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Dear Alan

ASIC Consultation Paper 301: Foreign Financial Service Providers

Chi-X Australia (CXA) is grateful for the opportunity of providing this submission on the Consultation Paper: Foreign Financial Services Providers (the CP).

Introduction & Overview of this Submission

This submission is exclusively focused on the potential impact of the proposals in the CP on foreign financial service providers (FFSPs) that provide liquidity on an Australian licensed market¹.

CXA acknowledges the concerns underpinning the ASIC proposals to require FFSPs to obtain an AFSL. However, it is not clear that those concerns are applicable to FFSPs that provide liquidity on licensed markets.

An FFSP providing liquidity on an Australian licensed market delivers significant benefits for Australian investors and is engaging in activity that is heavily regulated and monitored, independently of whether the FFSP holds an AFSL.

Australian investors currently benefit from the liquidity provided on Australian markets by FFSPs and are likely to benefit from additional FFSPs contributing liquidity in innovative new products that are to be introduced to Australian investors in the coming months. Imposing AFSL requirements on FFSPs providing this liquidity may deter existing and/or additional FFSPs from making this important contribution and inhibit innovation in Australia's markets.

¹ These firms are referred to in this paper as both liquidity providers and market makers. 'Market maker' is a term generally used to refer to a firm formally registered in some manner as a liquidity provider.



ASIC has also noted the concentration risk posed by the lack of market makers in exchange traded products². The proposals in the CP may exacerbate this risk by deterring new offshore based firms from providing liquidity on Australia's markets.

In these circumstances, there is a genuine query over whether requiring liquidity providing FFSPs to hold an AFSL is justified on a cost-benefit analysis.

The Importance of a Thorough Cost Benefit Analysis & the Structure of this Submission

CXA commends ASIC for the prominence given in the outline of the consultation process on page 4 of the CP, to the importance of a thorough cost benefit analysis. The remainder of this submission is aligned with such an analysis and is structured as follows:

1. the benefits of FFSPs providing liquidity on Australian markets, the loss of which would be a significant cost of mandating AFSLs for FFSPs, if that deters liquidity providing FFSPs from trading in Australia;
2. why imposing AFSL requirements may deter FFSPs from providing liquidity;
3. analysing the regulatory risks posed by market makers (ie the potential cost of not regulating the firms through AFSL requirements);
4. alternative regulatory mechanisms that may deliver more cost effective outcomes than AFSL requirements.

This submission concludes that in the case of liquidity providing FFSPs, there may be more effective regulatory mechanisms for addressing the issues identified by ASIC other than requiring those FFSPs to obtain an AFSL.

1. The Benefits of FFSPs Trading on Australian Licensed Markets

(a) The Role Played by Foreign Financial Services Providers on Australian Markets

CXA operates a licensed market that trades both ASX listed/quoted products and investment products that are uniquely quoted on CXA.

Liquidity provided by 'market making' firms ensures local investors are able to obtain competitive prices when buying and selling ASX listed/quoted products and CXA quoted investment products, that are traded on the CXA market. These market making firms can often be offshore based proprietary trading houses that apply proprietary trading strategies on markets globally.

² See paragraphs 94-97 of the ASIC Report 583: Review of exchange traded products, retrieved on 3 August 2018 from <https://download.asic.gov.au/media/4835387/rep583-published-02-august-2018.pdf>



(b) FFSPs as Market Makers in CXA & ASX Quoted Products

The Australian framework for CXA and ASX quoted investment products requires a product issuer to meet liquidity requirements before a product can be quoted on either the CXA or ASX markets. In the vast majority of cases this liquidity requirement is provided by market makers. Trading within the 'regulated' maximum spreads required of market makers is a low margin business. It requires significant investment and sunk cost in proprietary trading strategies and systems and an ongoing capital commitment.

