

2 April 2019

Kathy Neilson
Senior Lawyer, Investment Managers & Superannuation
Australian Securities and Investments Commission
Level 5, 100 Market Street
Sydney NSW 2000

Submitted via email to: feeandcostdisclosure@asic.gov.au

RE: ASIC Consultation Paper 308: Review of RG 97 Disclosing fees and costs in PDSs and periodic statements

Dear Kathy,

BlackRock Investment Management (Australia) Limited (**BlackRock**) is pleased to have the opportunity to respond to [Consultation Paper 308](#) issued by ASIC in relation to the regulatory framework for fees and costs disclosure for PDSs and periodic statements (**CP 308**).

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

BlackRock supports ASIC's objective to ensure that consumers receive transparent and usable fees and costs information to help them make informed decisions, compare products and understand the fees and costs charged to them. We also support ASIC's intention to find the appropriate balance between providing information that may help consumers make informed value for money decisions and ensuring that the fees and costs disclosure regime is practicable for industry. We recognise the complex challenges ASIC and industry face in meeting these consumer objectives and acknowledge the steps ASIC has taken to resolve these issues, including by obtaining independent expert advice and engaging with industry and consumer stakeholders.

Defined terms used in this submission have the meaning given to them in CP 308, unless the context indicates otherwise.

About BlackRock

BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

BlackRock helps investors build better financial futures. As a fiduciary to our clients, we provide the investment and technology solutions they need when planning for their most important goals. As of 31 December 2018, the firm managed approximately AUD\$8.5 trillion in assets on behalf of investors worldwide and AUD\$103.0 billion in Australia. For additional information on BlackRock, please visit www.blackrock.com/au.

Executive summary

We have summarised our submission in the following table:

| Proposal | Summary response |
|--------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| I. Proposal B5: Changing the treatment of transactional and operational costs | BlackRock does not agree that transaction costs should be disclosed in the fees and costs template, example fees or cost of product information. Transaction costs do not share the attributes of "Category 1" items as described in REP 581 (page 120). The inclusion of |

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| | <p>transaction costs does not promote ASIC’s objective of helping consumers make informed decisions, compare products and understand the fees and costs charged to them. Transaction costs should be reported as part of a Fund’s performance attribution, not as an additional cost.</p> <p>Additionally, BlackRock does not agree that gross transaction costs should be disclosed in addition to net transaction costs. We submit that such disclosure is duplicative, likely to confuse consumers and does not promote clear, concise and effective disclosure.</p> |
| <p>II. Proposal B7: Inclusion of counterparty spreads</p> | <p>BlackRock submits that counterparty spreads should be excluded from transaction cost disclosure as the complexity and impracticality of regulatory compliance and their technical nature outweighs the consumer benefit which we believe would be limited at best and would most likely add further confusion.</p> <p>Alternatively, should counterparty spreads be included, we submit that the term should be defined as the spread imposed by a market maker when dealing in an exchange-traded product as principal.</p> |
| <p>III. Proposal C6: Clarifying the treatment of amounts paid by third parties or offset against other amounts</p> | <p>We submit that in certain limited circumstances fees and costs should be permitted to be reduced or offset against related income. For example, in securities lending arrangements where the cost charged by a lending agent is recovered as a percentage of the income generated by the lending activity.</p> <p>In circumstances where cost and income are inextricable linked (that is, there is no cost without income), we submit that offsetting promotes clearer and more usable disclosure to consumers.</p> |

I. Proposal B5: Changing the treatment of transactional and operational costs

ASIC proposes to require explicit transaction costs and counterparty spreads (for the purpose of this section, simply ‘transaction costs’) to be:

- disclosed as a separate line item (net of buy-sell spread) in the ‘fees and costs template’ and in the ‘example of annual fees and costs’;
- included in the calculation of the ‘cost of product information’, and
- shown on a gross basis in ‘fees and costs details’.

| B5Q1 | Do you agree with our approach? If not, please explain why. |
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| | <p>We do not agree with proposal B5. The disclosure of transaction costs in the fees and costs template, example of fees and costs, and cost of product information does not help to increase transparency or add clarity to promote informed investment decision making.</p> <p>We do not agree that transaction costs meet many of the criteria of “Category 1” items as described in REP 581 (see page 120) and stated in CP 308 (see paragraph 80). In our view, transaction costs:</p> <ul style="list-style-type: none"> • would typically not be considered by consumers when comparing product cost impacts as they are generally not characterised as an additional cost of a product or a cost that is ‘charged to’ an investor (as this term is used in the fee example), • distort the narrative as inclusion of transaction costs in cost of product information makes it difficult to compare the fees and performance of products. Transaction costs are already captured in a fund’s <i>gross</i> return. Investors are likely to consider the ‘cost of product’ value to be an amount that should be deducted from a fund’s gross performance return, to yield a net performance. However, as transaction costs are inherently captured in a fund’s gross performance, there is a material risk of confusion and double counting and an adverse impact on the ability for consumers to compare products (see <i>Figure 1</i> below), • are backward-looking (as acknowledged by ASIC), |

