



**ASIC**

Australian Securities & Investments Commission

**REPORT 315**

# **Market assessment report: Chi-X Australia Pty Ltd**

## **ACN 129 584 667**

October 2012

### **About this report**

This report relates to the period from 4 May 2011 to 31 March 2012 (assessment period).

### 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.

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## A Summary of observations and conclusions

### Key points

ASIC conducts annual assessments of market licensees because it is required to do so under s794C(2) of the Corporations Act.

The scope of our assessment must always include the obligations found in s792A(c), which require the licensee to have adequate arrangements for operating the market, including arrangements to manage conflicts of interest and monitor and enforce compliance with the operating rules. We can also include other Ch 7 obligations.

We use the licensee's self-assessment report, our observation of the licensee's performance, market intelligence and other things to form a view of how well the licensee has operated its market.

Overall, our assessment concluded that Chi-X met its statutory obligations during the assessment period. However, there are nine agreed actions that focus on aspects of Chi-X's activities. While important, these agreed actions do not detract from our overall conclusion.

### The assessment

#### ASIC's obligations

- 1 Under s794C(2) of the *Corporations Act 2001* (Corporations Act), ASIC is required to assess how well a market licensee is complying with its obligations under s792A(c) at least once a year.

#### Licensee's obligations

- 2 In line with our statutory obligations, we reviewed Chi-X Australia Pty Ltd's (Chi-X) arrangements for operating its market under s792A(c). This includes its arrangements for handling conflicts of interest and its arrangements for monitoring and enforcing compliance with its operating rules.
- 3 Under s794C(1), we are permitted to extend the scope of our assessment to review how well a market licensee is complying with any or all of its obligations under Ch 7 of the Corporations Act. In keeping with our standard practice, we extended the scope of our assessment to include a review of whether Chi-X had sufficient financial, technological and human resources to operate its market properly: see s792A(d).

#### Assessment period

- 4 Our assessment covers the period from 4 May 2011 to 31 March 2012, which reflects the date on which Chi-X's Australian market licence was granted by the Minister and Chi-X's financial year-end date.

- 5 Chi-X commenced operation on 31 October 2011 and launched its off-market trade reporting facility in two phases—in May and June 2012.

## Our approach to assessments

### ASIC's strategic priorities

- 6 ASIC's current strategic framework focuses on three key priorities. These are to ensure:
- fair and efficient financial markets;
  - confident and informed investors and financial consumers; and
  - efficient registration and licensing.
- 7 The first two of these are particularly important for licensed markets. For example, appropriate resourcing is fundamental to ensure that markets operate in an efficient manner. The adequate management and transparency of matters such as conflict handling arrangements are important to the fairness of the market. Similarly, under a multi-market environment for the trading of ASX-listed equity securities, the effective coordination of trading halts between Chi-X and ASX is critical in ensuring that investors and financial consumers are confident and make informed decisions. For these reasons, we regard the assessment process as an important tool by which we continue to strive to meet our strategic outcomes.

### Guiding principles

- 8 Our assessments are guided by certain principles that draw on the International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation. The principles we use to guide assessments are:
- admission standards for participants are robust and administered in a fair and transparent way;
  - post-admission standards are robust and effectively monitored and enforced in a fair and transparent manner;
  - operating rules promote transparency to market users of material price and trading information;
  - the deterrence of unfair trading practices is supported by robust arrangements for detection and prompt referral to ASIC of significant contraventions of the operating rules and the Corporations Act;
  - conflicts of interest are adequately managed; and
  - sufficient resources (including technological resources) are deployed to operate the market in a proper and reliable manner.

## Methodology

- 9 In conducting our assessment, we:
- held discussions with senior Chi-X personnel;
  - reviewed internal Chi-X documentation obtained under notices issued under s30 of the *Australian Securities and Investments Commission Act 2001* (ASIC Act);
  - reviewed the annual regulatory report given to ASIC, dated 30 June 2012, as required under s792F of the Corporations Act;
  - considered information received from and about Chi-X in the ordinary course of ASIC's dealings with it as a market licensee;
  - considered information from external sources, including media and industry commentary; and
  - reviewed the operation of the market throughout the assessment period.

## Focus areas for this assessment

- 10 For the purpose of Chi-X's first assessment, and in considering Chi-X's statutory obligations, we paid particular attention to:
- the operation of Chi-X's conflict handling arrangements;
  - the sufficiency of Chi-X's financial, technological and human resources;
  - Chi-X's framework for admitting participants to its market;
  - Chi-X's framework for monitoring and enforcing compliance with its market's operating rules; and
  - Chi-X's approach to monitoring compliance with its licence obligations.

## Nature of licence obligations

- 11 A market licensee's obligations are ongoing and whether it is likely to comply with these obligations in the future cannot be judged merely by reference to its past compliance.
- 12 We therefore use the assessment process to:
- reach conclusions about the adequacy of the arrangements a market licensee has in place in accordance with its obligations under s792A(c) at the time of the assessment; and
  - identify issues, which in our view need, or may need, to be addressed to ensure ongoing compliance.

## Adequate arrangements

- 13 In assessing how well a market licensee is complying with its statutory obligations to have adequate arrangements in place to operate its market and monitor its market participants' compliance with its operating rules, we consider whether a licensee has adequate arrangements to monitor and enforce its operating rules, and to handle conflicts of interest.

### Arrangements for monitoring and enforcing participants' compliance with operating rules

- 14 In determining whether a market licensee is complying with its obligations to monitor and enforce its operating rules, we consider how the licensee:
- monitors participant activity in relation to its operating rules to detect potential or actual non-compliance with the law or the market's operating rules;
  - plans and documents procedures for ensuring frequent and comprehensive assessment of its ongoing compliance with its obligations, and market participants' compliance with their obligations;
  - deals with actual or suspected breaches of the law or the operating rules, including remedial, disciplinary and other deterrent measures;
  - deals with complaints about the market or market participants; and
  - shares information with ASIC and (where appropriate) operators of other markets.

