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By Email:
Dior Loveridge and Joseph Barbara
Australian Securities and Investments Commission
Level 5, 100 Market Street
Sydney NSW 2000
Email: marketstructure@asic.gov.au

Re: Consultation Paper 202 on Dark liquidity and high-frequency trading proposals

Dear Sir or Madam,

Industry Super Network (ISN) appreciates the opportunity to comment on the Consultation Paper 202 concerning proposals for dark liquidity and high-frequency trading (HFT) by the Australian Securities and Investments Commission (ASIC).

ISN is an umbrella organisation for the industry super movement. ISN undertakes collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings and incomes of over five million members.

Industry super funds are stakeholders in Australia's financial markets, particularly as providers of patient capital to business entities and infrastructure projects. Industry super funds are long-term investors focussed on deploying capital that supports sustainable economic growth and generates superior returns for beneficiaries. Although industry super funds avoided the products and practices implicated in the global financial crisis, our funds and members, along with the broader public, were harmed. As a result, ISN has a keen interest in improving the operation of financial markets and institutions, including through regulatory improvement.

ISN appreciates the efforts taken by ASIC to study and address the impacts of dark trading and HFT in Australia. Proposed rules requiring market operators to monitor and disclose information publicly are highly welcomed. However, most of the proposals responding to HFT and dark trading are focussed on symptoms, rather than causes, resulting in complicated reforms. We believe that there is a need for further consideration so that a holistic approach toward market microstructure can be taken with the view to create a fairer and more efficient (with respect to the allocation of resources) capital markets.

ISN has four comments for your consideration.

1. General comments

Fairness and its importance to investor confidence

Regulators need to have a clear understanding of why investor confidence in equity markets has reduced. Confidence is not a function of microstructure measurements such as order-to-trade ratios, resting times, or order sizes. Confidence arises from fairness, and fairness requires a level playing field where investment acumen determines winners and losers; where success is not the result of technological or regulatory arbitrage, or any other kind of asymmetry, except in investment skill. This

insight – that fairness requires a level playing field in which competition is oriented around investment acumen – has driven a decades-long program to improve capital markets fairness.

For capital providers to have the confidence to transact in lit equity markets, they must be assured that their successes and failures will be determined by the quality of their investment decision making. Yet, when investors who use long-term strategies look carefully at recent trends in market structure, it becomes immediately obvious that the playing field is being shaped to facilitate non-fundamental algorithmic trading based not on investment acumen, but on relative speed.

Fundamental investors know their strategies do not require latency measured in microseconds. Hence, the pursuit of lower latencies in continuous markets must be in someone else's interest. Nothing will shroud that reality.

Low latency trading platforms support algorithmic traders in their efforts to, among other things, stay at the top of order book queues (ahead of long-term investors), predict minute price movements within microsecond time frames, and pick off slower market participants. A playing field built for strategies that rely on relative speed requires long-term investors, who employ strategies that are far less speed sensitive, to try to defend themselves, or to exit. This is happening. Fundamental investors are leaving the lit market, and seeking out dark pools which promise that speed traders are not allowed in. Fundamental investors are also defending themselves (through their agents) with execution algorithms – which try to fit long-term strategic trades efficiently into low latency continuous markets populated by opportunistic traders.

A fair and orderly capital market is an important public policy objective. ISN believes that the answers to the problems presented by HFT and dark trading require a holistic approach to comprehensively review the current capital market structure against real economic objectives. ASIC's focus should be on remedying the cause of investor concerns, and thereby shoring up investor confidence. Treating the symptoms is not a sustainable solution. Restricting smaller trades in dark pools and imposing short resting times on small orders focus on the symptoms and, as outlined below, actually could undermine ASIC's intention as well as investor confidence.

Fundamental investors don't need, and didn't ask for, low latency trading platforms. Fundamental investors – the source of the capital flowing into the markets – want to be sure that they are not trading in a market where their strategies are at a structural disadvantage. ASIC's report on dark liquidity and high frequency trading did not address whether high frequency traders systematically tend to profit when they trade with fundamental investors.[1]

ISN strongly supports ASIC and its mission. However, ISN also encourages ASIC to change direction with respect to market structure, and to accept that long-term investors know low latency continuous trading is not important to their strategies, but is important to other participants' strategies. Low latency continuous markets distort the playing field, turning it away from rewarding investment acumen, and instead toward rewarding relative speed.

