

31 January 2007

Tracey Lyons
Director, Markets Regulation
Australian Securities and Investments Commission
By email: tracey.lyons@asic.gov.au

Dear Tracey

ASIC Consultation Paper 95 (CP 95) - Chi-X Global, Inc. (Chi-X Global) Response

Thank you for the opportunity to comment on CP 95.

Over the past 35 years, Instinet has operated a number of trading platforms around the world. At the same time, Instinet's institutional brokerage business has provided access to 60 global markets. Instinet is in a relatively unique position given it is both a global consumer of exchange trading platform services as well as an innovative developer of competing and complementary services.

In order to develop its trading platform business, Instinet has recently formed Chi-X Global. In March 2007, Chi-X Europe Limited launched a market in Europe where it competes effectively with the traditional exchanges and is now recognised as having helped bring additional liquidity and depth to the markets. Many of the issues which have been the subject of consultation by ASIC through CP 95 and the earlier Consultation Paper 86 are similar to the issues which have been confronted and addressed by Chi-X Global in other jurisdictions.

Chi-X Global is considering the opportunity to offer competitive market services in Australia. Chi-X Global is a believer in competition for market services generally and supports the consultation process which ASIC is presently undertaking.

We set out our responses to the various questions in CP 95 in the attached document.

Yours sincerely,

Tony Mackay
Chief Executive Officer
Chi-X Global, Inc.

POST TRADE TRANSPARENCY AND DATA CONSOLIDATION

ASIC Proposal – Data consolidation

- C5 A regulation should be introduced that obliges all market licensees who operate a competing market for trading in ASX-listed securities:
- (a) to make post-trade information available in a way that can be consolidated with the trading data of other market operators.
 - (b) to have a contractual arrangement with at least one market information vendor to requiring the information vendor to publish trading data in a consolidated form.

Your feedback

C5Q1 Do you agree with the introduction of a regulation of this kind?

Yes, as a general proposition there is a need for regulation to require market licensees to ensure data is disseminated in an efficient way. As for particular requirements, please see our response in C5Q3 below.

C5Q2 Should the regulation contain further detail about how a market licensee should meet the obligation? If yes, what additional detail is needed?

Trade data and market data should be made available to all vendors and market participants in industry standard formats.

C5Q3 Is proposal C5(b) a practical way of dealing with the need for post-trade information to be available in a consolidated form?

US regulations require publication of market data – pre- and post-trade – to a single platform so that there is a ‘National Best Bid and Offer’. In Europe, MiFID has left data publication to market forces, that is to leave it to the market operators to reach agreement with data vendors – similar to ASIC’s proposed approach. Early evidence in Europe suggests that the MiFID approach is leading to less than optimal results where not all major vendors provide the same data. For example, not all clients subscribe to all market data feeds as they have differing pricing structures.

We believe that all market data should be published to a central regulated location such as a web page or similar platform that provides access to the relevant data to all participants of all markets in Australia.

There would also be practical issues with mandating a contractual arrangement with a commercial third party. For example, a mandated requirement would place market operators at a disadvantage when dealing with market information vendors in relation to matters such as cost allocation, as the vendor would be aware that the market operator would be required to enter into an arrangement with one of a presumably limited number of vendors.

As such in Chi-X Global’s view it would not be necessary for market licensees to have an agreement with "at least one market information vendor" provided the market licensee had an agreement with the central regulated platform.

This centralised approach would not preclude the commercial provision of market data as information vendors could still provide enhanced analytics and delivery of the publicly available market data, at commercial rates.

ASIC Proposal – thresholds for transparency

- C6 A regulation should be made that:
- (a) imposes a pre-trade transparency requirement on a licensed financial market that competes for trading in ASX-listed securities, if the percentage of trading in a particular security on the market in any previous 6 month period equals or is greater than 5% of the volume of overall trading in that security on all licensed financial markets.
 - (b) specifies that the minimum requirements for pre-trade transparency are:
 - (i) information about all bids and offers in the market for an affected security should be made available to all participants on the market;
 - (ii) all participants in the market should be able to accept bids and offers in affected securities;
 - (iii) participants in the market should not be precluded from providing information to their clients and market users about bid and offer information made available through the market.
- C7 Market operators should be able to depart from the obligations imposed by the regulation in proposal C6 by adopting operating rules that allow trades to take place in a different way.
- C8 It should be a condition of any new licence to operate a market on which ASX-listed securities are to be traded that the market licensee must have systems and processes that enable it to monitor the volume and value of all transactions in ASX-listed securities on all licensed markets.