A concerning feature of the Australian market for investment products is the relative paucity of market making firms. For example, approximately \$39billion assets are under management pursuant to ETF issuance in Australia³ and yet there are only two primary market makers that investors rely upon for providing liquidity in the vast majority of those funds. These two firms are both Australian based subsidiaries of global firms as market making usually requires the support that can only be provided by firms with access to global expertise and infrastructure⁴.

In the coming weeks, CXA will launch a market for transferable custody receipts, or TraCRs, which are a security based on offshore securities such as Apple, Facebook, IBM, Disney and Microsoft. Liquidity provided by market making firms will be critical to the success of TraCRs and the benefits this product will provide to local Australian investors. As ASIC itself has stated:

Market makers earn their revenue from trading, and competition is a strong motivation to maintain tight bid-offer spreads that should then produce close alignment to the NAV and consequently to the iNAV⁵

The more market makers there are in TraCRs and other quoted investment products, the narrower bid-ask spreads will become. This will directly impact on the economic performance of these products and the benefits they can bring to Australian investors.

FFSPs are a natural source of competition to Australian based market makers, particularly for products that are based on offshore assets.

(c) FFSPs as Market Makers in ASX Listed/Quoted Products that are Traded on CXA

A critical element in the initial and ongoing success of the CXA market is the liquidity provided on the CXA platform by market makers or liquidity provided in ASX listed and quoted products. The benefits to Australia that are a direct result of the liquidity provided by these firms include:

- (i) estimated total broker cost savings of approximately \$133.6million⁶;

³ See page 3 of the ASX Investment Products Report for June 2018, retrieved on 3 August 2018 from https://www.asx.com.au/documents/products/ASX_Investment_Products_June_2018.pdf.

⁴ See footnote two above.

⁵ See Information Sheet 230, retrieved on 3 August 2018 from <https://asic.gov.au/regulatory-resources/markets/supervision/exchange-traded-products-admission-guidelines/>.

⁶ Source: CXA analysis of savings from the lower ASX and CXA execution and trade reporting fees that have been charged since CXA commenced trading in competition with the ASX.



- (ii) benefits, from a narrowing of spreads, that may amount to up to \$300million per year – see page 32 of Treasury’s Market Supervision Cost Recovery Impact Statement from 2013⁷;
- (iii) estimated welfare benefits from the first year of competition alone of \$36-220million, according to a study conducted by CMCRC published in 2013⁸.

2. Why Imposing AFSL Requirements May Deter FFSPs from Trading in Australia

Requiring an offshore firm to obtain an AFSL imposes additional costs on doing business. The extent to which this will result in offshore liquidity providers no longer trading in Australia is difficult for CXA to discern with precision. However, it is important when undertaking the cost benefit analysis of a proposal to require FFSL liquidity providers to obtain an AFSL, to note:

- (i) liquidity providers work on very low margins and as a result any increase in the sunk costs of entering a market can have a significant impact on attracting new entrants;
- (ii) the cost of trading in Australia is already expensive compared to other jurisdictions, making it difficult for CXA to compete with other global platforms as a place for FFSPs to direct liquidity;
- (iii) there are ongoing costs to being regulated in Australia that can be significant, even for firms that have the small regulatory footprint of proprietary traders. These costs will be a further disincentive for FFSPs to enter the Australian market and provide low margin services such as market making;
- (iv) CXA developed and received Ministerial non-disallowance of a market maker rule framework that has not been used by market makers because of the additional risk and cost it imposes relative to the non-rule based framework developed by ASX. CXA has now developed a similar framework to that of the ASX and under which a small number of market makers have registered. This suggests that market making firms are very sensitive to assuming additional regulatory obligations which in turn suggests that requiring firms to have an AFSL does risk deterring liquidity providing FFSPs from trading in Australia.

