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ASX 24 review 2016

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Executive summary

Purpose of this report

Australian Securities Exchange Limited (ASX 24) is licensed to operate the ASX 24 derivatives market (derivatives market) in New Zealand. We are required to report at least once every two years¹ on how well ASX 24 is meeting its licensed market operator obligations². This review period covers 1 July 2014 to 30 June 2016. This is our first review of ASX 24 since its licence came into effect on 1 December 2014.

The Australian Securities and Investments Commission (ASIC) is ASX 24's primary regulator. We therefore focused our review on whether ASIC was satisfied with ASX 24's compliance during the review period. See the Appendix for details about how we carried out our review.

Conclusion

We are satisfied that, during the review period, ASX 24:

- ensured, to the extent reasonably practicable, that its licensed market was fair, orderly and transparent
- had adequate arrangements for notifying disclosures from participants in its market, and for continuing to make them available
- had adequate arrangements for handling conflicts between its commercial interests, and the obligation to ensure its market operates in a fair, orderly and transparent manner
- had adequate arrangements for monitoring the conduct of participants in its markets
- had adequate arrangements for enforcing compliance with market rules
- had sufficient resources (including financial, technological and human resources) to operate its licensed market properly.

Our conclusion is based largely on ASIC's oversight of ASX 24 and its view of ASX 24's compliance, including previous assessments of ASX 24 carried out under the Australian Corporations Act 2001 (Corporations Act).

ASIC has said that it has no regulatory concerns with ASX 24, and no reason to believe that ASX 24 was not compliant with its market operator obligations under the Corporations Act during the review period.

ASX 24 has taken appropriate action to address matters raised by ASIC that would improve its derivatives market operations.

Monitoring the conduct of participants means monitoring all persons trading on licensed markets, including authorised participant firms and their clients. This would generally include surveillance of trading activity. Under the Corporations Act, ASX 24 must monitor and enforce compliance with its operating rules, which govern the behaviour of its participant firms; while ASIC has responsibility for real-time market surveillance. We are satisfied this provides appropriate supervision of the conduct of all participants in the derivatives market.

¹ A condition of ASX 24's licence is a review every two years. The licence is available on our website.

² A market operator's full obligations are set out in the Appendix.

We are also satisfied that ASX 24 complied with its other obligations except for two licence conditions that it could not meet immediately. We were aware of this when the licence conditions were agreed in December 2015, and ASX 24 has taken steps to comply as soon as practicable.

See the 'Findings' section of this report for details.

ASX 24

ASX 24 operates the derivatives market. Products traded on the market include futures and options on indices, interest rates and energy.

In the year ended 30 June 2016, approximately 137 million futures and options on futures contracts were exchanged on the derivatives market³.

ASX 24 is part of the ASX Group, which also operates the ASX securities market (securities market), and provides market services such as clearing and settlement.

ASX 24's licence

ASX 24 was an authorised futures exchange under the Securities Markets Act 1988. Under the transitional provisions of the FMC Act, it was deemed to hold a financial product market licence from 1 December 2014. The conditions of ASX 24's licence were largely carried over from the authorised futures exchange notice. ASX 24's licence can be viewed on our website [here](#).

ASX 24's home jurisdiction is Australia and ASIC is the primary regulator of its market operations. Its market operator obligations in Australia are contained in the Corporations Act. It is also subject to the ASIC Market Integrity Rules (ASX 24 Market) 2010 (ASX 24 market integrity rules).

A condition of ASX 24's FMC Act licence is that New Zealand investors must be informed that ASX 24 is regulated primarily under Australian law.

ASX 24 is required to give the FMA half-yearly information about trading participants who offer derivatives in New Zealand through the derivatives market.

As at 30 June 2016, 15 trading participants were authorised to transact New Zealand derivatives on the derivatives market. We do not require ASX 24 to monitor, or report, on the extent of trading in New Zealand derivatives by these participants, or by New Zealand investors.

