Australia readies for market competition

Article by Tony D'Aloisio, Chairman, Australian Securities and Investments Commission published in The Australian newspaper

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1 Wall Street's fall a fortnight ago was a reminder of the speed markets can move and the need for operators and regulators to co-operate to deal with these movements. The Dow Jones dropped 9.16 per cent in minutes before recovering to be down 3.2 per cent, while some stocks fell much more, going as low as $0.01. The derivatives markets dropped in tandem.

2 The jury is out on what caused the freefall. The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) have not nominated a single cause but suggest it might have been a confluence of events.

3 These include concerns over Greece and the UK elections; absence of liquidity providers, including high-frequency traders; a propensity for 'market orders' rather than 'limit orders'; algorithms programmed to respond to market events; and unusual volatility in exchange-traded funds.

4 During the fall, market operators responded in different ways. The NYSE's circuit breakers slowed trading on its exchange but liquidity just shifted to other markets that kept trading. What is more, the various markets did not have common trade cancellation arrangements. We understand many market operators have now agreed a framework to strengthen circuit breakers and handle erroneous trades on a market-wide basis.

5 In Australia, the ASX cash market was closed during the disruption. When the market opened, as usual, it took a strong signal from the end-of-day close in US rather than from the intra-day trading.

6 In contrast, the SFE's S&P/ASX 200 futures contract was available for trading and reacted with volatility but not to the same extent—few traders were immediately impacted and this impact could have been worse if the event had happened during the trading day.

7 The SFE does not have automated circuit breakers and did not suspend trading. Prices did not hit the SFE's threshold to trigger market-wide trade cancellations.

8 Sudden declines like on Wall Street are not limited to markets with multiple execution venues. Similar falls have happened on single markets. For example, those triggered by 'fat finger' errors in QBE Insurance in July 2008 and March 2009, that saw sudden declines from around $23 to $0.02 and $15.70 to $0.004 respectively, and back in a matter of minutes. There were also sudden movements on the SFE S&P/ ASX 200 futures contract in December 2008 and the 3-year bonds and 90 day bank bills in July 2007.

9 These events have influenced greater market focus on risk controls and clearer error resolution arrangements.

10 That is what happened. But what can we learn from the Wall Street events to prepare us for a multi-market environment?

11 I recognise competition (now Government policy) will bring new challenges for ASIC and the industry, including co-ordinating responses to market events and the impact of algorithmic trading.

12 We are giving much thought to how the Australian market might evolve. Overseas experience tells us competition may lead to many types of trading facilities, including diversity in exchange market models, third-party crossing facilities (such as specialist block crossings), broker-crossings that execute client flow (like Credit Suisse and UBS) and broker internalisation. Some of these are already happening in Australia under the ASX market rules.

13 We will be talking with the industry and reviewing the issues the SEC and CFTC have identified, including market-wide coordination of responses across cash and derivative markets, for example circuit breakers and error resolution. We will also consider whether ASIC requires access to extra information to replay market events and improve the investigation efficiency.

14 It needs to be borne in mind, however, that we have already taken steps - with ASX—that would help mitigate some of the risks of 6 May. These include the banning of naked short-selling, which should reduce short order volumes and slow declines; a review of algorithmic trading and direct access in Australia, which along with a recent ASX report, will inform market competition rules; and we are in the process of testing brokers' risk controls, including direct access filters, to limit erroneous and manipulative activity. ASIC is also engaged in IOSCO work to consider responses to the risks posed by high-frequency trading.

15 Other issues include how to ensure investors receive best execution and access to market data at reasonable cost. We intend to issue a consultation paper on market competition shortly after the transfer of supervision, and from there, begin a process of extensive discussion with the market.

16 What is more, we are putting in place a market surveillance system that will be able to take order and trade data from multiple markets and which will let ASIC monitor the whole-of-market in real-time. The system is scalable and has the flexibility to create new filters and alerts to respond to market changes.

17 The events on Wall Street two weeks ago underline the challenges we face in ushering in market competition. But the changes we have made—and keep making—have positioned us well to handle events like these. We continue to examine what happened on Wall Street and will listen to our stakeholders to ensure our system has integrity and is efficient, while also providing choice.