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- rely on estimations and approximations and are therefore less reliable as a forward-looking tool (transaction costs can vary year-on-year even without material changes to investment strategies, for example due to local and offshore regulatory changes (such as tax or duty variations), efficiencies in operational procedures or due to scale, or changes in member/asset activity that are not recouped in the buy-sell spread),
- are not significant fees that can be “gleaned at-a-glance”,
- do not create gameable opportunities if excluded from disclosure, as issuers have no incentive to inflate or otherwise manipulate transaction costs. In fact, the inclusion of transaction costs in cost of product information is more likely to result in issuer’s altering trading strategies to the detriment of consumers (such as by avoiding incurring transaction costs which may generate additional revenue or income to the fund) or otherwise seeking to distort the cost of product value, and
- will require extensive textual explanation if included in the fee template, to mitigate the confusion and double counting that would otherwise arise.

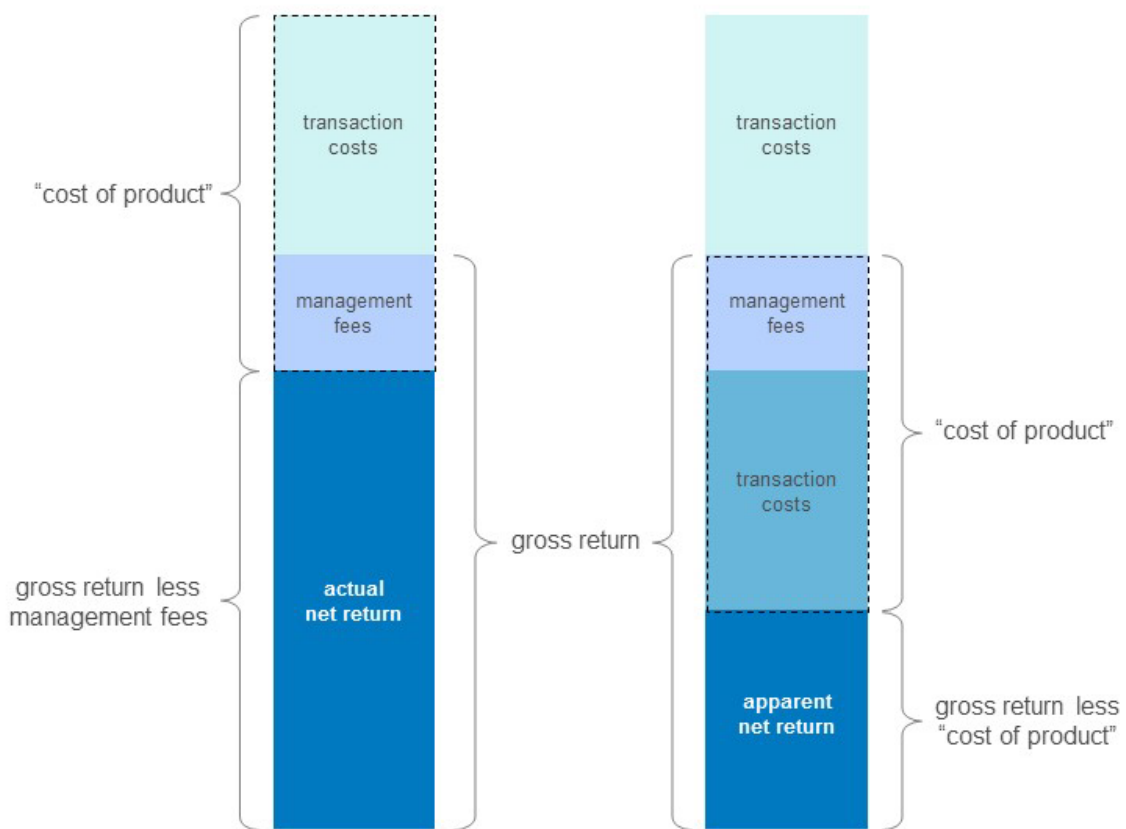


Figure 1 Double counting

Transaction costs may be considered to be “Category 2” items as described in REP 581. To the extent that transaction costs may be of interest or relevance to consumers, BlackRock submits that these costs are appropriately disclosed in the additional explanation of fees and costs, rather than in investment fees.

