



ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 86

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

July 2007

This consultation paper:

- deals with policy questions raised by applications for new Australian market licences from AXE ECN Pty Ltd and Liquidnet Australia Pty Ltd;
- sets out ASIC's approach to competition for market services involving trading the same securities on more than one market venue; and
- seeks the views of operators and users of Australian financial markets and interested members of the public.

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 might 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 23 July 2007 and is based on the Corporations Act as at that date.

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 might 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 might 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 17 August 2007 to:

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What will happen next?

Stage 1	23 July 2007	ASIC consultation paper released
Stage 2	17 August 2007	Comments due on the consultation paper Consideration of responses and development of preferred regulatory approach
Stage 3	September 2007	Advice to the Parliamentary Secretary to the Treasurer ('the Minister')

A What this paper is about

Key points

ASIC is considering applications for market licences from AXE ECN Pty Ltd and Liquidnet Australia Pty Ltd.

The proposed markets will compete directly with ASX's market for trading in ASX listed securities, and the sale of data relating to that trading.

- 1 This raises new policy issues, which ASIC is consulting about as part of developing our advice to the Minister. AXE ECN Pty Ltd (AXE) and Liquidnet Australia Pty Ltd (Liquidnet) have applied for Australian market licences (AML) under s795A of the *Corporations Act 2001* (Corporations Act). This type of licence is issued by the Minister on advice from ASIC. There are currently 17 licensed markets operating in Australia: see list in Appendix 1.
- 2 Both AXE and Liquidnet plan to operate a market for the trading of securities that have been admitted to the official list of ASX Limited's (ASX) financial market, and the sale of data relating to that trading activity.
- 3 The consultation package, of which this paper is a part, contains more information about the proposed AXE and Liquidnet markets.
- 4 The markets to be operated by AXE and Liquidnet will, if approved, be the first licensed securities markets to provide an Australian domestic alternative for transactions in equity securities listed on ASX's market.
- 5 The existing regulatory structure for markets was developed in an environment in which ASX (or entities related to it) provided a complete suite of listing and trading platform functions.
- 6 The prospect of competition between the new applicants and ASX might raise new issues and risks that did not previously arise when all listing and trading activities were centralised in a single entity. Therefore, it is appropriate to consider whether any of the existing regulatory arrangements, or extension of the existing regulatory approach to proposed new market operators, either enhances competition or unduly hinders competition. If so, it is appropriate to consider whether any regulatory barriers to competition can be removed or reduced consistent with the regulatory regime's objective of promoting fair, orderly and transparent markets.
- 7 We are consulting publicly on the implications of the operation of these markets as part of the process of developing our advice to the Minister. We

will take into account the results of this consultation in formulating advice to the Minister about the AXE and Liquidnet applications.

- 8 The market proposals we are dealing with are likely to involve competition with the ASX market in two areas:
- (a) competition for revenue derived from trading in securities; and
 - (b) competition for revenue from the sale of data about that trading activity.
- 9 They do not involve competition for listing services, or for clearing or settlement services. Nor do they involve competition with other licence holders (e.g. NSX).
- 10 Our consultation focuses on the implications for the overall market of competition for trading and sale of data. For simplicity's sake, we refer to these activities in this paper as 'competition for market services'.

Process

- 11 The new market proposals raise important implications for the operation of Australian securities markets. In developing our regulatory response to competition for market services, we have considered other options and outcomes, including the way regulatory regimes in other jurisdictions have responded to the issues raised by competition of this kind. There are regulatory options potentially available that range from minimal or no regulation (allowing the market to determine the necessary structures and arrangements in a competitive environment) to development of a new regulatory regime or adoption of a prescriptive regime.
- 12 At this point, we do not regard the first option as appropriate, as it might not produce the levels of investor protection and uniformity of outcomes that are necessary to maintain market quality and integrity. We do not see the latter options as practical or necessary because they might take an extended period of time to achieve, require law reform or require the development of a prescriptive approach that is not in keeping with Australia's principles-based regime. However, we are keen to hear views on whether a more prescriptive approach, or one more closely modelled on other countries' regulatory regimes, would be appropriate.
- 13 We engaged CRA International (CRAI) as an independent expert to help us assess the economic and other impacts of competition for market services. This consultation paper is to be read together with CRAI's report, which is published with this paper.
- 14 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 he or she thinks relevant: s798A(2). In considering an application and formulating our advice to the Minister, we take account of 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. We also take account of the likely impact of the new market on the overall operation of Australian financial markets.

