



23 March 2020

Product Regulation Strategic Policy
Australian Securities and Investments Commission
GPO Box 9827
Brisbane QLD 4001

By email: product.regulation@asic.gov.au

Dear Sir/Madam

ASIC Consultation Paper 325 on Product design and distribution obligations

Chi-X Australia Pty Ltd (**Chi-X**) is grateful for the opportunity to make a submission in response to CP 325 on Product design and distribution obligations (**DDO**).

Chi-X operates a market for secondary trading in ASX securities, including ASX exchange traded funds and managed funds (together **Quoted Funds**), and Chi-X Quoted Funds. Chi-X Quoted Funds are admitted to quotation by Chi-X and the Chi-X market is the exclusive market for their secondary trading. Chi-X is concerned about the lack of clarity surrounding the application of the DDO to Quoted Funds.

Treasury's revised explanatory memorandum (**EM**) stated,

*The new obligations **only** apply to **primary or initial offerings** of financial products to **retail clients**. They do not apply to sales of products on secondary markets **unless** such sales are made in circumstances that could otherwise be used to avoid the obligations. These situations are those already discussed in paragraphs 1.19 and 1.24 of this memorandum. This means that the obligations cease to apply if the product is no longer available to consumers by way of primary or initial offering.¹*

The nature and usual operation of Quoted Funds involve primary offerings only to authorised participants off exchange (external market making) or market participants on exchange (internal market making). Accordingly, in keeping with the EM: the DDO obligations would not apply to these usual operations of Quoted Funds; and very occasionally where a Quoted Fund does make a primary offering to retail clients off exchange DDO obligations would, and as they are off exchange they practically could, apply.

There are conceptual and practical reasons supporting this outcome. As outlined below Quoted Funds are already subject to a robust regulatory framework and as open ended funds traded on

¹ See *Explanatory Memorandum Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2019*, at para 1.45.

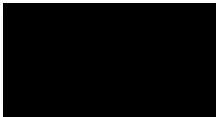
exchange and supported by market making and ongoing disclosures, they have standards and protections for retail investors and pose challenges to implementing the DDO obligations. Despite this, ASIC's draft Regulatory Guide (**RG 000**) and the technical operation of the legislation could be interpreted to apply more broadly to Quoted Funds. At present, stakeholders cannot apply the DDO obligations with any certainty or consistency.

Chi-X is concerned that the absence of clarity is unfair on issuers and may impose excessive compliance costs for no discernible benefit. To the extent that the clarity is resolved by applying all DDO obligations to Quoted Funds it is clear that this will impose a significant additional costs for no identified benefit and is not in keeping with the EM.

Chi-X would welcome the opportunity to discuss this matter further with ASIC and other stakeholders. Chi-X is strongly of the view that further consultation is required on the application of the DDO obligations to Quoted Funds to enable a full cost benefit analysis. This is particularly the case when the EM may create doubt on the legality of any ASIC measures that are not clearly aligned with the EM.

In terms of timing, COVID-19 and the resulting uncertainty, potential lockdown and substantial impact on all aspects of society is not an environment to be introducing seminal changes for products traded on financial market infrastructure.

Yours sincerely



Chi-X Australia Pty Ltd

(1) Robust regulatory framework for Quoted Funds

There is an existing robust regulatory framework for Quoted Funds which embeds standards and protections for retail investors and regulatory oversight of issuers and market participants. This framework also recognises that the nature of exchange trading poses practical challenges which require relief from certain provisions of the *Corporations Act 2001 (Cth)* (**Corporations Act**).

- Substantial ASIC guidance for issuers and market operators on the requirements for admission and supervision of Quoted Funds.² This guidance is to ensure that funds admitted to quotation for trading on exchange meet standards of liquidity, disclosure, transparency, naming etc to be suitable to be accessed by retail investors and setting a higher bar than for off exchange funds and also Listed Investment Companies (**LICs**) and Listed Investment Trusts (**LITs**).³
- Issuers of Quoted Funds and market participants trading units of the fund on exchange are subject to substantial regulation including AFSL, Market Integrity Rules (**MIR**), market operating rules, conditions of relief under class orders and instruments etc.
- Class orders and instruments recognise that due to the nature of these products being exchange traded issuers face particular challenges and accordingly relief is available. For example, exchange trading means issuers don't know the identity of the end client who is purchasing the units, at what price etc.⁴

