December 2, 2011

Manager, Financial Markets Unit
Corporations and Capital Markets Division
The treasury
Langton Crescent
PARKES ACT 2600

RE: Consultation Paper – Proposals of the Australian Council of Financial Regulation of Operators of Financial Market Infrastructure (CP)

Chi-X Global Holdings LLC (**CXGH** or **we**) welcomes the opportunity to provide comments to the Council of Financial Regulators on the proposals to reform the framework for financial market infrastructure (FMI).

CXGH is the sole shareholder of Chi-X Australia Pty Limited (CXA) and operates markets in other jurisdictions including Canada and Japan. As a global provider of trading venues, CXGH aims to establish and operate the most efficient markets possible through its high-speed, low-cost, intelligent trading model. It is our belief and experience that in regions where regulation has allowed for competition, market participants, including investors and issuers have benefited from product innovation, a lower overall cost of trading and deeper more liquid markets. In addition, competition can serve to diversify risk and mitigate the prospect of a single point of failure.

The world was brought to its knees in 2008 when the possibility of a systemic collapse of the financial system became reality. At that time, emergency measures were taken by regulators and governments to prevent a liquidity crisis (or crisis of confidence) and a collapse of the system itself. Learning from this experience, regulators around the world have prioritized the review of existing controls and began analysis of what may be needed to prevent a similar event from happening in the future.

In light of the lessons learned, we commend the Ministry on its initiative to review how best to address similar risks in Australia. As a global operator of markets we are concerned however that the proposals included in the CP may lead to several unintended consequences that will undermine the Ministry's chief objective of mitigating systemic risk and ultimately place Australia at a competitive disadvantage compared to other global markets. We believe the following outcomes may result if the reforms are implemented as proposed:

- It will become increasingly difficult to compete with entrenched incumbents such as the Australia Securities Exchange (ASX) for trading and clearing services in both the cash equity and derivatives markets. This in turn will lead to less efficiency, fewer options for participants and higher trading costs;
- The Australian market will become less attractive to foreign service providers due to increased operational risk and restrictive regulation that is often inconsistent with global best practice;
- Risk will concentrate into single points of failures for trading and clearing that are "too big to fail;" and
- Certain business activities may shift offshore or transact in the OTC market which in turn will degrade the quality of the public and "on-exchange" market.

The introduction of any new policy risks unforeseen and unintended consequences. As such, whenever possible, industry stakeholders should be consulted and international comparables should be taken into consideration. Unlike 2008 when actions had to be taken quickly, regulators now have

the benefit of time to carefully review and analyze what, if any new powers or controls are required to protect markets from systemic risk. As the proposals in the CP diverge significantly from current practice, we are surprised that no information was provided about what background analysis was conducted to justify the purpose of the reforms. We also note the absence of a cost benefit analysis and any discussion about alternatives considered. Given that no immediate risk threatens the Australia market, we would strongly urge the Ministry to take the time to publish a supplement to the CP laying out this analysis. We would also encourage the Ministry to convene working groups consisting of industry stakeholders to discuss the major issues laid out in the CP. Soliciting feedback from the industry will equip the Ministry with a better understanding of the potential impact of the proposals and also may lead to alternative solutions.

In large markets where regulation has enabled competition, we have observed similar stages of development – beginning with a period of rapid expansion where numerous providers enter the market followed by a period of consolidation where a limited number of markets are able to sustain a financially viable businesses. It is important to understand what developmental stage a market is in when considering the introduction of any new reform. If policies that restrict competition are introduced too early, participants will not be able to enjoy the benefits of competition. We fear that this may be the case in Australia where competition has only recently been introduced for the trading services of cash equities. All other financial market service providers are monopolies owned by the ASX.

The benefits of competition differ for each service in the value chain. We believe that not only is a country's central depository a national asset but that a central counterparty reduces overall risk and allows for better oversight. Unlike trading and clearing, a central depository that is operated as a utility provides the greatest cost savings to participants. With regard to trading and clearing services, as long as inter-operability exists between clearing agencies, we believe that competition can help lower costs, drive efficiencies and lead to product innovation.