- 15 We will use the results of this consultation process to prepare our advice to the Minister about the AXE and Liquidnet applications. We will also take into account discussion we have with interested stakeholders during the consultation period.
- 16 We have not yet formed a view about the applications and the advice we will give to the Minister.
- 17 We will consult with the Australian Competition and Consumer Competition (ACCC) about the AXE and Liquidnet proposals. We will ask the ACCC to provide advice to the Minister about the competition law aspects of the proposals and their interaction with ASX's operating rules.

B ASIC's approach

Key points

Our approach is based on three key principles:

- competition for market services is, in principle, desirable;
- the entry of competitors for market services should not result in a decline in the existing quality and integrity of the market for the securities that trade on more than one licensed market;
- 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.

Basic principles

- 18 Competition between different market venues for execution and reporting services in the same equity securities is common in other jurisdictions such as the United States and Europe. We have looked closely at how those jurisdictions have responded to the regulatory challenges posed by such competition. However, it is important to acknowledge that the Australian market for equity securities is different from those of either the United States or Europe. For instance, the market is smaller, and there are a smaller number of market participants and market operators. Because of this, it might not be appropriate to simply adopt or transfer the regulatory approaches used in other jurisdictions.
- 19 Nevertheless, the existence of competition in these markets indicates that competition for trading services can be workable.
- 20 In the United States, a national market framework has been in place since the 1970s. In response to market developments, the US Securities and Exchange Commission (SEC) in 1998 adopted Regulation ATS to establish a regulatory framework for alternative trading systems (ATS) and integrate them into the national market system. The SEC defined an electronic communication network (or ECN) as any electronic system that widely disseminates to third parties orders entered into the ECN by an exchange market maker or OTC market maker, and permits the orders to be executed in whole or part.
- 21 After the adoption of Regulation ATS, ECNs could either register as exchanges, or remain registered as broker-dealers and comply with the requirements of Regulation ATS. Beyond a minimum level of activity,

regulation under either option requires integration into the national market framework.

- 22 In Europe, the Markets in Financial Instruments Directive (or MiFID) becomes fully effective for investment firms and regulated markets in November 2007. Under MiFID, trading venues are classified as ‘regulated markets’, ‘multilateral trading facilities’ or ‘systematic internalisers’.
- 23 Appendix A of the CRAI report provides an overview of the operation of Regulation ATS and MiFID.
- 24 However, the AXE and Liquidnet proposals are new to Australia, and present challenges our regulatory regime has not had to deal with before. In our view, resolving these challenges effectively has significant implications for the continuing success of Australian domestic securities markets and their standing internationally.
- 25 The development of regulatory regimes in other jurisdictions has been guided by general principles. The United States adopts an approach that places a premium on competition between venues. In Europe, MiFID permits competition between exchanges. Member states will no longer be permitted to favour traditional exchanges over other trading venues. MiFID aims to create a level playing field between the three types of trading facilities described in paragraph 22 above.

Proposal

- B1** ASIC’s approach to proposed competition for market services involving trading the same securities on more than one market venue rests on three principles:
- (a) **Principle 1:** competition for market services is, in principle, desirable;
 - (b) **Principle 2:** the entry of competitors for market services should not result in a decline in the existing quality and integrity of the market for the securities that trade on more than one licensed market;
 - (c) **Principle 3:** 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.

Your feedback

B1Q1 Do you agree these are the relevant principles?

Principle 1—Competition

- 26 Competition for market services—especially execution services—is, in principle, desirable including because of its potential to:
- (a) reduce transaction costs 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.

