ASIC Consultation 202

Dark Liquidity and High Frequency Trading: Proposals

ASX Submission

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Executive Summary

There have been significant changes in global equity market structure and trading strategies over recent years. Advances in technology and regulatory responses that have accommodated increased off-market matching and strategies such as high frequency trading (HFT) are requiring a serious reassessment of their impact on the efficiency and fairness of secondary market trading.

ASX believes ASIC has been one of the few global regulators to act proactively to put in place a robust regulatory environment to manage these changes and pursue policies that are aligned with the interests of listed companies and long-term shareholders. International commentators are now referencing Australia and Canada as countries which have put in place arrangements that have struck an appropriate regulatory balance.

The ASIC reviews of dark liquidity and HFT are important pieces of work that educate market stakeholders about the impact of these phenomena. They present a persuasive argument that the current policy settings are about right and that the priority should be to bed down those arrangements, give them time to impact behaviour, and assess their effectiveness. It is only then that further change should be considered.

The market licensing review being concurrently conducted by Treasury is the other key element in updating the regulatory framework to address recent changes in market structure. A robust licensing framework is needed to ensure consistent regulation across the market, given the blurring of the line between the services provided by licenced markets and participants.

Dark Liquidity

ASX believes the package of policies that ASIC has already put in place to manage the risks associated with dark liquidity has provided a sound framework for balancing the interests of individual investors to get the best price, with the impact dark liquidity has on market quality and price discovery, which impacts on all investors.

The introduction of the Meaningful Price Improvement (MPI) requirement for trades below block size may address the growth of smaller off-market transactions, which research indicates can impact negatively on price discovery. The changes to block threshold levels should also ensure that trades which may involve significant market impact costs if conducted through lit public markets can be conducted off-market to minimise those costs.

These measures should go a long way to limiting off-market execution to circumstances where it can be justified, while protecting the efficiency and fairness of our public equity markets.

Minimum size threshold for dark orders

ASX continues to support the imposition of a minimum size threshold for dark orders. The choice between a flat level ($20,000 or $50,000) across the markets or a tiered arrangement similar to that applying to block thresholds is less critical. Imposing the threshold would provide certainty for stakeholders following an extended period of consultation.

The ASIC approach of defining criteria that can be used to trigger the imposition of thresholds (subject to Ministerial agreement) still leaves uncertainty about whether the threshold will ever be put into effect. This is not ideal given that market participants and market operators need to make significant systems changes now to accommodate the possible introduction of thresholds. ASX recommends giving all stakeholders certainty early.

ASX appreciates that some stakeholders argue that thresholds should not be imposed until the impact of the MPI and block tier threshold changes can be assessed. If that view is accepted by ASIC, ASX believes that such an assessment could be made one-year after their introduction. While this is not ASX's preferred position we believe it represents a reasonable compromise and does not rely on a complex trigger mechanism or further consultation. ASX's views on ASIC's proposed triggers are presented in the Appendix.

Crossing systems operators

ASX supports the proposals to require operators of crossing systems to provide more transparency into how their systems operate. It is important for market confidence that these venues are made more transparent so investors understand how they operate and the impact they have on market integrity and overall market quality. Crossing systems, and other off-market trading, account for a significant proportion of overall trading (around 25 per cent). Other than for those run by licensed market operators, the rules and procedures of such systems are largely opaque, while crossing systems continue to grow rapidly in number and in volume traded.

Customers of these systems need to have detailed information of how their orders will be treated, what sort of order flow they might interact with, and have greater control over which venues their orders might be routed to. It is also important for both their customers and overall market stability that crossing operators be required to monitor their venues for suspicious trading activity and have in place arrangements to deal with systems outages.

The ASIC proposals are sensible and should lead to a greater understanding of, and confidence in, the market structure. They will more closely align the requirements for crossing systems with those already applying to licensed markets, acknowledging that the lines between the two has become increasingly blurred over time.

ASX notes that the review of market licensing being conducted by Treasury is also considering the appropriate licensing arrangements for crossing system operators. These operators have moved further away from their original purpose of facilitating a broker's handling of client orders, to operating in a very similar way to a market. The potential for the emergence of multilateral/aggregated crossing systems is likely to facilitate further leakage of orders to away from lit markets. Such arrangements should be prohibited unless the operators possess a market licence and are required to meet all the obligations that come with that licence.

The ASIC proposals allow some important controls over crossing systems to be put in place in advance of the completion of that Treasury review.

