Dark liquidity and high-frequency trading: Proposals

Consultation Paper 202

20 May 2013

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1. General Concerns

AFMA recognises and commends the sound empirical work ASIC has undertaken in relation to dark liquidity and high frequency trading on the basis of the proposals in Consultation Paper 202. This has materially advanced debate on the appropriate form of regulation but further steps in policy analysis and development are required before a number of the measures ASIC is consulting on through CP 202 could be contemplated for implementation. The outcome would likely include refinement of some measures, exclusion of others and consideration of alternative approaches that would more effectively achieve the stated objectives.

All regulatory interventions carry costs, and typically significant costs, in one or more of compliance, creating barriers to competition, curbing innovation, decreasing the efficiency of markets and increasing transaction costs.

Regulators should not hurry to impose these costs when the subject of concern may not eventuate or might be addressed through more efficient market means.

ASIC currently has a policy of looking to be pre-emptive in its predicting of problems being identified. Pre-emption requires predicting of the future, and the shaping of appropriate responses to problems. This is a very difficult project and one that may be likely to result in outcomes that err on the side of excessive risk reduction at the expense of excessive cost increases.

Moreover, AFMA is concerned that some proposals in CP 202 are not based on sound risk assessments, and some analysis may have misidentified risks through technical approaches that are overly inclined towards regulatory intervention. The assessment around dark pools, for example, uses an All Ordinaries-wide average impact drawn from a Comerton-Forde and Putniņš paper[1] as a justification for intervention in dark liquidity. While the paper notes the impact as economically meaningful an impact of 15 basis points, *as this is an average* impact over the 500 stocks in the All Ordinaries it may not be apparent that S&P/ASX 50 impacts (the most significant stocks) would likely be less than one basis point. An impact of less than one basis point is a small fraction of transaction costs[2] and not economically meaningful.

AFMA is concerned that the timeframe within which difficult and complex issues such as dark liquidity are being considered, which incorporates a period when new structural regulation will take effect, creates risk of inappropriate regulatory actions. ASIC is doing

[1] We note the Comerton-Forde and Putniņš does not appear to have been peer reviewed at this time.
[2] Including exchange (trading, clearing, settlement), brokerage and spread costs.

sound research looking at the issue of dark liquidity in particular but should not expect to find optimal answers working within a matter of months.

It is important to ensure that the scope and scale of changes to the market regulatory landscape is prudently managed. As it stands, new proposals for far-reaching changes are being proposed when existing changes have not been bedded down and their full effect are not understood.

The proposal in CP 202 to remove time priority for proprietary orders is a good example of this. This would be a disruptive and far-reaching change that has not been properly explored and is in our view not sufficiently justified in the consultation paper. Further, it is a blunt instrument for addressing conflicts of interest that are already well managed by responsible participants.

As there is a Treasury consultation process already underway to update the market licencing framework there is a ready opportunity for these issues to be considered in the appropriate venue. ASIC should not proceed with implementing regulation in this regard on a timetable that pre-empts the Treasury process; particularly when its own research has suggested there is no imminent risk from dark liquidity and that any risks that are present are likely to be ameliorated by a yet-to-be-implemented untargeted price improvement requirement.

While there is not yet a formal framework placed around the appropriate limits of the Market Integrity Rules power we are concerned that ASIC has been steadily increasing the application of these rules areas for which they were not envisaged and may well not be appropriate. We would request that ASIC review the appropriateness of using Market Integrity Rules for purposes that effect substantive policy changes in Government policy.

As regulators are necessarily a stakeholder in the areas they regulate, and understandably place the highest priority on reducing risk, better regulation supports Treasury as the more appropriate place to deal with framework policy questions.

We also note in CP 202 that regulatory intervention is proposed often in the form of new rules which are often prescriptive in nature and rarely in the form of guidance. ASIC has recently made good use of guidance in its proposals in CP 184 and we would support this approach being adopted here.

2. Dark Liquidity

AFMA commends ASIC on its empirical approach to the issues considered in CP 202, and notes the important contribution that ASIC's research has made to the public debates on the issues both domestically and internationally. ASIC's work has lifted the quality of debate and moved it to a firmer footing where competing broad statements have been replaced with more direct analysis of the fit of proposals with desired policy outcomes. ASIC's work should contribute to any policy determination by the Government in relation to dark pools.

AFMA also commends ASIC's response to the industry's request for the targeting of intervention in relation to dark liquidity on a stock by stock basis. As noted in CP 202, AFMA proposed a model for the targeting of intervention in relation to dark liquidity in our submission to CP 168. This model proposed that an examination of the relationships between the ratio of short term to long term volatility, the average spread and the average daily traded notional. Subsequent to this, simpler implementation based around a cut-off drawing on this analysis around the S&P/ASX300 mark was discussed.

AFMA is not committed to these particular proposals and we are pleased to examine alternative methodologies aiming to target dark liquidity intervention to where it is most appropriate such as those put forward in the Consultation Paper.

AFMA's previous work suggested an alternative cut-off may be based on the ratio of short term to long term volatility. A high ratio may suggest that stocks are trading inappropriately on an intraday basis given their long term volatility.