- 27 The Corporations Act regime now clearly reflects the principle of competition for market services, and allows for licensing and operation of multiple market venues. The Financial Services Reform Act, commencing in March 2002, amended the previous Corporations Act to remove almost all references to specific market operators and instead set out general obligations that apply equally to all operators of financial markets. Nothing in the scheme or policy of the *Corporations Act 2001* suggests there should not be direct competition between different market operators dealing in the same financial products.
- 28 Section 3 of the CRAI report describes some important efficient market objectives that can result from competition between trading venues. However, CRAI also points out that the simultaneous operation of multiple trading venues brings both costs and benefits. Competition between trading venues can generate efficiencies, in terms of reduced transaction costs and improved services, but the fragmentation of previously centralised trading can undermine liquidity and transparency and, as a result, the quality of price formation and the efficiency of the market as a whole.
- 29 It is important that the benefits of competition can be realised in an environment that is fair and free of distortions that might have adverse impacts on the efficiency of the market as a whole. In particular, the applications with which ASIC is currently dealing involve, in varying degrees, interdependencies between proposed new markets and the existing ASX market. In this situation, there is some potential for ‘free-riding’ to distort market efficiencies, which may need to be addressed.

Principle 2—Maintaining market quality and integrity

- 30 The benefits that can flow from competition might be eroded if there is a reduction in the quality or integrity of the overall market for the securities that are traded on more than one market venue. Australian entities compete for capital, and their ability to do so efficiently depends on the reputation and integrity of the Australian markets on which their securities trade. A decline in, or threat to, that reputation potentially makes their securities less attractive to investors, and increases the cost of capital.
- 31 Where equity securities of entities are traded on more than one market, the market regulation regime should aim to ensure that competition between market venues does not result in a decline in the quality or integrity of the overall market for those securities. That is, the focus should be on the impact

of multiple venues on the entire market for the equity securities traded in those venues, and—more broadly—on secondary capital markets generally.

- 32 In dealing with these applications for competing market services, we take the view that the way competing markets interact is crucial to the overall quality of the market for securities trading. An individual market, viewed in isolation, might provide a fair, orderly and transparent market for a class of securities, but unless there are effective interactions with other markets on which those securities trade, the overall market in those securities might not be fair, orderly and transparent. Key elements that require effective interaction of this kind are information about trading activity, and measures to ensure integrity across all trading venues.
- 33 Maintaining market quality and integrity in a competitive environment might be more difficult in a comparatively smaller market than those of the United States or Europe. It might be important that a regime is developed that takes account of the specific needs of the Australian market and its users. However, we take as a starting point that the Australian market and its regulatory regime are capable of being open to competition without overall loss of market quality or integrity.

Principle 3—Role of the regulatory regime

- 34 In our view, it is not the role of the regulatory regime to decide what markets look like, or to detail the ways in which competition can occur. However, the regime can perform two roles:
- (a) it can set the minimum conditions for the framework to maintain market quality and integrity; and
 - (b) it can ensure that, as far as possible, regulatory barriers to competition are removed to produce benefits for market participants and users.

Your feedback

B1Q2 Do you agree with ASIC's approach to:

- (a) competition
- (b) the need to maintain existing market integrity and quality
- (c) the role of the regulatory regime?

B1Q3 Are there other key principles ASIC should take into account? What are they and why are they important?

C Minimum conditions for maintaining market quality and integrity

Key points

Minimum conditions to maintain market quality and integrity need to address:

- liquidity;
- price discovery; and
- integrity.

Post-trade transparency and market integrity are essential at all times, but limited pre-trade transparency might be acceptable.

Market operators might need to reconsider rules limiting their participants' ability to trade on more than one licensed market.

Rules dealing with market operators' obligations to manage conflicts of interest might need to be reviewed in a multi-venue environment.