Tick sizes

ASX does not think it is the right time to consider changes to tick sizes for certain listed companies.

ASIC has identified a group of securities, which are described as 'tick-constrained' (ie the bid-ask spread equals the ticks size for 90% or more of the time). It is not clear, however, that this is a problem that requires a regulatory response. In practice, wider tick sizes can create significant depth concentrating at the best bid and offer prices, providing an enhanced opportunity for an investor to transact a larger block of shares with minimal market impact costs.

There is considerable uncertainty about what the impact of reducing tick sizes would be and whether it would achieve ASIC's objective of encouraging more order flow into the lit market. The new MPI requirement is likely to go a long way towards achieving ASIC's objectives in managing dark liquidity across the market. This has certainly been the case in Canada.

There is a strong argument for providing sufficient time (say 12 months) to assess the impact of the MPI and block trade threshold changes before seeking to impose an additional policy change – particularly when the impact of narrower tick sizes is uncertain. The lowering of tick sizes will dilute the effectiveness of the MPI measure as it reduces the price improvement that needs to be provided to transact off-market.

The setting of tick sizes is a matter of judgement and subject to significant debate.

Overseas experience with narrower tick sizes has been problematic and has been identified as one of the drivers of the growth in HFT activity, as it makes it easier and cheaper for traders to step ahead to the top of the queue. While the impact of applying narrower tick sizes only to 'tick-constrained' securities is less clear, there is still enough uncertainty to advocate a cautious approach.

ASX would not support a pilot program for such a significant market structure change where there is a potential for a negative impact on trading in securities. Such experiments affect real investors in real companies. It would also be hard to isolate the impact of the change in tick sizes in an environment where other important structural changes are also being implemented at the same time.

We are not aware that there is a call to lower tick sizes from investors or from the affected companies themselves. They do not seem to be asking for, or value, a change in tick sizes. The changes would likely most benefit traders who trade in and out of securities quickly and are not concerned with long term price impacts. Listed companies and long-term investors are the groups most sensitive to any changes that may have the unintended impact of providing some incentive to HFT activity.

Published tick sizes are only one factor that contributes to the overall cost of transacting a parcel of shares. Implementation shortfall (the movement in overall price of the security between when the decision to trade was taken and the final execution price), which is driven by price volatility and time to fill the order, is potentially a more significant factor. Recent Canadian research argued that a decline in spreads following a reduction in tick sizes was more than offset by increased price volatility. The authors dubbed this effect the "new spread" and argued that it is a significant hidden cost for long-term investors, particularly those trying to transact in larger sized blocks.

While some may argue that retail investors would benefit from narrower tick sizes the question of how meaningful any benefit to retail investors is needs to be assessed against the impact on liquidity in the lit market. To the extent that liquidity in the lit market may be reduced and/or it is easier for more speedy traders to step ahead of the limit orders of retail investors they may actually find it more difficult to execute their trades. For retail clients investing indirectly in the market through managed funds or superannuation the impact of any reduced liquidity is likely to be more significant.

High Frequency Trading

ASX notes ASIC's conclusions that public concerns about HFT have been largely overstated. The prevalence of such trading activity (as reflected in metrics such as order/trade ratios) has not reached the levels experienced in other markets, as ASIC's policy settings have not allowed the same economic drivers of HFT to take hold here (maker-taker price rebates, trade-through rules, narrower tick sizes, etc).

Where specific risks have been identified (such as the potential for automated trading to prompt or contribute to 'flash crash' type events) we believe the measures ASIC has previously proposed and which are now in the process of being implemented will go a long way to managing them.

However, it is important to actively monitor our market to ensure the right balance continues to be struck between the interests of long-term investors and short-term 'traders'. Having established a regulatory framework that does not incentivise the activities of short-term traders, ASIC should be cautious about making any changes (eg narrowing tick-sizes) that may shift that balance in a manner that is not consistent with the overarching policy objective.

Small-sized orders/trades are an issue – speed is not a driving factor

ASIC proposes to target 'small and flickering' orders as a means of restoring market confidence. ASX does not see, based on ASIC's own analysis, that this is a problem that needs a policy response at this time. If any aspect of our current market outcomes is a concern it would be the proliferation of small orders (orders below $500 currently make up 40 per cent of valued traded, up from 10 per cent five years ago) not flickering quotes.

In other words, while there has been a proliferation of small orders, speed is not an issue.

ASX regularly fields questions from companies and investors who query an unusual pattern of trading in small parcels which they regard as suspicious. While this is often attributed to HFT, in fact the bulk of this behaviour is directly related to execution algorithms used by brokers to spread out trades over the trading day(s).

