



**ASIC**

Australian Securities & Investments Commission

CONSULTATION PAPER 95

# Competition for market services—response to CP 86 and further consultation

November 2007

## About this paper

This paper summarises the responses to Consultation Paper 86 *Competition for market services—trading in listed securities* (CP 86) and sets out our proposals on the appropriate regulatory structure in a competitive market environment. ASIC seeks further feedback on those proposals.

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Document history

This paper was issued on 21 November 2007 and is based on the Corporations Act as at 21 November 2007.

### Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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## The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information. We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on competition for market services. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Business Cost Calculator Report and/or a Regulation Impact Statement.

### Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 29 January 2008 to:

Tracey Lyons  
 Director, Markets Regulation  
 Australian Securities and Investments Commission  
 GPO Box 9827  
 SYDNEY NSW 2001  
 email: [tracey.lyons@asic.gov.au](mailto:tracey.lyons@asic.gov.au)

### What will happen next?

<b>Stage 1</b>	21 November 2007	ASIC consultation paper released Discussions with key stakeholders
<b>Stage 2</b>	29 January 2008	Comments due on the consultation paper Consideration of responses and development of preferred regulatory approach
<b>Stage 3</b>	February 2008	Advice to the Minister

## A Background

### Key points

In July 2007 ASIC issued Consultation Paper 86 *Competition for market services—trading in listed securities* (CP 86) and related data. CP 86 considers applications for market licences from AXE ECN Pty Ltd (AXE) and Liquidnet Australia Pty Ltd (Liquidnet).

Overall, respondents supported competition in Australian financial markets. However, there were differing views about aspects of the rules for competition.

ASIC believes that mechanisms need to be put in place to maintain market integrity in a multi-venue environment.

ASIC is consulting on proposals for those arrangements before we finalise advice to the Minister on the AXE and Liquidnet applications.

- 1 ASIC's role in the markets licensing process is to receive an application for a licence and provide advice about it to the Minister: s795A. The Minister is the decision maker, and must take into account a range of specific factors—ASIC's advice, the public interest and any other matter the Minister thinks relevant: s798A(2).
- 2 In considering an application and formulating our advice to the Minister, we take into account:
  - (a) whether the applicant is able to meet all of the statutory obligations of a financial market set out in Part 7.2 of the Corporations Act; and
  - (b) the likely impact of the new market on the overall operation of Australian financial markets.

### CP 86

- 3 ASIC issued Consultation Paper 86 *Competition for market services—trading in listed securities* (CP 86) and related data in July 2007. CP 86 was accompanied by an economic analysis prepared by CRA International Limited. CP 86:
  - (a) described the applications for market licences lodged by AXE ECN Pty Ltd (AXE) and Liquidnet Australia Pty Ltd (Liquidnet);
  - (b) set out ASIC's approach to dealing with those applications; and
  - (c) asked for comment on this approach.

- 4 We received 29 responses to the consultation paper: see Appendix 1 for a list of non-confidential respondents. These public submissions are available on our website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp).
- 5 Our approach to competition for market services, described in CP 86, is based on three key principles, namely:
- (a) competition for markets services is, in principle, desirable;
  - (b) the entry of competitors for market services should not result in a decline in the existing quality and integrity of the market for securities that trade on more than one licensed market; and
  - (c) the regulatory regime should set the minimum conditions that will allow competition to develop, where it is efficient and therefore without adverse effects on the market as a whole.
- 6 Respondents to CP 86 agreed that these are the relevant principles that should guide ASIC's thinking about competition for market services, and about the AXE and Liquidnet applications.
- 7 The responses to CP 86 have been helpful in confirming our overall approach. However, if markets like AXE or Liquidnet are to operate in Australia, there need to be regulatory mechanisms in place to ensure that:
- (a) the overall market operates in a fair, orderly and transparent way; and
  - (b) there is an appropriate market supervision framework to maintain market integrity.
- 8 CP 86 identified the need for these mechanisms but did not canvass details of what mechanisms were required and how those mechanisms could be established. This consultation paper identifies some proposed mechanisms and asks for comments on these proposals: see Section C.

## **This consultation paper**

- 9 Based on our consideration of the applications and the material provided through the consultation process to this point, we have concluded that mechanisms must be put in place to maintain market integrity in a multi-venue environment.
- 10 The consultation process has helped us to develop our thinking on the issues that arise from the AXE and Liquidnet applications. Competition for market services is workable, provided that some rules are in place about the operation of the competing markets.
- 11 Before we finalise any advice to the Minister, we need to be satisfied that rules can be put in place and to settle the details of:

- (a) the mechanisms needed to deal with the key issues that arise from there being more than one licensed market that provides a trading venue for ASX-listed shares; and
  - (b) the way to put those mechanisms in place as part of the market licensing process.
- 12 In our view, these issues need to be dealt with before competing market venues are permitted to operate. ASIC will not be in a position to recommend that the Minister grant market licences to AXE and Liquidnet unless workable rules can be implemented.
- 13 Our aim is to create a clear and certain regulatory environment for ASX and the current applicants, as well as any other market operators who might want to operate a competing market venue in the future. This is consistent with the principles-based approach in the *Corporations Act 2001* (Cth) (Corporations Act).
- 14 In light of these considerations, we are consulting further before we settle our final views on these important issues:
- (a) in Section B of this paper, we discuss and comment on the submissions we received in response to CP 86; and
  - (b) in Section C, we describe:
    - (i) the remaining unresolved issues and the reasons they require a regulatory response;
    - (ii) our proposals for mechanisms for dealing with them; and
    - (iii) the way we think they should be put in place.

## ASX's submissions on CP 86

- 15 The views of the ASX group (encompassing both the ASX and SFE markets) are important in our consideration of competition for market services and for the development of any advice ASIC gives to the Minister. ASX provided a detailed submission in response to CP 86 and a further supporting document to its first submission. These submissions are publicly available on our website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp).

Note: As well as referring to ASX's views in Section B, we have summarised the main points of ASX's submissions and our response to them in Appendix 2 of this paper.

- 16 CRA International has reviewed the ASX submissions and ASIC's response to those submissions: see appendix 3.

## Changes to aspects of AXE's proposed market

- 17 AXE has made some changes to its proposal in light of the responses to CP 86. In particular, AXE has agreed to:
- (a) remove the proposed delay of up to 3 days that might have been allowed under its draft operating rules for broker-facilitated trades on its market; and
  - (b) include operating rules requiring disclosure by participants to their clients of the relevant differences in AXE's Division 3 compensation arrangements and the NGF. AXE also proposes to add to its own scheme the coverage of losses where neither the NGF or AXE Division 3 arrangements apply but the loss would have been covered by the NGF if it had arisen at a time when ASX was the only execution venue.
- 18 AXE has also indicated to ASIC its willingness to consider further changes to its market in response to our proposals in this paper. For example, when ASIC issued CP 86, AXE's proposal did not include any rules or structures for pre-trade transparency on the market. Nor did the proposal include any form of limitation on the types of transactions that can be done on the market without any pre-trade transparency.

Note: For our proposal on a pre-trade transparency requirement, see Section C.

## B Feedback on CP 86

### Key points

This section considers the submissions ASIC received in response to CP 86 and our response those submissions on the following topics:

- legislative framework;
- desirability of competition;
- market quality—including post-trade transparency, trade reporting and data consolidation; and pre-trade transparency;
- market integrity—including market supervision framework, best execution obligations and conflicts of interest; and
- operation of the National Guarantee Fund and compensation arrangements.

### Legislative framework

19 In CP 86, ASIC said that it is not necessary to amend the legislative framework to accommodate the types of markets proposed to be operated by AXE and Liquidnet.

20 The only respondent to comment on this part of CP 86 was ASX.

21 In its submissions, ASX argues:

- (a) the activities AXE proposes to carry on do not amount at law to the operation of a market for which a licence can be granted;

Note: ASX says that this view is based on its analysis of the information that ASX has available to it about the AXE facility and how it will operate.

- (b) a new or significantly amended legislative regime is needed to allow for the operation of multiple competing markets, and that a substantial consultation process is required in order to develop and implement a new regime.

### ASIC's response

22 We are not persuaded by either of the propositions advanced by ASX.

23 The view expressed in CP 86 reflects our opinion that:

- the Corporations Act regime reflects the principle of competition for market services and allows for the licensing and operation of multiple market venues;

Note: The Explanatory Memorandum to the Financial Services Reform Bill, at paragraph 1.7, said that the FSR Bill would put in place a simplified authorisation process for market operators and clearing and settlement facilities. The new regulatory regime provides a flexible and adaptable framework that encourages innovation and competition in markets and clearing and settlement facilities.

- issues raised by the AXE and Liquidnet applications can be appropriately dealt with by using mechanisms available under the existing legislation, such as the regulation making power, the Minister's power to impose conditions on markets licensees, and the power to impose conditions on holders of Australian financial services (AFS) licences.

