



20 Anson Road #19-02
Twenty Anson
Singapore 079912
+65 6722 8800 tel
+65 6722 8801 fax
www.kcg.com

March 29, 2014

Financial System Inquiry
GPO Box 89
Sydney NSW 2001
Australia

Re: Financial System Inquiry

Ladies and Gentlemen:

KCG appreciates the opportunity to comment on the Australian government's Financial System Inquiry.

KCG's comments focus on the impact of the reforms made in the last ten years on market competition and market quality, as well as feedback on the anticipated benefits clearing and derivative market competition would bring to the Australian markets.

I. Introduction

KCG is a leading global liquidity provider, operating three distinct business lines that help investors access liquidity: executions services, trading venues and market making. As a leading electronic market maker, KCG posts two-sided markets to help investors efficiently transfer the risk commonly associated with assets such as stocks, bonds, commodities and options contracts. From offices located around the world, the firm transacts business in cash and futures products across four asset classes – equities, fixed income, currencies, and commodities – on over 50 trading venues. KCG provides liquidity on the Australian markets through its Australian subsidiary, KCG Australia Pty Ltd (“KCG Australia”). KCG Australia holds an AFSL to engage in market making activities and is a trading participant of ASX, ASX 24 and Chi-X. KCG is a minority shareholder of Chi-X Global.

II. Discussion

A. The Launch of Exchange Market Competition Has Benefited the Australian Market

KCG commends the Australian Government on its support of exchange market competition for trading in listed products in Australia. This support led to the launch of



a second Australian equity exchange, Chi-X Australia (Chi-X). The launch of Chi-X has had the expected benefits of providing efficiency and innovation. Chi-X often provides a better quoted price for a security than ASX and offers a less expensive trading venue, both benefits to the end investor. Competition from Chi-X also prompted ASX to improve its technology. Moreover, ASX substantially reduced the costs of executing trades in July 2010, a direct result of the Financial Services Minister's in-principle approval of Chi-X's application for an Australian market license in March of that year.

B. The Australian Market's Current Cost Recovery Approach Has Had the Inadvertent Impact of Discouraging Market Making and Undermining the Governments Stated Goal of Creating a Competitive Market place for Trading Listed Securities

Chi-X commenced trading shortly before the introduction of the Current Cost Recovery Approach. KCG believes that the message-based fee component of the Current Cost Recovery Approach has impeded Chi-X's ability to compete as a new entrant with the incumbent exchange, ASX.

A message-based fee is particularly burdensome on market makers that display quotations on public markets. A market maker's business requires it to send messages to maintain the accuracy of its displayed quotations as market conditions change. These displayed market quotations are accessible, public prices with which other market participants can choose (or choose not) to trade. The cost of maintaining this quotation is incurred by a market maker regardless of whether a market maker executes a trade.

On new markets, which have fewer participants and thus fewer transactions, a market maker must nevertheless update its quotations as frequently as on established markets. A message-based fee, thus, can make it uneconomic to make markets on new markets that have yet to develop significant trading volume. Further, because market makers are critical to the success of any new exchange, the impact of a message-based fee on market maker's ability to provide current, competitive quotations threatens the viability of any new entrant.

When a new exchange, like Chi-X, is launched, market makers' quotations may be the only prices displayed. In actively-traded securities, natural liquidity may develop over time. However, it may take years for an exchange to have sufficient trading interest to support a continuous market without market makers. Moreover, such "natural" liquidity is unlikely to ever develop in less-actively traded instruments. Accordingly, the high cost of the message-based fee on market makers is serving to limit the ability of Chi-X to attract and retain passive



liquidity providers, such as market makers, and may undermine Chi-X's long-term viability.

C. *The Absence of Competition in the Australia market's post-trade space may have an adverse effect on Market Development*

In our experience, the introduction of competing central counterpartys (CCPs) have historically led to lower clearing costs and improved efficiencies. We believe that this would be the case in Australia. We understand that competition in the clearing space continues to be under consideration and a review by various governmental agencies will be conducted at the end of this year. We do want to underscore, however, that CCPS are central to market competition framework, particularly as the role of CCPs expands to include products that have historically traded in the OTC space. Without CCPS, we see the Australian markets as lacking the main driver of lower clearing fees, innovation and user responsiveness and support for further market development.

D. *The Absence of Competition in the Australia's Derivatives Market May Also Have an Adverse Impact on Market Development*

We believe that the derivatives market in Australia is underutilized and could be far more robust. In our view, it serves as another example of a place where competition would catalyze market development by inducing lower clearing fees, innovation and user responsiveness. We believe that competition would bring about a reduced tick size for derivatives contracts and that this change would greatly stimulate the use of exchange traded derivatives products in Australia.

KCG appreciates the opportunity to submit these comments. Please do not hesitate to contact me at 65 8288 8455 with any questions.

Sincerely,

Rebecca Weinrauch
General Counsel, KCG Asia Pacific