

25 February 2022

Financial Services Legislation,
Australian Law Reform Commission,
PO Box 12953, George Street Post Shop,
Queensland 4003

By email: financial.services@alrc.gov.au.

FINANCIAL SERVICES INTERIM REPORT A

Thank you for the opportunity to provide a submission on the Australian Law Reform Commission (ALRC) Review of Financial Services Legislation and Financial Services Interim Report A.

ASX strongly supports the review

ASX strongly supports the review of the Corporations Act 2001 (**Corporations Act**) particularly as it relates to simplifying the application of the provisions within the Act and to provide clarifications that will promote diversified investment opportunities for Australian investors and attract investment and liquidity to Australian markets. ASX has considered how the changes proposed will impact the ASX market for equities, debt products, investment products and equity options and the ASX 24 market for derivatives over interest rates, commodities and other products (ASX markets).

ASX will respond to Questions A16 and A17 regarding the definitions of retail and wholesale client and in turn professional investor and sophisticated investor with the purpose of providing clarity to the market and investors. These definitions impact the licensing requirements for participants on the ASX markets and, in particular, the licensing obligations of market makers on the ASX markets. Market makers provide important benefits to the Australian market and investors. They provide liquidity to the ASX markets by making quotes during the trading day and updating their prices to reflect changes in the underlying markets. ASX seeks market makers in specific products or contract months where there is a need to improve price formation, transparency and risk transfer efficiencies. Market makers assist in the development of new products by providing the market with fair and transparent prices which represent the underlying asset's forward value, and by providing liquidity that allows end users to open and close positions in the contract.

ASX is becoming increasingly reliant on foreign market makers as a matter of necessity. Historically market making support has been provided by trading and investment banks in Australia. Due to increased capital and other costs, as well as increased regulation and compliance requirements including in relation to client flow and costs within the banking sector, many banks are not able or willing to undertake market making obligations. ASX understands that market making is often not a profitable model for investment banks in Australia due to the capital charges they face, and that the profit and loss analysis is more favourable for proprietary trading firms. These are often specialist firms based offshore.

When market makers have been absent from this market, spreads widened significantly (resulting in increased hedging costs) and the ability for users to manage risk decreased markedly.

The clarity that ASX suggests will provide certainty as to the requirements for these foreign firms.

Under s911A of the Corporations Act a person who **carries on a financial services business in this jurisdiction** must hold an AFSL covering the provision of the financial service. Foreign based market makers only require an AFSL because they are deemed to be carrying on a financial services business in Australia under section 911D of the Corporations Act, on the basis that they intend to induce clients in Australia to use the financial service. All persons that are induced to trade against market maker orders on the licensed markets operated by ASX are trading participants most of whom have an AFSL. The only trading participants that do not have AFSLs are those that trade on their own behalf and do not have clients and are exempt from holding an AFSL (called principal trading participants).

We submit that the Corporations Act should clarify that ASX trading participants are recognised as wholesale clients, professional investors and sophisticated investors under the Corporations Act particularly as all trading participants are recognised as professional market participants and must meet stringent ASX admission criteria. We note that this clarification would have no impact on investor protection. Retail clients execute orders through a trading participant, and that participant has an AFSL and operates within the operating rules and regulatory framework for the market. We also submit that the value test within the wholesale client test of \$500,000 also excludes “wholesale” markets and products that are traded on licensed Australian derivatives markets.

Further clarity required

For regulatory certainty the Corporations Act definitions should expressly clarify that:

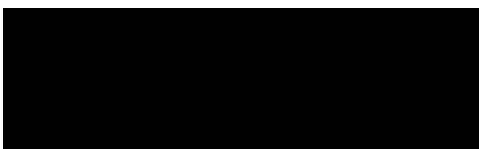
- The product price and value test for a wholesale client includes financial products available on a licensed derivatives market regardless of price or face value, and
- Trading participants of Australian market licensees are recognised as wholesale clients, professional investors and sophisticated investors.

ASX also supports simplifying the definitions given the number of different provisions in both the Corporations Act and the Corporations Regulations that must be referred to in determining what entities fall within the definitions of wholesale client, professional investor and sophisticated investor.

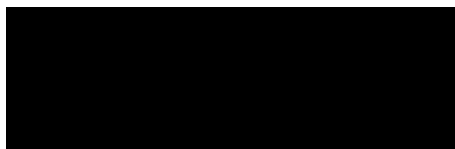
These submissions are set out in more detail in Annexure A.

