26 April 2019

The CRIS Team
Australian Securities and Investments Commission
Level 5, 100 Market Street
Sydney NSW 2000

By email: policy.submissions@asic.gov.au

Dear CRIS Team

Cost Recovery Implementation Statement: ASIC Industry Funding Model (2018-19)

Chi-X Australia Pty Ltd (Chi-X) is grateful for the opportunity to provide a submission in response to the ASIC Cost Recovery Implementation Statement; ASIC industry funding model (2018-2019).

This submission covers:

(a) the governance model for ASIC cost recovery;

(b) the impact of cost recovery measures on market makers; and

(c) the anti-competitive outcomes of the relative increase in the cost recovery levy imposed on large securities exchange operators.

1. The Governance Model for Consultation on Cost Recovery

Chi-X supports an industry funding model as a solid foundation on which to build a global benchmark model for the regulation of financial services in Australia.

The model for consultation on ASIC cost recovery is, however, based on that which is applied across the Australian economy in respect of all government services. There is a query over whether a model applicable, for example, to the charging of custom review of imported widgets, is applicable to a modern financial services industry undergoing significant cost pressures and frequent changes to local and global paradigms.

The queries over the application of the existing Government cost recovery model to the ASIC self funding levy, raises stark issues in many areas, including the following:

(a) Competition is a significant issue in financial services, bringing benefits to wider stakeholders in a way that is not always recognised in the current cost recovery regime[1];

[1] See, for example, the commentary on why the breaches examined by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, were so wide spread and numerous, and which

(b) The post event quantification of charges – the fact that global providers do not know the size of the ASIC fee until after they have budgeted for and engaged in the conduct, is problematic (see section 2.2 below); and

(c) The consideration of important cost recovery issues outside of the cost recovery consultation cycle – see, for example, the issues raised in section 2 of this submission.

The financial services industry poses specific issues in the cost recovery arena, not least in regards to the impact of cost recovery on competition. The lack of competition was highlighted by the Hayne Royal Commission as a factor in the number and widespread nature of the breaches, stating in response to the query why were breaches so many and so widespread: "Competition within the banking industry is weak. Barriers to entering the industry are high."

Global models for industry funding of financial regulators have developed on a more bespoke basis than that in Australia. The bespoke model enables fine attenuation for the needs and goals of facilitating the appropriate local development of a dynamic global industry. This can be found in the in depth examination and bespoke consultation on cost recovery measures contained in papers such as the FCA's annual consultation paper on fees[2].

2. Possible Impact of the Cost Recovery Proposals on Market Making

2.1 Overarching Issues

Market makers are systemically important to the fair/orderly operation of those markets in which they are registered to provide minimum levels of liquidity pursuant to bid ask spread metrics that are publicly available to investors and issuers.

These arrangements for providing minimum liquidity can be important not only in those products for which minimum liquidity requirements are an essential prerequisite for quotation on a stock exchange[3], but also those products such as cash equity shares, the market for which can benefit from liquidity provided by registered market makers[4].

It is not the intention of this submission to make the case for market makers in the trading of ASX listed cash equities, but rather to note that the cost recovery framework should be sufficiently flexible, while complying with existing governance requirements, to enable policy decisions to be made outside the annual cost recovery CRIS consultations. This flexibility could operate for the benefit of all stake

can be found on page 268 of the Interim Report retrieved on 26 April from https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf . The cost recovery model in force in Australia can act as a barrier to entry.

[2] See, for example, CP 18/34, retrieved on 26 April 2019 from https://www.fca.org.uk/publication/consultation/cp18-34.pdf

[3] For example products quoted on the Chi-X Investment products platform or on ASX's AQUA market platform.

[4] See, for example, the LSE market making rules, available at https://www.londonstockexchange.com/traders-and-brokers/rules-regulations/market-making/market-making.htm

holders to, for example, exempt registered liquidity providers from the levy on transactions and messages that is outlined in Table 55 of the CRIS.

