Exempt Professional Financial Markets

ASX Submission to ASIC CP 116

19 October 2009

EXECUTIVE SUMMARY

- ASX supports ASIC's consultation on the issue of granting exemptions from the market licensing provisions for professional markets, as timely and appropriate.

- ASX would support a broader re-thinking of ASIC's approach to market licence exemptions, including the circumstances in which market participants that operate internal matching engines and dark pools are exempt from obtaining a market licence.

- ASX suggests that ASIC re-think Regulatory Guide 172 (RG 172). ASIC should take into account developments such as the Government's announced transfer of responsibility for supervising market participants from market operators to ASIC, and the possible entrance of new market operators. An important enhancement to RG 172 would be the inclusion of a definition of fair, orderly and transparent markets.

- ASX does not support the proposed approach to exempt professional markets set out in Consultation Paper 116 ("CP 116").

    - The starting proposition when considering exemptions should be, 'is there a policy reason to regulate the market?'[1] Only in circumstances where there is no identifiable policy objective to be achieved from regulating the financial market, should an exemption be granted.

    - The default mechanism for regulating activities that meet the definition of "financial market" should be the market licensing regime, not the AFSL regime. The AFSL is primarily designed to protect retail investors.[2] It is not intended to achieve the objectives relevant to regulation of a financial market. The more appropriate regulatory tool for professional financial markets is the market licence, which is designed to maintain market integrity and investor confidence in the efficient operation of market facilities.[3]

    - The proposal in CP 116 would result in the creation of a hybrid category of financial markets based on ad hoc conditions attached to the AFSL. This approach would result in a process which lacks transparency and robustness and which undermines the legislative intent.

    - ASIC should not impose conditions in relation to fair, orderly and transparent trading onto exempt market operators without also putting in place arrangements to ensure an entity has adequate rules to this effect, and that they are working in practice – as envisaged in the market licence rule disallowance and annual audit requirements.

    - The operation of clearing and settlement facilities should not be a factor in whether exemptions are granted. This requirement is at odds with international moves to minimise possible contagion from financial failure (by minimising counterparty risk) and to encourage central counter-party clearing of a wider range of OTC products.

---

1 Financial Services Reform Bill Explanatory Memorandum ("FSR Explanatory Memorandum"), pg 53: "It is envisaged that the new exemption provision will be used in limited circumstances for example, in relation to a facility for which there is no policy reason to regulate as a market".

2 Financial Markets and Investment Products, Corporate Law Economic Reform Program Proposals for Reform: Paper no. 6 ("CLERP 6"), pg 89.

3 CLERP 6, pg 69.

- ASX proposes an alternative conceptual framework for considering applications for exemption which upholds the legislative intent of the licensing provisions.
    - Exemptions from the market licensing regime should only occur where the absence of market integrity in relation to trades conducted on the facility cannot detrimentally impact non-users by undermining allocative efficiency; and, if a lack of market integrity cannot detrimentally impact facility users.

INTRODUCTION

ASX Welcomes ASIC's Consultation as Timely and Appropriate

The immediate focus of Consultation Paper 116 ("CP 116") is amendments to ASIC's current approach to advising the Minister on when to exempt specialised financial markets from the operation of Part 7.2 of the Corporations Act. In particular, ASIC proposes to continue its current practice of requiring exempt market operators to hold an Australian Financial Services Licence ("AFSL"). ASIC also proposes to impose certain conditions on exempt market operators, including a requirement to have in place rules and procedures to ensure fair and orderly trading and to notify ASIC of market misconduct.

ASIC has highlighted a number of external environmental factors that have led to its proposal:

- An increase in the number of applications for exemption from the market licensing obligations;
- An increase in the scope of products traded on exempt markets; and
- International developments, specifically concerns about the opaqueness of certain OTC products following the recent global downturn.

We note that ASIC is currently assessing G20 and IOSCO recommendations and how to give effect to those that are relevant to the Australian market.

ASX agrees that these external factors make a review of the administration of the market licensing regime timely. We are disappointed, however, that although ASIC has identified some highly relevant international developments, these do not appear to have influenced ASIC's proposed approach.

We therefore welcome ASIC's initiative in seeking feedback on CP 116.