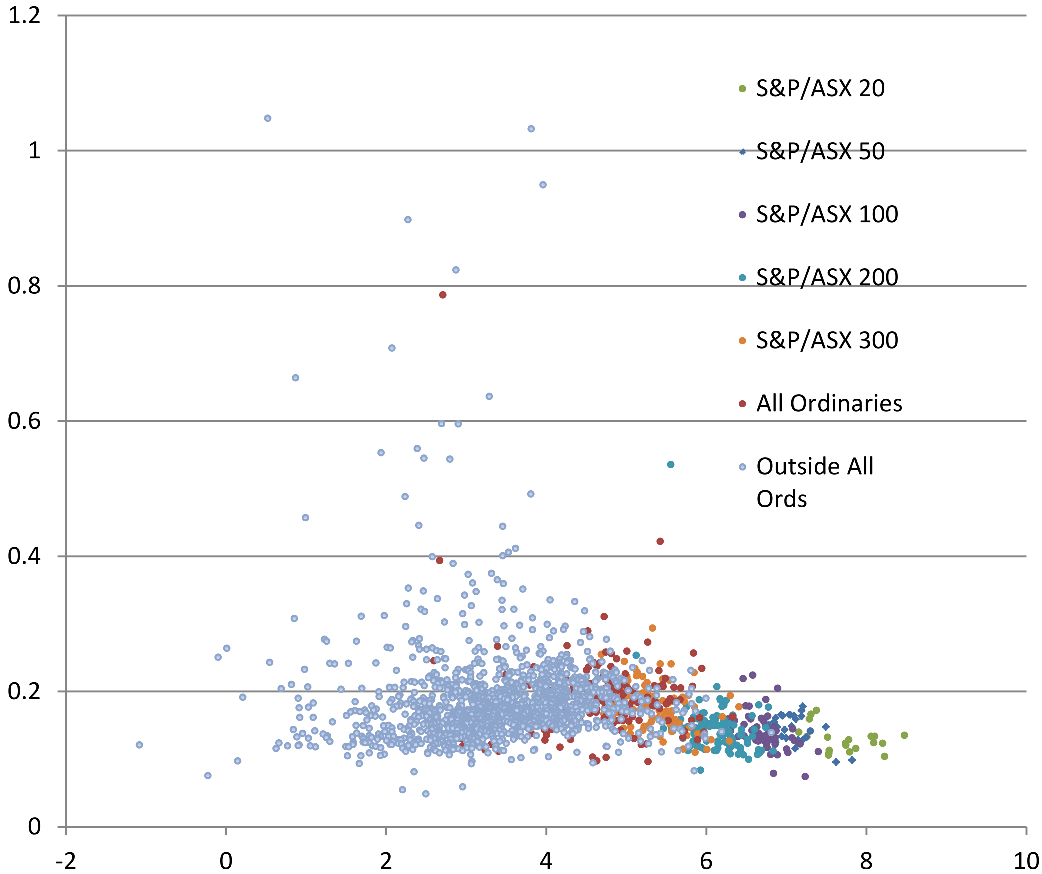

Figure 1 – Ratio of Short term to Long Term Volatility vs. Average Traded Value (Log10 scale)

A graph of the relationship between the ratio of short term to long term volatility versus the log of average daily traded notional during the continuous phase gives an indication of the types of approach that could be considered. Further work would need to be done to adjust for stock construction issues (as discussed below) before this approach could be used as a basis for identifying stocks with potential price formation issues.

While the intention of ASIC's models of targeting is aligned with the industry request for a targeted response, technical and timing concerns with the proposed approach and the analysis that justifies it, prevent AFMA from supporting the proposals in their current form.

AFMA's view is that ASIC's sound intention to avoid blanket measures that would indiscriminately intervene in the market is a complex undertaking and require significant work to get right. It should be recognised that there are no good international precedents for a targeted approach to protecting price formation from excessive migration to dark liquidity and there has been little academic work on different approaches at targeting. ASIC should not be concerned that it has not yet found the right response to these issues.

2.1. Concerns with the ASIC Proposal

A fundamental concern AFMA has in relation to the proposals is that they adopt an (a) relative and (b) historical baseline approach to determining when intervention is required. These are distinct matters and create issues that cannot be adequately corrected for, and in our view are terminal for the proposals.

Further, we consider that the levels proposed by ASIC are based on an analysis that would lead to action on stocks where ASIC's research suggests there is no economically meaningful impact. The approach that is used is demonstrated to be highly sensitive to stock universe selection and a more refined approach is needed.

Finally, AFMA considers that the issue of the impact of stock construction and dark liquidity has not been adequately explored given that high spread cost is a recognised driver of migration to dark venues. While stock construction is an issue for corporations to consider, and for more empirical work in general, it would appear appropriate to make adjustments in any scheme designed to limit dark liquidity migration where this migration is likely to be driven by high relative spread costs and the use of dark venues creates significant savings for investors that go some way to compensating for these construction issues. We note that stock construction, despite being elemental to market performance and efficiency, is poorly understood, and there is scope to increase understanding in this area.

These concerns are explored more below.

2.2. Relative vs. Absolute Threshold

The question of whether performance of price formation should be considered on a relative or absolute basis is critical and has so far not been subject to explicit public consideration.

AFMA's proposal in response to CP 168 sought to isolate all stocks with marginal price formation and to protect these stocks from impacts to their price formation by limiting migration of liquidity to dark venues. This is a conservative approach that seeks to intervene only where the risk of negative impact is over an *absolute* defined threshold.

In contrast, ASIC's proposal seeks to define a maximum change in market quality measures *relative* to a historical reference point for each stock that beyond which restrictions on dark liquidity will be imposed. In seeking to optimise stock performance this is a far more interventionist approach particularly for stocks that have no price formation issues.

