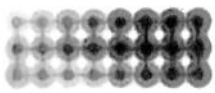

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COMMENTS IN RESPONSE TO CONSULTATION PAPER 145 (AUSTRALIAN EQUITY MARKET STRUCTURE: PROPOSALS)

INTRODUCTION

1. Thank you for this opportunity to present IMC's response to ASIC's Consultation Paper 145 concerning the Australian equity market structure.
2. IMC Pacific Pty Ltd, trading as IMC Financial Markets, is a wholly-owned subsidiary of IMC Financial Markets, a Netherlands based global proprietary trading firm established in Amsterdam in 1989. Since its establishment, IMC has specialised in market making in a range of financial products, including derivatives, equities and ETFs, on exchanges around the world. In addition to Amsterdam, IMC presently has subsidiaries or offices in Chicago, Hong Kong, Zug and Sydney. Collectively, IMC trades across markets in Europe, the United States and the Asia Pacific region, including Hong Kong, Japan and Korea. On the ASX and ASX 24 market platforms IMC is a registered market maker of Exchange Trade Options (ETOs), Contracts For Difference (CFDs) and ETFs.
3. The comments provided below reflect IMC's experience of over 20 years trading in these various markets and our observations of both regulatory and technological developments in these jurisdictions. We hope that ASIC will find our comments useful in navigating the best way forward as Australia enters this exciting phase of market development.

EXECUTIVE SUMMARY

4. As explained in greater detail below:
    - **Order entry controls:** IMC strongly favours the introduction of a requirement on Market Operators to implement controls to prevent the entry of anomalous orders into market platforms for both equity and derivative market products. A requirement on Market Operators to offer controls to prevent inadvertent crossings ("wash trades") should also be considered.

- **Error cancellation policies:** While IMC generally supports the implementation of Market Integrity Rules that mandates the adoption of clear, predictable cancellation policies, it should be possible for the resulting policies to take account of the circumstances of each product market. In particular, in the case of more complex and illiquid financial products, cancellation by mutual consent of the relevant parties should continue to be allowed. Further, the cancellation of all legs of Market Operator-prescribed combination strategies should be mandated.
- **Algorithmic trading:** As a general matter, IMC submits that while appropriate testing of algorithms is a necessary aspect of best practice in automated trading, the greater area of focus should be the organisational and technical resources, including filters, which stand between algorithms and the market platform.
- **Best Execution:** In IMC's view, the better regulatory approach to ensuring best execution is through the imposition of regulation at the level of the Market Operator, rather than the Market Participant. That is, a mandatory Smart Order Router obligation would appear to offer the most certain and cost-effective means of achieving this crucial regulatory outcome.
- **Pre-trade Transparency:** IMC broadly supports the approach proposed by ASIC to ensure pre-trade transparency and prevent market fragmentation, including the proposed numerical thresholds for exceptions to apply.

Below, IMC has also provided comments in response to ASIC's request for feedback regarding high frequency trading. We hope that these views will be helpful in guiding ASIC's approach to this important emerging area of market activity.

EXTREME PRICE MOVEMENTS (SECTION E)

Order entry controls for anomalous orders

5. IMC strongly supports the introduction of Market Operator level controls to prevent the entry of anomalous orders which are disruptive not only to the immediate market into which the order is entered, but also related markets which incorporate trade data from that immediate market. Where a Participant trades in such a related market, they will not necessarily be aware that price movements observed in the market are the result of erroneous trades in another market. This leads to knock-on effects as traders act in good faith on the basis of the original trade that is subsequently determined to have been entered in error.
6. In addition, IMC submits that ASIC should consider drafting a further Market Integrity Rule that requires a Market Operator to have in place operational

controls (filters) that would prevent the execution of inadvertent crossings or "wash trades". Such filters have recently become common in US markets[1] and provide an efficient and effective solution to an ongoing problem that, due to latency and other technical constraints, participant controls are incapable of completely controlling.

Market Integrity (E1Q1)

7. In IMC's view, Market Operator controls would significantly improve market integrity. By fixing parameters at the Market Operator level, market integrity will not be dependent on the consistency of the approach adopted by dozens of independent Participants who may not have a consistent view of what constitutes best practice or comparable capacity to enact best-practice controls.