We would welcome the opportunity to discuss the matters raised in this submission in more detail. If you have any queries on these matters please contact Catherine Sullivan or Sally Palmer.

Yours sincerely,



Sally Palmer
Deputy General Counsel



Catherine Sullivan
Senior Manager & Senior Legal Counsel



Annexure A

Question A16 Should the definition of 'retail client' in s 761G of the *Corporations Act 2001* (Cth) be amended:

- a. to remove:
 - i. subsections (5), (6), and (6A), being provisions in relation to general insurance products, superannuation products, RSA products, and traditional trustee company services; and
 - ii. the product value exception in sub-s (7)(a) and the asset and income exceptions in sub-s (7)(c); or
- b. in some other manner?

Regulatory ambiguity remains if the distinction between retail and wholesale clients is not clarified. Under s761G of the Corporations Act a financial product or financial service is provided to a person as a retail client unless subsection (5), (6), (6A) or (7), or section 761GA, provides otherwise. Of relevance to this submission are subsections (7)(a),(b), and (d) and s761GA. We have provided examples below to illustrate the issues we seek to address.

Meaning of retail client and wholesale client

Section 761G(7) For the purposes of this Chapter (7)the product or service is provided to the person as a retail client unless one or more of the following paragraphs apply:

- (a) the price for the provision of the financial product, or the value of the financial product to which the financial service relates, equals or exceeds the amount specified in regulations made for the purposes of this paragraph as being applicable in the circumstances (but see also subsection (10)); or*
- (b) the financial product, or the financial service, is provided for use in connection with a business that is not a small business (see subsection (12)); [subsection (12) states that a small business is one employing less than 20 people (unless manufacturing which is 100 people); or*
.....
- (d) the person is a professional investor.*

Price and Value Test s761(G)(7)(a)

Firms make markets in some products on the ASX 24 markets that are not classified as a product provided to wholesale clients under section 761G of the Corporations Act 2001, because the face value or the product value is less than \$500,000. In practice many of these products are in wholesale markets and of no interest to retail consumers. For example, the 90 Day Bank Bill futures contract has a face value of \$1,000,000 and meets the Wholesale Client test whereas the closely related Bond futures contracts which have a face value of \$100,000 do not meet the Wholesale Client test, despite both contracts being traded by the same ASX 24 participants and being similarly aligned interest rate futures contracts in the wholesale and professional futures market.

ASX submits that the definition of wholesale client should include allowance for a financial product or a financial product to which a financial service relates that is in a recognised wholesale market such as a licensed derivative market (such as the ASX 24 market). This could be achieved by the following drafting:

Section 761G(7)

For the purposes of this Chapter.....

(a) the price for the provision of the financial product, or the value of the financial product to which the financial service relates, equals or exceeds the amount specified in the regulations [\$500,000 as per Regulation 7.1.22] made for the purpose of this paragraph as being applicable in these circumstances (but see also subsection (10));

*(aa) **the financial product, or the financial product to which the financial service relates, is a derivative product traded on a licensed financial market; or ...***

Alternatively, the definition could refer to financial markets or financial products specified in the Regulations or another instrument (e.g. an ASIC Class Order).

Small Business Test – s761G(7)(b)

Firms that make markets in some products on the ASX 24 markets are financial market professionals that have met stringent entry requirements to become trading participants and are subject to ASX operating rules and contractual terms, ASIC Market Integrity Rules and Corporations Act requirements. Some of these firms have less than 20 employees. However, as professional trading participants they should not be classified as retail clients, and will not suffer any detriment if not classified in that way. ASX submits that the definition of wholesale client should include allowance for a small business that is a participant of an Australian market licensee. This could be achieved by the following drafting:

*(b) the financial product, or the financial service, is provided for use in connection with a business that is not a small business (see subsection (12)) **or is not a participant of an Australian market licensee;***

Alternatively, the definition of small business in subsection 12 could be amended by the following drafting:

(12) In this section:

"small business" means a business employing less than:

(a) if the business is or includes the manufacture of goods--100 people; or

(b) otherwise--20 people;

but excludes a business that is a participant of an Australian market licensee.

Professional Investor Test – s761G(7)(d)

Under s761G(7)(d) a wholesale client includes a professional investor. A professional investor is defined in s9 of the Corporations Act. Foreign financial services licensees are exempt from obtaining an AFSL where they provide financial services to professional investors from outside Australia. However, the professional investor test does not clearly include entities that would ordinarily be considered wholesale, professional and sophisticated investors.

