



**ASIC**

Australian Securities & Investments Commission

CONSULTATION PAPER 202

# Dark liquidity and high-frequency trading: Proposals

March 2013

## About this paper

This consultation paper is for market operators and market participants of Australia's equity and futures markets, as well as investors, intermediaries and listed companies.

It proposes Market Integrity Rules and guidance to address ASIC's concerns about the impact of developments in dark liquidity and high-frequency trading on market quality, market integrity and fairness.

Note: For more details about the recent developments and our concerns, see Report 331 *Dark liquidity and high-frequency trading* (REP 331).

### About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

**Consultation papers:** seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

**Regulatory guides:** give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

**Information sheets:** provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

**Reports:** describe ASIC compliance or relief activity or the results of a research project.

### Document history

This paper was issued on 18 March 2013 and is based on the Corporations Act as at the date of issue.

### Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

# Contents

<b>The consultation process</b> .....	<b>4</b>
<b>A Background to our proposals</b> .....	<b>5</b>
What are dark liquidity and high-frequency trading? .....	5
Summary of our proposals.....	6
<b>B Dark liquidity: Proposal for a minimum size threshold for dark orders</b> .....	<b>10</b>
The need for a minimum size threshold .....	10
Proposed trigger and threshold .....	11
<b>C Dark liquidity: Proposals for crossing system operators</b> .....	<b>16</b>
Transparency for the wider market.....	17
Disclosure to users .....	19
Fairness to all users.....	22
Opting out .....	23
Monitoring .....	24
Record keeping.....	25
Systems and controls .....	27
<b>D Dark liquidity: Other proposals</b> .....	<b>29</b>
Tick sizes .....	29
Course-of-sales disclosure (T+3) .....	30
Conflicts of interest .....	32
Payment for order flow.....	34
Indications of interest.....	36
<b>E High-frequency trading: Proposals</b> .....	<b>38</b>
Excessive messaging and market noise .....	38
Manipulative trading.....	42
<b>F Regulatory and financial impact</b> .....	<b>45</b>
Possible impact of the proposals .....	46
<b>Appendix 1: Sample of recent activity</b> .....	<b>50</b>
<b>Appendix 2: Proposed guidance on manipulative trading</b> .....	<b>52</b>
Trading practices that are illustrative of manipulative activity .....	52
Circumstances that may indicate manipulative activity .....	53
Trading strategies that impact the efficiency and integrity of the market.....	54
<b>Key terms</b> .....	<b>55</b>

## The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on dark liquidity and high-frequency trading. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see Section F, 'Regulatory and financial impact'.

### Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 10 May 2013 to:

Dior Loveridge and Joseph Barbara  
 Australian Securities and Investments Commission  
 Level 5, 100 Market Street  
 Sydney NSW 2000  
 facsimile: 02 9911 5232  
 email: marketstructure@asic.gov.au

### What will happen next?

<b>Stage 1</b>	18 March 2013	ASIC consultation paper released
<b>Stage 2</b>	10 May 2013	Comments due on the consultation paper
<b>Stage 3</b>	July/August 2013	Rules and regulatory guide released

## A Background to our proposals

### Key points

This consultation paper proposes a number of changes and additions to the ASIC Market Integrity Rules in response to the impact of dark liquidity and automated trading activities on the Australian market.

Our proposals are based on the recommendations from two internal taskforces that have undertaken thematic reviews of dark liquidity and high-frequency trading.

We consider these proposals are necessary to ensure the continued quality, integrity and fairness of the Australian market.

- 1 This consultation paper builds on ASIC's previous work on dark liquidity and automated trading. In July 2012, we established two internal taskforces to undertake thematic reviews of issues related to dark liquidity and high-frequency trading. The core aim of the taskforces was to build on work already undertaken and deepen ASIC's understanding of the impact of these developments on market quality, market integrity and fairness.
- 2 The proposals in this consultation paper reflect the recommendations of the taskforces. This consultation paper should be read in conjunction with Report 331 *Dark liquidity and high-frequency trading* (REP 331), which provides more detail on the issues and the findings of the taskforces, and provides evidence to substantiate the proposals.
- 3 The proposals in this paper are designed to maintain the quality, integrity and fairness of the Australian market. Our focus has been on the interests of listed companies, fundamental investors<sup>1</sup> and Australia's competitiveness as a regional financial centre.

### What are dark liquidity and high-frequency trading?

- 4 Dark liquidity and high-frequency trading are separate but related issues, with the two interacting and influencing investor activity. Both issues have emerged in the context of sophisticated market trading and operating technology.
- 5 Dark liquidity refers to orders that are not known to the rest of the market before the orders are matched as trades. Such trades, known as 'dark trades' can occur on public exchange markets (e.g. ASX's Centre Point and hidden orders on Chi-X's order book) and away from these markets. Rather than routing an order to a market, a market participant may choose to fill the order from its own inventory (known as internalisation), or may choose to 'cross' it with other client orders.

---

<sup>1</sup> A fundamental investor is a person that buys or sells a security based on an assessment of the intrinsic value of the security.

6 High-frequency trading is not a technical term and has been described in various ways. The International Organization of Securities Commissions (IOSCO) describes high-frequency trading as follows:

High-frequency trading is frequently equated to algorithmic trading. However, whilst HFT is a type of algorithmic trading, not all forms of algorithmic trading can be described as high frequency. A number of common features and trading characteristics related to HFT can be identified:

- It involves the use of sophisticated technological tools for pursuing a number of different strategies, ranging from market making to arbitrage;
- It is a highly quantitative tool that employs algorithms along the whole investment chain: analysis of market data, deployment of appropriate trading strategies, minimisation of trading costs and execution of trades;
- It is characterised by a high daily portfolio turnover and order-to-trade ratio (i.e. a large number of orders are cancelled in comparison to trades executed);
- It usually involves flat or near flat positions at the end of the trading day, meaning that little or no risk is carried overnight, with obvious savings on the cost of capital associated with margined positions. Positions are often held for as little as seconds or even fractions of a second;
- It is mostly employed by proprietary trading firms or desks; and
- It is latency sensitive. The implementation and execution of successful HFT strategies depend crucially on the ability to be faster than competitors and to take advantage of services such as direct electronic access and co-location.<sup>2</sup>

7 It is important to note that several of these attributes are not confined to those proprietary trading firms that identify themselves, or are identified by others, as ‘high-frequency traders’. Many investors and market participants use sophisticated technologies for trading and deploy algorithms to trade execution decisions according to predetermined parameters.

## Summary of our proposals

8 Table 1 and Table 2 summarise the topics that we seek feedback on in this consultation paper. These include:

- (a) proposed new or amended rules for addressing regulatory issues that have been identified;
- (b) options for addressing regulatory issues that have been identified; and
- (c) topics on which we seek industry views to help inform whether there are regulatory issues that need to be addressed.

9 For the draft new and amended rules reflecting these proposals, see the attachment to this paper.

---

<sup>2</sup> Technical Committee of IOSCO, *Regulatory issues raised by the impact of technological changes on market integrity and efficiency*, report, July 2011, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD354.pdf>.

**Table 1: Summary of proposals: Dark liquidity (Sections B–D)**

Note: The proposals in this paper apply to the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011, ASIC Market Integrity Rules (ASX Market) 2010, ASIC Market Integrity Rules (Chi-X Australia Market) 2011 and ASIC Market Integrity Rules (ASX 24 Market) 2010. A reference to a rule, part or chapter followed by '(Competition)', '(ASX)' and '(Chi-X)' or '(ASX 24)' refers to a particular rule, part or chapter of the relevant rules. 'ASIC Market Integrity Rules (Competition)' refers to the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011.

Issue	Proposal	Reference	Implementation from time rule is made	Products	Principle
Proposal for minimum size threshold for dark orders (see Section B)					
Minimum size threshold for dark orders	We propose to issue a statement on a trigger for implementing a minimum size threshold for dark orders to apply where there is evidence that dark liquidity has caused degradation in the price formation of a security or group of securities	See proposal B1	Issue statement in the third quarter of 2013	Equity market products	Market quality
Proposals for crossing system operators (see Section C)					
Transparency for the wider market	New and amended rules: crossing system operators to make publicly available information about their crossing system, including the products traded, access criteria, order types, whether it is an aggregator, fees and monthly turnover statistics	See proposal C1	One month	Financial products	Market integrity
Disclosure to users	New rule: crossing system operators to provide users with information about user obligations, execution risk, and the operation of the crossing system Amended rules: on trade confirmations, crossing system operators to specify venue (exchange or crossing system) and advise if trading as principal	See proposals C2–C4	Six months Three months	Financial products	Market integrity
Fairness to all users	New rule: crossing system operators to ensure procedures do not unfairly discriminate between crossing system users	See proposal C5	Three months/ Six months	Financial products	Fairness
Opting out	New rule: crossing system operators to provide clients with a choice to opt out of using the crossing system at no additional cost and with no additional operational or administrative requirements	See proposal C6	Three months	Financial products	Fairness
Monitoring	New rule: crossing system operators to monitor orders and trades on the crossing system and report to ASIC instances of suspicious activity or material non-compliance with user obligations and procedures	See proposal C7	Six months	Financial products	Market integrity

Issue	Proposal	Reference	Implementation from time rule is made	Products	Principle
Record keeping	New rule: crossing system operators to make records about all orders (including the parameters set for each order) in the crossing system and retain these for seven years	See proposal C8	Six months	Financial products	Market integrity
Systems and controls	New rule: to extend existing system and control requirements for automated order processing to crossing systems. Crossing system operators to notify users and ASIC about system issues  Guidance: crossing system operators to have adequate resources to manage stressed market conditions	See proposal C9	Six months/ May 2014	Financial products	Market integrity
Other proposals (see Section D)					
Tick sizes	We seek industry views on options to lower the tick size either for securities in the S&P/ASX 200 priced from \$2-\$5 (from \$0.01 to \$0.005), or for the 25 most tick-constrained securities (to the next tick size down), to be initially implemented on a pilot basis	See issue D1	N/A	Equity market products	Market quality
Course-of-sales disclosure (T+3)	New rule: ASX and Chi-X market operators to make available course-of-sales information on T+3 as they do now, with the addition of market participant identifiers and venue (including crossing system)	See proposal D2	Immediately, except the venue, which applies from March 2014	Financial products	Market integrity
Conflicts of interest	New and amended rules: to enhance conflicts of interest obligations (e.g. market participants to protect client information and give client orders priority when trading as principal)  Guidance: on managing conflicts of interest when handling and executing orders	See proposal D3	Three months	Financial Products	Fairness
Payment for order flow	New rules: to prohibit direct cash payments for the opportunity to handle and execute orders, and put controls around soft-dollar incentives  Guidance: for other Australian financial services (AFS) licensees affected by the new rules	See proposal D4	Immediately	Financial products	Fairness
Indications of interest	To determine what if any regulatory response is necessary, we have asked a number of questions about the impact of indications of interest on market integrity, market quality and fairness.	See issue D5	N/A	Financial products	Market integrity



**Table 2: Summary of proposals: High-frequency trading (Section E)**

Issue	Proposal	Reference	Implementation from time rule is made	Products	Principle
Excess messaging and market noise	New rule: minimum resting periods for small and fleeting orders applied to market participants Guidance: on order-to-trade ratios	See proposals E1–E2	Six months	Financial products	Market quality and fairness
Manipulative trading	Amend Rule 5.7.2(b) (ASX) and (Chi-X): to remove the reference to materiality and include the consideration of the impact of the order  Amend Rule 5.7.2 (ASX) and (Chi-X): to include the following additional circumstances in considering whether a false or misleading market has been created—the frequency with which orders are placed, the volume of products that are the subject of each order and the extent to which orders made are cancelled or amended relative to the orders executed  Amend Rule 3.1.2 (ASX 24): to harmonise manipulative trading provisions across the Market Integrity Rules for the ASX, Chi-X and ASX 24 markets  Guidance: on trading practices that are illustrative of manipulative activity	See proposal E3	Six months	Financial products	Market integrity

## B Dark liquidity: Proposal for a minimum size threshold for dark orders

### Key points

We seek comments on two options for circumstances in which we will amend the Market Integrity Rules to implement a minimum size threshold for dark orders for a security or group of securities. This would include:

- monitoring the relevant trigger on a quarterly basis to determine when to increase the minimum size threshold;
- not permitting the aggregation of orders to meet the threshold; and
- periodically reviewing the categories and thresholds in consultation with industry.

### The need for a minimum size threshold

- 10 It is important to balance pre-trade transparent liquidity (i.e. ‘lit’ exchange market liquidity) and dark liquidity so that the price formation process on public exchange markets is not undermined: see paragraph 73 of REP 331. There is a risk that if too much liquidity shifts away from lit exchange markets, it may lead to a wider gap between buying and selling interests (i.e. bid–offer spreads). This may lead to worse prices for those trading on lit exchange markets as well as those trading in the dark. Wider spreads can result in larger price fluctuations, which make it more difficult, and potentially costly, for companies to raise capital. It can also reduce investor confidence, because investors pay a higher price to access liquidity.
- 11 We have previously consulted on a minimum size threshold for dark orders.
- (a) In November 2010, we consulted on a \$20,000 threshold and a requirement for dark orders to receive meaningful price improvement: see Consultation Paper *Australian equity market structure: Proposals* (CP 145). We decided to consider these proposals further and instead implemented a threshold set to \$0.
  - (b) In October 2011, we consulted on price improvement and on increasing the threshold from \$0 to \$50,000 if dark liquidity increased by 50% in absolute terms within a three-year period from mid-2011: see Consultation Paper 168 *Australian equity market structure: Proposals* (CP 168). There was both support and opposition to a trigger and debate about it being based on an absolute value. We made the price improvement rule, which takes effect on 26 May 2013. We said we would monitor developments and engage with industry on potential triggers.

