ASIC

Australian Securities & Investments Commission

Maintaining market integrity in a changing environment

A speech by Greg Medcraft, Chairman,
Australian Securities and Investments Commission

Stockbrokers Association of Australia 2012 Annual Conference:
Keynote Speech

1 June 2012

Introduction

Good afternoon everyone. I hope you enjoyed your lunch.

I've been asked to speak about maintaining market integrity in a changing environment.

Our equity trading markets have always been dynamic. But every now and then, changes occur that fundamentally change the landscape.

These changes can be so significant that they require a review of the regulatory settings to ensure our markets remain fair and efficient – ASIC's second strategic outcome.

This also goes hand in hand with ASIC's first strategic outcome: confident and informed investors and consumers. As part of this, we need to ensure market integrity is maintained and that markets are fair, orderly and transparent.

Today, I would like to cover some of these changes, such as market structure, high-frequency trading (HFT) and dark pools, and enhanced market supervision.

Market structure: CP168

As you know, Australia now has competition in its exchange markets. As a result, we now have ASIC market integrity rules and market supervision has shifted to ASIC.

Technology has led to the markets becoming overwhelmingly electronic, and predominantly automated.

This raises a number of issues that can impact on the fair, orderly and transparent operation of the financial markets. These are important issues which ASIC is taking seriously.

In April, ASIC announced that it has refined its proposals for market structure reform. We also issued a timetable for implementing the regulatory framework.

The refined proposals are based on feedback that ASIC received on the key issues impacting market structure that were outlined in Consultation Paper 168 *Australian equity market structure: Further proposals* (CP 168). That paper was itself the result of an earlier consultation by ASIC.

Briefly, the refined proposals relate to:

- automated trading, including high-frequency trading;
- volatility controls for extreme price movements;
- enhanced data for surveillance;
- the product scope of best execution; and
- pre-trade transparency and price formation in the market.

For automated trading, ASIC will:

- make a new rule for kill switch capabilities;
- amend existing rules to require an annual review of systems; and
- publish guidance clarifying our expectations on trading system controls, testing of systems and additional minimum standards for direct market access.

For extreme price movements, ASIC will:

- amend existing anomalous order threshold and extreme cancellation range rules; and
- extend these rules to the ASX SPI 200 Index Futures contract.

For enhanced data for surveillance, ASIC will:

- seek to make a new rule requiring identification of some information, but, recognising the cost to industry, we will not extend it to all the information mentioned in CP168; and
- make no change to current clock synchronisation rules, and will publish guidance on the format of information provided to ASIC.

For best execution, ASIC won’t change the current obligations that apply.

For pre-trade transparency:

- ASIC will make a new rule on price improvement and alter the block sizes as proposed in CP168.
- There won’t be a minimum size threshold for dark orders. That said, ASIC plans to consult further with industry on these plans and potential triggers for future application of a minimum size threshold for dark orders.

Some of these areas I will discuss in a little more detail.

Dark pools and high-frequency trading

‘Dark pools’ and HFT continue to be very topical issues, both in Australia and globally.

Dark pools

The term 'dark pool' tends to evoke a strong reaction. Ex-ASIC Commissioner Shane Tregillis once correctly quipped that Alfred Hitchcock even called one of his TV dramas in the 1950s 'The Dark Pool', and that it conjured up the famous 'shark-approaching' music theme from the movie *Jaws*.

Last year, the International Organization of Securities Commissions (IOSCO) released a report, *Principles for dark liquidity*, which provided:

- a useful overview of the issues of dark liquidity;
- a description of the regulatory approaches taken by regulators internationally; and
- a set of principles to guide regulators, venues and general users of dark pools.

ASIC set out its views in the market competition consultation paper (CP 168). We acknowledged that various forms of non pre-trade transparent trading have always been part and parcel of our market structure and this has been – in large part – to minimise the impact of larger block transactions.

The block thresholds and crossing rules are meant to ensure an appropriate balance between exposure of trading on the market and facilitating larger transactions.