2.2 The Negative Impacts of the Lack of Certainty in the Liability of Market Makers for the Transaction and Message Based Levy in Table 55

Providing liquidity in an investment product requires capital expenditure on technology, connectivity and to meet ongoing trading costs. This in turn requires the sign off from internal governance committees within a market making firm. Obtaining this sign off is made more difficult by the following uncertainties that are inherent to the ASIC Cost recovery framework:

(a) the lack of certainty over the exemption of market makers from the transaction and message levy: and

(b) the post event calculation of the fee.

These uncertainties can preclude new market makers becoming registered at all and/or discourage existing market makers from expanding the suite of products in which they provide liquidity. Chi-X has observed these outcomes even though in practice and under existing ASIC policies, registered market makers are not always subject to the message levies in Table 55.

2.3 Evidence of the Negative Impacts of Imposing a Levy on Market Makers

The impact of a messaging tax and other similar curbs on liquidity, have been examined in a number of academic papers and it is not within the scope of this submission to re-present those studies and findings. However, it is important to note the preponderance of academic views that a message tax increases spreads and can decrease market efficiency for investors, particularly in products with low natural liquidity[5].

Independently of the negative impact on the efficient and orderly operation of a market, the message levy may also have the following negative impacts on a localised basis for Australian markets:

(a) decreasing the economic returns from market making in Australian markets may result in that activity being cutback relative to other global jurisdictions where no such decrease has occurred , with it being possible that the initial cutbacks will take place on the alternate markets seeking to bring competition to the ASX in new areas as traditionally they have less liquidity and hence a greater risk and cost in terms of liquidity;

[5] See, for example, Haferkorn & Zimmermann (2014), at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2514334 and Malinova Park Riordan (2013) retrieved on 26 April 2013 from http://qed.econ.queensu.ca/pub/faculty/milne/322/IIROC_FeeChange_submission_KM_AP3.pdf

(b) there is likely to be a decrease in the number of financial products in Australia in which market makers provide liquidity, denying investors in those products the benefits of market making liquidity and restricting the ability of issuers to launch new products;

(c) market makers are likely to widen spreads to address the economic impact of the message levy resulting in worse prices for retail investors;

(d) market makers may be less likely to provide liquidity in products traded on Australian markets and that have underlying assets traded on global markets that are closed, given the additional cost of providing liquidity in these products, and any such liquidity, if provided, may be anchored to the last trading price of the underlying rather than being based on real time market information. This negative outcome is exacerbated by the low number of market making firms in Australia;

(e) It will make it harder to attract more market makers in general but a lot harder to attract more market makers to financial products with low liquidity (ie those products which need market making liquidity the most);

(f) market makers will ask issuers to issue products with lower dollar value prices, resulting in wider relative bid-ask spreads and less efficient outcomes for investors.

3. <u>The Relative Increase in the Large Securities Exchange Levy</u>

Chi-X notes that the levy it will be charged has increased by approximately twenty percent. Chi-X is grouped with ASX as the only "large securities exchange operators". The relative ability of Chi-X and ASX to absorb this increase is apparent from the relative size of the balance sheets: ASX has a market capital over 400 times that of Chi-X.

Chi-X also continues to note that the ASX is not charged a cost recovery fee for the surveillance, supervisory and enforcement work undertaken by ASIC in respect of the listings business from which ASX generated over $220m in revenues in the 2018 financial year.

These outcomes are profoundly anti-competitive and Chi-X would be supportive of any review of the structure of the cost recovery regime and these outcomes.

I hope this submission is of assistance in your important work, please do not hesitate to raise any queries.

Yours sincerely

Chi-X Australia Pty Ltd

Tel: +61 8078 1700
Web: www.chi-x.com.au
Level 23 | Governor Phillip Tower | 1 Farrer Place
Sydney | NSW 2000 Australia