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6 February 2013

Manager
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The Treasury
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Dear Sir/Madam

Discussion Paper: Options for Amending the ASIC Market Supervision Cost Recovery Arrangements

Chi-X Australia Pty Ltd (Chi-X) is grateful for the opportunity to provide a submission on the above discussion paper (DP).

This submission is segmented as follows:

(i) the key issues raised by the proposals for the regime to be in place from 1 July 2013 – contained in **Part One**;

(ii) improving the existing regime – contained in **Part Two**;

(iii) a response to the feedback questions listed in the DP – contained in **Part Three**.

We hope this response assists in your deliberations in this important area. Please do not hesitate to contact us if you have any queries.

Yours faithfully

Chi-X Australia

Part One
Key Issues - Proposals

Chi-X is of the view that the following key issues are raised by the options in the DP for amending the cost recovery arrangements:

1. Market Making Relief – Justification and Nature;
2. Transparency on Cost Calculations and Fees;
3. Fairness of the Proposals;
4. Cost Recovery and Innovation in Australia's capital markets.

1. Market Maker Relief

This section of Part One outlines:

(a) why market maker relief is justified in the case of new market operators competing with a legacy monopoly in the secondary market trading of listed securities;

(b) some suggestions for an appropriate market maker regime.

(a) Justification – market makers improve market quality

Obtaining a licence and offering a trade execution platform are not sufficient steps for a new market operator to build liquidity and sustain competition: trading on a new platform must deliver better outcomes than trading on the legacy monopoly platform. Demonstrating these better outcomes requires trading by liquidity providers who will respond to price movements by immediately amending and/or replacing orders with new orders that reflect the changing market. In this way a competing platform is able to offer execution that matches or improves on that of the legacy monopoly market and, step by step, attracts natural liquidity that helps to build its market. Market makers that specialise in providing liquidity operate a business model that is traditionally low margin. Hence any levy imposed on every message they submit may deter them from operating in a particular market or jurisdiction.

This demonstrates why an increase in the message based component of the cost recovery measures may, irrespective of current volumes on Chi-X's market, result in the existing liquidity providers ceasing their activity. A message based levy that discourages liquidity providers from trading on a newly launched or alternative platform poses a direct threat to the sustainability of those platforms. The introduction of additional cost will also cause market makers to widen their spreads to minimise the need for adjustments to be made (as those adjustments will generate further costs). The bid-ask spread is the most significant component of transaction costs in the Australian market and so any measures which increase that cost will have a significant adverse impact on all other market users.

Ultimately, investor performance suffers when measures are introduced which disadvantage competition, innovation and the providers of liquidity.

This is why providing relief from the cost recovery proposal for liquidity provision is justified in the case of trading on an alternative platform: without this liquidity, competition and the benefits it brings may not be sustained.

The possible outcomes for market quality of a regime that inhibits liquidity provision is highlighted by an independent CMCRC study on high order to trade ratio trading strategies that has found a positive relationship between those strategies and market quality[1]. More particularly it found that the market quality measures of spread and depth were positively impacted by the introduction of high order to trade ratio trading strategies. The same study also found that when cost recovery measures (similar to those proposed in the DP) were introduced they resulted in (i) a decrease in order to trade ratios and (ii) a negative impact on market quality.

The evidence clearly indicates that the cost recovery proposals will negatively impact market quality in a way that has a disproportionate impact on the operator of a new trading platform seeking to compete with a legacy monopoly operator. This is contrary to government goals of enhancing Australia's financial markets and ensuring that any cost recovery measures produce competitively neutral outcomes[2].

Providing relief for market maker activity in respect of trading that provides liquidity may address these outcomes in part.

(b) Nature of the Market Maker Regime

The UK Government's Foresight Project stated in its Final Report:

> *The current system of exchanges determining how to structure market maker obligations and pay for them seems to be working well for most markets.*[3]

While a market maker exemption for cost recovery measures is obviously not within the gift of a market operator, Chi-X is of the view that the principle underpinning the conclusion of the UK's Foresight Report is sound: market operators are best placed to determine the affirmative obligations that a market maker must satisfy.

[1] Andrew Lepone and Alex Sacco: "The Impact of Message Traffic Regulatory Restrictions on Market Quality: Evidence from Chi-X Canada" (executive summary attached).

[2] See, for example pages 91-93 of "Australia as a Financial centre; Building on our Strengths", a report by the Australian Financial Centre Forum (http://www.fex.com.au/media/AFCF.pdf) and the principles of Australian Government policy listed on pages 2-3 of the Australian Government Cost Recovery Guidelines July 2005 (http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost_Recovery_Guidelines.pdf)

[3] Foresight: The Future of Computer Trading in Financial Markets (2012) Final Project Report, The Government Office for Science, London, at page 110.

