Competition for market services—trading in listed securities and related data

Submission by ASX Limited in response to the Australian Securities and Investments Commission Consultation Paper 86

17 August 2007

THE ASX POSITION

ASX welcomes the opportunity to comment on ASIC Consultation Paper 86.

ASX supports the three Principles identified by ASIC as the basis for assessing applications for new Australian market licences that would involve multiple venues for trading in the same securities. However, ASIC's suggested Principle 1 in relation to the desirability of competition is valid only to the extent that it involves competition occurring consistently with ASIC's suggested Principles 2 and 3.

ASX therefore endorses the following formulation:

> Competition for market services is desirable if and only if:
>
> - the entry of competitors for market services does not result in a decline in the existing quality and integrity of the market for the securities that trade on more than one licensed market; and
> - the regulatory regime sets the minimum conditions that will allow competition to develop, where it is efficient and therefore without adverse effects on the capital market as a whole.

ASX currently provides an efficient price formation process through a transparent price discovery mechanism – an electronically distributed central limit order book (CLOB) with pre-trade and post-trade transparency features. One measure of the quality of the CLOB is evidenced by the fact that the bid-offer spreads in Australia's equity market are the narrowest in the Asia-Pacific region. Investors rely upon the quality and integrity of the ASX CLOB for efficient price discovery and for pricing the cost of capital. Listed companies rely upon the CLOB to access the lowest possible cost of capital. ASX and ASIC also rely on the transparency of the CLOB to fulfil their regulatory obligations. Collectively, this forms an important part of the overall attractiveness of Australia to domestic and international investors and for domestic and international companies seeking to raise capital. Recognising the potential implications for all sectors of the economy, it is clear that the public policy stakes are high.

The AXE proposed model of operation will not promote competition – as properly understood. The AXE proposal enables market participants to internalise order flow, avoiding the truly competitive price formation process that is available on the ASX market. The ASX Market Rules allow crossings in certain circumstances where it is efficient to do so, recognising that allowing such transactions provides incentives to search out information. It restricts the ability to engage in crossings to ensure that they do not detract from market liquidity, and hence weaken the process by which opportunities to trade emerge and prices are discovered. The AXE proposal, on the other hand, allows crossings to occur in all circumstances.

ASX believes that fragmenting the market by facilitating further internalisation is not in the public interest. Such widespread use of crossings is likely to worsen market spreads and increase volatility because it allows market participants to take advantage of information hidden from the general market. This is likely to disadvantage other market users, especially smaller market participants, and retail investors. Periodic bouts of volatility of the type currently being experienced in global financial markets should heighten caution about fuelling this volatility with policy making that is not evidence-based.

Competition, properly understood, does not involve one market operator imposing such external effects on other market operators, market participants or investors. It cannot be assumed that an increase in the number of entities offering venues for trading will provide net public benefits. For the same reason, the assertions of proponents of multiple trading venues that there will be a further reduction in the bid-offer spread cannot be assumed to be correct.

ASX believes there is a significant risk that the AXE and LiquidNet proposals, as they are currently structured, will reduce pre-trade and post-trade transparency and decrease the quality and integrity of the Australian securities market. This will have a detrimental effect on market efficiency and

ultimately create a less effective and competitive price formation process, thereby disadvantaging Australian investors. The costs of these detrimental effects will also be borne by Australian companies through increased costs of capital raising, ultimately affecting Australia's international competitiveness.

The trading of securities on more than one market therefore gives rise to significant public policy issues. The resolution of these issues is a challenge to securities market regulation, which needs to balance a range of possibly conflicting competition and market integrity objectives. The actual effect of market fragmentation on the existing market is a question of fact to be determined by an appropriate inquiry and analysis of the costs and benefits of any proposed regulatory regime.

Before ASIC is in a position to advise the Minister that the granting of particular licences will not result in a decline in market quality and integrity, it should be able to articulate the anticipated costs and benefits of the regime. It should be able to answer a number of key questions as to the likely effect of the regime. Those questions include, but are not limited to the following:

- What effect will the new regime have on bid-offer spreads and overall liquidity?
- If bid-offer spreads could increase, what is the offsetting benefit that justifies a widening of those spreads or a reduction in overall liquidity?
- What are the supervisory costs of the regime and who will pay for these costs?
- What are the liquidity search costs of the regime and who will pay for them?

The design of any new regulatory regime must also set appropriate rules by which market operators and market participants must operate. The minimum conditions that safeguard investors and listed companies should include consistently applied:

- obligations that ensure that there is no degradation of pre-trade transparency, from the inception of the regime, through the delineation of transaction thresholds. (ASIC cannot adopt a 'wait and see' approach);
- best execution obligations of intermediaries;
- appropriate compensation arrangements; and
- minimum obligations in relation to the timeliness and content of post-trade reporting.

Specific issues of implementation, including conflicts of interest, should be addressed. This task can only be undertaken once the structure of the regulatory framework has been established.

ASX has significant reservations as to the extent of any public policy benefits of market fragmentation in the Australian environment. If the risks associated with fragmentation are going to be taken, it is the view of ASX that the imposition of such conditions offers the best prospect of satisfying ASIC's Principles. They are the necessary pre-conditions to competition being desirable and providing the best protection to existing market quality and integrity.

Almost certainly this will require legislative change to avoid a regulatory 'race to the bottom'. ASX recognises that one of the profound implications of such a new regulatory framework is a potential shift in the model for securities market regulation – from a co-regulatory approach to more centralised regulation.

The ASIC consultation process has been prompted by the AXE and Liquidnet proposals. ASIC needs to carefully consider the specific elements of the proposal and the issues that each proposal raises. However, many of the issues raised by these proposals relate to important public policy issues. In the absence of appropriate regulatory reform based on a principled approach (as distinct from an ad hoc response), these issues will continue to arise in respect of future proposals for alternative trading venues.

A wide set of stakeholders may be affected by these issues. Smaller brokers have traditionally been concerned about any reduction in pre-trade and post-trade information. Listed companies are likely to have a concern as to the impact of the proposals on their own liquidity and the cost of capital. The Takeovers Panel may be concerned about the impact of reduced transparency.

Shareholders as a body have an interest in these matters. Sufficient opportunity must therefore be given for considered responses from all stakeholder groups as part of an ongoing consultation process.

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This submission sets out 7 themes in support of the matters identified above. It then explores each of those themes in greater detail. Some worked examples are given of how investors might be affected if the regulatory regime is poorly set.

ASX has not provided separate answers to each of the specific questions asked by ASIC. This submission provides what ASX considers to be the correct approach to regulatory design and should be read as a whole in response to the ASIC Consultation Paper, including the specific questions. The submission sets out the necessary approach to answering the real questions that need to be addressed by ASIC and the Minister.

THE THEMES OF THE ASX SUBMISSION

1 Competition (on the merits) is good

- ASX agrees with the Principles set out by ASIC in their Consultation Paper. However, 'competition' must be properly understood.
- ASX welcomes 'competition on the merits'. ASIC and the Minister should seek to facilitate this sort of competition. The concept of 'competition on the merits' recognises that it is the object of competition policy to:
  - promote and protect the competitive process (as distinct from individual competitors); and
  - enhance welfare through efficiency-driven conduct.
- The ASX market is structured such that traders are restricted from engaging in conduct that is privately profitable but detrimental to the market as a whole. Such conduct should not be facilitated in the guise of 'facilitating competition'.
- The AXE proposal will adversely affect efficiency, and hence investors. If the AXE model is not to have adverse effects on the quality and integrity of the ASX market a number of difficult issues need to be addressed.
- The Liquidnet proposal offers different challenges. For Liquidnet, the issues centre around the necessary conditions to ensure that it does not have adverse information effects (hence on the quality and integrity of the ASX market[1]).

2 Rules help structure an efficient market

- Properly setting the rules for the operation of a financial market is an essential aspect of that market enhancing competition on the merits. The rules of the market tell us how the market will operate and the likely effect of that mode of operation on other market operators and the market as a whole.
- When considering how to properly assess the rules of a market, a number of matters need to be taken into account by ASIC and the Minister.
  - Rules that are restrictive in form may restrict competitors, but they do not necessarily restrict competition. Some rules play an important role in the establishment of a fair, orderly and transparent market and maintenance of market quality and integrity.
  - The operating rules of some markets, however, might allow the participants on that market to impose externalities (unpriced effects) on other market operators – to the detriment of competition on the merits and welfare.
  - Some rules can have a broader impact on the manner in which markets are operated, with significant public policy issues arising. This is the case in relation to the many rules that AXE has asked ASX to remove, which relate to a number of issues that are critical to the orderly running of the ASX market.

[1] The reference throughout this submission to the 'ASX market' is to the Australian cash equities market facilitated by the central limit order book operated pursuant to ASX operating rules.

3 Investor protection must be a key concern of ASIC

- The protection of investors is a key concern of the regulatory scheme found in the Corporations Act. The first object of Chapter 7 of the Corporations Act is confident and informed decision-making by consumers of financial products, while facilitating efficiency, flexibility and innovation in the provision of those products and services.
- Competition is not an end in itself. Neither ASIC nor the Minister should do anything that:
    - has a detrimental impact on the integrity of any of the markets the subject of the regulatory regime; or
    - increases the risk of market abuse flowing from fragmentation of the ASX market.
- Market fragmentation poses real risks for the integrity of securities markets. These risks include:
    - undermining transparency on the ASX market;
    - creating an incentive for price and market manipulation on the ASX market;
    - creating uncertainty as to whether best execution standards will be met reliably; and
    - creating an incentive for regulatory arbitrage (the ‘race to the bottom’).
- The ASX Market Rules allow crossings in certain circumstances where it is efficient to do so. They restrict the ability to engage in crossings to ensure they do not detract from market liquidity, and hence weaken the process by which opportunities to trade emerge and prices are discovered. The AXE model of crossings is likely to worsen market spreads and increase volatility – to the disadvantage of market users, including smaller market participants and retail investors.
- It is not easy to formulate supervisory agreements between each of ASX and AXE and Liquidnet. A number of difficulties, including market integrity issues, must be resolved.
- Investors must be properly informed and accept the risks of trades not being covered by the National Guarantee Fund in relation to trades occurring on other platforms and the possible inconsistencies in treatment that might arise.

4 Transparency is essential

- The obligation of transparency is owed by every operator of a financial market. There are different dimensions to transparency:
    - pre-trade transparency, including making available accurate information about the size and price of prospective trades, quotations and resting limit orders; and
    - post-trade transparency – the dissemination of information relating to trade price and volume of completed transactions.
- Both pre-trade and post-trade transparency are essential to an efficient securities market because they enable price discovery, assist with market surveillance and contribute to market integrity.
- Transparency is an important element of ensuring the best execution obligation is implemented: allowing market participants to identify the venue with the best terms of execution; and allowing investors to monitor whether or not market participants are carrying out their obligation.
- The ASX Market Rules have high standards of pre-trade and post-trade transparency. The Liquidnet and AXE proposals do not contemplate pre-trade transparency. The AXE proposal offers limited post-trade transparency.

