Susan Havyatt
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Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

1 February 2013

Dear Ms Havyatt

Re: Australia's Financial Market Licensing Regime: Addressing Market Evolution

Thank you for the opportunity to provide a submission.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 members who are responsible for investing $1.9 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Please find our submission enclosed. We look forward to discussing the contents with you. I can be contacted on 02 9299 3022.

Yours sincerely

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FSC SUBMISSION –
Australia's Financial Market Licensing Regime:
Addressing Market Evolution

INDEX

This submission contains comments on:

1. Context

Over the past two years, ASIC has been consulting with the financial services industry on equity market structure in Australia (following CP 145 which was issued in December 2010). Leading up to and following CP 145 there have been a number of market structure developments (such as the introduction of Chi-X in October 2011 and the US "flash crash" in May 2010).

This particular consultation has been established as a result of changing trading venue dynamics. It follows a number of consultation papers and issuance of Market Integrity Rules (MIRs) by ASIC.

ASIC's focus over the past two years has appropriately been on two thematic points: (1) dark liquidity / pools and (2) High Frequency Trading (HFT).

In June 2012, ASIC established a task force for each stream to develop market integrity rules and by November 2012, the Government released the first tranche of new market integrity rules to be phased in over the next 18 months.

This discussion paper is primarily related to dark liquidity. The dark liquidity market integrity rules issued by ASIC in November 2012 include:

1. ASIC's rules on pre-trade and post-trade transparency requires meaningful price improvement and a tiered threshold for block trades.
2. A rule of enhanced data for supervision for market integrity purposes and requires additional data on orders and/or trades including identification of crossing systems, flagging whether a participant is acting as a principal or agent, a client identifier or reference, identification of intermediary of Australian financial services licence holders, and whether a trade for a wholesale client was done through direct market access.

In December 2012 the Government released another consultation paper alongside this one on market structure which deals with the cost recovery arrangements for market supervision.

We understand that both will be resolved through further Regulation and legislative changes expected in 2013 and beyond.

The prevailing financial market licensing regime was created in 2001 along with the Corporations Act core framework. As noted in the discussion paper, trends in trading have changed significantly in the past decade whilst the licensing regime has remained static.

In particular the nature of dark trading and trading venues themselves has changed significantly.

The research undertaken by Baseline Capital in late 2012 on behalf of the FSC indicates that market evolution has not been facilitated or managed by the current regime.

2. FSC research

Thematically, the report highlighted that Australian capital markets have not been adversely impacted by high frequency and dark pool trading to the same degree as markets in other countries.

Further, technology changes and innovation in capital markets should not be seen as an unmanageable threat. Australia is well-positioned to introduce regulation to avoid the adverse impacts of high frequency and dark pool trading experienced in Europe and the United States.

However rapid changes in technology have impacted capital markets in respect of the speed and method in which trades are transacted and regulation now needs to keep pace with technological change to address the potential negative impact of technology on capital markets.

The research shows that the proportion of trading in dark execution venues has remained static over the past 10 years. However, HFT has increased trading volumes which has resulted in dark execution trading appearing artificially static. In other words, the increased trading volumes caused by HFT have disguised the increasing level of dark trading.

Therefore the primary change has been that dark execution has considerably increased on-market as opposed to off-market, and dark trade size has decreased considerably (i.e.: there is a move away from blocks). As summarised in the report:

> Dark trading is a vital part of the market, particularly when seeking liquidity, but the structure and stability of these dark venues varies dramatically. Dark venue structure and regulation needs to match the primary aim of matching liquidity without disclosure. There is strong support for a minimum acceptable order quantity in dark pools, although buy side participants can apply participation rules if required. Lit or primary market trading should not suffer unduly as a result of order flow fragmentation - price discovery, spreads, volatility are all negatively affected if the lit market is too thin.[1]

A large amount of trading now occurs in venues which either did not exist a decade ago or have experienced significant increases in trading volumes. For instance, the Government has provided 17 exemptions from the financial market licensing regime to domestic and foreign entities as such trading venues to do fit into the Corporations Act definitions.