- 35 To this point, ASX is the only Australian licensed market on which the securities quoted on ASX are traded.¹ For that reason, the starting point benchmark for the existing standard of market quality and integrity is the securities market conducted by ASX.
- 36 This does not mean that we are seeking to protect ASX's position in the market, or that we consider ASX's market structure and method of operation is to be preferred to that of potential competitors. Nor does it suggest ASX must be able to continue to operate without changes that might be needed to adapt its current rules or operations to changed overall market conditions.
- 37 Our central concern is the continuing quality and integrity of the market for trading in those securities that are quoted on ASX, whether they are traded on ASX or elsewhere.
- 38 CRAI's report accompanying this paper describes and assesses the economic framework in which financial market activity takes place. It highlights the role organised financial markets play in enabling efficient price discovery and price formation, and the critical function liquidity and transparency play in achieving that end. It also analyses the possible impact on existing liquidity and transparency that might flow from proposed competition between market platforms—the 'market fragmentation' question. We agree that these are key issues that need to be addressed.

¹ Other exchanges operating in Australia trade securities other than those listed on ASX.

- 39 To maintain the current quality and integrity of the market in securities traded in a multi-venue environment, we consider that a set of key objectives needs to be preserved or enhanced. These objectives are critical to the continuing reputation of Australian markets for equity securities.

Proposal

c1 Market quality and integrity—key objectives:

- (a) **Liquidity:** preserve or enhance existing liquidity levels by ensuring trading opportunities are widely known and can be acted on by market users, depending on their trading preferences;
- (b) **Price discovery:** preserve the integrity of price discovery by ensuring prices are transparent and all participants have access to those prices; and
- (c) **Integrity:** preserve or enhance integrity by effectively protecting against any added risk of market abuse in a multi-venue environment.

Your feedback

C1Q1 Do you agree these are the key objectives?

C1Q2 Are there others ASIC should take into account? What are they, and why are they important?

Minimum conditions under which competing markets should operate

- 40 On the basis of CRAI's analysis, we have reached some high level preliminary conclusions about the minimum conditions that should apply in circumstances where there are multiple trading venues for the same securities. One of the purposes of this consultation paper is to test those conclusions.

- 41 Our conclusions are based on the assumption that the new market proposals can be accommodated within the existing market regulation regime of the Corporations Act, and that significant law reform is not required.

- 42 They are:

Proposal

c2 Minimum conditions—high-level statement

- (a) **Post-trade transparency:** effective and timely post-trade transparency is essential to maintain the existing level of efficiency of price discovery and price formation;
- (b) **Pre-trade transparency:** full pre-trade transparency might not be essential at the time competing markets commence, but will

become essential if a new market starts to account for a significant amount of the trading in a security;

- (c) **Integrity:** overall integrity of the market as a whole must be maintained through:
- (i) effective working arrangements for whole-of-market supervision; and
 - (ii) ensuring the emergence of multiple market venues does not detract from intermediaries' best execution obligations to their clients.

Note: Each condition is dealt with in more detail below.

Your feedback

C2Q1 Do you agree with this statement of minimum conditions under which competing markets should be permitted to operate?

C2Q2 Are there other conditions ASIC should consider? What are they, and why are they important?

Implications for ASX and other markets

Trading

- 43 For most of the trading that takes place on its securities market, ASX operates a centralised market with order flow directed to a single electronic market place where bids and offers are matched on a price–time priority (orders with the best prices take priority over those with prices further from the market; and earlier orders take priority over later orders at the same price). This is ASX's 'central limit order book' (CLOB).
- 44 Trading through the CLOB is not the only way in which ASX trades can take place. A number of types of 'crossings' are permitted, and these depart from the central principles underlying the CLOB. Some crossings allow trading to take place off-market and without direct reference to prices set through the CLOB. These arose largely in response to market users' concern about short-run, adverse price impacts of large orders. Other crossings take time priority from other same-priced orders, but trades still take place at prices set by the CLOB. ASX rules also allow participants to trade with clients, or with one another, outside of normal ASX trading hours.
- 45 More than 30% by value (and 7% by number) of trades in ASX-quoted securities takes place other than through the CLOB. 16% takes place off-market, and 14% on-market but with departure from the time priority normally given in the CLOB.² That is, ASX's centralised market has already

² ASX published data.

adapted to a significant extent to the needs and trading preferences of its customers.