Your feedback

- C8Q1 Do you agree with the imposition of a threshold, above which pre-trade transparency is required?

No, pre-trade transparency should not be limited to any threshold. In Chi-X Global's view, a 5% threshold (or indeed any threshold) would be arbitrary and potentially lend itself to manipulation. For example, a 5% threshold in relation to an illiquid stock could conceivably be reached by no more than a few large transactions. On the other hand, a 5% threshold in relation to a large and liquid stock may require numerous transactions before the threshold is reached, resulting in decreased transparency and possible market manipulation of index and stock arbitrage products. Further, if a number of markets were to operate, each under a 5% threshold, the actual threshold in practice may become not 5% but a multiple of 5%, such that significantly more than 5% of volumes occur without pre trade transparency.

In Chi-X Global's view, markets should operate as either price makers (where all marketable orders are accessible to all participants on a strict time and price priority basis) or price takers (where participants accept Central Limit Order Book (CLOB) price benchmarks and negotiate only the size of transactions).

To the extent that a market operator allows limit orders, that is, where orders are 'price making', then in our view all the limit orders should be made accessible to form part of the price formation process in the overall CLOB.

In contrast, pre-trade transparency should not be required (as it would not serve any regulatory purpose) to the extent that orders are 'price taking', such as mid-spread crossings. Here the participants accept the price from the CLOB as the right benchmark, with only the 'size' of the trade to be negotiated. Such pools are commonly referred to as 'Dark Pools'.

MiFID has implemented rules that essentially require Alternative Trading Systems to be operated and regulated as either a CLOB or a Dark Pool.

We note that the use of algorithms to slice the orders and advanced order types such as iceberg and hidden orders allow the market impact of large orders to be reduced within a CLOB model. The important element is that even though some or all of an order may not be displayed, it is available to be executed on the CLOB with any equal and matching order. This functionality can be very advantageous to market participants: In Europe, Chi-X Global allows mid spread crossing in a CLOB market and as a result the average trade on Chi-X Global has been at prices more than 3 basis points better than the existing exchange.

C8Q2 Do you agree that 5% of overall trading in a security is the right threshold? If no, what is the right measure?

No – see C8Q1

C8Q3 Is 6 months an appropriate reference period? If not, what is and why?

No – see C8Q1

C8Q4 Do you agree with the proposed minimum pre-trade transparency requirements in proposal C6(b)?

Yes. However, participants should be able to display a smaller quantity to the market than that which they are ultimately willing to trade, that is, an iceberg order. The non-displayed quantity would be available for immediate execution if an equal and matching order is entered into the system. The rules of the market licensee would need to recognise relevant circumstances where full pre-trade transparency is modified in some way, as for example, with iceberg orders.

C8Q5 If you do not agree with a threshold, what other regulatory mechanism should be applied?

See C8Q1

C8Q6 Do you agree with the proposed market licence condition in proposal C8? How else might the threshold requirement be monitored?

Chi-X Global accepts that market licensees should have in place systems and processes to monitor transactions on its market in order to enable the market licensee to regulate, for example, market manipulation and other misconduct. However, for the reasons set out above, in our view monitoring of volumes on

other markets is not necessary, as in our view the 5% threshold approach should not be adopted.

C8Q7 Do you agree that ASX should be subject to the same limitations about off-market transactions as other licensed markets? If no, why not?

In Chi-X Global's view, to the extent that exceptions from the general requirement for pre-trade transparency are made in favour of ASX, these exceptions should be extended to all markets.

BEST EXECUTION

ASIC Proposal

C9 A 'best execution' regulation should be introduced to apply to holders of AFS licences who are participants on more than one market that trades ASX-listed securities.

C10 The regulation should:

- (a) apply to an AFS licence holder who:
 - (i) is a participant on more than one market that trades ASX listed securities; and
 - (ii) accepts instructions from a client to transact in ASX-listed securities;
- (b) oblige the AFS licence holder to decide the market on which it will execute the transaction by reference only to factors relating to:
 - (i) the client's instructions; and
 - (ii) which available market is most likely to result in a transaction which best meets those instructions;
- (c) list the factors which should be taken into account relating to the client's instructions, including but not limited to:
 - (i) price;
 - (ii) nature of the order (e.g. fill or kill);
 - (iii) order size;
 - (iv) transaction costs;
 - (v) certainty of execution;
 - (vi) speed of execution;
 - (vii) preferred trading venue.