5 The best execution obligation must be appropriate and enforceable

- There is a need for a more sophisticated regime of the best execution obligation which recognises the potentially different priorities of different sorts of investors across multiple platforms.
- A fundamental consideration in implementing best execution policies is whether the obligation should be enshrined in legislation or developed by the market.
- A key factor pointing to the need for centrally imposed regulation is the danger that 'regulatory competition' between self-regulatory organisations will cause a 'race to the bottom' in standards.
- The implementation of the best execution obligation raises a number of practical issues, including the need for accurate and transparent data to facilitate best execution and the creation and retention of data to monitor compliance.

6 Only those eligible should be granted a licence

- ASIC should have a clear basis in law for the licensing of entities that intend to provide financial services. The law should not be 'squeezed' as if it applied where it does not.
- This is important because of its impact on consumer protection.
    - Investors should not be led to believe they are dealing with a licensed entity, when the legal foundation for that license is precarious at best.
    - Investors should have a clear and enforceable right to compensation.
- AXE's proposed platform does not comply with the definition of 'financial market' in the Corporations Act for the purpose of obtaining an Australian market licence.
- Liquidnet may be ineligible for an Australian market licence because its lack of transparency may make it incapable of meeting the fundamental obligation of a licence holder to operate a 'fair, orderly and transparent market'.

7 ASIC and the Minister face complex issues of regulatory design

- The approach of ASIC and the Minister to regulatory design should be consistent with the approach to regulation embodied in the Corporations Act.
- One of the profound implications of a new regulatory framework is a potential shift from a co-regulatory approach to more centralised regulation.
- ASIC and the Minister should apply principles of good regulatory design:
    - Adopt an evidence-based approach, in compliance with the principles of good regulatory practice adopted by the Commonwealth Government.
    - Take account of the impact of the regulatory regime on international competitiveness and the interconnectedness of international financial markets.
    - Facilitate global capital formation by increasing the prospects of substituted compliance with other regulatory jurisdictions.
    - Allow for the likely competitive reactions of ASX and others in response to the new regulatory regime.
    - Proceed on a clear statutory basis to promulgate clear, enforceable obligations.

1 Competition (on the merits) is good

'Competition on the merits'

1.1 ASX welcomes competition. The competition that ASIC and the Minister should seek to facilitate is 'competition on the merits'. The concept of 'competition on the merits':

- properly draws a distinction between protection or promotion of competitors (which is not the object of competition law) and the protection or promotion of competition;
- identifies the object of competition policy as the enhancement of welfare through efficiency-driven conduct.

1.2 Competition (even 'ruthless' competition) between firms offering substitute goods or services should be encouraged.[2] However, the promotion of competition should not come at the expense of potential inefficiencies that can arise as a result of information problems or externalities. The ASX market is structured such that traders are restricted from engaging in conduct that is privately profitable but detrimental to the market as a whole. Such conduct should not be facilitated in the guise of 'facilitating competition' in trading services. 'Competition on the merits' views competition (as distinct from individual competitors) as performing an important role in the promotion of the efficient allocation of society's resources.[3] This concept is necessarily inconsistent with the existence of externalities.[4] This is the concept of 'competition' pursued under National Competition Policy.

1.3 In the context of regulatory design, 'competition on the merits' means that a regulatory regime should not override market structures that solve externality problems in order to facilitate the entry and expansion of firms offering substitute goods or services. There is widespread recognition that the current regulatory regime applying to financial markets in Australia does not address issues arising in relation to fragmentation, and competition across competing platforms offering substitute trading services. There is a risk that, in seeking to promote competition from firms offering substitute services to ASX, ASIC and the Minister could give rise to a problem of 'regulatory asymmetry', one result of which could be a reduction in the effectiveness of the process of competition in ensuring efficient outcomes.[5]

1.4 The interplay of competition for execution services with the quality and efficiency of the underlying market (in terms of liquidity and bid-offer spreads) are important considerations for a range of stakeholders:

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2 'Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to 'injure' each other in this way. This competition has never been a tort … and these injuries are the inevitable consequences of the competition s.46 [of the Trade Practices Act] is designed to foster.': *Queensland Wire Industries Pty Ltd v Broken Hill Proprietary Company Ltd* (1989) 167 CLR 177 at 191.

3 *Re Queensland Cooperative Milling Association Ltd* (1976) ATPR 40-012 at p.17,245.

4 'Competition produces an appropriate allocation of resources only if the real costs of an act and the real benefits it confers are fully reflected in the private costs and revenues of the actor: there must be no 'externalities'. When an activity involves real costs that the private producer does not have to pay, more resources will be devoted to that activity than should be. Similarly, when an activity confers benefits on others for which no payment is received, the resources devoted to that activity will fall short of the economic ideal.' Phillip E Areeda and Herbert Hovenkamp, *Antitrust Law* (Aspen, New York, 2006), ¶414.

5 The OECD says: 'Regulatory asymmetry gives rise to three potential problems. First, competition from differently regulated services may undermine certain public policy objectives. Second, the effectiveness of the process of competition in ensuring efficient outcomes may be reduced. Third, firms may incur costs in seeking to be regulated under the less restrictive regulatory regime. This is sometimes known as "regulatory arbitrage" or "forum shopping".': OECD Roundtable, *The Impact of Substitute Services on Regulation* (2006) at p.22.

- market users, both brokers and their investor clients (in terms of price and quality of service),
- listed companies (given their interest in lowering their overall cost of capital); and
- Governments, regulators and others with an interest in maintaining market integrity and stimulating strong and growing capital markets.

1.5 The Minister's response to the AXE and Liquidnet proposals (and the fragmentation of securities markets generally) must adequately address the risk that significant inefficiencies will be imposed on the ASX market. The potential for such an outcome is explicitly recognised in the CRAI Report,[6] which concludes that fragmentation could result in outcomes including the following in respect of the ASX market:

- a reduction in liquidity;[7]
- wider bid-offer spreads and increased price volatility;[8]
- a reduction in the reliability and stability of price discovery and efficient price formation overall;[9]
- a reduction in transparency;[10]
- deterioration overall of the 'quality' (in terms of liquidity and resulting pricing outcomes) of the ASX market;[11]
- reduction in the integrity and efficiency of the market;[12]
- the creation of an incentive for price manipulation;[13]
- the potential for free rider concerns to arise, particularly in relation to the costs of monitoring, detecting and punishing market manipulation.[14]

1.6 The specific effect of the AXE model on the ASX market – the imposition of information problems – is addressed separately below.

1.7 In the absence of an appropriate regulatory regime which recognises and attempts to minimise the inefficiencies imposed upon the ASX market by the fragmentation of securities markets, the implementation of the AXE and (to a lesser extent) the Liquidnet proposals (as currently formulated by those parties) will undermine the efficiency of the ASX market.

1.8 The entry of either without dealing with the matters set out in this submission does not promote competition on the merits. The entry of a competitor operating in the manner that AXE currently proposes in its business model should not be seen to promote competition, even if it promotes a competitor.

1.9 ASX agrees with ASIC Principle 2: the entry of competitors for market services should not result in a decline in the existing quality and integrity of the market for the securities that

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6 CRAI Report pp.18, 19 and 29.

7 CRAI Report pp.18, 20, 29, 31

8 CRAI Report p.31.

9 CRAI Report pp.18, 19, 25.

10 CRAI Report p.18.

11 CRAI Report p.27.

12 CRAI Report p.30.

13 CRAI Report p.36.

14 CRAI Report p.26.

trade on more than one licensed market. The CRAI Report draws a number of conclusions.

- The AXE and Liquidnet proposals 'will directly reduce liquidity in the reference market, [that is, the market facilitated by ASX] simply by virtue of the fact that fewer orders will be posted there'.[15]
- 'The AXE model would reduce information flows relative to current standards on ASX'.[16]
- '[T]he AXE proposal is likely to lead to an increase in the incidence of trades that have delayed disclosure, especially if the ASX amends its trading rules to more closely match those the AXE has set out.'[17]

1.10 ASX shares the concerns of CRAI. In ASX's submission, these outcomes will result in a decline in the quality and integrity of the ASX market contrary to the guiding principle set out in Principle 2.

2 Rules help structure an efficient market

Why rules are important to the consultation process

2.1 Properly setting the rules for the operation of a financial market is an essential aspect of that market enhancing competition on the merits. The rules of the market tell us how the market will operate and the likely effect of that mode of operation on other market operators and the market as a whole.

2.2 When considering how to properly asses the rules of a market, a number of matters need to be taken into account by ASIC and the Minister.

- Rules that are restrictive in form may restrict competitors, but they do not necessarily restrict competition. Some rules play an important role in the establishment and maintenance of a fair, orderly and transparent market.
- ASX's Market Rules have been designed to address issues consistent with sound regulatory objectives. Often, these Rules are against the interests of particular market participants, but are beneficial to the operation of the market as a whole. A market that is operating under a particular set of rules may, in fact, allow the participants on that market to undermine the Market Rules and hence their objective – to the detriment of competition on the merits and welfare. This is the case of the AXE rules, which may allow AXE and its participants to evade obligations to produce information. These matters are dealt with below under the topic of transparency.
- Some rules can have a broader impact on the manner in which markets are operated, and raise significant public policy issues. This is the case in relation to the many rules that AXE has asked ASX to remove.

Rules (including restrictive rules) are necessary for an orderly market

2.3 Competitive markets in the sense described are the most efficient means to allocate society's resources. But markets need rules as part of their basic structure to deliver efficient outcomes. These rules govern the rights and obligations of those carrying out transactions in the facilities. As RH Coase states:

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15 CRAI Report, p.20.

16 CRAI Report, p.32.

17 CRAI Report, p.25.

> 'It is evident that, for their operation, markets such as those that exist today require more than the provision of physical facilities in which buying and selling can take place. They also require the establishment of legal rules governing the rights and duties of those carrying out transactions in these facilities.'[18]

2.4 All rules governing markets are 'restrictions' – that is the nature of an orderly market. Far from restricting competition, such rules are essential to competition. This is another aspect of the important distinction between having an effect on individual competitors and having an effect on competition.

2.5 In recognition of this basic fact of market design, the Corporations Act imposes an obligation upon holders of an Australian market licence to have arrangements in place to ensure that the licence holder operates a 'fair, orderly and transparent market'.[19]

2.6 Poorly designed markets impose substantial costs on consumers and the public. Without properly designed rules, the field of effective competition on the merits cannot occur. Such rules allow inefficient behaviour. In the context of capital markets, these costs could be substantial.