### Arrangements for handling conflicts of interest

- 15 In assessing the adequacy of a market licensee's arrangements for managing conflicts of interest, it is relevant that the regulatory regime does not preclude the existence of conflicts. Chi-X must, however, manage any conflicts it does have so as not to allow its commercial interests to prevail over its obligation to operate a market that is fair, orderly and transparent.
- 16 Conflicts of interest may arise in any area where a market licensee makes decisions with respect to monitoring and enforcing its operating rules. For example, conflicts of interest may arise in connection with decisions about:
- admission of a person to the market as a participant;
  - monitoring of a market participant;
  - investigative or disciplinary action;
  - the exercise of discretions, such as granting waivers from the market's operating rules; and
  - the determination of the fees schedule of a financial market, including any trading incentive programs and/or relevant shareholder rebates.

- 17 In assessing a market licensee's arrangements for handling conflicts of interest, we consider a range of matters, including:
- whether, under current arrangements, actual or potential conflicts of interest are reliably anticipated, identified and appropriately responded to;
  - whether there is a sufficient level of disclosure to the market about the nature and existence of any actual or perceived conflict and the steps taken to adequately manage it; and
  - whether the licensee's organisational and reporting structures separate its commercial activities from its monitoring activities to a significant degree.
- 18 For example, a suitable organisational and reporting structure is one where employees who are responsible for assessing the market licensee's compliance with its monitoring obligations report to a person who is not responsible for making commercial decisions.

### **Sufficient resources**

- 19 In assessing how well a market licensee is complying with its obligation to have sufficient resources to operate its market properly under s792A(d), we consider:
- how the licensee makes available and uses resources to support its arrangements for operating its market, taking into consideration:
    - the financial, technological and human resources made available during the assessment period; and
    - a general expectation that resourcing should increase in step with the licensees' operations, and that any reduction is appropriate only where changed circumstances or specific efficiencies can be clearly demonstrated;
  - the licensee's information technology system 'uptime' and instances of market disruption; and
  - our own experiences and observations, as well as those of market users, that there can be confidence that the market will operate in a reliable manner.

## **Assessment findings**

- 20 ASIC is satisfied that, in terms of the standards set out in the Corporations Act, during the period from 4 May 2011 to 31 March 2012 (assessment period), Chi-X had adequate arrangements in place for meeting its statutory obligations under s792A(c), and the provision of those services was sufficiently resourced under s792A(d).



## Agreed actions

- 21 ASIC has identified nine areas for improvement or attention that Chi-X should address. While the agreed actions are important, they do not cause us to qualify our overall conclusion that Chi-X met its statutory obligations during the assessment period.
- 22 The agreed actions can be found in Section B of this report.

## Market conditions

- 23 A discussion of the market conditions for the 2011–12 financial year is contained in Section C of this report. The key features were:
- The S&P/ASX 200 suffered a pronounced decline in the 2011–12 financial year, falling by 11.1%.
  - After remaining relatively stable throughout 2010–11, volatility increased significantly during the first quarter of 2011–12. The riskiness of the share market peaked in October 2011 when the 30-day indicator went above 30%.
  - In light of the prevailing market conditions, turnover on Chi-X increased steadily during the second half of 2011–12, lifting its market share to around 3% by the end of the financial year. More recently, it has been publicly reported that Chi-X's share of daily trading volume has reached more than 5%.<sup>1</sup>

## Consultation

- 24 Chi-X has had the opportunity to view and comment on the factual accuracy of this report. Where appropriate, this report reflects Chi-X's comments.

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<sup>1</sup> G Lionidis, 'Chi-X makes its mark', *Australian Financial Review*, 31 August 2012, p. 20.

## B Agreed actions

### Key points

We have considered the adequacy of Chi-X's arrangements and resources for the operation of its market.

Our view is that Chi-X complied with its statutory obligations as they existed at the time of the assessment period. However, there are nine areas for improvement that Chi-X has agreed to address.

These agreed actions relate to Chi-X's:

- obligations to ensure that it has adequate arrangements for managing conflicts between its commercial interests and the need for it to ensure that its market operates in a fair, orderly and transparent manner;
- technological resources;
- obligations to monitor and enforce compliance with its operating rules; and
- human resources.

While these agreed actions are important, they do not cause us to qualify our overall conclusion that Chi-X met its statutory obligations during the assessment period.

ASIC notes that Chi-X has already commenced work to address some of the agreed actions outlined in this assessment report.

### Nature of agreed actions

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Our nine agreed actions can be broken down into four categories:

- *conflict handling*—Chi-X's ongoing obligation to ensure that it has adequate arrangements for managing conflicts between its commercial interests and its statutory obligations (Agreed actions 1 and 2);
- *technological resources*—Chi-X's obligation to have sufficient technological resources to operate its market properly (Agreed action 3);
- *monitoring and enforcing compliance*—Chi-X's obligation to have adequate arrangements for monitoring and enforcing compliance with its operating rules (Agreed actions 4 to 7); and
- *human resources*—Chi-X's obligation to have sufficient human resources to operate its market properly (Agreed actions 8 and 9).