C11 Regulation 7.2.07 should be amended by adding a requirement that market licensees must have rules that enable them to monitor and enforce their participants' best execution obligations.

Your feedback

C11Q1 Do you agree that a best execution obligation on intermediaries is necessary in a multi-venue environment?

Yes. Each intermediary should also be required to implement a best execution policy which clearly states how they interpret the items covered in C10(c).

One potential outcome of imposing a best execution obligation on intermediaries is that many smaller brokers that service retail customers could be at a competitive disadvantage to the bigger multi-national investment banks, as the latter category of participants will

likely be able to more easily develop systems to route orders between markets (**Smart Order Routers**). This may have the effect that smaller brokers, due to technological issues, may decide to define best execution by reference to one market only, thus limiting the number of markets accessed by smaller brokers and potentially disadvantaging their clients.

In this regard, the US response may be of interest to ASIC. In the US it has been accepted by the regulators that best execution can also be implemented at the level of the market itself, so that a market may use a Smart Order Router to pass an order on to another market if that other market is displaying a better price. In the US, markets such as INET and Archipelago were able to provide 'best execution' access to all the ECN markets for smaller market participants by providing smart routing services that would automatically send limit orders to the market with the best prices. Such multi-market access has helped participants develop sophisticated trading tools for investors which has given them much greater market access than previously.

Chi-X Global would plan to develop Smart Order Routing technology that would be made available to all its participants.

Finally, the proposal in paragraph C10 is to impose a best execution obligation on the market participant. ASIC could also consider whether an obligation analogous to the best execution obligation should be imposed on other intermediaries (other than market participants) who perform a function in routing orders from clients to market participants, such as financial planners and institutional investors.

C11Q2 Do you agree that a regulation is the appropriate mechanism to introduce a best execution obligation?

Yes. However, as discussed in C11Q1, ASIC may also wish to consider whether any regulation ought also recognise that a market may provide Smart Order Routed best execution services for participants who would essentially outsource their best execution requirements for CLOB orders to that market. Clearly, if best execution obligation were to extend beyond market participants to other intermediaries, as discussed in C11Q1, a regulation would be required to effect that.

C11Q3 Are there other or better mechanisms, and if yes, what are they? Please provide as much detail as possible about alternatives.

As discussed above, Australia could also consider allowing a hybrid model where market operators are allowed to Smart Order Route orders to other markets on behalf of common participants.

Such a model would address the fragmentation issue that is often given as a reason against allowing competition for market services. By allowing a participant to Smart Order Route to a virtual best execution book, the order will be executed on the best possible terms (including as to price) available at that time among all the applicable markets.

For completeness, we note that the outcomes referred to above could not effectively be achieved through a condition on each market participant's AFSL. It is possible that some market participants will not hold AFSL's but instead rely on licensing exemptions to participate in Australia's markets.

C11Q4 Do you agree with the proposed content of the regulation described in proposal C10?

Yes, subject to the additional matters set out above.

C11Q5 Should brokers who can transact on one market only be obliged to inform their clients of that fact?

Yes. However, the implementation of interoperability and Smart Order Routing should make this an unlikely situation.

C11Q6 Do you agree with the proposed addition to reg 7.2.07? Are alternative or other means of monitoring participants' best execution obligations needed?

In our view, it may be practically difficult for any one market operator to monitor participants' best execution obligations as there will potentially be limits on the information one market operator has in relation to trading on another market. It may be preferable for ASIC to assume responsibility for monitoring this element, although it would be expected that each market licensee would be required to assist ASIC as required in terms of its supervision of the requirement.

CROSS MARKET SUPERVISION ARRANGEMENTS

ASIC Proposal

- C12 A new regulation should be made that requires each market licensee who trades ASX-listed securities to:
- (a) have enforceable arrangements with other market licensees that trade ASX-listed securities to share supervisory information about financial products and participants;
 - (b) notify each other about suspected contraventions; and
 - (c) make referrals to each other as well as to ASIC.
- C13 To comply with this requirement, ASIC anticipates that:
- (a) each market operator will enter into agreements with the other markets that trade ASX-listed securities;
 - (b) the agreements will be provided to ASIC; and
 - (c) it will be a condition in each agreement is that a market licensee will advise ASIC if any party to the agreement is not meeting the terms of, or obligations under, the agreement.

In our role as supervisor of market licensees, ASIC will actively monitor the compliance of each licensee with its obligations under the Corporations Act and the Corporations Regulations.