The ASX operating rules

2.7 ASX has in place operating rules relating to the cash equities market, as required by the Corporations Act. Those rules consist primarily of the ASX Listing Rules, the ASX Market Rules, the ACH Clearing Rules and the ASTC Settlement Rules. They perform a number of specific functions in fulfilment of the primary obligation to run a fair, orderly and transparent market.

2.8 Even without its legislative obligations, ASX has a strong incentive to develop rules which promote transparency and market integrity. ASX generates its income from trading and exchange listings. Poor transparency reduces market integrity, as it deters uninformed trades,[20] increases trading costs, and reduces the incentives of firms to issue shares and list its shares on ASX. ASX's operating rules and procedures are designed to enable it to meet its legislative obligations and pursue its legitimate commercial interests.

2.9 The one Market Rule specifically referred to by ASIC in the Consultation Paper is part of a larger set of rules dealing with, among other things, the transparency of the market operated by ASX. It states:

> 'A Trading Participant must report to ASX in a Trading Platform the following:
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> (a) all sales of Cash Market Products effected by the Trading Participant;
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> (b) all Crossings and special Crossings in Cash Market Products; and
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> (c) all transactions effected pursuant to Rules 16.2.2 and 17.6,
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> except for transactions listed in the Procedures.'

2.10 This rule does <u>not</u>, contrary to the statement by ASIC in the Consultation Paper:

> 'mean that an ASX participant cannot transact in ASX quoted securities on the AXE market and comply with the ASX rules.'[21]

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18 RH Coase, *The Firm, the Market and the Law* (1988), p.10.

19 Section 792A(a) Corporations Act.

20 Uninformed trades are generally defined in the finance literature as those that are not based on special knowledge.

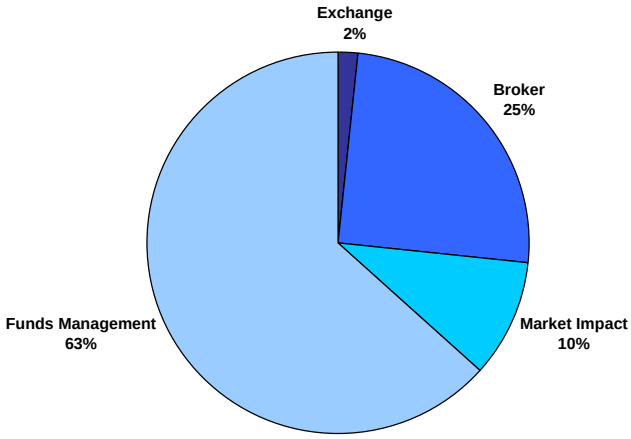
21 CP para 54.

2.11 The rule does not, either as a matter of legal interpretation or practical effect, operate as a barrier to an alternative trading platform commencing operations. Transacting on the AXE market (if that is what is happening) and complying with the ASX rules is consistent conduct. This Market Rule simply requires the transaction to be reported on the ASX market, no matter where else it is reported.

2.12 This is the legal interpretation of the rule. The same practical effect flows from an analysis of the actual costs that can be attributed to trading and reporting on both an alternative platform and on the ASX market. It is important to put in context the quantum and distribution between service providers of fees currently for executing trades and how they might be affected by the forces of competition and market fragmentation.

2.13 While it is difficult to determine, with any precision, the proportion of total fees paid by end investors that are captured by different segments of the traditional equity transaction value chain such an analysis is necessary to illustrate the potential costs and benefits of change to the regulatory regime. The following chart constructs an indicative fee allocation for one of the largest investor segments – superannuation funds.

Equity related fee distribution
(indicative analysis: superannuation funds)[22]



2.14 Approximately 60% of fees paid by superannuation investors go to the superannuation fund managers, with a further 25% going to executing brokers, just over 10% going into market impact costs, and around 2% being captured by exchanges/clearing houses in trading, clearing and settlement services.

2.15 If this analysis is typical, exchange fees are only a fraction of the overall costs of trading. Even if ASX offered its services for free this would only reduce the cost of trading to

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[22] Data is sourced from independent transaction cost analysis of institutional trades produced by Elkins-McSherry, supplemented by information on ASX fees and IFSA sponsored research. Using IFSA data on average fees charged by all superannuation funds and attributing around half of that sum, ie $5.25bn pa to equity investments (which make up around half of all superannuation assets) provides an indication of the fees charged on equity investment. This is divided by estimates of the amount of equity trading undertaken by superannuation funds (around $650bn) to give an indicative estimate of around 80bps of equity value traded. Of this, around 30bps is attributed, by Elkins-McSherry estimates, to trade execution costs.

investors by a very small amount. It is not the operation of Market Rule 16.12.1 that restricts or prevents competition. Given the magnitude of these relative costs, and the risk that any proposed regulatory regime will affect adversely the operation of the ASX market, ASIC should proceed only with appropriate evidence as to the likely effect of any new regulatory regime. A cost benefit analysis should be performed which takes into account the impact on the bid-offer spreads and liquidity and the impact of any proposed changes on market users. Such an approach is consistent both with Principle 2 articulated by ASIC in the Consultation Paper[23] and with general principles of good regulatory practice adopted as Commonwealth Government policy, further details of which are set out in section 7 of this submission.

Externalities will be imposed upon ASX

2.16 There are at least two concerns regarding the information available to the ASX market:

- Pre-trade transparency – the lack of reciprocity in the availability of pre-trade information prevents investors getting the best prices. One group of traders (the AXE participants) will hold information that is not available to all ASX participants. The price discovery mechanism may become fundamentally weakened and it is possible that prices formed will not accurately reflect the opportunities for trade.
- Post-trade transparency is critical to ensuring that investors are well-informed as to current trading opportunities and to monitor the behaviour of their agents. The ability of AXE to address this issue depends on the effectiveness of the arrangements put into place by AXE. The current description by AXE of those arrangements provides little comfort that post-trade information will be available in a timely or consistent form such that information can be compared.

2.17 These inefficiencies are specifically recognised by the CRAI International Report:

> '[F]ragmentaton of previously centralised trading can undermine liquidity and transparency, and as a result, the quality of price-formation and the efficiency of the market as a whole.'[24]

2.18 Market Rule 16.12.1 also has an important role to play in investor protection, having a critical place in the operation of the National Guarantee Fund. This issue is dealt with separately below.

Other rules with a public policy impact

2.19 The Consultation Paper fails to identify a large number of other ASX Market Rules that AXE has asked to be removed. AXE seeks the removal of at least 26 different ASX Market Rules.[25] These rules relate to five main areas:

- Reporting requirements. The central rule is Market Rule 16.12.1, which contains a general obligation to report to ASX any transaction in ASX-listed securities. AXE also seeks the removal of other related rules relevant to the reporting obligation.
- Crossings. Crossings relate to transactions that occur in certain circumstances. The rationale for ASX's crossing rules include investor protection, market quality and the provision of incentives to bring liquidity to the ASX market.[26]

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23 CP paras 30-33.

24 CRAI Report p.18.

25 ASX is not aware of any request by Liquidnet that ASX remove any of its Market Rules.

26 *ASX Market Rules Guidance Note 20: Crossings arising from the use of automated order processing* (10 April 2006).

- Forward delivery transactions. Reporting these transactions ensures the transparency of the market to the benefit of all investors and market participants.
- Short sales. Short sales are prohibited by the Corporations Act,[27] with some statutory exceptions, to which these rules relate.
- Takeovers. These rules relate to the announcement of market bids and their variation and regulates the trading in securities in these circumstances.

2.20 Each of these matters are clearly relevant to the operation of a fair, orderly and transparent financial market and cannot simply be removed. Deletion or amendment of some of the ASX operating rules might be appropriate. However, this could only occur after an investigation and consideration of the appropriate regulatory regime. There are good arguments for supporting centrally administered regulation, for example, in respect of short selling and takeovers in a fragmented market.

- *Short Sales:* At present, section 1020B(4)(d) Corporations Act allows certain securities to be sold on a licensed market provided they comply with the tick test in that section. The section does not require the market to have a tick test. At present, ASX Market Rule Section 19 does contain a tick test. It is conceivable that another market operator may introduce short selling rules without a tick test. This rule could impact adversely on the integrity of the market operated by ASX. In turn, the possibility of such a rule calls into question the policy underlying the downtick rules which reside in both the Act and the Market Rules. ASX is of the view that these policy questions are so significant that they should be determined at the legislative level.
- *Takeovers*: ASX rules governing crossings during takeovers are derived from an equity principle by which all participants in the market must have an equal opportunity to participate in an offer and the market for corporate control. The market for corporate control should be subject to the price discovery mechanism. Accordingly, ASX Market Rule 20.6 restricts the price at which crossings may be conducted during non-open trading hours and Market Rule 20.8 prohibits special crossings during a takeover. Without adequate legislative intervention, market fragmentation may lead to opportunities for regulatory arbitrage and circumvention of these policy objectives by shifting of order flow between varying exchange venues to avoid these ASX Market Rules.

3 Investor protection must be a key concern of ASIC

The dimensions of protection for investors

3.1 The protection of investors is one of the key concerns of the regulatory scheme found in the Corporations Act. The first object of Chapter 7 of the Corporations Act, as expressed in section 760A is:

> 'confident and informed decision making by consumers of financial products while facilitating efficiency, flexibility and innovation in the provision of those products and services.'

3.2 Competition is not an end in itself. Neither ASIC nor the Minister should do anything that:

- has a detrimental impact on the integrity of any of the markets the subject of the regulatory regime;

[27] Section 1020B.

- increases the risk of market abuse flowing from the fragmentation of the ASX market.

3.3 In addition, investors must be properly informed and accept the risks of trades occurring on platforms other than ASX not being covered by the National Guarantee Fund and the possible inconsistencies in treatment that might arise.

3.4 Each of these matters is dealt with in this part of the submission. In addition, there are other major matters of integrity and investor protection that flow from the likely effect of the AXE model of operation on:

- the transparency of the market;
- the obligation of best execution; and
- the possibility that the current applicants for an Australian market licence are not, in fact, eligible to obtain one, with investors being misled as to the status of those entities if a licence is granted.

The principle of market integrity

3.5 Market integrity is a key objective of the regulatory regime applying to financial markets in Australia.[28] Market integrity is important because it promotes confidence in, and use of the market, and therefore contributes to market liquidity. Market integrity requires, among other things:

- adequate, accurate and up-to-date market information, to ensure that market users use the market on an informed basis;
- that market users are confident that the market operates fairly, and that they will be treated fairly;
- that listed entities, participants and market users that breach the law or the market rules are likely to be detected and disciplined;
- that the market operates reliably.[29]

3.6 Market regulation seeks to achieve market integrity by requiring market operators to be licensed and to comply with the licensee obligations. In particular, holders of an Australian market licence must, 'to the extent that it is reasonably practicable to do so, do all things necessary to ensure that the market is a fair, orderly and transparent market'.[30] In addition, ASX is required to have adequate arrangements for the supervision of the ASX market.[31] ASX's operating rules and procedures are a key feature of its compliance with these obligations.

