for change, of the order of magnitude inherent in the AXE application, has not been fully evaluated from a cost, benefit and risk perspective.

This submission addresses five important issues. First, we examine the lack of focus to date in ensuring adequate investor protection under a multiple market operator regime. Secondly, we recommend ASIC consider a fourth principle – regulatory consistency – when considering an appropriate regulatory framework and be guided by this principle in coming up with better mechanisms for risk adjusting the volume of non-CLOB trading that is potentially deleterious to retail investors. Thirdly, we voice our concerns in relation to the viability of self-regulation of market participants in a multiple market operator environment. Fourthly, we again urge ASIC to consider the legal basis upon which it intends recommending that the Treasurer grant a licence to a reporting facility prior to it operating a genuine trading facility. Finally, we list the areas where changes to legislation and/or regulations will be needed to address gaps in the regulatory framework that have become apparent with the real prospect of multiple market operators.

Issue 1: Investor protection

In its 17 August 2007 submission on ASIC's July 2007 Consultation Paper 86, ASX focussed attention on the following:

- that the central issue was not about the desirability of competition but about the best way of regulating competitive activity involving crossing networks, block trading mechanisms and similar initiatives which cater for the needs of institutional investors otherwise than through provision of a CLOB. ("Price formation regulation outside of CLOBs");
- that ASX rules provided the primary content of the existing price formation regulation relating to the interaction between the only existing CLOB in Australia on which ASX-listed securities are traded and the various current institutional trading mechanisms outside of the CLOB (essentially crossings by intermediaries). Whilst ASIC is the agency with primary responsibility for most aspects of financial market regulation, ASX is the body with primary responsibility for "price formation regulation" (subject to ASIC oversight). This responsibility, which overlaps with ASX's commercial interests, is exercised in part by devising market rules which ensure that the interests of retail investors are not adversely affected by the impact which other trading venues may have on the competitive CLOB;
- that one of the important public policy reasons why there needs to be some form of price formation regulation – whether based around the rules of a market operator or on Government-imposed rules - is that in the absence of any constraints on the growth of alternative trading away from a CLOB, the cost to investors of buying and selling securities may increase because of the reduced liquidity in the CLOB.

In Consultation Paper 95 released in November 2007, ASIC acknowledged the need for price formation regulation to deal with the potential adverse effects on a CLOB of non-transparent trading on other venues; identified the principles which it considered should underpin that regulation; and put forward proposals designed to implement those principles. (AXE, in its media release of 22 November 2007, seriously misrepresented ASIC's approach when characterising ASIC as having "rejected ASX's posturing").

ASX is concerned that ASIC has also misunderstood (and as a consequence, has misrepresented in CP 95) ASX's position on the desirability of competition. ASIC publicly stated (in paragraph 34 of CP 95), in spite of it being quite contrary to the terms of ASX's 17 August 2007 submission, that ASX (and five other respondents) "opposed competition for trading in ASX-listed securities." ASIC erroneously inferred this conclusion from various accurately reported statements by ASX to the effect that ASX was (and remains) concerned about potential adverse effects on the operation and efficiency of any CLOB. Assuming ASIC develops an appropriately robust regulatory framework without any gaps or lessened standards, ASX does not oppose competition for trading in ASX-listed securities. ASIC is faced with many issues that must be addressed before such a framework can be developed and implemented. Furthermore, few respondents to the consultation process have been able to provide input into how this framework should be constructed (beyond glib 'competition is good' statements).

ASX has expressed a view, and continues to express a view, that a significant increase in the proportion of internalised trades relative to those subjected to the fully competitive price formation process of the CLOB may widen bid/offer spreads, which would not be in the interests of users of a CLOB (whether operated by ASX or a competitor). ASIC itself

has endorsed this view. This does not mean ASX and ASIC oppose competition for trading in ASX-listed securities. ASX believes that if an entity which satisfies the criteria for a market operator's licence applies for a licence, such licence should be granted, subject to the regulatory framework issues canvassed in this submission being properly addressed.

ASIC devised a proposal, in CP 95, which it saw as being an influence on the volume of internalisation. ASIC's proposal can best be characterised as a "safe harbour" from pre-trade transparency for a proportion of trades effected on each venue. This proposal would have a number of inappropriate (and presumably unintended) consequences. There are several other regulatory gaps yet to be satisfactorily addressed. As a result, ASX's position remains the same: it is not opposed to competition for trading in ASX-listed securities subject to the regulatory framework issues canvassed in this submission being properly addressed.