Should transaction costs (net) be included in either the fees and costs summary as proposed by ASIC (together with the buy-sell spread) or the additional explanation of fees and costs as submitted by BlackRock, we do not consider that it is necessary or helpful to separately disclose gross transaction costs in the ‘fees and costs detail’ section. We submit that such disclosure is duplicative, likely to confuse consumers and does not promote clear, concise and effective disclosure.

II. Proposal B7: Inclusion of counterparty spreads

ASIC proposes to include counterparty spreads in the transaction costs that will be disclosed in PDSs and periodic statements. ASIC describes counterparty spreads as the bid-ask spreads imposed by a counterparty or market maker for certain products traded on regulated markets. ASIC acknowledges that counterparty spreads are a type of implicit transaction cost, however it has adopted the recommendation to treat counterparty spreads on the same basis as explicit transaction costs. The rationale for ASIC's counterparty spread proposal is set out in paragraphs 95-99 of CP 308 with reference to REP 581 at pages 130-134.

| B7Q1 | Do you agree with our approach? If not, please explain why. |
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| | <p>We do not agree with ASIC's approach. We support the exclusion of counterparty spreads (among other implicit transaction costs) on the basis that:</p> <ul style="list-style-type: none"> • counterparty spreads do not share the characteristics of "Category 1" items identified on page 120 of REP 581 and so should not be disclosed in the headline tools, • only a portion of counterparty spreads are analogous to explicit costs such as brokerage and therefore disclosure of the entire counterparty spread on the same basis as explicit costs is misleading, • the portion of counterparty spreads that is analogous to explicit costs is not readily and relatively objectively ascertainable, • the calculation methodologies for counterparty spreads are prone to the points of difference itemised in REP 581 at page 131, • the difficulty in considering counterparty spreads is likely to translate to ambiguous legislation and lead to increased confusion, differing industry practices and poor consumer outcomes, • inclusion of counterparty spreads will require data collection processes and infrastructure that increase the costs of compliance, • whilst counterparty spreads may be calculable by issuers, we consider that it will be difficult to monitor, supervise and enforce consistent compliance with the disclosure obligation across the industry, • counterparty spreads are technical in nature and the complexity and impracticality of including counterparty spreads outweighs the limited consumer benefit granted, and • BlackRock does not share ASIC's concern that inappropriate trading practices may be adopted to avoid cost disclosure. Issuers are subject to statutory and fiduciary obligations including with respect to best execution which promotes investor protection by ensuring market participants do not place their own interests ahead of those of their clients. Best execution obligations facilitate market efficiency by creating a regulatory imperative for market participants to direct client orders to the market that offers the best outcome. <p>However, should ASIC include counterparty spreads in fees and costs disclosure, we submit that the term "counterparty spreads" should be accurately and narrowly defined to preserve the distinction drawn in REP 581 between counterparty spreads and market spreads. We submit that this outcome is best achieved by applying any disclosure requirements to spreads imposed by market makers when trading as principal in exchange-traded products.</p> <p>We believe there is a risk that a broad definition of the term "counterparty spread" may lead to the re-introduction of market spreads and other implicit transaction costs into the fees and costs disclosure in a manner that is inconsistent with the intention set out in REP 581 and the rationale set out in CP 308.</p> <p>For the avoidance of doubt, BlackRock supports Proposal B6 of CP 308, removing property operating costs, borrowing costs and implicit transaction costs from the fees and costs disclosure regime.</p> |