ASX 24 must also notify us if it intends to make any material changes to the rules for the derivatives market. Rule changes must be approved by ASIC and the Australian Minister for Revenue and Financial Services.

³ From ASX Limited Annual Report 2016

ASX Group and ASX Compliance

The ASX Group includes two licensed market operators and four licensed clearing and settlement systems. The group also includes ASX Compliance Limited (ASX Compliance). ASX Compliance has a separate board of independent, non-executive directors, and has overall responsibility for ensuring that all licensed entities in the group meet their regulatory obligations. This means that most of ASX 24's policies, procedures, systems, governance and other arrangements that satisfy its market operator obligations are designed and administered by ASX Group. Examples include:

- financial, technological and human resources for all licensed entities are managed at a group level
- Market Operations, which includes trading operations, surveillance and the market announcements office, carries out those services for both licensed markets
- ASX Compliance is responsible for managing conflict for the whole group, and for monitoring and enforcing the rules of both the derivatives and securities markets.

Findings

As ASIC is ASX 24's primary regulator, our review focused on whether ASIC was satisfied with ASX 24's compliance during the review period, and how ASIC had reached that view⁴.

ASIC's oversight of ASX 24

Compliance responsibilities are centralised within ASX Group. This means the same arrangements are generally used to meet the market operator obligations for both the derivatives market and the securities market. ASIC combines its oversight of ASX 24 with oversight of the securities market and the group's other licensed entities.

ASX Group must report to ASIC each year on whether it has complied with all of its market operator obligations for both the derivatives and securities markets.

Until 2013, the Corporations Act also required ASIC to annually assess a market operator's compliance with a number of its obligations. The last such assessment report for ASX Group was published in July 2014⁵. ASIC concluded that the group had met its statutory obligations for the relevant assessment period.

Changes in the legislation mean that ASIC can now choose to assess whether ASX Group complies with any or all of its market operator obligations, at any time. This allows ASIC to monitor the group's market operator arrangements on a risk basis. It also allows ASIC to target compliance reviews against specific obligations, based on its risk assessments.

To help identify risks, ASIC has introduced a standard quarterly report for ASX Group to complete. These reports give ASIC a significant amount of data about all areas of the group's operations on a regular basis. This quarterly reporting also forms part of the group's annual self-assessment of its compliance.

⁴ Further information on our approach is found in the Appendix.

⁵ The report is available at <http://download.asic.gov.au/media/1344638/rep401-published-28-July-2014.pdf>

If ASIC has concerns or queries about market operations, either from this reporting, its own monitoring activities or other sources of information such as complaints, it raises matters with ASX Group as necessary.

ASIC's risk-based monitoring helps to determine if more detailed reviews are necessary. Under this structure, ASIC has reviewed and reported on ASX Group's resources for managing cyber resilience and its listing standards for the securities market⁶. In both reviews, ASIC found that ASX Group had met the relevant obligations⁷.

Matters raised during the review period

ASIC raised three matters with ASX 24 during the review period.

High-frequency trading strategies affecting quarterly roll-over contracts

Before a futures contract expires, traders often seek to roll over their position into the next corresponding futures contract. This leads to a significant rise in trading volumes prior to futures contracts' expiry.

ASIC found that a small number of very active traders were dominating the market during this period by using multiple accounts and gateways to the market. This resulted in a greater cost to other participants and clients wishing to trade.

ASIC engaged directly with trading firms to address the behaviour. ASX 24 also took action by increasing the minimum lease period for gateways to the derivatives market. This reduced the incentive for participants to lease extra gateways to engage in high-frequency trading during the quarterly roll-over period.

ASIC published information about this matter in its *Market Integrity Update* for September 2015⁸, and in a review of high-frequency trading and dark liquidity in October 2015⁹.