Certain proposals in CP202, in our opinion, will place retail and fundamental institutional investors in a more disadvantaged position compared to high frequency traders. As an illustration, here are the options available for a genuine fundamental investor who wants to trade:

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[1] We refer ASIC to a recent paper which clearly shows that HFTs make profit at the expense of other investors, including fundamental investors. See Baron, M., Brogaard, J., & Kirilenko, A. (2012). The Trading Profits of High Frequency Traders. http://www.bankofcanada.ca/wp-content/uploads/2012/11/Brogaard-Jonathan.pdf

(1) To trade in the dark the investor may, under certain conditions, be required to satisfy a minimum order size. If the investor posts large dark orders, she is risking revealing information to the market and faces adverse selection. If her trading need is smaller than the size required, trading in the dark is not an option.

(2) If the investor trades in the lit market, she has to deal with HFT who seeks profit through unnecessary intermediation. If she chooses to break her orders into smaller parcels, there is a minimum resting time requirement which means that her passive orders have a risk of becoming stale and picked off by HFT strategies. The reduction in tick size in selected stocks also allows faster HFT to step up the queue ahead of the fundamental investor's orders through a negligible price improvement. Without any other proper choice, the fundamental investor has to either accept the costs of HFT or she has to join the speed race which produces no economic benefits.[2]

For retail investors who have less resource to dedicate to execution, the overall outcome will be much worse. The net effects of the major proposals in CP202 clearly reward HFT traders over other types of market participants.

ISN urges ASIC to reconsider the proposals, and to suggest new solutions, such as encouraging electronic call auctions.

Costs and complexity

The low latency continuous market is tilted against long-term investors. It is also costly to maintain and to regulate with adequate surveillance. It generates enormous and growing volumes of data that must be transmitted, stored, and occasionally reviewed. Regulatory efforts to accommodate high speed markets require significant expenditure on exogenous features such as kill switches, volatility controls, algorithms to monitor algorithms, overlaid with significant compliance resources to be expended by market operators and participants.

Favouring low latency markets has required a significant number of regulatory proposals so far, and we anticipate this will continue. Moreover the regulatory proposals are not principles-based and often rely on results from studies with limited scope or pure comparison with other markets. For example, it is not entirely clear how the thresholds for the current proposals were determined. It is not clear from ASIC's public statements what "excessive" noise id, nor what constitutes "too much" trading in the dark. ISN notes that ASIC's ability to meaningfully define such practices and thresholds was severely restricted by the limited nine-month empirical study which was unable to consider long-term trends inthe market.

In our opinion, principled-based regulation is far superior, which will ensure sustainable outcomes for the Australian capital market and restore confidence of all classes of investors.

2. Minimum size threshold for dark orders

ISN appreciated ASIC's discussion of the potential impacts of dark trading on the lit market. ISN believes that ensuring the quality of the lit market is an important objective for public policy. However, we question the effectiveness of the proposal to impose a minimum size threshold for dark orders for a number of reasons.

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[2] Of course, the fundamental investor can use more market orders (aggressive orders). This preference across investors would reduce overall market liquidity, which is a negative result to all participants. [3] Australian Securities & Investment Commission (2013) Report 331 Dark liquidity and high frequency trading: http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep331-published-18-March-2013.pdf/$file/rep331-published-18-March-2013.pdf

First, the proposal does not address the real reason why investors are abandoning the lit market. As acknowledged in Report 331, fundamental investors are "turning away" from the lit market because they view HFT as "predatory, unfair, and a barrier to efficient long-term investments".[3] The current proposal together with other proposals in CP202 fail to address this major concern. Imposing a minimum size threshold for dark orders effectively forces investors back to the lit market by discouraging dark trading. It may be a quick fix, at best covering over a symptom of the underlying fairness problem. However, by not addressing the fairness concerns, it is not a real solution. Investors are forced into a lit market that remains unfair to them, because it is oriented toward low latency trading.

To attract flows back to the lit market, the foundation of the lit market must be sound to ensure investor confidence and support. If the principal objectives of the market are constantly undermined, such as through the current support for HFT by lit market operators, it is not surprising that investors choose to divert their trading or resources elsewhere.

