

12<sup>th</sup> August 2007

Tracey Lyons  
Director, Markets Regulation  
Australian Securities and Investments Commission  
GPO Box 9827  
Sydney NSW 2001



Dear Tracey,

**Response to Consultation Paper 86 – Competition for market services – trading in listed securities and related data.**

I am a Chartered Accountant and Finance Director by occupation, with a keen interest in Australia's financial market structure through my direct investment in shares listed on ASX and indirect investment through my superannuation fund contributions. I am writing to express my concerns about the potential introduction of alternative execution venues for ASX listed securities. In forming an opinion, I have spoken to many other typical "mum and dad" investors and also to professional investors about the pros and cons of allowing alternative execution venues to compete for liquidity in ASX listed securities. I have also read the independent report written by CRA International and appointed by ASIC.

The main concern I have with permitting alternative execution venues to compete for execution of ASX listed securities, hence my concern with the AXE and Liquidnet proposals, is the negative consequences associated with fragmentation of the ASX liquidity pool. Fragmentation of ASX liquidity would pose substantial risk to investors and the Australian economy.

One of Australia's competitive advantages for attracting listings and capital in-flow is our efficient liquidity pool for trading in ASX listed securities. This liquidity pool offers a framework whereby listed companies receive the most attractive cost of capital. For example the recent listing of Boart Longyear (\$3 billion market cap) was fiercely contested on a global basis. ASX won the right to list this company. The major attractions of ASX as a listing environment are the efficiency of price discovery occurring on its exchange due to its central liquidity pool, the ability to offer the most attractive cost of capital for companies listing their securities, along with high transparency amongst all stakeholders.

A central liquidity pool with efficient price discovery also promotes confident participation by a wide class of investors, including attracting global order flow. Hence, the efficient liquidity effect builds on more liquidity and makes the process increasingly efficient. If liquidity of ASX listed securities was fragmented you would be potentially harming the efficiency and relevance of Australia's capital markets on a global stage. Australia needs to attract listings to remain globally relevant and also to give Australian investors the opportunity to invest locally in listed companies (especially with our growing superannuation pool). An efficient liquidity pool is essential for achieving this objective.

Fragmentation of liquidity poses a serious risk to the efficiency of the system and would increase the cost of capital for listed companies. The bid-ask spread would increase under a fragmented environment to compensate for the inefficiency of price discovery and added execution risk. Fragmentation of ASX liquidity would also increase transaction costs for investors in the form of higher market impact costs and introduction of liquidity search costs. Investors may not feel as confident under a fragmented liquidity model because they may not necessarily have access to all market liquidity. All these factors would compound the inefficiency problem associated with fragmentation.

With Australia's superannuation pool so important to every Australian citizen, I am cognisant of the need to ensure Australia's central liquidity pool is made as efficient as possible, with minimal execution costs for investors. Fragmentation of liquidity to alternative venues such as AXE and Liquidnet would reduce efficiency of price discovery, increase execution costs for investors, increase the cost of capital for listed companies and reduce ASX's relevance for attracting listings. It is interesting to note that my stockbroker has not reduced its standard brokerage fee over the past five years (\$32 for a \$10,000 trade), even though ASX exchange fees have fallen on a per trade basis over the same time period.

It is important to put any negative effect of fragmentation into context against the current wild volatility experienced as a result of the US sub-prime mortgage defaults and associated credit crunch. The Australian stock market has been extremely volatile, with many blue chip companies experiencing wild gyrations in price, both down and up. If ASX's liquidity pool was fragmented, the gyrations experienced would be much worse and liquidity may even temporarily evaporate for some stocks. This would have a significant impact on the investors who have taken out a margin loan to gear into shares listed on the ASX, of which I am considering. Investors with margin loans could be potentially faced with margin calls and/or a loss of their investment due to structural inefficiencies outside their control. Changing the market structure to allow fragmentation of ASX's liquidity pool would not encourage confident investing.

I genuinely believe the regulators (ASIC and the Minister) should decline the application by AXE and Liquidnet, in the current form, for executing trades in ASX listed securities.