- 12 Emerging evidence domestically and abroad confirms that a significant shift of liquidity away from lit exchange markets may lead to a degradation of price formation. There are early signs of this in the Australian market, with a number of securities seeing a decline in the quality of price formation: see paragraphs 103–119 of REP 331.
- 13 We expect that the price improvement rule, which takes effect on 26 May 2013, will mitigate these developments. This has been the case in Canada where there is a similar rule in place: see paragraphs 120–122 of REP 331. However, we consider it important to guard against possible future degradation of price formation.

## Proposed trigger and threshold

### Proposal

**B1** We propose to:

- (a) seek feedback on two (alternative) triggers which may indicate that dark liquidity has impaired price formation for a security or group of securities (see Option B1.1 and Option B1.2 in Table 3);
- (b) consider the feedback and:
  - (i) confirm to the market which trigger we intend to treat as indicative of impaired price formation;
  - (ii) monitor the relevant trigger on a quarterly basis by comparing the trigger each quarter to a static six-month reference period between April and September 2011;
  - (iii) if the confirmed trigger is met, announce that this is the case, and amend Rules 4.1.5 and 4.2.3 (Competition), subject to the Minister's consent at the time; and
  - (iv) apply the amended rules 40 business days from the date they are made;
- (c) not permit the aggregation of orders to meet the minimum size threshold (however, if a dark order that meets the threshold receives a partial fill, which results in the remaining balance being less than the threshold, that order may continue to remain dark); and
- (d) periodically review the categories and thresholds in consultation with industry.

This proposal applies to equity market products.

**Table 3: Proposed options for minimum size threshold for equity market products**

	Trigger	Minimum size threshold
<b>Option B1.1:</b> Threshold applies to a group of securities	<p>The minimum size threshold would apply if:</p> <ul style="list-style-type: none"> <li>• dark liquidity (excluding block size trades) for a security exceeds 10%;</li> <li>• there is a 4% increase in the pre-trade transparent quoted spreads for that security; and</li> <li>• there is a 15% decrease in the depth at the top five price points for that security.</li> </ul>	<p>The following minimum size threshold would apply to one or more categories of securities when one third of the securities in the category meet the trigger:</p> <ul style="list-style-type: none"> <li>• <i>Category 1:</i> \$50,000, for all equity market products in the S&amp;P/ASX 50;</li> <li>• <i>Category 2:</i> \$20,000, for all equity market products in the ASX 51–300; and</li> <li>• <i>Category 3:</i> \$20,000, for all equity market products in the ASX 300+.</li> </ul> <p>If a security moves from one category to another, it would be treated like other securities in the new category.</p>
<b>Option B1.2:</b> Threshold applies on a tiered security-by-security basis	<p>The minimum size threshold would apply if:</p> <ul style="list-style-type: none"> <li>• dark liquidity (excluding block size trades) for a security exceeds 10%;</li> <li>• there is a 20% increase in the pre-trade transparent quoted spread for that security; and</li> <li>• there is a 20% decrease in the depth at the top five price points for that security.</li> </ul>	<p>The following minimum size threshold would apply to any security in the category that meets the trigger:</p> <ul style="list-style-type: none"> <li>• \$50,000, for Tier 1 equity market products<sup>3</sup> as defined in draft Rule 4.2.3 (Competition) (approximately 205 products); and</li> <li>• \$20,000, for Tier 2 and 3 equity market products as defined in draft Rule 4.2.3 (Competition) (all other products).</li> </ul> <p>Securities would be allocated to tiers based on average daily volume on the same basis as Rule 4.2.1 (Competition) on block size trades, which takes effect on 26 May 2013 (quarterly).</p> <p>If a security moves from one category to another, it would be treated like other securities in the new category.</p>

*Your feedback*

B1Q1 Do you agree that a safety net proposal like this is necessary?

B1Q2 Do you agree that the proposed triggers in Option B1.1 and Option B1.2 are appropriate indicators that there has been degradation in price formation?

B1Q3 Do you have a preference for either option? Please explain your rationale.

<sup>3</sup> Tier 1 refers to equity market products with 2.5% of their average daily volume greater than \$1 million, Tier 2 refers to equity market products with an average daily volume of greater than \$500,000 but less than \$1 million, and Tier 3 refers to all other equity market products. The list of Tier 1 and Tier 2 equity market products is updated quarterly by ASIC and published online at <http://www.asic.gov.au/block-trade-tiers>.

B1Q4 Are there any securities or group of securities for which it would be preferable to implement a minimum size threshold immediately (e.g. securities outside the S&P/ASX 300)? If so, which threshold should apply?

B1Q5 Do you have any views on the proposed implementation timeframe of 40 business days for the thresholds if triggered?

## Rationale

- 14 The rationale for embedding a trigger for a minimum size threshold, rather than applying a threshold upfront, is that we anticipate that the price improvement rule will reverse some of the impacts of dark liquidity on market quality and price formation when it takes effect on 26 May 2013. A trigger also provides transparency to the market about the point at which a threshold would be implemented and what the threshold would be.
- 15 Research by Comerton-Forde and Putnins (2012) shows that price formation begins to deteriorate once dark trading below block size exceeds 10% of dollar volume for a security: see paragraph 103 of REP 331.<sup>4</sup> The triggers in Option B1.1 and Option B1.2 reflect this 10%, as well as requiring evidence that price formation has deteriorated (i.e. through wider bid–offer spreads and less depth of prices).
- 16 We have proposed that the minimum size threshold should be implemented on either a group of securities basis or a security-by-security basis. This approach is targeted and responds to the securities or groups of securities that are affected by dark liquidity. This is consistent with feedback received on CP 168 that any threshold should be targeted and based on evidence, as opposed to being applied to all securities whether or not they have been affected by dark liquidity.
- 17 This targeted approach, however, adds some complexity. To minimise the impact on industry, we propose to monitor developments, perform the calculations each quarter, and publish a list of securities that meet the trigger.
- 18 Appendix 1 shows the number and proportion of securities that met the proposed triggers at some stage during our sample period from September 2011 to September 2012. During our sample period, this was approximately as follows:
- (a) for Option B1.1, 12% of securities in the S&P/ASX 50, 18% of the securities in the ASX 51–300 and 1% of the securities in the ASX 300+; and
  - (b) for Option B1.2, no securities in the S&P/ASX 50, one security in the ASX 51–300 and nine securities in the ASX 300+.<sup>5</sup>

<sup>4</sup> Comerton-Forde, Carole and Putnins, Talis J, *Dark trading and price discovery*, 26 November 2012. Available from the Social Science Research Network (SSRN): <http://ssrn.com/abstract=2183392> or <http://dx.doi.org/10.2139/ssrn.2183392>.

<sup>5</sup> Most of these nine securities in the ASX 300+ were very small. Three have been subsequently delisted.

- 19 We expect the price improvement rule to reduce the volume of trading in the dark and to improve bid–offer spreads and depth. Therefore, we do not expect the proposed triggers to be met in the near term.
- 20 The reference period against which the proposed triggers in Option B1.1 and Option B1.2 would be measured is the six-month period from April to September 2011. This avoids the months where there may be seasonal impacts. It also precedes the period before there was a rapid increase in dark trading below block size and the number of securities above 10%.
- 21 In addition to the proposed triggers, we considered the merits of applying a minimum size threshold to individual securities based on a measure of bid–offer spreads against short-term and long-term volatility. This option was put forward by the Australian Financial Markets Association (AFMA) in response to CP 168.<sup>6</sup> While this option has some merit, we believe the options proposed in this paper represent the most balanced and targeted approach. The proposed options identify securities where dark liquidity has had a detrimental effect on price formation and cater for securities of different sizes and liquidity.
- 22 If a trigger is met, we would make an announcement, including details of our next steps. With the consent of the Minister, we would amend Rules 4.1.5 and 4.2.3 (Competition) to increase the minimum size threshold as soon as possible after the trigger has been met.
- 23 We have proposed a timeframe of 40 business days (two months) to implement a minimum size threshold from the date the amended rules are made. We believe this is adequate given that the trigger would be transparent so industry should be aware when a security is nearing or breaching it.

#### **Determining the minimum size threshold**

- 24 Our proposal would permit larger-sized orders (where the total consideration of the resulting trade would be valued at or above the relevant threshold) to continue to benefit from being fully dark, subject to them offering meaningful price improvement or being above the block or portfolio trade size threshold: see Rules 4.2.3, 4.2.1 and 4.2.2 (Competition) respectively. This is consistent with the initial reasoning for using dark order types, which was to facilitate the execution of large orders and manage market impact.
- 25 In determining the minimum size threshold, we looked at three different models:
- (a) *Individual security-by-security thresholds*: The level of the threshold would be set as a certain percentage of average daily volume. This method would mean that the threshold is tailored for different security characteristics and market conditions. However, it would vary across security and time, which is likely to be complex and costly to implement.

---

<sup>6</sup> [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp168-submission-AFMA.pdf/\\$file/cp168-submission-AFMA.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/cp168-submission-AFMA.pdf/$file/cp168-submission-AFMA.pdf)

- (b) *The three-tiered threshold structure in Option B1.1 and Option B1.2:* Option B1.1 sets different static thresholds based on the grouping of securities (S&P/ASX 50, ASX 51–300 and ASX 300+). Option B1.2 sets static thresholds based on the average daily volume calculated for the block size trade tiers in amended Rule 4.2.1 (Competition). These tiered approaches cater somewhat for differences in liquidity at the security level, without the need for individual security-by-security adjustment. The tiered model is not new for the industry.
- (c) *Single threshold for all securities:* We consulted on a single \$20,000 and then \$50,000 market-wide threshold in CP 145 and CP 168 respectively. We received feedback that \$20,000 may be too low for the most liquid securities and \$50,000 too high for the least liquid securities. This is the simplest model to implement. However, we received strong feedback from some respondents in those consultations that any threshold should be tailored by security size.

26 Currently, larger orders are often sliced into smaller orders before being routed to a market. This helps to minimise information leakage about the large order. If a minimum size threshold were introduced, we expect that an increased number of large orders would remain as block size orders or, where they are sliced, would either remain above the threshold or be routed to lit exchange markets. A minimum size threshold will significantly reduce the large volume of small trades occurring in crossing systems (see paragraph 88 of REP 331) and may help to reduce information leakage in dark trading.

#### **Aggregation of orders and stubs**

- 27 Market participants would not be permitted to aggregate orders to meet the minimum size threshold. This would undermine its purpose.
- 28 Existing Market Integrity Rules require that the ‘stub’ of an order (i.e. the remainder of an order after a partial fill) should no longer be entitled to the threshold exception where the remaining balance is less than the threshold: see Chapter 4 (Competition). However, based on feedback received about practical difficulties in implementing this requirement, we propose that the ‘stub’ of a dark order that originally met the minimum size threshold may continue to remain dark until cancelled or fully executed, reducing the impact of our proposal on institutional investors. We would seek to ensure that this exception could not be used to avoid the threshold.

## C Dark liquidity: Proposals for crossing system operators

### Key points

We propose to make new and amended Market Integrity Rules and issue guidance for market participants that operate a crossing system (crossing system operators).

Under our proposals, crossing system operators would be required to:

- make information about their crossing system publicly available;
- disclose to users information about user obligations, execution risk and the operation of the crossing system;
- have a common set of procedures which appropriately balance the interests of all users and do not unfairly discriminate between users;
- allow users to opt out of a crossing system at no additional cost, and with no additional operational or administrative requirements;
- monitor order and trades on the crossing system and report to ASIC material non-compliance with user obligations and procedures, or instances of suspicious activity;
- maintain records of all orders that enter a crossing system; and
- comply with certain system and control requirements for automated order processing and notify ASIC and users when there are material outages to their crossing system.

29 A crossing system is currently defined in the ASIC Market Integrity Rules (Competition) as:

any automated service provided by a Participant to its clients which matches or executes Client Orders with Orders of:

- (a) the Participant; or
- (b) other clients of the Participant,

otherwise than on an Order Book. (Rule 1.4.3 (Competition))<sup>7</sup>

30 Our proposals in this section reflect that crossing systems are rapidly evolving and have become more ‘market-like’. Overseas experience suggests that they will continue to evolve. Treasury’s paper *Australia’s financial market licensing regime: Addressing market evolution* (Market Licensing Review), which closed for consultation on 1 February 2013, included proposed options for amending the market licensing framework to better cater for developments in the market and to more directly apply to ‘dark pools’, which are a form of crossing system.

<sup>7</sup> For an amended definition of ‘crossing system’ that reflects recent developments in the operation of crossing systems, see draft Rule 1.4.3 (Competition) in the attachment to this paper.