## Conflict handling

- 26 As part of the assessment process, we reviewed Chi-X's:
- organisational and reporting structures;
  - conflict management policy;
  - processes and procedures for identifying and managing conflicts of interest; and
  - conflicts register.
- 27 In undertaking our review, we paid particular attention to how Chi-X's conflict handling arrangements operated in practice.
- 28 Chi-X's structure for identifying and managing its conflicts of interest include:
- a corporate governance framework with the following features: an independent non-executive director on the Chi-X Board; a Compliance Committee, which is chaired by the independent non-executive director; a Review Committee, which is chaired by an employee of a market participant; a Participant Suitability Committee; and a soon to be established Audit Committee;
  - allocating the ultimate responsibility to Chi-X's Chief Executive Officer (CEO), with assistance and monitoring by the Compliance team and oversight by the Compliance Committee, which reports directly to the Chi-X Board; and
  - ensuring Compliance plays an independent role in identifying and managing any conflicts of interest that may arise, and has a separate reporting line to the Compliance Committee.

### **Agreed action 1: Disclosure of conflicts and conflict handling arrangements**

#### **Conflicts arising from the market participation of the shareholders of Chi-X's parent company**

- 29 Chi-X is a wholly owned Australian subsidiary of Chi-X Global Holdings LLC (Chi-X Global), which is in turn majority owned by Instinet Global Properties Inc (Instinet) and six institutional investors. Instinet is a member of the Instinet group of companies, and is ultimately owned by Nomura Holdings Inc (Nomura). Instinet Australia Pty Ltd (Instinet Australia) and Nomura Australia Ltd (Nomura Australia) were admitted as participants of the Chi-X market as part of the market's launch on 31 October 2011.
- 30 It is noteworthy that, for a participant that is a related body corporate of a market licensee, s798DA of the Corporations Act requires the market's operating rules to provide for ASIC, instead of the licensee, to make decisions and to take action (or to require the licensee to take action on ASIC's behalf) in relation to specific matters, including the admission, suspension and disciplining of a participant.

- 31 In accordance with the Corporations Act, Chi-X has provided for ASIC's decision-making power in Chapter 10 of its market's operating rules. Under the Corporations Act and the Chi-X Operating Rules, ASIC considered and subsequently approved the participant applications of Nomura Australia and Instinet Australia on 25 October 2011.
- 32 During our assessment discussions, Chi-X indicated that other measures utilised to manage parent entity conflicts included ensuring that Instinet Australia, Nomura Australia and Chi-X are physically separated from each other in Australia, and not providing the employees of Instinet Australia or Nomura Australia with access to Chi-X's premises.
- 33 Our review did not identify any significant areas of concern in relation to Chi-X's arrangements for handling the potential conflicts arising from the market participation of the Australian operations of Chi-X Global's shareholders. Nevertheless, we believe that Chi-X could further enhance its conflict handling arrangements by establishing a section on its public website to clearly outline its framework and processes for managing its actual or perceived conflicts of interest. We believe this will increase the transparency of the Chi-X market and foster investor confidence in the fairness of the financial market that is operated by Chi-X. This recommendation is consistent with the approach we have taken with other market licensees, such as the ASX Group.

**Conflicts arising from Chi-X's independent non-executive director's role as Chairman of E.L. & C. Baillieu Stockbroking Ltd**

- 34 Chi-X's independent non-executive director was appointed on 29 September 2011, while E.L. & C. Baillieu Stockbroking Ltd (Baillieu) was formally admitted as a Chi-X market participant on 28 February 2012.
- 35 We understand that Chi-X's independent non-executive director is not a member of its Participant Suitability Committee, and therefore did not have any involvement in considering Baillieu's participant application. We also note that under the Compliance Committee Terms of Reference, if the Chairman has or may have a conflict of interest in relation to a matter to be considered by the Committee, an alternate person must be appointed as Chairman for that meeting. The alternate person will be appointed from Chi-X's Compliance Committee and Review Committee Panel.
- 36 In line with the recommendation above, we believe Chi-X could further enhance the transparency of its market by including its conflict handling arrangements for its independent non-executive director.

**Agreed action 1: Disclosure of conflicts and conflict handling arrangements**

Chi-X has agreed to update its public website to include the names of the entities with which it may have material actual or potential conflict, the nature of the conflict, and the arrangements that it has in place to manage the conflict.

## Agreed action 2: Conflicts register

- 37 Chi-X has established a conflicts register to record its actual and potential conflicts of interest. The register is maintained by the Compliance team, with oversight by the Compliance Committee.
- 38 While this conflicts register is a useful monitoring tool, our review indicated that the register could be enhanced, both in terms of the type of conflicts that are captured in the register and the nature of information that is recorded for each conflict matter. We believe these measures would help in ensuring the register is a comprehensive central repository of Chi-X's actual and potential conflicts.
- 39 Specifically, we think the conflicts register should be expanded to capture all potential material conflicts, including the independent director's role as Chairman of the Baillieu Board and the potential conflicts that may exist as a result of its Compliance Committee and Review Committee Panel members' associations with some of its market participants.
- 40 For matters that have already been included in the conflicts register, we believe the records could be enhanced by incorporating further details on who identified the conflict, how the conflict was identified, and the date on which the conflict was identified.

### Agreed action 2: Conflicts register

Chi-X has agreed to expand its conflicts register to include all potential material conflicts, and incorporate further details on who identified the conflict, how the conflict was identified, and the date on which the conflict was identified.

## Technological resources

- 41 Technology plays an integral role for financial markets and, in the context of ASIC's strategic priorities, plays a fundamental role in ensuring financial markets are fair and efficient. In light of the ongoing evolution and advancements in financial market infrastructure technology, and the increased proliferation of cyber crime due to the online revolution, the sufficiency of a market licensee's technological resources, including a licensee's arrangements for ensuring systems integrity and security against online attacks, will continue to be one of the key focus areas of our assessments in the foreseeable future.
- 42 In reviewing the adequacy of Chi-X's technological resources, we considered Chi-X's:
- IT governance framework;
  - business continuity and disaster recovery planning arrangements;
  - processes and procedures for capacity planning and stress testing;

- systems integrity and security arrangements;
- service agreements with third parties; and
- external stakeholder communications and engagement processes and procedures.