### **Is the AXE facility a financial market?**

- 24 The Corporations Act definition of 'financial market' is broad and applies to a variety of ways of organising facilities for trading in financial products. In Regulatory Guide 172 *Australian market licences* (RG 172), ASIC has said that in determining whether an activity falls within the scope of the definition, we will have regard to the object and purpose of the market regulation provisions, which are to protect market users, and enhance market integrity and financial system stability.
- 25 In ASIC's view, it is open to us and to the Minister to treat the AXE proposal as a financial market that can be licensed under the Corporations Act.
- 26 This is on the basis that, within the broad terms of the legislation, the AXE arrangements taken as a whole amount to a facility for trading in financial products, and it is through this facility that offers to acquire or dispose are regularly made and accepted. In ASIC's view, AXE's system of rules indirectly facilitates the acquisition and disposal of financial products by means of offers regularly made or accepted. This is sufficient to conclude that the AXE system is a facility through which, indirectly, acceptance of offers to buy or sell financial products is made.
- 27 ASIC notes the alternative construction referred to by ASX that each participant on AXE is separately conducting a separate financial market and each needs a separate market licence. ASIC agrees that, were it not for the existence of an AXE market, each participant may separately need a market licence, just as ASX participants carrying out crossings may each need a licence were those transactions not effected within the franchise of, and in accordance with the rules of, the ASX market.
- 28 To prefer the alternative construction would arguably impose significant regulatory burdens on participants, without any corresponding benefit for the integrity of the market or the protection of those who use it. In ASIC's view,

the licensing regime in the Corporations Act was not intended to produce that result.

### **Is new legislation required?**

- 29 Parliament's intention in introducing financial services reform was to provide for a flexible and scalable approach to markets regulation that is principles based, rather than prescriptive or based on narrow assumptions about the type of market. The regulatory regime under Part 7.2 of the Corporations Act also envisages that the regime can be adapted by tools such as licence conditions and regulations, as an adjunct to the statutory obligations of a market licensee as set out in Part 7.2.
- 30 Provided that regulatory and supervision arrangements of the type we describe in this paper can be put in place, ASIC is satisfied that markets like AXE and Liquidnet can be licensed to operate under the current legislative settings.

## **Desirability of competition**

- 31 In CP 86, we said competition for market services, especially execution services, is in principle desirable including because of its potential to:
- (a) reduce transaction costs for market participants and users and increase efficiency;
  - (b) cater effectively for different trading preferences of market participants and promote flexibility; and
  - (c) create incentives for innovation in the provision of market services.
- 32 We were and remain mindful that central to achieving these benefits is the continuing integrity and quality of our market
- 33 Respondents supported ASIC's key principle that competition for market services is desirable, because entry of new operators is expected to lead to greater variety in trading opportunities as well as innovations in technology and services. The Australian Competition and Consumer Commission views the emergence of competition as likely to be a welfare-enhancing development for the Australian economy. Respondents also noted that the market for ASX-listed securities is already somewhat fragmented, with trading in these and related instruments currently occurring away from the ASX.
- 34 Six respondents opposed competition for trading in ASX-listed securities. They are concerned about potential adverse effects on the operation and efficiency of ASX's central limit order book (CLOB).

## Fairness of competition

- 35 ASX argues that the efficiency and quality of its market should not be undermined by unfair competition, and that the markets proposed to be operated by AXE and Liquidnet could have this consequence. ASX argues that AXE's proposal in particular is unfair competition in that orders within its market would not necessarily be subject to a competitive price discovery process.

## Dark pools

- 36 ASX and five other respondents have also said that the operation of markets like AXE and Liquidnet will encourage the growth of so-called dark pools of liquidity, which will have a detrimental effect on the overall quality of the market.
- 37 Other respondents remarked that there is currently very little or no pre-trade transparency in the current ASX crossings market.

## ASIC's response

- 38 One of ASIC's basic principles expressed in CP 86 is that competition for market services should not result in a decline in the existing quality and integrity of the market for securities that trade on more than one licensed market.
- 39 In CP 86, we recognised ASX's market as the benchmark for the current level of quality and integrity. However, this does not mean that ASX should be protected from competition for trading services, as the way of achieving that quality and integrity. Quality and integrity across the whole (expanded) market is the key factor that should be preserved.
- 40 ASIC does not accept the proposition that any market that is allowed to operate in competition with ASX should be required to substantively replicate or mirror the ASX model in order to be considered 'fair' competition.

Note: For a more detailed description of ASX's submissions and ASIC's comments on them, see Appendix 2.

- 41 ASIC's proposals, particularly those about pre-trade and post-trade transparency, are designed to ensure that some limited trading away from a fully transparent market can occur without that trading having a negative impact on the overall quality of the market. Our proposals contemplate that some non-transparent trading can continue to take place on the ASX crossings market, as well as on other markets.
- 42 The proposed limitation on trading without pre-trade transparency will ensure that dark pools cannot develop to the extent that a significant amount

of trading is occurring away from a fully transparent market. This approach is consistent with ASIC's acceptance of arguments put to us that pre-trade transparency can result in increased market impact costs for some types of trading.

- 43 In our view, the proposals we outline below in greater detail adequately address the competition issues ASX has raised. It is difficult to envisage another model (apart from making the competing markets homogenous) that would meet ASX's expectations about competition.

## Overall market quality

- 44 In CP 86, we said our central concern is the continuing quality and integrity of the market for trading in those securities that are listed on ASX, whether they are traded on ASX or elsewhere. We pointed to the importance of liquidity and price discovery in preserving or enhancing existing market quality.

### Post-trade transparency, trade reporting and data consolidation

- 45 In CP 86, we suggested that, where there are multiple trading venues for the same securities, appropriate levels of post-trade transparency are critical for maintaining the existing level of overall market quality.

- 46 Respondents agreed that post-trade transparency by all market venues was critical to ensuring that security prices reflect the latest information.

- 47 On the issue of data consolidation, respondents felt that commercial arrangements between data vendors, market venues, and end users would be sufficient to ensure any consolidation needs would be met. So there was no need for this process to be guided by regulators.

### Trade reporting

- 48 Both AXE and Liquidnet, along with a number of respondents, say that ASX Market Rule 16.12.1 has the effect of prohibiting transactions in ASX-listed securities on any other market, as the rule requires sales of cash market products, crossings and special crossings of cash market products and certain types of transactions defined in the market rules to be reported to ASX.

- 49 In its submission, ASX takes the contrary view that the rule does not prohibit transactions on other markets: it merely requires the transaction to be reported to ASX, as well as to the market on which the transaction took place.

### **Delayed reporting**

- 50 Respondents highlighted a proposed difference between the reporting requirements on ASX and AXE for broker-facilitated crossings where a broker takes a position as principal. Under the proposed AXE rules, this type of transaction could be reporting up to 3 days after it took place, so as to allow the broker an opportunity to unwind any position it took in order to facilitate the client.
- 51 ASX rules also currently permit delayed reporting of certain types of transactions, but the reporting delay is much less than 3 days.
- 52 AXE anticipates broker-facilitated trades would account for a small percentage of the overall trades on its market. However, following further discussions with ASIC and in light of the views expressed in the responses to CP 86, AXE has decided to align its delayed reporting rules to those of ASX. This means the proposed reporting delay of up to 3 days has been removed.

### **ASIC's response**

#### **Trade reporting**

- 53 As indicated in CP 86, ASIC accepts that ASX Market Rule 16.12.1 serves a valid regulatory purpose.
- 54 However, subject to resolution of the inter-connecting issues about reporting of trades and the operation of the National Guarantee Fund described later in this paper, it is not clear that in a multi-venue environment, there is continuing regulatory benefit in requiring a transaction that occurs on one market to be reported to that market, and simultaneously to another market. This would also impose cost and burden on market participants. Post-trade transparency can arguably be provided as, or more, effectively by other means.
- 55 Aspects of existing ASX rules that were formulated when, and arguably on the assumption that, market trading in ASX-listed securities would only take place on an ASX market may need to change in an environment in which trading in ASX-listed securities can take place on more than one licensed market.
- 56 For example, it is arguable that Market Rule 16.2.1 may be inappropriate in this environment, insofar as it purports to prevent an ASX participant from conducting cash market transactions (a term that includes trades in ASX-listed securities) other than on an ASX trading platform. It is hard to see the basis for retaining this rule as it would apply to an ASX participant who was, at the same time, a participant in another licensed market such as AXE's market.

57 If AXE and Liquidnet are granted market licences, ASIC will ask ASX to amend the operating rules that restrict trading in ASX-listed securities to the ASX platform and the rules that require reporting of all transactions to ASX, even if the trades occur on another licensed market.

58 It may also be open to the Minister to give a direction to ASX to change its operating rules, on the basis that in the absence of rule changes, aspects of the operation of the market may no longer be fair, orderly and transparent.

