



**Industry
Super
Network**

Head Office:
Melbourne
Casselden Place
Level 30, 2 Lonsdale Street
Melbourne Victoria 3000

P: 03 9657 4321

Sydney
Level 2, 50 Pitt Street
Sydney, NSW 2000

P: 02 8076 5270

Canberra
Level 3, 39 Brisbane Ave
Barton, ACT 2600

P: 02 6273 4333

01 February 2013

By Email:

Manager, Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600
Financialmarkets@treasury.gov.au

Re: Options Paper concerning Australia's Financial Market Licensing Regime: Addressing Market Evolution

Dear Sir or Madam,

Industry Super Network (ISN) appreciates the opportunity to comment on the Options Paper concerning Australia's financial market licensing regime and the applicability of market integrity rules to High Frequency Trading (HFT) firms.

ISN is an umbrella organisation for the industry super movement. ISN undertakes collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings and incomes of over five million members.

Industry super funds are stakeholders in Australia's financial markets, particularly as providers of patient capital to business entities and infrastructure projects. Industry super funds are long-term investors focussed on deploying capital that supports sustainable economic growth and generates superior returns for beneficiaries. Although industry super funds avoided the products and practices implicated in the global financial crisis, our funds and members, along with the broader public, were harmed. As a result, ISN has a keen interest in improving the operation of financial markets and institutions, including through regulatory improvement.

ISN welcomes the Options Paper and generally support the concerns and proposed solutions raised in the paper. With that said, we do have a handful of comments and suggestions for your consideration.

First, in respect of the discussion of the financial market licensing regime, the Options Paper focuses on the form of regulation (e.g., whether the different treatment of markets is accomplished via Ministerial discretion to "switch off" certain requirements, or whether different market classifications are embedded in the statute). There is little discussion of the substance of market regulation that would apply to different classes of markets. As a result, it is difficult to assess the options. If there are no clear principles tied to public policy objectives that would guide the exercise of discretion to "switch off" requirements, then a statutory approach would, without question, be superior. We do support the broad notion that there should be different and tailored regulation for different kinds of markets, reflecting the reality that there are important differences between the operation and need for regulation in respect of wholesale and retail markets. With that said, simplicity in regulation is a virtue and more than two or three market licensing regimes could introduce regulatory arbitrage opportunities and

excessive burdens on Commonwealth resources to accommodate business models which may not be justified insofar as existing markets are reasonably successful at facilitating transactions.

Second, the notion of “competition” underlying the paper was not always complete. This is particularly the case in respect of HFT, where the Option Paper asserts that “HFT activity ... facilitate[s] competition in stock trading ... through acting as a market maker to smaller public exchanges.” There are a number of elements of competition in stock trading, and they can be in tension. For example, there can be competition to exploit differences in the market ecology, or an unlevel playing field. This is the nature of most competition in stock trading today, as evidenced by the significant resources that are put toward maximising returns to high speed and low latency, as well as construction of trading systems that increase the differences between co-located and other traders. By contrast, we see relatively little resourcing put toward (or “competition” in) facilitating primary offerings, or creation of new capital stock via investing.

ISN believes that before HFT is promoted as a means of improving competition, Treasury should evaluate the different ways in which traders and investors might compete, and which types of competition should be encouraged and discouraged.¹ There are a number of academic papers discussing the arms’ race nature of HFT and how, absent intervention, it eventually could become rational for each large long-term investor to make substantial investment in high frequency technology notwithstanding that doing so would be a net loss from a general economic and general welfare point of view.

Indeed, promoting “competition” in stock trading may be misguided; encouraging “coordination” may be superior. We would encourage Treasury to consider the coordination problems and possible solutions discussed in the survey on market microstructure literature of Biais, Glosten and Spatt (2005), particularly where call auctions are compared with continuous trading.² (Please see ISN’s comment letter on the Treasury Discussion Paper concerning ASIC Market Supervision Cost Recovery Arrangements, which includes as an attachment an ISN research paper on modern call auctions.)

Third, “easily accommodat[ing] the (often global) operating models of various types of ‘alternative markets’” is not necessarily an intrinsically desirable feature of a regulatory regime. Instead, we would encourage clear principles of market regulation based on the public interest and that support the needs of Australian market participants, especially capital providers and users. It is not necessarily the case that if Australia is a desirable place of business for financial intermediaries, the public or long-term investors here will be well-served. A number of developments in market structure that have occurred overseas and have been imported to Australia have not resulted in tangible benefits to long-term investors and it is clear that the confidence in the integrity of Australia’s lit equity market, in particular, is far lower than it was in the middle of the last decade, prior to recent changes. Insofar as the competitiveness of Australia from the perspective of foreign intermediaries will turn on (i) the decisions of other jurisdictions (which, empirically, are not always of high quality) and (ii) the self-interest of such intermediaries, there is a clear risk that accommodating global operating models may not be in the national interest or otherwise a desirable policy objective.