The impact of fragmentation on ASX market integrity

3.7 Market fragmentation poses real risks for the oversight and hence integrity of securities markets. The UK Financial Services Authority states that:

> 'fragmentation of trading and trading information could result in [market operators] having insufficient information on activity in the broader marketplace to asses or understand any disorderliness in their own markets.'[32]

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28 ASIC Regulatory Guide 172.7.

29 RG 172 pp.6 and 7.

30 Section 792A(a) Corporations Act.

31 Section 792A(c) Corporations Act.

32 UK Financial Services Authority, *Trading of MTF shares: impact of proposed stamp duty changes* (Discussion Paper 07/3, July 2007), p.24.

3.8 The UK Financial Services Authority also noted the broader challenges that fragmented trading brings. One of the ways that this is mandated in the United Kingdom under MiFID is to ensure the quality of the data passing through the system. One of the issues being considered in the UK context is whether the degree of fragmentation makes it less likely that any individual venue might detect abusive trading, for example, because the abuse is concealed by spreading trading across several venues, or because an abusive position is established on one platform and unwound on another.[33]

3.9 The implementation of the AXE and (to a lesser extent) the Liquidnet proposals threatens to negatively affect the integrity of the ASX market. This risk is recognised in the CRAI Report, which states that the fragmentation of securities markets could:

- Undermine transparency on the ASX market.[34] In particular, the implementation of the AXE model would reduce information flows relative to current standards on the ASX market,[35] and lead to an increase in the incidence of trades that have delayed disclosure.[36]
- Create an incentive for price and market manipulation on the ASX market.[37] The risk of market manipulation could, in turn, harm investors' confidence in the ASX market, thereby detracting from its liquidity and overall efficiency.[38]
- Create uncertainty as to whether best execution standards will be met reliably.[39]
- Reduce the integrity of the ASX market.[40]

3.10 These risks are closely linked to the impact of fragmentation on the information available to the ASX market. In particular, reduced transparency will undermine ASX's capacity to meet its market supervisory obligations by impairing its ability to detect unusual price movements which may constitute evidence of market manipulation or insider trading.

Internalising orders

3.11 There are exceptions to the rule that trades on the ASX market are centralised. The ASX Market Rules in relation to crossings are summarized in the CRAI Report.[41] The ASX Market Rules in relation to these matters are complex rules that set out the conditions for allowing such trades to occur.

3.12 The ASX Market Rules in relation to crossings recognise that allowing such transactions provide incentives to search out information, allowing trades to occur which would not otherwise occur on the ASX market. The rules attempt to identify situations in which it might be efficient to allow such trades to occur. As noted by the CRAI Report,[42] the reason crossings are limited is to ensure that crossings do not significantly detract from market liquidity, and hence weaken the process by which opportunities for trade emerge and prices are discovered. A further problem is that widespread use of crossings *indirectly* worsens market spreads and increases volatility because it allows market participants to take advantage of information hidden from the general market.

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33 UK Financial Services Authority, *Trading of MTF shares: impact of proposed stamp duty changes* (Discussion Paper 07/3, July 2007), p.16.

34 CRAI Report at p.18.

35 CRAI Report at p.32.

36 CRAI Report at p.25.

37 CRAI Report at p.36.

38 CRAI Report at p.26.

39 CRAI Report at p.32.

40 CRAI Report at p.30.

41 CRAI Report, p.3.

42 CRAI Report, p.31.

3.13 If AXE market participants are allowed to cross orders (particularly when acting as a principal on one side), then one could reasonably expect that they will cross those orders where they are highly likely to make a profit. That is more likely when the market price of the share is unlikely to move against the broker – for 'uninformed' trades in relatively liquid shares.

3.14 These uninformed trades tend to be smaller trades from retail investors. While allowing such executions may benefit the market participants and investors undertaking these practices (as investors' net execution costs would likely be lower), the quality of the trades remaining on the main exchange suffers from an 'adverse selection' problem – the 'good' (uninformed) trades get siphoned away leaving more of the 'bad' (informed) trades to ASX. Market participants on ASX, recognising that many uninformed trades had been executed elsewhere, will protect themselves against dealing with the greater proportion of informed trades by reducing their exposure and offering less liquidity.

3.15 As AXE market participants appear to be using AXE as a vehicle to engage in greater internalisation or crossing of orders, the AXE proposal potentially brings with it additional problems for the market generally.

The difficulties of implementing a supervisory agreement between ASX and AXE or Liquidnet

3.16 Should AXE and/or Liquidnet be granted an Australian market licence, AXE, Liquidnet and ASX will each be obliged to have appropriate information sharing arrangements in relation to their respective markets.[43]

3.17 A number of practical difficulties arise in relation to the implementation of such arrangements, including:

- Technology issues. There are possible significant technological issues in relation to the coordination of supervisory oversight of markets operated by each of ASX, AXE and Liquidnet. Such technological issues may be expensive to resolve and an issue arises as to who bears the costs of that resolution.
- Integrity issues. Competition principles and principles of proper corporate governance require appropriate safeguards to be in place in relation to the sharing of information between competitor market operators, to ensure that the information is used only for the limited supervisory purposes for which the information is exchanged, rather than for commercial purposes. Such safeguards require both technological solutions and corporate governance solutions to ensure their effectiveness.
- Practical problems arising from discrepancies between ASX operating rules and procedures and those proposed by AXE or Liquidnet.
- Difficulties associated with monitoring and enforcing compliance with different rules and procedures across a number of platforms. For example, time stamps are not required on AXE reporting.[44] This would make it impossible to monitor for best execution, market manipulation or insider trading.

3.18 These difficulties are not easily resolved. They highlight the extent to which the operating rules and procedures of a competing market can significantly and negatively impact on the integrity of the ASX market and ASX's ability to perform its supervisory obligations.

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[43] Section 793A(2) Corporations Act and Corporations Regulation 7.2.08(a)(ii). ASX has difficulty understanding the suggestion that Liquidnet does not currently contemplate entering into any information sharing arrangement with ASX or any other market operator: *ASIC Information Release*, 23 July 2007, IR 07-38, p.4.

[44] AXE Procedure 4.3.3.

The operation of the National Guarantee Fund

3.19 The National Guarantee Fund (NGF) is a compensation fund which is available to meet certain claims arising from dealings with participants of ASX. Claims that can be made under the NGF include those arising from the breach of a broker's obligations to a selling or buying client.

3.20 We understand that under AXE's current proposal, participants on the AXE platform will not be covered by the NGF.

3.21 The NGF is governed by Division 4 of Part 7.5 of the Corporations Act and the Corporations Regulations. Market Rule 16.12.1 complies with Corporations Regulation 7.5.01 (which defines what is a 'reportable transaction') and ensures that NGF protection is extended to investors dealing in ASX listed securities. If the reporting rule is removed, as AXE has requested, ASX's existing compensation arrangements would be undermined with the result that there will be no NGF coverage – even for those transactions conducted on the ASX market.

3.22 The NGF's contract guarantee protection regime only applies to ASX 'reportable transactions', defined as:[45]

- the sale or purchase of ASX quoted securities;
- by a participant of ASX;[46]
- which is either:
  - required to be reported by the participant to ASX under ASX's operating rules; or
  - a sale (or purchase) by an ASX participant to (or from) a participant (the second participant) of another participating market licensee (the alternative participating market licensee), and the alternative participating market licensee's operating rules require the second participant to report the transaction to the alternative participating market licensee.

3.23 Under the AXE proposal, transactions on AXE's platform do not satisfy the definition of 'reportable transaction' and therefore would not be covered by the NGF. Inconsistent results may follow, for example, for different investors placing an order through the same market participant for the same shares where that market participant executes the trade on different platforms. Such inconsistencies undermine investor confidence in the securities market generally, including the ASX market.

Issues for investor protection

3.24 The inability of trades on AXE's platform to be covered by the NGF raises a number of serious issues for investor protection, including:

- Is it proposed that the Regulations will be amended to enable AXE to be covered by the NGF?
- The adequacy of AXE's proposed investor protection arrangements and how they interact with those provided by the NGF. As AXE's operating rules are currently drafted, the AXE compensation fund does not apply to losses incurred by retail clients if the loss relates to the AXE ECN or to ASX and the retail client

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45 See Corporations Regulation 7.5.24(1)(a) and (b), 7.5.25(1)(a) and (b), 7.5.26(1)(a) and (b), 7.5.27(1)(a) and (b).

46 See the definition of participating market licensee in regulation 7.5.01(1). This does not mean a participant of AXE because AXE is not and is not able to become a member of SEGC because it does not operate a financial market.

did not expressly or impliedly instruct the participant to use a particular market.[47]

- Broader issues that bring into question the appropriateness of the continued operation of the NGF. In particular, is it appropriate, in the context of multiple trading venues transacting in ASX listed securities, to maintain the distinction between Division 3 and Division 4 compensation arrangements under Part 7.5 Corporations Act.
    - *For example*: Is the approach taken by section 888A(2) and section 885D(2) still appropriate where there are multiple venues trading ASX-listed securities?

      Those provisions potentially create an uneven playing field and benefit AXE's operations at the expense of the NGF. This is because a loss incurred by a retail client as a result of the actions of an AXE participant (who also happens to be an ASX participant) is potentially borne by the NGF and not by AXE's compensation fund even though the actions of the AXE participant have no actual connection with the ASX market.

      If a loss incurred by a retail client is caused by a participant who is both an AXE participant and an ASX participant that loss will be 'connected with' the ASX market for the purposes of section 885D(2)(b) by reason of the operation of section 885A(2). Unless the retail client specifically instructed the participant to use the AXE market (or it was reasonably apparent from usual business practices that the AXE market would be used) the loss is taken not to be a Division 3 loss covered by AXE's compensation fund. Rather, the client will potentially have a claim on the NGF even though the transaction had no actual connection with the AXE market (other than the fact that the transaction involved ASX-listed securities).
- This suggests that the operation of and interaction between Divisions 3 and 4 of Part 7.5 of the Corporations Act should be reviewed in the light of a proposal to permit multiple trading venues for the same securities. If it is not, a number of inconsistencies – questions of fairness –- arise including:
    - Why should ASX and its participants be subject to the NGF levy obligations when AXE and its participants are not?
    - Why should AXE be permitted to have a compensation fund of only $200,000 and require claims to be made within 28 days, when the NGF maintains a fund of almost $100 million and claims can be made within six months?
- What disclosure will AXE's participants be required to give to investors regarding its (lack of) investor protection arrangements: will there be a requirement to specifically disclose which transactions will not be subject to NGF protection?
- If AXE's participants have a choice of venue to execute transactions, one of which is covered by the NGF and one of which is not, how is conducting client orders on the venue not backed by the NGF consistent with the discharge of the participants' the best execution obligation?