CXA is of the view that ASIC should not lightly dismiss the risk of deterring liquidity providing FFSPs from trading in Australia if ASIC requires those firms to obtain an AFSL. ASIC has identified the significant risks posed, by the lack of market makers, to the Australian market for exchange traded

⁷ See https://static.treasury.gov.au/uploads/sites/1/2017/06/Consultation_draft_CRIS.pdf , retrieved on 2 August and which references the conclusions of a study by the Strategic Intelligence Unit at ASIC, that the benefits of competition may be worth more than \$300 million per year.

⁸ See <https://cmcrc.com/wp-content/uploads/2018/01/1372142696hascompetitionbeenbeneficialforaustralianmarketplace.pdf> , retrieved 2 August 2018.



products⁹. CXA is of the view that therefore there is merit in developing a regulatory framework that will attract, not deter, FFSPs that may provide liquidity on our licenced markets.

3. The Regulatory Risks Posed by Market Makers

The regulatory foot print of an FFSP providing liquidity on the CXA is small. The small regulatory profile is due to the heavily regulated and risk managed framework of an Australian licensed market operator, including:

- (i) CCP clearing and T+2 settlement cycles;
- (ii) the 'flat book' nature of most market making strategies;
- (iii) all trading takes place through recognised market participants;
- (iv) a market making liquidity provider is not dealing directly with any retail clients;
- (v) trading obligations are managed through an Operating Rule framework that is contractually based with cross border application.

This is relevant in a cost benefit analysis of the ASIC proposals as it suggests there is little or no benefit in requiring an FFSP, whose only activity in Australia is providing liquidity, to obtain an AFSL.

4. Alternative Regulatory Tools

The cost benefit analysis of the proposals in CP 301 is fundamentally different depending on whether it concerns activity that takes place within the regulatory framework of a regulated market.

In Australia, the regulatory framework of a licensed market operator includes:

- (i) advanced and sophisticated monitoring of all market activity by ASIC and market operators;
- (ii) Operating Rules that have effect as a statutory contract between each participant and between each participant and CXA as market operator;
- (iii) Operating Rules that allow for non-AFSL holders to become participants subject to any conditions imposed by CXA –these conditions may require the participant to submit to and comply with the Corporations Act and Market Integrity Rule requirements as if they were an AFSL holder;
- (iv) a obligation on participants to self-report breaches and misconduct;
- (v) the power to compulsorily acquire information and other material;

⁹ See footnote 2 above.



- (vi) a direction power; and
- (vii) an enforcement and disciplinary power to fine and take other action with respect to participants.

This framework provides a foundation that can effectively leverage the regulatory supervision undertaken in the home jurisdiction of the FFSP.

There may also be scope for Australian markets to incorporate a market making framework within the Operating Rule framework. This would, however, require a sufficient incentive for firms to register under a Rule framework when the existing benefits for being a market maker are provided without a market making firm assuming liquidity obligations under the Operating Rules.

The reality of the relative position occupied by licensed Australian markets means that attracting the liquidity provided by global firms will often require the accommodation of regulatory standards and supervision in the major financial centres as this provides the benchmark by which those global firms are structured and managed¹⁰. Further, imposing additional local regulatory requirements may outweigh the relative attraction of Australia's markets for these firms, particularly given the size of the markets that can be accessed by meeting the regulatory requirements of a major financial centre.

Conclusions

It is beyond the scope of this submission to precisely identify how liquidity providing FFSPs will respond to being required to obtain an AFSL. It is clear that the requirement will increase costs for liquidity providing FFSPs and may deter them from trading on Australian markets.

FFSPs that provide market making liquidity are easy to identify. In circumstances where there are already concerns over the lack of market makers in the Australian market, there is a legitimate basis for ASIC to fully explore alternate regulatory mechanisms before implementing the AFSL requirement proposed in the CP on FFSPs that may provide this liquidity.

I hope this submission assists in your important work in this area, please don't hesitate to contact me if you have any queries.

Yours sincerely

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¹⁰ See, for example, Simmons, Beth A. 2001. The international politics of harmonization: The case of capital market regulation. International Organization 55(3): 589-620.