- 31            Regardless of the outcome of the Market Licensing Review, we see the proposals in this section as being important for the appropriate regulation of crossing systems. Given the rapid evolution of crossing systems, we consider that we need to introduce these proposals now to ensure that the Australian market continues to work efficiently, that investors are adequately informed about their own dealings, and that the regulatory framework caters for future developments.
- 32            The proposals in this section apply to all financial products traded on a crossing system.

## Transparency for the wider market

- 33            There is very little information provided to the wider market about the existence, nature and operation of crossing systems: see paragraphs 151–157 of REP 331. The information that is made available by crossing system operators varies greatly in its detail, is not necessarily made available in a timely or consistent manner and is selective in nature.
- 34            There are currently no rules in place to require crossing system operators to disclose to the market, and therefore the potential users of crossing systems, key information about their facility. This is out of step with the IOSCO Principles for Dark Liquidity, which gives considerable guidance on what the minimum expectations should be for ‘dark pools’.<sup>8</sup>
- 35            These expectations are generally to ensure that dark pools provide sufficient information so that market users can understand the manner in which orders are handled and executed. They recommend that ‘dark pool’ operators should provide those who participate in financial markets with detailed explanations of:
- (a) how trading occurs within the pool;
  - (b) how dark orders interact with transparent orders;
  - (c) which orders have priority;
  - (d) whether indications of interest are disseminated, and if so, what information is included in the indication and to whom they are disseminated; and
  - (e) the policies and procedures that facilitate the management and disclosure of conflicts of interest and that disclose who has access to information about the dark pool and/or dark orders.

---

<sup>8</sup> IOSCO, *Principles for dark liquidity* (IOSCOPD353), Technical Committee of IOSCO, Final report, May 2011.

## Proposal

- C1** We propose to make new and amended rules requiring crossing system operators to make publicly available on a website, enough information so that market users can understand how their orders may be handled and executed. This information would include:
- (a) the identity of the operator of the crossing system;
  - (b) the date the crossing system commenced operation in Australia;
  - (c) the types of financial products traded on the crossing system;
  - (d) the order types available on the crossing system;
  - (e) the access criteria to the crossing system (i.e. the types of users and the criteria applied to access the crossing system);
  - (f) which, if any, other crossing systems' orders may be matched with their orders, and on what basis (e.g. whether client orders may be sent to other crossing systems or whether orders from other crossing systems come into the crossing system);
  - (g) the fees for using the crossing system where they differ to standard broking fees and commissions;
  - (h) monthly aggregate turnover statistics for each financial product, including when trading as principal (similar to the transaction elements of the crossing system reporting information currently provided to ASIC under Part 4.3 (Competition)), which should remain public for at least two years; and
  - (i) any material changes that may be made to the above information.

See draft Rules 4A.2.1 and 4.3.3 (Competition).

The proposed new and amended rules would apply one month from the commencement of the rules.

### *Your feedback*

- C1Q1 Are there any reasons that the proposed information should not be made public?
- C1Q2 Is a website an appropriate publication means?
- C1Q3 Is there additional information that market users should understand, or be informed of, about the handling and execution of orders through a crossing system?
- C1Q4 An alternative to crossing system operators publishing the monthly aggregate turnover statistics in proposal C1(h) is for ASIC to publish these statistics based on the reports we receive under Rule 4.3.2 (Competition). Do you have a preference for whether ASIC or crossing system operators should publish the statistics?
- C1Q5 Would there be benefit in ASIC maintaining a register on our website of all crossing system operators with a link to each crossing system's website where the information in this proposal is disclosed?

## Rationale

- 36 The proposal will help market users to:
- (a) compare the operations of crossing systems;
  - (b) inform themselves of which crossing system may better meet their investment needs; and
  - (c) have the necessary information to understand the nature and risks of trading in the dark.
- 37 It will also create a more level playing field with licensed market operators and mean market users and listed companies are more informed about Australian market structure and where dealings in financial products may be executed.
- 38 This proposal will bring this aspect of the regulatory framework more in line with the IOSCO Principles for Dark Liquidity.

## Disclosure to users

- 39 We are concerned about gaps in information being made to users and prospective users of crossing systems.
- 40 In particular, as outlined in paragraphs 151–157 and 226–229 of REP 331, we have seen that crossing system operators give limited, and varied, information about how orders are executed, whether there is principal trading or high-frequency trading presence in the crossing system, and if there are material changes to the crossing system. There is also limited information about where orders are executed: see paragraphs 164–168 of REP 331.

### Proposal

- c2** We propose to make a new rule requiring a crossing system operator to provide written disclosure to their existing users and ASIC, to new users before accepting an order for the first time, and when there is a material change, about all the matters listed in proposal C1, as well as:
- (a) any obligations imposed on users;
  - (b) execution risk distinguished from any risks on an exchange market, including settlement risks;
  - (c) details about the operation of the crossing system, including but not limited to:
    - (i) how orders are managed (e.g. how price is determined and cancellations are managed);
    - (ii) details about any different treatment or arrangements for certain users or order types;

- (iii) the level of anonymity given to orders, including whether indications of interest are allowed and the types of information contained in the indication of interest;
- (iv) whether related bodies corporate use the crossing system, and if so, how conflicts of interest are managed;
- (v) how any other conflicts of interest that may arise in the use of the crossing system are managed;
- (vi) if there are liquidity providers or market makers in the crossing system, what commitments (if any) they have (e.g. quoting obligations) or any benefits they receive (e.g. fee discounts); and
- (vii) the circumstances in which principal orders may interact with user orders and the nature of the principal orders (e.g. proprietary desk, facilitation, market maker).

See draft Rule 4A.2.2 (Competition).

The proposed new rule would apply six months from the commencement of the rule.

#### *Your feedback*

C2Q1 Do you have any comments on our proposed approach including whether this information should be made available only to a crossing system's users, or to wider market users?

## **Proposal**

- c3** We propose to:
- (a) make a new rule requiring a crossing system operator (Operator A) that sends a client's orders to a crossing system operated by a different entity (Operator B) to provide sufficient information relating to the matters in proposal C2 about Operator B's crossing system to its client; and
  - (b) amend Rule 4.3.1 (Competition) to clarify, for the avoidance of doubt, that crossing system operators must disclose to ASIC whether the crossing system receives orders from other crossing systems.

See draft Rules 4A.2.2 and 4.3.1 (Competition).

The proposed new Rule 4A.2.2 (Competition) would apply six months from the commencement of the rule. The proposed amended Rule 4.3.1 (Competition) would have immediate effect.

*Your feedback*

- C3Q1 If a market participant routes client orders to another market participant's crossing system (e.g. through an 'aggregator'), it is important for the market participant's client to also receive the information on the crossing systems its orders may be routed to. We have proposed a new rule to require this. Are there any alternative means to achieve this? One alternative is to require that all the matters in proposal C2 be made publicly available.
- C3Q2 Is six months sufficient time to amend disclosures for existing and new clients?

**Proposal**

- c4** We propose to amend the following rules:
- (a) Rule 3.4.1(f) (ASX) and (Chi-X) to include that where a trade confirmation includes a statement that a transaction involved a crossing, it also identifies which crossing system the transaction took place on; and
  - (b) Rule 3.4.3 (ASX) and (Chi-X) to have the effect of requiring market participants, when confirming a trade to their wholesale clients, to:
    - (i) confirm when a market participant entered into the trade as principal (this includes the extended meaning of dealing as principal as set out in Rule 3.2.5 (ASX) and (Chi-X), and is already required for retail clients); and
    - (ii) identify the crossing system as the venue where the trade was executed.

See draft Rules 3.4.1 and 3.4.3 (ASX) and (Chi-X).

The proposed amended rules would apply three months from the commencement of the rules.

*Your feedback*

- C4Q1 Do you agree that a client should be made aware when a market participant trades with the client as principal and when trades are executed on the crossing system?

**Rationale**

- 41 Our proposals seek to bring Australia more in line with the IOSCO Principles for Dark Liquidity. The proposed disclosures will also better equip crossing systems' users to properly understand the risks and rewards of a particular crossing system.
- 42 It is also important for clients to understand the capacity in which the crossing system operator has filled the order, particularly where they have traded as principal. This is already embedded in Rule 3.2.3 (ASX) and (Chi-X) for retail clients; however, there is no such requirement for wholesale clients. The proposed amendment to this rule seeks to redress the information

asymmetry that exists for wholesale clients, and bring it into line with the obligations for retail clients. Market participants may choose to implement this proposal by using the FIX tag 29.

- 43 The proposal to include the crossing system venue on trade confirmations for retail and wholesale clients enables all clients of a market participant to understand where trades have been executed. This adds meaning to market participants' best execution disclosure, made to all clients under Part 3.3 (Competition), as it demonstrates to clients when a crossing system has been able to offer the best outcome for a trade.
- 44 We expect that if a crossing system operator sends orders to another crossing system for execution (e.g. via an aggregator), the underlying client should have information about all crossing systems in which their orders are sent for execution. Under our proposal, the crossing system operator would provide tailored information to its clients about any other crossing system it sends orders to.

## Fairness to all users

- 45 In paragraph 84 of REP 331, we noted that we are seeing an increased volume of retail client orders being executed in the dark. Crossing system operators have considerable discretion over persons who access the crossing system, and the terms in which their orders execute. We have seen crossing system operators treat some clients less favourably than others by giving them access to particular order types: see paragraphs 230–232 of REP 331.

### Proposal

- c5 We propose to make new rules requiring crossing system operators to ensure that:
- (a) the crossing system is operated by a common set of procedures, which appropriately balances the interests of all users and does not unfairly discriminate between users; and
  - (b) if there are different rules for different types of orders (e.g. market, resting), there is adequate disclosure to clients about the price consequence of the selected order type.

See draft Rules 4A.3.1 and 4A.2.2 (Competition).

The proposed new Rule 4A.3.1 (Competition) would apply three months from the commencement of the rule. The proposed new Rule 4A.2.2 (Competition) would apply six months from the commencement of the rule.

#### *Your feedback*

C5Q1 Do you have any comments on our proposed approach?

## Rationale

- 46 We seek to achieve a balance in allowing crossing system operators to retain discretion on how they execute orders in the best interests of their clients while ensuring fair treatment of client orders, especially for retail clients. This is important because retail clients are generally less familiar with order execution methodology and practices and cannot access similar levels of technology available to wholesale clients that would allow them to use different trading strategies.
- 47 We acknowledge that there are circumstances where it may be appropriate for different users to be treated differently in a crossing system. For example, when a crossing system operator executes orders on its own account, it may be appropriate to give other users more favourable treatment (e.g. time priority).
- 48 In offering execution services, we see it as necessary for crossing system operators to inform all clients of the potential price consequences at execution for selecting different order types that the crossing system has made available to users.

## Opting out

- 49 In the Australian market, most crossing system operators allow their clients to opt out of having their orders participate in crossing systems. However, we have seen instances where a client's election to opt out is not available through their preferred broking method and would result in a higher fee: see paragraphs 164–168 of REP 331.

### Proposal

- c6** We propose to make a new rule requiring crossing system operators to give clients the choice to opt out of their crossing system(s) or any other crossing system that may be accessible through the crossing system at no extra cost and without additional operational or administrative requirements.

See draft Rule 4A.3.2 (Competition).

The proposed new rule would apply three months from the commencement of the rules.

#### *Your feedback*

- C6Q1 Is there demand from clients to opt out of trading in a crossing system?
- C6Q2 Should clients have the option to opt out of all forms of dark liquidity, including principal trading?
- C6Q3 What is involved for crossing system operators to build the capacity for clients to opt out in this way?

## Rationale

- 50 The proposed rule will allow clients more flexibility to exercise choice in how their orders are executed. It also gives comfort to market participants who operate a crossing system that they can still comply with their best execution obligations if clients do choose to opt out.

## Monitoring

- 51 Currently, there are no specific obligations on crossing system operators to monitor activity in their crossing systems, and to maintain records of such monitoring. ASIC does not have access to information about orders resting in a crossing system, so we are unable to monitor them: see paragraphs 176–182 of REP 331. There is a risk that this gap in monitoring may undermine confidence in the Australian market.

### Proposal

c7 We propose to:

- (a) make a new rule requiring crossing system operators to:
  - (i) monitor orders entered and trades matched through their crossing system(s) for compliance with the crossing system's user obligations and operating procedures;
  - (ii) report to ASIC any significant non-compliance with these obligations and procedures;
  - (iii) take action to ensure breaches of the user obligations do not recur; and
  - (iv) keep records of the monitoring activities, the identified breaches, and the reports to ASIC in accordance with subparagraphs (i) and (ii); and
- (b) replicate Part 5.11 (ASX) and (Chi-X) on suspicious activity reporting for crossing system operators to ensure that a market participant reports to ASIC suspicious activity that occurs in its crossing system.

See draft Rules 4A.4.1 and 4A.4.2 (Competition).

The proposed new rules would apply six months from the commencement of the rules.

#### *Your feedback*

C7Q1 What is involved for crossing system operators to undertake the proposed monitoring?

C7Q2 Is six months sufficient time to implement the changes?