Chi-X is proposing a market maker regime that will impose a number of affirmative obligations upon registered market makers. It is essential, if the negative market impact and anti-competition outcomes of the cost recovery proposals are to be addressed, for trading by registered market makers, which is in compliance with those obligations, to obtain relief from the cost recovery measures. Chi-X has an interest in ensuring that these obligations are sufficiently strict to ensure that the liquidity being provided is genuine and is demonstrably beneficial to liquidity takers trading on the Chi-X market.

Chi-X is therefore of the view that the cost recovery regulations containing relief for market making activity should:

(i) provide that the market operator has control over the ways in which liquidity can be attracted to its market and that in particular:

  (a) it would be inappropriate for the regulations or ASIC to set a 'one size fits all' regime that does not recognise the fundamental difference in the economics of competing platforms; and

  (b) it is important to recognise that the nature of market making obligations and applicable metrics means that a market operator must have the flexibility to amend those obligations/metrics on a timely basis in response to changing market circumstances;

(ii) apply the relief not only to a market participant that is a liquidity provider but also to a market operator in respect of any cost recovery impost that relates to those messages generated by liquidity providers – the costs linked to this activity should be excluded from the cost recovery pool (ie not imposed on other market participants)[4].

2. Transparency

Chi-X is appreciative of the transparency provided in the DP and it is beneficial for those subject to the cost recovery proposals to be aware, at a high level, of the aggregate costs. However, the aggregate figures should be unpacked to provide further details on how they are constituted. Otherwise it is not possible to know what is subject to cost recovery (eg is the ASIC HFT Task Force work included or not). The benefits of this will include the discipline it imposes on those providing the figures and enabling those impacted by cost recovery to assess the amounts involved and respond to the consultation in a meaningful way. This is not possible if an unpacking of the figures is left until the CRIS is published, which will be after the drafting of regulations upon which the cost recovery will be based. It is a fundamental requirement that those businesses impacted by the proposals (and the impact is real and significant) should have an opportunity to provide a

[4] See the comments in section one of Part Two on broadening the base of the costs recovery measures and which outlines the broader stakeholders in Australia's financial markets.

meaningful contribution to the debate before the impost is finalised[5]. Unless the aggregate figures are unpacked in a DP this is not possible and the regulated community is denied the opportunity to have meaningful input on:

(a) the measures that are subject to the cost recovery measures (eg whether trading on ASX's Centre Point platform is captured); and

(b) the use of the funds and whether there are more advantageous options that should be considered.

Chi-X is also of the view that there should be greater transparency on the scenario where the actual cost incurred by ASIC is below the budgeted costs. Evidence obtained over the last couple of months indicates that the cost of a replacement system was over budgeted. It is therefore important that the budgeted and actual costs are subject to detailed review by a body of industry representatives which is also well placed to review the method of ensuring that the overpaid funds are returned to the industry.

3. Fairness

The publicly available material raises two fundamental queries on the fairness of what is being proposed.

Firstly it appears that no cost recovery takes place in respect of the ASX equity options market. This market is fundamentally reliant upon the integrity of the market for the underlying cash equity instruments upon which the options are based. Chi-X queries whether, in these circumstances, it is fair that some markets are captured while others are excluded from the cost recovery proposals[6]. Similarly, it appears inequitable to have closely related markets treated in disparate ways when looking at the quality of market supervision performed and the cost of that supervision.

Secondly it is not clear why, based upon the publicly available material outlining ASIC's surveillance and supervision work, there is such a focus on message traffic. ASIC Report 296[7] does not accord a commensurate prominence to message traffic in its outline of the work undertaken by ASIC during January to June 2012. The report does state:

> *The number of alerts* [generated by the IT systems subject to cost recovery] *continues to be affected by a range of factors, including general market volatility, the level of corporate transactions and trading conditions generally.*[8]

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[5] Appropriate consultation with all stakeholders is required by principle 10 on page 3 of the Australian Government Cost Recovery Guidelines July 2005 (http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost_Recovery_Guidelines.pdf).

[6] See also paragraph (iv) of Section 1 in Part Two for further queries on why cost recovery is not imposed on a broader set of stakeholders in the cash equity markets.

[7] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep296-published-16-August-2012.pdf/$file/rep296-published-16-August-2012.pdf

[8] Ibid 10

and:

> *We are working closely with ASX in identifying and investigating possible breaches of the continuous disclosure requirements.*[9]

Chi-X queries the fairness of the cost recovery proposals disproportionately attaching an importance to message traffic when the publicly available material on the allocation of ASIC resources references a number of other factors (eg corporate transactions and continuous disclosure). Chi-X acknowledges the work that has been done by ASIC's HFT Task Force but it is not clear why this work should be subject to cost recovery when it appears to have been primarily driven by a perceived need to respond to concerns raised in the media.