3.25 These issues have the potential to seriously affect investor protection and confidence. However, they are not currently the subject of the consultation process. It is ASX's view that these issues require further consideration.

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[47] AXE rule 6.2.3(f).

4 Transparency is essential

The ASX Market Rules and transparency

4.1 ASX is obligated under the terms of its Australian market licence, 'to the extent that it is reasonably practicable to do so, do all things necessary to ensure that the market is a fair, orderly and transparent market'.[48]

4.2 Transparency is essential to an efficient securities market for two key reasons:

- it facilitates price discovery; and
- it assists with market surveillance and contributes to market integrity.

4.3 Transparency is also a necessary to enable investors to monitor whether or not market participants are meeting their best execution obligations.

4.4 Transparency in securities markets may be divided into several discrete dimensions. Pre-trade and post-trade transparency are the usually-identified dimensions of market transparency.[49]

4.5 ASX's Market Rules are implemented in satisfaction of these obligations. The rationale behind many of the Market Rules is to ensure transparency.

The effect on transparency of the AXE and Liquidnet proposals

4.6 The AXE proposal will have a clear impact upon the operation of the ASX market. Those matters are discussed below. ASIC should advise the Minister that an Australian market licence should not be granted to AXE until AXE overcomes those effects by having adequate pre-transparency and post-trade transparency.

4.7 The Liquidnet model of operation, so far as ASX is able to understand it, raises different issues. ASX considers that, subject to a condition, Liquidnet can be licensed to run a financial market. Liquidnet says that its model is to seek out trades that would not otherwise occur on the ASX market, by having a system that facilitates anonymous block trades that would not otherwise occur on the ASX market. It should be held to operating in that manner.

4.8 The condition on the Liquidnet licence referred to relates to the possibility that Liquidnet attracts trades that would occur on the ASX market. In such circumstances, the Liquidnet model might raise similar issues to those of the AXE model in respect of pre-trade transparency. This issue has been recognised by the US Securities and Exchange Commission, through the operation of the Fair Access Rule contained in Regulation ATS.[50] Liquidnet has previously obtained an exemption from certain aspects of Reg ATS.[51] The practical implications and difficulties of introducing a similar exemption are discussed below.

Pre-trade transparency

4.9 Pre-trade transparency includes making available accurate information about the size and price of prospective trades, quotations and resting limit orders.

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48 Section 792A(a) Corporations Act.

49 IOSCO Principle 27, to which ASIC subscribes, is that 'Regulation should promote Transparency of Trading'.

50 www.sec.gov/divisions/marketreg/mrecn.shtml.

51 SEC Release No 34-52514, 27 September 2005.

4.10 Pre-trade transparency is important to efficient market operation for the following reasons:

- it ensures that all trading opportunities are exhausted;
- it ensures that trades that occur are those that maximise the value of trading; and
- it assures investors that their trades are occurring at the best available prices.

4.11 Transparency is also important as it:

- allows market participants to identify the venue that offers the best terms of execution; and
- allows investors to monitor whether or not market participants are meeting their best execution obligations.

4.12 The AXE and Liquidnet models do not provide for pre-trade transparency. To the extent these platforms substitute trades that would otherwise occur on the ASX market, price discovery for trades in ASX listed securities will be weakened. Under these proposals, not all available prices for ASX listed securities are available to all market participants at the same time. AXE and Liquidnet participants will hold information that is not available to all participants, therefore, prices formed may not accurately reflect the opportunities for trade and thus lead to distortion of the market.[52]

4.13 An example illustrates the effect of this distortion. Suppose a bid is made by an ASX-only participant on ASX, and the bid is matched with an offer to sell on ASX, but the bid is not as high as the prevailing bid on the secondary platform. A trade may well occur on ASX, even though the trade would be more valuable if it were consummated with the buyer on the secondary platform. Similarly, where offers to sell are lower on the secondary platform but are not observed by ASX-only participants, trades may take place on ASX at higher prices than would be efficient. In both cases, the overall process of price discovery is harmed, as the trade prices would not accurately reflect all trading opportunities on ASX and the secondary platform. The more trades that occur in this fashion, the greater the less informative prices formed on the ASX market will be.

4.14 In the Consultation Paper, ASIC proposes that 'full pre-trade transparency might not be essential at the time competing markets commence, but will become essential if a new market starts to account for a significant amount of the trading in a security.'[53] ASX does not agree with this approach. Substantial pre-trade transparency is essential for price formation and the overall efficiency of securities markets. This is implicitly acknowledged in ASIC's proposal C2(b), and is identified as an issue in the CRAI Report.[54] Once this proposition is accepted, steps ought be taken to ensure that pre-trade transparency, through reporting obligations, is preserved if the AXE and Liquidnet proposals progress.

4.15 There are serious practical limitations with the 'wait and see' approach proposed. At the broadest level, it will be difficult to monitor whether 'a new market starts to account for a significant amount of the trading in a security' absent the reporting which would be present in a market with pre-trade transparency.

4.16 ASIC's approach also appears to be predicated on assumptions that the transfer of liquidity will be linear (for example, a similar percentage across all stocks) or gradual (for example, observable over a period of time). This will not necessarily be the case. It is conceivable, for example, that the new market may gain significant market share in a

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[52] The lack of pre-trade transparency on the proposed Liquidnet platform is of less concern because ASX understands that Liquidnet will primarily involve trades that would not otherwise occur on the ASX Market.

[53] Proposal C2(b), CP para 42.

[54] CRAI Report, at p.18.

security on day 1 of the market commencing operation. It would then, of course, be too late to impose pre-trade transparency obligations.

4.17 There are other practical difficulties with ASIC's proposed approach. For example: what constitutes a significant amount of trading in a security? How will this be determined? Over what time period? How will compliance be monitored and enforced and by whom? Steps may be taken by individual alternative markets to avoid whatever threshold is set, which may not be beneficial for the market as a whole, for example, 'turning off' the market to ensure that the 'significant amount of trading' threshold is not reached.[55]

Post trade transparency

4.18 Post-trade transparency refers to the dissemination of information relating to trade price and volume of completed transactions from all markets trading that security.

4.19 Post-trade transparency is essential for the following reasons:

- Information about recent trades are valuable in providing information about the current state of trading opportunities. That is, information about recent values provides information about 'current' values of securities and trading opportunities with respect to those securities.
- As with pre-trade transparency, it enables concerned investors to monitor their agents and the degree to which they have acted to secure the best prices for their trades.
- It facilitates the effective monitoring and supervision of the market. Transaction reporting provides an audit trail of exchange business by its participants. This enables the exchange to monitor the quality of the market that it regulates. Without capturing details of all trades, the ability to detect unusual price movements, which may constitute evidence of market manipulation or insider trading, is significantly impaired.

4.20 There is full post-trade transparency on the ASX platform, facilitated by the ASX Market Rules. Integral to this is Market Rule 16.12, which requires all trades in ASX-listed securities to be reported to ASX regardless of where those transactions take place. The information collected through this consolidated reporting is then available through consolidated sources for use in real time and is made available free of charge on a delayed basis.

4.21 According to the CRAI Report, the Liquidnet proposal provides full post-trade transparency.[56]

4.22 The ability of AXE to address the availability of post-trade information depends on the effectiveness of the arrangements put in place by it. AXE proposes to deal with post-trade transparency by making trade reporting arrangements with information vendors.[57] ASX is not aware of the precise nature of those relationships, however, based on the information currently available to ASX, AXE's proposal does not ensure that post-trade transparency will be at an acceptable level. ASX agrees with the conclusion of CRAI:

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55 A similar approach was adopted by Liquidnet in the United States when it temporarily disabled trading in order to avoid being subject to the Fair Access Rule which, at the time, applied when an alternative trading system accounted for 20% of the average daily volume in a security over four of the preceding six months: see SEC Release No 34-52514, 27 September 2005, p.4.

56 CRAI Report, pp.12 (information provided 'without delay') and 13 ('Immediately transparent').

57 However, ASX notes that the AXE procedures provide that time stamps are not required on AXE reporting: AXE Procedures 4.3.3.

'The AXE model would reduce information flows relative to current standards on ASX.'[58]

4.23 Under the current regulatory regime, there is no mechanism for the oversight of the adequacy of AXE's proposed levels of post-trade transparency.

4.24 ASX agrees with ASIC's proposal C2(a)[59] and agrees with its conclusion that a consolidated source of market information is important to ensure that investors have adequate information to assist them in making investment decisions.[60] The reporting requirements contained in the ASX Market Rules, in particular Market Rule 16.12.1, ensure that there is central reporting of all trades and a consolidated source of market information.

4.25 ASX agrees with ASIC that there must be common reporting standards across markets for similar types of transactions.[61] This is not, however, the position under AXE's proposal which contemplates longer reporting times than ASX. This would result in an unacceptable level of information asymmetry.

Other aspects of the transparency principle

4.26 A properly functioning market also needs to know the rules by which it is structured. Just as rules are essential to the functioning of a well-ordered market, they must also be known by the market participants.

4.27 Knowledge of the rules is important because:

- Investors play an important role in the monitoring of compliance with the rules.
- Investors need to know when the rules change, as the rules have an effect on the ability of the market participants to comply with their broader obligations, such as the obligation of best execution.

Are the proposed models of AXE and Liquidnet capable of being transparent?

4.28 The models proposed by AXE and Liquidnet have limited transparency. If they can not be characterised as transparent markets, they can not meet the fundamental obligation imposed on an Australian market license holder under section 792A of the Corporations Act.

4.29 ASIC should consider whether AXE and Liquidnet are able to meet these requirements before making a decision to grant a licence under the current regulatory regime.

5 The best execution obligation must be appropriate and enforceable

A specific application of the concerns about investor protection

5.1 Best execution is a specific application of the concerns about investor protection. Best execution obligations are currently satisfied by a combination of the application of the

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58 CRAI Report, p.32.

59 CP para 42.

60 CP para 68.

61 CP para 71.

ASX crossing rules, the price/time functionality in the ASX CLOB and the legal and equitable obligations that exist between market participants and their clients.[62]

5.2 There must be a proper recognition of the obligations of market participants to act in the best interests of their client, thereby fulfilling their legal and equitable obligations.