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| <p>B7Q2</p> | <p>Do you have any suggestions on how the concept of counterparty spreads could be defined in cl 101 of Sch 10? Please provide details.</p> |
| | <p>A counterparty spread is the bid-ask spread that is imposed by a counterparty or market maker when trading as principal in a product that is able to be traded on a regulated market (being an exchange).</p> <p>When trading on exchange, a broker may act as agent to facilitate a trade between counterparties and charge brokerage or commission (an explicit transaction cost to the trading party). Alternatively, a broker may act as principal when trading an exchange-traded product, in a market making or counterparty capacity. When trading as principal, the market maker or counterparty will typically impose a bid-ask spread on the trade rather than brokerage or commission (however in some cases may impose both). We consider that the term “counterparty spread” essentially refers to the bid-ask spread imposed when a broker is trading in an exchange-traded product in a principal capacity.</p> <p>We provide the following draft definition:</p> <p>Counterparty spread means the difference between the midpoint of the bid-ask spread and the execution price for an Exchange-Traded Product acquired from, or disposed of to, a person making a market (within the meaning of section 766D of the Act) in relation to that Exchange-Traded Product.</p> <p>Exchange-Traded Product means a financial product of a kind that is able to be traded (within the meaning of section 761A of the Act) on a Part 7.2A Market or a Regulated Foreign Market.</p> <p>Part 7.2A Market means a financial market the operator of which is licensed under subsection 795B(1) of the Act, but does not include a financial market operated by an operator specified in regulation 10.15.02 or any other financial market that ASIC does not have the function of supervising under section 798F of the Act.</p> <p>Regulated Foreign Market means a financial market in a foreign jurisdiction determined by ASIC to be a Regulated Foreign Market for the purposes of subclause 103(1), where, in the opinion of ASIC, the operation of the financial market in the foreign jurisdiction is subject to requirements and supervision that are sufficiently equivalent, in relation to market integrity and market transparency, to the requirements and supervision to which a Part 7.2A Market is subject in this jurisdiction.</p> <p>We submit that only a portion of counterparty spreads are analogous to explicit costs such as brokerage and therefore disclosure of the entire counterparty spread on the same basis as explicit costs is misleading. Further, the above definition does not address the points of difference in calculation methodologies itemised in REP 581 at page 131.</p> <p>BlackRock would support the ability for issuers to disclose the lesser of the counterparty spread and the equivalent hypothetical brokerage cost that would have applied if the product was traded through the Part 7.2A Market or Regulated Foreign Market.</p> |
| <p>B7Q3</p> | <p>REP 581 (at page 133) notes that counterparty spreads are readily and relatively objectively ascertainable. Do you agree? Please provide details.</p> |
| | <p>The bid-ask spread imposed by a market maker or counterparty when trading an exchange-traded product as principal may broadly and simplistically be considered to be readily and relatively objectively ascertainable to the trading entity (but not to the broad market).</p> <p>There are some circumstances in which bid-ask spreads are not readily ascertainable, including due to low liquidity and lack of market maker supply or demand. In these circumstances, bid-ask spreads can be distorted and otherwise unreliable.</p> |

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| | <p>Further, the portion of the bid-ask spread that is analogous to explicit costs such as brokerage is not readily and relatively objectively ascertainable. For example, a portion of the bid-ask spread represents the adverse selection spread component that compensates counterparties and market makers for trading losses and exposure to market risk. We submit that this portion is not analogous to an explicit cost and should not be disclosed.</p> <p>In addition, we note that the points of difference in calculation methodologies which are itemised on page 131 of REP 581 generally also apply to counterparty spreads, and so industry practice may vary should the methodology not be prescribed.</p> <p>For the avoidance of doubt, we submit that market spreads, being spreads on products traded in quote-driven markets such as OTC markets, are not readily and relatively objectively ascertainable.</p> |
| B7Q4 | <p>What types of financial products and markets do you think the concept of counterparty spreads would apply to? Would it be applicable to Australian markets or only to overseas markets? Please provide details.</p> |
| | <p>We submit that counterparty spreads would apply to financial products traded on Australian or overseas exchange markets.</p> <p>We submit that counterparty spreads would not apply to products traded on quote-driven markets, such as OTC products (including financial markets such as Yieldbroker or Bloomberg). REP 581 refers to such spreads as market spreads which are proposed to be treated as excluded implicit transaction costs.</p> <p>Please see our draft definition in Response B7Q2 and further detailed analysis in Annexure A.</p> |
| B7Q5 | <p>What are the additional costs associated with implementing this proposal? Please provide details of one-off and/or annual costs as applicable.</p> |
| | <p>If counterparty spreads are required to be reported, issuers will need to implement systems and processes to collect this information in a manner that can be utilised in RG 97 calculations, as well as retain records for internal compliance and external supervision by ASIC.</p> |
| B7Q6 | <p>What would be a reasonable timeframe for issuers to implement this proposal, in light of the other changes proposed in this paper?</p> |
| | <p>If systems need to be built to collect and categorise transaction cost information as proposed by ASIC, we estimate the new system build necessary could delay effective implementation of fees and costs disclosure requirements by at least 12 months.</p> |

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III. Proposal C6: Clarifying the treatment of amounts paid by third parties or offset against other amounts

ASIC proposes to include guidance to clarify the principles for and the treatment of fees, costs and other amounts paid by third parties or offset against other amounts. ASIC provides the following rationale in paragraph 132 of CP 308:

We also believe that fees and costs cannot be reduced or offset against other income or through income-sharing arrangements. Although income may be generated, the superannuation entity or managed investment scheme will incur costs in doing so.

| C6Q1 | Do you agree with our approach? If not, please explain why. |
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| | <p>We submit that in certain limited circumstances, fees and costs should be permitted to be reduced or offset against other income. For example, we submit that the costs incurred in appointing a securities lending agent should be permitted to be offset against the income earned from the securities lending activity because in this instance, there are in fact no fees <i>unless</i> there is associated revenue.</p> <p>We acknowledge that this issue is raised in ASIC Report 398, which refers to the practice of offsetting securities lending income against other fees, thus reducing disclosed fees. We agree that securities lending income should not be used to offset fees generally, however we submit that such income should be able to offset fees incurred in carrying out the securities lending activity.</p> <p>Securities lending</p> <p>Where an issuer participates in a securities lending program, securities held within the fund are lent to approved borrowers for a fee. The collected securities lending fee represents securities lending income, which generates additional investment returns for the fund.</p> <p>Issuers generally appoint a third-party lending agent to carry out the securities lending program on the issuer’s behalf. For its services, the securities lending agent will receive a fee (provided there is revenue generated by the program). The income earned from securities lending is generally allocated between the participating fund and the securities lending agent and paid on a percentage basis to the securities lending agent. For example, where BlackRock participates in a securities lending program, the fund will typically receive approximately 60% of the associated revenue generated from securities lending activities and the remaining 40% will be received by the securities lending agent, which will pay for any securities lending costs out of its portion of the securities lending income.</p> <p>While participation in the securities lending program requires the payment of securities lending agent fees, all fees are paid for out of any generated securities lending income.</p> <p><i>Critically, if no securities lending income is generated, no securities lending agent fees will be payable.</i></p> <p>The inability to offset such paired costs raises the risk of confusing or misleading disclosure, similar to the double counting of transaction costs demonstrated in Figure 1 of our submission. Using a simplified example, should securities lending activities generate \$100 of income, \$60 of income goes to the fund, and \$40 goes to the securities lending agent. If issuers disclose \$40 of transaction costs without explicitly linking those costs to the associated revenue, the consumer has limited information to evaluate whether the securities lending program is adding value or not. Such disclosure does not promote informed decision making and is likely to be confusing or misleading. Provided the securities lending activity generates a positive net return to the fund, we believe the preferred way to represent this is by netting the costs from the revenue, and hence reporting zero net fees.</p> |

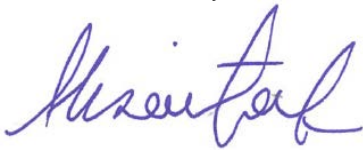
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However, if circumstances arise where the securities lending activity costs exceed the corresponding revenue (and BlackRock is not aware of such circumstances existing), then the net cost should be reported. Transparency of that type of activity should be visible to consumers to help them make informed value for money decisions in line with ASIC's stated rationale.

BlackRock submits that the inability to offset securities lending costs against income may present a disincentive against carrying out securities lending activities to the detriment of consumers. Whilst securities lending activities afford an issuer the opportunity to generate additional investment returns, the increase in disclosable costs may render such activities unpalatable due to the heightened focus on fees and costs. This is particularly the case for low-cost index-tracking strategies such as exchange-traded funds which are particularly cost-sensitive and often apply securities lending income to improve index-tracking performance.

We welcome further discussion on any of the points that we have raised. Should ASIC have any questions or wish to request further information about BlackRock's position on the fees and costs disclosure proposals, please reach out to the contacts below.

Yours faithfully,



Alison Telfer
General Counsel, Australia
+61 (2) 9272 2323



Michael McCorry
Chief Investment Officer, Australia
+61 (2) 9272 2234



Vinod Kumar
Legal Counsel, Australia
+61 (2) 9272 2303

Attached: Annexure A *Detailed analysis of counterparty spreads*

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Annexure A: Detailed analysis of counterparty spreads

BlackRock acknowledges the rationale set out in CP 308 and REP 581 for including counterparty spreads into the fees and costs disclosure requirements whilst excluding other implicit transaction costs. There are complexities in this approach, and BlackRock considers that the complexity and impracticality of including counterparty spreads (and, importantly, preserving the exclusion of market spreads and other implicit transaction costs) is disproportionate to the limited consumer benefit achieved.

We have set out below our analysis of counterparty spreads, which supplements our submission to Proposal B7 of CP 308.