- 46 We have not observed any decline in the quality or integrity of ASX's market as a result of this level of activity outside the main ASX market framework. Arguably, this is a result of the legislative and rule framework under which ASX operates and that delivers price discovery, liquidity, and integrity to the market it conducts.
- 47 Significant advances in the technology that supports market-based trading enable new opportunities and ways of trading to emerge in a competitive environment. Technology also allows for the rapid aggregation and distribution of information.

Your feedback

C2Q3 Are the implications of competition for market services in Australia different from those in other jurisdictions?

Clearing and settlement

- 48 As currently proposed, neither AXE nor Liquidnet will provide any clearing or settlement services for their markets.
- 49 On the AXE market, participants will bear the counterparty risk. The counterparty will be known in each transaction and a participant will make an assessment as to whether the counterparty risk is acceptable. Settlement will be effected by the entry of settlement messages on both sides of the transaction into the CHES system operated by ASX group, utilising participants' existing arrangements. ASX will receive a settlement fee in the normal course.
- 50 Similarly, trades will not be novated on the Liquidnet market. Liquidnet proposes to engage Bear Stearns Securities Corporation (BSSC) as its settlement agent. As BSSC is not a CHES participant, it will issue delivery instructions to Citibank NA Melbourne, which is a CHES participant. ASX will receive settlement fees.
- 51 There appears to be no policy reason why markets such as AXE and Liquidnet should not have access to the settlement services provided by the ASX group. Indeed, some public policy reasons support this approach. Settlement through a central clearing facility, with a well-established role in maintaining accurate records of the ownership of interests, is arguably more efficient and more certain than multiple settlement facilities. Settlement services are a distinct segment of ASX's business and are capable of being priced and operated separately from other market services.
- 52 The operating rules of ASX Settlement and Transfer Corporation Pty Ltd (ASTC) do not preclude the settlement of transactions that have occurred

somewhere other than on the ASX market, provided that the party responsible for effecting settlement is a CHESSE participant and they comply with ASTC Settlement Procedure 10.4.5. The procedure says that a participant must inform ASTC if a transaction that is to be included in the batch settlement either:

- (a) was not entered into in the ordinary course of trading on a market of an ‘Approved Market Operator’ (AMO) recognised by ASTC; or
- (b) is not categorised as ‘special’ under ASX market rules.

53 This suggests that either:

- (a) participants would have to flag each AXE or Liquidnet transaction under this procedure; or
- (b) AXE and Liquidnet could become AMOs for the purposes of the ASTC rules.

Your feedback

C2Q4 Are there any policy reasons why AXE and Liquidnet should not have access to settlement facilities operated by the ASX group?

C2Q5 What practical issues arise and how might they be addressed?

ASX rules

54 The ASX Market Rules currently contain restrictions that mean that an ASX participant cannot transact in ASX quoted securities on the AXE market and comply with the ASX rules. Market rule 16.12.1 says that a trading participant must report to ASX all sales of cash market products, all crossings and special crossings in cash market products, and other transactions effected under particular rules. This rule was adopted by ASX in an environment where ASX provided the only trading venue for securities listed on its market. It prevented trading off-market other than in accordance with the rules of ASX as a licensed market, and accordingly served a readily identifiable public policy objective.

55 However, if this rule were to remain in a multi-venue environment, it appears to have the effect of prohibiting intermediaries that are ASX participants from conducting transactions in ASX quoted securities on other venues. If they do so, they will breach the ASX rules.

56 Where multiple licensed markets are in operation, we do not see a sound Corporations Act policy basis for maintaining rules that do not go to the overall quality and integrity of the market, but whose effect is to advantage one market over another. Provided that effective best execution obligations apply, and overall arrangements deliver key liquidity, price discovery and market integrity objectives across all competing licensed markets, we

consider that market rules should not limit the markets on which intermediaries can trade. We will consult with the ACCC on the operation of rule 16.12.1.

57 A corollary is that we would not expect new operators to introduce rules that have a similarly prohibitive or restrictive result vis-a-vis trades on the ASX market.

58 Possible approaches include:

- (a) ASX removing rules that have this effect or adopting appropriate exceptions for AXE and Liquidnet trades;
- (b) requiring through regulations all licensed markets to introduce a rule requiring participants to trade in accordance with the rules of a licensed market.