5.3 A best execution obligation becomes particularly acute in a marketplace where there is more than one platform as firms must consider the relative merits of execution by means of different trading platforms, including in some cases such as AXE where the market participants have such a significant ownership interest in the platform.[63]

5.4 An appropriate and enforceable best execution policy is a necessary, but maybe insufficient, condition for investor protection. Some jurisdictions appear to form the view that they are insufficient. Thus, for example, they are actively considering the implementation of a 'no trade through rule' as an important adjunct to best execution obligations.[64]

The implementation of the best execution obligation

5.5 The obligation of 'best execution' (including all pre- and post-trade aspects of the trade) must be well-defined and guidance should be given as to how this is to be implemented practically. Such guidance needs to deal with issues such as:

- The meaning of best execution. The factors traditionally listed in considering whether the obligation has been met are: price; costs, speed of execution; the likelihood of execution; the speed of settlement; and the size of the order.
- The nature of the clients. There may be a distinction between retail and institutional clients or large and small trades (whether retail or institutional in nature). Retail clients arguably are interested only in time/price priority. Those who engage in small trades are less able to monitor the performance of their agents in the execution of their trades.
- The circumstances in which the trade takes place. There may be differences in relation to retail clients for spread bets and Contracts for Differences; corporate finance business; venture capital; and securities lending.[65]
- The mechanisms for reporting and monitoring of compliance. Without transparency of the best execution requirements there can be little comfort that these requirements will be complied with.

5.6 Each of these matters are the subject of intense work in overseas jurisdictions, especially in the context of the yet to be implemented MiFID regulatory regime. The interrelationship between securities and derivatives markets needs to be given special attention. As the UK Financial Services Authority identifies, in a Contract for Difference product market, the best execution obligation now applies. They also point to the need to undertake a factual inquiry as to whether instruments are the economic equivalent of investing in the cash

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62 ASIC should recognise, however, that the legal and equitable obligations between market participants and their clients, including any fiduciary obligations, can be modified by agreement. ASIC may wish to consider if this is appropriate: *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (No. 4) [2007] FCA 963.

63 UK Financial Services Authority Consultation paper 154, *Best execution*, October 2002, para 4.8; FESCO (now CESR) *The Regulation of Alternative Trading Systems in Europe. A Paper for the EU Commission*, (Ref. Fesco/00-064c), September 2000, para 47.

64 See for example, the obligations discussed by the Ontario Securities Commission, *Trade-through Protection, Best Execution, Access to Marketplaces and the Consolidation of Data* (2007), 30 *OSC Bulletin*, Issue 16 (Supp-3).

65 UK Financial Services Authority, *Best execution: Feedback on DP06/3 and CP06/19 (part)* (Policy Statement 07/15, August 2007).

market in order to determine the applicability of the best execution obligation.[66] This is an illustration of the broader question of regulatory asymmetry referred to earlier in this submission, namely, that any regulatory regime must apply neutrally so as to not cause unintended distortions to markets.

How to enact the best execution obligation

5.7 A fundamental consideration in implementing best execution policies is whether the obligation should be enshrined in legislation or developed by the market.

5.8 A key factor pointing to the need for a centrally imposed regulation is the danger that 'regulatory competition' between self-regulatory organisations will cause a 'race to the bottom'[67] in standards because lower standards are perceived to have lower compliance costs. This is especially likely to be a concern in an environment in which there is a lack of information about the actual best execution policy and compliance with that policy.

5.9 If it is left to each market to enact best execution obligations, any difference in standards between those markets will make it difficult in practice for participants of both markets to comply with those standards. For example, compliance with the best execution obligation of market A may be a breach of the best execution obligation of market B.

The data issue

5.10 The market fragmentation which results from multiple execution venues also has an impact on the price discovery mechanism. In order to achieve efficient price discovery and facilitate the achievement and monitoring of best execution, trade information published through different sources needs to be reliable and presented in a way which allows investors and market participants to compare prices and other factors.

5.11 A regulatory response to best execution must also therefore deal with the issue of the provision of accurate and transparent data to facilitate best execution and the creation and retention of data to monitor compliance.

5.12 MiFID mandates in some detail the information that must be disclosed in the interests of transparency. It also prescribes that arrangements to make pre- and post-trade information public must meet certain conditions. The published information must be:

- reliable and continuously monitored for errors. Any errors must be corrected as soon as they are detected.
- published in a way that facilitates consolidation of the data with similar data from other sources; and
- made available to the public on a reasonable and non-discriminatory commercial basis.[68]

5.13 Considerable guidance has been given by both the UK Financial Services Authority and The Committee of European Securities Regulators to supplement and give content to these obligations.[69] CESR is charged with addressing at a practical level some of the

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66 UK Financial Services Authority, *Best execution: Feedback on DP06/3 and CP06/19 (part)* (Policy Statement 07/15, August 2007), p.10.

67 Eleanor Fox, 'Antitrust and Regulatory Federalism: Races Up, Down and Sideways' in Daniel C Esty and Damien Geradin (eds), *Regulatory Competition and Economic Integration: Comparative Perspectives* (Oxford University Press, New York, 2001), chapter 16.

68 UK Financial Services Authority, *Implementing MiFID for Firms and Markets* (CP06/14, July 2006), para 16.82.

69 See UK Financial Services Authority, *Implementing MiFID for Firms and Markets* (CP06/14, July 2006), and *Implementing the Markets in Financial Instruments Directive,* Policy Statement, (PS 07/2, January 2007), CESR, *Publication and consolidation of MiFID market transparency,* Public Consultation, (Ref. CESR/06-551, October 2006) and CESR, *Publication and consolidation of MiFID market transparency data,* (Ref. CESR/ 07-043, February 2007).

complex issues around the transparency of market data. Its focus is to mitigate the fragmentation of transparency information, which:

> 'if not addressed properly, could undermine the overarching transparency objective in MiFID, and may even result in less transparent markets than is the case today. In order to achieve efficient price discovery and facilitate achievement and monitoring of best execution, trade information published through different sources needs to be reliable and brought together in a way that allows for comparison between the prices prevailing on different trading venues. It should be available in a format that is easy to consolidate and that is capable of being readily understood and be available at a reasonable cost.'[70]

6 Only those eligible should be granted a licence

Have a clear basis for granting a licence

6.1 ASIC should have a clear basis in law for the licensing of entities that intend to provide financial services. The law should not be 'squeezed' as if it applies where it does not.

6.2 This is important because of its impact on consumer protection.

- Investors should not be led to believe they are dealing with a licensed entity, when the legal foundation for that licence is precarious at best.
- Investors should have a clear and enforceable right to compensation.

The AXE proposal

6.3 Based on ASX's understanding of the AXE proposal either:

- AXE does not operate a financial market and is therefore not entitled to obtain an Australian market licence; or
- AXE's participants each operate a financial market and cannot conduct their proposed operations unless they each obtain an Australian market licence. No such application has been made.

6.4 ASIC's overview of AXE's proposed market services states:[71]

> 'AXE will not … provide a central marketplace for bids and offers to interact. The physical receipt of client orders, the search for counterparties to these orders, and the matching of these orders will take place within participants' own technological infrastructure (for example: telephones, order management systems, trading portals).'

6.5 The CRAI report states:

> 'AXE will not provide any technological infrastructure to support the interconnectivity of AXE participants in respect of order matching. ...The physical receipt of client orders, the search for counterparties to orders, and the matching of orders will take place within participants' proprietary trading systems.'[72]

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70 CESR, *Publication and consolidation of MiFID market transparency data,* (Ref. CESR/ 07-043, February 2007), p.2.

71 *ASIC Consultation- Overview of New Market Proposals*, p.1.

72 CRAI Report, p.7.

AXE's operations do not meet the requirements of section 767A(1) Corporations Act

6.6 In order to qualify for an Australian market licence, AXE must satisfy the definition of a financial market pursuant to section 767A(1) Corporations Act. AXE must provide a facility through which:

- offers to acquire or dispose of financial products are regularly made or accepted; or
- offers or invitations are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in:
  - the making of offers to acquire or dispose of financial products; or
  - the acceptance of such offers.

6.7 AXE's proposed operations do not meet the requirements of section 767A(1) in a number of respects.

- 'Facility' – ASIC's overview document and the CRAI report make it clear that AXE will not provide any order matching infrastructure for bids and offers to interact. The receipt of client orders, the search for counterparties, and the matching of orders will take place within participants' own technological infrastructure.
- 'Through which' – Even if, contrary to the above, AXE's operations amount to a facility, it will not be a facility *through which* offers to acquire or dispose of financial products are made or accepted. The expression 'through which' is to be construed narrowly.[73] A facility will not constitute a financial market merely because it is a step in a process that results in the eventual making or acceptance of offers or invitations.[74] Offers must be made or accepted by means of the facility[75] ASIC has previously stated:

  > 'only a facility by means of which or on which offers, invitations or acceptances are received constitutes a financial market. An order routing facility that merely routes offers to another person, who then enters them on a market operator's platform, is not a financial market because *there is no receipt of the offer on such a facility*.' (emphasis added)[76]

- 'Offers are made' – The process by which execution occurs in relation to AXE's 'platform' is set out in Rule 4.2.1 of AXE's operating rules. That rule appears to provide that execution occurs when participants match offers and report to the electronic communications network (ECN). However, in this case, AXE is not actually an execution platform for the trade but rather is a reporting platform. Therefore, offers, acceptances and invitations are not made or accepted by means of or on AXE. They are made on the participants own infrastructure.
- AXE's rules in respect of execution – AXE's rules purport to make execution conditional on the receipt of a report to AXE, and thereby imply that AXE is the facility 'through which' execution takes place. Nonetheless, various AXE rules contradict the notion that execution is effected by reporting to the platform. For example, the AXE rule in respect of the time for reporting (Procedure 4.3.2) requires transactions 'executed' on the platform to be reported to the platform within 30 seconds.

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73 ASIC, Regulatory Guide 172.20 and 172.31.

74 ASIC Regulatory Guide 172.20.

75 ASIC Regulatory Guide 172.20.

76 ASIC Regulatory Guide 172.25.

Liquidnet

6.8 Liquidnet may be eligible for an Australian market licence but only if it is able to satisfy the transparency aspect of the composite 'fair, orderly and transparent markets' obligation. It is not clear from the material available that its business model will allow this requirement to be satisfied.

7 ASIC and the Minister face complex issues of regulatory design

Principles-based regulation

7.1 The scheme of regulation embodied in the Corporations Act[77] is that of a principles-based approach to regulation. That is, the Corporations Act does not dictate through detailed, prescriptive rules how financial markets (in this case) should be regulated. Rather, it develops a number of key principles which focus on the outcomes that are desired. Those key principles include:

- Financial markets should be operated in a fair, orderly and transparent manner.[78]
- Financial service providers should treat clients in a fair, honest and efficient manner.[79]
- Clearing and settlement services should be operated so as to reduce systemic risk and provide services fairly and effectively.[80]
- Issuers of securities should continuously disclose material information.[81]
- Market users should not engage in market abuse (insider trading, market manipulation, misleading and deceptive conduct).[82]

7.2 A corollary of the principles-based approach to regulation is the co-regulatory role played by those who are licensed to operate financial markets. As identified above, the operating rules of ASX play an important role in the regulation of market activity. This approach is consistent with the approach of National Competition Policy to the regulatory task. However, ASIC and the Minister must consider what roles are appropriately given to the operator of a financial market and what rules are set in the legislation or other regulatory instrument. The best execution obligation has been referred to in this submission as one possible area where the co-regulatory role will not work in a multi-platform environment.