4. Ensuring that the cost recovery measures do not hamper innovation in Australia's markets

On page 14 of the current DP it is stated that ASIC should have a discretionary power to recover costs incurred by it in the regulation of significant innovations. Chi-X is concerned that this may inhibit innovation and, in the DP at least, is proposed without any accompanying governance structure. Indeed there are no details of any proposed checks on the exercise of this power. In these circumstances it is not clear how the proposals address the requirement in the Cost Recovery Guidelines that cost recovery should not be applied when to do so would unduly stifle competition[10].

Chi-X accepts that if there is innovation by one market operator that creates a particular need for regulatory resources then it is not appropriate for other market operators to bear the costs associated with that further resource. However there is a need to ensure that the matter is subject to appropriate governance. Additionally there should be recognition that the current infrastructure has been developed at no cost to ASX to specifically meet the needs of ASX products (eg VolumeMatch, PureMatch, CentrePoint and TradeMatch).

[9] Ibid 11

[10] See principle 2 on page 2 of the Australian Government Cost Recovery Guidelines July 2005 (http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost_Recovery_Guidelines.pdf).

Part Two
Key Issues – Improving the Existing Regime

Chi-X is of the view that the current regime does not produce the best possible outcomes for Australia's financial markets and that, like any matter of this significance, the underlying policies should therefore always be open to review.

In this context Chi-X has comments on the following aspects of the current measures that are equally relevant to the proposals contained in the DP:

1. broadening the stakeholders on whom cost recovery measures are imposed;

2. governance.

1. Broadening the costs recovery base

There are global precedents for setting the cost recovery base for market surveillance and supervision more broadly than has happened in Australia. Chi-X is not aware of a global benchmarking of the Australian approach designed to ensure the measures do not prejudice (and preferably enhance) Australia's competitive position.

Many different stakeholders need and rely on the integrity of Australia's cash equity markets, as has been concisely stated by ASIC Commissioner Mr Greg Tanzer:

> *The penalties that apply* [to market misconduct] *are really quite severe and they reflect the importance of market integrity to the Australian economy as a whole.*
>
> *It's really important to the Australian economy. There are thousands of Australian public companies that rely on the market to provide an efficient source of funds and they employ directly or indirectly millions of Australians and on top of that there's many, many Australian superannuation funds that invest the retirement savings of millions of Australians.*[11]

Specific instances in which persons creating the need for market supervision will be outside the scope of the current cost recovery measures include the following.

(i) Issuers create a need for ASIC to ensure market integrity in respect of secondary trading (distinct from any continuous disclosure monitoring undertaken by the ASX) and examples of this in the last twelve months include the David Jones and Macmahon Holdings takeover rumours[12].

[11] Transcript at http://www.abc.net.au/7.30/content/2013/s3667080.htm retrieved on 1 February 2013.
[12] See Commissioner Tanzer's statement, ibid, and the articles: "DJs takeover bid- predator confirmed" - http://www.smh.com.au/business/djs-takeover-bid--predator-confirmed-20120629-216hf.html retrieved on 31 January 2013; and "ASIC investigates hoax takeover bid for Macmahon" -

(ii) Indirect market participants create a need for market regulation which is exemplified by the Swift Trade matter in the UK where the indirect participant traded through a series of different direct participants[13].

(iii) Wider investors create a need for regulation which is exemplified by the interests of shareholders in the market movements generated in the Whitehaven case[14].

(iv) Those generating income and revenue from products that are priced off equity instruments are reliant upon market integrity being maintained by ASIC in the underlying instruments – for example:

(a) the ASX options market is dependent on ASIC maintaining market integrity in the underlying cash equity market but makes no contribution to the cost ASIC incurs in discharging that function;

(b) contracts for difference are outside the cost recovery regime and yet provide a revenue source dependant on the integrity of the underlying instruments and can be used to effect the very behaviour that ASIC monitors through resources paid for by the cost recovery measures[15].

Broadening the cost recovery base would address counterintuitive results in the current regime by creating a greater nexus between the revenue streams generated by the activity in respect of which cost recovery is sought and the cost recovery measures. At present those measures ignore the multiple revenue streams that are generated from the activities that are subject to cost recovery.

2. Governance

It appears from the DP that the total IT cost of ASIC's market monitoring and at least part of the ASIC surveillance staff costs, are subject to cost recovery. However as outlined by Commission Tanzer and the cases listed in the above section, there are clearly cases where most of those entities subject to cost recovery have no part to play in generating the need for or benefitting from the market surveillance required in those matters.

While not expressly set out in the DP, it appears that ASIC is responsible for:

(i) co-authorship of the policy underlying the cost recovery proposals;

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http://www.theaustralian.com.au/business/companies/asic-investigates-hoax-takeover-bid-for-macmahon/story-fn91v9q3-1226489487822 , retrieved on 31 January 2013.