We are concerned that the following proposals in the CP will effectively eliminate competition by making it less attractive to foreign market service providers 1) location requirement 2) pre-approval of Directors of holding companies of domestic service providers, and 3) the step-in power for ASIC to take over a FMI or direct a third party to take over the FMI. As a global operator of markets two main factors are assessed when considering entering a new market; the business opportunity and the existing (and any proposed) regulatory framework. With regard to the regulatory framework, a balance needs to be struck where the framework is sufficiently robust to ensure investor confidence while at the same time not being overly burdensome to interfere with business operation. We believe that when considered as a collective set of reforms, the proposals mentioned above will risk Australia's global competitive position without necessarily lowering systemic risk.

Although the regulatory mandate differs from commercial interests, new regulatory proposals need to consider what impact on business the proposal may have and ensure that the net benefits justify the costs. Where benefits do not outweigh costs, action should not be taken. Not only will this lead to a more efficient and higher quality on-shore market but it will ensure that the country does not fall behind others in attracting foreign investment.

A final potential development from the proposals is the overall cost of trading could increase to a level that is out of line with other markets. As such, participants will seek off-shore alternatives to trade and OTC markets may become more appealing than exchanges to gain exposure to ASX-listed issuers. If the migration of activity to both these markets is significant it will degrade the quality of the public market and its price discovery function.

Comments on Specific Proposals

Location Requirement

It is unclear what will be achieved by the proposed location requirement that can not be satisfied today through Australia's existing regulatory licensing framework. Australia is not unique in how it regulates exchanges and clearing agencies. The need to meet recognition criteria in order to operate is required in most other jurisdictions. Likewise, reliance on the oversight of a foreign regulator when considering issuing an off-shore license is a well adapted approach. When a license is granted, additional terms and conditions can be included in the recognition order that is required in order for the license to be maintained. This allows any specific concerns to be addressed on a case-by-case basis. The concern outlined in the CP where a domestic clearing agency that is controlled by an off-shore holding company is not able to recapitalize can easily be addressed through additional capital or margin requirements set out in the recognition order.

The CP appears to address many issues including location requirements raised in the context of the SGX merger application with the ASX. Although the introduction of the proposals will create greater certainty for a potential new bidder of what will be required in order to have the transaction be approved, we believe that ultimately they will lead to making the ASX a less attractive option than it is today. The burden that these new proposals place on any potential buyer will make the opportunity less attractive and will lead them to pursue other options. Any specific concern that is raised by a potential acquisition can be addressed by making an approval conditional on meeting certain terms and conditions that address these concerns.

A graduated approach has been proposed on which additional location requirements will be applied as the size (and systemic importance) of a service provider grows. However, the uncertainty associated with the longer term location requirements may disincent new entrants from establishing a presence in Australia. As a result, should the proposal go forward it will place the Australian market at a competitive disadvantage as it will become less attractive for foreign service providers to enter the market.

Pre-approval of Directors of FMIs and Parent Entities

The CP includes a requirement that ASIC would have to approve any holding company Director appointment of a subsidiary of an FMI that is operating in Australia. Similar to our comments regarding the location requirement, we struggle to understand the benefit this additional requirement will provide. Any material decision that is made by a holding company on behalf of a subsidiary domiciled in Australia will require ASIC approval. As a result, it is unclear what concern the additional authority or oversight would provide ASIC.

Several concerns are raised by this proposal. Often the assessment of suitability requires regional expertise to assess the quality of a nominee's previous work experience. Without knowledge of the businesses outside Australia, ASIC will not be well equipped to make these determinations. For this requirement the local regulator where the holding company is domiciled is better positioned to make such a determination for this reason. It stands that there is nothing that excludes ASIC from contacting a local regulator should it have concerns regarding a potential nominee. Not only will this ensure that better suitability decisions are made but will also avoid ASIC being perceived to undermine the judgment of the local regulator.