Use of the off-market block trade facility for S&P/ASX 200 A-REIT index futures

The block trade facility is an off-market place which allows professional market users to deal in large orders. The ASX 24 market integrity rules prohibit participants from using the block trade facility to roll a contract position from the nearest delivery month to a different delivery month. ASX 24 had asked ASIC to waive this rule for market participants trading in the S&P/ASX 200 A-REIT index futures contract (the A-REIT contract).

The waiver was requested because the A-REIT contract had moved over from another trading platform, ASX Trade, where this rule did not apply.

Following consultation, ASIC took a temporary no-action position for two specific contract expiry periods for the A-REIT contract. This allowed participants to use the block trade facility for those two periods but did not waive the rule permanently. It also gave ASIC more time to consider what was appropriate going forward.

ASX 24 has managed the issue for future expiry periods by changing the tick size (which determines how much a price can move up or down) of the contract during the last week of a contract's expiry period, as well as allowing the contracts to be pre-negotiated¹⁰. ASIC was satisfied this would help participants to comply with the ASX 24 market integrity rules. Information about this issue was also published in ASIC's *Market Integrity Update* for September 2015.

⁶ The listing standards do not apply to ASX 24.

⁷ Reports on these assessments were published in March and June 2016 and are available at <http://asic.gov.au/regulatory-resources/markets/licensed-market-and-clearing-and-settlement-facility-assessment-reports/>

⁸ Available at <http://asic.gov.au/about-asic/corporate-publications/newsletters/market-integrity-update/market-integrity-update-issue-64-september-2015/>

⁹ Available at <http://download.asic.gov.au/media/3444836/rep452-published-26-october-2015.pdf>

¹⁰ Notice of the changes is available at <http://www.sfe.com.au/content/notices/2016/0148.16.02.pdf>

Market maker disclosure

Market makers play an important role in providing liquidity in ASX Group's markets. However, ASIC considered there was a risk that incentives for market makers, such as payments that encouraged activity at any cost, could result in behaviours that did not promote market integrity.

ASIC raised concerns with ASX 24 about the need to provide transparency around this market activity, as well as monitoring the commercial arrangements that underpin market maker activity. ASX Group now provides increased disclosure on its website about market-making incentive schemes in all of its markets¹¹.

ASX 24's compliance with its licence conditions

The conditions of ASX 24's licence in New Zealand include that ASX 24 must:

- require trading participants to inform New Zealand clients of the differences between trading derivatives on an Australian market and a New Zealand market
- ensure that trading participants making regulated offers¹² of derivatives in New Zealand are licensed under the FMC Act if required.

To implement these two conditions, ASX 24 would need to impose the corresponding obligations on its trading participants. This requires amendments to the existing operating rules for the derivatives market.

When we agreed on the conditions for the licence, ASX 24 notified us that it would be unable to meet these two conditions immediately. We were comfortable that ASX 24 would make arrangements to comply as soon as practicable. ASX 24 has since consulted with us on proposed changes to the operating rules, and is in the process of obtaining approval for those changes. We have no reason to believe that there has been any harm to New Zealand clients in the meantime.

Conclusion

With the exception of the two licence conditions noted above, we are satisfied that ASX 24 complied with the market operator obligations under the FMC Act during the review period. The reasons are:

- ASIC, in its most recent full assessment of ASX Group's market operator arrangements, found ASX Group had met all market operator obligations
- ASIC's risk-based monitoring has not led to reviews of ASX 24's compliance with any of its obligations. A review of ASX Group's resources for managing cyber resilience found the group was compliant with the relevant obligation
- ASIC has said that it has no regulatory concerns with ASX 24. It also has no reason to believe that ASX 24 was not compliant with its market operator obligations under the Corporations Act during the review period
- we have not received any complaints about the operation of the ASX 24 derivatives market in New Zealand.

We are satisfied that ASX 24 will be compliant with the conditions of its licence following the proposed changes to the derivatives market rules.