What has changed, however, is technology and the emergence of multiple pools of liquidity, both in formal venues and via internalisation within market participants. This more readily facilitates smaller and greater numbers of non-pre-trade orders being transacted off the lit markets. The changes to the 10-second crossing rule a few years ago also mean that crossings are no longer exposed to the market before being crossed internally on the books of a participant.

While in the short term it may seem everyone is better off by these developments, the actual result may be quite different. Even though most of the dark liquidity is priced by reference to the prices on the lit markets, research suggests that increased flows of dark liquidity can widen spreads on the lit market, resulting in everyone being worse off.

Accordingly, ASIC remains of the view that the quality of price formation on public markets continues to be an important public policy issue. Consistent with our strategic priorities of ensuring confident and informed investors, and fair and efficient financial markets, this issue is one that we intend to address.

One of the lessons from overseas is that ASIC needs to pay attention and deal with the issues early, given the dynamics involved. By the time everyone agrees on the extent of the problem, we may have already passed a tipping point.

As I stated earlier, we announced last month that we intend to:

- make a new rule requiring price improvement for dark trades below block size;
- replace the $1 million threshold for block trades with a tiered model;
- not implement a minimum size threshold for dark orders, but discuss with industry potential triggers for future application of a threshold; and
- consult on the draft market integrity rules very shortly, with the aim of making final rules in September/October 2012.

ASIC will also create a taskforce to review dark pools and other forms of off-market trading. The taskforce will look at:

- compliance with existing market integrity rules and Corporations Act requirements, including compliance with trading rules and conflict handling,
- supervision of trading in dark pools; and
- whether there should be additional requirements to ensure there is appropriate transparency and supervision.

As always, we look forward to engaging with you all as we make our way through these proposals.

High-frequency trading

We generally characterise HFT as automatically generating large numbers of orders based on price movements and market information, holding positions for a very short time, and ending the day with a zero position.

Relative to our international counterparts, HFT is not as prevalent in Australia. It is expected to grow, however, with industry feedback suggesting that HFT may already account for 15–25% of equity market turnover, up from 3–4% estimated by industry in February 2010. However, we also believe that overall market turnover generated by algorithms is close to 50%.

We further expect HFT to grow as competition between ASX and Chi-X plays out.

The ASIC position on HFT is a neutral one. We acknowledge the increased role of technology in trading, as well as the associated efficiency benefits it brings, but we are also acutely aware of the new regulatory risks that it brings. However, HFT and algorithmic trading can also disrupt the orderliness of the market if there has been poor programming or insufficient testing.

ASIC has no tolerance for any form of market misconduct, including market manipulation, irrespective of whether it originates from HFT or other participants.

We monitor HFT and algorithmic trading activity as part of our surveillance function. In addition to our focus on insider trading and market manipulation, we have identified matters concerning order management, including problematic algorithms. In this regard, we will continue to work with participants and their clients to reduce the risk of algorithms having a negative impact on market integrity.

Some of our regulatory concerns about electronic trading and HFT are also mitigated through the rules we currently have in place. For example:

- Participants are required to have controls. Unfiltered direct market access is prohibited under our market integrity rules.
- Operators are required to have anomalous order entry controls and trade cancellation policies (common extreme cancellation range).
- Naked short selling is prohibited, except for limited circumstances.
- If we see developments that pose an immediate risk to market integrity or client interests, we have an emergency rule-making power and can act quickly.

As I mentioned earlier, we have consulted on the main issues facing HFT and intend to:

- make a new market integrity rule for kill switch capabilities;
- amend existing market integrity rules to require an annual review of systems; and
- publish guidance on our expectations of trading system controls, testing of systems and additional minimum standards for direct market access.

As per our approach with dark pools, we will consult on these proposals very shortly.

Enhanced market supervision

As many of you would know, as part of the federal budget last month, the Government announced a budget commitment for ASIC to invest in a market surveillance system allowing it to plan for a future that includes:

- greatly increased message traffic;
- new technologies and trading techniques;

- increased competition between trading venues; and
- the increasing globalisation of capital markets.

This tackles many of the things that I've referred to above, including but not limited to HFT and dark pools.