Regulatory Guide 172 - Time for a Review

CP 116 is not wide-ranging enough to deal with the complexities and challenges of recent developments in the financial markets industry. A further re-think is required to take into account the following domestic and international developments:

- Transfer of supervision responsibilities from market operators to ASIC, as announced by the Government on 24 August 2009;
- Possible entrance of new market operators;
- Trends towards increasing internalisation of trades;
- Emergence of 'dark pools'.

These developments heighten the need for consistent application of core obligations to all providers of trade execution facilities in identical, fungible products. In particular,

there is a need for consistency based on a commonly understood interpretation of what constitutes reasonable efforts by a market operator to ensure that the relevant market is fair, orderly and transparent.

FOT Definition

ASIC should update relevant sections of RG 172 relating to market supervision, and explain its own role in cross-market supervision and maintenance of fair, orderly and transparent ("FOT") markets generally.

The possible entrance of new market operators trading competing products (including ASX-listed equities) makes a uniform definition of FOT principles essential to eliminate regulatory arbitrage on this basis. It is also needed to provide a transparent and consistent framework for the government's assessment of rule change proposals that are subject to Ministerial disallowance after taking account of the "consistency of the change with the licensee's obligations", in particular the obligation to conduct FOT markets.

IOSCO and other overseas regulatory agencies have produced literature which could inform any Australian definition of this phrase. In the absence of guidance to date, ASX operates on the basis of the definitions at **Attachment A**, which are derived from the relevant international literature and which have been provided to ASIC.[4]

ASX invites the Government to adopt these definitions through legislative amendment and to confirm that they will apply to all licensed markets. The legislative amendment package to establish the pre-conditions for granting of further market operator licences would provide an appropriate vehicle. The greater particularity could usefully be contained in either the legislative amendments or the explanatory memorandum. We encourage ASIC to promote such an approach with Government and to adjust RG 172.

Equity Market Exemptions

Global developments in technology and markets include the emergence of 'dark pools' and internal crossing engines for listed securities. As a result of these trends, it would be timely for ASIC to re-think the approach to exemptions from market licence requirements for direct participants in the market who contract with the licensed operator to use the trade execution facilities ('participants'), and who conduct an internal market for listed securities. RG 172 suggests that the current approach is to exempt these participants from requiring a market licence because they are supervised by a licensed operator. The exemption is subject to thresholds which suggest that where the traded volume is less than 10% of all volume in the security, the exemption is automatic. Where the volume is between 10-50%, the exemption is subject to ASIC scrutiny. Where the volume exceeds 50%, the assumption is that a market licence is required.

We submit that the approach to exempting internal markets in RG 172 has been overtaken by market trends and should be re-considered for two reasons. First, the reasoning in RG 172 implies that a market licence is not required because the participants are already subject to oversight by a market operator and that this replaces the need for ASIC oversight. In practice, market operators' supervision of participants consists of monitoring their conduct on, or in relation to the market. It does not extend to monitoring their conduct more broadly (such as monitoring the operation of internal crossing engines or liquidity pools), and certainly does not involve any assessment of whether the participant conducts these markets according to FOT principles. In short, supervision in the context of being a market participant is not the same as regulation by ASIC under the market licence regime.

[4] ASX's FOT interpretation is available at: http://www.asx.com.au/supervision/pdf/asx_key_licence_obligations.pdf

Secondly, the volume thresholds set out in RG 172 are not suitable. The current test could result in an outcome where three participants each internalise 20% of trading in a single security, with the result that 60% of the trading occurs 'off-market'. This could undermine the price discovery function of the central market. It also removes a large portion of market activity from ASIC or market operator oversight. Debate in the US has focussed on the appropriateness of thresholds for this type of activity, with suggestions that thresholds of 1% per participant may be more appropriate.

There are growing trends globally towards internalisation of trades. In the absence of amendments to RG 172, there is a real possibility that the majority of trading of equity securities will occur outside the licensed market framework, undermining the integrity of Australia's financial system.