It is therefore necessary to examine the adequacy of the licensing regime.

3. Australia's financial market licensing regime

The only way that dark trading venues have been able to be licensed and operated has been by using the participants' AFSL – a licensing system established for a completely different purpose.

The result of this compromise is that dark trading venues operate with fewer rules than lit markets. For instance, there is no requirement to monitor users of the venues and ASIC has fewer directions powers. This results in a situation where there is a higher possibility of market integrity issues arising.

There is also no capacity for ASIC to levy dark pool operators for market supervision cost recovery directly.

Further, dark trading venues have become more prevalent for retail trading – that is, retail trades on behalf of retail clients are executed in venues which are now lit markets (and subject to the additional licensing conditions and ASIC directions powers).

[1] Page 46

FSC therefore concurs with the Government that the financial market licensing regime is out-dated, inflexible and in need of legislative reform. To do otherwise may expose investors to market integrity risks.

It is important that Australia's Corporations Act is flexible enough to accommodate market practices today but also to allow for future evolution. This is necessary for domestic needs but also international regulatory developments and competitiveness.

4. Specific reform options

Page 19 onwards in the discussion paper canvasses the options for making legislative amendments to the financial market licensing regime.

In summary the options presented by the Government are:

1. The Government (the Minister, with ASIC's advice) specify licence categories in regulations which could be altered over time. This would include the ability for the Government to remove certain licence conditions as necessary through MIRs or other guidance. Such discretion would apply on a consistent basis for each licence category.
2. A new legislative regime with tiered obligations for different market licensees solely set in legislation.

The key differences between (1) and (2) is that (1) is flexible and dynamic whilst (2) is stable and certain. There are a range of risks and benefits from both approaches which are documented in the discussion paper.

FSC's view is that the existing Corporations Act provisions are not sufficiently nimble and are in need of additional flexibility. Accordingly we are supportive of a version of Option 1 where:

1. The Act is reformed to permit licence categories to be determined by regulation;
2. The Minister determines and publishes the financial market licence categories and the set of relevant obligations;
3. This occurs by regulation which is subject to exposure drafts and regulatory impact statements;
4. The Minister may modify either the licence categories or the related obligations on a consistent basis (after a formal consultation process including exposure drafts and regulatory impacts of any potential changes);
5. To be clear, where a Minister seeks to alter licence obligations for a particular category, the process is identical to creating a new licence category; and
6. ASIC would issue the relevant licence in accordance with the categories and requirements set out in the Act and Regulations.

We are cognisant that the loss of a legislative market licence framework results in less Parliamentary review and may give rise to uncertainty. Therefore a robust and consistent process based on regulations issued by the Minister (which are subject to disallowance) is critical.

5. High Frequency Trading

As non market participants are not required to hold an AFSL, a non-market participant engaging in algorithmic HFT may undertake activity which the AFSL participant has no control over.

The MIRs are therefore indirectly applied to non market participants and outside the regulatory reach of ASIC. The Government is considering making HF traders directly subject to the MIR regime.

Pages 33 and 34 of the discussion paper canvass options for requiring HFT to become subject to the MIRs. As noted, the challenges include:

1. Defining HFT; and
2. Enforcing extraterritorial reach.

In principle, we are in support of directly regulating all significant market participants in a consistent manner. Therefore we support making HF traders being directly regulated by ASIC – although we recognise the above challenges will be significant.

Ultimately the definition of HFT will require a level of judgement. It is important that consultation is undertaken on the definition and that it is consistent with the following factors:

1. relative competitiveness and strength of Australia in the Asian region;
2. the potential for unintended consequences or negative trends in our capital markets; and
3. confidence, stability and investor protection.

In conclusion, these decisions on Australia's capital market structure should reflect the work of the financial services industry and Government towards developing Australia as a regional financial centre.