ASIC Consultation 181 – Retail Trading in Commonwealth Government Securities

ASX Submission

August 2012

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ASX strongly supports the proposal to facilitate retail trading in Commonwealth Government Securities ('CGS'). The development of retail trading in CGS addresses a range of critical short and long-term policy objectives. These include:

1 Diversification and reducing the volatility in returns of Australia's savings pool

Australian retail investors' investment portfolios are heavily weighted towards the equity and property asset classes. The development of a retail bond market underpinned by low-risk CGS provides retail investors with an ability to diversify their investments and reduce the volatility in returns by providing easier access to these securities in an efficient manner and using trade and post-trade infrastructure with which they are familiar. This is especially relevant given an aging population, the expansion of self-managed superannuation and the need for greater certainty in income streams through low-risk products such as CGS. To the extent that this development helps underpin the growth of a local corporate bond market it would also provide a means for rebalancing the heavy weighting of equities in institutional investment portfolios.

2 Improving Australia's economic competitiveness

Making CGS accessible to the retail market will help develop demand for debt securities, which will underpin the future development of a corporate bond market. A vibrant corporate bond market then complements and provides a competitive medium to long-term funding source to banks and equity markets. Such a market enables companies to use corporate bonds to reduce their financing costs, spread their funding risks, and in turn makes Australia more economically competitive.

3 Reducing Australia's reliance on offshore funding

The development of an exchange traded CGS and corporate bond market will assist in mobilising domestic savings for investment in infrastructure and corporate expansion, and in so doing reduce Australia's reliance on offshore markets for funding requirements and exposure to external shocks and movements in foreign exchange rates. Retail CGS may also lead to increased foreign investment in Australia as it adds a further low risk asset class.

ASX has developed an operational and legal framework based on the use of depository interests to facilitate trading in CGS. The use of CGS depository interests allows for an exchange-traded market in CGS without creating a separate retail-only issue of CGS. It does not interfere with the current wholesale issue process for CGS as it is not necessary for the CGS to be taken out of Austraclear. Further, it is minimises the changes required as it leverages off the efficiency of existing infrastructure.

The use of depository interests also links the wholesale and retail markets and effectively creates a retail price for a wholesale bond. This overcomes a major challenge faced by some overseas markets in relation to price formation for the retail product. The alternative is to have a retail-only issue, which might trade at a completely different price to the wholesale CGS.

The use of contracted market makers to support trading in the CGS is very important to ensure that investors will be able to enter and exit the market easily and with low transaction costs. ASX is putting in place market making arrangements which will provide incentives to market makers to provide liquidity and thereby promote the development of the market for CGS. These arrangements are detailed in Appendix 1.

There are also a small number of operational issues around the implementation of this initiative, which are set out in Appendix 1.

Appendix 1: ASX Responses to specific issues in relation to CP 181

ASIC Proposal	ASX Response
Market Makers	ASX will appoint market makers that will be able to create depository interests over CGS. It is proposed that while the market is being established only market makers appointed by ASX will be able to create depository interests in this way. ASX considers that providing an incentive to market makers will be critical in the formative stages of this market, particularly if they are being asked to agree to obligations in relation to price (based upon the wholesale market price), spread and volume. In the early stages of a market's development the provision of committed two-way pricing is typically uneconomic and in the absence of incentives leads to poorer market outcomes with wider spreads or non-existent pricing. ASX seeks to prevent this outcome the market for CGS and is proposing to appoint a minimum of three market makers that will provide streamed continuous two-way bid/ask prices at significant volumes. An important incentive in return for market makers meeting these obligations is exclusivity in sourcing depository interests for meeting settlement obligations relating to trades on the ASX market. This incentive will assist in offsetting the considerable cost borne by market makers in providing liquidity. An absence of this incentive will result in wider bid/ask spreads for retail investors. It is the intention that this exclusivity would be removed once the market reaches a certain level of maturity. ASX expects that this would be when the market reaches a minimum average daily turnover of $250 million (i.e. $10 million on average per series of CGS).
Extreme Price Movements **D1Q1** Do you agree that applying some controls around extreme price movements for CGS depository interests would be desirable? **D1Q2** If so, do you agree with our proposals? **D1Q3** In particular, do you agree with our proposed extreme cancellation range of more than 20% away from the reference price?	The extreme cancellation range (ETR) of 20% is consistent with existing interest rate securities. Note that the impact of the ETR may not be significant because ASX needs to apply an anomalous order threshold (AOT) which should prevent any trades in the ETR during continuous trading. Trades in the ETR could occur during the auction, and would need to be cancelled. ASX is likely to set the AOT at the same level as for Equity Market Products under the Market Integrity Rules (Competition in Exchange Markets) 2011 (MIRs). ASX's comments on draft MIR 2.2.2C and Reg Guide 223.50 in ASX's submission on CP 179 (page 16) also apply to CGS. We understand that ASIC is considering this issue.

Pre-Trade Transparency **F1Q1** Do you agree with our proposal to apply the pre-trade transparency regime in Chapter 4 of the competition market integrity rules to CGS depository interests.	ASX agrees with this proposal. In relation to the block trade threshold for CGS depository interests, ASX is happy to be guided by market feedback as to the level at which this should be set, provided there is a consistent block trade threshold for all CGS depositary interests.
Post-Trade Transparency **F2Q2** Do you agree with our proposal to apply the post-trade transparency regime in Chapter 5 of the competition market integrity rules to CGS depository interests?	ASX agrees with this proposal, but has a query in relation to its implementation. MIR 5.1.6 requires ASX to make certain trading information in relation to CGS Depository Interests available on its website. ASX notes that a number of the categories of trading information refer to information which does not change (i.e. coupon, maturity date and face value). As this information is static it may be located on a different part of the ASX website to the other trading information. Would ASIC please confirm that this approach is acceptable.
Timing of Proposed MIR Changes	ASX assumes that where MIR amendments proposed in ASIC CP 179 are to be applied to CGS Depository Interests those amendments will take effect at the time stated in ASIC Report 290 and CP 179. Could ASIC please confirm that this is correct.

Contact Information

Contacts

For general enquiries, please contact:

Mr Gary Hobourn
Senior Policy Analyst, Regulatory and Public Policy
T: 02 9227 0930
E: gary.hobourn@asx.com.au

Media enquiries, please contact:

Ms Kristen Kaus
Media and Communications Executive
T: 02 9227 0410
E: Kristen.kaus@asx.com.au