ASX Supports the Existing Definition of a Financial Market

A "financial market" is defined in Corporations Act section 767A(1). ASX supports the current definition. The concept of a "facility" through which offers to buy or sell financial products are "regularly" made, is one which has a sufficient degree of specificity to be practical, without being either too prescriptive or unreasonably broad. References to a "market" in this submission are to a financial market as defined in the Corporations Act.

The definition is both carefully considered and conceptually sound. It forms the basis for delineating between financial services, which are provided on a bi-lateral basis, and a financial market which has multilateral characteristics i.e. the facility is a meeting point for bids and offers from multiple participants. This conceptual foundation is useful for considering which OTC markets have the necessary multilateral characteristics which make licensing under the market license regime more appropriate than licensing under the AFSL regime.

We conclude that the current definition should be retained. It provides ASIC with scope to assess, on a case-by-case basis as detailed in RG 172, whether particular conduct constitutes the operation of a financial market.

ASX Supports the Existing Regulatory Architecture

The regulatory architecture that underpins Australia's two-pronged licensing regime is a product of the Financial System Inquiry ("Wallis Inquiry"), as implemented in the CLERP 6 reforms. ASX supports the architecture of the current licensing regime.

The architecture is briefly summarised as a two-pronged licensing framework:

- AFSL – governs the provision of financial services, being services that are conducted bi-laterally between a client and a service provider. Its primary function is to protect retail investors. Its primarily tool is the obligation on licensees to provide their services in a fair, honest and efficient (FHE) manner.

- Market Operator Licence – governs the operation of a financial market, being a multilateral facility. Its primary function is to ensure market integrity. Its primary tool is the obligation on licensees to conduct markets that are fair, orderly and transparent (FOT). It complements, rather than being a substitute for, the regulation of market participants that occurs via the AFSL regime.

The global financial crisis has drawn attention to new regulatory challenges, such as bringing greater transparency to some OTC markets. However, notwithstanding these new challenges, the principles of good regulation remain the same. Governments should seek to achieve an appropriate regulatory balance, to underpin regulation in clear principles and objectives, and to be wary of unintended consequences. This is not easily achieved in practice. The Wallis Report had the following to say:

> "One of the most complex issues facing governments is identifying the appropriate level and form of intervention. Regulatory efficiency is a significant factor in the overall performance of the economy. Inefficiency ultimately imposes costs on the community through higher taxes and charges, poor service, uncompetitive pricing or slower economic growth.
>
> The best way to control the costs and to ensure the effectiveness of regulation is to place it within a consistent framework. To do this, it is necessary to establish clearly what needs to be regulated and why, as well as to define the principles for effective and efficient regulation."[5]

It is in the spirit of articulating what needs to be regulated and why, and in considering how this can be done effectively in a consistent framework, that ASX makes its submission in response to CP 116.

REGULATORY AIMS AS SET OUT IN CP 116 ("WHY" REGULATE)

ASIC has identified its high-level regulatory aims as to protect market participants and enhance market integrity and financial system stability. It has also referred to six regulatory outcomes, further explained in RG 172, to achieve these objectives. The regulatory outcomes relate to areas of: market information [transparency], trading [fairness], participant supervision, market supervision [orderliness; conflict handling], market stability, clearing and settlement. We suggest that ASIC re-think whether these are the appropriate regulatory outcomes, as part of the suggested revision of RG 172. We are not convinced that these factors are consistent with the delineation of the licensing regime outlined above.

The absence, in CP 116, of any consideration of the fundamental questions of why certain regulatory objectives are appropriate and how these are best achieved is unfortunate. These are the central questions that ought to be addressed.

Furthermore, whilst CP 116 includes commentary on overseas developments, including risks identified through the global financial crisis, these risks are not linked to ASIC's regulatory objectives or the tools available to it, to achieve those objectives. It is therefore not apparent why the regulatory solution proposed in CP 116 is the most appropriate to take into account the international developments that are identified:

- facilitating the movement of OTC trades onto electronic platforms
- enhancing OTC market transparency
- enhancing OTC market surveillance and supervision
- facilitating central clearing of all standardised OTC derivative contracts

As outlined in more detail later in this submission, the logical starting point when considering what is the most appropriate tool for regulating financial markets should be the market licensing regime – however curiously, this is not considered an option – instead, CP 116 uses the AFSL as the starting point.