¹¹ Available at <http://www.asx.com.au/products/market-maker-arrangements.htm>

¹² As defined in the FMC Act

Appendix: how we conducted our review

Our role

Under the FMC Act, we are required to periodically review how well a licensed market operator is meeting its obligations, and to publish a written report.

Market operator obligations

In the FMC Act, 'market operator obligations' means:

- the general obligations contained in section 314 of the FMC Act:
 - to ensure, to the extent reasonably practicable, that each of the licensed markets is fair, orderly and transparent
 - to have adequate arrangements for notifying disclosures from participants in its markets, and for continuing to make them available
 - to have adequate arrangements for handling conflicts between its commercial interests and the obligation to ensure its markets operate in a fair, orderly and transparent manner
 - to have adequate arrangements for monitoring the conduct of participants in its markets
 - to have adequate arrangements for enforcing compliance with market rules
 - to have sufficient resources (including financial, technological and human resources) to operate its licensed markets properly
- an obligation to respond to any request from us to make changes to market rules (section 333)
- an obligation to provide us with an annual self-assessment of how it complies with its obligations (section 337)
- an obligation to act on our, or the Minister's¹³, direction if it has failed to meet any of its obligations (sections 340 to 342)
- any obligation imposed as a condition of a market operator's licence.

Approach

A market operator that is authorised and regulated in an overseas country may be licensed under the FMC Act if certain conditions are met.

A key requirement is that the home jurisdiction regulating and supervising the market operator should provide a comparable level of investor protection and market integrity as the FMC Act¹⁴. This allows us to rely on the overseas

¹³ New Zealand Minister for Commerce and Consumer Affairs

¹⁴ The original authorisation of ASX 24 as a futures exchange was assessed under a similar requirement in the repealed Securities Markets Act 1988. ASX 24 was deemed to have a licence from 1 Dec 2014 as it moved to the FMC Act regime.

regulator to assess and monitor the capability, and compliance, of the market operator.

ASX 24's market operator obligations in the Corporations Act are largely equivalent to its FMC Act obligations. ASX 24 does not have an obligation in Australia to carry out surveillance of real-time trading activity. This function has been carried out by ASIC since 2010.

ASX 24 must report to ASIC annually on how it complies with its market operator obligations. ASIC may assess, at any time, how well ASX 24 is complying with any or all of the obligations. These provisions are also equivalent to those in the FMC Act.

Our approach was therefore to focus on:

- whether ASIC was satisfied with ASX 24's compliance with its market operator obligations under the Corporations Act during the review period
- how ASIC reached that view.

Information reviewed

A key component of our review was a discussion with ASIC about its ongoing oversight of ASX 24; any matters or concerns raised with ASX 24 during the review period; how ASX 24 addressed those matters; and ASIC's overall view of ASX 24's compliance with its market operator obligations.

We also looked at the following:

- reports provided by ASX 24 on its compliance with its obligations for the years ended 30 June 2015 and 2016 (as required under section 337 of the FMC Act). These were the same reports ASX provided to ASIC under the Corporations Act
- information on the ASX website about how ASX meets its market operator obligations for both the securities and derivatives markets. This included:
 - how ASX interprets its obligation to operate fair, orderly and transparent markets
 - how ASX meets its obligation to have adequate arrangements for monitoring and enforcing compliance with the operating rules of its markets
 - how ASX meets its obligation to manage conflicts between commercial and regulatory interests, and a summary of its conflict handling arrangements
 - the ASX Compliance board charter, that sets out the roles and responsibilities of ASX Compliance¹⁵
- past reports by ASIC on ASX's compliance with its market operator obligations¹⁶.

¹⁵ This information is available on ASX's website at <http://www.asx.com.au/regulation/regulatory-compliance/asx-corporations-act-obligations.htm> and <http://www.asx.com.au/about/corporate-governance.htm>

¹⁶ These reports are available on ASIC's website at <http://www.asic.gov.au/regulatory-resources/markets/licensed-market-and-clearing-and-settlement-facility-assessment-reports/>