Counterparty spreads vs market spreads

REP 581 contrasts the bid-ask spread imposed by a counterparty or market-maker in “regulated markets” (referred to as **counterparty spreads**) against the bid-ask spread that applies in “quote driven markets” (referred to as **market spreads**). REP 581 recommends **including** counterparty spreads and **excluding** market spreads, and so the difference between the two is an important one.

The rationale for treating counterparty spreads differently to market spreads is set out on page 133 of REP 581 and summarised in the following table:

| Counterparty spreads | Market spreads |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none">• Relate to products traded on “regulated markets”• Readily and relatively objectively ascertainable• Within the control of the investing party• Analogous to explicit costs like brokerage• Representative of costs or services• Risk of avoidance practices through trading adjustments | <ul style="list-style-type: none">• Relate to products traded on “quote-driven markets”• Not readily ascertainable• Not controllable• Analogous to timing decisions such as asset allocation decisions• Not representative of costs or services• Not paid to any party |

Table 1

It is critical to preserve the distinction between counterparty spreads and market spreads and to exclude market spreads from fees and costs disclosure. To achieve this, it is necessary to understand the intention of REP 581 in contrasting products traded on “regulated markets” with those traded on “quote-driven markets”.

There is some difficulty in this approach, as these terms are not defined for the purposes of REP 581 and CP 308 and in some cases the general meaning of the terms can overlap (that is, there are quote-driven markets that are also regulated markets). This raises uncertainty in regulatory intent and drafting challenges.

What is a regulated market?

Typically, the term “regulated market” is used by ASIC to refer to financial markets supervised by ASIC or an equivalent offshore regulator. [ASIC Regulatory Guide 172](#) provides detailed guidance on ASIC’s regulation of financial markets in Australia. In this context, financial markets are market venues including exchange and non-exchange facilities.

The Corporations Act defines the term “financial market” in [section 767A](#). A list of licensed and exempt financial market operators is available on ASIC’s [website](#). The narrower term “prescribed financial market” is defined in section 9 of the Corporations Act and affected by [Regulation 1.0.02A](#).

As a starting point, and subject to our comments below, we consider the term “regulated market” as used in REP 581 and CP 308, to mean a financial market as defined in the Corporations Act. However, to maintain consistency with the related commentary and recommendations in REP 581 and CP 308, we consider that

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the intended meaning of “regulated market” is to capture financial markets which are **order-driven**, rather than quote-driven. Typically, these are exchange venues with a central limit order book.

This interpretation is also consistent with how the independent expert uses the term “regulated market” elsewhere in REP 581, namely on page 133 as follows:

*Market impact costs also become more difficult to measure, and therefore more unreliable, for less liquid assets and where assets are not traded on or through **regulated markets**.*

Used in this context, it would further indicate that the term “regulated markets” means a financial market such as the ASX, where the market impact of trades may be more readily observable.

What is a counterparty spread?

Trading on order-driven exchanges is generally effected through brokers facilitating trades as agent between parties using a central limit order book. In some cases, a broker (or market maker) may act as principal to provide direct liquidity to a trading party. When acting as agent, brokers typically charge a brokerage fee or commission. When trading as principal, market makers typically impose a bid-ask spread.

The bid-ask spread imposed by a market maker or counterparty in respect of such principal trades typically includes two components:

- a transaction cost that compensates counterparties and market makers for their normal costs of doing business (inventory costs, order-processing costs etc), and
- the adverse selection spread component that compensates counterparties and market makers for trading losses (and essentially prices in the risk of their activities).

In setting its bid-ask spread, a counterparty or market maker is generally competing with the central limit order book and may be limited by venue rules.

We understand that the term “counterparty spread” as used in REP 581 and CP 308 refers to the bid-ask spread imposed by market makers and counterparties when trading as principal in products traded on an order-driven financial market. It is these spreads that broadly display the attributes identified in the left column of Table 1 (with the exception that not all of the bid-ask spread in this context is analogous to explicit costs, as discussed further below).

ASIC has raised concerns in paragraphs 97(c) and 98 of CP 308 that issuers may inappropriately adjust trading practices to minimise costs disclosure (namely, by deciding to deal with a market maker as principal and incurring a non-disclosable spread rather than trading through a broker as agent and incurring disclosable brokerage). Whilst we do not share the same concerns as ASIC, and note that spreads and brokerage are not entirely analogous, we note that ASIC’s rationale is consistent with our interpretation of counterparty spreads above.

What is a quote-driven market?