---

[5] Financial System Inquiry, Final Report ("Wallis Report"), March 1997, pg. 177.

ASSUMPTIONS UNDERLYING ASIC'S PROPOSED APPROACH ("WHAT" IS REGULATED AND "HOW")

There are a number of important assumptions that underlie the proposed approach in CP 116. Many of these are erroneous or outdated, and together result in an approach that fails to clearly establish what needs to be regulated and why, and how this should be achieved.

Regulatory Objectives:

The proposal in CP 116 is based on the premise that relevant regulatory outcomes for "specialised" financial markets may not be the same as those for licensed financial markets. ASIC has not defined what it means by "specialised" market. We submit that any detailed consideration would conclude that it is not a viable construct. The structural issues raised by ASIC apply equally to equities and to other asset classes, and to markets comprising of only professionals or of professional and retail users.

In order to sustain the premise that different regulatory objectives apply to "specialised" markets, it is necessary to conclude that the market failures which warrant regulatory intervention in respect of licensed markets are different from the failures that may be evident in other financial markets. Only if these differences can be identified, can it be convincingly argued that different regulatory objectives should apply. We suggest that ASIC give further thought to this issue, including taking into account international trends in this area. Comparable countries appear to be moving towards a view that regulatory objectives should be the same across financial markets because the potential market failures are the same.

In the excerpt below, the Canadian Central Bank identifies relevant market failures as fraud, insider trading and manipulation. The regulatory objective in response to these failures is market integrity.

"Integrity is the cornerstone of market efficiency. Markets tarnished by fraud, insider trading and manipulation cannot attract a large investor base. Without broad participation, liquidity decreases, there is even less incentive to participate, and a vicious circle develops where markets become less liquid, and as a consequence, less efficient, over time. There are many ways to foster market integrity. Three that are particularly relevant to this discussion are disclosure, to enable equal and timely access to all relevant information; efficient regulation and codes of conduct, to establish the rules of the game in a cost effective manner; and vigorous enforcement, to punish wrongdoers."

We also note that the US Securities and Exchanges Commission (SEC) has recently asked US Congress for direct access to real-time data for OTC transactions such as credit default swaps and other derivative products. SEC Director, Mr Henry Hu, stated that lack of this information made the SEC's investigations into potential fraud and market manipulation in OTC markets more difficult.[6]

We conclude that market integrity, as encapsulated in the obligations to conduct fair, orderly and transparent markets, is an appropriate regulatory objective for all "financial markets" as defined in the Corporations Act.

Regulatory Tools:

ASIC's proposal is based on the premise that even where regulatory objectives for exempt operators and market licensees are the same, the means of achieving the objectives may be different. This raises the important issue of regulatory consistency, and the associated risks of regulatory arbitrage where standards differ. Further, in

[6] Written Testimony to the House Financial Services Committee, 7 October 2009.

determining when it is appropriate to use different tools to achieve the same objectives, two conflicting principles must be reconciled: competitive neutrality and minimising regulatory burdens.

As stated in the Wallis Report, "Competitive neutrality requires that the regulatory burden applying to a particular financial commitment or promise apply equally to all who make such commitments…"[7] Accordingly, a risk attached to the use of different regulatory tools for functionally equivalent products is that competitive neutrality is undermined. The regulatory environment could create an unfair competitive advantage to some market users over others.

The second principle is that regulations should be kept to the minimum necessary to achieve the desired objectives. Excessive or poorly targeted regulation can impose unnecessary costs on both the government, e.g in implementing and enforcing the regulations, and to the broader community, through increased business costs that are often passed onto consumers in the form of higher prices.[8] The recent experience of the global financial crisis suggests that some financial products were not adequately regulated or that regulations were poorly targeted. The challenge now is to ensure that those regulatory gaps are overcome, with appropriately tailored regulation rather than an excessive response.

ASX submits that the market licence regime is a sufficiently flexible regime that it can be used to achieve the regulatory outcome of market integrity in respect of different facility-types. It is an appropriate regulatory response which both minimises the risks associated with undermining competitive neutrality, and with over-regulation.