59 Alternatively, ASIC will request ASX to articulate its enforcement policy in relation to its rules in circumstances where participants conduct trades on licensed markets other than ASX, and/or do not report those transactions to ASX.

60 It may also be open to parties who are aggrieved or feel they are unduly restricted by the operating rules of a market to take this matter up with the ACCC. ASIC has not explored this issue with the ACCC.

#### **Delayed reporting**

61 ASIC agrees post-trade transparency is vital to ensuring that market prices fully reflect available information, and that uniform standards for delayed reporting of the same types of transactions should apply to all market venues.

#### **Data dissemination and consolidation**

62 ASIC had useful discussions with several market information vendors during the consultation period. We accept that commercial interests will likely be a sufficient driver to ensure that market data is made available to end users in the format required by those users. The market information vendors have indicated that they will respond to the demands of their customers in a multi-venue environment by providing consolidated and collated market information.

### **Pre-trade transparency**

63 In CP 86, we said that, where there are multiple trading venues for the same securities, appropriate levels of pre-trade transparency are critical for maintaining the existing level of overall market quality, but that full pre-trade transparency may not be essential at the time competing markets commence.

64 Wholesale investors and brokers noted that not being subject to mandatory pre-trade transparency was a key attraction of the proposed alternative market venues. They argued that ASX priority and off-market crossing rules are too restrictive and unfairly limit investors' trading options. Currently on

ASX, crossings account for approximately 31% of market turnover, of which 16% are on-market crossings and 15% are off-market crossings.

65 Pre-trade transparency can result in information leakage and substantial market impact costs, and large traders typically do not go through with much of the trading that they may otherwise undertake. Institutional investors noted that it is not just information leakage to the broader market that is a concern, but also leakage to intermediating brokers.

66 On the other hand, some commentators argued that pre-trade transparency is useful for a broker to be able to demonstrate that best execution has been achieved for a client. By first advertising a client's trading interest by revealing their order, a broker can be certain that all avenues to find a counterparty are exhausted. These comments are pertinent to the discussion about best execution following in this paper, particularly since no express best execution obligation applies to intermediaries under the current Corporations Act.

67 Other respondents noted that by being able to view best-priced bids and offers, investors are able to independently verify the prevailing market prices for securities. However, even on the ASX market, the ability to view best priced bids and offers before a transaction takes place is limited to bids and offers in the CLOB and on-market crossings.

68 Some commentators argued that less pre-trade transparency will result in a less efficient market and a wider bid-ask spread, with trades by uninformed traders being 'cherry-picked' in internal crossings. ASX further argues that, if other market venues do not have the same pre-trade transparency standards as ASX, these competing venues would be able to free-ride on the information being generated in the ASX market, and so execute transactions at best prices without making a contribution to the price discovery process. ASX believes that all markets must be subject to the same pre-trade transparency standards, with opaque transactions only allowed for high value trades, for example the types of trades that take place as ASX off-market crossings.

69 Counter to this, a number of respondents argued that this type of free-riding does not occur, since ASX charges fees to users to access information on prevailing bid and offer orders currently in its market. Because this data is made available on commercial terms, the free-riding issues do not arise.

### **ASIC's response**

70 Pre-trade transparency is important from two perspectives:

- it contributes to the quality of price formation across the market as a whole; and

- in a multi-venue environment, it enables a participant to meet best execution obligations to clients, particularly where best price is of paramount importance to the client (as opposed to the other elements of best execution discussed later in this paper).

- 71 The inherent difficulty in the AXE proposition, at the time CP 86 was released, is that at any point in time there may be a better price somewhere else in the AXE market than a participant is able to provide to its clients when it matches a buyer and a seller. The only other price reference point for the participant is the price on ASX. In the absence of any form of pre-trade transparency in the AXE market, a participant will not be able to know about or access the prices at which other AXE participants might have willing buyers or sellers. Some respondents say this is currently the case in parts of the ASX crossings market.
- 72 Pre-trade transparency is less of an issue in the context of the Liquidnet market, as the participants in that market are trading as principal and are able to make their own decisions about where and with whom to trade, and at what price. There are no intermediaries in the proposed Liquidnet market.
- 73 ASIC is not persuaded there should be a requirement for pre-trade transparency on all markets in all circumstances. Prohibiting non-transparent trading would constrain trading options open to investors. It is clear from the responses to CP 86 that mandatory pre-trade transparency is good for some traders but negative for others, precisely because some investors benefit from the information disclosed by other investors revealing their trading intentions before execution occurs. Wholesale investors in particular highlighted this as a concern, due to the information leakage and market impact costs that often result from having to make their trading intentions known beforehand. Respondents indicated that in some cases the costs are so high that the trading does not occur at all.

## Market integrity

- 74 In CP 86, we said that, in a multi-venue market environment, it is critical to preserve or enhance integrity by effectively protecting against any added risk of market abuse in a multi-venue environment. In particular, we said that the overall integrity of the market as a whole must be maintained through:
- effective working arrangements for whole-of-market supervision; and
  - ensuring the emergence of multiple market venues does not detract from intermediaries' best execution obligations to their clients.

## Market supervision framework

- 75 In CP 86, we said comprehensive, cross-market supervision arrangements will be needed to preserve the existing level of market integrity. We outlined what we see as the minimum elements of the market integrity framework, including the need for effective supervision arrangements between market operators, as well as with ASIC, to regulate the conduct of market participants and listed entities.
- 76 Apart from the ASX, market operators were confident that appropriate market supervisory arrangements could be put in place through a network of Memoranda of Understandings and information sharing agreements. ASX expressed reservations about how this will work in practice and who will bear the costs of supervision.
- 77 ASX has concerns as to effectiveness of market supervision arrangements in a competitive environment. While market operators might be willing to enter into information sharing arrangements to ensure adequate market supervision, there are likely to be a number of practical difficulties with this, such as technological incompatibilities, competitive tensions, and discrepancies in operating rules and procedures.
- 78 ASX argued that the existence of multiple market venues for ASX-listed securities would undermine the co-regulatory framework that currently exists in terms of ASX's role as a front-line supervisor of market participants.
- 79 ASX suggested that a review of the statutory settings for market regulation might be needed, including the role of a market operator and the regulator. A few other respondents supported this, in the context of the perceived conflict of interest in ASX continuing to supervise its market in a for-profit environment.

## ASIC's response

- 80 ASIC does not consider these concerns mean AXE and Liquidnet should not be able to obtain market licences under the current Corporations Act framework.
- 81 Market licensees are obliged, to the extent that it is reasonably practicable to do so, to do all things necessary to ensure their markets are fair, orderly and transparent: s792A(a). In a multi-venue environment, the fairness, orderliness and transparency of a market operated by one licensee will, to some degree, depend on the fairness, orderliness and transparency of the whole market in those securities. In ASIC's view, this provides an appropriate basis for cooperative arrangements between different market licensees.

- 82 Some practical matters need to be worked out in setting up cross-market supervisory arrangements, including the fair sharing of regulatory burdens. ASIC remains confident that appropriate arrangements can be implemented.
- 83 In any event, we would recommend to the Minister not to grant licences to AXE and Liquidnet, or that they not be permitted to start operations, until these arrangements are in place.
- 84 As practical examples, ASX, AXE and Liquidnet will need to have cooperative arrangements in place to investigate conduct and exchange information about potential manipulation activity involving trading across markets. Other situations could arise where one market supervisor could become aware of problems through its own monitoring in advance of the other market operator, such as prudential concerns affecting a common participant. There must also be arrangements in place to deal with the suspension of trading in listed companies by ASX and the timely provision of this information to AXE and Liquidnet.
- 85 Cross-market supervision arrangements are not a novel concept. ASX has previously entered into supervisory-based arrangements with other market operators—for example, with NSX in relation to common participants, and with SFE in relation to the supervision of trading in individual share futures. There is also an MOU between the clearing houses of ASX and SFE (entered into before the merger of the entities in July 2006).

## Best execution and conflicts of interest

- 86 In CP 86, we pointed out that in a multi-venue market environment, some intermediaries will have a choice of the market venue on which they execute client orders. This makes it essential for there to be a clear ‘best execution’ rule, and an effective means of monitoring compliance with it.
- 87 The responses to CP 86 indicate support for the introduction of a best execution obligation in a multi-venue environment. A number of respondents who are market participants suggest their business models for dealings for clients already include the best execution concept.
- 88 There is a connection between pre-trade transparency and best execution. Where best price is the paramount concern for a client, some degree of pre-trade transparency is required to ensure that a broker fulfils their best execution obligations.
- 89 The extent of internalisation of orders by brokers that would be allowed under AXE’s proposed market model was of particular concern to some respondents, particularly retail users. They are wary of the potential conflicts

of interest that brokers might face if they are free to internalise significant volumes of trades.