It will replace the existing market surveillance system and will improve on technology which was originally designed for a single market environment. It will be a significant system upgrade, which will allow for greater capacity and capability, as well as cope with the increase in HFT and algorithmic trading.

The enhanced market surveillance system will have superior capabilities to search data records and identify suspicious trading by connecting patterns and relationships. This will improve our detection of insider trading relationships, which is consistent with ASIC's strategic priority of maintaining fair and efficient financial markets.

Stock markets are the engine room for economic growth in Australia. The new surveillance system will promote the integrity of our stock markets through the prevention, detection and investigation of market misconduct. This, in turn, will contribute to the confidence of investors, and the efficiency of our capital markets.

The cost of the enhanced surveillance system reflects an increase in the cost of supervision due to the increase in the complexity of trading methods used in our market with the advent of competition and dispersed trading venues – the licensed exchange markets and dark pools operated by the large investment banks. The funding has been provided on the basis of full cost recovery from the industry.

While there may be some concern in relation to cost recovery, we understand the model is a matter for Treasury who will take advice from the industry representatives on the cost recovery panel. That being said the actual cost of market supervision as a percentage of market turnover is favourable when compared to overseas jurisdictions.

We expect the funding cost will be smoothed out to minimise impact, and will be outweighed by the medium to long-term benefits of competition and of well-regulated, fair and efficient markets.

Markets Disciplinary Panel

With the transfer of market supervision to ASIC in 2010, ASIC established the Markets Disciplinary Panel (MDP), a forum for disciplinary action against market participants and market operators for alleged breaches of the market integrity rules.

The Panel is a peer review body and consists of part-time members with relevant market or professional experience. All its current members have, or have had, senior roles in broking firms and investment banks.

The Panel was established to make decisions about the issuance of infringement notices or to accept enforceable undertakings for alleged breaches of the market integrity rules. ASIC decides which matters are referred to the Panel, which will then decide whether it has reasonable grounds to believe that the person has breached the market integrity rules, and, if so, whether to issue an infringement notice, or accept an enforceable undertaking.

Infringement notices and enforceable undertakings are useful tools in ASIC's arsenal as they can produce timely and efficient outcomes. While infringement notices have a good deterrent effect, enforceable undertakings can influence behaviour and have a forward looking component.

Since its inception, the MDP has announced penalties totalling $120,000 for matters relating to alleged breaches of market integrity rules – and there are more in the pipeline. The most recent penalty was announced earlier this week, and dealt with an alleged contravention of a market integrity rule relating to fair and orderly markets.

I would like to take this opportunity to thank the members of the Panel for their contribution to the public interest, a contribution which illustrates the collaborative approach between ASIC and industry in working towards better and stronger outcomes for financial markets.

Conclusion

I hope this has given you a good snapshot of what ASIC is currently focused on in terms of maintaining market integrity in the current environment. This is part of ASIC's commitment to its strategic outcomes of fair and efficient financial markets, supported by confident and informed investors and consumers.

Before I finish, I'd like to mention ASIC's MoneySmart website: www.moneysmart.gov.au.

MoneySmart is ASIC's independent consumer website for all Australians, young or old, rich or poor, at different financial turning points and in different life stages.

MoneySmart provides consumers with unbiased tips and tools to help them with financial matters like investing in shares.

It's a great resource for the Australian public and I encourage you to refer retail investors to the site.

Since its launch in March 2011 more than 2 million Australians have visited MoneySmart.

Last week MoneySmart was named 'best service delivery website' at the 2012 Excellence in e-Government Awards.

Last year, it won the award for best government website at the 2011 Australian Web Awards.

Our user research tells us MoneySmart has successfully encouraged many people to take action on their finances, with 91% of users saying they have taken specific actions as a result of visiting the site.

MoneySmart was also one of only 10 sites out of 200 investor protection sites that were rated 'outstanding' and given a 5/5 rating by IOSCO.

We are organising a national initiative called MoneySmart Week from the 2nd to the 8th of September, which will encourage Australians to take simple steps to improve their finances. More information about this important initiative can be found at www.moneysmartweek.org.au.

Thank you for your time.

I'm happy to take questions.