The threshold for intervention set on a percentage (relative) basis leads to outcomes that may be at odds with investor expectations. For example, a stock with an average of $10 million dollars of stock at the spread that experiences a reduction to $8.5 million for Option B1.1 or a reduction to $8 million for Option B1.2 would be enough (with a sufficient migration to dark venues and percentage spread changes that could equate to less than 1 basis point) to trigger strong restrictions on dark liquidity, even though $8 million would still be widely considered very significant liquidity, and not cause for restrictions on use of dark venues.

Conversely for stocks with lower liquidity and existing marginal price formation the relative approach ASIC propose would result in less intervention. For example, a stock that has pre-existing marginal liquidity of an average of $1000 at the spread would not see any restrictions on dark venues until average liquidity fell to $850 or $800.

This choice of a relative threshold is a critical issue with ASIC's approach. For large investors it is not relative changes in liquidity that matter so much as the ability to access substantial liquidity – that is to say that investors measure liquidity to an absolute scale for large and mid-capitalisation stocks.

It would be more consistent with the regulatory approach in many other areas of the financial markets and elsewhere if minimum acceptable standards were proposed rather than regulatory requirements to optimise performance.

2.3. Threshold Levels not Economically Meaningful for the most Significant Stocks

We note that the trigger limits are tight. Dark liquidity exceeding 10% is not a high level as it would reserve 90% of liquidity for lit markets.

ASIC's choice of a 10% figure for dark liquidity draws on the Comerton-Forde and Putniņš paper and uses its "economically meaningful" conclusion[3]. This paper looked at the entire All Ordinaries as its stock universe which includes the top 500 stocks by capitalisation and discusses average impacts across this divergent group of stocks. In our view discussing average impacts across such a diverse range of stocks may lead to inappropriate interventions and is not a sufficiently targeted basis for intervention.

For example, the average traded spread on the All Ordinaries ranges from around 2.5 basis points (0.025%) for the stocks with the tightest spreads to well over 400 basis points (4%) for the widest spread stocks. This is a function of the breadth of the companies in this index which range from a few tens of millions in market capitalisation (around $45 million) to over $170 billion in the case of BHP Billiton[4].

In the context of the this broad spread of stocks, the average spreads are a very large at 129 basis points (1.29%) and a 12% increase in spreads is an economically meaningful 15 basis points. However, for the stocks in the S&P/ASX 50 in comparison the average spread is much lower at around 7 basis points. An increase of 12% would be around 0.8 basis points and this is not an economically significant impact, particularly given the relative size of other costs.

For perspective, spread costs, exchange costs and brokerage would result in real cost increases before taking into account spread savings from using dark venues of around 3% for S&P/ASX 50 stocks and these costs should be adjusted by benefits in terms of reduced spread and signalling. We note that in some cases spread costs alone are over 20 basis points due to stock construction.

To demonstrate the necessity in selecting the appropriate stock universe when determining likely impacts, using the simple approach relied on by ASIC, consider that, as the average spread for all listed stocks on the ASX is around 700 basis points, impacts of dark trading on average spread could be estimated at 84 basis points. This scale of impact, however, could even be misleading when considering likely impacts on stocks in the S&P/ASX 50 trading on spreads of 2 or 3 basis points.

As such, it may be inappropriate to formulate interventions for the stocks in the S&P/ASX 50 for example, on the basis of a group of stocks with such wide average spreads. To do

[3] See Comerton-Forde and Putniņš and ASIC Report 331 at 103.

[4] http://www.bloomberg.com/quote/BHP:AU as at 9 May 2013.

so would be to take action on the basis of economically meaningful impact that is not actually present under closer examination for the most significant stocks.

ASIC should ensure that when evaluating risks to stocks it uses a realistic basis to determine if impacts are likely to be economically meaningful for each particular stock and their likely relevance in comparison to other transaction costs such as spread, exchange and clearing fees, brokerage, etc.

We note that if the Comerton-Forde and Putniņš paper's view that 15 basis points is economically meaningful is accepted, working backwards to see where a 12% increase in spreads would create an increase of 15 basis points in spread costs this would suggest stocks outside the top 400 based on average spreads. A 10 basis point economically meaningful level would approximate to stocks outside the S&P/ASX 300.

2.4. Historical Baseline

ASIC's proposal to use a baseline from 2011 in a time of relatively low dark pool usage is another critical issue and barrier to industry support for the model.

An historical baseline approach is inherently problematic and should be abandoned.

New stocks will emerge that will not have a baseline in the referenced period. Addressing this can only add substantial complexity and result in a hybrid system with some stocks assessed by a baseline and some by 'some other measure'. Consistency should be an aim of any proposal and would not be possible with this approach.

Also, the further in time the market is from the baseline period the increasingly irrelevant it will become. The market itself has been changing rapidly over time and it is quite possible that depth could increase or decrease due to market-wide trading technology developments (such as electronic market making improvements) or other structural factors. These developments could result in the triggers being activated unnecessarily or inappropriately or not being activated when they should be.

Similarly for individual stocks it is likely that as time progresses many will undergo significant changes including reconstructions, corporate actions, ownership changes that may affect the free-float or trading velocity, and increases or decreases in market capitalisation and stock price (and hence relative tick size). Adjusting for these changes to maintain the relevance of the historical baseline for all listed stocks that were in existence in 2011 would in practice be impossible.

By the likely time of implementation in 2014 the baseline period will already be 3 years out of date and by 2017 or 2018 it will likely already be irrelevant and need replacement. As it will not be possible to reset the baseline to a period after the more widespread adoption of automated dark liquidity (as no more recent period without dark liquidity is likely to exist) it is likely that the replacement methodology would need to be independent of a baseline.