8. The impact of Market Operator controls on trade cancellations will necessarily be dependent on the relationship between such controls and any trade cancellation policy adopted by the Operator. However, generally speaking, IMC expects that such controls will assist in reducing cancellations. Its impact will be particularly beneficial in derivatives markets both in this regard and in reducing the risk of other uncommercial trades concluded on the basis of error in the market for the underlying product.

Publication of thresholds (E1Q5)

9. IMC firmly believes that whatever thresholds are decided upon should be made public. This information will allow Participants to develop both any automated trading strategies and also appropriate resources required under MIR 5.6.3 in light of these thresholds and thereby reduce the risk to market integrity in the event that the Market Operator controls fail for any reason.

Controls for derivatives markets (E1Q8)

10. In IMC's view, controls should also be implemented for derivatives markets including markets for exchange trade options (ETOs). In the case of ETOs, the relevant parameters will need to be set relatively broadly for more distant contract months than nearer months, to reflect the significantly reduced liquidity in these more distant series. This is an issue identified correctly, in IMC's view, in two of the alternative trade cancellation models suggested in ASX's Consultation Paper dated 6 October 2010 regarding a revised Trade Cancellation Policy.[2]

Volatility controls for extreme market movements

11. IMC supports the proposal to require the implementation of volatility controls. Broadly, IMC would favour a mechanism that responded to spikes in volatility of

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1 Consider, for example, NYSE ARCA: http://www.nyse.com/pdfs/7277_STP_Modifiers.pdf.

2 See models 2 and 3 at pages 9 and 10: http://www.asxgroup.com.au/media/PDFs/20101006_trade_cancellation_policy.pdf

pre-determined size by placing the relevant financial product in an intra-day auction state, similar to that under the "notice received" regime in place on ASX. Such a mechanism would allow market participants an opportunity to consider the market transaction which resulted in the sudden price movement and whether that transaction reflected the true value of the financial product or a period of aberrant trading, possibly resulting from an error.

Application to operators of derivatives markets (E2Q11)

12. In IMC's opinion, volatility controls should be required for derivatives markets also. Market makers of Exchange Trade Options (such as IMC), are obliged to provide Bid and Ask quotes in a large number of options "series" throughout the trading day. Sudden price movements expose Market Makers to very significant losses where those Bids and Asks can not be removed from the market prior to being traded with on-market. This is a further, and IMC submits, unnecessary risk that must be reflected in the prices at which Bids and Asks are provided to the market via wider Bid/Ask spreads.

Transparent cancellation policies for clearly erroneous trades

Risks and benefits of transparent cancellation policy (E3Q1 and E3Q2)

13. IMC is in favour of clear trade cancellation policies that promote predictability in the how erroneous trades will be handled. To this end, it is generally preferable that Market Operators be relieved of a discretionary role in determining which trades should be cancelled on a case by case basis. Rather, Market Operators should be charged with determining parameters in which trades will be subject to given or possible outcomes that are not subject to determination by the Market Operator.

Multi-leg trades (E3Q2)

14. IMC recognises that, given the increasingly innovative ways that investors seek to trade one product with reference to another, a policy that allows for the cancellation of all legs of a trade that are merely "connected" in a particular trading strategy is unlikely to be practicable. However, in the case of established product combinations that are recognised in the Operating Rules of a Market Operator, there are strong reasons for a policy that either mandates or permits the cancellation of all legs of such a combination where one or more legs has been concluded in error.

15. By way of illustration, under the ASX Operating Rules Procedures, both Derivatives Only Combinations and Derivative/Cash Combinations must fall within the lists of "prescribed strategies" provided in Part A of Procedure 4503. These prescribed strategies are traded as multi-legged strategies at a net price, reflecting the net value of all the composite legs. Accordingly, trade in these

strategies is conducted on the assumption of a single strategy consolidating multiple legs and on the basis of a single net price, rather than on the assumption of individual legs each trading at a given price.