### **Agreed action 3: Hidden order threshold control failure**

- 43 In May 2012, Chi-X notified ASIC that it had discovered an issue with the implementation of a software change (before the launch of its market) in relation to its hidden order type.
- 44 Before 4 May 2012, hidden orders submitted to the Chi-X market were required to have a minimum order value of \$20,000. In accordance with this requirement, Chi-X created a hidden order threshold control for rejecting hidden orders that are submitted with a value of less than \$20,000.
- 45 The software change relates to the implementation of a user-definable hidden order threshold control, which allows for a parameter to be set in Chi-X's production environment.
- 46 We note that the software change was successfully tested in Chi-X's test environment and that during the period before Chi-X's market launch the parameter was set to '\$0' to facilitate the use of the system by its participants. Chi-X has advised that although the threshold control functionality was successfully migrated into its production environment, due to human error, the parameter was incorrectly set to '\$0' (the default setting) rather than '\$20,000' in the production environment. Further complicating the matter was the Markets and Operations team's omission to validate the parameter setting before going live.
- 47 We note that this matter was brought to ASIC's attention as soon as Chi-X became aware of the human oversight, and that the hidden order threshold control setting was rectified immediately by Chi-X.
- 48 Following the discovery of the hidden order threshold control error, Chi-X completed a review of the other filters and controls in its systems and verified that they had all been set correctly. In addition, Chi-X has implemented several procedural changes to minimise the risk of errors, including:
- performing daily cross-checks of market-wide settings to ensure that no setting has been inadvertently changed or deleted;
  - extending its IT and operations workflow management system to cover changes to parameter values; and
  - ensuring changes to the production system are subject to formal change request procedures in its IT and operations workflow management system, are signed-off by the Director, Markets and Operations, before implementation, and tracked using its workflow management system.

- 49 Chi-X has advised that its Markets and Operations team will continue to review its current operational processes and procedures with a view to minimising the risk of human error. At the time of writing, Chi-X's internal review of the hidden order threshold control failure had yet to be finalised.

#### Agreed action 3: Hidden order threshold control failure

Chi-X has agreed to provide ASIC with a final report on the outcome of its internal review on the hidden order threshold control failure, including the changes that it plans to implement to address the issues highlighted by that review, by 30 November 2012.

## Monitoring and enforcing compliance

- 50 The third category of agreed actions relates to Chi-X's obligation to have adequate arrangements in place for monitoring and enforcing compliance with its operating rules. Our focus was on reviewing Chi-X's processes and procedures for:

- the admission of participants;
- monitoring and enforcing compliance with its market's operating rules;
- monitoring compliance with its licence obligations; and
- recording its Compliance Committee meeting minutes.

#### Agreed action 4: Participant admission process

- 51 Corporate entities are required to make an application to Chi-X for approval before being granted access to the Chi-X market. Chi-X considers applications for the admission of participants to its market in accordance with its operating rules and operating rules procedures.
- 52 In December 2011, ASIC requested two participant admission files from Chi-X under s792D of the Corporations Act. ASIC requested those files following an earlier review of the participant admission files relating to two other applicants, which highlighted some areas for improvement.
- 53 Consequently, as part of the assessment, we paid particular attention to the following:
- whether all admission criteria have been satisfied before admission is granted;
  - Chi-X's documentation and record keeping; and
  - whether sufficient checks and follow-ups have been made, where required.
- 54 During the assessment process, we reviewed Chi-X's documentation and record keeping in relation to a number of its participants, and examined the application relating to the only participant that it had admitted to its market since the start of this calendar year.

### **Preliminary review of participant applications**

55 During the preliminary review process, the Markets and Operations, IT and Compliance teams would separately review an application against set criteria, and for completeness of the documentation attached to the application.

56 Following the review by the relevant Chi-X teams, the Markets and Operations team would contact the applicant with a list of follow-up inquiries. Generally, these requests are dealt with via email; however, for specific compliance-related inquiries, Compliance may contact the applicant directly.

#### *Chi-X participant application guide*

57 During the assessment process, we noted that Chi-X's participant application guide still contained processes and procedures in relation to its market's launch. We therefore believe that Chi-X should review and update its participant application documentation to ensure these documents reflect the current processes and procedures.

#### *Review by Chi-X Compliance*

58 The review undertaken by the Compliance team is 'Chinese-walled' from the Markets and Operations and IT teams. We believe this arrangement is a positive step in ensuring that Chi-X's compliance function is separated from its commercial activities.

59 The Compliance team prepares a compliance checklist, which it uses as an internal workflow document, for each applicant. All compliance checklists are centrally maintained in the 'Compliance—Applications' file, with details being transferred to a different file upon approval of an application ('Compliance—Participants' file).

60 During our review of the 'Compliance—Applications' file, we noted that the following information was not clearly shown in some of the checklists:

- (a) the full legal name of the applicant;
- (b) the date on which the application was received;
- (c) the date on which matters were followed up; and
- (d) records of follow-up inquiries made for items on the checklist, including responses from the applicant and the date on which they were received.

61 We also noted that once approval has been granted, the checklist was not updated to reflect the date of approval.

62 Chi-X has advised that within its participant application workflow management system, which it uses for formally tracking participant applications and generating admission letters, the full legal entity name of each participant is maintained. Formal documents are recorded in the workflow system under a file for each applicant, with the date being automatically inserted by the system each time a document is added or updated.



63 As part of our review, we also examined the file note relating to the follow-up meeting that Chi-X held with the participant that it admitted during this calendar year. While the file note contained sufficient details regarding the key issues discussed during that meeting, we believe it could be enhanced, for audit trail purposes, by including the date on which the meeting was held.