It would be preferable to move to a methodology in the first instance that will not require replacement in a relatively short period of time and be likely to decline in market relevance increasingly with time.

2.5. Integrating Stock Construction into the Methodology

While the Consultation Paper offers some proposals in relation to stock construction, these are not sufficiently integrated with the proposals that relate to dark liquidity given the fundamental connections between these phenomena.

A review of the stocks that are most traded in dark venues[5] would suggest that stocks with high tick size to stock price ratio (for a given liquidity) are associated with relatively high levels of dark trading.

This relationship is viewed in the industry as causative, as investors and brokers see much higher relative gains in saving spread costs when these costs are high in basis point terms and are thus more inclined to seek fills in dark venues at the mid-point. Telstra is the standard example in this regard. The stock is the most traded by value in ASX's Centre Point dark pool with $506 M traded in March 2013. Its spread cost is approximately 20 bps, which given its high liquidity is quite high. By trading in the dark in Telstra to address this relatively high spread costs investors reduced their transaction costs by approximately $500,000 in March, in the Centre Point dark pool alone.

As such the use of dark venues for some stocks may be a way of the market 'working around' stock construction issues with particular stocks.

AFMA does not make any recommendation about stock construction, listed companies have flexibility around how they choose to construct their stocks (within reconstruction cost constraints) as they see fit and in any case there is insufficient empirical work to guide work around finding the right balance between keeping spread costs low while sufficiently encouraging the creation of liquidity at each tick price point (keeping ticks economically meaningful). However, given that high spread costs (and hence by implication stock construction) are such key factors in driving participation in dark liquidity it is appropriate that any proposals to limit dark liquidity adjust appropriately for these factors.

[5] see for example http://www.asx.com.au/documents/trading_services/ASX_Advanced_Order_Types_March_2013.pdf

For example, it may be appropriate to exclude stocks that have high dark liquidity participation for reasons of stock construction from measures to restrict dark liquidity participation. If high levels of dark liquidity in these stocks are driven by a logical reaction of the market designed to lower costs to investors then it may be inefficient and produce sub-optimal outcomes if this logical use of dark liquidity with measurable benefits for a particular stock is unduly restricted.

The costs of stock construction in more liquid stocks can be seen to be in the order of up to 20+ bps, that is stocks could be trading with (ignoring dark trades) spread costs of 23 bps or more when they could, given comparisons with similarly liquid stocks, be trading on spreads of 2 to 3 bps. In comparison, the transaction costs for decreases in informational efficiency is indicated by Comerton-Forde and Putniņš for the migration of 10% of a stock's liquidity to dark venues at around 12%. As noted for a liquid stock trading on an average S&P/ASX 50 spread of around 7 bps this could equate to an increase cost in the order of 0.8 bps. Therefore for some stocks the concerns around dark liquidity are orders of magnitude less significant in terms of spread costs.

More generally, and significantly in terms of the principles of ASIC's approach to responding to any 'market failure', if there is an issue that has a known cause in general it is more appropriate to either address that issue directly or accept the prevailing situation rather than make changes in an unrelated area in an attempt to 'compensate'. Addressing areas unrelated to the underlying cause will deny the efficiencies the market has identified and so reduce market efficiency while leaving the underlying cause unchanged.

2.6. Adverse Selection Risk Argument

Comerton-Forde and Putniņš note in support of forcing less informed traders to go to lit markets by denying them access to dark liquidity that "When *forced* to interact with informed traders in a single market, uninformed traders implicitly contribute to price discovery *by providing compensation to informed traders* for the costs of becoming informed" [emphasis added].

Particularly as retail investors may be less informed than professional investors, ASIC should ensure its approach adequately considers the appropriate role for regulation in engaging with "the wealth transfer from uninformed traders to informed traders" that Comerton-Forde and Putniņš describe.[6]

2.7. Policy Siting and Sequencing

[6] Comerton Forde and Putniņš, p.27.

As proposals around thresholds that are many multiples of prevailing average trade sizes are existential questions for dark pools AFMA would view these are properly determined by the Government's policy making body rather than a regulatory body. The role of the regulator in the Australian context does have some residual policy making function but this should not extend to the potential effective termination of a globally significant development of equity markets.

Regulators are stakeholders in policy matters relating to their regulatory area with a well-recognised bias[7] towards risk aversion. There are incentives for regulators to decrease risk that are not balanced by incentives associated with the benefits in efficiency, and competition associated with refraining from regulating. For this reason while regulators will typically retain a residual policy role more balanced outcomes may be expected from policy bodies that are at least one step removed from the implementation front-line.

Further, broad policy is not properly made with administrative rules whose purpose is to fine tune the application of Government policy. Just as by-laws should not set a framework for environmental policy so market integrity rules should not define the market. Market definitional issues should be done within the procedural disciplines of the Corporations Act, and, where more flexibility is appropriate, within the Parliamentary oversight of the accompanying regulation. Market Integrity Rules should then be used to 'gap fill' and round out more minor policy matters.

While regulators can look to their respective Acts to guide their work given the evolution of the structure of executive Government to include substantial regulatory bodies such as ASIC and the delegation of policy making functions, it would be beneficial for the Government to consider more formal work to fill out the framework for policy construction and delegation.

This would dovetail with the work done in the Uhrig Report which deferred to the respective legislation (and their interactions with their Minister) in regards to statutory bodies determining their appropriate role. Particularly in relation to policy creation, and the appropriate limitations on powers in this regard, more structure is appropriate to prevent power drift, and to ensure resourcing is optimally and appropriately deployed.

