REPORT 721

Response to submissions on CP 347 Proposed amendments to the prohibition on order incentives in the ASIC market integrity rules

March 2022

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 347 *Proposed amendments to the prohibition on order incentives in the ASIC market integrity rules* (CP 347) and details our responses to those issues.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 265 *Guidance on ASIC market integrity rules for participants of securities markets* (RG 265).

Contents

A Overview and consultation process 4
Responses to consultation.. 5
B Amending the prohibition on order incentives............................ 6
Proposal to amend the current prohibition.. 6
C Soft dollar incentives for order flow 9
Feedback on current approach to soft dollar incentives.................... 9
Appendix: List of non-confidential respondents 10

A Overview and consultation process

1 In Consultation Paper 347 *Proposed amendments to the prohibition on order incentives in the ASIC market integrity rules* (CP 347), we consulted on our proposal to amend the current prohibition on payment for order flow, which is set out in Part 5.4B of the ASIC Market Integrity Rules (Securities Markets) 2017 (Securities Markets Rules).

2 We have identified that this prohibition does not deal with certain payment for order flow scenarios. In CP 347 we proposed to close this regulatory gap and, in doing so, also simplify the concept of 'negative commission' in the current rules.

3 Our policy position on payment for order flow arrangements is well established. In our view, the harms associated with these arrangements outweigh the benefits. Our proposed amendments in CP 347 are a proactive measure to circumvent the emergence of payment for order flow arrangements in Australia.

4 In CP 347 we also sought feedback on our approach to soft dollar incentives for order flow. The current prohibition in Part 5.4B of the Securities Markets Rules deals with cash payments (i.e. monetary benefits) only. Soft dollar (i.e. non-monetary benefits) are dealt with under Regulatory Guide 265 *Guidance on ASIC market integrity rules for participants of securities markets* (RG 265).

5 This report highlights the key issues that arose out of the submissions received on CP 347 and our responses to those issues.

6 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 347. We have limited this report to the key issues.

7 We received five non-confidential and one confidential response to CP 347. We also had discussions about our proposal with some of our stakeholders. We are grateful to respondents for taking the time to send us their comments.

8 For a list of the non-confidential respondents to CP 347, see the appendix. Copies of these submissions are currently on the CP 347 page on the ASIC website.

Responses to consultation

9 The main issues raised by respondents about the proposal to amend the current prohibition on payment for order flow related to:

(a) concerns that the proposal would result in an undue or unfair regulatory burden on market participants, and that the prohibition should instead apply directly to non-market participant intermediaries ('intermediaries'); and

(b) the potential unintended application of the prohibition to certain payment or fee arrangements.

10 The feedback on our current approach to soft dollar incentives for order flow was mixed. Some respondents requested that ASIC conduct further consultation before any changes are made.

B Amending the prohibition on order incentives

Key points

This section outlines the feedback we received on our proposed amendments to the prohibition on order incentives and our responses to those submissions.

While most respondents broadly supported our proposal, two respondents argued that it placed an undue regulatory burden on market participants.

Some respondents sought clarification on the potential unintended application of the prohibition to certain payment or fee arrangements.

Proposal to amend the current prohibition

11 In CP 347 we proposed to amend the prohibition on order incentives in Part 5.4B of the Securities Markets Rules to:

(a) simplify the concept of ‘negative commission’, which is currently set out in Rule 5.4B.1(2) (and referred to as ‘net cost’);

(b) include in the current prohibition, payments that are made to an ‘associate’ (defined in Rule 5.4B.1(2)) of the other person;

(c) require a market participant to take reasonable steps, in circumstances where the market participant handles or executes orders as a result of an arrangement with another person, to ensure that the other person has not made a cash payment to a third party (or an ‘associate’ of the third party) for that third party’s orders (or their client’s orders), where the value of that cash payment exceeds any payment made by the third party to the other person for directing those orders to the other person; and

(d) prohibit a market participant (or an ‘associate’ of the market participant, defined in Rule 5.4B.1(4)) from accepting a cash payment from another person for directing the market participant’s orders to that person, where that cash payment exceeds any payment made by the market participant to the other person for directing those orders to the other person.

12 Four respondents were broadly supportive of our proposal. Two other respondents supported our proposal to simplify the concept of ‘negative commission’. One respondent submitted that our current prohibition is unduly narrow and that our proposal is a proportionate measure to close the regulatory gap on cash payment for order flow.