"Lite-touch" Regulation:

The proposal in CP 116 is based on the premise that obligations imposed on AFSL holders are a sufficient basis for licensing of exempt market providers instead of market licence obligations. However, this premise cannot be sustained unless it is possible to align the regulatory objectives relevant to exempt markets (i.e. market integrity) with the obligations imposed on AFSL holders. We submit that there is a fundamental misalignment that cannot be overcome through the use of conditions attached to the AFSL. The proposed approach, in blurring the distinction between service providers and trading platforms, is unique among comparable jurisdictions, and there does not seem to be any rationale for the approach.

The AFSL is primarily designed to protect retail investors who are obtaining a financial service.[9] A market licence is primarily designed to maintain market integrity and investor confidence in the efficient operation of market facilities.[10] Whilst these are clearly related concepts, they are not simply interchangeable.

ASIC has proposed to overcome these differences by imposing certain key market licence conditions onto AFSL holders (rules to ensure fair and orderly markets). However, in the absence of additional arrangements to ensure that the exempt market operator actually has adequate rules in place, and arrangements to continuously monitor that these rules are working in practice, the conditions are meaningless. In addition to requiring the entity to have rules in place, ASIC should also review the facility's rules and review the facility's operations to ensure that rules are being properly administered. There is no need for ASIC to impose all of these requirements as conditions on an AFSL holder, as they are already envisaged in the market licence framework rule disallowance and annual audit requirements. The reliance on the AFSL

7 Wallis Report, pg. 196.
8 Rethinking Regulation, January 2006, pg 8-10.
9 CLERP 6, pg 89.
10 CLERP 6, pg 69.

seems a strange approach given there is a superior alternative in the market licence regulatory framework.

Similarly, CP 116 asks whether a "transparency" requirement should be imposed on exempt professional markets. Consistent with our earlier arguments that all financial markets should be subject to the same regulations, ASX supports imposition of a transparency obligation on any exempt market.[11] However, as noted above, the obligation must be accompanied by checks to ensure that it is being adhered to in practice. We note that transparency can relate to price and volume, and depending on the circumstances, may be satisfied by pre- or post- trade disclosures.

Another feature of the market licence that is absent from the AFSL is the Minister's ability to determine whether clearing and settlement arrangements are necessary for a financial market (section 796A(4)(c)). This is a feature that is increasingly relevant in light of the international trends highlighted by ASIC in CP 116, in particular efforts by the SEC and other regulators to encourage some OTC products to be centrally cleared.

The operation of clearing and settlement facilities should not be a factor in whether exemptions are granted. However, the Minister's ability to influence the type of settlement arrangements a facility has in place is another reason for preferring the market licence for regulation of financial markets. Excluding a facility from an exemption on the basis that they operate a facility for clearing and settlement of the product traded is at odds with international moves to minimise possible contagion from financial failure (by minimising counterparty risk) and to encourage central counter-party clearing of a wider range of OTC products.

ASIC's rationale for 'lite-touch' regulation of exempt markets is that the cost of regulation required to achieve the desired regulatory outcomes significantly outweighs the benefits. This assumption should be reconsidered. The events that led to the global financial crisis have revealed that benefits have been seen to be severely underestimated. It should also be reconsidered given that the obligation to supervise market participants will be transferred from market operators to ASIC, significantly lessening the regulatory burden on licence holders.

If ASIC concludes that "lite-touch" regulation is appropriate, for example because the risks of damage to the wider economy through loss of market integrity are less significant, then it can administer the market licence regime accordingly. For instance, ASIC could take this reduced risk into account when determining what are "sufficient resources" to operate the market properly (s792A(d)). Any analysis should be driven by an assessment of the possible systemic risks posed by the facility and the likelihood of contagion. Risks may arise from lack of accurate price formation or participant default.

Ring-fencing:

ASIC's proposal is based on the premise that exempt markets and their professional participants operate separately from both licensed markets and from retail investors. Their activities are (or can be) quarantined from licensed markets and retail investors. We submit that this is a flawed policy approach, as evidenced by the key drivers of the global financial crisis.