The Corporations Act framework does not envision the current market realities, these need to be addressed at this level by the Treasury review, and then subordinate rules and regulations fitted into that framework.

Proceeding without the very fundamental licencing changes that are contemplated by the Treasury review being first settled may be to act before the key framework is in place. Only once the regulatory framework has evolved through this work and the

7 See the 2005 Tony Blair speech on the motivational bias for regulators
http://www.guardian.co.uk/politics/2005/may/26/speeches.media

proper role for dark pools has been established should work proceed on fine tuning the framework.

Completing the Treasury work first would also enable consistent application across exchange-run dark pools such as the ASX's Centre Point and broker run pools.

2.8. Price Improvement

Market Participants make particular note that ASIC's untargeted requirement for 'meaningful price improvement' is yet to be implemented.

While ASIC has referred to the effects of a similar policy change in Canada that led to an approximately 40% drop in dark pool activity as a guide to what can be expected to occur in the Australian market, a prudent approach to domestic regulation may be to wait until this major change has been implemented and data has been gathered about its effect before proceeding to implement subsequent changes.

Similarly, any changes in tick size as proposed in the Paper could also be expected to have an impact on dark venues that should be first observed before further changes are contemplated.

As a general regulatory principle, changes should not be compounded on one another when there are no immediate risks to be addressed. If dark trading does decrease significantly as per the Canadian experience any risks to price formation could be expected to also reduce again, weakening the case for intervention at this time.

Given the substantial change to market dynamics that is likely to accompany price improvement many market participants hold that this alone may be reason enough to defer further change until a new baseline has been established.

3. Responses to Specific CP 202 Questions

B1Q1 Do you agree that a safety net proposal like this is necessary?

While the industry supports targeted protection of price formation AFMA does not support the implementation of either of the proposed methodologies for targeting of dark liquidity intervention due to the technical concerns discussed above which would result in inappropriate intervention, and the preference for the policy work to take place in the context of the Treasury licencing review.

Further, there are pending changes in the price improvement requirement that are expected to have a significant impact on dark liquidity.

B1Q2 Do you agree that the proposed triggers in Option B1.1 and Option B1.2 are appropriate indicators that there has been degradation in price formation?

AFMA is concerned that the historical benchmark approach proposed by ASIC is an inappropriate approach as it will lose relevance comparatively quickly, is relative rather than absolute and therefore is more aligned with attempting to optimise the market rather than a more conservative approach to market intervention.

AFMA is also concerned that the proposed approach does not sufficiently compensate for the role of high tick to stock price ratios in dark liquidity migration for affected stocks.

B1Q3 Do you have a preference for either option? Please explain your rationale.

AFMA does not support either option but prefers option B1.2 to B1.1.

It is unclear where the one third of a category trigger comes from in B1.1. When two thirds of stocks in a category do not show even a 4% increase in quoted spreads it is difficult to understand why all stocks in that category should be subject to restrictions on dark trading.

This is particularly the case when spreads are tight (such as in the most capitalised stocks) and a 4 % increase may be a fraction of a basis point.

B1Q4 Are there any securities or group of securities for which it would be preferable to implement a minimum size threshold immediately (e.g. securities outside the S&P/ASX 300)? If so, which threshold should apply?

If an appropriate methodology was adopted that determined that the cost benefit analysis supports intervention in a particular stock to protect its price formation then there should be one consistent and principled approach. It is difficult to see how multiple inconsistent approaches would be a desirable outcome.

B1Q5 Do you have any views on the proposed implementation timeframe of 40 business days for the thresholds if triggered?

Market Participants have a full development and deployment schedule for 2013 based on the extensive work that has already been scheduled by ASIC through the previous consultation processes.

The tiered threshold approach while more appropriate than a single threshold given the divergence of stocks in the listed market will take additional time to implement.

Some members indicate concern that the proposed timeframe may be too tight and suggest 6 months.

C1Q1 Are there any reasons that the proposed information should not be made public?

Where appropriate disclosures are made to clients of broker venues and marketing is not conducted publicly, a requirement for public disclosure may be disproportionate to the risks involved.

The industry supports increasing transparency around alternative execution venues by the publication of information in Proposal C1 where there is public marketing of the venue to non-wholesale clients that would make it appropriate.

We would suggest that guidance should be sufficient to implement this proposal.

C1Q2 Is a website an appropriate publication means?

A website is a suitable venue for publication.

C1Q3 Is there additional information that market users should understand, or be informed of, about the handling and execution of orders through a crossing system?

AFMA members believe the proposal is sufficiently detailed where public marketing is involved.

C1Q4 An alternative to crossing system operators publishing the monthly aggregate turnover statistics in proposal C1(h) is for ASIC to publish these statistics based on the reports we receive under Rule 4.3.2 (Competition). Do you have a preference for whether ASIC or crossing system operators should publish the statistics?

If publication of these statistics is made a requirement, for reasons of efficiency market participants would support ASIC publishing the statistics for all venues on an aggregated basis. Market users would be interested in volumes matched against lit markets as a total as would listed entities, not necessarily which crossing system operators had executed the most volume.

C1Q5 Would there be benefit in ASIC maintaining a register on our website of all crossing system operators with a link to each crossing system's website where the information in this proposal is disclosed?

AFMA members do not see sufficient value in this proposal to warrant proceeding.

C2Q1 Do you have any comments on our proposed approach including whether this information should be made available only to a crossing system's users, or to wider market users?

AFMA members support a principles-based approach to increasing disclosure requirements around dark venues. There are concerns that the current proposal may be too prescriptive.