Singapore is cited in the paper as an example of a jurisdiction where this requirement currently exists. Apart from this exception, we do not know of another jurisdiction where this is the case. International best practice is to rely on the foreign regulator determination and the local approval process of material changes in the subsidiary. Consequently, we believe that this proposal is over-reaching and may prove to be an additional disincentive.

Proposals for Step-in Powers

Although the proposed step-in power is meant to ensure the continued operation of certain critical key services, a critical shortcoming is that there will not be the necessary expertise or experience to operate these services in the event of a take-over. Instead, we believe that this concern can be better addressed by increasing the power of direction by ASIC and the RBA who can demand more stringent requirements in periods of higher market risk.

The triggers outlined in the CP where ASIC would be able to step-in and take control or grant control to a third party of the operations of a FMI are extreme and can be prevented by 1) extending the length of time that a licensee must comply with a direction made by ASIC 2) moving the appeal process from the courts to a hearing committee and 3) making the heaviest allowable sanction a punitive fine. Section 4.2.3 of the CP outlines the existing powers which are limited and subject to court enforcement. We suggest that the Corporations Act be amended to enable ASIC to give directions that must be obeyed beyond 21 days and until a ruling regarding the direction is made. We also recommend that instead of a court being responsible for determining the appropriateness of a direction, that a hearing committee consisting of industry representative bare this responsibility. As these determinations require specialized knowledge of financial markets, a court may not have the necessary expertise. Finally, we recommend that a significant fine be levied to a licensee for non-compliance with an ASIC direction. Whereas suspension or termination of a licensee is not realistic (because it would lead to a service interruption) a fine may serve as sufficient motivation for compliance.

If ASIC is granted greater authority it will be able to demand additional requirements from licensees in periods where greater market risk is anticipated or has occurred. Capital requirements for brokers can be raised and margin requirements increased for clearing members in an effort to mitigate market risk and the possibility of default. The risk of a system error occurring at a licensed marketplace leading to a "shut down" can be addressed by requiring regular capacity tests for critical systems and a systems review by an independent third party. Incident reporting should be mandated when a problem occurs, that should include an assessment of the cause and what actions have been taken to prevent a similar occurrence in the future. All of these reports should be provided to ASIC for review. Collectively, these additional reporting requirements should address the issues cited for proposing the need to provide ASIC step-in powers.

As mentioned in the introduction, the developmental stage of a market should be taken into consideration when deciding to implement any new reform. With only one service provider, the risk that a critical system will become unavailable is heightened as there are no alternatives if an issue is experienced by the single provider.

Conclusion

We believe that the overall effect of the proposals is that foreign service providers will not enter the Australian market and that ASX's existing monopolies will continue to operate as the sole providers of critical services. Because there are not any established competitors already operating in Australia, with the exception of Chi-X Australia, risk will continue to be concentrated in single points of failure which will lead to the opposite outcome intended by the proposals. In our experience globally, regulation that is not burdensome will encourage new entrants and lead to multiple service providers operating which in turn will not only bring benefits to participants but also help diversify the risk concentrated by a single provider.

The CP notes that one of reasons behind the proposals is to keep pace with other jurisdictions who are taking steps to address similar risk. Reference is made to Dodd Frank in the US and MiFid II in Europe. These comparisons are very different than Australia as new regulation is being introduced after a period where competition has been able to flourish. Also, whereas the main focus of Ministry's proposals is to address systemic risk of the cash market; Dodd Frank and MiFid II focus on creating a

clearing solution for OTC derivatives. Given that there has never been an instance where a centralized clearing agency has failed, the Ministry has more time to review and take an approach unlike the derivatives market. We recommend that the Ministry take this time to conduct a cost-benefit analysis of the proposals.

Again we would like to commend the Ministry on its initiative how to address mitigating systemic risk in the Australian market and would welcome the opportunity to discuss the content of our submission or our international experience with staff at their convenience.

Sincerely,

"Tal Cohen"

Tal Cohen
CEO Chi-X Global Inc.