16. In this regard, these Market Operator-prescribed strategies are to be contrasted with undefined trader-determined strategies such as index/underlying arbitrage or ETF/underlying arbitrage strategies in which the contingent nature of the individual legs may not be capable of ready and objective verification in the case of a cancellation. The readily identifiable content of these strategy combinations make the cancellation of all legs reasonably practicable as well as an imperative measure for the maintenance of fair and orderly markets.

Policy should recognise the different needs of different product markets (E3Q3)

17. In relation to the types of outcomes that are appropriate, IMC agrees that a simple no cancellation range policy may be appropriate for cash equities. However, in relation to more complex financial instruments such as Exchange Traded Options (ETOs), the drive for greater commercial certainty should be tempered by some degree of flexibility both to protect properly informed price formation and to protect the interests of retail investors and in turn the long term trading volumes of the ASX market for ETOs.

18. In IMC's experience as an ETO market maker on the ASX, errors by counterparties trading ETOs are relatively frequent and may be made in respect of volume, price and also product. Possibly as a result of the relative complexity of ETOs, such errors appear to be more common than in Cash Market Products and are typically made by retail investors.

19. Two common types of error seen that are peculiar to ETOs are the following.

    (a) Mistakes in respect of option type: that is, a person may erroneously enter a buy order for the Dec 11 5000 BHP **Put** instead of the Dec 11 5000 BHP **Call** that they intended to buy. These are distinct products with typically different theoretical values and directly opposing views of future movements in the underlying product.

    (b) Mistakes in respect of the strike price: that is, a person may erroneously enter a buy order for the Dec 11 **5000** BHP Call instead of the Dec 11 **5500** BHP Call that they intended to buy. These are distinct products with quite different theoretical values.

20. It will be possible for a counterparty to "trade out" of an ETO position realised as the result of an erroneous order. However, in the many relatively illiquid ETO markets (the illiquid nature of which is the rationale for market making schemes) this will be costly. Under current market practice, the trades resulting from such errors are frequently cancelled with the consent of both counterparties acting in

recognition of their broader responsibility to uphold the orderliness of the market. A policy which prevented this current practice would necessarily harm retail investors who make the types of errors noted above without an appreciable benefit to market integrity.

21. For these reasons, in IMC's view, the long-term health of the ETO market will be better served by a trade cancellation policy for this class of product which continues to allow for cancellation of errors by consent between counterparties.

ELECTRONIC TRADING REQUIREMENTS (SECTION F)

General comments

22. IMC is broadly in favour of ASIC's proposals in relation to direct electronic access minimum requirements. There must not be a competitive advantage, resulting from lesser regulatory scrutiny, for a trading firm that accesses the market via a Market Participant rather than via its own connectivity after assuming the regulatory responsibilities of being a Participant in its own right.

Algorithmic trading minimum requirements

23. IMC notes that ASIC has proposed Market Integrity Rules that would introduce obligations on Market Participants in respect of algorithmic trading (F4). As a general matter, IMC submits that while appropriate testing of algorithms is a necessary aspect of best practice in automated trading, the greater area of focus should be the organisational and technical resources, including filters, which stand between algorithms and the market platform. It is this level of automated trading systems which must ultimately prevent the passage of erroneous orders into a market platform. Further, this level of trading systems is already subject to ASIC oversight through the Automated Order Processing system certification and notification (of any material change) regime under the ASIC Market Integrity Rules (Part 5.6).

High Frequency Trading: Feedback

HFT strategies prevalent in Australia (F6Q1)

24. The proliferation of automated trading in markets globally has given rise to a new, loosely-defined category of proprietary trading firms called "high-frequency trading firms." Although there is no industry wide accepted definition of the activity of high-frequency trading ("HFT"), we believe it sensible to define it as all high turnover, high capacity, latency sensitive strategies in need of physical proximity to an exchange matching engine. Adopting this definition of high frequency trading, the range of strategies which are pursued in Australia is broad.

25. That said, these strategies can be broken down into two general, though not mutually exclusive, categories:

    (a) **Market Making:** Market making strategies provide liquidity to markets by displaying continuous Bid and Ask quotes on the relevant market platform. The market maker seeks to earn a profit on each quote that is accepted by investors looking to sell or purchase the relevant security on market. These prices are amended frequently as new public information is incorporated into the displayed quotes.