The term “quote-driven market” is not commonly used in a regulatory setting. However, ASIC does define the term in [ASIC Report 215 Australian equity market structure](#) to mean:

An electronic exchange system in which prices are determined from quotations made by market makers or dealers.

Quote-driven markets can be contrasted with order-driven markets. Report 215 provides the following definition of “order-driven markets”:

An auction market in which prices are determined by the publication of orders to buy or sell shares.

Quote-driven markets are environments where prices are set only by market maker quotes in the market. Each market maker provides bid and offer quotes on a range of instruments and all trades are executed via

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these market makers. Typically, trades are effected directly with counterparties as principal (however in some cases they may be arranged by interdealer brokers).

The clearest example of a quote-driven market is the over-the-counter (**OTC**) market. Market spreads on the OTC market broadly display the attributes identified in the right column of Table 1 and are naturally less transparent.

OTC trading incurs market spreads which should remain excluded from the disclosure requirements

Provided that our interpretation of REP 581 and CP 308 is correct, we support the comments made on page 133 of REP 581 regarding market spreads implicit in transactions on quote-driven markets. We submit that REP 581 supports the position that market spreads incurred in trading on OTC markets remain implicit transaction costs and should not be disclosed. It is imperative that this intent is reflected in the fees and costs disclosure regime.

BlackRock is aware of ambiguity in the market as to whether spreads on OTC trades are intended to be included as counterparty spreads or excluded as market spreads. BlackRock submits that it is certainly unusual to refer to the OTC market as a regulated market and not a quote-driven market. Similarly, OTC trades do not have spreads which are readily and relatively objectively ascertainable or otherwise share the attributes of counterparty spreads identified in REP 581 and summarised in Table 1.

If the intention of REP 581 and CP 308 is to capture spreads on OTC trades, then BlackRock considers further guidance is required to correct any drafting errors and clarify the intended regulatory position and rationale.

For the avoidance of doubt, should ASIC's counterparty spread proposal extend to products traded on quote-driven markets such as OTC markets, then BlackRock would oppose such a proposal on the grounds that OTC spreads share the attributes of market spreads. BlackRock submits that the regulatory outcome in such a case would be extremely confusing, result in large variations of interpretation, implementation and compliance, and lead to poor consumer outcomes. BlackRock further submits that such spreads are not Category 1 items as described in REP 581 (page 120).

Some regulated markets are also quote-driven markets

Not all financial markets (as defined in [section 767A](#)) are order-driven markets. For example, Yieldbroker and Bloomberg are quote-driven markets which hold financial market licences and could generally be considered to be regulated markets. Yieldbroker and Bloomberg are examples of how the distinction drawn in REP 581 and CP 308 between regulated markets and quote-driven markets becomes complex.

BlackRock submits that the counterparty spread proposal should apply to trades with a counterparty or market maker in respect of exchange-traded products only. The proposal should not extend to trading on OTC or quote-driven markets, including trading through a non-exchange market venue such as Yieldbroker or Bloomberg. In considering the commentary and rationale set out in REP 581 and CP 308, the categorisation and regulatory treatment of market spreads should not be impacted merely because the OTC trade was implemented through a non-exchange market venue such as Yieldbroker or Bloomberg.

How to define counterparty spreads

The approach to defining relevant terms should:

- accurately capture the distinction drawn in REP 581 and CP 308 between:
 - trading on exchange vs trading on OTC markets, and
 - trading with a market maker as principal vs trading through a broker acting as agent,
- confine counterparty spreads to only that portion of the bid-ask spread that is analogous to explicit costs such as brokerage, and
- be consistent with the proposal to remove implicit transaction costs, and not inadvertently re-introduce implicit transaction costs into the disclosure requirements (in particular, not re-introduce disclosure of the bid-ask spread on exchange-traded products that are effected through a broker

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using the central limit order book which is proposed to be an excluded transactional and operational cost).

Distinguishing between counterparty spreads and market spreads

A useful reference point to assist in drafting Sch 10 is the [ASIC Derivative Transaction Rules \(Reporting\) 2013 \(derivative reporting rules\)](#). The derivative reporting rules are designed to capture OTC derivatives and exclude exchange-traded derivatives. The derivative reporting rules also accommodate not only Australian regulated markets but also offshore regulated markets. Whilst the derivative reporting rules relate to derivatives only, they provide an effective means of defining OTC products (see Rule 1.2.4).