64 Separately, during our review of the ‘Compliance—Participants’ file, we noted that the compliance checklist relating to three of its admitted participants was not available in the file. For one of the applicants, Chi-X’s view was that as the applicant had submitted a comprehensive application to Chi-X, it was unnecessary for an internal compliance checklist to be maintained.

65 Notwithstanding this, we believe the maintenance of accurate and complete records for all participant applications, including all correspondence with applicants, is essential for ensuring audit trails are available and easily accessible when required.

#### *Review by Chi-X Markets and Operations*

66 As part of our review, we also examined the internal workflow documents used by the Markets and Operations team for tracking participant applications. Our review highlighted some instances where details were inaccurately recorded, including instances where generic participant names were recorded (i.e. the name of the financial service group to which the participant belongs was used rather than the legal entity name).

67 We consider the maintenance of accurate records, including the use of accurate legal entity names, in all formal and internal documentation relating to participants to be important for ensuring ease of cross-referencing across all files and records. We also think that the use of generic participant names in some of the files could result in confusion should Chi-X admit another entity from the same financial services group to its market in the future.

68 As highlighted above, accurate participant legal entity names are maintained in Chi-X’s participant application workflow management system.

#### **Formal review of participant applications**

69 A Participant Suitability Committee (PSC) has been established by the Chi-X Board, consisting of the CEO, Director, Markets and Operations, Chief Technology Officer (CTO) and Head of Compliance, to consider and decide upon participant applications. Any applications for participation that are not unanimously agreed upon by the PSC are submitted to the Chi-X Board for final resolution.

70 Once the preliminary review process has been completed, a PSC meeting is scheduled to formally consider the application.

*Granting approval*

- 71 During the assessment process, we reviewed a number of the admission letters that Chi-X had sent to its participants.
- 72 Our review of the admission letters indicated that there were several instances where Chi-X granted admission subject to conditions that are outlined as the admission criteria under its operating rules. Specifically, there were several instances where admission was granted before the applicant received a written automated order processing (AOP) certification from ASIC under the ASIC Market Integrity Rules (Chi-X Australia Market) 2011 (ASIC Market Integrity Rules (Chi-X)) and confirming that it had finalised its clearing and settlement arrangements.
- 73 These admissions took place as part of Chi-X's market launch. We note that Chi-X did inform ASIC about its processing of participant applications, and that, due to practical reasons, most of the attestations had to occur at a late stage in the preparation of the launch of its market.
- 74 Our review also highlighted an instance where an application was approved subject to the applicant providing an updated management plan to Chi-X. However, we note that, in that instance, Chi-X did receive and review a penultimate version of the applicant's management plan before granting approval.
- 75 Notwithstanding the above, as a future practice, we would expect that participants meet all admission criteria before being formally admitted.
- 76 During our review, we also noted an instance where the wrong application lodgement date was inserted in the participant admission letter. While we do not consider this error to be critical in nature, it does suggest that Chi-X's process for reviewing participant admission letters could be enhanced.

*Effective date of admission*

- 77 The effective date of admission to the Chi-X market is the date stated on each participant's admission letter.
- 78 Our review of the admission letters indicated that Chi-X could enhance the letters by clearly stating the effective date of admission, the relevant operating rule for admission, and also stating that, upon admission, the participant will be required to comply with both the Chi-X operating rules and ASIC Market Integrity Rules (Chi-X). We consider this to be important in ensuring its newly admitted participants are fully aware of the effective date of admission and their obligations upon admission.
- 79 Separately, our review also highlighted an instance where there was a three-month gap from the date of admission to the commencement of trading operations. Chi-X has advised that, while the participant intended to commence trading operations immediately upon admission taking effect, the

commencement of its trading operations had to be delayed because it had identified a deficiency with the smart order router that it had originally acquired.

80 We acknowledge that circumstances may arise that are beyond the control of Chi-X. Nevertheless, we think it is important that participants are in a position to commence trading operations as soon as practicable after Chi-X grants admission. This ensures that the considerations and documentation supporting the decision to admit a participant remain current upon commencement of trading.

*PSC meeting minutes*

81 Chi-X's CEO or, if the CEO is not available, the Director, Markets and Operations, must ensure that minutes relating to the key issues debated and decisions made by the PSC are recorded and copies provided to each member of the Board.

82 Before the launch of the Chi-X market, decisions of the PSC were recorded via email. Our review of the emails indicated that the PSC minutes could be improved by including the date on which the PSC meeting was held, the meeting attendees, the key issues debated, and the decisions made during the meeting.

83 Given that the PSC is a crucial component of Chi-X's governance and control framework, we believe the quality and level of detail of the meeting minutes are important to:

- facilitate oversight of decision making and performance monitoring of the PSC by the Chi-X Board; and
- provide regulatory transparency over Chi-X's participant admission process.

84 As part of our review, we also examined the PSC meeting minutes relating to the participant that Chi-X admitted during this calendar year. Our review indicated that Chi-X has taken positive steps to improve its processes and procedures for recording its PSC meeting minutes and reporting the minutes to the Chi-X Board.

#### Agreed action 4: Participant admission process

Chi-X has agreed to review its processes and procedures for the admission of participants, and implement improvements, including:

- ensuring that admission is not granted until a participant is ready to commence trading operations;
- where possible, ensuring that a participant is in a position to commence trading operations immediately upon admission taking effect;
- updating its compliance checklist to include the date on which the application was received, the date on which follow-up inquiries were made, records of all correspondence relating to follow-up inquiries made for items on the checklist (including the responses from the applicant and the date on which the responses were received), and the date on which the application was approved;

- updating its participant admission letter to ensure that its newly admitted participants are aware of the effective date of admission, and that, upon admission, the participant will be required to comply with the Chi-X operating rules and ASIC Market Integrity Rules (Chi-X);
- ensuring that accurate and complete records are maintained in all the files and systems that it uses for reviewing and approving participant applications;
- continuing to enhance its processes and procedures for recording PSC meeting minutes; and
- updating all documents relating to the admission of participants to ensure the documents reflect the current processes and procedures.