    The economics of market making is driven by the ability of the participant to capture and retain part of the prevailing market spread in the relevant securities. Besides the required risk premium, other costs such as exchange connectivity, trade fees and clearing costs are all factors determining how much of this spread is retained. It is for this reason that increased competition between exchanges results in lower exchange costs which in turn leads to tighter spreads and more liquidity.

    (b) **Arbitrage:** arbitrage strategies seek to profit from price differentials between products that are closely correlated, such as multiple-listed equities, futures, CFDs and ETFs. These strategies provide an essential service to the rest of the market by ensuring that prices remain consistent among different trading venues. In addition to this, these strategies add liquidity to platforms that would not ordinarily have natural liquidity themselves.

Affect on market integrity (F6Q1)

26. Market participants, including retail investors, benefit from competition among proprietary trading firms. Increased competition in the markets among such professional firms provides greater depth of liquidity, decreases short-term volatility and tightens spreads. The result for investors is that they are able to buy and sell at more favourable prices and with lower execution costs. Various studies have shown that the average institutional transaction cost has decreased substantially over the last 10 years. IMC believes that HFT firms have played a critical role in this development.

27. Competition also promotes efficiency. Professional firms devote substantial resources to their exchange connectivity, pricing models, and market data, which allow them to effectively react to market inefficiencies. The benefit for all market participants is a more efficient market where pricing imbalances are corrected quickly and effectively. Similarly, competition protects against manipulative pricing and abuse, as pricing is dictated by a greater number of professional trading firms, rather than through a few specialist firms.

Order cancellations in HFT (F6Q4)

28. The primary source of order updates in the markets stems from market making activities that proprietary firms, like IMC, employ. Proprietary firms that engage in market making use publicly available market data to submit bids and offers, thereby providing liquidity in the marketplace at specific prices. Proprietary firms engaging in market making are simply fulfilling the traditional role that exchange specialists held on manual trading floors. However, they are doing it more efficiently in a more competitive environment.

Message volume controls (F6Q5)

29. In IMC's view, controls on message volume will necessarily come at the expense of wider Bid/Ask spreads than would otherwise be provided in a market. This follows from the economic drivers for market makers and others providing liquidity via two-sided quoting strategies.

30. In short, a market maker is financially exposed for the time that any given quote provided sits in a market. Any gap in time between the publication of new information relevant to the price of a security and the market maker incorporating that information in its quote prices represents a financial risk that must be incorporated in the market maker's prices. The shorter the gap in time, the better the price (via tighter Bid/Ask spreads) that may be provided in the market maker's quotes. This relationship between speed, spread and liquidity is evident on many exchanges and clearly adds value to all participants.

31. Conversely, measures that would increase the above gap in time (for example, message speed limits) or otherwise increase the financial risk or cost of providing liquidity to markets via a two-sided quoting strategy (for example, minimum exposure times for orders or fees for order cancelations) will necessarily lead to wider Bid/Ask spreads as Participants incorporate the additional financial risk into their quoted prices.

Impact of HFT on price formation, depth and quality of the order book (F6Q6)

32. In IMC's experience, HFT has had a significant positive impact on the quality of markets globally. Firms engaged in HFT contribute significant liquidity, particularly in financial products that may otherwise be relatively illiquid such as some derivatives and newly-issued ETFs. Through the operation of arbitrage strategies, firms engaged in HFT make a significant contribution to price formation.

Formal obligations on liquidity providers (F6Q7)

33. In IMC's view, liquidity providers should not be subject to obligations other than those obligations a liquidity provider elects to meet pursuant to a formal market making agreement entered into with either a Market Operator or an issuer of a

financial product. Quoting obligations are dealt with adequately under these agreements and additional regulation would appear likely to significantly complicate matters without necessarily providing a material benefit in market quality. Further, such agreements typically provide incentive for a Participant to undertake those obligations and, accordingly, a more coercive approach to achieving responsible liquidity provision would not appear necessary.