[13] http://www.fsa.gov.uk/library/communication/pr/2013/009.shtml retrieved on 30 January 2013

[14] http://www.afr.com/p/business/companies/cancel_hoax_whitehaven_trades_mp_HZgO7qtsGpfuFB7gFc3mel retrieved on 1 February 2013.

[15] See the facts relating to the offences in Hartman v R [2011] NSWCCA 261

(ii) selecting the market surveillance systems used and the price to be paid/recovered;

(iii) assessing what fee should be attached to innovation by market operators;

(iv) undertaking market surveillance and participant supervision;

(v) deciding what surveillance/supervision resources are/are not subject to cost recovery;

(vi) deciding which activities of the market operators/participants that are subject to cost recovery should be investigated and prosecuted;

(vii) the level of fine to be issued/enforcement action taken against market participants and operators in respect of the matters which are the subject of cost recovery (which takes place independently of and prior to the right of appeal to the Panel).

In circumstances where there is no independent non-executive function within the ASIC structure and there is ambiguity over how particular costs should be recovered, Chi-X queries whether the cost recovery measures should be accompanied by a greater degree of independent oversight.

Part Three
Chi-X Response to Feedback Questions

Section	Feedback questions	Chi-X Response
Current cost recovery arrangements (1 January 2012 to 30 June 2013)	(1) Do you consider that the impact of the current cost recovery approach on overall market quality has been (a) mostly neutral, (b) positive, (c) negative or (d) other? Please provide examples to support your answer.	The impact of the cost recovery measures has been overwhelmingly negative. The current approach unfairly discriminates against a new market operator such as Chi-X by requiring it to pay a much higher portion of its trading revenue than the incumbent. Please refer to Part One of the covering letter for further details, including an explanation of how the cost recovery measures have damaged market quality.
	(2) Are there any specific segments of our market that you consider have responded to the current cost recovery arrangements in ways inconsistent with government policy or in a manner detrimental to market quality? Please provide examples to support your answer.	The proposed cost recovery measures are contrary to the Government guidelines ("Guidelines") dealing with cost recovery measures. They are contrary to Government policy of opening up the equity market for competition. The Guidelines make specific mention that cost recovery measures should not hamper competition or lessen innovation. As discussed elsewhere in this document, the primary proposals contained in the DP will have a significant damaging effect on competition and lessen the innovation that will flow from healthy competition.

Section	Feedback questions	Chi-X Response
Introduction of a fixed component of cost recovery for cash equity market participants	(3) Do you consider that a fixed fee on direct market participants reflecting the proportion of cost-recovered participant supervision that is attributable to direct market participants better aligns the fee model with ASIC's regulatory costs.	Yes. A fixed fee should be imposed upon participants of **all markets** that are subject to ASIC supervision and the fee should be reflective of the costs involved.
	(4) Do you consider that the proposed fixed fee in the order of $1,800 per quarter is reasonable? Please explain your answer. If you do not view this proposal favourably, please explain your preferred alternative/s .	The proposed cost per participant seems relatively small particularly when compared with the total cost of $43.7 million that is estimated in the DP.
	(5) What impact does the proposed approach have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?	Any adjustment to the recovery measures is likely to have an impact upon all parties since the proposals represent a full recovery arrangement. As such if some parties pay less, then others will be required to pay more and vice versa.
Increased messaging fees – Inclusion of Operational costs into messaging fees	(6) Do you consider that the cost recovery arrangement for equities market supervision costs (for ASX listed securities) should be amended so that some non-IT costs should be recovered through fees on messages? If not, please explain your preferred alternative.	Section 1 of the covering letter describes the importance for a new market operator to attract resting liquidity and the high message-to-trade rates that are experienced until resting liquidity is attracted from multiple sources, e.g. retail and institutional clients. A switch to recover a greater proportion of ASIC's costs through a charge based upon messages will cause further damage to competition. It is however noted that this harm may be ameliorated by implementing proposals dealing with messages

Section	Feedback questions	Chi-X Response
		generated by market makers. Chi-X remains of the view that it is appropriate to broaden the base of those liable to contribute to cost recovery and that the administrative simplicity of the message based system should not mistakenly be regarded as a fair and efficient outcome for Australia's financial markets. It is not clear from the publicly available material on the ASIC activities funded by the cost recovery proposals, why disproportionate attention is focused on messages. There may be a HFT task force but it is not clear that this work has been driven by genuine market issues identified by ASIC market surveillance, rather it seems possible that it has been driven by matters such as the media attention given to HFT or events overseas. This does not seem sufficient reason for influencing the imposition of ASIC cost recovery measures and the impact they have on business profitability. There are no enforcement outcomes reported by ASIC that justify the focus on messages, whereas there are genuine market integrity matters that are not message orientated (eg insider trading cases, the David Jones takeover rumours, Whitehaven, McMahon Holdings).