Your feedback

C2Q6 Are there policy reasons that support the continuation of rules such as market rule 16.12.1?

C2Q7 Which of the approaches mentioned in paragraph 58 is the better one? Are there other approaches? What are they?

C2Q8 Do any other current ASX rules raise similar issues?

Managing conflicts of interest

59 The Corporations Act obliges a market licensee to have adequate arrangements to handle conflicts of interest between its commercial interests and the need for the licensee to ensure that its market is fair, orderly and transparent: s792A(c). The legislation also contains:

- (a) specific rules for dealing with conflicts arising from a licensed market operator's financial products (including securities) trading on a market it operates (s798C and s798D);
- (b) a general rule that regulations can be made to deal with other types of conflicts (s798E);
- (c) regulations made under s798E that deal with conflicts between ASX's commercial interests and those of entities that are listed or seeking to be listed on an ASX market (reg7.2.16).

60 These provisions to date have largely dealt with conflicts between licensed market operators and entities listed on their markets. Historically, ASIC has also dealt less formally with conflicts between ASX as a licensed market operator and ASX group entities that hold an Australian financial services licence and participate in ASX's market.

61 So, licensed market operators' conflicts are not a new issue. What is new is the potential for conflicts between supervisory obligations and commercial

interests in the context of market operators in direct competition with one another. This does not only apply to ASX, but to all competing market operators.

- 62 These types of conflicts might be more pervasive than previous types and might extend to a broad range of actions a licensed market operator takes as a market supervisor. For example, they might include:
- (a) making rules;
 - (b) the exercise of discretions to waive the application of rules, especially if market operators retain rules to the effect of ASX market rule 16.12.1;
 - (c) investigative and disciplinary decisions;
 - (d) entry into supervisory and information sharing agreements with other market operators.
- 63 Conflicts or potential conflicts might also affect a licensee's decision-making on issues that go to the quality and integrity of the market as a whole, as well as the position of competitor markets or their participants.

Your feedback

C2Q9 What rules about supervisory decision-making might competing market operators need to have?

C2Q10 What are the minimum conditions that should apply to ensure supervisory decisions are not tainted by actual or potential conflict?

C2Q11 What are the implications for decision-making structures within a licensed market operator?

C2Q12 Should regulations be made to deal with the broader range of potential conflicts?

C2Q13 Should ASIC's role as substitute decision-maker be expanded to cover a wider range of conflicts? If yes, which ones?

D How might the minimum conditions work in practice?

Key points

Information about trading activity in the same securities on different markets should be available in a consolidated form.

Pre-trade transparency might only be required until trading activity on a given market reaches a threshold level.

Comprehensive, cross-market supervision arrangements will be needed.

Conditions are likely to require a combination of conditions on individual licences and possibly some new regulations.

- 64 Different mechanisms might be required to give effect to the proposed minimum conditions. Some conditions might be achieved by individual market operators alone, through a combination of the rules they adopt, operating practices, and the contractual arrangements they have with suppliers of services to the market (e.g. with market data vendors). Others might require co-ordinated and co-operative activity by the operators of competing markets to maintain market quality and integrity. It seems clear, for example, that effective market supervision can only be achieved in this way.
- 65 We do not have fixed views about the way in which minimum conditions should be achieved. We will assess their efficacy by asking the following questions:
- (a) Are they effective to deliver the minimum condition reliably?
 - (b) Can compliance with them be readily monitored?
 - (c) Are there effective ways of enforcing them against the market operator and its agents or contractors, and against market participants?
- 66 In doing so, we will look at the proposed framework to deliver on the minimum conditions and, importantly, whether the framework will work effectively in practice.

Condition 1—Post-trade transparency

- 67 In our view, effective and timely post-trade transparency is essential to maintain the existing level of efficiency of price discovery and price formation. It is a vital source of information to market participants and users. Where the same securities trade on more than one market venue, information

about completed trading activity should be readily available in an aggregated form.