So-called "professional" markets have been found to have significant systemic importance. Manipulation of the US energy derivatives market was undertaken at very high social and financial cost to Californian residents. Market manipulation in money markets is relevant to the cost of retail loans. Furthermore, in the Australian context,

---

[11] For a discussion of the impacts of transparency on the US corporate bond market, see Hendrik Bessembinder and William Maxwell, "Transparency and the Corporate Bond Market",
Journal of Economic Perspectives—Volume 22, Number 2—Spring 2008—Pages 217–234.

compulsory superannuation means that many professional markets are actually funded with the retirement savings of ordinary Australians. Any losses in these markets or any participant default could easily impact non-market users. Finally, we note that professional products could be re-packaged and offered ultimately to retail investors.

Reliance on a ring-fencing policy assumes that ASIC has the ability to monitor market participants' business connections, so that it can satisfy itself that any failure will not have systemic repercussions. Similarly, it implies that ASIC can map the product life-cycle and relationships to other financial products in order to satisfy itself that there is no risk of 'contagion'. There are two types of contagion that ASIC should bear in mind: market-based contagion (i.e. prices in one market are influenced by prices in another market); and risk-based contagion (i.e. failure of a participant in one market may influence the ongoing viability of participants in other markets).

ASIC's suggested criteria that "a limited range of specialised financial products are traded on the facility that are not usually traded on public markets by retail clients" is merely the first stage in administering a ring-fencing policy. ASIC would also need to ensure that no derivative products are tradeable on a licensed market and that a licensed market would not be used to hedge exposures in the exempt market. Finally, ASIC would also need to assess the links between market participants and the possibility that loss of confidence stemming from the failure of a market participant could adversely impact other markets.

We submit that ring-fencing as a policy has severe limitations and ultimately is unlikely to successfully address contagion risks.

LICENCE EXEMPTIONS – A SUGGESTED CONCEPTUAL FRAMEWORK

When the legislative licensing framework was being developed, it was envisaged that there would be very few exemptions from the requirement to hold a market licence. The Explanatory Memorandum to the Act states "It is envisaged that the new exemption provision will be used in limited circumstances – for example, in relation to a facility for which there is no policy reason to regulate as a market."[12]

The Wallis Inquiry considered the issue of what types of markets should be licensed, and concluded that some OTC markets may operate outside the scope of the market licensing regime. It stated, "formal exchanges should continue to be subject to more detailed regulatory requirements than OTC markets, in part because they operate a centralised market open to a large number of participants."[13] We submit that the definition of a "financial market" has appropriately captured this multilateral test, with the result that OTC markets which are conducted on the basis of one-off bi-lateral deals fall outside the scope of the market licensing provisions. However, to the extent that an OTC market falls within the definition and therefore encompasses the same risks of lack of market integrity, licensing under the market licence regime is appropriate.

The events of the past two years have changed the way in which overseas regulators regard OTC markets and the extent to which they should be regulated. As noted earlier in this submission, two features of the financial system have become apparent: i.) increased linkages between products traded on OTC and regulated markets, and ii.) greater difficulty quarantining products to 'professional' investors. These points

---

12 FSR Explanatory Memorandum, pg 53: "It is envisaged that the new exemption provision will be used in limited circumstances for example, in relation to a facility for which there is no policy reason to regulate as a market".

13 Wallis Report, pg 282.

collectively undermine any arguments that OTC markets per se should be treated differently to exchanges.

ASIC's starting proposition when considering what advice to provide the Minister in relation to market licence exemptions should be, 'is there a policy reason to regulate the market?' Only in circumstances where there is no identifiable policy objective to be achieved from regulating the market, should ASIC consider recommending an exemption.

We submit that there is a two-stage test to be satisfied before any market licence exemptions are granted.

The first stage focuses on externalities. ASIC should consider the question: 'could a lack of market integrity in relation to the facility detrimentally impact non-users by undermining allocative efficiency'? In order to answer this question, ASIC will likely have regard to criteria such as linkages between products traded on the facility and those traded on other financial markets, relationships between users of the facility and other participants in the financial system (including retail participants), the size of the facility, and price transparency.