Section	Feedback questions	Chi-X Response
		The ASIC supervision report for January-June 2012 does not indicate any disproportionate amount of time being taken by message based activity. In summary, it is important that at least some evidence should be put forward that can be independently tested before decisions of this nature are taken.
	(7) What impact does the proposed approach have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?	Considered in isolation of other proposals the impact of this proposal would be adverse and has the potential to be material.
Market maker discounts	(8) In your view, have market makers responded to the current cost recovery arrangements in a manner detrimental to market quality? Please provide examples to support your answer.	The initial response of market makers to the cost recovery proposals was to (a) trade on the Chi-X market in significantly diminished quantities, fewer symbols and at wider spreads and (b) consider withdrawing from the Australian market. Toward the end of March 2012 it became clear that if volumes on Chi-X did not improve then Chi-X would have to consider terminating its operations in Australia and so market makers responded in a very constructive manner to aid market quality despite their business model being severely damaged by the cost recovery

Section	Feedback questions	Chi-X Response
		measures.
	(9) Do you consider that the cost recovery arrangements for equities market supervision costs (for ASX listed securities) should be amended so that beneficial market making activity (subject to strict eligibility criteria) is subject to a reduced cost recovery levy for message based charges? If not, is there an alternative method to prevent the cost recovery arrangements creating a disincentive to undertaking beneficial market making activity?	Yes, we strongly believe that harmful effects of the current and proposed cost recovery measures may be partially addressed if the important and constructive contribution of market making activity is recognised and supported. There are other actions that could be taken to ensure that the cost recovery measures cause less harm to the market but those actions require a holistic approach to reform and an acceptance that the current measures have led to undesirable and unintended consequences. Chi-X is strongly of the view that the pain involved in addressing the deep seated issues with the current cost recovery regime would be rewarded by the delivery of long term benefits to Australia's financial markets.
	(10) Do you believe we should recognise beneficial market making in the fees regulations and if so, how do you believe we should set the criteria and conduct the process to define beneficial market making activity?	Yes; the determination of criteria and conduct should be set using a market operator controlled regime that delivers the best outcome for market quality and meets minimum conditions imposed by ASIC. It should be appreciated that it is in the interests of a market operator to extract the best possible quotes (providing the tightest spread and greatest volume) from market makers on a sustained basis.

Section	Feedback questions	Chi-X Response
	(11) Should firms that benefit from such a discount or exemption be subject to strict, enforceable obligations? If so, what obligations would be appropriate and how should they be enforced?	Yes, market making activity should be subject to firm obligations. Enforcement should be the responsibility of the relevant market operator that, in turn, will be subject to oversight by ASIC.
	(12) What impact would the approach referred to in question (9) have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?	Recognition of the importance of market making activity for the good of the overall market has the potential to be significant and helpful. ASIC should be able to assist in quantifying the benefit once the quantum of the reduction is specified. Without Treasury providing that transparency it is not possible to specify the benefit in dollar terms.
Fixing of charges in advance	(13) Do you consider that the cost recovery arrangements should be changed so that fees are fixed by ASIC prior to the start of each billing period? Why/why not?	Yes, it will certainly be helpful although it should be noted that business does not typically plan with a 3-month horizon so the value is somewhat limited.
	(14) If you agree with the approach referred to in question (13) what, if any, oversight or safeguard arrangements, including notice periods, would you consider appropriate in relation to this process? If you disagree with the approach referred to in question (13), what alternatives do you believe would be appropriate?	The amount of over- or under-charge is likely to be relatively small and the mechanism to deal with it should not be overly onerous or expensive to operate.
	(15) If you agree with the changes referred to in	See the response to questions 13 and 14. In a broad

Section	Feedback questions	Chi-X Response
	question (13), do you agree that ASIC should set the fixed fees on a quarterly basis. If not, what other arrangement would be appropriate?	sense, a longer period of certainty concerning costs will assist business planning. It is noted that the DP incorrectly focuses upon recover of budgeted costs rather than actual costs. This is a fundamental flaw in the proposed arrangements that highlights the need for greater oversight of ASIC's activities and a greater degree of transparency concerning its expenditure (both budgeted and forecast).
Mandatory pass through	(16) Do you agree that participants should be made to pass trade and message fees on to their clients? If so, why is such an arrangement preferable to voluntary pass through of costs?	A pass through model that does not impose disproportionate administration costs is an appropriate step in broadening the base of parties contributing to the measures and appropriately recognises the wider community that generates the need for regulation and benefits from ASIC's oversight. Such a pass-through arrangement would help to ensure that there was appropriate transparency concerning the services provided by ASIC.
	(17) What changes would be necessary in order for your business to implement the approach referred to in question (16)? Can you provide estimates of the costs of those changes?	Chi-X is of the view that if pass through is applied then it should apply to the full ASIC market supervision costs. As such the impact would be significant and beneficial.
	(18) What impact would the approach referred to in	See response to question 17.

