

Competition for Market Services

AXE PHASE II – Full Equity Trading

ASIC Consultation Update

21 November 2007

About AXE

- Backed by five of Australia's leading market payers - Citi, CommSec, Goldman Sachs JBWere, Macquarie Securities and Merrill Lynch (10% each)
- NZX owns 50%
- AXE Phase I is a facility to execute and report transactions in ASX listed securities (mainly crossings)
- AXE Phase II is a fully automated equity trading system
- AXE is an ECN
 - *Low cost platform that offers trade execution services*
 - *Separates the trading and listing functions of a traditional Exchange.*
 - *ECNs are available in most leading global markets In the United States and Europe there are approximately 34 ECNs.*

AXE Phase II

- Electronic order book and matching system
- The financial products traded will be equity securities listed on ASX.
- Competitive pricing, technology and market design.
- Core trading functions are already available on the GlobalVision™ trading system that AXE uses.
- NZX already uses GlobalVision as its trading system.
- GlobalVision has adequate capacity for our needs and is scalable to meet future growth requirements.
- IRESS best market routing will be ready for AXE phase II.

Phase I update

- AXE responded to first round of consultation by:
 - Addressing the overlap between AXE compensation requirements and NGF cover.
 - Changing delayed reporting rules.
 - Bringing forward development of a full trading system.
- ASIC commencing second round of consultation with a narrower set of issues:
 - Pre-trade transparency.
 - Consolidation of post-trade information (AXE substantially agrees).
 - Best execution obligations (AXE substantially agrees).
 - Cross-market supervision (AXE substantially agrees).

ASIC's proposed Pre-trade transparency threshold is too low

- ASIC propose a pre-trade transparency requirement if trading on the market = or $>$ 5% of overall trading in a six month period.
- This is targeted at internalised trades such as those AXE Phase I caters for.
- Whilst AXE proposes to have its full trading system operating within this period the 5% threshold is too low.
- There are many stocks where individual brokers already cross greater than 5% market share.
- In the YE 30 September 2007 133 of the S&P/ASX200 stocks had at least one broker with $>$ 5% market share just in crossings and in 73 of those stocks there were 4 or more brokers each with $>$ 5% market share in crossings.

Pre-trade transparency

AXE's entry does not alter the existing levels of pre-trade transparency in the overall Australian Capital Market

- 30% of the equity turnover is currently crossed.
- There is no pre-trade transparency requirements for ASX Special Crossings which account for 15% of equity turnover.
- The ASX crossing rules do not create any effective pre-trade transparency.
- Traders are attracted to internalised transactions because the information leakage and market impact are lower.

Why does ASX object to competition?

- ASX is a vertically and horizontally integrated monopoly.
- ASX argues that fragmentation will increase transaction costs – this ignores all the evidence that the opposite will occur.
- ASX argue that its fees are only a fraction of the total cost of trading – their customers are telling them that their fees are a major cost of doing business.
- Robert Elstone says that “brokers are precluded from crossing against their own order flow”[†] – This is wrong. Principal to client transactions are specifically allowed under ASX rules and are a large and legitimate part of the market.
- ASX say that dark pools of liquidity are bad – this demonstrates a fundamental misunderstanding of the differences between trading venues and the value brought by innovation.
- ASX says that proposing competition for ASX is like building a new airport to keep down airport landing fees – Why does Jetstar fly into Avalon?* Why isn't Tiger Airways planning to fly into Sydney?

[†] ABC Lateline Business 30 October 2007

* “Secondary airports such as Avalon charge lower landing and terminal fees compared to major airports” – Geelong City Council (<http://www.geelongcity.vic.gov.au/library/pdf/5066/20.pdf>). “The airline told The Daily Telegraph last week that gates at Australia's largest airport could prove ‘too expensive’.” – Daily Telegraph 30 October 2007.

Competition in Market Services delivers on the FSR objectives

The following observations are made in the Explanatory Memorandum to the Financial Services Reform Bill 2001:

- The reforms are aimed at facilitating a more efficient and competitive business environment.
- The primary problem in relation to Australian markets is the lack of competition in the sector.
- The Government aims, with the new regulatory regime, to increase competition in these areas by lowering the barriers to entry and encouraging new participants to operate competing markets and facilities.