‘Reasonable steps’ requirement

13 Two respondents did not support our proposed ‘reasonable steps’ requirement in draft Rule 5.4B.1(1)(b).

14 Both respondents raised concerns that this requirement placed an undue or unfair regulatory burden on market participants, particularly if market participants were expected to actively monitor intermediaries and be responsible for their actions. Both respondents argued that the prohibition should instead apply directly to the intermediaries.

15 We held meetings with each respondent to discuss their submissions and to clarify our expectations with respect to the proposed requirement.

Other fee or payment arrangements

16 Some respondents submitted that our proposal may unintentionally prohibit certain fee or payment arrangements and sought clarification or further guidance. Such arrangements included:

(a) payment arrangements between licensed market operators and market makers;

(b) fee arrangements between licensed market operators and market participants;

(c) differential brokerage rates;

(d) structured products which may involve an on-market execution and where fee arrangements for the on-market execution may be embedded in the product terms; and

(e) internal transfer pricing arrangements between related bodies corporate.

> *ASIC’s response*
>
> We have amended the current prohibition on order incentives, as proposed in CP 347.
>
> We consider this essentially a passive requirement for market participants, largely through their intermediary documentation and on-boarding processes, to ensure that their intermediaries do not engage in prohibited payment for order flow arrangements. We do not expect market participants to actively monitor their intermediaries.
>
> The amendments commence three months after the new rules are registered.
>
> We expect the compliance impact of these amendments to be minor as payment for order flow arrangements are not common in the Australian market. However, market participants may need to make changes to their existing intermediary arrangements

(e.g. updates to agreements) and to their intermediary on-boarding processes.

We consider that a three-month transition period provides adequate time for market participants to make these changes. It is also consistent with feedback we received from a number of market participants on this point.

We also intend to update our guidance in RG 265 to clarify that what constitutes 'reasonable steps' will depend on the nature, scale and complexity of a market participant's business, and that it might include one or more of the following:

- incorporating terms or clauses in the market participant's agreement with that person that deal with the requirements under Part 5.4B;
- obtaining an undertaking from that person (e.g. during the on-boarding process) that the person will not engage in a payment for order flow arrangement that contravenes Part 5.4B; or
- obtaining an annual declaration from the person that the person has not engaged in a payment for order flow arrangement that contravenes Part 5.4B.

We will clarify that this is guidance only and is not intended to be an exhaustive list of requirements. Ultimately each market participant can determine what they consider to be 'reasonable' based on their own circumstances.

We also intend to update our guidance in RG 265 to clarify that the prohibition does not apply to:

- payments made by licensed market operators to market participants or other market intermediaries—that is, the rule only applies to payment between market participants or other market intermediaries (or a combination of both);
- fee or payment arrangements (such as different brokerage rates, structured product fee arrangements or internal pricing arrangements) provided such arrangements do not result in a 'negative commission'.

C Soft dollar incentives for order flow

Key points

This section outlines the feedback we received on our current approach to soft dollar incentives for order flow.

The feedback we received was mixed. Some respondents supported further guidance and rule amendments. Other respondents argued that the current approach was appropriate or sufficient.

Some respondents requested that if changes were to be made, ASIC should first conduct a separate industry-wide consultation process.

Feedback on current approach to soft dollar incentives

17 In CP 347 we sought feedback on our current approach to soft dollar incentives for order flow.

18 Two respondents supported rule amendments which prohibit or otherwise control soft dollar incentives. Both respondents also supported enhanced or more prescriptive guidance. One respondent did not comment directly on soft dollar incentives.

19 Three respondents broadly were not in favour of making changes to our current approach to soft dollar incentives. One respondent submitted that the current guidance in RG 265 sufficiently addresses the potential risks associated with such arrangements.

20 Two of those respondents requested that if ASIC were to make changes, it should first conduct a separate industry-wide consultation process.

ASIC's response

We do not propose to make any changes to our current approach to soft dollar incentives for order flow, at this time.

We will continue to monitor market practices and observe how the market responds to our amendments to the prohibition on cash payments for order flow in Part 5.4B.

If we identify actual or potential harmful practices, we will reconsider our position. Before making any changes to our approach to soft dollar incentives, we will undertake further consultation in some form.

Appendix: List of non-confidential respondents

- ASX Limited
- Australian Financial Markets Association
- Chi-X Australia Pty Ltd (now known as Cboe Australia Pty Ltd)
- Law Council of Australia
- Stockbrokers and Financial Advisers Association Limited