## Rationale

- 52 This proposal is important because we currently have no visibility of orders resting in or passing through crossing systems.
- 53 We have also seen the recent introduction of aggregators across some crossing systems, which means that crossing systems are becoming multilateral trading venues (dealing with orders for clients of other market participants), heightening the need for more targeted conduct monitoring.
- 54 Under the proposed replication of the rules on suspicious activity reporting, market participants who operate a crossing system would be required to notify ASIC when they become aware, in the course of their business activities and in the course of complying with existing obligations, of certain suspicious trading activity that occurs on their crossing system.
- 55 This is consistent with existing market participants' obligations under Part 5.11 (ASX) and (Chi-X), which apply when such activity occurs on a trading platform or a lit exchange market. We would provide guidance to crossing system operators on their reporting obligations in relation to suspicious activity in Regulatory Guide 238 *Suspicious activity reporting* (RG 238).

## Record keeping

- 56 Currently, the *Corporations Act 2001* (Corporations Act) and Market Integrity Rules require order records to be kept for a period of time, and that such records contain certain specified details about an order. See, generally: s991D of the Corporations Act, reg 7.8.19(2) and (5) of the Corporations Regulations 2001 (Corporations Regulations), Rules 4.1.1, 4.1.4, 5.5.3 and 5.5.4 (ASX) and (Chi-X), and Rules 3.1.1(3)(b) and 3.1.1(4)(b) (Competition).
- 57 Different order types emerge as the Australian market becomes more automated. This includes where a large order (known as a 'parent order') is broken into many smaller orders (known as 'child orders') by an automated algorithm. These child orders may then be routed to different trading venues, often at the discretion of an automated order router.
- 58 We are concerned that the current regulatory requirements for order records do not adequately capture child orders that are sent to a crossing system and may rest there until they execute (either in the dark or on a lit exchange market).

## Proposal

**c8** We propose to:

- (a) make a new rule requiring crossing system operators to keep records of the following matters and retain these records for seven years from the date the record was made:
  - (i) all orders, including principal orders, currently in the crossing system; and

- (ii) any parameters set for an order (e.g. requests to avoid executing with certain other users, minimum executable size, order type, execution venues); and
- (b) issue guidance that records produced in response to a request from ASIC under this rule must be in a particular format (CSV).

See draft Rules 4A.5.1, 4A.5.2, 4A.5.3 and 4A.5.4 (Competition).

The proposed new rules and guidance would apply six months from the commencement of the rules.

#### *Your feedback*

- C8Q1 Do you agree with our approach to capturing orders that rest or transit through a crossing system?
- C8Q2 Will the proposed requirements for record keeping successfully enable the replay of orders in a crossing system at any point in time?

## **Rationale**

- 59 We expect that crossing system operators should be able to ascertain what orders are resting in their crossing system at a particular point in time. This is fundamental to their ability to appropriately monitor conduct in the system as well as to be able to meet the best execution obligations in Part 3.1 (Competition).
- 60 Maintaining a clear trail of orders in a crossing system also enables us to properly assess any potential misconduct that a user of a crossing system may be involved with and to quickly monitor market activity in stressed market conditions.
- 61 Our proposal seeks a more consistent approach to the record requirements for orders entering a crossing system and those that enter a lit exchange market.
- 62 It also clarifies how these requirements apply to the new order types that are emerging in an increasingly automated environment, where orders are split by algorithms into parent and child orders and are routed to different execution venues by smart order routers. We expect the same level of records to be maintained for child orders as for parent orders, regardless of whether they are sent to the lit exchange market or into a crossing system by a client or by a crossing system operator as principal.
- 63 The proposed extension of record keeping requirements to include parameters set by the client is to ensure that these are maintained for seven years as part of a market participant's existing order record obligations and best execution evidencing obligations under Part 3.4 (Competition).

## Systems and controls

- 64 As discussed in paragraph 93 of REP 331, we have seen a proliferation of crossing systems over recent years. As their market share grows, they may become systemically important. It is important that they have adequate systems and controls and business continuity planning to ensure the stability of the wider Australian market.
- 65 We have issued guidance on automated order processing, which applies to most crossing systems, which states that market participants should have adequate business continuity, backup and disaster recovery plans. See Regulatory Guide 241 *Electronic trading* (RG 241) at RG 241.62.
- 66 Typically, in the event of system failures in a crossing system, we understand that the order routing logic relied upon by the crossing system operator will see orders bypass the system. However, we have seen some evidence that crossing system operators in Australia may not have adequate:
- (a) resources and capacity during stressed market conditions; and
  - (b) disaster recovery and capacity management: see paragraphs 183–187 of REP 331.

### Proposal

**c9** We propose to:

- (a) amend Rules 5.6.1 and 5.6.3 (ASX) and (Chi-X) on the responsible use of and system and control requirements for automated order processing, to cover conduct which interferes with the integrity of a crossing system;
- (b) make a new rule requiring crossing system operators to notify all users of the crossing system, and ASIC, as soon as practicable, and at least within 60 minutes, of:
  - (i) any system issues that may materially interfere with the efficiency of the execution of client orders and proper functioning of the crossing system;
  - (ii) how the issues are being managed;
  - (iii) alternative arrangements that have been put in place; and
  - (iv) when the issues have been resolved; and
- (c) issue guidance, in addition to Chapter 5 (ASX) and (Chi-X), to reinforce that crossing system operators, as with all automated order processing, should have adequate resources during stressed market conditions and adequate disaster recovery and capacity management. Depending on the nature and complexity of the crossing system, this may include switching to a back-up facility or bypassing the crossing system and routing to a lit exchange market. Whatever the case, it must not result in a worse outcome for clients or the lit exchange markets.

See draft Rules 5.6.1 and 5.6.3 (ASX) and (Chi X) and draft Rule 4A.2.3 (Competition).

The proposed amended Rule 5.6.1 (ASX) and (Chi X) and new draft Rule 4A.2.3 (Competition) would apply six months from the commencement of the rules.

The proposed amended Rule 5.6.3 (ASX) and (Chi X) would apply from 26 May 2014 when ASIC Market Integrity Rules (ASX Market) and (Chi-X Market) Amendment 2012 (No. 3) comes into effect.

#### *Your feedback*

C9Q1 What processes do crossing system operators currently have in place to inform clients of system issues?

C9Q2 Is 60 minutes an appropriate time period to require a crossing system operator to inform its users and ASIC that there is an issue that may materially interfere with the execution of orders in the crossing system?

## **Rationale**

- 67 As the Australian market experiences a proliferation of crossing systems, we need to ensure that they are managed in a manner that does not undermine its ongoing stability. We seek to avoid situations where poorly programmed algorithms that trade in a crossing system, interfere with a lit exchange market as a result of the trades being reported to this market and made publicly available.
- 68 Our proposal to amend the rules for automated order processing seeks to ensure that there is a requirement for crossing system operators to maintain adequate systems and controls, and to ensure that they operate an efficient and robust crossing system.
- 69 Crossing system operators consistently refer in their best execution disclosures that their crossing systems may be used to meet their best execution obligations. We therefore consider it appropriate that outages to their crossing systems should be disclosed to their users in a timely manner as such outages may significantly impair their service offerings.
- 70 We considered whether extreme volatility controls should apply to crossing system operators (e.g. like those that currently apply to exchange market operators in Part 2.2 (Competition)). Crossing system operators are currently required to price a crossing (other than blocks) by reference to prices on lit exchange markets. As of 26 May 2013, this will require price improvement of one tick size or the midpoint of the best bid and offer: see amended Rules 4.1.1 and 4.2.3 (Competition). Given that prices are constrained, we do not consider it necessary to introduce any rules for crossing systems in addition to those that apply to exchange market operators.

## D Dark liquidity: Other proposals

### Key points

We seek your feedback on the following issues and proposals:

- whether we should consider a pilot on reduced tick sizes for constrained equity market products;
- the embedding of existing market practice for market operators to make available course-of-sale reports;
- enhanced conflicts of interest obligations for market participants in handling and execution of orders and confidential order information;
- a prohibition on direct payments for order flow, and control of soft dollar incentives; and
- the potential information leakage arising from the use of indications of interest in the Australian market.

### Tick sizes

- 71 As noted in paragraphs 124–132 of REP 331, some securities are tick constrained. A security is tick constrained if its bid-offer spread is frequently equal to the minimum tick size. This means that they have considerable liquidity queuing on lit exchange markets at the minimum price increment. Tick size constraint can drive trading activity off lit exchange markets into the dark to avoid waiting in the queue or to avoid crossing the constrained spread.
- 72 Our analysis shows that:
- (a) the prices of almost all securities in the S&P/ASX 200 priced between \$2 and \$5 are *somewhat* tick constrained, being at the minimum tick size 90% of the day or more; and
  - (b) there are at least 25 *severely* tick constrained securities in the S&P/ASX 200 based on a number of indicators (including the proportion of the day a security was tick constrained, the proportion of trades and value traded that offered price improvement and whether effective spreads were lower than quoted spreads) (see REP 331, Table 9).
- 73 The options we are considering target the securities that we consider to be the most tick constrained. The purpose of considering the options on a pilot basis is to enable us to consider the impact of the change. This is important because:
- (a) any changes to tick sizes may lead to changes in high-frequency trading activity; and
  - (b) we recently amended the Market Integrity Rules to require that dark trades must offer meaningful price improvement of one tick size or the midpoint

of the best bid and offer (see amended Rules 4.1.1 and 4.2.3 (Competition), which come into effect on 26 May 2013). Any narrowing of tick sizes reduces the price improvement that is required by the new rule.

### Issue

**D1** We seek your feedback on two options we are considering to address the issue of tick constraint for equity market products: see Table 4. We would consider initially implementing one of these options on a pilot basis, and periodically update the equity market products on the list (e.g. quarterly with the S&P/ASX index rebalancing).

**Table 4: Options to address tick constraint for equity market products**

	Description	Result
<b>Option D1.1:</b> Increase middle tick tier	Increase the middle tick tier for equity market products in the S&P/ASX 200 priced from \$2–\$5	Equity market products priced from \$2–\$5 that currently have a tick size of \$0.01 would move to \$0.005.
<b>Option D1.2:</b> Reduce tick size of severely constrained securities	Reduce the tick size of severely tick-constrained equity market products (as listed in Table 9 of REP 331) to the next lowest tier in Part 6.4 (Competition)	A tick-constrained equity market product that currently has a tick size of: <ul style="list-style-type: none"> <li>• \$0.01 would move to \$0.005; and</li> <li>• \$0.005 would move to \$0.001.</li> </ul>

### Your feedback

- D1Q1 Do you agree that tick sizes are constraining some security prices and that this may be leading to more trading shifting to the dark?
- D1Q2 Do you agree that we should target the most affected securities rather than a complete overhaul of the tick size regime?
- D1Q3 Do you have a preference for Option D1.1 or Option D1.2? Is there an alternative model we should consider?
- D1Q4 Is a pilot desirable and is six months sufficient time to introduce it?

## Course-of-sales disclosure (T+3)

- 74 ASX and Chi-X publish a course-of-sales report three days after each trading day in relation to traded financial products on their markets. This report identifies the key attributes of all trades conducted on their market or reported to them, including the market participants to the trade. This means it is possible to view all trading by a particular market participant.
- 75 This is unique to the Australian market. The full course-of-sales information, including market participant identifiers, is typically not made publicly available in other jurisdictions (including Europe, the United States and Canada).

- 76 This practice arose in 2005 when ASX became anonymous—that is, it stopped disclosing in real-time trade reports the market participants to a trade. The course-of-sales reports helped to fill the information void when real-time disclosure ceased. Chi-X conformed with this practice when it commenced operation in October 2011 despite it not being a regulatory requirement for market operators.
- 77 Representations have been made to ASIC that market participants should have the option to elect for their participant identifiers to be excluded from these reports. It has been suggested, for example, that the disclosure of identifiers may expose certain market participants' trading strategies and enable their profit and loss to be reverse engineered.
- 78 We understand that both market participants and investors have come to rely on having this level of information available. For example, fund managers and others have advised that this information is important:
- (a) in transaction cost analysis;
  - (b) to monitor execution quality;
  - (c) to identify sources of liquidity;
  - (d) to monitor trading behaviours of concern to them, including potential front-running; and
  - (e) as a tool to analyse market share and market structure developments.

## Proposal

**D2** We propose to make a new rule requiring market operators to make available (on the same terms as required by Rule 5.1.5 (Competition)) at a minimum the following information on financial products traded on their market, or reported to them, three business days after a trading day and for each transaction:

- (a) the product code;
- (b) the time of the transaction;
- (c) the price;
- (d) the volume;
- (e) the value;
- (f) the market participant identifier;
- (g) the condition code (e.g. type of crossing); and
- (h) the specific market or venue (e.g. ASX's Trade Match, ASX's Centre Point, Chi X, a market participant's crossing system).

See draft Rule 5.1.6A (Competition).

The proposed new rule would apply immediately on commencement of the rule. However, the requirement to identify crossing systems in the venue field would apply from March 2014 when the new ASIC Market Integrity Rules (Competition) on regulatory data take effect.

*Your feedback*

D2Q1 Should the proposed rule permit market participants to elect for their participant identifiers to be excluded from these reports when those market participants trade exclusively as principal (i.e. not on behalf of clients)?