Each counterparty to a market maker initiated trade on the ASX 24 market is a trading participant of ASX 24. Most of the trading participants, as defined under the ASX24 Operating Rules, hold AFSLs in order to

provide financial services but a small number are exempt from holding an AFSL under the Corporations Act exemptions. Principal trading participants are exempt from holding an AFSL because they act on their own behalf and do not have clients. These trading participants are an important part of the ASX 24 market bringing much needed liquidity and price transparency, must pass stringent admission criteria, and are recognised as professional market experts. Excluding principal trading participants from the definition of professional investor means that AFSL relief does not apply if they are a party to a market maker initiated trade. As bids and offers on the market are matched automatically market makers have no control over which participants they interact with so will not have certainty as to whether the relief applies.

A professional investor is defined in section 9 of the Corporations Act, as modified by regulation 7.6.02AE of the Corporations Regulations. This definition provides that a professional investor means a person in relation to whom one or more of the following paragraphs apply:

- (a) *the person is a financial services licensee whose Australian financial services licence covers the provision of financial services that are not limited to claims handling and settling services;*

.....

The definition of professional investor could clarify that an AFSL holder includes a person that would be required to hold an AFSL for the provision of its financial service but for an exemption from the requirement to hold an AFSL. Whilst the section does not go on to say “or is exempt from holding an AFSL” such a provision is inferred and is consistent with other provisions of the Corporations Act and practical implementation. This practical approach to implementation is supported by part (i) of the definition of professional investor which states that a professional investor includes “a foreign entity that, if established or incorporated in Australia, would be covered by one of the preceding paragraphs”. This could be achieved by the following drafting:

Section 9 – Dictionary

“professional investor” means a person in relation to whom one or more of the following paragraphs apply:

- (a) *the person is a financial services licensee whose Australian financial services licence covers the provision of financial services that are not limited to claims handling and settling services **and includes a person who is exempt from holding an Australian financial services licence for the provision of those financial services;***

Alternatively, to be specific to the trading participants that this request applies to:

- (a) *the person is a financial services licensee whose Australian financial services licence covers the provision of financial services that are not limited to claims handling and settling services and **includes a person who is a participant of a licensed market operated by an Australian market licensee;***

Alternatively, to provide a specific provision for trading participants:

- (j) the person is a participant of a licensed market operated by an Australian market licensee.**

Question A17 What conditions or criteria should be considered in respect of the sophisticated investor exception in s 761GA of the *Corporations Act 2001* (Cth)?

Sophisticated Investor Test s761GA

ASX also submits that the sophisticated investor test should recognise trading participants as professionals in financial markets that may have been granted an exemption to holding an AFSL for the financial services they provide. The basis of this submission is the same as for the professional investor test, as set out above. This could be achieved by the following drafting:

Section 761GA

Meaning of retail client--sophisticated investors

*For the purposes of this Chapter, a financial product, or a financial service (other than a traditional trustee company service, a crowd-funding service or a superannuation trustee service) in relation to a financial product, is not provided by one person to another person as a **retail client** if:*

- (a) the first person (the **licensee**) is a financial services licensee **and includes a person who is exempt from holding an Australian financial services licence for the provision of those financial services or a person who is a participant of a licensed market operated by an Australian market licensee**; and*
- (b) the financial product is not a general insurance product, a superannuation product or an RSA product; and*
- (c) the financial product or service is not provided for use in connection with a business; and*
- (d) the licensee is satisfied on reasonable grounds that the other person (the **client**) has previous experience in using financial services and investing in financial products that allows the client to assess:
 - (i) the merits of the product or service; and*
 - (ii) the value of the product or service; and*
 - (iii) the risks associated with holding the product; and*
 - (iv) the client's own information needs; and*
 - (v) the adequacy of the information given by the licensee and the product issuer; and**
- (e) the licensee gives the client before, or at the time when, the product or advice is provided a written statement of the licensee's reasons for being satisfied as to those matters; and*
- (f) the client signs a written acknowledgment before, or at the time when, the product or service is provided that:
 - (i) the licensee has not given the client a Product Disclosure Statement; and*
 - (ii) the licensee has not given the client any other document that would be required to be given to the client under this Chapter if the product or service were provided to the client as a retail client; and*
 - (iii) the licensee does not have any other obligation to the client under this Chapter that the licensee would have if the product or service were provided to the client as a retail client;**
- (g) subsection (e) and (f) do not apply where the client is a participant of a licensed market operated by an Australian market licensee.***