68 In our view, it is important that investors have access to a consolidated, single source of comprehensive information to assist them in making investment decisions. In the absence of a consolidated source, investors' search costs might be higher and overall efficiency might be eroded. Consolidated reporting might also reduce incentives for a market operator or its participants to withhold or unduly delay information about trading activity on a market.

69 Consolidation of trading information might be achieved through:

- (a) contractual arrangements between each market operator and third party information vendors to take trading information feeds from all markets and aggregate and publish that data; or
- (b) the creation of a new point for centralised aggregation of trading information, to be operated by one or more of the market operators, or an independent third party.

70 At a minimum, market users need consolidated information about the security transacted, the price at which the transaction took place, the volume and time at which the transaction occurred.

71 The full benefits of consolidated trading information will accrue when there are common reporting standards across markets for similar types of transactions. On the basis of AXE's current proposal, for instance, there are differences in the reporting obligations for transactions that are characterised as block specials on ASX, and larges trades in a single security on the AXE market.

Your feedback

D1Q1 Do you agree that trading information from multiple venues should be consolidated?

D1Q2 Are there other options apart from those described at paragraph 69 above?

D1Q3 Do you agree there should be common reporting requirements for similar types of transactions across different market venues? If not, why not?

Condition 2—Pre-trade transparency

72 Neither the AXE nor the Liquidnet proposal envisages any pre-trade transparency. AXE is proposing to operate a bulletin board for the posting of indications of interest. This is only likely to be used by AXE participants in circumstances where they cannot be certain they are meeting their best execution obligations to clients by either internalising a transaction or

conducting the transaction on the ASX market. In any event, the bulletin board will only be available to other AXE participants.

- 73 We have not come to the conclusion that pre-trade transparency is essential in relation to all markets. Market users have different preferences that might be better accommodated in markets with differing standards. This arguably creates efficiencies for those users, but might result in some overall reduction in transparency.
- 74 We have not concluded that we should require or mandate standardised pre-trade transparency. Other jurisdictions have adopted a threshold model, where, once trading in a particular security reaches a level of defined significance (for instance, a certain percentage of overall trading in a stock), a different standard of transparency applies.
- 75 In an open market, such as that proposed by AXE, where dealing occurs through intermediaries, arguably once trading in particular stocks reaches a level of significance or passes a threshold point, it might become difficult for those participants to be certain they can meet their best execution obligations without pre-trade transparency.
- 76 In direct investor markets, such as that proposed by Liquidnet, the lack of pre-trade transparency might be of less concern to participants who make their own decisions about where and with whom to trade.

Your feedback

- D1Q4 Is a lack of pre-trade transparency acceptable? Why and in what circumstances?
- D1Q5 Should a threshold model be adopted? What thresholds should apply?

Condition 3—Integrity

- 77 Continued market integrity relies on an effective supervisory framework. To date that framework has comprised the market monitoring and supervision arrangements operated by ASX, together with market oversight, compliance and enforcement activities conducted by ASIC. In a multi-market environment, there must be effective supervision arrangements between market operators, as well as with ASIC, to regulate the conduct of market participants and listed entities.
- 78 Minimum elements of an integrity framework include:
- (a) best execution requirements (for instance, rules that bind participants in an environment where users can be confident that compliance with the rules will be monitored and, where necessary, enforced by the market operator);

- (b) an agreed framework for market supervision, which could be through formal agreements (MOUs) between market operators to foster:
 - (i) cross-market flows of supervisory information and ensure that confidentiality obligations do not impede information flows;
 - (ii) co-ordinated supervisory action by market supervisors; and
 - (iii) effective supervision of both market activity and conduct by intermediaries,
- (c) confidence that the whole-of-market supervisory framework will operate robustly in practice.

Your feedback

D1Q6 Are there other market integrity factors that should be considered?

D1Q7 Do you agree with the above as a proposed minimum framework? If not, why not?

How might minimum conditions be imposed?

79 Within the existing legislative framework, there are a range of powers available to ASIC and the Minister to achieve the minimum conditions identified above. Some mechanisms are forward-looking, e.g. new regulations for operating requirements that could apply to all market operators. Other mechanisms are backward-looking and initially rely on the market participants instituting operational procedures or frameworks themselves to meet the minimum objectives identified by ASIC. In the absence of agreement by the participants, ASIC has remedial powers, which we can exercise to ensure our objectives are met.