D2Q2 Do you agree that there is benefit in disclosing the particular crossing system where a trade has been matched?

**Rationale**

- 79 We consider it necessary to require market operators to continue to make available course-of-sale reports. This will ensure there is a consistent minimum set of information available for all markets. These reports play an important role in the transparency and integrity of the Australian market, as outlined in paragraph 77.
- 80 The proposed rule mirrors existing market practice, with the addition of disclosure of the specific trading venue. This inclusion will help listed companies to understand where their securities are being traded, and market users to understand the venues that their orders may be executed on.
- 81 We consider that the rule should apply to trades of all market participants, as it is important that clients can understand not only how their orders are being managed, but also which parties are on the other side of a transaction (including in a crossing system).

**Conflicts of interest**

- 82 As identified in paragraphs 189–203 and 233–236 of REP 331, we are concerned that market participants are not adequately identifying or managing all conflicts of interest that arise in their off-market trading, including their client facilitation services. If a market participant’s trading takes advantage of information asymmetries, it may result in worse outcomes for the client.
- 83 We are also seeing market participants allowing considerable amounts of their own orders, or those of a related body corporate, to trade with retail clients. This raises conflicts of interest. There appear to be instances where retail clients have been charged commission where a market participant has traded with them as principal.
- 84 Currently, market participants are required to:
- (a) under s912A of the Corporations Act, have in place ‘adequate arrangements for the management of conflicts of interest’;



- (b) under the Market Integrity Rules for the ASX and Chi-X markets, ‘act fairly and in due turn when dealing with client orders’, and ‘allocate transactions fairly’;
- (c) consider our guidance in Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181), which provides general guidance for all AFS licensee activity; and
- (d) meet certain conduct provisions in Div 7 of Pt 7.8 of the Corporations Act.

85 We consider it appropriate to supplement the existing rules that apply to all market participants to address the conflicts that arise in handling and executing client orders if a market participant trades as principal and there are information asymmetries.

### Proposal

- D3** We propose to make new and amended rules requiring market participants for all their dealings in all financial products to:
- (a) protect client information, including order routing instructions;
  - (b) manage and protect client information when engaging outsourced and third party service providers;
  - (c) ensure market participants preference client orders over principal orders at the same price (by amending Rule 5.1.4 (ASX) and (Chi-X) on relevant factors for the obligation on fairness and priority in dealing in Rule 5.1.3 (ASX) and (Chi-X));
  - (d) not interpose principal trading between client trades that would otherwise have crossed (by amending Rule 5.1.4 (ASX) and (Chi-X)); and
  - (e) not charge retail clients commission when dealing as principal (including on behalf of a related body corporate) (by amending Rule 3.2.4 (ASX) and (Chi-X) on brokerage and commission).

See draft Rule 7.4.1 (Competition) and draft Rules 3.2.4 and 5.1.4 (ASX) and (Chi-X).

We would include additional guidance in RG 181 on the management of conflicts of interest that arise in the handling and executing of orders.

The proposed new and amended rules and guidance would apply three months from the commencement of the rules.

#### *Your feedback*

- D3Q1 Do you have any comments on the proposed new and amended rules, or the time frame for commencement of these rules?
- D3Q2 Are there any other rule amendments or proposals we should consider for conflicts of interest?
- D3Q3 Do you have any comments on the proposal to supplement our guidance in RG 181?

## Rationale

- 86 Our proposals aim to address the deficiencies in identifying and managing conflicts of interest in the handling and execution of client orders by amending or clarifying existing rules and implementing new rules.
- 87 These rules would supplement market participants' broader AFS licence obligations. We would provide specific guidance in RG 181 on our expectations for market participants to have in place adequate arrangements to manage the conflicts of interest that arise when handling and executing an order.

## Payment for order flow

- 88 As noted in paragraphs 204–213 of REP 331, it is commonplace in the United States and United Kingdom for incentives such as payment for order flow to be made from a market participant to acquire orders from another market participant, securities dealer or fund manager. These incentives can be in the form of direct cash payments or soft dollar incentives (e.g. provision of free services, such as research or technology).
- 89 These incentives create conflicts of interest as they may result in the recipients directing their orders to market participants that provide the best incentive rather than the best outcome for the client. This can result in the client receiving a worse overall outcome: see paragraphs 208–209 of REP 331.
- 90 Regulators in the United States and United Kingdom<sup>9</sup> have noted significant concerns about the distortive impact of payment for order flow. While direct cash payments for order flow do not appear to be commonplace in the Australian market, we have seen evidence of clauses in crossing system operators' client terms of business that set out a direct cash payment for order flow scenario. Soft dollar incentives are much more common: see paragraph 204 of REP 331.

## Proposal

- D4** We propose to make a new rule for all dealings in financial products that:
- (a) expressly prohibits a market participant from paying direct cash payments or cash rebates to other market participants or AFS licensees for the opportunity to handle or execute their orders; and

<sup>9</sup>Financial Services Authority (UK), *Proposed guidance on the practice of 'payment for order flow'*, October 2011. At paragraph 29, it is stated: 'It is difficult to see any advantage in the PFOF [payment for order flow] arrangements for the end client...[PFOF could] give rise to a significant conflict of interest that, if not satisfactorily managed, could lead to client detriment through breaches of our conflicts of interest, inducements and best execution rules. For this reason, PFOF is a serious concern for the FSA.'

- (b) allows soft dollar incentives for arranging the execution of orders in circumstances where:
  - (i) there is no impact on the market participant's best execution obligations;
  - (ii) details of any incentives offered and received are disclosed to the client in a comprehensive, accurate and understandable way before the service is provided; and
  - (iii) the incentive enhances the quality of the financial service to the client.

See draft Rule 7.5.1 (Competition).

We would include additional guidance in RG 181 on how the obligations in the proposed rule may affect securities dealers and other AFS licensees.

The proposed new rule and guidance would apply immediately on commencement of the rule.

#### *Your feedback*

- D4Q1 Do you agree that direct cash payments and cash rebates should be prohibited?
- D4Q2 How would the prohibition of direct cash payments and cash rebates affect commission-based incentives (i.e. commission sharing or commission recapture arrangements) currently used in the industry?
- D4Q3 Commission-based incentives may raise similar issues to direct cash payments and cash rebates. How prevalent are commission-based incentives and should they also be specifically prohibited?
- D4Q4 Do you agree that soft dollar incentives should be treated differently to direct cash payments?

## **Rationale**

- 91 We have an opportunity to provide a clear framework about how to appropriately and fairly manage incentives. This is because direct cash payments for order flow do not appear to be as prominent in the Australian market as in overseas markets.
- 92 If orders are diverted to off-market trading venues that offer the best incentives, lit exchange markets may be affected through widening spreads and reduced access to liquidity for all investors: see REP 331.
- 93 We consider that soft dollar incentives should only be used where there is a clear relationship between the incentive given to the recipient and the benefit to end clients in terms of the trading and dealing services provided.

- 94 Consistent with our power to make Market Integrity Rules, the proposed rules would only apply to payments by market participants. They would not cover all parties involved in payment for order flow, such as other AFS licensees, including securities dealers and fund managers. However, we note that these parties must all ultimately operate through a market participant to trade.
- 95 Our guidance in RG 181 would explain how the obligations on market participants under the proposed rules affect the payments or incentives they may be receiving and reinforce the existing obligations:
- (a) for all AFS licensees to have in place adequate arrangements to manage conflicts of interest (s912A(1)(aa)) and to provide financial services efficiently, honestly and fairly (s912A(1)(a)); and
  - (b) for responsible entities (i.e. fund managers) to act in their members' best interests when exercising their powers and carrying out their duties, and if there is a conflict between the members' interests and its own interests, to give priority to the members' interests (s601FC).

## Indications of interest

- 96 An indication of interest is an electronic mechanism to identify potential counterparties to a trade. It provides an insight into the trading interests (e.g. the security, size, price) of the person expressing the interest. Indications of interest as used by market participants are not usually disseminated through a public exchange market, but rather through known contacts or by means of a third party service provider. An example is a Bloomberg instant messaging service.
- 97 As discussed in paragraphs 214–219 of REP 331, indications of interest raise concerns such as:
- (a) a lack of transparency about, and accessibility to, the indication of interest;
  - (b) the potential for conflicts of interest to arise; and
  - (c) possible leakage of information about a client's trading intentions, which can result in a worse outcome for the client (e.g. if recipients trade ahead of the person issuing the indication of interest, this may lead to an adverse price movement).
- 98 Currently, there are no rules specifically governing the use of indications of interest in the Australian market. We do not have a transparent or consistent approach to managing indications of interest and the confidential information that they hold. As noted in paragraph 214 of REP 331, indications of interest are common in other jurisdictions and some jurisdictions have implemented rules around their use.

## Issue

- D5** Indications of interest raise a number of regulatory concerns. We seek your feedback on these issues in the context of the Australian market.

### *Your feedback*

- D5Q1 Should market participants be required to disclose whether a proposed order is on behalf of a client or as principal (including for a related body corporate)? What controls should be in place to ensure there is appropriate representation about the nature of liquidity?
- D5Q2 If a market participant discloses that a proposed order is a client order, should such disclosure only be permitted when the market participant has received a client order? Or are there instances in which a client would not want to place an order with a market participant, but would want the market participant to send an indication of interest?
- D5Q3 Should market participants be required to obtain client consent for:
- (a) using indications of interest in relation to the client's order(s); and
  - (b) disclosing in the indication of interest that it is in relation to a client order?

## E High-frequency trading: Proposals

### Key points

This section covers a range of issues identified by the high-frequency trading taskforce (relating primarily to trading algorithms in general rather than trading strategies) that apply to all market participants across the ASX, Chi-X and ASX 24 markets.

We propose to make new and amended Market Integrity Rules and/or issue guidance to address:

- excessive messaging and market noise (in particular, small and fleeting orders and order-to-trade ratios); and
- manipulative trading.

### Excessive messaging and market noise

#### Small and fleeting orders

- 99 In paragraphs 341–342 of REP 331, we noted that trading algorithms are responsible for the majority of small and fleeting order (trading) messages. These include entry of orders, amendments and deletion of orders. Users of these algorithms tend to be hedge funds, buy-side institutions, statistical arbitrageurs and a market participant’s execution algorithms.
- 100 Our analysis of all orders in S&P/ASX 200 securities in the period from 1 July 2012 to 30 September 2012 revealed that the proportion of all orders that are ‘small’ (e.g. orders that are less than or equal to \$500 value) and ‘fleeting’ (e.g. orders that rest for less than 500 milliseconds) was 3.6% of all untraded orders: see paragraphs 333 and 339 of REP 331.
- 101 We have received feedback from market users that there are too many small and fleeting orders. There are two concerns: these orders are being used to elicit a response from others in the market and disrupt other trading strategies.
- 102 We have seen significant reduction in volume of messages over the last 15 months that we attribute to the introduction of cost-recovery in January 2012. This cost is partially based on messages and resulted in a marked drop in the number of trading messages.
- 103 Notwithstanding this reduction, we concluded that small and fleeting orders are impacting market integrity and efficiency and investor confidence. To minimise this impact, we consider it is appropriate to require these orders to rest for a minimum amount of time in our markets.

## Order-to-trade ratios

- 104 An order-to-trade ratio is generally described as the number of times orders submitted into an order book are amended or cancelled relative to the execution of a trade. Order-to-trade ratios can be measured at individual order, account, market participant or market operator level.
- 105 As part of our market surveillance activities, we see one-off incidences of poorly programmed algorithms being responsible for sometimes extremely high order-to-trade ratios. In such instances, we have worked with market participants to address specific problematic (excessive) order-to-trade ratios, resulting in algorithms being re-programmed or switched off.
- 106 Currently, we do not consider order-to-trade ratios to be an issue across the market. Therefore, market-wide reforms to standardise order-to-trade ratios are not justified. This is because imposing market-wide maximum order-to-trade ratios may have unintended consequences. For example, imposing a standardised level across markets may:
- (a) cause an adjustment to algorithms to ensure the maximum level is not breached, but in turn creates an increase in overall messages (up to the maximum); and
  - (b) create a competitive disadvantage for one market operator over the other due to a standard order-to-trade ratio being applied across markets offering different trading platforms and levels of liquidity and activity.
- 107 We are, however, concerned to ensure that order-to-trade ratios do not become an issue in the future. We consider it is appropriate to update Regulatory Guide 241 *Electronic trading* (RG 241) to provide market participants with guidance about monitoring order-to-trade ratios as part of their ongoing automated order processing obligations in the ASX and Chi-X markets.

### Proposal

- E1 We propose to make a new rule requiring market participants to:
- (a) prevent small orders being cancelled or amended within 500 milliseconds of being submitted to the trading platform of a lit exchange market; and
  - (b) establish systems, policies and procedures to prevent the cancellation or amendment of small orders within 500 milliseconds of being submitted to the trading platform of a lit exchange market.

For the purposes of this proposal, we propose to define a 'small order' as being less than or equal to:

- (a) \$500 value for equities traded on the ASX and Chi-X markets;
- (b) \$500 value for contracts for difference traded on the ASX 24 market;

- (c) 10 futures contracts for the ASX 24 market (for all contracts with the exception of the ASX SPI 200 Index Future (ASX SPI 200 Future));
- (d) three futures contracts for the ASX SPI 200 Future.