Section	Feedback questions	Chi-X Response
	question (16) have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?	We note that the pass through model would require cost recovery arrangements to be based upon a charge per trade and that charge should be reflected as a percentage of the trade value.
Changes to ASX24 cost recovery	(19) Do you consider that the current proposed cost recovery approach for equities market supervision costs (for ASX listed securities) can be extended to the ASX24 market once ASIC's real-time market surveillance system receives ASX24 data in real-time via the Australian Markets Regulation Feed? If not, please explain your preferred alternative.	Yes, Chi-X considers that all markets should be treated fairly and equitably and such treatment should be open to public scrutiny. This is not the case at present and we fear that cash equities is unfavourably treated when compared to other markets such as the warrants market, ASX 24 and the equity options market (although the lack of transparency means this is difficult to assess with certainty). We question whether any disparity in the application of the cost recovery measures across the various financial markets supervised by ASIC would cause the proposals to be inconsistent with the Government cost recovery guidelines. Chi-X is also of the view that broadening the scope of the market conduct rules contained in the Market Integrity Rules is appropriate. Distinguishing the conduct of business and prudential rules, for example, from those relating to market conduct and then broadening the coverage of the market conduct rules would facilitate a more efficient market conduct

Section	Feedback questions	Chi-X Response
		regime (see for example the Swift Trade matter referenced in the covering letter, which would fall outside the MIRs as currently drafted). Any penalties imposed in relation to the broadened rules should also be applied to cost recovery. In this way direct and indirect participants on all of the major markets would be treated in a fair and equitable manner.
	(20) What impact does the proposed approach have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?	See response to question 19.
Cost recovery and penalties for breaches of market integrity	(21) Do you consider it appropriate that pecuniary penalties issued by the MDP be applied to the cost recovery figure? If so, please explain why.	Yes, as persons found to have contravened the Market Integrity Rules will have generated the need for ASIC resources in that matter. As noted above, Chi-X is of the view that broadening the scope of the market conduct rules is appropriate and it is in keeping with this principle that any penalties imposed in relation to the broadened rules should also be applied to cost recovery.
Changes to late payment fees	(22) Do you consider that the proposed change to late payment fees is more administratively simple and efficient, and easier for billing entities to reconcile? If not, please explain your preferred alternative.	The DP does not contain any details on the incidence of late payments so it is difficult to assess the extent to which the late payment of fees poses a problem. Consequently, it is difficult to comment on whether any changes are justified in fact or simply in theory.

Section	Feedback questions	Chi-X Response
		Chi-X is of the view that given the very substantial policy issues and real market impacts generated by the cost recovery measures, the DP gives disproportionate consideration to the late fee regime.
	(23) What impact does the proposed change have on your business model? Can you provide examples of how the proposed change would affect your business in dollar terms?	We suspect the impact is likely to be insignificant.
Other sanctions	(24) Do you consider that the sanctions for late payments of cost recovery fees should be expanded? If so, what sanctions do you believe are appropriate?	There is no evidence presented to suggest that this is a material problem that warrants such focused consideration.
	(25) Do you consider that granting ASIC the power to suspend or revoke an entity's licence may be appropriate under certain circumstances? If so, how should those circumstances be defined? What safeguards would be appropriate in relation to such a power?	The case has not been made to provide ASIC with a power to strip a business of its right to conduct its day to day activities. It is also difficult to envisage how it could be appropriate for the same agency to act as the co-author of cost recovery policy, the day to day supervisor of that policy, the policing agency, the prosecutorial authority and the judge/jury of policy breaches and ultimate court of appeal on any step in that process. Given these factors and the lack of the case that has been made out, it appears inappropriate to grant ASIC the powers specified.

Section	Feedback questions	Chi-X Response
	(26) Do you consider that granting ASIC the power to ban an entity from further trading may be appropriate under certain circumstances? If so, how should those circumstances be defined? What safeguards would be appropriate in relation to such a power?	Chi-X is of the view that a case has not been made to justify the use of this additional power as a debt collecting tool: it is not clear why ASIC is deserving of a special status as a creditor.
	(27) Do you consider that the Fees Act should be amended to provide for the repayment of recovered fees or the adjustment of future fees when ASIC spends less than its budgeted costs? Should the Act provide for just one of these processes or both? Why?	Chi-X is of the view that the budgeted and actual costs incurred by ASIC should be subject to review by an independent body of industry experts. There should be a clear and objectively transparent method of ensuring that any difference between actual and budgeted costs are returned to the industry on a transparent basis.
	(28) What process, repayment or adjustment, is most likely to be efficient to administer? Why?	The fairest and most efficient way to repay or adjust fees should be subject to ongoing independent review. It may be that a pro rata reimbursement on the basis of the past aggregate fees paid is the most equitable method of administering an overpayment but the matter is deserving of further and ongoing independent review.