An effective way to capture the distinction between counterparty spreads and market spreads as intended by REP 581 and CP 308 is to adopt a similar approach to that taken in Rule 1.2.4 of the derivative reporting rules with the modifications necessary to expand the application from derivatives to other financial products. Specifically, ASIC's counterparty spread proposal should only apply to financial products that are traded (within the meaning of section 761A of the Corporations Act) on a **Part 7.2A Market** or a **Regulated Foreign Market** (with those terms taking the same definitions set out for them in the derivative reporting rules).

For reference, a Part 7.2A Market means a financial market the operator of which is licensed under subsection 795B(1) of the Act, but does not include a financial market operated by an operator specified in [regulation 10.15.02](#) of the Corporations Regulations (which includes Yieldbroker, Bloomberg and other similar OTC trading venues) or any other financial market that ASIC does not have the function of supervising under section 798F of the Act.

Distinguishing between broker agency trades and market maker principal trades

An important element to the definition of counterparty spreads is the distinction between products traded *through a broker acting as agent* and *with a market maker acting as principal*. Preserving this distinction is particularly important to align the legislation with ASIC's rationale set out in paragraphs 97(b) and 98 of CP 308.

BlackRock submits that ASIC may distinguish between broking activities and market making activities with reference to [section 766D](#) of the Corporations Act (meaning of makes a market for a financial product). That is, a counterparty spread is the bid-ask spread imposed by a person making a market (within the meaning of section 766D) in a product that is able to be traded on a Part 7.2A Market or Regulated Foreign Market.

Limiting counterparty spreads to the portion that is analogous to explicit costs

BlackRock supports limiting the definition of counterparty spread only to that portion of the spread which may be considered to be analogous to explicit costs such as brokerage costs. For example, the adverse selection spread component that compensates counterparties and market makers for trading losses (and essentially prices in the risk of their activities) is not analogous to explicit transaction costs and should not be disclosed.

To demonstrate this, BlackRock notes that spreads can vary substantially depending on the risk exposure and appetite of the market maker. For example, spreads are often narrower at the beginning of the trading day and wider towards the end of the trading day. This is because market makers may be exposed to market movements overnight should they not be able to cover their trading position before the close of market. This increased risk is reflected in a wider spread. BlackRock submits that this risk allocation is not analogous to brokerage or any other explicit transaction cost, which would typically remain fixed in line with agreed fee schedules.

BlackRock concedes that such a definitional approach is difficult and, for this reason, reiterates that counterparty spreads should not be included in fees and costs disclosure. Alternatively, BlackRock would support the ability for issuers to calculate the counterparty spread based on the *equivalent and hypothetical brokerage cost* that would have been paid if the transaction were effected on-market through a broker. In this case, BlackRock submits that issuers should disclose the lesser of the counterparty spread and the equivalent hypothetical brokerage.

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Consistency with proposal to remove implicit transaction costs

ASIC proposes to adopt the recommendation of REP 581 to exclude implicit transaction costs (with the exception of counterparty spreads) from fees and costs disclosure.

ASIC has provided draft wording in cl 103(2) of Sch 10 and in paragraphs RG 97.341-344 to reflect these “excluded transactional and operational costs”.

Excluded transactional and operational costs include:

- where an asset is acquired other than through a financial market, any part of the acquisition price of the asset that exceeds the price at which the asset could have been disposed of; and
- where an asset is acquired through a financial market, any part of the acquisition price of the asset that exceeds the bid price in the financial market that would apply without the acquisition having occurred either:
 - immediately following the acquisition; or
 - if the acquisition was part of multiple acquisitions reflecting a single and non-recurring instruction to acquire, after the last acquisition made in accordance with the instruction.

The proposed drafting of Sch 10 and RG 97 would ordinarily include counterparty spreads within the above limbs of excluded transactional and operational costs (as well as other types of spreads).

Accordingly, the definition of “counterparty spreads” must be appropriately confined to only those spreads imposed by a counterparty or market maker when dealing in exchange-traded products and operate to preserve “excluded transactional and operational costs”. This may be achieved by modifying the definition of ‘excluded transactional and operational costs’ to specifically exclude counterparty spreads. If such an approach is taken, it is particularly important to ensure that counterparty spreads are defined narrowly to avoid re-introducing certain implicit transaction costs into the disclosure regime in a manner inconsistent with REP 581 and CP 308.

Draft Regulatory Guide 97

ASIC has provided industry with a draft Regulatory Guide 97 (Attachment 1 to CP 308). Draft RG 97 does not currently provide guidance or explanation of the treatment of counterparty spreads.

Should counterparty spreads be included in the fees and costs disclosure requirement, BlackRock submits that RG 97 should include sufficient guidance to facilitate compliance, including to clarify the products and markets to which the requirement extends and the calculation methodology.