This proposal does not apply to derivatives such as exchange-traded options, options on futures and warrants.

See draft Part 5.1A (ASX) and (Chi-X) and draft Part 3.1A (ASX 24).

The proposed new rules would apply six months from the commencement of the rules.

#### *Your feedback*

- E1Q1 Do you agree that we should discourage small and fleeting orders? If not, why not?
- E1Q2 Do you agree with the minimum resting time of 500 milliseconds for small orders before any amendment or cancellation can occur? If not, why not?
- E1Q3 Do you think the proposed sizes for a 'small order' are appropriate, or too small or too large?
- E1Q4 Do you think there is a better way to address excessive small and fleeting order messages and trades in the Australian market?
- E1Q5 Do you think any category of market participant should be exempted from this proposal? If so, describe the impact the proposal may have on these market participants.
- E1Q6 Does the six-month period for commencement of these rules allow sufficient time to make the appropriate system changes?

### **Proposal**

- E2** We propose to amend RG 241 to include guidance to market participants about compliance with automated order processing obligations to consider:
- (a) identification of order-to-trade ratios that may indicate a dysfunctional automated order processing system;
  - (b) the responsible use of automated order processing to monitor and control the generation of large numbers of orders that may either have an adverse impact on market quality and integrity, or that constitutes a breach of a market operator's requirements in respect of order-to-trade ratios; and
  - (c) the inclusion of analysis of order-to-trade ratio performance as part of a market participant's annual review or material change review processes.

#### *Your feedback*

- E2Q1 Do you have any comments on our proposed guidance?
- E2Q2 Do you think there is a need to address order-to-trade ratios in the Australian market?



## Rationale

### Small and fleeting orders

108 Introducing a minimum resting time for orders below a notional value would:

- (a) prevent the rapid amendment and removal of small orders that offer little contribution to market liquidity and efficiency;
- (b) help to limit unwanted trading behaviours such as pinging and quote stuffing by increasing the notional value at risk for rapid order revisions and/or cancellations, and increase execution risk and resting time of small orders; and
- (c) provide a level of assurance to users of the market that small orders placed into the Australian market have a greater degree of intent to trade.

109 The proposed sizes for a ‘small order’ for particular securities was determined as follows:

- (a) *Equities*: The proposed size was determined by reference to the recognised ‘marketable parcel’ of securities (as defined in the ASX Operating Rules and procedures).
- (b) *Contracts for difference*: The proposed size was determined by reference to ASX equity contracts for difference alongside the underlying equities traded on ASX to ensure consistency in the application of the rule across physical equities and contracts for difference. The same \$500 minimum order size applies to ASX index contracts for difference even though single-lot trades on these contracts for difference are currently in excess of \$500.
- (c) *Futures*: The proposed size recognises that the notional contract value is significantly higher, given they are leveraged products in which parcel sizes are determined with reference to amounts invested by way of a margin rather than the notional value of the underlying product.
- (d) *ASX SPI 200 Future*: The proposed size is smaller because these contracts require a high initial margin, and therefore they trade in relatively small average trade sizes compared to other futures contracts.

### Order-to-trade ratios

110 Our guidance in RG 241 on responsible use of automated order processing (see RG 241.70) and controls for suspending limiting or cancelling messages (see RG 241.53–RG 241.56) specifically considers the impact of continued patterns of order deletions, amendments, over-trading and wash trading. It does not raise the issue of order-to-trade ratios. We propose to update our guidance in RG 241 to include that the impact of order-to-trade ratios—from sources such as an authorised person, account or algorithm—should be appropriately considered and addressed.

- 111 An order-to-trade ratio is a simple quantitative tool that may be used by market participants to measure execution efficiency. In highlighting market participant obligations through this technical measure, our intent is to discourage excessive activity on any market.
- 112 Our proposed guidance would outline our expectations for market participants to take into account the following factors when considering the market impact of large numbers of concurrent orders, orders of small executable quantity and automated order processing systems that react to order book changes:
- (a) order-to-trade ratio relative to current market liquidity;
  - (b) order-to-trade ratio relative to current market volatility;
  - (c) the impact of the order-to-trade ratio on security;
  - (d) execution goals of the algorithm in light of the order-to-trade ratio; and
  - (e) the market operator's maximum order-to-trade ratio.
- 113 It seeks to focus market participants' attention on these ratios. We consider that a market participant's ability to monitor and limit order-to-trade ratios is an important consideration in assessing whether it is complying with its obligations (e.g. for ASX and Chi-X market participants, the obligations under Rule 5.6.1 (ASX) and (Chi-X) for responsible use of automated order processing). We may consider this factor when determining whether to direct a market participant to cease using an automated order processing system under Rule 5.6.12 (ASX) and (Chi-X).
- 114 Our proposed guidance would:
- (a) remind market participants of their obligations under Rule 7.1.1 (Competition), and s793C of the Corporations Act to adhere to the operating rules of any market; and
  - (b) discuss how market participants should judge and monitor order-to-trade ratios in accordance with their automated order processing obligations.

## Manipulative trading

- 115 In REP 331, we have noted that some trading practices are of concern and may be considered predatory. These include layering, quote stuffing, latency arbitrage, abusive liquidity detection and momentum ignition. Such practices may be deployed by a variety of entities, and not just high-frequency trading entities: see paragraphs 378–395 of REP 331.
- 116 The current regulatory framework for market misconduct is contained in s1041A–C of the Corporations Act and Rules 5.7.1 and 5.7.2 (ASX) and (Chi-X). We consider it necessary to enhance the current Market Integrity Rules to address manipulative trading practices that may be effected through trading algorithms.

## Proposal

E3 We propose to:

- (a) amend Rule 5.7.2(b) (ASX) and (Chi-X) to remove the reference to materiality and include the consideration of the impact of the order;
- (b) amend Rule 5.7.2 (ASX) and (Chi-X) to include the following additional circumstances that market participants must have regard to when considering the creation or likely creation of a false or misleading appearance of active trading or the price for a financial product:
  - (i) the frequency with which orders are placed;
  - (ii) the volume in each order; and
  - (iii) the extent to which orders made are cancelled or amended relative to the orders executed;
- (c) repeal Rule 3.1.2 (ASX 24) on manipulative trading and replace it with a new rule that is identical to Rule 5.7.1 (ASX) and (Chi-X) and the proposed amendments to Rule 5.7.2 (ASX) and (Chi-X); and
- (d) issue guidance when introducing these rules that will clarify:
  - (i) trading practices that we consider are illustrative of manipulative activity and are therefore prohibited under the Corporations Act and Market Integrity Rules (e.g. layering, quote stuffing, quote manipulation, and spoofing);
  - (ii) circumstances that may indicate manipulative activity; and
  - (iii) trading strategies that impact the efficiency and integrity of the market.

See draft Rule 5.7.2 (ASX) and (Chi-X) and draft Rule 3.1.2 (ASX 24).

The proposed amended and new rules would apply six months from the commencement of the rules.

### *Your feedback*

- E3Q1 Do you consider that removing 'materiality' from circumstance of the order will have a negative or positive impact on compliance and enforcement with the rule? Please explain your rationale.
- E3Q2 Do you consider the proposed additional circumstances of order adequately cover those which should be considered by a market participant when assessing whether an order or orders are manipulative? Are there additional circumstances that should be included?
- E3Q3 Do you think it is appropriate to align the rules on market manipulation for the futures and equities markets? Do you consider that one or more aspects of the current Part 5.7 (ASX) and (Chi-X) on manipulative trading do not apply to the derivatives markets and trading? Are there other circumstances that should be included that specifically apply to the futures market?

E3Q4 Do you agree with our proposal to issue guidance on the trading behaviour considered to be market misconduct? If not, why not? What other examples, if any, should be included in our guidance, and why?

## Rationale

- 117 The proposed amendment to Rule 5.7.2(b) (ASX) and (Chi-X) to remove the reference to materiality will require market participants to consider in all circumstances the impact on the market of the order, no matter how large or small. This would require market participants to consider the impact of all orders, including those that do not impact price but are equally indicative of manipulative activity.
- 118 The proposed additional circumstances for market participants to consider in Rule 5.7.2 (ASX) and (Chi-X) may indicate manipulative activity in a market for a security. Market participants would be required to consider the proposed additional circumstances to determine whether such practices have or are likely to have created a false or misleading appearance of active trading.
- 119 We consider that this proposal will align the Market Integrity Rules for the futures and equities markets in relation to manipulative activity.
- 120 Our proposed guidance would clarify the types of algorithmic trading strategies that may be seen as manipulative trading so that market participants can assess possible misconduct and facilitate the process of prompt referral of suspected misconduct to ASIC. This will help us to effectively pursue manipulative trading matters in a timely and efficient matter. For the substance of our proposed guidance, see Appendix 2 of this paper.

## F Regulatory and financial impact

- 121 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:
- (a) maximising market efficiency and opportunities for innovation brought by technology; and
  - (b) mitigating risks to the quality, integrity and fairness of the Australian market and protecting the interests of investors and financial consumers.
- 122 Before settling on a final policy, we will comply with the Australian Government's regulatory impact analysis (RIA) requirements by:
- (a) considering all feasible options, including examining the likely impacts of the range of alternative options which could meet our policy objectives;
  - (b) if regulatory options are under consideration, undertaking a preliminary assessment of the impacts of the options on business and individuals or the economy;
  - (c) if our proposed option has more than low impact on business and individuals or the economy, consulting with OBPR to determine the appropriate level of regulatory analysis; and
  - (d) conducting the appropriate level of regulatory analysis—that is, complete a Regulation Impact Statement (RIS).
- 123 All RISs are submitted to the OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.
- 124 To ensure that we are in a position to properly complete any required RIS, please give us as much information as you can about our proposals or any alternative approaches, including:
- (a) the likely compliance costs, for example:
    - (i) Will compliance with this proposed obligation require any changes to your systems or procedures?
    - (ii) What are the likely costs of such changes (where possible, please identify the nature of likely costs, quantify the estimated costs and indicate whether such costs will be one-off or ongoing)?
    - (iii) Are there likely to be any significant impediments to making these changes?
  - (b) the likely effect on competition; and

- (c) other impacts, costs and benefits, for example:
- (i) Is this proposal likely to impose any other additional costs or burdens on any class of stakeholder? Where possible, please identify the nature of the likely costs/burdens, quantify the estimated costs (including any assumptions and relevant data) and indicate whether such costs/burdens will be one-off or ongoing;
  - (ii) Are there other practical implications associated with complying with this proposal?
  - (iii) Are transitional arrangements necessary? What are your views on what the transitional time period and arrangements should be?

125 We have included below a high-level summary of what we understand will be the possible impact of the proposed new and amended Market Integrity Rules and guidance. The discussion relates to the proposed regulatory changes that are likely to affect stakeholders' systems and business models. We would appreciate your comments on these issues.

## Possible impact of the proposals

### **Dark liquidity: Proposal for minimum size threshold for dark orders (proposal B1)**

- 126 The proposed trigger may lead to an increase in the minimum size threshold for dark orders if an increase in dark liquidity below block size harms price formation in the future. This would benefit the Australian market by providing a safety net against future degradation of price formation if dark liquidity grows despite the introduction of meaningful price improvement in May 2013.
- 127 A minimum size threshold would mean that trading activity off-market would be impacted, as a large proportion of current trading does not satisfy the proposed thresholds. Crossing system operators will be impacted as a significant proportion of dark trading value would need to be done on a lit exchange market for securities or groups of securities that meet the trigger. Depending on the size of the threshold and the liquidity of the security (see Option B1.1 and Option B1.2 in Table 3 of Section B), it is likely to eliminate 90–99% of dark trading below block size, which accounts for 20–40% of dark trading value below block size.
- 128 A minimum size threshold would limit pinging in dark venues and may help to reduce information leakage. It may also make it harder to find counterparties and lower fill rates as a result. If a minimum size threshold were introduced, we expect that some dark orders (such as parent orders being sliced into much smaller child orders) would not be sliced into sizes below the threshold, reducing the impact of the threshold on institutional investors.

129           Operationally, market operators and market participants would need to make one-off changes to their systems, including trading, crossing and routing systems, as well as execution algorithms, to ensure only trades exceeding the minimum size threshold could be executed in the dark. ASIC would be responsible for monitoring and identifying increases in dark liquidity that harms price formation at a security level.

### **Dark liquidity: Proposals for crossing system operators**

#### **Transparency for the wider market and disclosure to users (proposals C1–C4)**

130           The proposed rules would benefit the transparency of the market and standardise disclosure practices among operators of crossing systems. Crossing system operators are likely to incur some additional compliance costs in providing transparency to the wider market and enhancing disclosure to their clients about the way in which they operate. We consider it that this is a necessary cost to improve understanding of crossing systems by clients as well as the wider market.

131           Market participants may incur costs associated with changes to systems and procedures that allow them to identify principal trades and trades in crossing systems in trade confirmations to their institutional clients.

