

Confirmed Rules on Internal Market Making for ETFs – Are You Ready?

Updated ASIC INFO 230

On 15 April 2020, the Australian Securities and Investments Commission (**ASIC**) provided updated guidance on better practices for “internal market making”¹ in actively managed exchange traded funds, or commonly referred to as “Active ETFs” (see Information Sheet 230 Exchange traded products: Admission guidelines (**INFO 230**)).

We expect this to be a focal point for ASIC, given the exponential growth of Active ETFs and the continued innovation in structures and investment strategies, particularly following the fallout of ASIC’s six-month review.

In July 2019, ASIC placed an official suspension on new ASX listings of Active ETFs that do not disclose their daily portfolio holdings and have internal market makers.² A subsequent ASIC six-month review of the industry was conducted, which identified market integrity issues stemming from certain internal market making models (where a market maker uses non-public information as part of its pricing methodology) and non-disclosure of daily holdings.³ The review ultimately resulted in ASIC lifting the suspension, and publication of the updated INFO 230.⁴

Active ETFs have reached AU\$3.9 billion in assets under management, with the total ETF market capitalisation at AU\$56.6 billion as at 31 March 2020.⁵ Active ETFs that use internal market making arrangements have ramped up in Australia, growing on average by 6.2% in monthly funds under management since launching (from April 2015 until March 2020).⁶

Confirmed – Required Measures to Manage Market Integrity Risks

In light of the updated INFO 230, responsible entities and market making agents need to review their current arrangements and develop robust internal compliance and supervision arrangements to ensure the following:

- **The input for market making quotes is limited to publicly available information** (for example, the indicative net asset value (**iNAV**), publicly available portfolio holdings disclosures, general market conditions and trading activity).

- **Information barriers are established to ensure decisions to buy or sell units are not made by “persons or systems” with knowledge of the current portfolio holdings.**
- **There are adequate arrangements for identifying and responding to instances of substantial information asymmetry in the market**, which may include cessation of market making activities or requesting a trading halt. Examples of those instances include, where publication of the iNAV has ceased, the iNAV is no longer an accurate reflection of the fund’s current value (due to technical malfunctions or stale data inputs) or when the responsible entity seeks to change the parameters of its market making operations.

Improving Internal Market Making Practices

INFO 230 also provides the following guidance on improving internal market making practices (which reiterates ASIC’s guidance provided in December 2019):

- **The iNAV being as accurate and frequently disseminated as practicably possible.** This will help to manage market integrity risks and enable investors to trade at prices that reflect the fund’s current value.

The responsible entity should have robust processes in place to maintain the integrity and continued distribution of the iNAV. For example, this could include the responsible entity undertaking its own monitoring or contracting with a second iNAV provider as a backup. ASIC notes that where an iNAV is provided, it is important that licensed exchanges are satisfied that it is calculated through systems that can be independently verified or by an independent third party with reasonably reliable and robust systems.
- **Full portfolio holdings disclosure being delayed only to the extent necessary to protect the fund’s intellectual property.** Full portfolio holdings disclosure must be provided at least quarterly with a delay of no more than two months subsequent to actual live prices being struck. The responsible entity must also disclose an iNAV as frequently as practicably possible.

1 Internal market making occurs when a managed fund’s responsible entity acts as the market maker for its own fund on the fund’s behalf, either by submitting bids and offers itself or by engaging a transaction agent that executes its instructions.

2 Refer to 19-195MR (30 July 2019), <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-195mr-asic-implements-pause-on-admission-of-managed-funds-with-internal-market-makers/>.

3 Refer to 19-348MR (11 December 2019), <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-348mr-outcomes-of-review-into-internal-market-making-for-quoted-managed-funds/>.

4 [Information Sheet 230](https://asic.gov.au/regulatory-resources/markets/supervision/exchange-traded-products-admission-guidelines/) Exchange traded products: Admission guidelines (INFO 230) (April 2020), <https://asic.gov.au/regulatory-resources/markets/supervision/exchange-traded-products-admission-guidelines/>.

5 ASX Investment Product Summary (March 2020), https://www.asx.com.au/documents/products/ASX_Investment_Products_March_2020.pdf.

6 ASX Investment Product Summary (March 2020), https://www.asx.com.au/documents/products/ASX_Investment_Products_March_2020.pdf.

- **Improved arrangements to support exiting investors and incoming investors being able to transact at “fair and orderly prices”.** While ASIC’s guidance in relation to this item is limited, ASIC specifically referred to the arrangements relating to the bid-offer spread, minimum order size and time in market each trading day. In addition, ASIC has encouraged licensed exchanges to make average bid-offer spreads for all ETFs available on a regular basis so investors can assess the cost of entering and exiting their investments.

What Should You Do Next?

In light of the updated INFO 230, responsible entities and market making agents should:

- Review current market making arrangements (including the contracts that underpin the internal market making arrangement) as a priority for compliance with INFO 230. If any changes are made to the operation an ETF for compliance with INFO 230, caution should be taken to ensure that they do not adversely impact members’ interests (a key element of the duties imposed on responsible entities under the Corporations Act 2001 (Cth) (**Corporations Act**)).

We can provide further information on how ASIC’s new guidance impacts you and how to comply or, provide assistance in reviewing your current arrangements.

- Review their risk management processes in relation to internal market making arrangements (with a focus on processes to identify and respond to instances of heightened volatility, illiquidity events, large market movements and substantial information asymmetry in the market) to ensure those processes are robust.

ASIC has specifically highlighted risk management as a factor that licensed exchanges should consider in assessing the appropriateness of internal market making arrangements for ETFs.

- Ensure that the internal market making arrangement complies with the Corporations Act, including the prohibitions on market manipulation and insider trading, the duties to act in the best interest of members, manage conflicts of interest and maintain compliant withdrawal provisions.

In INFO 230, ASIC specifically encourages responsible entities to seek legal advice explaining how their proposed arrangements will comply with the Corporations Act. We have extensive experience in dealing with such issues and would be happy to assist you navigate through the complexities of the legislation.

- Review their Product Disclosure Statements to ensure they provide adequate disclosure of the additional risks of ETFs.

For example, the responsible entity may not always be able to make a market in times of uncertainty about values, due to its duty to act in the best interests of members. In addition, the fund will bear the risk of market making activities, which may result in a profit or loss to members. Based on our industry experience, ASIC has placed a high priority on improving disclosure for managed investment schemes.

- Ensure they have the appropriate competencies, resources, policies, procedures, systems and controls as necessary to carry out their role in relation to the internal market making (similar to the resource and competency requirement for issuers in Schedule 10A of the ASX Operating Rules).

This is another area that ASIC has specifically highlighted as a factor that licensed exchanges should consider in assessing the appropriateness of internal market making arrangements.

How Can We Help?

Whether you are a responsible entity or market making agent of an existing ETF, or you are looking to enter the ETF market, we can help you with the matters discussed above.

We would be pleased to assist you in establishing and admitting an ETF, with particular regards to compliance with INFO 230, Schedule 10A of the ASX Operating Rules and the Corporations Act.

We note that some of the practices outlined in INFO 230 may change over time as the market continues to grow and innovate. We will continue to monitor developments in this area and assess the impact on the industry.

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