Your feedback

C13Q1 Is a regulation the appropriate mechanism?

Chi-X Global agrees in principle with this mechanism. However, in practice there may be instances where the mandating of co-operative arrangements between commercial competitors may lead to sub-optimal outcomes, for example, the withholding of information to frustrate new market entrants. Any regulation should enable ASIC to step in to deal with situations where cross-market co-operation fails to achieve appropriate outcomes.

C13Q2 Are there other matters that the regulation should address? What are they and why are they important?

See 13Q1

C13Q3 Are there alternatives for the implementation of effective arrangements besides agreements between the market operators? If yes, what are they?

See 13Q1

SHORT SALES

152 Section 19 of the ASX Market Rules sets out a regime for short selling of cash market products on the ASX market.

153 ASX may designate a cash market product to be an approved short sale product if:

- (a) 50 million cash market products have been issued;
- (b) the market capitalisation of the cash market products of the class on issue is not less than \$100 million;
- (c) in the opinion of ASX there is sufficient liquidity in the market for cash market products; and
- (d) ASX considers that the cash market products should be designated as an approved short sale product for the purposes of the rules.

154 Short sales of Australian securities are expressly excluded under the Liquidnet Trading Rules.

155 AXE rule 4.11 sets out the requirements for short selling on the AXE market. Rule 4.11.5 says that AXE will make a declaration from time to time identifying the class or classes of financial products that can be short sold in accordance with s1020B(4) of the Corporations Act.

156 AXE rule 4.11.4 states that AXE may restrict, prohibit or otherwise limit short selling in all or any equity securities for such period and for such reasons as it may, in its complete discretion, determine.

157 The AXE rules do not set minimum volume or value limits on the financial products that can be short sold, in the way that the ASX rules do.

158 Orderly market issues might arise where a financial product is not permitted to be short sold on the ASX market, but can be short sold on the AXE market, or vice versa.

159 Standardised requirements about short selling of financial products could overcome any orderly market issues.

Your feedback

C13Q4 Should requirements about short selling should be standardised across markets? If not, why not?

In Chi-X Global's opinion, the regulation of short selling in Australia would benefit from a comprehensive review. Short selling is an essential feature of a sophisticated capital market. In any event, to the extent short selling is permitted by a market operator, we agree that there ought be a consistent regulatory regime governing such trading, in the absence of a compelling reason to depart from consistent requirements.

C13Q5 Is standardisation best achieved through the operating rules of each market?

If standardisation is the desired outcome, then regulation, rather than operating rules would in our view better achieve that outcome.

C13Q6 Is there another, better mechanism to achieve standardisation?

See C13Q5.

TAKEOVERS

- 160 AXE now proposes to include a rule that prohibits buying and selling on the AXE market of securities that are the subject of an on-market takeover offer on ASX. This will mean that:
- (a) an orderly market for the securities the subject of the bid is maintained; and
 - (b) AXE participants are not able to conduct crossing transactions on the AXE market in securities the subject of a bid in circumstances where the ASX market rules limit late, overseas and overnight crossings, and prohibit special crossings during an offer period.

Your feedback

C13Q7 Are the proposed settings in the AXE rules about trading during a takeover the right settings? If not, why not?

In Chi-X Global's view, it would be preferable if all market participants adhered to one set of rules governing securities subject to a takeover bid. In relation to the specific question at hand, AXE's decision to not allow trading in stock subject to an on-market takeover on ASX is a matter for AXE.

- 161 The Liquidnet Australian Rules and Procedures and the Liquidnet Trading Rules do not contain any specific rules about trading during an offer period. ASX and AXE rules that go to the conduct of participants during an offer period are not relevant to Liquidnet because the market is not intermediated.
- 162 During an offer period, a willing seller who might otherwise conduct its transaction on Liquidnet will have incentives to sell into an on-market offer on ASX. This is because the seller can be assured of a price for its whole order, and can be certain that the transaction will be completed.
- 163 While it is likely that demand and supply forces will have the effect of maintaining a share price at or near the bid price, the Liquidnet rules do not contain any limitations about pricing of trades in securities that are subject to a takeover offer.

Your feedback

C13Q8 Are there any orderly market issues that arise from the lack of limitations in the Liquidnet rules about trading in securities during a takeover offer?

As noted above, as a general principle it would be preferable if all market operators adhered to one set of rules governing securities subject to a takeover bid.

C13Q9 How should these issues be addressed?

See C13Q8.