C3Q1 If a market participant routes client orders to another market participant's crossing system (e.g. through an 'aggregator'), it is important for the market participant's client to also receive the information on the crossing systems its orders may be routed to. We have proposed a new rule to require this. Are there any alternative means to achieve this? One alternative is to require that all the matters in proposal C2 be made publicly available.

Members suggest that guidance may be appropriate in regard to this proposal. Public disclosure would then not be required but may be used to achieve the outcome if desired. ASIC should only require disclosure of the system, not of any functionality of that system. ASIC has already proposed that crossing system operators publish information about their crossing system. A broker can direct the client to the appropriate website for information and updates.

C3Q2 Is six months sufficient time to amend disclosures for existing and new clients?

Nine months is supported as a sufficient time for the disclosures.

C4Q1 Do you agree that a client should be made aware when a market participant trades with the client as principal and when trades are executed on the crossing system?

We note the drafting issues raised by members in relation to the impact of the proposed drafting on existing requirements.

In relation to the substantive question, AFMA views this as producing limited value and creating technical difficulties in terms of implementation. Systems to create contract note changes in particular would be expensive.

The industry notes little interest from wholesale clients in this information which is available on request.

C5Q1 Do you have any comments on our proposed approach?

This proposal is supported in principle. Further detail around any associated guidance is requested for review by participants.

C6Q1 Is there demand from clients to opt out of trading in a crossing system?

Members report that some clients prefer not to participate in trades that involve crossing engines.

C6Q2 Should clients have the option to opt out of all forms of dark liquidity, including principal trading?

The industry is not opposed to providing an option to opt-out of crossings. AFMA is concerned, however, about ASIC setting regulated pricing for execution features in a competitive and well contested market.

AFMA holds that ASIC should remove the requirement to price features (including but not limited to a crossings opt-out) at zero and leave the pricing of this requirement to the market.

C6Q3 What is involved for crossing system operators to build the capacity for clients to opt out in this way?

Some participants already have this capacity while others will face build costs. Build costs will include the requirement to add options to existing routing systems and build and maintain systems that hold lists of clients that have opted out.

C7Q1 What is involved for crossing system operators to undertake the proposed monitoring?

ASIC's proposal is ad hoc and may not be a proportional response to the risks associated with crossing venues. These matters should be rolled into the Treasury consultation on market licencing to ensure monitoring requirements are appropriate to the role of different types of market venues and their associated risks.

C7Q2 Is six months sufficient time to implement the changes?

Market participants suggest a 12 month lead time for implementation of increased surveillance given the already substantial regulatory load driven by other changes.

C8Q1 Do you agree with our approach to capturing orders that rest or transit through a crossing system?

Given the already extensive order keeping obligations further record keeping is not considered necessary.

C8Q2 Will the proposed requirements for record keeping successfully enable the replay of orders in a crossing system at any point in time?

While the data would be available replay of markets is a function that would require custom software to be built. Requiring replay software to be built for all crossing engines is not supported.

C9Q1 What processes do crossing system operators currently have in place to inform clients of system issues?

At this time crossing systems are clearly not systemically important and are an optional service provided to clients of a broker. The Treasury review of market licencing should allow for the possibility that particular systems may become systemically important and have proportionate regulation should this occur.

We do not believe ASIC should be creating more structures to address potential developments and do not agree with the statement at this time that “It is important that they have adequate systems and controls and business continuity planning to ensure the stability of the wider Australian market”. Should all the crossing systems currently in existence in the Australian market stop functioning trading would continue uninterrupted on the lit venues and flow would all be directed to these venues. While it is possible to envisage a time when this may not be the case for the foreseeable future this is likely to hold.

Outages in relation to optional services provided at the discretion of a broker do not warrant the same type of arrangements appropriate for systemically important markets. Market forces are sufficient to address problems with outages within broker systems. Regulatory measures should be proportional to the risk they are addressing.

C9Q2 Is 60 minutes an appropriate time period to require a crossing system operator to inform its users and ASIC that there is an issue that may materially interfere with the execution of orders in the crossing system?

We do not support measures to require outages in non-systemically important crossing venues to be reported to clients and ASIC. These systems are an additional service and their availability is a matter for market participants and their clients.

D1Q1 Do you agree that tick sizes are constraining some security prices and that this may be leading to more trading shifting to the dark?

It is generally agreed that a high ratio of tick size to stock price for liquid stocks contributes at least one factor to the level of dark trading in stocks.

D1Q2 Do you agree that we should target the most affected securities rather than a complete overhaul of the tick size regime?

There is no support for creating different tick size regimes for particular securities, given the associated costs and technical difficulties, and the complexity it would introduce for retail investors, particularly as stock construction allows companies to set stock prices and hence tick size to stock price ratios as they see fit, subject to the associated costs of doing so.

D1Q3 Do you have a preference for Option D1.1 or Option D1.2? Is there an alternative model we should consider?

There is no support for option D1.2. We note that individual firms can remove tick constraints on their stocks by restructures if they so choose.

Some members support option D1.1 and some prefer a full overhaul of the tick regime while others do not support change given the associated costs. We note that there does not appear to have been sufficient consideration to problems associated with very low tick to stock price where liquidity is insufficient to support pooling of liquidity at tick intervals. Further work on optimal stock construction, the relationship between liquidity and tick size to stock prices ratios, and an integration of this work with any proposals in relation to restricting access to dark liquidity as discussed previously were this option to be pursued.

D1Q4 Is a pilot desirable and is six months sufficient time to introduce it?

There is a consistent view that given the other regulatory change loads that 6 months is insufficient at this time.

Market participants do not support a pilot of the proposal given the additional costs.