7.3 The policy approach of ASIC and the Minister should be consistent with this underlying philosophy of the Corporations Act. In adopting a consistent approach ASIC and the Minister should have regard to a number of important aspects of regulatory design.

- The need to adopt an evidence-based approach to regulatory design, in compliance with the principles of good regulatory practice that have been adopted by the Commonwealth Government.
- The impact of the regulatory regime on international competitiveness and the interconnectedness of international financial markets.

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77 And in other economic regulatory instruments relevant to securities markets, for example, the agreements forming National Competition Policy.

78 Section 792A(a) Corporations Act.

79 Section 912A(1)(a) Corporations Act.

80 Section 821A(aa) and (a) Corporations Act.

81 Chapter 6CA Corporations Act.

82 Part 7.10 Corporations Act.

- The desirability of facilitating global capital formation by increasing the prospects of substituted compliance with other regulatory jurisdictions.
- The need to allow for the likely competitive reactions of ASX and others in response to the new regulatory regime.
- The need to take into account the actual market conditions in Australia.
- The need to proceed on a clear statutory basis so as to promulgate clear, enforceable obligations.

Evidence-based regulation

7.4 The process of designing a good regulatory system is a complex task. The rules formulated should:

- comply with the principles of good regulatory practice as set out in government policy of good regulatory-policy making;[83]
- be consistent with the statutory philosophy of the Corporations Act and National Competition Policy so as to produce a consistent, regulatory 'neutral' body of regulations that do not promote one competitor over another (competition not competitors must be promoted) so as to promote the objectives of the Corporations Act and the charter of ASIC.[84]

7.5 Policy-making in this context must be *evidence-based*, that is, ASIC must undertake a considered *factual inquiry* as to whether the proposed regulatory regime is likely to promote the objectives of the Corporations Act and the ASIC charter. The UK Financial Services Authority adopts such an approach:

> 'When deciding on new policy initiatives, we take an evidence-based approach. We consider carefully whether there is a market failure which needs to be addressed and, if so, whether regulation is the best way to deal with the concern. In deciding whether to make rules, we examine the potential costs and benefits of such regulatory intervention.'[85]

7.6 As this quote makes clear, the evidence-based approach requires a careful cost benefit analysis to be undertaken. ASIC appears to assume that the current proposals by AXE and Liquidnet will not increase aggregate bid-offer spreads and will not reduce the liquidity of securities markets. The bid-offer spread on the ASX market is the narrowest in the Asia-Pacific region. In assessing the costs and benefits, ASIC should have regard to, among other things:

- transaction costs and agency costs involved in the implementation of any regime, for example, liquidity search costs and the costs of supervisory oversight; and
- the diversity of interests of market participants (market participants are not uniform in their interests).

7.7 ASIC should also have regard to the broader policy implications of changes to the rules by which markets operate. For example, it should have regard to the implications of any rule changes for the 'market for control' – takeover activity – and the concerns that have

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83 Australian Government, *Rethinking Regulation: Report on the Taskforce on Reducing Regulatory Burdens on Business* (January 2006), chapter 7, 'Addressing the underlying causes of over-regulation' and Final Government Response (15 August 2006); and as embodied in the guidance given by the Commonwealth Government Office of Best Practice Regulation, *Best Practice Regulation Handbook* (Draft, November 2006).

84 Section 760A Corporations Act; section 1 Australian Securities and Investments Commission Act.

85 UK Financial Services Authority, *Principles-based regulation: Focusing on the outcomes that matter* (April 2007), p.3.

been articulated by expert bodies such as the Takeovers Panel on these rules. The Takeovers Panel has expressed views in relation to the removal of the '10 second rule'.[86]

- Pre-arranged trades are likely to be easier to effect (and to effect undetected) if the 10 second rule is abolished.
- There is a question as to whether the abolition of the 10 second rule makes it easier to avoid the statutory requirements of disclosure in section 671B(4) Corporations Act by using a crossing that purports to comply with the section 671B(5) requirements.
- Competition for control of the market may be reduced by reducing the opportunity for rival acquirers to bid for the crossing shares at higher prices than the market participant proposes to cross in-house.

7.8 ASIC has presented no evidence that the licensing of either AXE or Liquidnet will have a positive effect or will not have a negative effect. It should provide that evidence.

7.9 This approach is both consistent with and mandated by National Competition Policy – the framework document by which Australian Commonwealth and State and Territory Governments have agreed to structure the Australian market economy. National Competition Policy requires that the 'guiding principle' be implemented:

> 'The guiding principle is that legislation (including Acts, enactments, Ordinances or regulations) should not restrict competition unless it can be demonstrated that:
>
> (a) the benefits of the restriction to the community as a whole outweigh the costs; and
>
> (b) the objectives of the legislation can only be achieved by restricting competition.'[87]

7.10 Any regulation that is imposed by ASIC or the Minister should comply with this guiding principle and regulatory best practice.

International competitiveness

7.11 'It is now axiomatic in financial market regulation that international financial markets are interconnected.'[88] Capital flows and capital markets are global in nature. Securities exchanges operate in a global market. The SEC's recent testimony to the US Senate states:

> 'Today, no one would dispute that the capital markets are becoming increasingly global. As markets have evolved, innovations in technology have eliminated many physical barriers to market access, with the result that exchanges worldwide have pursued alliances and mergers in order to more effectively participate in the global exchange business.'[89]

7.12 By their nature, capital markets do not take into account national borders. Exchanges now consider themselves to be engaged in global competition. This fact is one of ASIC's greatest challenges in this consultation.

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86 Communication from Takeovers Panel.

87 *Competition Principles Agreement*, April 1995, clause 5.

88 Niamh Moloney, *Financial Market Regulation: Lessons from the EU*, Seminar Paper, Ross Parsons Centre of Commercial, Corporate and Taxation Law, University of Sydney Law School, 10 July 2007, p.23.

89 Written Statement of the US Securities and Exchange Commission, 'A Global View: Examining Cross-Border Exchange Mergers', Before the Subcommittee on Securities, Insurance, and Investment of the US Senate Committee on Banking, Housing, and Urban Affairs (12 July 2007).

> 'It is this seamless capital market, made possible by technology, that now, more than anything else, presses on financial regulators around the world.'[90]

7.13 The once dominant US securities markets have urgently called for regulatory and other reforms in response to the threats of international competition.

> 'Financial markets outside the United States are growing faster than domestic markets in terms of both depth and liquidity; international capital now has many competing locales into which it can flow. The dynamism and growth of some of these markets makes them inherently attractive, but capital flow decisions also reflect favorable developments in corporate competition and financial market regulation. Meanwhile, advances in technology and communications are freeing capital from the limitations of geographic boundaries and some of the need for financial services firms to locate their various businesses in the same place. Conditions are ripe for financing, risk management, and other financial services to shift from more mature and stable economies to emerging, more dynamic markets.'[91]

7.14 Karel Lannoo has noted that 'capital markets are increasingly interconnected and global, and rules which are seen to be too burdensome or protective will turn business away to other centres.'[92]

7.15 Any form or regulatory response must recognise that it has effects on the attractiveness of the local market compared to other financial centres. ASIC is in a form of 'regulatory competition' of its own, that recognises the mobility of capital and the already substantial ambit for competition among securities law systems.[93]

Substituted compliance

7.16 Regulatory competition is not the only possible response to global capital markets. There can also be a form of regulatory cooperation. One effect of the international connectedness of capital markets is increasing dialogue among regulators. A further effect is the willingness to mutually recognise the rules of other jurisdictions as being sufficient compliance with its local rules.

7.17 The SEC has indicated its interest in forms of selected bilateral mutual recognition treaties as a response to international portfolio selection and the recognition that capital markets are global.[94] The territorial principle – requiring foreign service providers to comply with US securities laws – would give way to a form of 'substituted compliance'. If the SEC is to recognise the Australian regulatory regime it will have to undertake a detailed examination of this jurisdiction's regulatory regime in order to determine whether it is a 'substantively comparable' form of regulation.[95] Comparability requires that the regime adequately addresses such matters as investor protection, fair markets, fraud, manipulation, insider

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90 Ethiopis Tafara and Robert J Peterson, 'A Blueprint for Cross-Border Access to US Investors: A New International Framework' (2007) 48 *Harvard International Law Journal* 31, p.31.

91 McKinsey, 'Sustaining New York's and the US' Global Financial Services Leadership' (January 2007) (the Schumer-Bloomberg report).

92 Karel Lannoo, 'MiFID and Reg NMS: A test-case for 'substituted compliance'?', *ECMI Policy Brief No.8*, Centre for European Policy Studies, July 2007.

93 Joel P Trachtman, 'Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation' in Daniel C Esty and Damien Geradin (eds), *Regulatory Competition and Economic Integration: Comparative Perspectives* (Oxford University Press, Oxford, 2001).

94 'SEC Announces Roundtable Discussion Regarding Mutual Recognition' (SEC Media Release 2007-105, 24 May 2007). The Roundtable was held on 12 June 2007. Video streaming of the Roundtable can be found at www.connectlive.com/events/secopenmeetings/.

95 Ethiopis Tafara and Robert J Peterson, 'A Blueprint for Cross-Border Access to US Investors: A New International Framework' (2007) 48 *Harvard International Law Journal* 31, p.32.

trading, registration qualifications, trading surveillance, sales practice standards, financial responsibility standards, and dispute resolution.[96]

7.18 One important measure of comparability is the treatment given by the local regime to ECNs and how it deals with the fragmentation of markets, and the consequent effects on price discovery and manipulation of markets.

Competitive reactions

7.19 Regulation is not a static process. A new regulatory regime will cause competitive reactions. ASIC must anticipate that, whatever regulatory regime is adopted, ASX will consider its legitimate competitive response. This very process of consultation may prompt ASX to change its operating rules, including rules dealing with crossings.

7.20 ASIC and the Minister must have regard to two particular matters when setting the regulatory regime.

- It would be contrary to competition principles and those of good regulatory practice to seek to prevent those changes as the CRAI Report recognises.[97] The response will be an efficient response.

- More generally, ASIC and the Minister should avoid putting into effect a form of 'regulatory competition' as described in a previous part of this submission. It should avoid the regulatory 'race to the bottom'.

7.21 The timing of any proposed regulatory regime should take into account the need to provide for competitive responses by ASX and should allow for further consultation with ASX in so far as there is the possibility that the licensed operations of AXE or Liquidnet could adversely impact upon the operations of the ASX market.