ASIC found that only around 3.6 per cent of unfilled orders below $500 (the level at which the proposed policy is directed) are removed and/or amended within 0.5 seconds. Of these, only around 25 per cent can be attributed to HFT firms, with the remaining 75 per cent attributed to investors likely using participant-sourced algorithms – with around half accounted for by two trading participants.

ASX believes that influencing the operation of these automated programs, rather than imposing a market-wide technical solution, is likely to achieve the best result at the minimum cost. Should this approach be unsuccessful then it may be appropriate to consider economic incentives (minimum trade fees, etc) that would be more likely to drive behaviour and not involve significant system costs.

ASX supports the 'soft' controls that ASIC proposes, to require participants to monitor and ensure their automated trading programs are well designed and operating in a manner that does not have an adverse impact on market integrity or market quality. Such controls can effectively influence behaviour in a way that will reduce the proliferation of small orders/trades.

Minimum resting times for 'small and flickering' orders

ASX does not support the introduction of minimum resting times for small orders in both the equity and futures markets. ASIC's analysis of 'small and flickering orders' in the equity market does not present a compelling case that a problem currently exists that requires a regulatory response. In any event, the proposed solution is likely to be costly to implement across the market, may well have unintended consequences, and is unlikely to materially improve market confidence.

While minimum resting times may reduce, at the margin, some of the 'noise' associated with the sharp increase in trade messages; this may come at the expense of a reduction in willingness to enter limit orders, particularly at times of heightened market volatility. Applying minimum resting times only to orders in lit markets may also provide a further incentive for the posting of small orders into crossing systems and other off-market venues (absent a minimum threshold), contrary to ASIC policy objectives for dark liquidity.

While the proposal only applies to small orders, the benefits do not seem to outweigh either the costs of implementing the control or the risks of the arrangements merely causing a different set of problems.

A minimum resting time is a policy that has been examined (albeit on a whole of market basis) in other jurisdictions and rejected.

The recent Foresight Report[1], from the UK Government Office for Science, drawing on views from over 150 experts in 20 countries, contained a strong critique of the efficiency of minimum resting times in addressing any concerns around HFT. While the report noted that empirical evidence is very limited, since these policies have only been tried in very limited cases, they noted that:

> *The independent academic authors who have submitted studies are unanimously doubtful that minimum resting times would be a step in the right direction, in large part because such requirements favour aggressive traders over passive traders and so are likely to diminish liquidity provision.*

If there is a concern that such order activity constitutes an attempt to create a false or misleading appearance of active trading then it should be dealt with severely. If changes to legislation are required to achieve that ASX would support such changes. However, this does not appear to be the case, as ASIC has indicated there is no evidence of systemic market manipulation. In addition the Foresight Report found that "*there is no clear evidence that such market abuses only involve flickering quotes, and for those that do, surveillance and fines may prove a more efficient deterrent than imposing a minimum resting time*".

While the ASIC proposal is for minimum resting times only for orders below $500, we believe that the increased complexity (and inefficiency) will play into the hands of those who have the resources and the technical ability to recalibrate their algorithms to exploit that complexity. In the case of minimum resting times, that may involve strategies designed to pick-off stale quotes, potentially discouraging some investors from posting limit orders.

Minimum resting times for derivative products

The associated proposal to also apply a minimum resting time to 'small and flickering' orders in the futures market is even more problematic. We believe no problem has been identified and (as mentioned above) the solution proposed, minimum resting times, is not an efficient policy tool.

There is no indication in CP202 or ASIC Report 331 that the small and flickering quote phenomena is present, or causes problems, in futures markets. Futures markets are largely professional wholesale markets and there has been no indication that small and flickering quotes are undermining market confidence.

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[1] Foresight: "The Future of Computer Trading in Financial Markets: An International Perspective" (2012), Final Project Report, The Government Office for Science, London

The same general criticisms of minimum resting times that apply to cash equities also apply to future markets. In addition, many futures products have contracted market makers and ASX would be concerned if the imposition of a minimum resting time for small orders was to adversely affect the ability of market makers to provide the liquidity necessary for these products, particularly at times of high volatility. This could be very damaging.

The definition ASIC has chosen for what constitutes a small trade in futures products seems to have been set at levels which imply a significant impact on the operation of that market. Futures products in Australia generally have high nominal values (even if the initial margin is a smaller amount given the leverage in the product) designed to be attractive to wholesale investors.