The Impact of Message Traffic Regulatory Restrictions on Market Quality: Evidence from Chi-X Canada (Executive Summary)

Andrew Lepone[a], Alexander Sacco[a]

[a] *Discipline of Finance, The University of Sydney Business School, 2006 Australia*

Executive Summary

This paper examines the association between Order to Trade ratios (OTT), commonly used as a proxy for AT, and broad liquidity based market quality metrics for Chi-X Canada. Using the implementation of IIROC's Integrated Fee Model on 1 April, 2012, this study examines the impact of the regulators pro-rata fee model on order submission and market quality. Results of the study include –

- Across the entire sample, an increase in OTT is associated with a decrease in quoted and effective spreads, and an increase in quoted depth.
- Stocks with lower market capitalization exhibit a strong negative relation between OTT and spread based liquidity measures. Larger market capitalization firms exhibit a strong positive relation between OTT and depth.
- The relation between OTT and spread based liquidity measures is weaker for higher trading activity stocks; the relation between OTT and depth is stronger for higher trading activity stocks.
- Implementation of the IIROC Fee Model results in a decline in message traffic, trading volume, OTT, and liquidity measures. Regression analysis reveals a deterioration in the relation between OTT and market quality following the implementation of the IIROC 2012 Fee Model.

These results have important implications for exchanges, market participants, and regulators. High OTT trading strategies are associated with lower transaction costs (effective and quoted spreads) and increased depth. The implementation of IIROC's 2012 Integrated Fee Model results in a decrease in message traffic, and a subsequent deterioration in market liquidity. These results highlight the importance of message traffic, predominantly from liquidity supplying HFT, to market quality.

Introduction

Recent research generally suggests a relation between high quote message traffic and trading activity, and improving market quality; increasing liquidity, price discovery, and reduced volatility (Hendershott, Jones, and Menkveld, 2011; Hasbrouck and Saar, 2010; Brogaard, 2012). Academic studies, including Hendershott, Jones, and Menkveld (2011), and a range of market participants attribute this high quote message traffic and trading activity to the recent increased incidence of Algorithmic Trading (AT) and High Frequency Trading (HFT). The contemporary growth in Algorithmic Trading (AT) has occurred in a dynamic financial market, realized through the active relation between regulatory development, firm and market competition, as well as significant technological changes.

Despite recent empirical research suggesting a positive relation between AT and improvements to market quality, several market participants question the tangible benefits of AT. Recently, several market regulatory bodies have proposed or implemented cost recovery and fee models that charge brokers for market participation on a pro-rata basis with respect to message traffic and trading activity. Findings suggest that high order-to-trade ratio trading strategies, often characterized as HFT, are linked to improvements in spread and depth measures of liquidity on Chi-X Canada. Further, the implementation of IIROC's Integrated Fee Model on 1 April, 2012 has coincided with a decline in quote submission, trades, volume, and a deterioration of liquidity. The relation between order-to-trade measures, that proxy for AT, and liquidity measures, deteriorates following the implementation of the IIROC 2012 Integrated Fee Model.

This paper examines the association between order-to-trade (OTT) ratios, commonly used as a proxy for AT, and broader liquidity based market quality metrics for the ATS Chi-X Canada. Using the implementation of Investment Industry Regulatory Organization of Canada's (IIROC) Integrated Fee Model on 1 April, 2012, this study examines the impact of regulators' fee models that are allocated pro-rata with respect to participants' quote message traffic and trading strategies, on quote message traffic, trading strategies, and market quality. It follows that restrictions imposed on firms that employ higher OTT strategies (that are shown in empirical studies to improve market quality) is expected to detract from market quality measures.

Institutional Details

Chi-X Canada, launched on February 20, 2008, is an ATS providing registered dealers with fully automated order matching and execution of trades in Toronto Stock Exchange (TSX) listed equities. Chi-X Canada offers price/time priority, post-trade attribution, market-agnostic smart routing, advanced order types, trade reporting, risk management tools, historical market data, co-location and cross connectivity services (Chi-X Canada, 2012). Order price and volume information is available, while orders and trades are anonymous. Chi-X Canada operates from 8:30am to 5:00pm ET, and does not participate in opening or closing call auctions. On-market trading occurs between 9:30am and 4:00pm. The market, which is one of the largest ATS platforms in Canada, holds 9.9 – 15.6% average TSX listed monthly volume market share in the Canadian Marketplace over the sample period.