The real consultation process should not be about whether or not there is support for competition – on which it is easy to gain consensus. The real consultation process should be about the merits or otherwise of how ASIC proposes to protect the interests of issuers and investors and particularly retail investors. If the issues raised by ASX are not addressed, intermediaries will be the primary beneficiaries of any relaxation of current restrictions on crossings at the expense of retail and institutional investors. The interests of institutional investors in improved block order trading can be achieved by initiatives akin to the LiquidNet offering and appropriate changes to ASX crossing rules. Furthermore, the interests of retail investors would be sacrificed in the belief that they will get a compensating benefit from more trades being internalised. However this need not be a zero-sum game. ASX believes that ASIC must give serious consideration to the impact of the current proposals on the interests of retail investors. ASIC must distinguish between competition which is beneficial to the market as a whole (including retail investors) and the competition which would exist if some intermediaries were able to by-pass effective investor protection regulation by establishing a reporting framework in the guise of establishing a financial market whose rules they designed.

Issue 2: Regulatory consistency and risk-adjusted internalisation thresholds

The consultation process to date has highlighted the importance of articulating the principles which should be reflected in any financial market regulatory framework. It enables the proposals which ASIC and others have put forward to be judged against the three principles which ASIC has already identified.¹ ASIC does not appear to have assessed its proposals against the second of its suggested principles, namely that there should be no diminution in market quality or integrity. It is difficult to see how a regime which does not adequately deal with significant new conflicts of interest, permits internalisation of retail transactions by intermediaries and generally incentivises transactions occurring without pre-trade transparency could be consistent with no diminution in market quality and integrity.

ASIC's proposed "safe harbour" treatment² for 5% of trades affected through each separate licensed market operator has highlighted the relevance of both the market integrity principle and of another principle applicable to the design of any regulatory framework: that comparable activities need to be regulated consistently. Whether that outcome is achieved by a principles-based approach (where possible) or by a more prescriptive approach (where necessary), the

¹ In CP 86, ASIC expressed the view that its approach to competition for market services was based on the following three key principles:

- (a) competition for markets services is, in principle, desirable;
- (b) the entry of competitors for market services should not result in a decline in the existing quality and integrity of the market for securities that trade on more than one licensed market; and
- (c) the regulatory regime should set the minimum conditions that will allow competition to develop, where it is efficient and therefore without adverse effects on the market as a whole.

² ASIC proposed that a regulation be made specifying the following minimum requirements to be satisfied by all markets facilitated by an owner (subject to the "safe harbour" exception set out below):

- (a) information about all bids and offers in the market for an affected security should be made available to all participants on the market;
- (b) all participants in the market should be able to accept bids and offers in affected securities;
- (c) participants in the market should not be precluded from providing information to their clients and market users about bid and offer information made available through the market.

However, each separate operator would be afforded a quota of trading that didn't need to satisfy these transparency and competition principles, being 5% of total trading of each ASX-listed security (considered separately) across all execution venues. It was proposed that the 5% level of trading in a particular trading would be measured over the previous 6 months.

result must be the same: there must be no scope for competition to be distorted by the deliberate or inadvertent imposition of obligations (or relief from obligations) on one entity that is not extended to another entity engaging in the same activities, in the absence of a sound regulatory or other public policy justification for the differentiation.

Whilst it is important that the pre-trade transparency and accessibility principles be set out in a regulation as proposed by ASIC, the particular "safe harbour" proposal devised by ASIC raises retail investor protection concerns that warrant its abandonment and replacement by an alternative approach. The "safe harbour" treatment on the basis of "5% per operator" is flawed for the following reasons:

- today, under ASX operating rules, only certain transactions involving institutional investors (courtesy of a \$1million trade size proxy) are exempt from pre-trade transparency. This is justified on the basis that this lowers market impact costs for these institutional investors. No such public policy rationale exists for exempting transactions undertaken for retail investors from the normal principles underpinning price formation regulation. For retail investors, transparency is lost without any countervailing benefit;
- the solution proposed by ASIC as a way of capping potentially deleterious trades so as not to harm retail investors, could result in the creation of new dark pool arrangements every six months to which liquidity would shift as soon as one operator had reached its quota of trading (that had no conceptual basis for the "safe harbour" in the first place);
- it would amount to a "100% per operator" safe harbour (not the intended "5% per operator") for the first six months for any operator other than ASX because only at the end of that period would trading on a new execution forum be taken into account. The (unintended) discrimination against the existing operator implicit in this flawed measurement aspect offends the fundamental principle that comparable activities should be regulated consistently; and
- the solution is incompatible with "best execution" for retail investors. Whilst speed, volume discovery, etc, may be relevant to achieving best execution for institutional investors, there is little point having price formation regulation to address market failure if ASIC does not recognise that achieving lower prices for retail investors who cannot achieve it for themselves is the reason ASIC has been given oversight responsibility for ASX's price formation regulation to date. North American regulatory frameworks recognise this to the extent of defining "best execution" in terms of price (notwithstanding that this may not always accurately reflect the aspirations of institutional investors), because of the importance they attach to securing real "best execution" for retail investors. ASX understands the reasons for considering something closer to the European approach to defining "best execution". But, however it is defined, retail investors will invariably not be receiving anything approaching best execution if their small orders result in intermediaries obtaining wider spreads at the expense of their clients.

In summary, the 5% proposal provides asymmetry in the regulation of exchanges. It delivers an advantage to non-transparent venues, provides no protection against retail trades becoming executed in a non-transparent manner, encourages the proliferation of non-transparent venues, and provides no control over the amount of non-transparent trading.

In ASX's opinion, the legitimate objective underpinning ASIC's proposal – namely, limiting the risk of excessive draining of liquidity away from transparent competitive execution forums – would be better addressed simply by ASIC (in place of ASX) regulating the size of transaction which is exempt from the pre-trade transparency and accessibility principles underpinning price formation regulation and CLOB-type markets. With ASIC in control of these levers, it should have adequate capacity to raise or lower thresholds from time to time based on the liquidity of relevant securities and the ease with which institutional shareholders can effect trades in the CLOB without incurring higher market impact costs. This could deliver a desired public policy outcome (the capacity to impose a risk-adjusted limit on trading away from any CLOB) while also ensuring market efficiency is considered in the setting of the thresholds. It also has the important advantage, as acknowledged in ASIC's paper, that it is more straightforward to administer.

Issue 3: Co-regulation and managing conflicts of interest

ASIC appears to be more confident than ASX that:

- as much of the standard-setting or regulation-making function can remain with competing market operators as it did when there was only one market operator; and
- that the new conflicts faced by market operators in relation to the enforcement of standards or rules in a multi-operator environment are as manageable as the existing more limited types of conflict faced by ASX in the current single operator environment.

Whilst ASX does believe it is viable for competing market operators to have both a standard-setting role and an enforcement role that has similarities to the role performed by ASX in a single-operator environment,³ ASX considers that there are aspects of the current enforcement role, in particular, that would be quite problematic if continued into a multi-operator environment. If ASIC does not adequately address the conflict of interests issues which arise, ASIC will struggle to deliver on the second of the principles which it has indicated will guide its thinking about competition for market services: "the entry of competitors for market services should not result in a decline in the existing quality and integrity of the market for securities that trade on more than one licensed market".

Inherent in the proposed governance of AXE is a serious conflict of interest: the regulator being part-owned by the organisations it is regulating (i.e. a reversion to "self-regulation" from the "co-regulation" which now exists between ASIC and a market operator, ASX, that is independent of the intermediaries that it regulates).

This conflict deserves the greatest scrutiny given that AXE felt emboldened to submit a set of draft operating rules to ASIC in which the maximum penalty for a breach as significant to the integrity of financial markets as delayed reporting of internalised trades was \$1000⁴. The independent tribunal established by ASX typically imposes fines in the order of \$25,000 - \$40,000 for such serious offences.

Over the past decade there has been a significant move away from intermediary ownership of major exchange groups in most of the well developed financial economies of the world. The Australian market was a leader in demutualisation when ASX became a publicly listed company, responsible to its shareholders and responsive to a wide range of stakeholders. While there are a number of factors driving the trend away from the mutual model, one is clearly the desire to remove any real, or perceived, conflicts of interest between the intermediary owners of the market operator and the other key stakeholders (institutional and retail investors, listed companies, etc). The recent trend of recreating mutual exchanges and the consequential recreation of previously avoided conflicts should be carefully scrutinised when evolving the legislative framework within which markets operate.⁵

³ At a headline level, most public commentary on "self-regulation", "co-regulation" or other descriptions of the involvement by ASX and other exchanges proceeds on the false assumption that ASX's "regulatory powers" are all conferred on it by the State and can be taken away by the State. The reality is that most of any exchange's powers over its direct customers (typically, but not exclusively, intermediaries) are conferred on the exchange contractually by those direct customers and would need to remain in place irrespective of whether these powers were supplemented by the law/State. This is true even in the jurisdictions (typically European) where it is now traditional to describe exchanges as no longer performing regulatory functions.