Second, by limiting dark trading while refusing to address concerns regarding HFT, ASIC is leaving fundamental and retail investors, i.e. those with passive orders, with limited choices. They are forced to stay in the lit market where the playing field has shifted to prioritise competing on speed and short term market data analysis. ASIC's support for the alignment of the playing field toward speed trading strategies could require long-term investors to continue to spend more resources "bolting-on" execution algorithms to their long-term strategies to reduce the disadvantages compared to HFT in terms of privileged access to market information and computing power. In our view, it is unfair to implement a rule which clearly benefits one type of traders (HFT) at the expense of others (fundamental and retail investors).

Third, there is some ground to doubt that this proposal will divert smaller orders back to the lit market. The current smaller size of dark trades may be due largely to the number of child orders from several large orders. If the minimum size threshold for dark order is in place, those who want to avoid information leakage may either:

- post large size dark orders and face increasing adverse selection, or
- "place the order into a liquidity pinging (or pouncing) algorithm that is not instantly available to other market participants". This may lead to reduction in overall liquidity, which is certainly an undesirable outcome.[4]

3. Tick size reduction in a selected number of stocks

ISN opposes the proposal for tick size reduction in a selected number of stocks. While we understand ASIC's motivation is to discourage dark trading in stocks with large tick size relative to price and stocks where bid-ask spreads are constantly at minimum tick size, we believe that this proposal is not the appropriate solution.

[3] Australian Securities & Investment Commission (2013) Report 331 Dark liquidity and high frequency trading: http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep331-published-18-March-2013.pdf/$file/rep331-published-18-March-2013.pdf

[4] BMO's Financial Group (2011) response to the Canadian Joint Canadian Securities Administrators / Investment Industry Regulatory Organization of Canada on Position Paper 23-405 – Dark Liquidity in the Canadian Market: http://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20110110_23-405_ehrenspergerj.pdf

ISN would like to reiterate that the quality of the lit market is the most important factor to attract order flows of fundamental investors away from dark trading. Public policy should focus on the fundamental cause of diminished investor confidence in the lit market – i.e., that it is increasingly favouring speed-based strategies, not investing – rather than trying to treat the symptom, especially if it involves seeking to stop investors from protecting themselves.

On the specific proposal of a more granular tick size regime, ISN believes that there is enough evidence of potential negative effects of such an action. According to the French securities regulator: [5]

- Smaller tick size leads to more HFT activity. As tick size decreased, the number of orders and volume traded by HFTs increased considerably as the reduced tick size afforded HFTs greater "opportunities to intermediate for profit".
- Investors may be discouraged to post orders since it may be overstepped easily. The AMF report found that the proportion of non-HFT orders decreased from 4% to 1% following tick size reduction, while their share of volume traded reduced significantly from 19% to 9%.
- Smaller tick size reduces the cost of a higher bid and "urges market participants to cancel/modify orders more frequently". The French report also found that smaller tick size "decreases the execution rate of orders".

4. Minimum resting time for small orders of less than $500

ISN does not believe that imposing a minimum resting time will be effective in quarantining the harmful effects of HFT. We are not the only one with this view. In fact, a minimum resting time itself may create some negative effects. Research undertaken as part of the UK Government's Foresight Project (The Future of Computer Trading in Financial Markets) found potential negative effects of this proposal to include:[6]

- It may prevent passive orders from being cancelled and put them in "constant dangers of being stale." As passive orders are being discouraged, transaction costs and volatility may increase due to liquidity reduction.
- Retail investors, whose orders are small in nature, may be further disadvantaged by this rule. This again raises the question of fairness: in order to curb HFT behaviour, is it fair to hurt other classes of investors?

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[5] A presentation of this report by Autorité des marchés financiers (AMF) to the US Securities and Exchange Commission's roundtable on tick size (February 2013) can be read here http://www.sec.gov/comments/4-657/4657-8.pdf

[6] Farmer, Doyne, and Spyros Skouras. (2012) *Minimum Resting Times and Transaction-to-order Ratios - Review of Amendment 2.3.f and Question 20*. London.

If ISN may answer any questions about this submission or otherwise be of any assistance, please do not hesitate to contact me at .

Kind regards,

Zak May
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