Regulation should take into account the actual market conditions in Australia

7.22 The fact that capital markets are global in nature does not mean that a regulatory regime from one jurisdiction can be transplanted, without modification, to another jurisdiction.

7.23 Each regulatory regime must be designed so as to have regard to the characteristics of the local jurisdiction. Those characteristics include the size of the market, the number and diversity of participants, and the quality and integrity of the existing market platforms.

7.24 The United States and European regulatory regimes have been the product of a lengthy consultation and design process and have evolved to meet the particular characteristics of their markets – one explanation for the very different approaches taken by each. As ASIC states, the 'Australian market for equity securities is different from those of either the United States or Europe'.[98] One instance of such differences, for example, is that the emergence of ECNs in the United States was, in part, a competitive response to the floor-based specialist market model of the New York Stock Exchange, providing enhanced (not diminished) pre-trade transparency and price discovery. Australian conditions, in particular the existence of a single CLOB, are fundamentally different.

Clear statutory base for acting

7.25 The requirement that ASIC and the Minister have a clear statutory base for implementing a regulatory regime has a number of features. The regulatory regime should not be

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96 Written Statement of the US Securities and Exchange Commission, 'A Global View: Examining Cross-Border Exchange Mergers', Before the Subcommittee on Securities, Insurance, and Investment of the US Senate Committee on Banking, Housing, and Urban Affairs (12 July 2007), p.4.

97 CRAI Report, p.27 (implications of 'competitive neutrality').

98 CP para 18.

'squeezed' into an inadequate current regime. The basis should be clear and beyond reasonable doubt. The failure to build a regulatory regime upon a clear statutory power is likely to lead to a loss of confidence in the regulatory structure and attempts by future participants to game the system. Both of these features are detrimental to the health of the financial system.

7.26 ASIC has suggested a number of statutory bases for dealing with the issues arising in the Consultation Paper. None of those statutory bases are sufficiently clear.

- Section 793A Corporations Act. This power is not to impose a specific regulation but, in accordance with the principles-based scheme in the Corporations Act, to identify the particular 'matters' which the licence holder must deal with. The specific way in which that is dealt with is left to the licence holder.
- Section 794A Corporations Act. The Minister's powers to issue a direction to a licence holder only applies when the licence holder is not complying with its obligations as a licence holder. This is a particularly problematic power in the current circumstances where, as the CRAI Report acknowledges, the operation of the AXE business will impact adversely upon the transparency and efficient operation of the ASX market.
- Section 796A Corporations Act. The power of the Minister to impose conditions upon a licence must have regard to the licence obligations of the holder of the Australian market licence. The Minister cannot be said to have regard to those obligations if he or she issues a direction that adversely impacts upon the ability of the licence holder to ensure that its own market is operated in a fair, orderly and transparent manner.
- Section 798B Corporations Act. This is merely a power to give the Minister advice.
- Section 798E Corporations Act. This power exists only in limited circumstances not relevant to these matters. There is no conflict between the commercial interests of ASX and its need to ensure that the ASX market operates in a fair, orderly and transparent manner.

The manner of implementing regulatory change

7.27 If there is to be a new regulatory regime, there needs to be statutory change to deal specifically with the issues raised by ECNs. The current statutory regime does not contain sufficiently clear powers and obligations to deal with the matters set out in this submission.

7.28 This submission has identified issues about where the regulatory regime is to be found. In the case of the best execution obligation, that might best be placed directly in the legislation so as to avoid a regulatory 'race to the bottom'. There may be other examples of where the approach of co-regulation is no longer tenable. Some of those issues may include, for example, short-selling and takeover related rules.

7.29 This submission has also identified a number of practical difficulties in relation to the implementation of a number of features of a new regulatory regime, for example, cooperation between ASX and another market. Once the outline of any new proposed regulatory regime has been articulated, further consultation and discussions between the relevant parties and ASIC should occur to ensure that these practical difficulties can be overcome in an efficient, cost-effective manner without adversely affecting the operation of the ASX market.

8 Other issues

Clearing and settlement

8.1 ASX makes its clearing and settlement services available to other market operators on commercial terms and will continue to do so. Neither AXE nor Liquidnet has requested clearing and settlement services, presumably because those functions will be performed by their respective market participants, who have and will continue to have access to the relevant services.

The implications of getting the rules wrong: worked hypothetical examples

CASE STUDY 1

The facts

A retail client instructs a broker who is both a participant of AXE and of ASX to purchase 100 shares in Company X for $1.00. The client does not specify on which market the securities are to be purchased.

At the time the order is placed with the broker ASX's central limit order book shows that the bid-offer spread for Company X is $0.99 and $1.00.

Some implications

- **conflict of interest**

The participant has a choice as to which venue to place the client's order. This equates to a choice as to which operating rules with which it wishes to comply. It can place the order on ASX's public market or decide to internalise the order (either against its own proprietary book or against another client sell order) and then report the executed transaction to AXE.

The participant's choice may be influenced by the participant's own interests rather than the interest of the client – given the participant is a major shareholder of AXE. This gives rise to a potential conflict of interest on the part of the participant.

- **investor protection**

If the participant places the order on ASX the client will receive the benefit of NGF protection.

If the participant places the order on AXE and the client suffers a loss there are no investor protection arrangements protecting the client (even in the event of the participant's fraud). The AXE compensation fund does not apply to losses if the loss may relate to the AXE ECN or to ASX and the retail client did not expressly or impliedly instruct the participant to use a particular market (see AXE rule 6.2.3(f)).

- **pre-trade transparency**

At the time that the client places its buy order with the broker it knows that the bid-offer spread on ASX is $0.99 - $1.00. The client therefore knows that if the order is placed on ASX it will be filled at $1.00 because of the operation of ASX's price/time priority rules.

There is no pre-trade transparency on AXE. The client therefore does not know what the bid-offer spread is on AXE. If the participant matched the order internally at $1.00 this would mean that the AXE seller (ie either the participant as principal or acting on behalf of another client or another AXE participant) will have "jumped" the price/time priority queue. The seller who has been sitting in ASX's public market at $1.00, contributing to the price discovery mechanism, will not have their sell order filled. Rather a sell order later in time would take priority.

If the participant was able to internalise the order at $0.99 then the client would be better off transacting on AXE rather than ASX but the benefit to the client would again come at the expense of someone else because the client would have jumped the price/time priority queue: there is already another purchaser in ASX's CLOB earlier it time who has been wanting to purchase the securities at this price whose order would remain unfilled. Because of the delayed reporting requirements on AXE, the ASX CLOB would no longer be a reliable source of price discovery. It would still be showing a bid-offer spread of $0.99 - $1.00 even though the latest sale of the securities was at 99 cents.

- **best execution**

If the best price is available on ASX then it is difficult to see how a participant is able to discharge its best execution obligations by placing the order on AXE.

Given the difference in applicable investor protection regimes, noted above, it is also difficult to see how a participant is able to discharge its best execution obligations by placing the order on AXE (which has inferior investor protection arrangements) even if a better price could be obtained on AXE.

- **post trade transparency**

If the order is placed on ASX the market will receive a report of the transaction immediately thereby contributing to timely and informed price discovery.

If the order is placed on AXE the release of post trade information relating to the transaction will occur later than it would on ASX. The market as a whole is therefore better off if the transaction is completed on ASX rather than AXE.

CASE STUDY 2

The facts

A retail client gives money to participant A and participant B and instructs them to purchase shares in two companies listed on ASX. Participant A and B are participants of both ASX and AXE. Both participants were going to transact on the AXE ECN rather than ASX. Before doing so, Participant A and B fraudulently misuse the money. Participant A then becomes insolvent. Participant B remains solvent.

Some implications

- **The retail client's loss is not covered by AXE's compensation fund**

Rule 6.2.3(f) of AXE's proposed operating rules specifically excludes the retail client's loss from the AXE compensation fund:

- the loss may relate to the AXE ECN or to ASX because the transaction is to purchase ASX listed securities and the transaction could be effected either on ASX or using AXE.
- the retail client did not expressly or impliedly instruct the participant to use a particular market.
- the use of a particular market is not reasonably apparent from the usual business practice of the participant when acting for that retail client. For example, this may be the first time that the retail client has instructed the participant to deal in securities. Even if the retail client is a regular client, compliance with the participants' best execution obligations must mean that the transaction may be undertaken either using AXE or ASX's market.

Thus, even though the client has been the victim of a fraud by the participant in connection with a transaction that was going to occur on AXE it cannot make a claim on AXE's compensation fund. What then are the client's options?

- **The loss caused by Participant A**

The retail client may have a claim on the NGF under Regulation 7.5.64(1). Each of the elements of Corporations Regulation 7.5.64(1) are potentially met:

- Participant A is a 'dealer' because they are also a participant of ASX: Corporations Regulation 7.5.03(3)(a).
- Participant A has become insolvent.
- Prior to becoming insolvent, property (money is property: Corporations Regulation 7.5.01) was entrusted to or received by the participant as trustee in the course of or in connection with its securities business.
- At the time that Participant A became insolvent the participant's obligations to the retail client in respect of the property have not been discharged.

This result means that the NGF may be available to provide compensation even though the transaction was going to be transacted by Participant A on AXE and not on ASX. While the NGF remains exposed to claims in these circumstances, it is ASX and not AXE that is exposed to potential levies under section 889J to replenish the NGF following any claim. Similarly, ASX participants who are not participants of AXE will be exposed to ASX passing these levies on to them under section 889K. In other words, it is ASX and ASX participants that are ultimately responsible for underwriting the potential wrongdoing.

This result cannot be overcome by amending AXE's operating rules. This is because it is also mandated by section 885D(2) – a provision drafted at a time when there were not multiple execution venues for the same securities. Section 885D(2) applies because:

- the retail client's loss satisfies the requirements of section 885C(1).
- the loss is "connected with" the ASX market within the meaning of section 888A(2) because it has been caused by a participant who is also a participant of ASX.
- the client did not expressly or impliedly instruct the participant to use AXE ECN or ASX.
- it is not reasonably apparent from the usual business practice of the participant (for the reasons noted above) which market the participant would use when acting for the client.

It therefore follows from section 885D(2) that 'the loss is taken not to be a Division 3 loss' ie a loss falling within the AXE compensation fund.

The client therefore only has 2 available options:

- make a claim on the NGF; or
- pursue recovery proceedings from the insolvent participant.

- **The loss caused by Participant B**

The loss is not covered by AXE's compensation fund for the reasons noted above.

The loss is also not covered by the NGF. Regulation 7.5.64(1) does not apply because Participant B is solvent. The NGF contract completion provisions do not apply because the participant has not entered into a reportable transaction as required by Corporations Regulation 7.5.26(1).

Accordingly, the client's only option is to take recovery proceedings directly against the participant.