Support for Competition

- *The AXE and Liquidnet proposals are supported by the market and peak bodies*
 - The five AXE participant shareholders account for 40% of equity turnover
 - ABN AMRO – a top ten institutional equity broker with a 50% interest in a retail broking firm
 - Investment & Financial Services Association - representing the fund management, superannuation and life insurance industries
 - Australian Financial Markets Association – representing participants in wholesale banking and financial markets
 - Securities & Derivative Industry Association – representing institutional & retail stockbroking firms and investment banks
 - Institutional investors representing \$120b in funds under management

Competition will increase liquidity not diminish it

- Competition will increase efficiency, enhance liquidity, and improve price formation. It will:
 - Result in growth in the market in terms of both trades and participants, and hence increase liquidity.
 - Providing incentives for competing execution venues to offer better services, improving efficiency.
 - Execution choice through competing platforms will encourage innovation and cost reduction and will advantage the market as a whole.

Competition will also reduce systemic risk and single supplier dependency thus giving the market greater integrity

AXE will have a positive economic impact

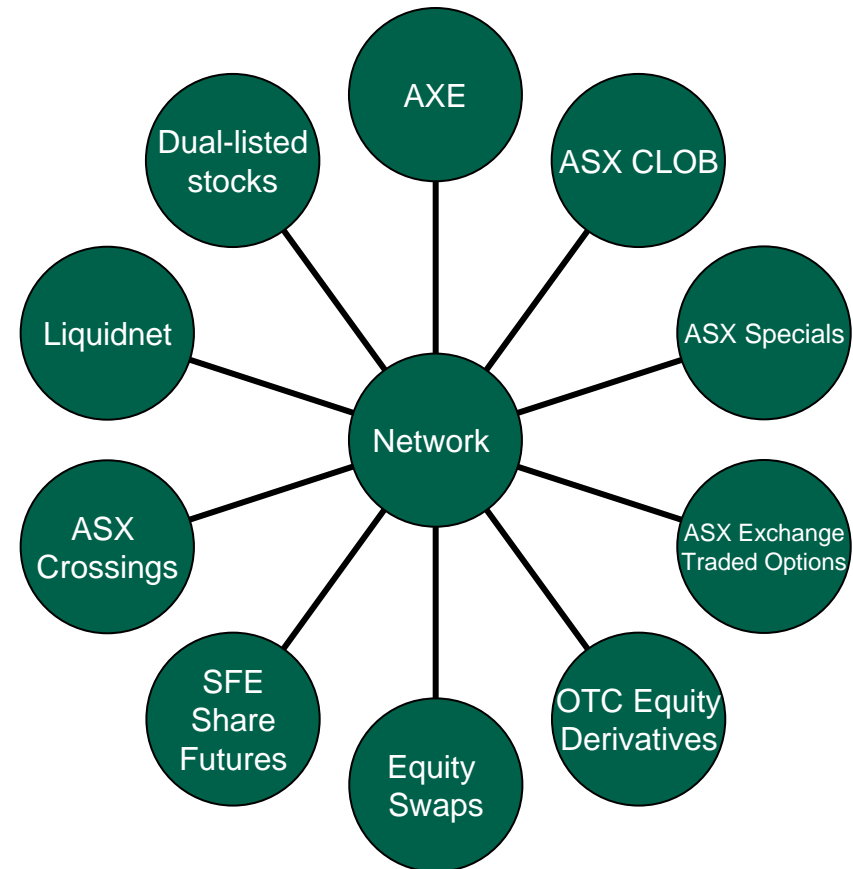
There will be an increase in liquidity across the overall market.

- For the most liquid stocks:
 - Crossing engines will be able to better match broker's internal order books with DMA/Algorithmic (time sensitive) flow.
 - Lower fees mean a new set of trades become economic
- For less liquid stocks:
 - Clients looking to trade “market moving” positions can match with clients that will not appear in the ASX Central Limit Order Book due to potential market impact.
 - This means there is more efficient access to additional order flow.
 - More currently unexecuted liquidity will come to market

Competition will increase liquidity not diminish it thus strengthening Australia's position as an efficient market place to raise capital

Choice of execution venue does not fragment the network

- Execution choice is consistent with the economic benefits of liquidity
- The market for ASX listed stocks is already segmented at the execution venue level
- Best Execution protects and enhances the network effect. AXE will not result in negative effects on overall market liquidity. The opposite is true.
- Liquidity can move between these venues efficiently
- Pre and post trade transparency is not changed



AXE will assist in growing total output, with network effects undiminished

Competition will improve market quality

- *Competition is supported by the market and peak industry bodies*
- *ASIC have undertaken a thorough and rigorous analysis and are proposing conditions that will facilitate competition and improve market quality*
- *Competition between competing venues in the Australian capital market will bring benefits as material as in any other service market*
- *Competition in Market Services delivers on the FSR objectives*
- *Lower costs will be in the interest of all investors*