- 90 Where a client has not given an instruction about which market venue is to be used to execute an order, multi-venue participants may face significant conflicts of interest in choosing where to direct orders. This is especially the case where market venues will likely be aggressively competing with one another to attract orders.

### **ASIC's response**

- 91 Best execution should not be strictly defined as best price. Other factors could be important for a specific transaction, such as transaction costs, market impact costs, or time constraints for filling the complete order. Because of the need for flexibility to meet client requirements, an overly prescriptive definition of best execution should not be embedded into the Australian regulatory regime. This is consistent with the approach under MiFID in Europe.
- 92 ASIC acknowledges the potential for conflicts of interest where brokers are subject to direct and indirect inducements by market venues competing to attract order flow. Even if a market venue has rules that govern how such conflicts of interest are to be handled, the difficulty is that the jurisdiction of one market venue does not extend to trades executed on other market venues. A market operator may not be able to enforce its operating rules in relation to activity that occurs on another market.
- 93 So, rather than having a general and separate best execution obligation in the operating rules of each competing market, we think a best execution obligation should be imposed directly on brokers where they are participants of more than one market that trades ASX-listed securities.
- 94 Market licensees have an obligation to monitor the conduct of participants on or in relation to the market: s792A(c)(ii). Supervision of other aspects of the obligations of Australian financial services (AFS) licence holders sits with ASIC.
- 95 It may be desirable to introduce an additional regulatory requirement about the content of a market's operating rules, such that market operators are required to set out the manner in which best execution will be enforced and supervised through their market.

## The operation of the National Guarantee Fund (NGF) and compensation arrangements

- 96 CP 86 did not deal with the operation of the NGF and other market operators' compensation arrangements in a multi-venue environment.
- 97 Submissions by ASX and Securities Exchange Guarantee Corporation Ltd (SEGC) highlighted some uncertainties regarding the NGF and compensation regimes that need to be resolved:
- (a) there is potential for some transactions not to be covered by either ASX's or any other market operators' compensation regimes because of the way some provisions of the Corporations Act currently operate;
  - (b) in some situations, the NGF may be responsible for paying out compensation for activities conducted on other markets; and
  - (c) ASX Market Rule 16.12.1 has an important role to play in ensuring that a transaction is covered by the NGF, and therefore any attempt to delete this rule may 'switch off' a client's coverage.

### ASIC's response

#### Requirement to have compensation arrangements

- 98 The NGF is the compensation regime applying to the ASX market. It operates in accordance with the provisions of Division 4 of Part 7.5 of the Corporations Act.
- 99 Other market licensees are required either to have a compensation arrangement approved by the Minister under Division 3 of Part 7.5, or become a member of SEGC which administers the NGF. By becoming a member of SEGC, the market operator is bound by the NGF requirements, and transactions that occur on the market have NGF coverage.
- 100 AXE must have an approved compensation arrangement because participants on its market will provide financial services for retail clients: s881A(1)(a). Liquidnet is not required to have an approved compensation arrangement because its users trade as principal and there is no retail participation.

#### Heads of claim for compensation

- 101 Under s885D of the Corporations Act, a loss suffered by a client can be excluded as a Division 3 loss if:
- it is also connected with a financial market to which the NGF applies;
  - the client did not either expressly or impliedly instruct the participant to use a particular market; and

- it is not otherwise apparent from usual business practice which market would be used.

102 AXE has drafted its compensation arrangements to meet the minimum requirements of Division 3 compensation arrangements, and the AXE market will operate in such a way that clients would not ordinarily direct their broker to execute via ASX or AXE. It could be the case that a client might instruct a broker to use one market in preference to another as part of that client's instructions about best execution.

103 The NGF provides contract guarantee protection (under subdivision 4.3 of the Corporations Regulations 2001) for those transactions that must be reported to ASX by the dealer.

Note: ASX Market Rule 16.12.1 is the reporting rule that establishes this nexus.

104 NGF also provides compensation for loss where a dealer transfers securities without authority (under subdivision 4.7 of the Corporations Regulations), and compensation for loss if a dealer becomes insolvent in respect of a person's property entrusted to it (under subdivision 4.9 of the Corporations Regulations).

105 ASX argues that if Market Rule 16.12.1 was removed as requested by AXE, then there would be no NGF coverage for both AXE and ASX transactions under subdivision 4.3. Furthermore subdivisions 4.7 and 4.9 appear to be drafted in such a way that claims can be made on the NGF for losses even if those losses relate to another market.

106 SEGC may levy either member market operators or participants of these markets (or a class of), if the minimum amount of the NGF falls below the amount required by s889I of the Corporations Act (currently \$80 million). The market operator, if levied itself, may itself impose a contributory levy on participants. In the context that it is possible claims related to AXE's market might be made on the NGF, ASX has suggested that it is inequitable that neither AXE nor its participants are able to be levied directly as participants of AXE.

#### **Is there a 'gap' in compensation arrangements?**

107 On our analysis, the legislation contemplates that a person who is a participant of two markets might have access to two compensation schemes. This is the result of s885D of the Corporations Act. This conclusion is supported by the Explanatory Memorandum to the Financial Services Reform Bill. Also the premise of s885D(2) of the Corporations Act is that, to the extent that there is the possibility of double recovery from a Division 3 (e.g. AXE) and a Division 4 compensation scheme, the legislature has determined that recovery should just be from the Division 4 compensation scheme—the NGF.

108 Our primary concern in the short term is to ensure that there are no gaps in the investor compensation regime. The fact that there is potential for overlap is of less concern. This outcome appears to be intended under the legislation.

109 ASX says that if Market Rule 16.12.1 were removed as requested by AXE and some other respondents, then there would be no NGF coverage for both AXE and ASX transactions. ASIC does not support the complete removal of the rule. ASX could however restrict rule 16.12.1 to ASX transactions only, including off market transactions completed under ASX rules. This would have the result that the contract guarantee provision would apply to ASX but not AXE transactions. This is because the nexus in the regulation is with reporting of a transaction to a market licensee that is an SEGC member.

#### **Changes to AXE's proposed compensation arrangement**

110 AXE now proposes to include operating rules requiring disclosure by participants to their clients of the relevant differences in AXE's Division 3 compensation arrangements and the NGF. AXE has also proposed to add to its own scheme the coverage of losses where neither the NGF or AXE Division 3 arrangements apply but the loss would have been covered by the NGF if it had arisen at a time when ASX was the only execution venue.

#### **ASIC's advice to the Minister about compensation arrangements**

111 ASIC is satisfied there are no immediate gaps or other difficulties with the operation of AXE's compensation arrangements alongside the NGF that need to be urgently rectified. Whether there should be an overlap between the coverage of the NGF and other compensation arrangements is a policy issue for the Government to consider. As part of our advice to the Minister, ASIC will highlight the issues that ASX and SEGC have raised and suggest that the provisions in the Corporations Act and the regulations governing the operation of the NGF and other compensation arrangements should be reviewed.

## C Proposals on key regulatory mechanisms

### Key points

Competition is workable, provided that some rules are in place about the operation of competing markets.

ASIC is consulting about the details of the mechanisms that are needed to deal with the key issues that arise from there being more than one licensed market that provides for trading in ASX-listed securities.

We are seeking feedback on some differences between the ASX, AXE and Liquidnet rules in relation to short selling and takeovers. We have not previously consulted about these issues.

### ASIC's views on the AXE and Liquidnet applications

- 112 The consultation process has assisted ASIC to develop our thinking on the issues that arise from the AXE and Liquidnet applications. Competition for market services is workable, provided that some rules are in place about the operation of competing markets.
- 113 Before we finalise any advice to the Minister, we need to be satisfied that rules can be put in place and to settle the details of:
- (a) the mechanisms needed to deal with the key issues that arise from there being more than one licensed market that provides a trading venue for ASX-listed shares; and
  - (b) the way to put those mechanisms in place as part of the market licensing process.
- 114 In our view, these issues need to be dealt with before competing market venues are permitted to operate. ASIC will not be in a position to recommend that the Minister grant market licences to AXE and Liquidnet unless workable rules can be implemented.
- 115 Our aim is to create a clear and certain regulatory environment for ASX and the current applicants, as well as any other market operators who might want to operate a competing market venue in the future. This is consistent with the principles-based approach in the Corporations Act.

### ASIC's current position

- c1 Key conditions must be imposed on competing markets and the Minister must be satisfied that arrangements are or will be put in place

to make those conditions effective in practice before granting a licence to a competing market.

- c2** Mechanisms are needed to deal with the following key issues at both the whole-of-market and the individual market level:
- (a) post-trade transparency and data consolidation;
  - (b) pre-trade transparency;
  - (c) best execution obligations for market intermediaries; and
  - (d) effective cross-market supervision.
- c3** These mechanisms should be effected through a combination of:
- (a) conditions on market licences;
  - (b) new regulations applying to all holders of market licences;
  - (c) new regulations imposing obligations on AFS licence holders who are able to trade the same securities on more than one licensed market.
- c4** Any recommendation to the Minister to grant a market licence to a competing market will include our recommendations about the best way to implement these mechanisms. In the rest of this section we are seeking your views to assist us with the best way to implement these mechanisms.

