FINANCIAL SERVICES COUNCIL

7 May 2019

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Australian Securities Investment Commission
Level 5, 100 Market Street,
Sydney, NSW 2000

BY EMAIL: policy.submissions@asic.gov.au

Dear Mr Christie,

ASIC INDUSTRY FUNDING: DRAFT COST RECOVERY IMPLEMENTATION STATEMENT – MARKET MAKER LEVY

On 29 March 2019, ASIC published estimated industry sector levies for 2018-2019, as well as details on how it allocated its regulatory costs in 2017-18, as part of its draft Cost Recovery Implementation Statement (**CRIS**). ASIC has sought feedback on the CRIS prior to preparing the final version in May 2019.

The calculation of the graduated levy component for the subsector was simplified on 1 July 2018 by removing the split between IT costs and non-IT costs. Instead:

- 90% of ASIC's costs relating to the subsector will be recovered based on the number of recognised transactions reported to a large securities exchange, and
- the remaining 10% of ASIC's costs relating to the subsector will be recovered based on the number of recognised messages reported to a large securities exchange.

Participants are proposed to be charged a minimum levy of $9,000, plus a graduated levy based on each entity's share of the total number of messages sent and transactions entered or reported to a large securities exchange that are recognised by ASIC's Markets Supervision and Surveillance System.

The draft indicative levy for large securities exchange participants is $9,000 plus 1.8 cents per transaction and 0.049 cents per message.

We understand that MO36 market making quote message types used by Exchange Traded Funds (**ETF**) market makers will now be recognised by ASIC's Markets Supervision and Surveillance System and therefore be subject to the indicative levy for messages.

1. GENUINE ETF MARKET MAKING ACTIVITY

We submit that the messaging levy should distinguish between genuine ETF market making activity and messages sent for other purposes.

As noted by ASIC in Report 583, ETF market makers perform a fundamental role in ensuring that exchange traded products which do not have sufficient natural liquidity function efficiently. Market makers seek to provide continuous liquidity to the market by quoting buy and sell prices throughout the trading day—these prices are updated continually to reflect price changes in the underlying securities. In doing so, market makers provide a visible and transparent order book in a "live" environment on both the ASX and Chi-X reflect. To preserve the integrity of ETF, the live ETF value must take into consideration changes in the portfolio prices, related instruments (e.g. futures) and FX all of which can result in new portfolio value every few seconds. This pricing service by multiple market makers provides a mechanism for ETF trading throughout the Australian day thus giving investors a simple, transparent and cost effective vehicle to build global portfolios.

As observed by ASIC in Report 583:

- market makers are critical to the liquidity ecosystem,
- the low number of market makers who have formal agreements with issuers for liquidity purposes results in concentration risk for the market, and
- the specialist skills and high capital costs of running a market making business may make it difficult for new players to quickly commence.

2. INADVERTENT NEGATIVE IMPACT ON ETFS

Based on estimates for the new ASIC cost recovery model, the total levy charged to all market participants for message count will be 10% of ASIC's total fixed costs for supervising the market, however it's likely that with the inclusion of MO36 message types, firms conducting ETF market making will pay a larger proportion of the overall smaller levy attributable to message count. This increase in cost will be proportionally substantial in a low margin local business.

The employment of an ETF market maker by an ETF Issuer is a fundamental necessity for the liquidity of an ETF and issuers are required under the listing rules to have a designated market maker.

ETF market makers should not be financially penalised for providing a mandated service designed to promote liquidity and protect investors who expect to transact at fair and accurate prices.

This increased cost could have the following impacts for ETF and ETF investors in Australia:

1. a reduction of pricing on the order book of non-primary listing exchanges (e.g. Chi-X) and hence reducing exchange competition and competitive pricing,
2. less support for smaller niche exposure which over the long term could potentially limit the choice of ETF exposures,
3. wider ETF spreads directly impacting investors, or an additional cost for issuers preventing them passing on the economies of scale in the form of lower management costs,
4. increased cost and relatively low trading volumes, increasing the barrier to entry for new market makers in Australia. As highlighted in the recent ETF review, a multiple market maker environment in Australia create competition thus reducing spread and providing a live price via the ETF arbitrage mechanism.

In recognition of the liquidity that genuine ETF market makers provide and the potential impact that a messaging levy may have on this activity, the FSC submits that the messaging levy should distinguish between genuine ETF market making and messages sent for other purposes (such as active traders). It is important that the fee charged is commensurate with the regulatory oversight and does not adversely impact the viability of genuine ETF market makers.

3. DISTINCTION BETWEEN GENUINE ETF MARKET MAKING ACTIVITY AND TRADING

The observations made by ASIC in Report 583 can be contrasted with earlier observations made by the Government in relation to high frequency traders (see Treasury Consultation on CRIS 2015-2016). The Government has previously acknowledged the increased adoption of algorithmic trading techniques by both the buy side and the sell side, and the entry of specialist high frequency trading firms to Australia, which has resulted in average trade size declining and an increase in the number of orders in the Australian market. A study by ASIC's high-frequency trading taskforce found evidence of high order to trade ratios (indicative of order proliferation) in the Australian market that was widespread and not limited to high frequency traders. The Government has also noted that order proliferation makes the detection of market misconduct more difficult using ASIC's current systems and processes.

We submit that the supervisory costs incurred in supervising high frequency trading and other forms of trading are disproportionate to those incurred in supervising genuine market making activities. Accordingly, we submit it is not equitable to have genuine market makers bear the same costs per message as other forms of traders.

The fees for genuine ETF market makers should be offered at a discounted rate per message so as to not create a disincentive to send messages for efficient pricing of ETFs. The ETF Issuers represented by the FSC can assist ASIC and Treasury to identify genuine market makers, as opposed to high frequency traders or other functions that may send similar messages.

Recommendation

The FSC submits that the messaging levy should distinguish genuine ETF market making from active traders. The FSC recommends that ASIC and Treasury undertake formal consultation to determine what is an appropriate discounted fee per message for regulatory oversight of messages sent by genuine ETF market makers.

We would welcome the opportunity to discuss this submission, please do not hesitate to contact me on (02) 9299 3022.

Yours sincerely

BIANCA RICHARDSON
Senior Policy Manager