- For example, for cash equity markets ASIC defines a small order as $500, around 10 per cent of the average trade size. By comparison, for the SPI futures product a small order is defined as three contracts which, in a market where the average trade size is only 1.8 contracts, is 167% of that average trade size.

Attached is a more detailed response to those questions raised in the consultation paper that ASX has specific comments on. We would be happy to discuss and expand on any of the points made in our submission.

Appendix 1 – Detailed Responses to Issues Raised

Dark Execution

Minimum Threshold ASIC propose to issue a statement on a trigger for implementing a minimum size threshold for dark orders to apply where there is evidence that dark liquidity has caused degradation in the price formation of a security or group of securities	
ASIC questions	**ASX position**
• Do you agree that a safety net proposal like this is necessary? • 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? • Do you have a preference for either option? Please explain your rationale. • Are there any securities or group of securities for which it would be preferable to implement a minimum size threshold immediately (eg securities outside the S&P/ASX 300)? If so, which threshold should apply? • Do you have any views on the proposed implementation timeframe of 40 business days for the thresholds if triggered?	• ASX supports ASIC's objective to manage dark liquidity so that it does not adversely impact on the efficiency of the lit market and the price discovery process. • Significant fragmentation of liquidity through around 20 crossing systems is increasing the complexity of liquidity search. The emergence of multilateral/aggregated crossing systems is likely to facilitate further leakage of orders to dark venues and also increase the risk of information leakage. Such aggregated venues are moving further away from the original purpose of facilitating a broker's handling of client orders and closer to operating as a market as they bring together a wide range of clients. Such arrangements should be prohibited unless the operators possess a market licence and meet all the relevant obligations. • A simple minimum threshold would deliver an arrangement that investors, participants, and listed companies understand and removes residual uncertainty. It would also address directly the trend for small order proliferation in dark venues, where average and median trade sizes have fallen sharply just as they have in the lit market. ASIC noted that the median trade size in crossing networks is around $400 and average trade size around $2,200 - both lower than in the lit market. • ASX believes that implementation, and active enforcement, of the new MPI requirement will be an effective means to reduce the impact of dark liquidity on price formation. On average around 70-75% of trades conducted off-market were done 'at the touch' rather than offering price improvement. Under MPI this will no longer be permitted. The introduction of a minimum order threshold remains a further policy tool to manage the leakage of orders to dark execution venues. • While the principle of providing greater certainly around the circumstances when ASIC would recommend imposing minimum thresholds is good, ASX would caution against overly complex criteria. Such an approach also implicitly accepts that any response should be reactive, implemented only after market quality has already deteriorated – we do not think this is an optimal basis for policy settings. • ASX acknowledges that it may be appropriate to assess the impact of the new policy initiatives (eg MPI, tiered block trade thresholds) before introducing a minimum threshold. We would support a review, 12 months after implementing the new policies, to assess the impact they have had on the size and nature of dark liquidity. The review would decide whether a minimum threshold should be introduced across all securities. In addition to the security level criteria ASIC sets out in CP202 we believe there should also be a criterion regarding the "overall health" of the lit market. • ASX does not have strong views, if required to choose only between the two options proposed in CP202. There are clear trade-offs between Option 1 (threshold applies to a group of securities) and Option 2 (threshold applies on a security by security basis). The former being simpler to understand and transparent to the public while the latter is more targeted at securities where the level of dark execution has already affected market quality. On balance, Option 2 may be marginally superior. It would ensure that securities experiencing a severe deterioration in market quality would have a threshold applied promptly. In contrast, under Option 1 a problem with a single security would not be addressed until sufficient securities in the same group also breached the trigger – thereby penalising investors and listed companies in the intervening period.

Dark Liquidity: Proposals for crossing system operators

Transparency for the wider market

New and amended rules: crossing system operators to make publicly available information about their crossing system, including the products traded, access criteria, order types, whether it is an aggregator, fees and monthly turnover statistics