34. ASIC further asks whether there should be a limit on "aggressive liquidity [taking] during extreme market conditions". With respect, IMC would question how "aggressive" liquidity taking may be distinguished appropriately from acceptable liquidity taking and also how "extreme" market conditions may be distinguished in real-time from market conditions that are more typical in their volatility. More generally, in IMC's experience, trading against sitting market orders is a crucial tool for market makers to manage product inventory and commercial risk as the subject market and related markets move in response to new market information. Restricting a market maker's capacity to appropriately manage inventory and risk, particularly in volatile market situations, would greatly compromise a market maker's ability to provide this financial service efficiently, honestly and fairly.

Exemption from naked short selling bans for liquidity providers (F6Q8)

35. Market volumes from one day to the next and the quantity of a financial product that a market maker must hold of that product, or a related hedge product, to meet market demand are necessarily uncertain. In IMC's view, properly targeted relief from short selling restrictions can play an important role in mitigating the consequences of this uncertainty by allowing a market maker to sell the relevant security before securing the product to ensure settlement. Relief thereby allows a market maker to provide a two-sided market continuously through a trading day. Further, by reducing the cost incurred in either holding or borrowing the traded product, targeted relief allows a market maker to provide a relatively tighter Bid/Ask spread in the relevant market.

BEST EXECUTION (SECTION G)

General comments

36. In IMC's experience in multi-market jurisdictions, the question of how to ensure execution at the best available price is the single most important regulatory issue to be addressed. While IMC believes ASIC has proposed a workable solution, we also believe that the European approach of achieving the desired policy outcome through regulating Market Participant, rather than Market Operator, conduct should not be followed.

37. In IMC's view, the better approach is to mandate best execution at the Market Operator level. Specifically, exchanges should be prohibited from executing an

order at a price inferior to that available at another exchange. As noted in the Consultation Paper,[3] this is the approach that has been adopted in the United States under Regulation NMS (National Market System) which proceeds on underlying principles that, IMC submits, would also benefit the Australian marketplace as it moves to a multi-market trading environment.

Specific Comments: Benefit of Trade-through protection

Overlay of trade-through protection (G1Q2)

38. In IMC's view, for the reasons that follow, the benefits of imposing Market Operator level trade-through protection outweigh the costs which the Consultation Paper notes as a primary reason for not mandating this type of solution.[4]

Investor protection

39. Investor protection lies at the heart of best price execution. In the United States, this principle underlies the Order Protection Rule. As the US Securities and Exchange Commission (SEC) commented in relation to the rationale for Regulation NMS:

> Why did a broad spectrum of commenters, many of which have extensive experience and expertise regarding the inner workings of the equity markets, support the Order Protection Rule and its emphasis on the principle of best price? They based their support on two fundamental rationales, with which the Commission fully agrees. First, strengthened assurance that orders will be filled at the best prices will give investors, particularly retail investors, greater confidence that they will be treated fairly when they participate in the equity markets. Maintaining investor confidence is an essential element of well-functioning equity markets. Second, protection of the best displayed and accessible prices will promote deep and stable markets that minimize investor transaction costs.[5]

40. This view was supported by empirical evidence gathered by SEC staff in relation to "trade-throughs" or trades executed at prices inferior to the prevailing best execution price available. The SEC staff study of trades undertaken in respect of NYSE and Nasdaq stocks revealed that 2.5% of trades were executed at a price inferior to the best available price.[6] Relevantly to the decision now before ASIC, these were the results realised under a broker-focussed model under which brokers sought the best execution price for their clients.

41. Further, as the SEC noted, the repeated trade-throughs can be expected to have a deleterious effect on investors' confidence in the fair and efficient treatment of

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3 CP145, paragraph 208.

4 CP145, paragraph 213.

5 SEC, 17 CFR PARTS 200, 201, 230, 240, 242, 249, and 270 [Release No. 34-51808; File No. S7-10-04] (9 June 2005) at page 11, accessed via: http://www.sec.gov/rules/final/34-51808.pdf.

6 Id, page 58.

their orders.[7] Moreover, as the SEC noted, the quality of market depth and liquidity necessarily depends on the strength of price protection offered.[8] Where market participants perceive a significant risk that displayed orders will not be matched, this perception will lead to a disinclination to display significant order size.

