MDP Circular
3 August 2017

Matter: MDP 265/16
Market Participant: Anonymised

The purpose of this release is to inform market participants of a recent decision of the Markets Disciplinary Panel ("the MDP") that did not result in the giving of an infringement notice to the market participant. The name of the market participant, the class of shares and the dates the conduct occurred have been anonymised.

The MDP recently made a finding that it did not have reasonable grounds to believe that the market participant had contravened subsection 798H(1) of the *Corporations Act 2001* in respect of the trading on ASX by the participant in a relatively illiquid class of shares during a 2 month period using a volume weighted average price (VWAP) algorithm with a participation cap.

ASIC had alleged that the trading contravened Rule 5.9.1 of the *ASIC Market Integrity Rules (ASX Market) 2010* ("the Rules"). Rule 5.9.1 of the Rules states:

> A Market Participant must not do anything which results in a market for a Product not being both fair and orderly, or fail to do anything where that failure has that effect.

The algorithm's effect on the market for the shares over the 2 month period was not considered by the MDP to have created a market for the shares that was not fair and orderly but, in the MDP's view, it did have an effect on the market for the shares that is a cause for some concern, particularly nearing the close, and also during the closing ASX auction. The subsequent changes to the logic of the algorithm made by the participant indicates that the participant itself recognised the same cause for concern.

The MDP was mindful of not creating an undesirable precedent that might have unintended consequences beyond this particular matter by effectively deeming a VWAP algorithmic strategy with a participation cap as being inherently not fit for purpose for markets that utilise a closing auction model. The MDP was also mindful of not creating an equally undesirable precedent of encouraging participants to routinely plead a "common trading algorithm defence". Rule 5.9.1 is a technology-neutral market integrity rule. An algorithm must yield to the Rules, not the other way round. It was open to ASIC to test the boundaries of Rule 5.9.1 in relation to certain kinds of common algorithmic trading strategies.

Particulars

A related party of the participant was acting on behalf of an underlying client. The underlying client wished to buy approximately 50,000 shares in the relevant class of shares.

The related party elected to implement the underlying client's instructions using an algorithm made available by the participant. The algorithm elected by the related party utilised logic based on volume weighted average price (VWAP) but subject to a maximum participation rate. The related party elected a maximum participation rate of 1% of daily traded volume of the shares. The algorithm aimed to match the daily VWAP benchmark but in a way that was intended to minimise market impact.

As the algorithm had a directive to buy and was endeavouring to track VWAP, the bid entered needed to transact with the best available offer in order to achieve an appropriate sampling size to track VWAP as closely as possible. During the day, if a resting bid submitted by the algorithm did not result in a trade after a period of time (e.g. 30 minutes), the algorithm would adjust the bid and cross the spread so as to match the best available offer. The algorithm would pursue liquidity throughout the trading day. The algorithm had a default setting that it would seek to participate in all closing ASX auctions.

ASIC acknowledged that the use of the algorithm in this particular matter was not motivated by any improper purpose. ASIC's key argument was that the use of the algorithm in relation to the shares during the 2 month period, particularly during the pre-closing single price (CSPA) session which occurs between 4.10pm and 4.12pm on each trading day, had a price impact on the shares that was disproportionate to the volume of shares acquired by the participant using the algorithm. ASIC placed considerable weight on a comparison of price increases, price volatility and trading occurring in closing auctions in relation to the shares as between the relevant 2 month period during which the algorithm was being used to buy the shares, and the immediately preceding 11 month period where it was not.

The participant argued that the bids submitted by the algorithm reflected genuine demand for the shares. The bids could not be said to be significantly away from the market price of the shares. The bid / offer spread reflected the market for the shares. The bids may have been crossing the spread during the day session (i.e. before the pre-CSPA session), but it could not be said that crossing the spread for a relatively illiquid stock resulted in the market for it not being fair and orderly.

The MDP found that the bids submitted during the pre-CSPA session seemed to be more problematic because they had an appearance of "marking the close" at very small volumes on a number of occasions during the relevant 2 month period. The algorithm participated in all 36 of the closing auctions for the shares with the algorithm being 100% of the buy-side volume on 33 of the closing auctions.

ASIC submitted that the algorithm participated in all 14 closing auctions in which the auction resulted in a price increase for the shares from the last traded price. The participant submitted that the algorithm's participation in closing auctions which resulted in a price increase had to be balanced against the following factors:

(a) during the relevant 2 month period, the algorithm participated in all 5 closing auctions in which there was a price decrease in the shares from the last traded price, and also in every remaining closing auction in which the auction price for the shares did not change from the last traded price;

(b) the average change in the last traded price to the auction price fell from the 0.37% price increase in the comparative 11 month period to the 0.29% price increase in the relevant 2 month period, which suggested that the effect of orders during the pre-CSPA session, did not vary significantly as between those respective periods.

The MDP did not consider the price movements of the shares throughout the 2 month period that were attributable to the bids submitted by the algorithm to have resulted in the market for the shares not being fair and orderly.