ASIC questions	ASX position
• Are there any reasons that the proposed information should not be made public? • Is a website an appropriate publication means? • Is there additional information that market users should understand, or be informed of, about the handling and execution of orders through a crossing system? • 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? • 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?	• The measures should enhance market confidence by providing greater understanding of the number and scope of crossing networks and how they operate. Given the rapidly growing proportion of trading now conducted through crossing networks there is no reason why such information shouldn't be available. This type of information is already required to be published by dark venues run by licensed market operators. • It is adequate that the material is published on a public, freely accessible website of a crossing system operator. Although this should be supplemented by ASIC publishing on its website a list of registered crossing systems with links to where the material can be accessed to ensure stakeholders are able to access the information easily. • Publication of crossing system aggregate monthly turnover statistics should be done by ASIC to ensure the material is easily accessible and comprehensive. ASIC should also ensure that the statistics provided by each crossing system operator are compiled in a consistent manner and are therefore comparable. There is a strong case for requiring more regular disclosure of crossing system activity, either on a daily basis or through real-time disclosure in the post-trade data feed, to ensure timely dissemination of this information for order routing decisions. • The obligation for crossing systems to be more transparent will facilitate greater understanding of the existing market structure. This will support a stronger regulatory framework and, combined with any recommendation coming out of the Treasury's market licence review, help raise overall regulatory standards for crossing systems and the overall equity market. • Such disclosures are consistent with the IOSCO principles for dark liquidity.

Disclosure to users

New rule: crossing system operators to provide users with information about user obligations, execution risk, and the operation of the crossing system
Amended rules: on trade confirmations, crossing system operators to specify venue (exchange or crossing system) and advise if trading as principal

ASIC questions	ASX position
• 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? • If a market participant routes client orders to another market participant's crossing system (eg 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. • Is six months sufficient time to amend disclosures for existing and new clients?	• ASX supports clients having full disclosure of the operating rules of all the crossing systems they interact with as well as the sorts of traders allowed to access liquidity in the system. Without effective disclosure clients do not have sufficient information to make decisions on order routing. For example, ASIC's finding that a number of crossing systems allowed HFT access that was not adequately disclosed to other clients would not enable those clients to decide if they were comfortable sending orders to that venue. • We can see no reason why such information should not also be more publicly available to all market users. This would further add to their understanding of market structure and hence market confidence in the efficiency and fairness of the equity market. • As noted above, the practice of routing orders between crossing systems through aggregators should be prohibited unless the operators have a market licence as this activity increasingly resembles the services provided by a market licensee. • A client should be made aware when their participant trades with them as principal or when their trade is executed on the participant's crossing system. Such visibility will enable them to better monitor the nature of the services provided to them and to assess if they have any concerns they wish to raise with their broker. In the case of interaction with principal order flow it will also enable them to confirm they have not been charged commission on those trades.

• 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?	
Fairness to all users New rule: crossing system operators to ensure procedures do not unfairly discriminate between crossing system users	
ASIC questions	**ASX position**
• Do you have any comments on our proposed approach?	• ASX supports the proposal as an important investor protection measure given that that the ASIC review identified certain practices in some crossing systems that raised concerns. • It also more closely aligns the obligations for crossing networks with those applying to licensed markets.
Opting out New rule: crossing system operators to provide clients with a choice to opt-out of using the crossing system at no additional cost and with no additional operational or administrative requirements	
ASIC questions	**ASX position**
• Is there demand from clients to opt-out of trading in a crossing system? • Should clients have the option to opt-out of all forms of dark liquidity, including principal trading? • What is involved for crossing system operators to build the capacity for clients to opt out in this way?	• ASX supports clients having the ability to control where their orders are routed to. While participants are bound by the best execution requirements their clients may have other important considerations they wish to take into account in their order routing arrangements (such as potential information leakage, potential conflicts arising from interacting with principal trading flow, or concerns about HFT being allowed to participate). • ASIC found that a significant proportion of retail orders are routed through a crossing system before being sent to a licensed market, although E-Trade recently announced it was no longer executing trades through its crossing system. ASIC also noted that retail investors are often not aware of how their orders are executed or that they can choose to opt-out of such an arrangement. • An opt-out arrangement with minimal cost is a reasonable compromise. It could be argued that an opt-in arrangement would be more appropriate but ASX recognises that compliance costs associated with implementing such an arrangement may be prohibitively high compared to the additional benefit gained.
Monitoring New rule: crossing system operators to monitor orders and trades on the crossing system and report to ASIC instances of suspicious activity or material non-compliance with user obligations and procedures	
ASIC questions	**ASX position**
• What is involved for crossing system operators to undertake the proposed monitoring? • Is six months sufficient time to implement the changes?	• ASX strongly supports the proposal. It is important that all operators of trade execution venues are vigilant for any suspicious activity and report occurrences to the authorities to ensure market integrity is maintained, no users are adversely affected and there is no undermining of overall market confidence. • This brings the obligations for crossing networks more into line with those applying to licensed markets.
Record keeping New rule: crossing system operators to make records about all orders (including the parameters set for each order) in the crossing system and retain these for seven years	
ASIC questions	**ASX position**
• Do you agree with our approach to capturing orders that rest or transit through a crossing system? • Will the proposed requirements for record keeping successfully enable the replay of orders in a crossing system at any point in time?	• ASX supports the proposal.