## Post-trade transparency and data consolidation

- 116 ASIC remains convinced adequate post-trade transparency is vital to the continuing quality and integrity of markets for trading in ASX-listed securities.
- 117 If markets that trade in the same securities as other licensed markets are allowed to operate, in ASIC's view, a new regulation under the Corporations Regulation should require all market licensees who operate a competing market for trading in ASX-listed securities to:
- (a) make post-trade information available in a way that can be consolidated with the trading data of other market operators;
  - (b) have an agreement with one or more data vendors that requires the data vendor to consolidate data from more than one market source and report it to the data vendor's customers in such a consolidated form.
- 118 The proposed regulation will help to maintain a high standard of post-trade transparency across the market. Based on our discussions with market users and market information vendors in the first round of consultation, ASIC expects the practical result to be that vendors will collate data from each market about trading in individual stocks and will package that information to meet the needs of their subscribers.

- 119 The regulation does not need to detail how the obligation should be met. ASIC is confident that market and competitive forces between information vendors will produce the result intended by this requirement.

### Proposal

- c5** A regulation should be introduced that obliges all market licensees who operate a competing market for trading in ASX-listed securities:
- (a) to make post-trade information available in a way that can be consolidated with the trading data of other market operators.
  - (b) to have a contractual arrangement with at least one market information vendor to requiring the information vendor to publish trading data in a consolidated form.

#### *Your feedback*

- C5Q1 Do you agree with the introduction of a regulation of this kind?
- C5Q2 Should the regulation contain further detail about how a market licensee should meet the obligation? If yes, what additional detail is needed?
- C5Q3 Is proposal C5(b) a practical way of dealing with the need for post-trade information to be available in a consolidated form?

## Pre-trade transparency requirements

- 120 ASIC does not consider that pre-trade transparency is a pre-requisite for a licensed market, unless the volume of trading on that market is material to the quality of the price formation process across all market venues.
- 121 Responses to CP 86 confirm that there are valid reasons for some types of transactions to occur in an environment with minimal or no pre-trade transparency. Market users and intermediaries point especially to the market impact costs associated with the market as a whole being made aware, before a transaction occurs, of buying or selling interest. This occurs most often when a large transaction is involved.
- 122 To date, these types of transactions have occurred on the ASX crossings market or on a negotiated basis away from the ASX market. Market users' concerns about market impact costs are the rationale for transactions currently permitted to occur other than in accordance with the ordinary operation of ASX's CLOB.
- 123 ASIC accepts trading of this kind is a legitimate aspect of the Australian financial market.

- 124 Nonetheless, if competing markets are allowed to operate with minimal or no pre-trade transparency, there is a possibility that a significant volume of trades that would otherwise be done on the ASX central market (or not at all) might move from the ASX market or be internalised by brokers to be executed on other markets. If that occurs, the quality and reliability of price formation across the market as a whole is likely to be impaired.
- 125 To deal with this possibility, measures are needed to ensure that transactions that are not subject to market-wide pre-trade transparency rules do not damage the reliability of the ASX CLOB market as a reference point.
- 126 In CP 86, ASIC proposed dealing with this issue by imposing an overall size limit on a market for a security that does not have a pre-trade transparency requirement. The rationale was that once a market reaches a point where it facilitates a significant level of transactions in a stock, those transactions should be subject to a level of pre-trade transparency that contributes to price formation and best execution.
- 127 An alternative approach is for uniform (minimum) size requirements for trades that can occur without any pre-trade transparency, without any limitations on the amount of trading that can take place in this way. This is the approach ASX suggests in its submissions.
- 128 A transaction size requirement of this kind may be more straightforward to administer. But it raises two problems not present in a limitation based on overall market size:
- (a) There is no limit on the amount of trading that can take place without pre-trade transparency;
  - (b) It could have the effect of confining competition for trading services to a narrow range of activity.
- 129 On balance, ASIC prefers the volume turnover approach described in the following paragraphs.
- 130 We particularly ask for feedback on these approaches to pre-trade transparency, and whether there are other or better mechanisms to achieve the same regulatory outcome as ASIC's proposed threshold.

### **ASIC's proposed threshold**

- 131 ASIC's proposed threshold is 5% of overall trading volume in a single stock in the previous 6 months. 'Overall trading' is taken to mean the aggregate of trading of the particular stock across all licensed financial markets that are competing for trading in ASX-listed securities. Once trading in a market exceeds this point, the market must facilitate pre-trade transparency.

- 132 If a market venue reaches this threshold and pre-trade transparency is required, the minimum requirements for acceptable pre-trade transparency should be:
- (a) information about all bids and offers in the market for an affected security should be made available to all participants on the market;
  - (b) all participants should be able to accept bids and offers in affected securities;
  - (c) participants in the market should not be precluded from providing information to their clients and market users about bid and offer information made available through the market.
- 133 This would provide the same level of pre-trade transparency and trading opportunities as currently exists in ASX's market.
- 134 This approach should be able to be subject to exceptions to the across-the-board transparency requirement above the 5% threshold. For instance, a market might adopt crossing-style rules or other rules about internalisation of trades that still allow some restricted types of transactions to occur without pre-trade transparency. These trades would be the exception, rather than the norm, and would be confined to very particular, clearly defined circumstances. These trades would probably not involve retail investors.
- 135 Exceptions would need to be introduced by the market operator adopting new business rules. These rules would be subject to regulatory scrutiny through the rule disallowance process.
- 136 Arguably, as a licensed market ASX should be subject to the same limitations on the volume of transactions that can occur 'off-market' (i.e. without any pre-trade transparency) as other licensed markets. The arguments that have been put forward about the potential detrimental effects of so-called dark pools of liquidity also apply to transactions that occur as off-market crossings on ASX. This is particularly the case if the number of transactions that occur as off-market crossings on ASX were to grow over time.

## Proposal

- c6** A regulation should be made that:
- (a) imposes a pre-trade transparency requirement on a licensed financial market that competes for trading in ASX-listed securities, if the percentage of trading in a particular security on the market in any previous 6 month period equals or is greater than 5% of the volume of overall trading in that security on all licensed financial markets.
  - (b) specifies that the minimum requirements for pre-trade transparency are:

- (i) information about all bids and offers in the market for an affected security should be made available to all participants on the market;
  - (ii) all participants in the market should be able to accept bids and offers in affected securities;
  - (iii) participants in the market should not be precluded from providing information to their clients and market users about bid and offer information made available through the market.
- c7** Market operators should be able to depart from the obligations imposed by the regulation in proposal C6 by adopting operating rules that allow trades to take place in a different way.
- c8** It should be a condition of any new licence to operate a market on which ASX-listed securities are to be traded that the market licensee must have systems and processes that enable it to monitor the volume and value of all transactions in ASX-listed securities on all licensed markets.

*Your feedback*

- C8Q1 Do you agree with the imposition of a threshold, above which pre-trade transparency is required?
- C8Q2 Do you agree that 5% of overall trading in a security is the right threshold? If no, what is the right measure?
- C8Q3 Is 6 months an appropriate reference period? If not, what is and why?
- C8Q4 Do you agree with the proposed minimum pre-trade transparency requirements in proposal C6(b)?
- C8Q5 If you do not agree with a threshold, what other regulatory mechanism should be applied?
- C8Q6 Do you agree with the proposed market licence condition in proposal C8? How else might the threshold requirement be monitored?
- C8Q7 Do you agree that ASX should be subject to the same limitations about off-market transactions as other licensed markets? If no, why not?

## Best execution in a multi-venue market

- 137 Brokers who deal on behalf of clients and have access to multiple trading venues on which to execute client trades should be subject to a best execution obligation. This obligation should be clear and enforceable.
- 138 Accordingly, ASIC favours the introduction of a regulation that imposes a best execution obligation on an AFS licence holder who acts as an intermediary for clients and is a participant in more than one market trading ASX-listed securities.

- 139 A best execution obligation will not apply to an intermediary who is a participant in only one market because the participant does not have a choice of venue in which to execute trades. The proposed regulation is not intended to force an intermediary to become a participant on more than one competing market.
- 140 If a broker chooses to remain as a participant on only one competing market, then that broker must continue to act in the best interests of the client, and must not take other collateral issues into account. For instance, a broker should not route orders to another participant who does have access to a second competing market, if the routing of those orders benefits the broker but is not in the client's best interests.
- 141 Once an intermediary becomes a participant on more than one market trading ASX-listed securities, the best execution obligation will apply.
- 142 The regulation should incorporate the concept that best execution consists of more factors than just best price. An intermediary will be obliged to obtain instructions from its client about best execution, including but not limited to, price, size, cost, certainty, speed, and preferred trading venue.
- 143 ASIC also proposes that reg 7.2.07 about the content of operating rules and procedures be amended so a market licensee must have rules about monitoring and enforcing best execution obligations in relation to its market.