By allocative efficiency, we refer to the "efficient allocation of resources to provide a strong foundation for economic growth and development".[14] Functions that are performed by a market and which contribute to allocative efficiency include:[15]

- mobilising and directing savings to their most productive uses;
- providing price discovery through the exchange and evaluation of information;
- facilitating the management and pricing of risk;
- assisting individuals in assessing and making investment decisions by reflecting risk in the pricing of financial instruments; and
- facilitating capital raising by a diverse range of firms.

A positive response to the first test should result in a refusal to consider an exemption from the obligation to hold a market licence. This is because there is a public policy objective to be achieved through government intervention, i.e. addressing possible market failure in the form of lack of market integrity.

If ASIC concludes that the facility is genuinely 'ring-fenced' from the wider financial system, then the second stage of the test would be triggered. This stage focuses on market users. ASIC should consider the question: 'to what degree could a lack of market integrity on the facility detrimentally impact facility users?' Depending on the response to this question, ASIC may recommend options ranging from granting a market licence, to granting a licence with conditions, to granting an exemption from the market licence obligations.

CONCLUSION

Approach to Granting Exemptions

ASIC proposes creating a hybrid category of financial markets based on ad hoc conditions attached to the AFSL. There are a number of flaws in attempting to create a quasi third limb to the licensing regime, rather than using the more appropriate financial market licence. These include mis-alignment of the regulatory objectives and the tools

14 Wallis Report, pg 177.
15 CLERP 6, pg 20-21.

to achieve those objectives; lack of robustness around the proposed regulatory framework; lack of a level playing field and undermining of competitive neutrality.

A market licence is primarily designed to maintain market integrity and investor confidence in the efficient operation of market facilities.[16] The AFSL is primarily designed to protect retail investors.[17] We do not agree with ASIC's assumption that an AFSL can be used to effectively regulate a professional market. It was not designed for that purpose, and the obligations imposed on AFSL holders are not designed to achieve the regulatory objectives of a market licence – primarily being market integrity (i.e. fair, orderly and transparent markets).

An exemption should only be granted in those limited circumstances where ASIC concludes that on a cost-benefit analysis, the potential harm to non-market users from lack of integrity undermining allocative efficiency, and to market users resulting from lack of market integrity, does not warrant government intervention in the form of licensing. In these circumstances, ASIC may have legitimate grounds, as envisaged by the legislation, for recommending that the Minister grant a market licence exemption.

Proposed Conditions

ASX does not agree with the proposed approach that a facility operator which is exempt from the requirement to hold a market licence, be required to hold an AFSL, and that conditions be attached to the AFSL so that the facility operator is obliged to have in place rules and procedures to ensure fair, orderly and (maybe) transparent trading. It is illogical to require an 'exempt' facility operator to hold an AFSL, and then to impose on them by way of conditions, the key obligations of a market licence.

ASIC should not impose conditions in relation to fair and orderly trading without also putting in place arrangements to ensure that the entity has adequate rules to this effect, that those rules are working in practice and that compliance with those rules is being independently monitored and assessed. In the absence of these additional measures, the imposition of the condition in the first instance is hollow. ASIC should review the facility's rules and also review the facility's operations to ensure that rules are being properly administered – as envisaged in the market licence framework rule disallowance and annual audit requirements.

Any facility that ASIC considers should attract fair, orderly (and transparent) conditions should be licensed as a market operator in the first instance. This would result in a more efficient, effective, and transparent licensing regime.

Other Issues

ASIC should review its approach to exemptions more generally, including considering the circumstances in which participants that operate internal matching engines and dark pools are exempt from obtaining a market licence. The current volume thresholds are inadequate to deal with the realities of increasing internalisation.

ASIC should undertake a wide-ranging re-think of RG 172. Industry developments mean that there are clear deficiencies in the guide, including lack of a working definition of fair, orderly and transparent markets.

16 CLERP 6, pg 69.
17 CLERP 6, pg 89.

ATTACHMENT A: ASX Definition of Fair, Orderly and Transparent Markets

The phrase "fair, orderly and transparent" is a composite of three heterogeneous qualities rather than a single homogenous quality. In particular circumstances one or more of the qualities may conflict with one or more of the others. In addition, the same market conduct may have different effects on different market participants (e.g. what is fair to one part of the market may be unfair to another part).