² ASIC Information Sheet 230, REP 583 Review of exchange traded products, REP 644 Assessment of ASX's arrangements for exchange traded AQUA products etc

³ **Quoted Funds are subject to:** (1) Liquidity obligations so that investors can buy and sell and at prices close to the net asset value (**NAV**) and which are generally met by market makers or the fund providing on exchange liquidity. LICs, LITs and off exchange funds don't have the same liquidity obligations and so don't offer retail investors the comfort of liquidity, price transparency and trading near the NAV; (2) Underlying asset suitability requirements, meaning the assets must be liquid with sufficient price transparency, and limit derivatives or clearly identify this in their naming. LICs, LITs and off exchange funds don't apply the same scrutiny to the suitability of underlying assets and so provide less protection for retail investors by allowing a wider range of underlying assets; (3) Disclosure obligations including portfolio and pricing disclosures, often intraday or daily. LICs, LITs and off exchange funds don't provide indicative NAV or the same frequency of portfolio disclosures.

⁴ **Exchange trading means** (1) The price of units may move with the market price and value of scheme property, so issuers cannot set out in the constitution the price at which an interest is acquired or disposed (see relief from s601GA(1) under [CO 13/655]); (2) issuers don't know the transaction price at which the investor bought/sold their interests, so issuers face challenges preparing periodic statements (see relief from 1017B under [CO 13/1200]); (3) issuers face challenges providing individual notifications to retail investors (see relief from 1071B under [CO13/721]).

(2) The nature of Quoted Funds

Quoted Funds by their nature as exchange traded and open ended pose challenges to the application of the DDO obligations. The cost and complexity of applying the DDO obligations to exchange trading of Quoted Funds would outweigh the benefits gained for the retail investor.

- Exchange traded

Interests in Quoted Funds are bought and sold on exchange by market participants. A retail investor can only access Quoted Funds on exchange via a market participant.

A retail investor might be a client of the market participant (e.g. if the market participant is an online retail broker like Commsec) but in many cases the retail investor is not known to the market participant and is instead a client of another broker or advisor who has routed the order to the market participant to trade on exchange.

Exchange trading means there is difficulty for an issuer to 'look behind' the market participant to ascertain who the clients are – in some circumstances it may be impossible. This and the layers of intermediation between the issuer and the consumer pose more challenges to applying the DDO obligations.

- Open ended

Interests in the Quoted Fund are issued and redeemed daily. Generally an authorised participant applies to the fund to create and redeem units daily and secondary trading on exchange occurs soon after the primary issuance (external market making). Sometimes, the fund appoints a market maker on an agency basis and the fund is thereby counterparty to the market maker's on exchange transactions (internal market making).

Under these scenarios units from the primary issuance will be acquired either by an authorised participant off exchange OR by a market participant on exchange. Regardless of the market making model all trading of Quoted Funds on exchange is by market participants.

So the vast majority of consumers will be accessing Quoted Funds on the secondary market through exchange trading via a market participant and possibly other intermediaries. Rarely there may be an off exchange primary issuance to a retail investor.

(3) Lack of clarity

There is a lack of clarity on how to interpret and apply the DDO obligations in relation to Quoted Funds. This is problematic on several fronts including:

- The lack of certainty may result in inconsistent application across issuers, market participants and intermediaries.
- Issuers, market participants and intermediaries may not know what is required of them and so are at risk of non-compliance.
- This will likely require more resources from firms to consider how they are going to comply with the DDO obligations and more resources from ASIC to supervise the same.

(4) The Target Market Determination and Distribution

RG 000 did not include any example for Quoted Funds which may have highlighted the challenges in applying the DDO obligations to these products. A target market for exchange traded products is any client of a market participant, which as outlined above must comply with the applicable AFSL, MIR and market operating rule requirements. This creates a number of issues in applying the obligations in the DDO guidance to an issuer of exchange traded products:

- the difficulty for an issuer to 'look behind' the market participant to ascertain who the clients are – in some circumstance it may be impossible;
- the lack of a substantial benefit in imposing obligations on an issuer above and beyond those already imposed pursuant to their responsible entity obligations, the MIRs, the market operating rules, the AFSL obligations of market participants and the obligations of market operators;
- The potential for it to be contrary to the market operating rules for an issuer to target an audience as that would implicitly result in the discriminatory treatment of one category of investor over another.