### **Agreed action 5: Monitoring participants' compliance with its operating rules**

- 85 Chi-X initially planned to develop a risk matrix for prioritising the participants on which the Chi-X supervision program would focus. However, following an internal review, the Compliance Committee decided in March 2012 that it would revise its approach by implementing a participant self-assessment program.
- 86 Chi-X's participant self-assessment program will involve the completion of a questionnaire (that has been internally developed by Chi-X Compliance) by its participants, the formulation of an internal risk rating matrix by Chi-X Compliance, and targeted participant visits.
- 87 Chi-X has advised that it is planning to roll out the self-assessment questionnaires by around end of October or early November 2012 (i.e. around the first anniversary of the Chi-X market) and develop a schedule for participant visits by the end of this calendar year. Chi-X is planning to undertake thematic participant visits by the end of March 2013.
- 88 Chi-X plans to undertake the self-assessment program on an annual basis.
- 89 Although Chi-X's self-assessment program is still in the process of being finalised, we understand that, during the assessment period, Chi-X has undertaken some participant investigations as a follow-up to specific compliance matters that have come to its attention as part of its ongoing supervision of its participants' compliance with its market's operating rules.

### **Agreed action 5: Monitoring participants' compliance with its operating rules**

Chi-X has agreed to finalise the processes and procedures relating to its participant self-assessment program, and provide ASIC with a copy of the self-assessment questionnaire and its plan for rolling out the questionnaire to its market participants by 30 November 2012. In addition, Chi-X should provide ASIC with its schedule for targeted participant visits by the end of the 2012 calendar year.

## Agreed action 6: Monitoring compliance with licence obligations

- 90 Chi-X's processes for monitoring compliance with its market licence obligations (including conflicts) include ad hoc, quarterly and annual internal reviews.
- 91 In accordance with s792F of the Corporations Act, Chi-X submitted its annual regulatory report to ASIC in June 2012 to outline the extent to which it has complied with its obligations as a market licensee.
- 92 Separately, at its March 2012 meeting, the Chi-X Board resolved to establish an Audit Committee. Chi-X has advised that it is in the process of drafting the Terms of Reference for the Audit Committee. We believe the establishment of an Audit Committee would further facilitate the monitoring and review of Chi-X's processes and procedures, particularly for its compliance function.

### Agreed action 6: Monitoring compliance with licence obligations

Chi-X has agreed to finalise the establishment of its Audit Committee and provide ASIC with a copy of the Audit Committee Terms of Reference by 30 November 2012, and ensure that the committee's mandate includes the review of the Compliance team's activities.

## Agreed action 7: Minutes relating to Compliance Committee meetings

- 93 As part of the assessment process, we also considered the Compliance Committee meeting minutes that were submitted to the Chi-X Board. Our review indicated that the meeting minutes were inconsistent with the guidelines outlined in the Compliance Committee's Terms of Reference. Specifically, we noted that the meeting minutes only provided a list of items that were discussed during each meeting, but did not provide a summary of the key issues raised for an agenda item, the key reasons for decisions, actions arising, the person responsible for each action item, and the Committee's observations about the monthly reports from the Head of Compliance.
- 94 We note, however, that instead of providing the Chi-X Board with more detailed meeting minutes, the Compliance Committee has been submitting its comprehensive monthly reports to the Board for review.
- 95 Given that the Compliance Committee is a vital component of Chi-X's governance and control framework, we believe the quality and level of detail of its meeting minutes, both for Chi-X's internal compliance matters and participant compliance matters, are important for:
- facilitating oversight of decision making and performance monitoring of the Compliance Committee by the Chi-X Board; and
  - providing regulatory transparency over Chi-X's decision-making process, particularly for participant compliance matters.

- 96 During the assessment discussions, the Compliance Committee advised that the Chi-X Board had requested it to provide more detailed meeting minutes (rather than the comprehensive monthly compliance reports that it had been providing). The Compliance Committee also advised that, following the feedback from the Chi-X Board, it is planning to review its processes and procedures for recording and reporting its meeting minutes and update its Terms of Reference.

#### Agreed action 7: Minutes relating to Compliance Committee meetings

Chi-X has agreed to update the Compliance Committee's Terms of Reference to reflect the revised requirements for the recording of meeting minutes that relate to its internal compliance and participant compliance matters, including the reporting of the minutes to the Chi-X Board, and provide a copy of the updated Terms of Reference to ASIC by 31 December 2012.

## Human resources

- 97 The fourth category of agreed actions relates to Chi-X's obligation to have adequate human resources to operate its market properly.
- 98 In assessing the adequacy of Chi-X's human resources, we considered a range of matters, including:
- the appropriateness of the skills and experience of its staff, compared with their roles and responsibilities;
  - Chi-X's approach to managing and resolving temporary resourcing issues, including metrics that it uses to track staff workload;
  - Chi-X's approach to managing key person risks and succession planning; and
  - Chi-X's approach to identifying and planning for its longer term resourcing requirements, including its skills and capabilities and resourcing mix requirements.