Competition

42. Fundamentally, a best execution obligation drives competition in two respects. First, the obligation will drive competition between exchanges to maximise trading revenues by offering efficient and innovative trading services. Secondly, the obligation drives competition between market orders leading to the increasingly efficient pricing of individual stocks.

43. While a broker-focussed regulatory system will tend to produce this competition, an exchange-focussed system will provide this result with certainty as it removes the risk of inferior prices being inadvertently rewarded as a consequence of the infrastructure of the broker through whom an order is placed. The comments of the SEC noted above in relation to the frequency of inferior transaction prices in Nasdaq and NYSE stocks prior to the introduction of Regulation NMS are apposite in this regard.

Participant Infrastructure costs

44. Under a Market Participant-focussed regulatory regime, and even with proposed provision for smart order routing, Participants can be expected to upgrade order placement and market data feed infrastructure connecting to each exchange on a regular basis to ensure commercial performance as well as compliance with best execution obligations. This will lead to significantly increased IT costs for Participants. By contrast, under a Market Operator-focussed regulatory regime, connectivity and market data feed infrastructure can be consolidated as Participants relying on the order routing infrastructure of one exchange will not be subject to a competitive disadvantage in doing so.

Reduced enforcement and compliance costs

45. A Participant-focussed regulatory regime will necessarily require ASIC and each Participant's compliance staff to monitor the Participant's performance in meeting its best execution obligations. This monitoring will be complex and the results often uncertain. Particularly as market latencies descend to microseconds, significant effort will be required to discern retrospectively whether a particular order was routed in accordance with the Participant's obligations. The interests of effective enforcement would require that this exercise is undertaken in respect of the order routing infrastructure of each

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7 Id, page 59.

8 Id, page 59 to 62.

Participant, with significant attendant cost. By contrast, a Market Operator-based regime can be monitored effectively from the vantage of points of each participating Market Operator only.

Best execution for trade in derivative markets (G1Q9)

46. Should further derivative market platforms be established in Australia, IMC would be strongly in favour of extending a best execution obligation for trade in those products. Given the relative difficulty in attracting sufficient liquidity to existing derivative markets, IMC believes that the case for Market Operator level obligations explained above, is stronger again in the context of trade in derivatives.

PRE-TRADE TRANSPARENCY AND PRICE FORMATION (SECTION H)

General comments

47. The introduction of competition by allowing a further Market Operator in Australia is to be welcomed. Clearly, however, this welcome development also increases the importance of maximising the flow of orders to these markets.

48. Based on IMC's experience globally, we believe that trading in dark pools detracts from price transparency and that this threat to price transparency will only increase as dark pools attract increasingly higher trading volumes. In IMC's view, the cost of this loss of transparency will primarily be born by investors as providers of liquidity, including market makers, incorporate the risk posed by unknown market data into the prices at which they are prepared to offer to trade in the relevant product.

49. For this reason, IMC generally supports the proposals put by ASIC to prevent market fragmentation, including the proposed numerical thresholds for exceptions to apply. IMC would only note the need to draft relevant MIRs to prevent circumvention by methods such as client order aggregation.

Specific Comments

Block trade regime (H1Q1)

50. In IMC's view, the proposed block trade regime strikes a reasonable balance between mitigating market impact from large orders and ensuring the integrity of market prices.

Priority for pre-trade transparent orders (H3Q1)

51. IMC agrees that pre-trade transparent orders should always be given time priority over undisclosed orders. By placing orders in a transparent market, a trader contributes to the important public good of price discovery and formation. The confirmation of priority for pre-trade transparent orders is an appropriate reward for this contribution. Further, the converse situation in which undisclosed

orders are afforded time priority would impact negatively on transparent market activity. Here, a trader would enter orders into a transparent market order book necessarily ignorant of true priority of his or her order relative to the market. Clearly enough, this would be an unwelcome development for traders in equity markets.

CONCLUSION

52. Thank you for the opportunity to provide the comments above. If IMC may expand on any of these comments, please do not hesitate to contact us via IMC's Legal and Compliance Officer, [redacted]

Yours faithfully

IMC Financial Markets