An alternative proposition for the regulators to consider would be to distinguish between on-market and off-market trades. On-market trades are conducted during the hours of 10am and 4.10pm within ASX's central limit order book (CLOB). The efficiency of Australia's equity market is directly related to the amount of liquidity executed within ASX's CLOB. Therefore I believe any attempt to fragment ASX's on-market liquidity should be declined. The need to maintain efficiency within the CLOB is one of the reasons why ASX retains market rule 16.12. Approximately 90% of ASX trading occurs through the CLOB and many of the trades occurring in the CLOB actually include "crossings". However, approximately 10% of ASX trading occurs outside the CLOB, for example "special crossings" (crossing greater than \$1 million in value) and "overnight crossings". Competition for execution of trades occurring outside of the ASX CLOB may not necessarily affect the efficiency of price discovery within the CLOB. Therefore, competition could be considered for off-market transactions only.

The AXE licence application includes the ability for stockbrokers to "internalise" order flow that would otherwise end up in ASX's on-market CLOB. This idea of internalisation should be categorically rejected under the same efficiency and cost reasons for rejecting attempts to fragment ASX's on-market liquidity. Internalisation would also deny many Australians access to market liquidity and it would introduce favoritism and bias into order execution. This is in contrast to the ASX liquidity pool whereby access is available to all investors. A change of market structure towards internalisation would not create a fair or transparent environment for all investors in the Australian market place.

One important thing to consider is that the five brokers associated with AXE (Goldman Sachs, Macquarie Bank, Merrill Lynch, Citigroup and CommSec) represent approximately 50% of the market for facilitating trades in ASX listed securities. Therefore, if they were allowed to internalise on-market volume, or create an exclusive liquidity pool amongst themselves, this could potentially remove 50% of the on-market volume from ASX's central limit order book. Orders residing within ASX's CLOB would be at an obvious disadvantage. This situation would not be acceptable to Australian investors and would damage ASX's competitive advantage for attracting listings, its efficient liquidity pool.

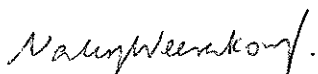
In addition, fragmentation of ASX's "on-market" volume would mean that the stockbrokers are now controlling the liquidity. Under the present ASX central liquidity structure, the investors are controlling the liquidity. Investors have the choice over which stockbroker they establish a relationship with because all the stockbrokers are competing on an equal footing. No matter which stockbroker an investor decides to become a client of, every investor will have access to all market liquidity through ASX's central liquidity pool. Under the structure proposed by AXE, investors may have to become a client of a stockbroker aligned with AXE in order to get access to internalised liquidity in certain stocks, for example secondary market trading in broker sponsored floats.

One of the fundamental characteristics of ASX's "on-market" central limit order book is that price and time priority for execution is standard for every investor. This standardisation of "best execution" for whole of market liquidity would not exist under the multi-venue environment being proposed by AXE and Liquidnet.

As part of the submission process an independent body, CRA International, was appointed by ASIC to consider the business cases of AXE and Liquidnet. As can be seen from the statements made within the independent report, fragmentation of ASX liquidity and internalisation of ASX liquidity by stockbrokers can have serious implications for the efficiency of the Australian market. Fragmentation of ASX liquidity would reduce the efficiency of price discovery, increase market impact costs, increase execution risk for investors, introduce execution favoritism and preferencing, impede investor access to all market liquidity, introduce liquidity search costs and increase price volatility. All these factors would directly affect the efficiency of the Australian economy.

Australia has the most efficient liquidity structure already in place, with a central liquidity pool structure. We do not need to change it, especially given there are so many risks and disadvantages associated with a fragmented liquidity model. On public interest and national interest grounds, Australia should reject the idea of internalisation and fragmentation of ASX's on-market CLOB, and decline the applications by AXE and Liquidnet in their current form.

Yours sincerely



Nalin Weerakoon CA

22 Mahratta Avenue, Wahroonga NSW 2076

Disclosure:

I own a portfolio of blue-chip stocks, including 2,040 ASX shares and a Perpetual managed fund that may have an interest in ASX shares.

cc:

The Honourable Chris Pearce MP

Mr Wayne Swan MP

Mr Graeme Samuel, Chairman ACCC

Mr Robert Elstone, Managing Director & CEO ASX Limited.