### Proposal

- c9** A 'best execution' regulation should be introduced to apply to holders of AFS licences who are participants on more than one market that trades ASX-listed securities.
- c10** The regulation should:
- (a) apply to an AFS licence holder who:
    - (i) is a participant on more than one market that trades ASX-listed securities; and
    - (ii) accepts instructions from a client to transact in ASX-listed securities;
  - (b) oblige the AFS licence holder to decide the market on which it will execute the transaction by reference only to factors relating to:
    - (i) the client's instructions; and
    - (ii) which available market is most likely to result in a transaction which best meets those instructions;
  - (c) list the factors which should be taken into account relating to the client's instructions, including but not limited to:
    - (i) price;
    - (ii) nature of the order (e.g. fill or kill);

- (iii) order size;
- (iv) transaction costs;
- (v) certainty of execution;
- (vi) speed of execution;
- (vii) preferred trading venue.

**c11** Regulation 7.2.07 should be amended by adding a requirement that market licensees must have rules that enable them to monitor and enforce their participants' best execution obligations.

*Your feedback*

C11Q1 Do you agree that a best execution obligation on intermediaries is necessary in a multi-venue environment?

C11Q2 Do you agree that a regulation is the appropriate mechanism to introduce a best execution obligation?

C11Q3 Are there other or better mechanisms, and if yes, what are they? Please provide as much detail as possible about alternatives.

C11Q4 Do you agree with the proposed content of the regulation described in proposal C10?

C11Q5 Should brokers who can transact on one market only be obliged to inform their clients of that fact?

C11Q6 Do you agree with the proposed addition to reg 7.2.07? Are alternative or other means of monitoring participants' best execution obligations needed?

## Cross-market supervision arrangements

- 144 In CP 86, we said that in a multi-venue environment, integrity of the market as a whole must be maintained through effective working arrangements for whole-of-market supervision. Respondents agreed with this.
- 145 Supervisory obligations should apply equally to competing markets, in relation to the services that each market offers. All market operators must take account of what occurs on competing markets in order to be able to properly supervise their own market.
- 146 This obligation must be clearly expressed and it must be evident that the obligation applies to a new entrant or potential new entrant.
- 147 ASIC envisages an addition to the Corporations Regulations that requires each market licensee who trades ASX-listed securities to have enforceable arrangements with other market licensees that trade ASX-listed securities to share supervisory information about financial products and participants, to notify each other about suspected contraventions, and to make referrals to each other as well as to ASIC.

- 148 The business unit or person(s) within each market licensee that carries out market supervision activities should be able to perform information-sharing and supervisory functions in a way that is not impeded by other factors. All market licensees have a statutory obligation to have adequate arrangements to handle conflicts between the commercial interests of the licensee and the need for the licensee to ensure that the market operates in a fair, orderly and transparent way.
- 149 There remains a risk that implementation of effective arrangements in the form of memorandums of understanding or similar agreements between market operators could be frustrated by commercial or other factors.

### Proposal

- c12** A new regulation should be made that requires each market licensee who trades ASX-listed securities to:
- (a) have enforceable arrangements with other market licensees that trade ASX-listed securities to share supervisory information about financial products and participants;
  - (b) notify each other about suspected contraventions; and
  - (c) make referrals to each other as well as to ASIC.
- c13** To comply with this requirement, ASIC anticipates that:
- (a) each market operator will enter into agreements with the other markets that trade ASX-listed securities;
  - (b) the agreements will be provided to ASIC; and
  - (c) it will be a condition in each agreement is that a market licensee will advise ASIC if any party to the agreement is not meeting the terms of, or obligations under, the agreement.

In our role as supervisor of market licensees, ASIC will actively monitor the compliance of each licensee with its obligations under the Corporations Act and the Corporations Regulations.

#### *Your feedback*

C13Q1 Is a regulation the appropriate mechanism?

C13Q2 Are there other matters that the regulation should address?  
What are they and why are they important?

C13Q3 Are there alternatives for the implementation of effective arrangements besides agreements between the market operators? If yes, what are they?

## Short sales and takeovers

150 In its submissions, ASX has said that some rules can have a broader impact on the manner in which markets are operated, with significant public policy issues arising. ASIC makes comments in response to this at Appendix 2.

151 Some of the rules that ASX has highlighted as having a public policy impact include rules about short selling and takeovers. There are some differences in the ASX, AXE and Liquidnet rules dealing with these areas.

### Short sales

152 Section 19 of the ASX Market Rules sets out a regime for short selling of cash market products on the ASX market.

153 ASX may designate a cash market product to be an approved short sale product if:

- (a) 50 million cash market products have been issued;
- (b) the market capitalisation of the cash market products of the class on issue is not less than \$100 million;
- (c) in the opinion of ASX there is sufficient liquidity in the market for cash market products; and
- (d) ASX considers that the cash market products should be designated as an approved short sale product for the purposes of the rules.

154 Short sales of Australian securities are expressly excluded under the Liquidnet Trading Rules.

155 AXE rule 4.11 sets out the requirements for short selling on the AXE market. Rule 4.11.5 says that AXE will make a declaration from time to time identifying the class or classes of financial products that can be short sold in accordance with s1020B(4) of the Corporations Act.

156 AXE rule 4.11.4 states that AXE may restrict, prohibit or otherwise limit short selling in all or any equity securities for such period and for such reasons as it may, in its complete discretion, determine.

157 The AXE rules do not set minimum volume or value limits on the financial products that can be short sold, in the way that the ASX rules do.

158 Orderly market issues might arise where a financial product is not permitted to be short sold on the ASX market, but can be short sold on the AXE market, or vice versa.

159 Standardised requirements about short selling of financial products could overcome any orderly market issues.

*Your feedback*

C13Q4 Should requirements about short selling should be standardised across markets? If not, why not?

C13Q5 Is standardisation best achieved through the operating rules of each market?

C13Q6 Is there another, better mechanism to achieve standardisation?

**Takeovers**

160 AXE now proposes to include a rule that prohibits buying and selling on the AXE market of securities that are the subject of an on-market takeover offer on ASX. This will mean that:

- (a) an orderly market for the securities the subject of the bid is maintained; and
- (b) AXE participants are not able to conduct crossing transactions on the AXE market in securities the subject of a bid in circumstances where the ASX market rules limit late, overseas and overnight crossings, and prohibit special crossings during an offer period.

*Your feedback*

C13Q7 Are the proposed settings in the AXE rules about trading during a takeover the right settings? If not, why not?

161 The Liquidnet Australian Rules and Procedures and the Liquidnet Trading Rules do not contain any specific rules about trading during an offer period. ASX and AXE rules that go to the conduct of participants during an offer period are not relevant to Liquidnet because the market is not intermediated.

162 During an offer period, a willing seller who might otherwise conduct its transaction on Liquidnet will have incentives to sell into an on-market offer on ASX. This is because the seller can be assured of a price for its whole order, and can be certain that the transaction will be completed.

163 While it is likely that demand and supply forces will have the effect of maintaining a share price at or near the bid price, the Liquidnet rules do not contain any limitations about pricing of trades in securities that are subject to a takeover offer.

*Your feedback*

C13Q8 Are there any orderly market issues that arise from the lack of limitations in the Liquidnet rules about trading in securities during a takeover offer?

C13Q9 How should these issues be addressed?

## Appendix 1: List of non-confidential respondents to CP 86

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- |   |  |
|---|--|
| • ABN AMRO Equities Australia Ltd                       | • Liquidnet  |
| • Australian Competition and Consumer Commission (ACCC) | • Macquarie Securities (Australia) Ltd                   |
| • Australian Financial Markets Association (AFMA)       | • McGregor, Andrew                                       |
| • ASX Ltd   | • NSX Ltd  |
| • AXE ECN Pty Ltd                                       | • Optiver Derivatives Trading                            |
| • Bonouvrie, Simon (2 submissions)                      | • Scholtz, Stephen                                       |
| • Brachi, Rosalind                                      | • Securities and Derivatives Industry Association (SDIA) |
| • Commonwealth Securities Limited                       | • Securities Exchanges Guarantee Corporation Ltd (SEGC)  |
| • Investment and Financial Services Association (IFSA)  | • Weerakoon, Nalin                                       |
| • Group of Institutional Investors                      | • Yieldbroker Pty Ltd                                    |
| • Kalorama Legal Services                               |  |
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Note: Eight confidential submissions were also received.

## Appendix 2: ASX's submissions on CP 86 and ASIC's response

A1 This appendix considers in more detail the issues raised in ASX's submission dated 17 August 2007 and the supporting analysis to that submission dated 27 September 2007 (together referred to as 'ASX's submissions'). Both the submission and the supporting analysis are available on ASIC's website at [www.asic.gov.au/CP](http://www.asic.gov.au/CP) under CP 86.