D2Q1 Should the proposed rule permit market participants to elect for their participant identifiers to be excluded from these reports when those market participants trade exclusively as principal (i.e. not on behalf of clients)?

Market participants note that removing participant identifiers from principle trades may not be sufficient to prevent reverse engineering of proprietary positions.

D2Q2 Do you agree that there is benefit in disclosing the particular crossing system *where a trade has been matched?*

Members did not note significant benefit from a participant perspective but do not object to the proposal.

D3Q1 Do you have any comments on the proposed new and amended rules, or the time frame for commencement of these rules?

Proposal D3(c) in relation to removing time priority for proprietary orders is an inappropriate and disproportionate response to conflicts of interest issues that already have a sound management framework.

Removing time priority for house orders would be a considerable restructure of broking and trading activities, would be costly to implement and would generate substantial inefficiencies.

ASIC has provided no substantive justification for the proposal and as such it has no basis to proceed. As it is indiscriminate in its application to proprietary trading it is likely to impact liquidity and client services such as facilitation.

Technically the proposal would also be difficult to implement and would likely result in many brokers choosing to trade away and reducing the attractiveness for international banks in having an Australian office. This in turn would decrease the attractiveness of Australia as a financial centre.

The proposal D3(d) would be disruptive to automated facilitation, which will often stand in a market making role between clients in the market so reducing client risk. Preventing proprietary trading meeting client trades that might otherwise have crossed would be complex and costly and would likely decrease client risk reducing offerings while providing no benefit to the market or clients.

ASIC has not made the case for these changes which are strongly opposed by the industry.

The industry has consistently argued that there is a large amount of change that is already underway and further market restructuring change is undesirable. It would be of benefit to industry confidence in the Government's approach to regulation if proposals proceeded through a structured analysis such as ICSA's Principles for Better Regulation [8] which propose a sensible approach to assessing the need for regulation.

[8] http://www.icsa.bz/img/letter_pdf/PrinciplesBetterRegulation.pdf

If ASIC does proceed with this measure it should discriminate between client-related and non-client-related proprietary orders. Orders originating from a bank's proprietary desk are different in nature to those associated with unwinding risk taken on from clients, associated with swaps or other client related activities. While we see harm to the attractiveness of Australia as a financial centre in forcing each bank's proprietary desk to trade away given the appropriate conflict of interest management that is currently required, we see further damage to the domestic market if these requirements are also extended to client related orders as it will likely lead to a reduction in client service offerings and increased costs associated with trading away proprietary flow.

D3Q2 Are there any other rule amendments or proposals we should consider for conflicts of interest?

No.

D3Q3 Do you have any comments on the proposal to supplement our guidance in RG 181?

The approach of supplementary guidance in relation to handling orders is supported.

D4Q1 Do you agree that direct cash payments and cash rebates should be prohibited?

As ASIC acknowledges there is no issue with inappropriate payments at present, this proposal should not proceed.

ASIC should not be limiting commercial arrangements where conflicts of interest are appropriately addressed. Again ASIC is proposing a disproportionate response to an issue that is not present and could be appropriately managed.

As a responsible regulator ASIC should try to avoid mandating commercial arrangements. Commercial arrangements often produce more efficient and lower cost outcomes.

The case has not been made in the Consultation Paper for such a serious intervention in the market. ASIC should maintain the prevailing approach which looks to ensure conflicts of interest are managed rather than using interventions such as banning direct payment for flow.

D4Q2 How would the prohibition of direct cash payments and cash rebates affect commission-based incentives (i.e. commission sharing or commission recapture arrangements) currently used in the industry?

The proposal to ban direct cash payments would devalue retail flow and may prevent decreases in execution cost that have been seen in the US. Participants have a range of views on the proposition.

D4Q3 Commission-based incentives may raise similar issues to direct cash payments and cash rebates. How prevalent are commission-based incentives and should they also be specifically prohibited?

D4Q4 Do you agree that soft dollar incentives should be treated differently to direct cash payments?

There are a range of views on these proposals.

D5Q1 Should market participants be required to disclose whether a proposed order is on behalf of a client or as principal (including for a related body corporate)? What controls should be in place to ensure there is appropriate representation about the nature of liquidity?

A majority of the market views market intervention in relation to Indications of Interest (IOI) are not justified. The Consultation Paper's use of the term "proposed order" is misleading. IOIs are not proposed orders but non-binding indications of interest.

Existing prohibitions around misrepresentations are sufficient to deal with any of the suggested issues.

IOIs are managed specifically to avoid leakage of client information. Clients from time to time will ask for orders not to be sent around via IOI or to have communications on them limited to particular types of counterparties. Market participants and clients have a sound understanding on the appropriate use of IOIs and regulatory intervention by ASIC is unjustified.

D5Q2 If a market participant discloses that a proposed order is a client order, should such disclosure only be permitted when the market participant has received a client order? Or are there instances in which a client would not want to place an order with a market participant, but would want the market participant to send an indication of interest?

There is currently no case for intervention in relation to IOIs.

There are instances where clients indicate that they wish the broker to disclose interest without providing an order.

ASIC regulatory intervention is likely to lead to inelegant outcomes in an area that does not require intervention. Guidance may be of assistance in coordinating industry understanding and norms.

D5Q3 Should market participants be required to obtain client consent for:

(a) using indications of interest in relation to the client's order(s); and

(b) disclosing in the indication of interest that it is in relation to a client order?

We note that no intervention has been justified in relation to IOIs. These matters are handled well by the market, and where they are not, guidance may be sufficient to bring all participants up to the expected standard.