### Agreed action 8: Ongoing monitoring of human resource requirements

#### Chi-X's approach to identifying and managing its current resourcing requirements

- 99 Chi-X Australia currently has 14 staff. Chi-X's resourcing requirements are the responsibility of its local managers, who are able to raise any concerns directly to local senior management and, if necessary, the Compliance Committee. The Chi-X Compliance Committee is responsible for monitoring the adequacy of resource planning and reporting any concerns to the Chi-X Board.
- 100 For Chi-X's IT functions, Chi-X Global Technology (Chi-Tech) provides monitoring services outside of Chi-X's business hours and a 'second pair of eyes' monitoring service to supplement the system monitoring performed by Chi-X staff during normal business hours. Chi-X has advised that these

services are provided on a non-contested basis and that Chi-Tech has a clear understanding that production issues of a critical nature take precedence over all other matters.

101 For IT system development, a team within Chi-Tech is permanently allocated to work on Chi-X projects. We understand that it is possible for additional resources to be added to the team to reduce specific project timeframes if required, through discussion with the CEO of Chi-X Global. Chi-X has advised that, to date, it has not been necessary to involve the Chi-X Global CEO in such discussions.

102 We note that Chi-X did not have any performance monitoring metrics in place during the assessment period. During the assessment process, Chi-X advised that it is planning to develop some key performance indicators (KPIs) for its Markets and Operations team. We agree that the development of KPIs for the Markets and Operations team is appropriate, given the nature of the work undertaken by that team.

103 Due to the start-up nature of the Chi-X market, and the corresponding size of its team, we have noted the potential for some pressure points in the staffing of the Chi-X team. While we understand that, in light of the percentage market share that it has acquired to date, and due to cost considerations, Chi-X does not plan to recruit additional staff members at this point in time, we would, however, recommend that Chi-X continue to monitor its human resourcing requirements to ensure that it has adequate resources in place as its market evolves.

#### **Chi-X's approach to identifying and managing its future resourcing requirements**

104 In assessing the adequacy of Chi-X's human resources, we also examined Chi-X's approach to identifying and planning for its future resourcing and skills and capabilities requirements.

105 During our assessment discussions, Chi-X advised that because its systems are scalable, it does not envisage a need to acquire a significant number of new staff as its market share grows. In addition, Chi-X also advised that its future resourcing and skills and capabilities requirements would largely depend on the Chi-X Board's decision about its business strategy, including its business mix and product offering.

106 We understand that the Chi-X Board is actively reviewing its strategic options. Therefore, we would encourage Chi-X to incorporate human resource planning as part of its business/strategic planning process to ensure that it has sufficient human resources, with the appropriate skills and capabilities, as its market evolves.

#### **Agreed action 8: Ongoing monitoring of human resource requirements**

Chi-X has agreed to finalise the development of its performance monitoring metrics and provide ASIC with a copy of the relevant documentation by 31 December 2012.

## Agreed action 9: Management of key person risk

- 107 Due to the size of the Chi-X team, we consider that there are several key person risks within the organisation. We understand that Chi-X seeks to schedule the timing of staff annual leave to ensure that adequate resources are available to support its market at all times. Consequently, as part of our assessment, we reviewed Chi-X's arrangements for back-filling these key roles should an unexpected event result in the incumbent staff not being available to perform their duties.
- 108 During the assessment discussions, we discussed Chi-X's approach to managing the key person risk for the following key roles: CEO; CTO; and Head of Compliance and Head of Regulatory Affairs. Chi-X has advised that it has plans or interim arrangements to manage the key person risk associated with these roles. Notwithstanding this, we consider that one role in particular presents a more heightened risk.
- 109 We note that Chi-X's temporary resourcing arrangements for this important function include its independent non-executive director temporarily stepping into the role, with support from other Chi-X staff, including some aspects of the role being shared between the other senior executives and the in-house counsel. We also understand that, if required, a senior staff could be seconded from another part of the Chi-X Group.
- 110 During the assessment discussions, we noted that there was insufficient documentation of the day-to-day processes and procedures for the performance of this role and cross-training of relevant staff to adequately support the independent non-executive director, if required.
- 111 We believe the documentation of the day-to-day processes and procedures relating to the function managed by this role, along with some cross-training of relevant staff, is important to ensure the smooth operation of this crucial function should an unexpected event occur.

### Agreed action 9: Management of key person risk

Chi-X has agreed to develop documentation on the processes and procedures that are necessary for the smooth operation of the function that is managed by the specific key person risk that ASIC has identified to ensure that the role can be performed by other relevant staff if the key person is unavailable to carry out this crucial function. The documentation should include a reference guide for accessing and maintaining the key documents managed or held by this role. In addition, appropriate cross-training should be provided to relevant staff to ensure that they are able to sufficiently support its independent non-executive director, if required.



## C Market conditions

### Key points

This section discusses the market conditions during the assessment period. Some key features included:

- The S&P/ASX 200 index suffered a pronounced decline in the 2011–12 financial year, falling by 11.1%.
- After remaining relatively stable throughout 2010–11, volatility increased significantly in 2011–12, peaking at above 30% in October 2011.
- In light of the prevailing market conditions, it has recently been publicly reported that Chi-X's share of daily trading volume has reached more than 5%.

### Market performance

- 112 The S&P/ASX 200 suffered a pronounced decline in the 2011–12 financial year; the large decline was the first negative end-of-financial year reading the index has had since the credit crisis in 2009.
- 113 The S&P/ASX 200 index remains more than 20% below its level in June 2008.<sup>2</sup> Based on a compound annual growth rate, the index has averaged a 5.5% yearly loss since June 2008.
- 114 Data from the Australian Bureau of Statistics in March 2012 suggest that investors prefer to hold lower risk assets such as bonds and cash deposits, with 26% of Australians' financial wealth now being held in cash and bank deposits, which is well above the long-term average.<sup>3</sup>

### Volatility of the market

- 115 The evolution of risk in the S&P/ASX 200 index is depicted by the 30-day volatility indicator. An increase in the volatility measure can be interpreted as an increase in the riskiness of investing in Australian equities.
- 116 After remaining relatively stable throughout 2010–11, volatility increased significantly during the first quarter of 2011–12 and peaked at above 30% in October 2011.
- 117 From November 2011, the 30-day volatility indicator began to decline. However, volatility began to trend upwards again and approached 20% by the end of the 2011–12 financial year (the S&P/ASX 200 fell to 3985 points in early June 2012, a six-month low).