Appendix 3 also comments on aspects of ASX's submissions.

A2 The appendix begins with an overview outlining the essential propositions raised in the ASX submissions and ASIC's response to them.

A3 Specific issues raised by ASX are discussed under the seven headings suggested by ASX:

- (a) competition (on the merits) is good;
- (b) rules help structure an efficient market;
- (c) investor protection must be a key concern of ASIC;
- (d) transparency is essential;
- (e) the best execution obligations must be appropriate and enforceable;
- (f) only those eligible should be granted a licence;
- (g) ASIC and the Minister face complex issues of regulatory design.

A4 In our work on designing of a regulatory framework for markets competing in ASX-listed securities, we have paid particular attention to these matters:

- (a) internalisation thresholds;
- (b) best execution obligations;
- (c) compensation fund obligations;
- (d) post-trade reporting deadlines; and
- (e) eligibility for a market operator's licence.

### Overview of ASX submissions

A5 As ASIC understands them, the ASX submissions make three basic propositions:

- (a) the AXE proposal does not amount to a financial market that can or should be licensed under the current law;

- (b) the AXE and Liquidnet market proposals create potential risks for the quality and integrity of ASX's current markets and should not be licensed unless and until the regulatory framework can ensure that those risks will not emerge; and
- (c) the current legislation is not adequate to create such a framework and therefore the AXE proposal at least should not be licensed until the legislation has been amended.

### **ASIC's response**

- A6 ASIC does not agree with ASX's legal analysis of the AXE application: see 'ASIC's response' at paragraph 22 of this consultation paper (CP 95).
- A7 In CP 86, ASIC noted that proposals to establish new market venues for trading in ASX-listed securities was a new development in Australian financial markets. CP 86 suggested a framework for analysing those proposals and principles that that should guide sound regulatory decision making.
- A8 The economic analysis by CRA International that ASIC commissioned as part of its consideration of the issues raised by the AXE and Liquidnet applications identified potential risks to the quality and integrity of the market for trading in ASX-listed securities. ASIC therefore agrees with ASX about potential risks for adverse impacts on the quality and integrity of the market for ASX-listed securities.
- A9 But ASIC does not regard the existence of those risks as determinative of what the regulatory response should be to the AXE and Liquidnet applications. Rather, detailed consideration should be given to how those risks might be best managed in a multi-venue environment. If ways of managing those risks are available and can be implemented in a practical way through the markets licensing process, then in ASIC's view there are potential benefits in permitting competition for some of the market activities currently performed exclusively by ASX.
- A10 The proposals ASIC makes in Section C of this consultation paper are designed to create a regulatory framework that manages those risks and at the same time permits markets to compete for trading in ASX-listed securities and related trading information.
- A11 It is important to stress that ASIC's objective is to identify the necessary minimum conditions to ensure the continuing quality and integrity of the overall market for trading in ASX-listed securities. If that market becomes a market comprised of three (or more) trading venues, what is critical is that the overall market retains (or increases) its current level of quality and integrity.

A12 ASIC acknowledged in CP 86 that the ASX market is the benchmark for the current level of quality and integrity of ASX-listed securities. That is because it is presently the only licensed market on which those securities are traded.

Note: ‘ASX-listed securities’ should be seen in this context as way of describing a class of market-tradeable products, not as creating a right for ASX to control how those securities are to be traded.

A13 But it does not follow that:

- the ASX’s market must be preserved exactly in its current form; or
- the limits of what competing market venues—such as those provided by AXE and Liquidnet—should be permitted to do are to be determined by reference to the structure and operation of the current ASX market.

A14 If the environment in which ASX conducts a market for ASX-listed securities changes, it may be that aspects of ASX’s rules and market supervision framework may need to adapt to that changed environment to ensure ASX’s market remains fair, orderly and transparent.

A15 Much of ASX’s concern about the AXE market proposal appears to stem from the fact that:

- AXE participants ‘internalise’ orders;
- trade execution does not take place on a central market facility; and
- AXE rules do not limit the trades that can be effected in this way in the same way that ASX limits off-market trading through ASX crossing rules.

A16 ASIC’s proposals for the regulatory framework seek to limit the potential for adverse impacts on market quality and integrity, or on participant behaviour, that may flow from this market structure by:

- Limiting the amount of trading activity that can take place without:
  - pre-trade transparency across the AXE market as a whole; and
  - trading opportunities being afforded to all AXE market participants; and
- Creating explicit best execution obligations for market participants.

## Specific issues

### Competition (on the merits) is good

A17 ASX agrees with the principles set out by ASIC in CP 86. However, ‘competition’ must be properly understood.

- A18 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:
- (a) promote and protect the competitive process (as distinct from individual competitors); and
  - (b) enhance welfare through efficiency-driven conduct.
- A19 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’.
- A20 We should understand ‘competition’ to mean the process by which society’s resources are allocated efficiently. This concept is necessarily inconsistent with the existence of externalities.
- A21 The ASX’s market structure solves externality problems. By promoting competition from firms offering substitute services to ASX, ASIC and the Minister could damage the efficiency of ASX’s market, if this is done without proper consideration of the functioning of ASX’s market, and if regulation is imposed asymmetrically.
- A22 Aside from this, competition may also have detrimental effects on ASX’s market in the following areas:
- (a) liquidity;
  - (b) bid-ask spreads, volatility, and price discovery;
  - (c) transparency;
  - (d) efficiency; and
  - (e) participant and investor conduct.
- A23 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.
- A24 The Liquidnet proposal offers different challenges. For Liquidnet, the issues centre on the necessary conditions to ensure that it does not have adverse information effects (hence on the quality and integrity of the ASX market).

## ASIC’s response

- A25 ASIC acknowledges that constraints put on participants’ behaviour by ASX, which in form may appear anti-competitive, are generally based in good public policy. Participants agree to these constraints, which are intended to

increase the welfare of all participants over the longer run, even if this may seem detrimental to a particular participant in a particular circumstance.

- A26 But in ASIC's view it does not follow that the emergence of another operator should be prohibited. The existence of such competitors, or merely the possibility that one could emerge, can be expected to provide incentives for ASX to innovate, reduce costs, and enhance other aspects of its services.
- A27 ASIC accepts that ASX's operations meet required standards. But if the integrity of the market for trading in ASX-listed securities can be preserved, while additional competitive pressures are brought into play, then ASIC sees potential for welfare enhancement.
- A28 ASIC does not agree that the potential for externalities to emerge is a sufficient argument to prevent competition. Likely efficiency gains of competition should be weighed against the potential for efficiency costs of externalities. The aim of much of ASIC's consultation process has been to identify and minimise these costs while still facilitating competition.
- A29 ASIC agrees with ASX that the existence of one or more competitors has the potential to result in a decline in the number of orders that are executed within ASX's market.
- A30 The potentially adverse effect of this on ASX's market business creates a strong incentive to retain as many of these orders as possible. ASX can do this by offering a better combination of service, price and quality than any other operator. The existence of competition, precisely because of the threat to ASX's market, can be expected to result in a more efficient economic outcome for investors seeking to trade.
- A31 ASIC believes ASX will continue to be the beneficiary of powerful network externalities, in the form of an 'order flow' externality. Investors will direct their orders to a market venue where they believe they will have the best chance of filling their order. There is a self-reinforcing process, by which investors direct their orders to ASX simply because many other investors direct their orders to ASX. This type of externality is a common one for information 'manufacturers'. ASX, like other market operators, has a prime function as a creator of trading information.
- A32 However, if another market operator offers trading services that are more attractive to a group of investors who previously had no choice but to execute transactions through ASX, the migration of these investors to this competing operator should not be regarded as an inefficient outcome. Although this may result in a drop in the number of transactions on ASX, the fact that these investors prefer to transact elsewhere suggests that the volume of orders on ASX's market was being artificially boosted due to absence of an alternative, more attractive, market venue. If these investors prefer to trade elsewhere, this may be a net improvement in social welfare, even if the

welfare of investors that continue to trade on ASX may have declined due to this migration.

## Rules help structure an efficient market

- A33 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.
- A34 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.
- (a) Rules that are restrictive in form may restrict competitors, but they do not necessarily restrict competition. Rules play an important role in the establishment of a fair, orderly and transparent market and maintenance of market quality and integrity.
  - (b) 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.
  - (c) 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.
- A35 Poor transparency reduces market integrity, deters uninformed traders, increases trading costs, and reduces the incentives of firms to issue and list shares on ASX.
- A36 Rule 16.12 et al does not restrict ASX participants from transacting ASX-quoted securities on other markets, it merely requires such transactions to be reported to ASX.
- A37 Fees charged by ASX are a tiny proportion of equity-related transaction fees.
- A38 Other rules with a public policy impact include rules about:
- (a) reporting requirements;
  - (b) crossings;
  - (c) forward delivery transactions;
  - (d) short sales; and
  - (e) takeovers.