80 The main relevant powers are:

- (a) the power to make regulations that prescribe the matters the operating rules of a licensed market must deal with (s793A(1)) or that prescribe matters to be addressed in operating procedures (s793A(2));
- (b) the power of the Minister to direct a licensee to do specified things to promote compliance with its obligations under the Corporations Act (s794A);
- (c) the power of the Minister to place conditions on a market licence or to vary conditions (s796A);
- (d) ASIC's power to advise the Minister (s798B).

The power conferred by s798E could be used to deal with the conflict of interest issues discussed in paragraphs 59–63.

81 These powers, which are available to ASIC and the Minister, are known to market participants and they are relevant both as options to address policy

issues and because they might provide market operators with an incentive to self regulate.

- 82 Whatever mechanism is used, we prefer a principles-based approach. This is consistent with the existing markets oversight regime. In this context, it means that regulations or conditions should focus on the outcomes a market licensee must produce, rather than on specifying detailed rules to achieve those outcomes. It allows market operators choice about what arrangements they adopt to ensure the minimum quality and integrity conditions are met, in a manner that is appropriate for the particular market.
- 83 In our view, obligations set out in regulations that apply to all market operators and that are known to potential operators at the time they commence developing a proposal for a new market are preferable as a regulatory model. This ensures that minimum standards can be set across the whole market. It will also create uniformity and resolve uncertainty. Relying purely on operating rules, in the absence of any statutory requirement about the content of the rules, is problematic as they can be changed by the individual market operator (subject to the Minister's power of disallowance).

Your feedback

- D1Q8 Do you agree that principles-based regulation should be the preferred approach? If not, why not.
- D1Q9 What are the relative merits of using regulations or conditions on market licences to achieve minimum overall market quality and integrity objectives?
- D1Q10 Are there other mechanisms to ensure the minimum quality and integrity conditions can be met? What are they?

E Fair competition

Key points

Access issues can be adequately addressed by commercial solutions.

- 84 Regulatory barriers to competition in the market should be minimised to allow market participants to compete with each other without jeopardising the objectives outlined above.
- 85 In a multi-venue environment where new entrants compete with an established market operator, issues of free-riding can arise. The way the regulatory regime operates should not create a competitive advantage for one entity over another by that entity externalising costs that are (or have been) borne by another, competing, entity.
- 86 AXE has proposed that its participants will use ASX share prices as the reference point in meeting their best execution obligations.
- 87 In our view, there is no inherent problem in one market having the listing function (the admission of entities to listing and subsequent monitoring of compliance with continuous disclosure obligations). This is because listing is a revenue source and the costs can be recovered by the listing market.
- 88 Similarly, costs associated with operating a clearing or settlement facility can be recovered by the facility operator. Indeed, a single venue for clearing and settlement of transactions conducted across different markets might arguably be preferable from a regulatory perspective, as it allows for certainty of transfer of title and passing of proceeds of transactions.
- 89 We anticipate that these types of access issues can be resolved on a commercial basis among the market operators.

Your feedback

- E1Q1 Do you agree with this analysis?
- E1Q2 Are there free-riding issues associated with using ASX prices as a reference point?
- E1Q3 How should these issues be dealt with?
- E1Q4 Are there other competition issues that might need to be addressed? What are they?

Appendix 1: Licensed markets operating in Australia

- ASX Limited
- Sydney Futures Exchange Limited
- National Stock Exchange of Australia Limited
- Bendigo Stock Exchange Limited
- Yieldbroker Pty Limited
- Australian Pacific Exchange Limited
- Golden Circle Limited
- EBS Service Company Limited
- Mercari Pty Limited
- IMB Ltd
- BGC Partners (Australia) Pty Limited
- Bloomberg Tradebook Australia Pty Ltd
- London Metal Exchange Ltd
- Eurex Frankfurt AG
- Chicago Mercantile Exchange, Inc.
- Reuters Transaction Services Limited
- Board of Trade of the City of Chicago, Inc.