#### **Fairness to all users (proposal C5)**

132           We expect this proposal to benefit the fairness of the market by ensuring that users of a crossing system are governed by a common set of procedures, which balances the interests of all users, and does not unfairly discriminate between users. Crossing system operators that currently have arrangements in place that may systematically result in less favourable outcomes for particular users may incur costs to amend their systems, policies and procedures.

#### **Opting out (proposal C6)**

133           The proposed rule would ensure clients' flexibility to exercise choice in whether they participate in a crossing system, while allowing market participants to meet their best execution obligations. Crossing system operators that currently do not allow clients to opt-out of their crossing systems without additional cost would incur compliance costs to amend their systems, policies and procedures.

#### **Monitoring (proposal C7)**

134           Some crossing system operators are likely to incur additional compliance costs in conducting monitoring of orders in their crossing systems. However, some are already doing this. We consider that this is a necessary cost involved with operating a crossing system, as it is imperative that dark orders be subjected to surveillance and do not interfere with the fairness and orderliness of the market.

**Record keeping (proposal C8)**

- 135 We expect this proposal to bring a more consistent approach to record keeping of orders entering a crossing system as those that enter a lit exchange market. The maintenance of a clear trail of orders will benefit market integrity by allowing us to properly assess any potential misconduct that a user of a crossing system may be involved with. Some market participants may incur additional data storage and management costs associated with the proposed record keeping rule.

**Systems and controls (proposal C9)**

- 136 The proposed guidance on crossing systems would reinforce existing expectations and practice, and contribute to the fair and orderly operation of the market. We expect it would involve a one-off cost to all market participants, as they review and adjust existing systems and controls to ensure that they are adequate given the nature and complexity of the crossing system.

**Dark liquidity: Other proposals****Tick sizes (issue D1)**

- 137 The options for reducing tick sizes would facilitate trading and attract order flow from the dark to the lit exchange market in the relevant securities, due to less queue time and lower cost to cross the spread.
- 138 Operationally, market participants and operators would need to make system changes to adapt to any changes to the current tick size regime. The proposal is to implement the option on a pilot basis. We are interested in receiving feedback on the cost implications for market participants in making system changes for the pilot, particularly if the changes to the tick size regime are not pursued beyond the proposed pilot.

**Course-of-sales disclosure (T+3) (proposal D2)**

- 139 The proposed rule would reinforce post-trade transparency by ensuring that both market participants and investors continue to have access to course-of-sales information.
- 140 Operationally, we expect no change for market participants and minimal change for market operators. The proposed new data field (venue) must already be provided by market participants to market operators in March 2014 when Chapter 5A (Competition) on enhanced regulatory data takes effect. Market operators may need to amend their reporting systems.



**Conflicts of interest and payment for order flow (proposals D3–D4)**

- 141 The proposals strengthen conflicts of interest obligations. They would help to limit information leakage on client orders and manage conflicts that may arise through third party outsourcing. Some market participants may need to adjust the way orders are prioritised to favour client orders over principal orders at the same price, and to avoid a principal order being interposed between client orders that could otherwise have matched. We do not expect significant compliance costs for other market participants.
- 142 Prohibiting payment for order flow would have limited impact on business models, as direct cash payments are not yet prevalent in the Australian market. This proposal seeks to prevent it from becoming more prevalent, which has been shown to create the wrong incentives for order routing decisions in overseas markets.

**High-frequency trading: Proposals****Excess messaging and market noise (proposals E1–E2)**

- 143 The proposal benefits market participants, market operators and ASIC, as it will limit the growth in message ‘noise’ by reducing small and fleeting order amendments and cancellations. We expect this to alleviate ongoing system processing and data storage pressures caused by excessive order messaging and result in long term cost benefits.
- 144 The implementation of the proposal would require market participants to make system changes that prevent small orders from being amended or cancelled within 500 milliseconds of submission. We expect it will also give market participants an incentive to consider and improve the efficiency of their execution algorithms.
- 145 The proposal would also help limit unwanted trading behaviours such as pinging and quote stuffing by increasing the notional value for rapid order revisions or resting time and hence the execution risk of smaller orders.
- 146 We expect market participants to incur minor costs associated with monitoring small and fleeting orders and order-to-trade ratios.

**Manipulative trading (proposal E3)**

- 147 Expanding the factors relevant to the circumstances of an order that a market participant should consider in its assessment of false or misleading appearance would improve the enforceability of rules on market misconduct. We expect market participants to incur costs associated with considering and monitoring the proposed additional factors.

## Appendix 1: Sample of recent activity

148 Table 5 shows the number and proportion of securities that met the proposed triggers for the proposed minimum size threshold at some stage during our sample period from September 2011 to September 2012.

149 The figures are calculated for each combination of increased spreads and decreased depth for securities in the S&P/ASX 50, ASX 51–300 and ASX 300+. The highlighted cells correspond to the proposed triggers for individual securities (number) and groups of securities (%) respectively.

**Table 5: Sensitivity analysis of trigger parameters based on 10% below block dark liquidity**

S&P/ASX 50										
Increase spread \ Decrease depth	10%		15%		20%		30%		40%	
	1%	20	41%	20	41%	20	41%	19	39%	17
2%	16	33%	16	33%	16	33%	16	33%	15	31%
3%	9	18%	9	18%	9	18%	9	18%	9	18%
4%	6	12%	<b>6</b>	12%	6	12%	6	12%	6	12%
5%	5	10%	5	10%	5	10%	5	10%	5	10%
10%	1	2%	1	2%	1	2%	1	2%	1	2%
15%	1	2%	1	2%	1	2%	1	2%	1	2%
20%	0	0%	0	0%	<b>0</b>	0%	0	0%	0	0%
25%	0	0%	0	0%	0	0%	0	0%	0	0%
30%	0	0%	0	0%	0	0%	0	0%	0	0%

  

ASX 51–300										
Increase spread \ Decrease depth	10%		15%		20%		30%		40%	
	1%	67	28%	66	28%	64	27%	60	25%	58
2%	62	26%	62	26%	60	25%	56	23%	51	21%
3%	52	22%	52	22%	51	21%	48	20%	44	18%
4%	42	18%	<b>42</b>	18%	41	17%	38	16%	34	14%
5%	34	14%	32	13%	31	13%	29	12%	26	11%
10%	5	2%	5	2%	5	2%	5	2%	5	2%
15%	2	1%	2	1%	2	1%	2	1%	2	1%
20%	1	0%	1	0%	<b>1</b>	0%	1	0%	1	0%

ASX 51–300 (cont.)										
25%	1	0%	1	0%	1	0%	1	0%	1	0%
30%	1	0%	1	0%	1	0%	1	0%	1	0%

ASX 300+												
Increase spread \	Decrease depth		10%		15%		20%		30%		40%	
1%	21	1%	19	1%	19	1%	17	1%	16	1%		
2%	19	1%	17	1%	17	1%	16	1%	15	1%		
3%	18	1%	16	1%	16	1%	14	1%	14	1%		
4%	15	1%	14	1%	14	1%	12	1%	12	1%		
5%	15	1%	14	1%	14	1%	12	1%	12	1%		
10%	13	1%	12	1%	12	1%	11	1%	11	1%		
15%	10	1%	9	1%	9	1%	8	0%	8	0%		
20%	9	1%	9	1%	9	1%	8	0%	8	0%		
25%	9	1%	9	1%	9	1%	8	0%	8	0%		
30%	9	1%	9	1%	9	1%	8	0%	8	0%		

## Appendix 2: Proposed guidance on manipulative trading

- 150 This appendix gives a broad overview of what would be included in our guidance on the proposed amended and new rules on manipulative trading: see proposal E3(d).
- 151 We have identified potentially abusive trading strategies that may be facilitated by automated order processing systems. In our view, it is the abusive nature of these practices, rather than the means by which the practices are conducted, that harms the market. Market abuse is prohibited whether conducted manually or electronically, with or without the use of automated order processing systems and direct electronic access.
- 152 Our proposed guidance aims to encompass:
- (a) trading practices that are illustrative of manipulative activity and are therefore prohibited under the Corporations Act and proposed amended and new rules (e.g. layering, quote stuffing, quote manipulation, and spoofing);
  - (b) circumstances that may indicate manipulative trading activity; and
  - (c) trading strategies that impact the efficiency and integrity of the market.
- 153 There has been an increasing focus by regulators globally on strategies linked to algorithmic and high-frequency trading that are of a manipulative nature whether in a known or novel form.

### Trading practices that are illustrative of manipulative activity

- 154 Regulators globally have identified the following trading strategies that are considered to be illustrative of manipulative activity:
- (a) *Layering*: This is the creation of large numbers of orders, often at various price points, to create a false impression of demand or supply. These orders are then deleted, or moved, as they move closer to trading.
  - (b) *Quote stuffing*: This is a strategy to impede the processing of markets, or participant processes, by overloading an order book with trading messages.
  - (c) *Quote manipulation*: This is a strategy of placing non-bona fide orders on visible markets in an attempt to change the best bid price and or the best ask price and affect the price calculation at which a trade will occur with a dark order.
  - (d) *Spoofing*: The entry of large volumes of orders at best bid or offer price, which are then deleted within seconds of entry.

155 Using the above strategies, whether through an automated order processing system as part of algorithmic trading, high-frequency trading or any other means of trading would be considered by ASIC to be contravention of the Market Integrity Rules and the Corporations Act. This list should not be considered an exhaustive list, and may be added to as further developments are made, and misconduct identified, in our markets

## Circumstances that may indicate manipulative activity

156 Under Rule 5.7.2 (ASX) and (Chi-X), a market participant must have regard to certain circumstances of an order when considering whether or not a false or misleading appearance of active trading or price for a financial product has or is likely to have been created.

157 Each of the circumstances must be considered by the market participant either individually or in totality with the other circumstances prescribed in the Rule 5.7.2 (ASX) and (Chi-X). We would include additional circumstances under this rule, such as:

- (a) the impact of the frequency of messages submitted;
- (b) the extent that orders are traded; and
- (c) volume of orders being entered into.

158 These circumstances may indicate to the market participant that manipulative activity in a particular financial product is occurring. For example, under the proposed amended Rule 5.7.2(b) (ASX) and (Chi-X), the market participant must have regard to the impact of the order or execution of the order on the market for or price of the product. When considering such a circumstance, market participants should consider whether there is a pattern of orders that impact price, and whether such a pattern of price impact is disproportionate to the price impact of other orders in the market.

159 A market participant must also consider the volume of the order for the financial product. When considering the volume of an order, for example, market participants should have regard to whether, where orders of sufficient volume have traded through multiple price levels, there appears to be a pattern where only small volume trades are effected at the higher or lower prices.

160 Other circumstances that may indicate the prevalence of quote stuffing are the frequency of the orders being entered into, and the extent of cancellation of orders, particularly when such amendments and/or cancellations are being effected during the open/close pre-open phases of the market. Under the proposed amended rule, market participants would be required to consider the frequency of the order as well as the extent to which orders made are cancelled or amended relative to the orders executed.

- 161 The proposed amendment to Rule 5.7.2(b) (ASX) and (Chi-X) and Rule 3.1.2 (ASX 24) includes the removal of the reference to ‘materiality’. Market participants would be required to consider all the circumstances of the impact of all orders, no matter how large or small the order. There may be circumstances where orders that do not impact price may be equally indicative of manipulative activity. An example of such an order is an order that is put in place to maintain a price rather than increase a price of a product. Price maintenance at different price levels may be indicative of activity such as layering.

## **Trading strategies that impact the efficiency and integrity of the market**

- 162 Market participants need to be aware of the unintended consequences of highly automated trading strategies to ensure that the implementation of such strategies does not impact the efficiency and integrity of the market. Such strategies include strategies that use market microstructure efficiencies such as speed and processing power without a clear execution goal.