## ASIC's response

- A39 ASIC agrees that rules that restrict certain behaviours play a fundamental role in a market operator's ability to operate a fair, orderly and transparent market. Such rules can also minimise externalities that might be otherwise detrimental to a market's operations.
- A40 ASIC understands ASX's point about Market Rule 16.12. But it notes that the rule in its present form appears to permit ASX also charge fees for all transactions reported to it, whether or not they were transacted on another market.
- A41 ASIC does not believe that amending rule 16.12 endangers ASX's ability to operate its market effectively, so long as participants on other markets and those other markets are subject to similar restrictions so as to not damage the market in ASX-listed securities. That is, so long as the externality problems solved by ASX's 'closed system' are similarly solved by regulations. The potential externalities that ASX has identified include those that might result from different standard of pre- and post-trade transparency, as well as difficulties in cross-market supervision of participants.

Note: For a further discussion of rule 16.12 and rule 16.2.1, see 'ASIC's response' at paragraphs 53–62 of the consultation paper (CP 95).

- A42 ASIC considers other market operators should be subject to requirements to adhere to minimum standards of post-trade transparency, and—when their markets are large enough to have an impact on the quality of the overall price formation process—standards of pre-trade transparency. Proposals about how this should occur are set out in Section C of this consultation paper (CP 95).

### Forward delivery transactions

- A43 Neither the AXE nor the Liquidnet markets will permit forward delivery transactions.

### Short selling and takeovers

- A44 ASIC has requested feedback on differences in the ASX, AXE and Liquidnet rules: see paragraphs 150–159 of this consultation paper (CP 95).

### Transparency is essential

- A45 The obligation of transparency is owed by every operator of a financial market. There are different dimensions to transparency.
- A46 Pre-trade transparency is important for the following reasons, it:
- (a) ensures that all trading opportunities are exhausted;

- (b) ensures those trades that occur are those that maximise the value of trading;
- (c) assures investors that their trades are occurring at the best available prices;
- (d) allows market participants to identify the venue that offers the best terms of execution;
- (e) allows investors to monitor whether or not market participants are meeting their best execution obligations.

A47 Post-trade transparency is also essential:

- (a) data about recent trades are valuable in providing information about the current market valuation of securities;
- (b) it enables investors to monitor their agents;
- (c) facilitates the effective monitoring and supervision of the market.

A48 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.

A49 AXE's proposal in particular would be detrimental, since it would almost certainly lead to the erosion of price discovery on ASX's market. Liquidnet also has the potential for a detrimental impact, due to its lower transparency standards.

A50 A staggered approach to requiring pre-trade transparency is not workable, since it is possible that the new market may gain significant market share in a security on day 1.

## ASIC's response

A51 ASIC agrees with much of the substance of ASX's arguments about market transparency. Where ASIC differs is largely on whether other market operators should be obliged in all circumstances to have standards of pre-trade transparency of the type provided on the ASX market (information about bids and offers is available to market participants and, through them, to their clients): see paragraphs 120–136 of this consultation paper (CP 95).

A52 On the question of staggered thresholds for triggering transparency requirements, ASIC notes that other jurisdictions—notably the United States—rely on such a mechanism. ASIC will consider carefully comments in response to the proposal in this consultation paper (CP 95) about the practical effects of its proposal for a threshold under which pre-trade transparency is not required.

## **The best execution obligation must be appropriate and enforceable**

- A53 There is a need for a more sophisticated regime of the best execution obligation that recognises the potentially different priorities of different sorts of investors across multiple platforms.
- A54 A fundamental consideration in implementing best execution policies is whether the obligation should be enshrined in legislation or developed by the market.
- A55 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.
- A56 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.

## **ASIC’s response**

- A57 ASIC agrees that the best execution obligation must be appropriate and enforceable: see ‘ASIC’s response’ at paragraphs 91–95 of this consultation paper (CP 95).

## **Only those eligible should be granted a licence**

- A58 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.
- A59 This is important because of its impact on consumer protection.
- A60 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.
- A61 Investors should have a clear and enforceable right to compensation.
- A62 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.
- A63 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’.

## ASIC's response

- A64 For ASIC's comments on the legal status of AXE's proposed market, see 'ASIC's response' at paragraphs 22–30 of this consultation paper (CP 95).

## ASIC and the Minister face complex issues of regulatory design

- A65 The approach of ASIC and the Minister to regulatory design should be consistent with the approach to regulation embodied in the Corporations Act.
- A66 One of the profound implications of a new regulatory framework is a potential shift from a co-regulatory approach to more centralised regulation.
- A67 ASIC and the Minister should apply principles of good regulatory design:
- (a) adopt an evidence-based approach, in compliance with the principles of good regulatory practice adopted by the Commonwealth Government;
  - (b) take account of the impact of the regulatory regime on international competitiveness and the interconnectedness of international financial markets;
  - (c) facilitate global capital formation by increasing the prospects of substituted compliance with other regulatory jurisdictions;
  - (d) allow for the likely competitive reactions of ASX and others in response to the new regulatory regime;
  - (e) proceed on a clear statutory basis to promulgate clear, enforceable obligations.

## ASIC's response

- A68 ASIC considers the current regulatory framework is adequate for dealing with the AXE and Liquidnet applications: see paragraph 19 of this consultation paper (CP 95).

## **Appendix 3: CRA International's review of ASX's submissions**

The following two pages are CRA International's review of ASX's submissions.

## 1. BACKGROUND

I have reviewed the Submissions presented by ASX Limited on 17 August 2007 and 27 September 2007 in response to ASIC Consultation Paper 86 (“the ASX Submissions”). Both those submissions draw on and refer to findings made in the CRAI Report that was appended to that Consultation Paper. That Report was prepared under my supervision.

The ASX Submission dated 27 September 2007 presents an extensive summary of the “market microstructure” literature on which the CRAI Report also drew. That summary appears to endorse the conclusions reached in the CRAI Report. It also advances a number of proposals, one of them being that “further empirical work is required before either ASIC or the Minister can properly form the view that an unrestricted license ought to be issued” (ASX, at 1.12).

I comment on this proposal below.

## 2. DISCUSSION

As a general matter, the “market microstructure” literature makes the following points:

- The dynamics of exchanges, and of securities markets more generally, are complex, and do not lend themselves to reliable *ex ante* simulation. While simulation studies of those markets have been undertaken from time to time, the range of restrictive assumptions that need to be made for these exercises to be tractable inevitably reduces their value;
- Nonetheless, there is a great deal of empirical work that confirms what would one expect from theory, namely, that while competition between exchanges can enhance efficiency, the resulting fragmentation of trading can also raise efficiency concerns, including concerns about the efficacy of investor protection;
- As a result, moves to allowing competition between exchanges need to be accompanied by measures aimed at preventing or correcting those potential adverse effects, at least to the extent necessary to ensure that the gains from competition can be expected to outweigh its likely costs.

I would draw from this literature the following conclusions:

1. It is relatively clear what the main issues are in terms of which a policy response may be required so as to avert or minimise any potential adverse effects from competition;
2. It is also relatively clear what the relevant policy instruments are for addressing those issues, and how those instruments operate;

3. Subject to the resulting regulatory interventions being well-designed, it is likely that – as the ASX’s 27 September 2007 Submission notes, in summarising the results of the relevant empirical studies – “market-fragmenting competition can deliver lower transactions costs, and that market quality is not seriously diminished” (Box 1, page 53).

As a result:

- (a) It is not clear to me what the “further empirical work” sought by the ASX amounts to or could amount to. Thus, as noted above, there is little reason to believe that simulation studies would be of real value; and
- (b) It appears to me more important to focus on ensuring that the concerns clearly identified in the literature are being addressed, in a manner consistent with the results of the many theoretical and empirical studies that have been carried out in a wide range of settings.

### 3. CONCLUSIONS

There is a vast, and still rapidly-expanding, literature on the effects of market fragmentation on the various dimensions of exchange efficiency. Although that literature is far from unanimous, it generally concludes that there are benefits to competition, so long as regulations are in place to prevent or minimise its potential adverse effects.

Any attempted empirical study of the impact of changing the Australian regulatory settings so as to allow competition between exchanges would necessarily be forward-looking and would likely involve simulating the impact of that competition on a range of criteria related to outcomes. It is not clear how such a study could be undertaken without relying on so wide a range of assumptions as to limit its value. Moreover, it is unclear what such a study would add to the very large body of literature drawn on the CRAI paper and in the ASX Submission. Rather, there is a reasonable degree of consensus in the literature as to

1. The nature of the problems competition can give rise to;
2. The fact that there are regulatory remedies to those problems; and
3. The likelihood that, so long as those remedies are in place, the benefits from competition are likely to outweigh its costs.

Henry Ergas,

November 19, 2007.