Accordingly, any discussion about transfer of responsibilities from ASX to another body – whether state-appointed or privately owned – needs to be a discussion about which aspects have a sufficiently "regulatory" character and give rise to such a significant conflict of interest that they should sensibly be transferred, rather than a discussion about exchanges ending up with no capacity to impose contractual sanctions on users of its services (i.e. "losing their regulatory powers").

⁴ Procedure 4.5.3, AXE ECN Pty Limited, Operating Rules Procedures, March 2007.

⁵ Whilst there have been attempts by intermediaries to re-mutualise in Europe (e.g. Project Turquoise, Boat, etc), where market operator licences don't come with the same responsibility to be a regulator of intermediaries, there does not appear to be any recent precedent in a leading financial centre for the licensing of a market operator/self-regulator of the type inherent in the AXE application.

Coupled with the unsatisfactory prospect of reviving this “regulating one’s owners” conflict, there would be the significant additional conflict in a multi-operator environment of a market operator/regulator regulating its competitors. ASX would also face this conflict if it were to impose disciplinary sanctions on the owner participants of a competing operator. It would not be surprising in this environment if even the most sophisticated of institutional investors, that have an appreciation of the benefits which accrue to them from ASX’s regulation of intermediaries, were to be sceptical as to whether these new conflicts could or would actually be managed satisfactorily by each market operator/regulator.

Financial regulators’ understanding of the need to identify and manage conflicts of interest has come a long way in the last few years. Both legislative change and ASIC guidance has been used to set common standards and help manage conflicts in relation to diverse areas such as client advice, audit rotation and analyst research. It is now apparent that the regulation of market participants must be reconsidered and that change is required. The system which worked well in a demutualised, single-operator environment needs adjustment to deal with the systemic conflicts that would be inherent in a multi-platform environment.

The Government should seriously consider whether any application from a market operator that could reasonably be expected to be controlled by the intermediaries that it is to regulate, could ever satisfy the statutory criteria requiring it to manage the conflict of interest between its commercial objectives and market integrity.

It is worth noting that the current approach to issuer regulation – where ASX is responsible for monitoring the listing rules that it creates but ASIC is responsible for investigating whether a breach has occurred and pursuing enforcement through civil penalties or court procedures – is a model that is not susceptible to any of the new conflicts in intermediary regulation that need to be considered.

It would not be necessary, in respect of intermediary regulation, to have a comparable shift of all responsibility for investigation and enforcement of market operator rules to ASIC; but ASIC will need to handle investigation and enforcement of ASX rules as they apply to intermediaries that have substantial shareholdings in AXE, or in any other competing market platform.⁶

In relation to the separate prospect of there no longer being a single operator with information about client activity on one forum affecting the integrity of trading on another forum, ASIC’s proposed approach involves a high degree of faith and optimism that all cross-market supervision issues could be resolved through memoranda of understanding between competing operators. The concept of relying on understandings between competing operators, as ASIC has proposed, has some limited utility in the area of information sharing but is not a viable vehicle for addressing the multitude of new enforcement and integrity issues that arise in a multi-operator environment and does not begin to address the serious conflicts of interest issues which arise. For instance, non-AXE ASX participants would be rightly concerned at the prospect of ASX being obliged to share trade information, including broker identifications, on a real-time basis with AXE, given the obvious conflict issues which arise. In any event, there are no meaningful sanctions available to one operator in the event of tardy compliance or non-compliance by another operator on real-time integrity issues. ASX is also mindful that any such arrangements need to be developed in a way which is consistent with the competition law regulatory issues which could otherwise arise through information sharing arrangements. ASIC must develop workable cross market supervision arrangements, which are both consistent with its guiding principles and which are practically aligned with other aspects of the regulatory framework, such as data sharing.

ASX remains ready and willing to assist ASIC in transitioning from the current arrangements to ones in which market operators, Government, ASIC, investors and issuers have confidence.