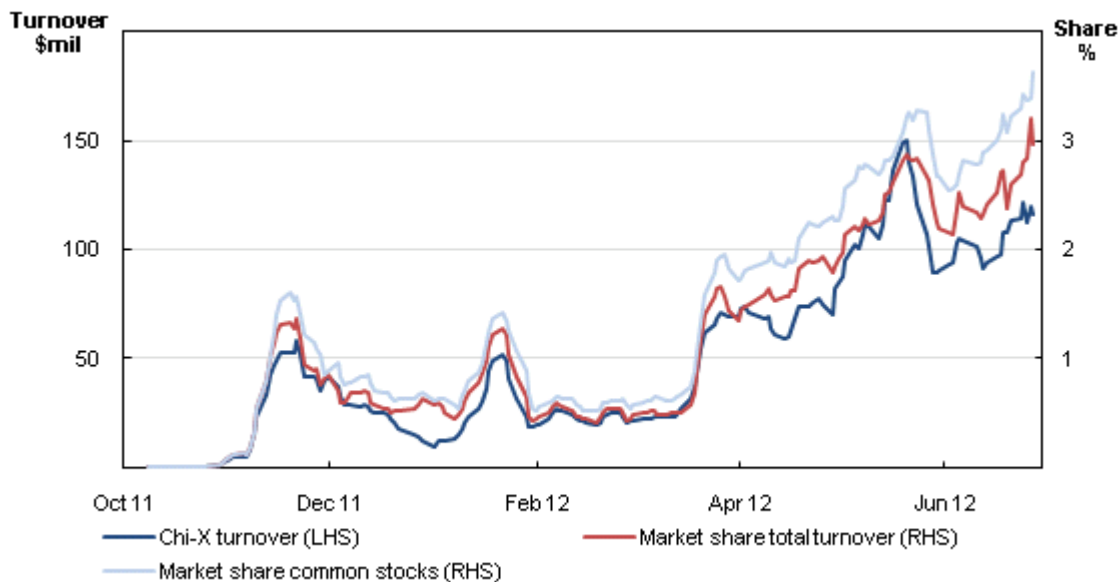
<sup>2</sup> To illustrate the poor relative performance of the S&P/ASX 200, in the past year the index declined at almost twice the rate of the MSCI Emerging Markets Index, measured in local currency terms.

<sup>3</sup> Australian Bureau of Statistics (ABS), *Australian national accounts: Financial accounts Mar 2012*, cat. No. 5232.0, ABS, Canberra.

## Market activity

- 118 Trading activity—measured by the daily number of executed trades—has increased steadily in the past few years. The monthly average of daily trades in 2009–10 was 459,768; the monthly average in 2010–11 was 491,241; and the monthly average in 2011–12 was 521,968.
- 119 Global equity market turnover has been weak during the 2011–12 financial year. Australia was no exception, with average daily turnover in 2011–12 being 10% lower than the turnover for 2010–11.
- 120 In light of the prevailing market conditions, turnover on Chi-X increased steadily during the second-half of 2011–12: see Figure 1. Up until March 2012, turnover on Chi-X remained below \$50 million—a market share of less than 1%. However, daily turnover increased during the final four months of the financial year (it reached a high of \$150 million in mid-May), lifting Chi-X’s market share to around 3% by the end of 2011–12.
- 121 It has been recently publicly reported that Chi-X’s share of daily trading volume has reached more than 5%.<sup>4</sup> Some of the improvement in turnover on Chi-X can be attributed to the launch of its trade reporting facility for off-market trades.

**Figure 1: Daily value of the daily turnover and total market share of Chi-X: October 2011–June 2012 (five-day moving average)**



Source: SMARTS, ASIC Office of the Chief Economist

<sup>4</sup> G Lionidis, ‘Chi-X makes its mark’, *Australian Financial Review*, 31 August 2012, p. 20.

## Key terms

Term	Meaning in this document
AOP certification	Written certification a participant has received from ASIC for its automated order processing under ASIC Market Integrity Rules (Chi-X)
ASIC	Australian Securities and Investments Commission
ASIC Market Integrity Rules (Chi-X)	ASIC Market Integrity Rules (Chi-X Australia Market) 2011—rules made by ASIC under s798G of the Corporations Act for trading on Chi-X
ASX	ASX Limited or the exchange market operated by ASX Limited
Ch 7 (for example)	A chapter in the Corporations Act (in this example numbered 7)
Chi-Tech	Chi-X Global Technology, which is the technology division of Chi-X Global
Chi-X	Chi-X Australia Pty Ltd or the exchange market operated by Chi-X
Chi-X Global	Chi-X Global Holdings LLC, which is the parent company of Chi-X
Chi-X Operating Rules	All rules determined or established by Chi-X that deal with the activities or conduct of the market or the activities or conduct of persons in relation to the market
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
IOSCO	International Organization of Securities Commissions
IOSCO Objectives and Principles of Securities Regulation	The Objectives and Principles of Securities Regulation, originally adopted by IOSCO in September 1998, as amended from time to time
market licensee	Holder of an Australian market licence
Minister	Minister of Financial Services and Superannuation
PSC	Participant Suitability Committee
s794C (for example)	A section of the Corporations Act (in this example numbered 794C), unless otherwise specified
S&P/ASX 200 Index	An index of the largest 200 shares listed on ASX by market capitalisation