¹ There are countless examples of the need for regulation of an environment to encourage competition in particular ways rather than others. One example is Formula-1 racing. Formula-1 racing was at risk of being dominated by competition in racing car technology, rather than driver judgment and skill (which were considered desirable areas of competition). As a result, there has been significant intervention into the technology permitted to be deployed in Formula-1.

² Biais, Bruno, Larry Glosten, and Chester Spatt. “Market Microstructure : A Survey of Microfoundations , Empirical Results, and Policy Implications The Microstructure of Stock Markets.” *Journal of Financial Markets* 8.2 (2005): 217–264.

With respect to specific options proposed, ISN's views are as follows:

AML licensing options

Either Option 1 or Option 2 can be successful, provided the public interest is prioritised and there are clear and appropriate principles guiding the regulatory requirements applicable to each class of market, whether those classes are established in the statute or by regulation.

Whether the regime is established by statute or regulation we believe there is a need for greater consideration of the interest of constituents -- natural persons across Australia -- in the formation of financial regulatory policy. For example, in the ongoing debate about HFT, we have been troubled by the apparent lack of concern by policy makers that natural persons residing far from market centres are indisputably at a disadvantage when trading in the market place. There is no question that, for example, a retail investor residing in Western Australia is not on a level playing field in terms of receiving market information and reacting to market information relative to co-location users. It is a policy decision to allow and encourage differential access to market centres (even if offered on non-discriminatory terms) coupled with low latency continuous trading systems. While this is a policy decision, we have seen little serious consideration of equity and fairness. Typically, the disadvantages faced by persons who are not in co-location facilities are dismissed by stating that co-location is open to all. But the idea that open access to co-location is the same as a level playing field does not survive careful scrutiny. Can it reasonably be expected that a retail investor from Western Australia who wishes to make passive trades and seeks true fairness should relocate to Gore Hill, translate their decision making into an algorithm, and make a substantial technological outlay? This is neither fair nor realistic. Indeed, the implementation of technological advances in financial markets is nearly unique in the way it advantages trading institutions rather than ordinary consumers. Fast and sophisticated technology sits behind the majority of today's electronic social and economic interaction, yet from Amazon to Google to eBay, in each case technology is deployed equally and to improve the experience of consumers. By contrast, financial markets have established stratified access that empirically permits exploitation of many customers by a relative few institutions.

Greater consideration of fairness to natural persons in market regulation is important insofar as financial markets are a key part of the country's economic infrastructure, and equal participation in them is important to a society that promotes personal responsibility and capitalism.

Differential access to financial markets, will, over time, continue to poison the confidence of stakeholders who are not high frequency traders. Awareness of the structural advantages enjoyed by fast traders is increasing. If structural market unfairness is allowed to persist, serious future market shocks or periods of weak equity market performance can only magnify the negative effect on investor confidence. It is already the case that any market anomaly undermines confidence and some role for high frequency trading is suspected. This reality must be considered when assessing public policy options regarding HFT.

AML reform that incorporates alternative trading systems into the cost recovery regime

ISN supports the objective of fair cost recovery from alternative trading systems and dark pools for oversight. We would anticipate that the cost recovery formula would reflect any differences in how oversight costs are generated (for example, dark pools may be lower in terms of risk-based inspection and analysis given the nature of participants).

G-20 obligations and mutual recognition

It is not clear that the form of Australian market regulation – as opposed to its substance – will significantly affect whether Australia is out of step with the G-20. In addition, the nature of swap

execution facility regulation in the US that might satisfy the on-exchange aspiration of the G-20 commitments regarding OTC derivatives remains under consideration. Through the proposal stage, there are open questions about what an execution facility must look like for it to satisfy legal requirements – for example, it might be the case that a market that does not have features traditionally associated with exchanges (such as “one-to-many” communication and pre-trade transparency) may nonetheless qualify as a swap execution facility. As a result, whether market regulation is in the form of a license which has relatively light obligations with no exemptions, or is in the form of a license granted with tailored exemptions from significant obligations, the equivalency assessment is likely to be based on the substance of the obligations that ultimately fall on exchange operators.

As an aside, and consistent with our general comments above, we stress that decisions about the substance of regulation should be based on the interest of Australian investors and companies, not securing a mutual recognition arrangement (particularly if the practical outcome is the entry to Australia of US alternative trading systems, which will further fragment our market and which have tended to cater to high frequency traders).

Applying regulatory burdens directly to HFT.

ISN supports this.

Exemptions at an operator rather than facility level.

We think exemptions should be based on the nature of the market provided, and obligations should flow to both the operator and the facility. As a result, at least provisionally, it would not be desirable to provide single exemptions to operators. In addition, while the operator-level exemption discussed in the Option Paper would be desirable for the operator of multiple facilities, it would appear to simply shift the some of the regulatory costs arising from operating multiple facilities from the operator to ASIC (and the public).

* * * * *

If ISN may answer any questions about this submission or otherwise be of any assistance, please do not hesitate to contact me at zmay@industrysuper.com or on (03) 9657 4369.

Kind regards,



Zak May
Director of Regulatory Policy, ISN