Systems and controls New rule: to extend existing system and control requirements for automated order processing to crossing systems. Crossing system operators to notify users and ASIC about system issues Guidance: crossing system operators to have adequate resources to manage stressed market conditions	
ASIC questions	**ASX position**
• What processes do crossing system operators currently have in place to inform clients of system issues? • 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?	• ASX supports the proposal for crossing system operators to notify users and ASIC promptly about technical difficulties they are experiencing that could impact on the clients orders. Where that system issue impacts on the ability of a client's orders to be routed for execution to another venue then it should be immediately advised to the client so alternative arrangements can be put in place. • In cases where that problem may impact on the overall market there would be case to require broader communication with the market. • It is important for overall market stability, integrity and confidence that all venues executing trades have adequate resources in place to manage stressed market conditions.

Dark Liquidity: Other proposals

Tick sizes We seek industry views on options to lower the tick size either for securities in the S&P/ASX 200 priced from $2–$5 (from $0.01 to $0.005), or for the 25 most tick-constrained securities (to the next tick size down), to be initially implemented on a pilot basis	
ASIC questions	**ASX position**
• Do you agree that tick sizes are constraining some security prices and that this may be leading to more trading shifting to the dark? • Do you agree that we should target the most affected securities rather than a complete overhaul of the tick size regime? • Do you have a preference for Option D1.1 or Option D1.2? Is there an alternative model we should consider? • Is a pilot desirable and is six months sufficient time to introduce it?	• On balance, ASX does not believe that now is the time to consider lowering tick sizes. We acknowledge that the choice of an appropriate tick size requires a judgement that balances the impacts on transaction costs against the willingness of investors to post limit orders. • The fact that a stock trades at a spread equal to its minimum tick size is not evidence of a market failure. It may, in fact, benefit long-term investors at the expense of short-term traders by making it more expensive for rapid trading of stocks and hence encouraging greater liquidity provision in the lit market. This in turn can enable larger blocks of stock to be executed on the lit market with a smaller overall market impact. • The reduction in tick size for a group of tick-constrained securities has been suggested as a means of further reducing trading in the dark. The impact on tick-constrained securities of a lower tick size is difficult to anticipate. It may not significantly change the incentives for dark liquidity as it also effectively weakens the impact of meaningful price improvement by reducing the price step that needs to be provided to trade off-market. • Other policies, such as the introduction of MPI and changes to block-trade thresholds, will significantly change the nature of dark liquidity, including a likely reduction in the leakage of non-block sized orders to dark pools. Consideration of the need for further change, such as narrower tick sizes, should not occur until the impact of the current set of changes can be monitored and assessed. ASX believes a period of 12 months from implementation would be sufficient to determine their impact and if further policy change is required. • Lower tick sizes may, however, encourage more short-term trading. Experience overseas has been that a lower tick size has been one factor that has driven increasing penetration of HFT (by lowering the cost and risk associated with stepping ahead of other orders). The proposed tick size changes are large: a 50% decline in the 1 cent tick and an 80% decline for some securities in the 0.5 cent tick category. It is not clear such a change will lead to a net improvement in the trading environment for those securities.

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- ASX doesn't support a pilot program as it imposes the risk of unintended consequences for real companies and their investors. We have detected little demand from end users (listed companies and investors) for the reform, particularly given the uncertain impact.
  - While tick size is a factor that drives overall transaction costs, for investors seeking to transact in medium-large parcels, other factors such as the time taken to execute a given trade and the price volatility during that period are likely to be more important.
  - Recent research by RBC Capital Markets has questioned the net benefit of the lowering of tick sizes in Canada. They argued that it contributed to a marked increase in the short-term price volatility of individual stocks which can lead to a significantly higher net transaction cost for investors.
- This degree of uncertainty about the net impact of tick size change would suggest that ASIC should take a cautious approach and consider the issue again when the impact of other policies affecting dark liquidity can be assessed.
- If ASIC were to proceed with a pilot, Option 2 is preferred as it limits the change to the sub-set of securities that are 'severely' tick-constrained. Option 1 would apply to all securities in the S&P/ASX 200 index (priced between $2-$5), including those which may not be tick-constrained.