## Key terms

Term	Meaning in this document
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services  Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act  Note: This is a definition contained in s761A of the Corporations Act.
agency	Where a market participant acts on behalf of a client
aggregator	An aggregator provides links between crossing systems. It receives and transmits orders from and to other crossing systems, providing clients with access to more sources of liquidity
aggressive order	An order that is priced so that it is immediately executable (i.e. priced to buy at or above the current offer, or to sell at or below the current bid). An example of an aggressive order is a market order
algorithmic program	Automated strategies using programmable logic/system-generated orders (rather than human-generated orders) based on a set of predetermined parameters, logic rules and conditions. These include algorithmic trading, automated order generation, high-frequency trading and automated market making
algorithmic trading	Electronic trading activity where specific execution outcomes are delivered by predetermined parameters, logic rules and conditions
arbitrage	The process of seeking to capture pricing inefficiencies between related products or markets
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
ASIC Market Integrity Rules (ASX 24)	ASIC Market Integrity Rules (ASX 24 Market) 2010—rules made by ASIC under s798G of the Corporations Act for trading on ASX 24
ASIC Market Integrity Rules (ASX)	ASIC Market Integrity Rules (ASX Market) 2010—rules made by ASIC under s798G of the Corporations Act for trading on ASX

Term	Meaning in this document
ASIC Market Integrity Rules (Chi-X)	ASIC Market Integrity Rules (Chi-X Australia Market) 2011—rules made by ASIC under s798G of the Corporations Act for trading on Chi-X
ASIC Market Integrity Rules (Competition)	ASIC Market Integrity Rules (Competition in Exchange Markets) 2011—rules made by ASIC under s798G of the Corporations Act that are common to markets dealing in equity market products and Commonwealth Government Securities depository interests quoted on ASX
ASX	ASX Limited or the exchange market operated by ASX Limited
ASX 24	The exchange market formerly known as Sydney Futures Exchange (SFE), operated by Australian Securities Exchange Limited
ASX 300+	All Australian equity market products admitted to quotation on ASX that do not otherwise fall within the S&P/ASX 300
ASX 51–300	The equity market products listed in the S&P/ASX 300, excluding the equity market products listed in the S&P/ASX 50
ASX Market Rules	Previous operating rules made by ASX Limited dealing with activities or conduct of its market and of persons in relation to the market
ASX Operating Rules	ASX Limited's operating rules, which replace the pre-existing ASX Market Rules
ASX SPI 200 Future	The ASX 24 futures contract over the S&P/ASX 200
ASX TradeMatch	The order book operated by ASX, known as 'TradeMatch', that is ASX's central order book for equity market products and Commonwealth Government Securities depository interests
Australian market licence	Australian market licence under s795B of the Corporations Act that authorises a person to operate a financial market
automated order processing	The process by which orders are registered in a market participant's system, which connects it to a market. Client or principal orders are submitted to an order book without being manually keyed in by an individual (referred to in the rules as a DTR). It is through automated order processing systems that algorithmic programs access our markets
below block size dark trades	Trades executed during normal trading hours that are not pre-trade transparent and that are not block size trades
best available bid and offer	See 'NBBO'



Term	Meaning in this document
best execution	A requirement under Chapter 3 (Competition) for a market participant to achieve the best outcome for its client
bid–offer spread	The difference between the best bid and the best offer (also known as ‘bid–ask spread’)
block size trade	Trades that rely on the exception to the pre-trade transparency obligations in Rules 4.2.1 and 4.2.2 (Competition)
buy-side	Advising institutions typically concerned with buying, rather than selling, assets or products. Private equity funds, mutual funds, unit trusts, hedge funds, pension funds and proprietary trading desks are the most common types of buy-side entities
Centre Point	An ASX-operated, dark execution venue that references the midpoint of the bid–offer spread on ASX’s CLOB
Chapter 5 (ASX) and (Chi-X) (for example)	A chapter of the ASIC Market Integrity Rules (ASX) and ASIC Market Integrity Rules (Chi-X) (in this example numbered 5)
Chapter 5A (Competition) (for example)	A chapter of the ASIC Market Integrity Rules (Competition) (in this example numbered 5A)
Chi-X	Chi-X Australia Pty Limited or the exchange market operated by Chi-X
CLOB (central limit order book)	A central system of limit orders, operated by a market operator, where bids and offers are typically matched on price–time priority
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
course-of-sales report	A record of all trades executed on an exchange market or reported to the market operator
crossing	A type of transaction where the market participant is the same for both the buyer and seller. The market participant may be acting on behalf of the buying client and the selling client, or acting on behalf of the client on one side of the transaction and as principal on the other side of the transaction

Term	Meaning in this document
crossing system	An automated service provided by a market participant to its clients that matches or executes client orders with orders of the market participant (i.e. against the participant's own account) or with other users with orders in the system. These orders are not matched on a pre-trade transparent order book
crossing system operator	A market participant that operates a crossing system
dark liquidity/ trading	Orders that are not pre-trade transparent (i.e. not known to the rest of the market before they match): see paragraph 22 of REP 331 for the full meaning of this term
dark pools/venues	Electronically accessible pools of liquidity that are not pre-trade transparent, including crossing systems and dark venues operated by exchange market operators
depth	Volume of orders on an order book available to be traded
direct electronic access	<p>Electronic access to markets via the electronic infrastructure of a market participant.</p> <p>The process by which an order is submitted by a client, agent or participant representative into a market participant's automated order processing system directly without human intervention. Direct electronic access enables a client to access a market without being a direct market participant and without being directly bound by the operating rules of the market they are accessing</p>
DTR (designated trading representative)	Representative of a market participant that has been authorised by the participant to submit trading messages to the execution venue on behalf of the participant
equity market products	Shares, interests in managed investment schemes, rights to acquire shares or interests in managed investment schemes under a rights issue, and CHES depository interests admitted to quotation on ASX
exchange market	A financial market operated by a licensed market operator (under Pt 7.2 of the Corporations Act)
execution venue	<p>A facility, service or location on or through which transactions in equity market products and Commonwealth Government Securities depository interests are executed and includes:</p> <ul style="list-style-type: none"> <li>• each individual order book maintained by a market operator;</li> <li>• a crossing system; and</li> <li>• a market participant executing a client order against its own inventory otherwise than on or through an order book or crossing system. This includes an order book and other matching mechanisms</li> </ul>

Term	Meaning in this document
facilitation trade	Where a market participant acquires securities directly from its client and holds the securities briefly as principal for prompt resale
financial market	As defined in s767A of the Corporations Act, a facility through which offers to acquire or dispose of financial products are regularly made or accepted
financial product	Generally, a facility through which, or through the acquisition of which, a person does one or more of the following: <ul style="list-style-type: none"> <li>• makes a financial investment (see s763B);</li> <li>• manages financial risk (see s763C); and</li> <li>• makes non-cash payments (see s763D)</li> </ul> <p>Note: See Div 3 of Pt 7.1 of the Corporations Act for the exact definition.</p>
fleeting orders	Orders that fail to rest within a market for a meaningful period of time. This liquidity, although posted, is effectively inaccessible because investors are unable to trade purposefully against it
front running	The practice of transacting on one's own behalf because of, and in front of, a client order
fundamental investor	A person who buys or sells a security based on an assessment of the intrinsic value of the security (these persons are sometimes referred to as 'long-term investors')
high-frequency trading	There is no internationally agreed, formal definition of high-frequency trading. For the purposes of this paper, we have used the description provided by IOSCO: see paragraph 6
indications of interest	A non-binding, electronic expression of trading interest that may contain information including the security name, capacity (agency or principal), volume and price instructions to identify potential counterparties
institutional investor	Advising institutions typically concerned with buying, rather than selling, assets or products. The most common types of institutional investors include private equity funds, mutual funds, unit trusts, hedge funds, pension funds and proprietary trading desks
internalisation	Where a client order is transacted against a market participant's own account
IOSCO	International Organization of Securities Commissions
IOSCO Principles for Dark Liquidity	The principles set out in <i>Principles for dark liquidity (IOSCOPD353)</i> , Technical Committee of IOSCO, Final report, May 2011

Term	Meaning in this document
latency	An expression of how much time it takes for data to get from one point to another
layering	The creation of large numbers of orders, often at various price points, to create a false impression of demand or supply. These orders are then deleted, or moved, as they move closer to trading
limit order	An order for a specified quantity of a product at a specified price or better
liquidity	Volume of orders
liquidity provider	An entity that places orders, often on both sides of the market, for significant proportions of the trading day, with the aim of profiting from the bid–offer spread
listed companies	Companies that are listed on an exchange market
lit exchange market	An exchange market where orders are displayed on the order book of a market operated by a market licensee and the orders are therefore pre-trade transparent
market impact	The effect on the formation of price, volume and market depth created by order flow or trading activity. This includes the associated cost incurred when the execution price differs from the target price, or when the liquidity required by the execution is different from the liquidity available
Market Integrity Rules	Rules made by ASIC, under s798G of the Corporations Act, for trading on domestic licensed markets
market licence	An Australian market licence
market licensee	Holder of an Australian market licence
Market Licensing Review	Treasury's paper <i>Australia's financial market licensing regime: Addressing market evolution</i> , which closed for consultation on 1 February 2013
market maker	An entity that provides liquidity to a market when it is generally absent or weak, and manages short-term buy and sell imbalances in customer orders by taking the other side of transactions. Market makers often take on this role in return for rebates or other incentives
market manipulation	As defined in Pt 7.10 of the Corporations Act
market operator	An operator of a licensed market
market order	An order matched at the best price currently available
market participant	A participant of a licensed market

Term	Meaning in this document
market users	Investors who acquire or dispose of financial products in a financial market, including an OTC market. Investors may be participants dealing for themselves or, where participants act as intermediaries, the clients of the participants
minimum size threshold	The minimum volume required before a trade can be executed in the dark
NBBO (national best bid and offer)	The highest bid (best buying price) and the lowest offer (best selling price) for a product that is available across all pre-trade transparent order books at the time of the transaction
off-market trading/ transactions	Transactions that take place away from a CLOB and that are not pre-trade transparent. This is often referred to as 'dark liquidity' or 'upstairs trading'. It includes bilateral OTC transactions and transactions resulting from a market participant matching client orders or matching a client order against the participant's own account as principal
operating rules	As defined in s761A of the Corporations Act
order book	An electronic list of buy orders and sell orders, maintained by or on behalf of a market operator, on which those orders are matched with other orders in the same list
order-to-trade ratio	The number of times orders submitted into an order book are amended or cancelled relative to the execution of a trade
OTC	Over the counter
Part 3.1A (ASX 24) (for example)	A part of the ASIC Market Integrity Rules (ASX 24) (in this example numbered 3.1A)
Part 4.3 (Competition) (for example)	A part of the ASIC Market Integrity Rules (Competition) (in this example numbered 4.3)
Part 5.11 (ASX) and (Chi-X) (for example)	A part of the ASIC Market Integrity Rules (ASX) and ASIC Market Integrity Rules (Chi-X) (in this example numbered 5.11)
payment for order flow	An arrangement whereby a market participant, securities dealer or fund manager receives a payment from another market participant in exchange for sending its clients' order flow to them
pinging	The practice of using the placement of very small orders to test if there is liquidity
post-trade transparency	Information on executed transactions made publicly available after transactions occur

Term	Meaning in this document
pre-trade transparency	Information on bids and offers being made publicly available before transactions occur (i.e. displayed liquidity)
price formation	The process of determining the price of a security through the interaction of buyers and sellers
price improvement	From 26 May 2013, amended Rule 4.2.3 (Competition) takes effect. It provides an exception to the pre-trade transparency obligations where the dark trade provides price improvement of one tick size or the midpoint between the best available bid and best available offer
price step	See 'tick size'
price-time priority	A method for determining how orders are prioritised for execution. Orders are first ranked according to their price; orders of the same price are then ranked depending on when they were entered
priority crossing	A type of crossing on ASX's CLOB that is transacted with time priority
Pt 7.2A (for example)	A part of the Corporations Act (in this example numbered 7.2A), unless otherwise specified
quote stuffing	A strategy to impede the processing of markets, or participant processes, by overloading an order book with trading messages
reg 7.2A.02 (for example)	A regulation of the Corporations Regulations (in this example numbered 7.2A.02), unless otherwise specified
REP 331	An ASIC report (in this example numbered 331)
retail client	Has the meaning given in s761G and 761GA of the Corporations Act
retail investor	A retail client as defined in s761G of the Corporations Act
RG 241 (for example)	An ASIC regulatory guide (in this example numbered 241)
Rule 3.1.2 (ASX 24) (for example)	A rule of the ASIC Market Integrity Rules (ASX 24) (in this example numbered 3.1.2)
Rule 4.2.3 (Competition) (for example)	A rule of the ASIC Market Integrity Rules (Competition) (in this example numbered 4.2.3)
Rule 5.7.1 (ASX) and (Chi-X) (for example)	A rule of the ASIC Market Integrity Rules (ASX) and ASIC Market Integrity Rules (Chi-X) (in this example numbered 5.7.1)
S&P/ASX 200	The index known as the 'S&P/ASX 200'
S&P/ASX 300	The index known as the 'S&P/ASX 300'

<b>Term</b>	<b>Meaning in this document</b>
S&P/ASX 50	The index known as the 'S&P/ASX 50'
s912 (for example)	A section of the Corporations Act (in this example numbered 912), unless otherwise specified
securities dealer	An entity that is an AFS licensee but is not itself a market participant and that accesses the market on behalf of its clients through a market participant
settlement	The exchange of payment and delivery for purchased securities
settlement risk	The risk of counterparty default
smart order router	An automated process of scanning various execution venues to determine which venue will deliver the best outcome on the basis of predetermined parameters
soft dollar incentives	The provision of a benefit to another party that does not involve a cash payment—for example, technology or bundled services (such as advice, research, data and analytical tools, in conjunction with trade execution)
spoofing	The entry of large volumes of orders at best bid or offer price, which are then deleted within seconds of entry
spread	The difference between the best bid and offer prices
stub	The residual volume from a partly filled order
T+3	The business day three days after the transaction date
tick constrained	A security is 'tick constrained' if its bid–offer spread is frequently equal to minimum tick size
tick size	The minimum increment by which the price for an equity market product or Commonwealth Government Securities depository interest may increase or decrease
total consideration	For a buy order, the purchase price paid by a client in relation to performance of a client order, plus transaction costs; or for a sell order, the sale price received by a client in relation to performance of a client order, less transaction costs
trade confirmation	A legal document provided to clients which sets out the terms of an executed transaction
trade report	An electronic message created when a transaction is executed, detailing the terms of the transaction
trading messages	Messages submitted in relation to trading functions, such as orders, amendment or cancellation of orders, and the reporting or cancellation of market transactions