Issue 4: Market licences need to be granted in accordance with the Corporations Act

The current application by AXE is understood by ASX to be a reporting platform and, as such, does not fall within the definition of “financial market” in the Corporations Act. In CP 95 ASIC states that it rejects ASX’s legal arguments on this issue. ASX has obtained the advice of Senior Counsel. This advice confirms ASX’s view, that if offers or invitations or

⁶ Where the Government sanctions the content of necessary regulation being located in the rules of competing market operators rather than in legislation or regulations (e.g. because of the greater speed, flexibility, etc. associated with operator rule changes) the Government needs to require ASIC or another independent body to assume responsibility for enforcement of those rules of any market operator that are important to the integrity of the entire market. (See also footnote 3).

acceptances are not actually made on the AXE facility, but within facilities operated by the AXE participants, then the current AXE application does not involve a “financial market”.

Further, Senior Counsel has advised that the drafting or form of AXE’s operating rules cannot be constructed to overcome the practical substance of the arrangements between AXE and AXE participants. This means that if the AXE operating rules are drafted in a way which suggests that the execution of a transaction is only complete on the reporting of the transaction on the AXE platform, such drafting does not overcome the fact that in substance the only relevant activity carried out through the AXE facility is the reporting of trading activities which have been carried out through other facilities.

ASIC has stated that AXE’s system of rules “indirectly facilitates the acquisition and disposal of financial products” and that this is sufficient. Senior Counsel has advised that the phrase “directly or indirectly” in the definition does not derogate from the fundamental requirement that the relevant trading activities occur through the relevant facility.

In CP 95 ASIC pointed to “significant regulatory burdens on participants” if individual AXE participants had to obtain market licences, which is said to be the consequence of ASX’s position. Senior Counsel has expressed the opinion that ASIC’s considerations for the regulatory burdens on participants have been overstated. First, ASX is advised that if an outcome is the consequence of a proper construction and application of the Corporations Act that is not a sufficient basis for adopting a different construction. Second, Senior Counsel has pointed to the market integrity concerns if market participants, who operate the facilities through which virtually all trading activities will be conducted under the AXE arrangements, are not licensed.

ASX does not believe, based on Senior Counsel’s advice, that the Treasurer can be satisfied that the current application for the AXE reporting platform satisfies the requirements for an Australian market licence. A change to the definition of “financial market” in the Corporations Act would be needed if the Government wanted to pursue a public policy of enabling intermediaries to conduct internalisation of trades otherwise than pursuant to the rules of a financial market operator that also operates a CLOB.

Alternatively, the Government could simply indicate that it will only consider licence applications from applicants that are eligible, i.e. when they have satisfied ASIC that they could satisfactorily operate a CLOB and ASIC has addressed issues that this would raise (these being issues that have not formed part of the licence applications before ASIC nor the public consultation process to date.) These include the sharing and synchronising of market data and the provision of central counterparty clearing services.

Issue 5: New gaps in legislation and regulations need to be addressed

The fact that some applicants have made commercial judgments which erroneously assumed that legislative change could be avoided is not a reason for the Government to avoid undertaking the proper examination of how to facilitate a multi-operator environment.

Legislation and/or supporting regulations will be needed, at a minimum:

- to ensure enforceability of information sharing arrangements between competing market operators;
- to introduce uniform and enforceable client order priority standards and short-selling standards, including prohibiting short-selling during a takeover, across all market platforms (the sell-off that occurred in recent weeks in global equity markets reinforces the important role of properly regulated short-selling in an efficient market);
- to ensure consistent imposition of obligations to compensate retail investors in the event of a intermediary insolvency; and
- to achieve various other objectives already identified by ASIC.

Conclusion

There are many aspects of ASIC's proposals which ASX supports. ASIC has proposed several constructive adjustments to the regulatory framework. They include:

- New Corporations Act regulations will impose a best execution requirement on intermediaries if they are participants in multiple markets;
- New Corporations Act regulations will require post-trade information to be available for consolidation;
- Post-trade data consolidation will be achieved through commercial arrangements;
- New Corporations regulations will require enforceable arrangements between market operators to share supervisory information;
- Standardised requirements for short sales will be necessary to overcome orderly market issues.

Furthermore, ASX supports ASIC's view that additional licences should not be granted until adequate cross-market supervisory arrangements are in place.

We look forward to continuing to provide ASIC and the Government with the benefit of our experience as price formation regulator as the necessary new regulations are developed, new oversight arrangements for intermediaries are implemented and the totality of the issues embedded in a multiple operator market are fully evaluated and understood.