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Course-of-sales disclosure (T+3)

New rule: ASX and Chi-X market operators to make available course-of-sales information on T+3 as they do now, with the addition of market participant identifiers and venue (including crossing system)

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- 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 (ie not on behalf of clients)?
- Do you agree that there is benefit in disclosing the particular crossing system where a trade has been matched?

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- ASX provides such information already and we note the additional information to be included on crossing systems would come into effect from March 2014.
- There is an argument that, at least for the crossing system identifiers, they should be publicly available in real-time to allow investors to identify liquidity.
- We note that the T+3 information is used by fund managers for a range of analytical purposes. Although similar assessments are also conducted in other markets where such T+3 information is not provided. Where a participant does not act on behalf of clients but solely as principal, those arguments for requiring identification of the participant on the T+3 course-of-sales disclosure are less relevant.
- For certain principal trading organisations, the disclosure of such information may influence their decision on whether they become a market participant or choose to trade through another market participant. The latter better camouflages the principal trader's activity but may also make it more difficult for the executing broker's other clients to interpret the data for their own purposes.
- On balance, ASX can see merit in considering the costs and benefits of excluding principal trading participants from the public course-of-sales disclosure.

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Conflicts of interest

New and amended rules: to enhance conflicts of interest obligations (e.g. market participants to protect client information and give client orders priority when trading as principal)
Guidance: on managing conflicts of interest when handling and executing orders

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- Do you have any comments on the proposed new and amended rules, or the time frame for commencement of these rules?
- Are there any other rule amendments or proposals we should consider for conflicts of interest?
- Do you have any comments on the proposal to supplement our guidance in RG 181?

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- ASX supports the proposal as a sensible and measured response to protect client interests.
- The ASIC review identified that around 38% of crossing activity involves clients trading against the operator's proprietary order flow. This is a significant proportion and suggests there would be benefits (in terms of enhancing confidence in dealing in crossing systems) from having more robust conflict of interest requirements.

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Payment for order flow New rules: to prohibit direct cash payments for the opportunity to handle and execute orders, and put controls around soft-dollar incentives Guidance: for other Australian financial services (AFS) licensees affected by the new rules	
ASIC questions	**ASX position**
• Do you agree that direct cash payments and cash rebates should be prohibited? • 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? • 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? • Do you agree that soft dollar incentives should be treated differently to direct cash payments?	• ASX supports the proposal as a sensible measure to protect client interests. • ASX is aware that the phenomenon of payment of order in the US has reached such a level that it is estimated that nearly 100% of retail order flow from discount brokerages is sold to market-makers and does not ever reach the public market. This has raised concerns about whether this is giving rise to conflicts of interest in order routing decisions that may mean retail investors do not get the best overall price for their orders.

High Frequency Trading

Excessive messaging and market noise New rule: minimum resting periods for small and fleeting orders applied to market participants Guidance: on order-to-trade ratios	
ASIC questions	**ASX position**

• Do you agree that we should discourage small and fleeting orders? If not, why not?
• 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?
• Do you think the proposed sizes for a 'small order' are appropriate, or too small or too large?
• Do you think there is a better way to address excessive small and fleeting order messages and trades in the Australian market?
• 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.
	• On ASICs own analysis, only a relatively small proportion of all 'untraded' orders are 'small and fleeting'. For those cancelled/amended within half a second the proportion ranges between 3.6% (orders < $500) to 7.0% (orders <$2,000).
	• While such activity adds to market noise it is not apparent that it has negatively impacted on overall market quality.
	• While the phenomenon of small and fleeting orders is often attributed to HFT, ASIC found that it largely reflects the activities of non-HFT traders, such as institutional investors executing their trades using (perhaps badly designed/configured) algorithms.
	• ASX believes that rather than putting in place a costly technical solution that affects the whole market, the 'soft' controls proposed to ensure that participants are required to consider more carefully the design and impact of their algorithms (eg order/trade ratios), would be a more cost-effective initial means of seeking to influence behaviour.
	  – ASIC identified two participants which accounted for a significant proportion of the small and flickering order phenomenon. The most effective way to deal with the issue is to understand what is driving that very different trading behaviour.
	  – ASX's experience has been that when seeking explanations from participants about unusual trading patterns it often reflects poorly configured algorithms that are swiftly tweaked. We note ASIC has been working with participants, whose own (or client) algorithms have generated high order/trade ratios, leading to reprogramming or decommissioning of problematic algorithms.