PS172.68 – 85 sets out ASIC's approach to interpreting the phrase and guidance on how it will assess whether a licensee is meeting the obligation[18].

The goal is to achieve an overall objective of a "fair, orderly and transparent *market*" rather than to ensure that *every aspect* of the market is fair *and* orderly *and* transparent, or that each of those qualities is enjoyed equally by all participants.

To achieve the overall objective, a market operator must find an "appropriate balance"[19] between fairness, orderliness and transparency. This means a market operator may give less weight to one or more of the qualities in particular circumstances, if this is necessary to achieve another quality and is consistent with the "appropriate" overall balance.

What is "appropriate" must be determined in light of the characteristics of the market and in light of overarching commercial and regulatory objectives. The overarching objective should be to operate an economically efficient market which is fair to market users. There is a difference between a fair market, namely one which operates overall as a fair market by treating like alike, and a market that treats everyone in the same way.

Market efficiency is recognised by the legislature as a legitimate commercial and regulatory objective. One of the goals of Chapter 7 of the Corporations Act is to facilitate "efficiency, flexibility and innovation in the provision of [financial] products and services" (s792A(a)). And section 1(2)(a) of the ASIC Act states that in exercising its powers under the ASIC Act, ASIC must strive to:

> Maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs and the efficiency and development of the economy.

Furthermore, critical components of an efficient market – timely and widely available, relevant information – are also critical components of a fair market.[20]

The above analysis is captured in the following articulation of what ASX considers would be reasonably practicable for all market operators. ASX would welcome ASIC's support in recommending to the Government that it capture the essence of the

---

18 http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=ps172_pdf

19 This term is used in the Explanatory Memorandum to the Financial Services Reform Bill 2001 at 7.3.8. The term is also used by ASIC in PS 172.83.

20 The interplay of primary obligations and other regulatory and commercial considerations involved in striving to achieve efficient markets can be seen in the importance of relevant information to the price formation process. Without a focus on ensuring timely disclosure by issuers of price sensitive information there would be increased scope for market abuses (insider trading, market manipulation, etc) to detract from the confidence of users in the integrity of the price formation process, i.e. to detract from confidence in the fairness and efficiency of the market.

following interpretation in either foreshadowed legislative amendments or an explanatory memorandum.

A market operator is likely to have satisfied its obligation to maintain an appropriate balance between fairness, orderliness and transparency if the infrastructure and rules which it provides and the market operations which it satisfactorily monitors, enable users to be confident that:

• prices obtained on the market are a reflection of genuine supply and demand.[21]	FAIR
• the market operates by a common set of rules which appropriately balance the interests of all market users and does not unduly favour some market users over others.[22]	FAIR
• market users with fiduciary responsibilities do not take improper advantage of persons to whom such fiduciary duties are owed (clients) in the conduct of market transactions.[23]	FAIR
• the information that is being reflected in the prices at which transactions occur is reliable.[24]	FAIR ORDERLY
• market users know with some degree of certainty whether, and at what prices, they can deal and can know the prices and volume of all individual transactions concluded.[25]	TRANSPARENT

21 For market users to be confident of the integrity of this price formation process, there must be surveillance to detect unlawful trading practices – such as market manipulation – which involve attempts to create artificial prices and enforcement action taken against those who engage in such practices. A market which is fair and efficient because of the absence of manipulation is also less likely to be disorderly.

22 The provision of price and time priority for limit orders in auction markets is an example of structural arrangements designed to ensure that some market users are not unduly favoured over others. Ensuring that investors have equal and timely access to material information concerning the issuer of traded financial products is another example.

23 The right of a client not to be disadvantaged by the acts of a fiduciary (e.g. front-running) are primary examples of the objective of not tolerating trading practices or structural arrangements which are improper by virtue of intermediaries taking improper advantage of clients.

24 Conversely, a market may be considered disorderly if it experiences panic buying or selling, users experience significant variability over short time periods in the costs of transacting (bid-ask spread) or there is uncertainty as to whether the prices at which financial products are traded accurately reflects material information and genuine supply and demand.

25 "Transparency" is not about dissemination of information unrelated to the price or value of financial products traded on the market. Nor is it about the processes adopted by the market operator that are unrelated to price transparency.