Data and Method

Data are sourced from Thomson Reuters Tick History (TRTH) via the Securities Industry Research Centre of Asia-Pacific (SIRCA). The data consists of trade-by-trade data for the top 60 market capitalized, continuously listed shares on Chi-X Canada from 1 January, 2011 to 1 August, 2012. This study uses raw measures of message traffic, trades, and OTT ratio to examine the association between message traffic and trading and liquidity. Further, following Hendershott, Jones, and Menkveld (2011), a normalized measure of Chi-X Canada electronic message traffic (submissions, amendments, and cancellations) and trades is used as a proxy for AT activity. This measure offers a proxy for variation in algorithmic liquidity supply associated with limit order submission strategies. Because the IIROC 2012 Integrated Fee Model is a pro-rata structure based on message traffic and trades, the OTT ratio measures the association between message traffic, trading activity and liquidity. Liquidity is measured through quoted spreads, effective spreads, and quoted best depth. This study also employs regression analysis to examine the relation between OTT ratio and market quality using the sample of top 60 stocks. This sample period covers the phase-in of IIROC 2012 Integrated Fee Model (1 April, 2012), an exogenous event that is expected to decrease the amount of message traffic and trades in stocks on Chi-X Canada.

Summary of Results

- Regression results across the entire sample of 60 stocks indicate a statistically significant relation between OTT and effective and quoted spreads, with coefficients (t-statistics) of -0.0002 (-18.8) and -0.0005 (-21.72), respectively.
- When considering best depth as the dependent variable, the independent variable OTT has a coefficient of 0.0174 and t-statistic of 4.38. For quartiles based on stock market capitalization (quartile 1 being the largest stocks), all four quartiles exhibit a similar and consistent statistically significant relation between OTT and effective spreads, quoted spreads, and depth.
- Coefficients (t-statistics) are analogous in sign yet vary in magnitude with respect to effective and quoted spreads; from -0.00004 (-5.03) in quartile 1 to -0.00032 (-14.06) in quartile 3 for effective spreads, and -0.0001 (-5.78) in quartile 1 to -0.00078 (-15.72) in quartile 3 for quoted spreads. This relation weakens when considering quartile 4, which has a significantly higher OTT and effective and quoted spreads compared to the other quartiles.
- The relation between OTT and depth suggests that higher message traffic-to-trades in the higher market capitalization firms is associated with an increase in depth, while an increase in message traffic-to-trades in lower market capitalization stocks is associated with lower best depth.
- When considering the fixed effects panel data regressions across message traffic and trading activity, results for message traffic quartiles indicate that for effective spreads, OTT is a statistically significant explanatory variable in quartile 1 with a coefficient (t-statistic) of -0.00003 (-4.10), increasing in magnitude to -0.00066 (-12.61) in quartile 4 (similar results for

quoted spreads). Stocks that have higher message traffic experience a positive relation between OTT and depth, while lower message traffic stocks experience a negative relation.

- When comparing results between Market Capitalization and Message Traffic quartiles, it is apparent that message traffic is not directly related with market capitalization. Further, for stocks with lower trading activity, and presumably lower AT activity, the relation between OTT and depth weakens and becomes negative.
- t-tests for the difference in Trades, Message Traffic, Volatility, Trade Value, Volume, ALGO, OTT, and Liquidity measures with respect to the introduction of the IIROC 2012 Integrated Fee Model reveal that the model has led to a statistically significant decrease between the pre- and post- samples; this result is robust across the market capitalization quartiles.
- For Quartiles 1 and 3 there is a statistically significant increase in effective spreads of 0.4263 and 0.9224 basis points, respectively. This relation weakens into the smaller market capitalization quartiles, consistent with studies that suggest that AT is concentrated in larger stocks. It follows that there is a statistically significant decline in OTT and ALGO measures for the entire sample.
- Results for changes in depth suggest that a reduction in AT activity and quote submission linked to the IIROC 2012 Integrated Fee Model are associated with a decrease in best depth, with a statistically significant decline across the entire sample.
- Coefficients for liquidity measures on OTT decrease in magnitude and significance. For the entire sample there is a negative (but statistically insignificant) relation between OTT and effective spreads. Similarly, the coefficient (t-statistics) for OTT on quoted spread is -0.00009 (-2.26) compared to -0.00057 (-23.25) in the pre-IIROC 2012 Integrated Fee Model sample.
- The relation between OTT and effective and quoted spreads deteriorates when considering market capitalization quartiles. There is still a statistically significant relation between OTT and effective and quoted spreads in quartile 1, with coefficients (t-statistics) of -0.0002 (-5.56) and

-0.00044 (-5.97), respectively, however this relation weakens into quartiles 2 and 3, and reverses for quartile 4.

- When considering depth, there remains a statistically significant and positive relation with OTT for the entire sample, with an OTT independent variable coefficient of 0.0720 (8.65).