• Does the six-month period for commencement of these rules allow sufficient time to make the appropriate system changes?	• A technical and complex solution should always be the last, and not the first, option considered. Complexity is always likely to lead to unintended consequences as those with the skill and resources are able to adapt their behaviour to take advantage of the changed arrangements. This is consistent with overseas studies of policies such as minimum resting times which argue they are likely to give rise to different market behaviour/problems, for example, developing algorithms that pick-off stale quotes that are required to rest in the order book for a minimum time. • ASX believes that the small order proliferation has more of an impact on overall market confidence and perceptions of market quality than do small and fleeting orders. Although there is no strong evidence to suggest that it has led to an actual deterioration in market quality. Around 40% of all orders are now below $500 compared to only 10% in 2007. • Improved execution algorithm design and configuration can go a long way to also addressing the proliferation of small orders, and it would be the most cost-effective response if change was required. Economic disincentives (much as minimum order fees) could also play a role in changing behaviour if necessary. Structural changes like minimum order sizes are unlikely to be an efficient solution as they raise their own unintended consequences, such as the need for an 'odd-lot' market to deal with very small parcels of stock (more likely to be held by retail holders) that fall below the threshold. • Even though the minimum resting time only applies to 'small' orders it may have a detrimental effect on the willingness of investors to post liquidity at times of significant market volatility, which could impact on market efficiency. Minimum resting times for ASX 24 products • The proposal to impose small order controls for ASX 24 markets is not supported and is even more problematic. There is no evidence presented that a 'small and fleeting' order problem exists that requires any policy response. • The ASX 24 market comprises a range of futures products. In a number of derivative products contracted market makers are employed to provide liquidity to ensure the efficiency of the market. Imposing minimum resting times for small orders may impact on their ability to conduct their operations or increase the costs of doing so. Market makers are required to adjust orders rapidly in response to market movements and such a restriction would be particularly onerous at times of extreme volatility. • The definition of a 'small' order seems much more significant for futures products than for cash markets. Futures contracts on ASX 24 have not been denominated in amounts designed to attract retail participation (ie no mini-sized contracts). – In the case of cash equities, ASIC has chosen $500 as the basis of its proposed policy, which is around 10 per cent of the average trade size. – In contrast, for SPI futures the definition of a small order is three contracts (a combined nominal value of around $375,000), which is higher than the average trade size of 1.8 contracts. – For interest rate futures the proposed 10 contracts minimum size is also above the average trade size of 8 contracts for the 10 year bond futures, and relatively high compared to the average trade size of 36 contracts for the 3 year bond contract. • Applying minimum resting times on this basis would impose a significant change on trading in these products. ASX believes that would potentially have a significant detrimental impact on the operation of the market.
• Do you have any comments on our proposed guidance? • Do you think there is a need to address order-to-trade ratios in the Australian market?	• ASX supports the enhanced guidance. Soft controls that require participants to give due regard to how their proprietary and client algorithms work in practice should see improvements in market quality. • Poorly designed/configured algorithms are the prime cause of small order proliferation affecting investor and listed company confidence. The measures, combined with guidance on manipulative trading (see below) should provide appropriate incentives for tidying up problematic algorithms. • On the evidence available, existing order-to-trade ratios are well below levels in other major markets as policy settings have not incentivised excessive order entry.

Manipulative trading Amend Rule 5.7.2(b) (ASX) and (Chi-X): to remove the reference to materiality and include the consideration of the impact of the order Amend Rule 5.7.2 (ASX) and (Chi-X): to include the following additional circumstances in considering whether a false or misleading market has been created - the frequency with which orders are placed, the volume of products that are the subject of each order and the extent to which orders made are cancelled or amended relative to the orders executed Amend Rule 3.1.2 (ASX 24): to harmonise manipulative trading provisions across the Market Integrity Rules for the ASX, Chi-X and ASX 24 markets Guidance: on trading practices that are illustrative of manipulative activity.	
ASIC questions	**ASX position**
• 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. • 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? • 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? • 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?	• We note that ASIC found that some trading practices discovered in the course of the review were of concern. • ASX supports the proposal as a sensible measure to ensure that the MIRs are updated to clearly deal with manipulative trading practices undertaken (deliberately or not) through automated trading algorithms. • Providing clear guidance to the market on what trading activities may be illustrative of or indicate manipulative behaviour will assist participants and their clients in understanding what practices are unacceptable. • We agree that the strategies identified, including layering, quote stuffing, quote manipulation, and spoofing are activities that should be eliminated.