E1Q1 Do you agree that we should discourage small and fleeting orders? If not, why not?

No. While we commend the empirical work done in relation to HFT by ASIC we see no basis for this proposal.

In the first instance, we do not believe that ASIC should discriminate between different classes of investors. In this regard we note with concern the comment in Report 331 (at 131) which suggests that ASIC sees High Frequency Trading as something that is to be discouraged in the market. ASIC should approach market behaviours without prejudice; it is AFMA's position that the market benefits from a mix of investors with different priorities and time horizons.

In any case, as ASIC's own research shows, small orders that change in price frequently are not associated with market making firms. They are more typically associated with the automated execution of investor (client) orders. As such, targeting of these orders to address fears around high frequency trading are inherently inappropriate.

Further, it is not a proper justification for regulatory intervention to address market concerns where these concerns are baseless (as confirmed by ASIC's research). Fear should be addressed with investor education. Investor confidence should be attained by the most appropriate means.

Orders that frequently adjust in price are a feature of modern computerised trading environment do not do any harm and should not be of concern to regulators.

Further the measure would be costly to implement. Implementation at the market operator level would be most efficient but even here the costs would be substantial and could impact market performance.

The measure itself would inherently make the markets less efficient by introducing stale pricing and removing the interest in sophisticated participants executing in smaller size.

In the futures markets this policy would create even more substantial negative impacts. Three futures contracts are currently over $370,000 of notional exposure (or $18,000 margin). This is not a small order, and is larger than the average order size on the ASX24 market.

Particularly given the need to keep pricing fresh for index arbitrage trading on futures markets and noting this is a very desirable trading strategy from a market efficiency viewpoint, it is critical that orders are not required to go stale.

Furthermore, ASIC has not included any evidence to justify where the proposed minimum volumes for futures markets has been determined. ASIC has used research to justify equities market minimum thresholds but none for futures related markets.

This proposal is entirely unacceptable and unjustified in the view of the market and should be considered no further. There is broad opposition to the implementation of this proposal.

E1Q2 Do you agree with the minimum resting time of 500 milliseconds for small orders before any amendment or cancellation can occur? If not, why not?

No. We note that if ASIC were to proceed with this proposal it should be implemented at the exchange for efficiency.

E1Q3 Do you think the proposed sizes for a 'small order' are appropriate, or too small or too large?

We do not support this proposal for any size of order.

E1Q4 Do you think there is a better way to address excessive small and fleeting order messages and trades in the Australian market?

Where there are isolated instances of algorithms generating what ASIC considers non-optimal market activity, market participants have demonstrated their willingness to address these on a case by case basis. We understand this has already led to reductions in this phenomenon along with the proposed changes to Price Improvement and cost recovery restructure on messages.

E1Q5 Do you think any category of market participant should be exempted from this proposal? If so, describe the impact the proposal may have on these market participants.

We do not support this proposal for any market participants.

E1Q6 Does the six-month period for commencement of these rules allow sufficient time to make the appropriate system changes?

Not applicable.

E2Q1 Do you have any comments on our proposed guidance?

ASIC's focus on order to trades ratios may be misplaced.

Different market participants and different strategies will have large variability in order to trade ratios and these may not indicate any problem.

For example, a valid market making function that would contribute meaningfully to market quality may involve making a wide spread in an illiquid security that has a natural link to a fast moving liquid security. This illiquid security may not trade very often but it is a benefit to the market if the market making in this security continues to update frequently to reflect the more actively traded security.

Order to trade ratios are a simplistic metric and guidance that they should be reviewed may not be appropriate.

E2Q2 Do you think there is a need to address order-to-trade ratios in the Australian market?

No.

While excessive inappropriate orders may need to be managed and identifying these internally by ASIC through measures such as order to trade ratios may be useful, order to trade ratios are too crude a metric to be warrant being "addressed".

E3Q1 Do you consider that removing 'materiality' from circumstance of the order will have a negative or positive impact on compliance and enforcement with the rule? Please explain your rationale.

We disagree with this proposal. This will make the operation of the rule open to unrealistic, unintended and impractical outcomes. Impact is a far better gauge by which the rule should be applied.

Further, ASIC should not be focussing on immaterial market events. The existing drafting assists focussing ASIC's work on material concerns and this is appropriate.

Removing consideration of materiality would increase regulatory costs significantly and would not result in the correction of any additional 'material' issues.

E3Q2 Do you consider the proposed additional circumstances of order adequately cover those which should be considered by a market participant when assessing whether an order or orders are manipulative? Are there additional circumstances that should be included?

Order behaviour and trading patterns can be too complex to define fully by circumstances or enumerated factors. This should be a principle based rule.

E3Q3 Do you think it is appropriate to align the rules on market manipulation for the futures and equities markets? Do you consider that one or more aspects of the current Part 5.7 (ASX) and (Chi-X) on manipulative trading do not apply to the derivatives markets and trading? Are there other circumstances that should be included that specifically apply to the futures market?

In principle AFMA members support appropriate alignment of rules on market manipulation across different market types. However, this should be subject to consultation specific to the market (for example futures) before proceeding.

The bundling in of changes for the futures market with equity market changes risks insufficient futures market engagement may be an inappropriate approach. Members see that Market Rule harmonisation should be a priority rather than the considerable additional changes that have been imposed on Market Participants over the past three years.

E3Q4 Do you agree with our proposal to issue guidance on the trading behaviour considered to be market misconduct? If not, why not? What other examples, if any, should be included in our guidance, and why?

AFMA members agree with this proposal.

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