Australian Shareholders' Association
the trusted voice of shareholders

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Australian Shareholders' Association Submission
Dark Liquidity and High Frequency Trading
ASIC 18 March Report and Consultation Paper 202

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Background

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. The ASA is an independent not-for-profit organization funded by and operating in the interests of its members, primarily individual and retail investors, self-managed superannuation fund (SMSF) trustees and investors generally seeking ASA's representation and support. ASA also represents those investors and shareholders who are not members but follow the ASA through various means, as our relevance extends to the broader investment community.

This submission is a response to the ASIC report and paper. We note the conclusions drawn from submissions received by ASIC and wish to present information, examples and suggestions for further consideration and to ensure that retail shareholders are protected in an investing climate that is fairer for all participants.

ASA believes that restricting dark pool trades to a minimum size threshold will prevent retail shareholders from taking part in cross trades which typically are undertaken with their own broker. There are advantages for those involved in these trades. There is certainty of the trade rather than the client being placed at the back of a queue. Brokerage is cheaper as a rule as the broker is on both sides of the transaction and does not have to pay ASX for the use of the market.

In recent years dark pool trades, which are identified by the condition XT, have grown considerably and are now at a level which undermines confidence in the market. The proposal by ASIC suggests that big traders will be allowed to continue as now while small investors will be excluded.

Cross trades no longer appear to be just a trade between clients within the same broker. Large market participants have created their own pools. It is not appropriate for a principal, who controls the trade, to take part in a crossing particularly if the party on the other side of the trade has no knowledge of this.

We appreciate that Dark Pool trading is part of a complex problem and we would like to see ASIC do what it can to make the system fairer and more open without making retail traders the scapegoats. All investors must get the best price available.

In regard to tick sizes, ASIC is suggesting changes to stocks in the range \$2 to \$5. Thirty six stocks are shown on Commsec as last trading at 0.1 cents and the tick size there is 100 percent between \$0.001 and \$0.002. More than half the stocks on the ASX markets trade at

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less than 30 cents and we believe this is the area that needs attention. If a stock is trading at 10c or more, the minimum tick size is 0.5 cents and at that price, it represents 5 percent of the share price which is too large. Such a large tick percentage encourages Centre Point trading, and in the opening and closing auctions, it encourages HFT's to control the price and decide whether they want to be the buyer or the seller in the milliseconds before the auction ends. If the tick size is made much smaller in this range of prices, there will be much less gain to be made from manipulation or from unfair HFT speed advantage.

The ASA does not have access to High Frequency algorithms or trading so we can only see what is happening on the markets from our own retail position. The underlying concern of many of our members is that we no longer have a market operating as a level playing field and that there are several situations where there appears to be one set of rules for large investment bodies (including High Frequency Traders) and another for retail investors.

In section E of document CP 202, ASIC puts questions about small orders not being able to be withdrawn within 500 milliseconds. Unless it is a clearly mistaken order, we believe that no orders should be put in and withdrawn that quickly, not just small ones, and we also believe that orders below $500 should not be allowed at all unless it is the full holding of a seller. The number of small trades taking place in recent times has changed the market enormously. As one example of this, a large well known trader recently advised the market that it had become a substantial shareholder of Cabcharge (see http://www.asx.com.au/asx/statistics/announcements.do?by=asxCode&asxCode=cab&timeframe=D&period=W). Cabcharge is not a particularly large company with a market capitalisation of $576 million. In less than four months this trader did approximately 3,600 trades in Cabcharge as shown at the end of that announcement. How many bids did the trader actually put into the system if that number of trades took place. What was the effect that these transactions had in terms of brokerage, volatility and gains/losses for those on the other side of the trades. In our view, transactions of that frequency are not passive and have taken control of the process.

While the very large order to trade ratios of HFTs is a concern, it is the quality of those orders which seems even more relevant. As an example, after the close of trading on April 23rd, the highest Lynas seller was seeking 77.5c compared to a last sale price of 48c. Just prior to the start of trading on April 24, there were 43 new sellers seeking prices from 78c to $3.60. After the close, the largest seller was 77.5c again. This happens frequently at the start and end of the Lynas market. Is the point of these offers an attempt to make the selling volume look heavier than the buying. This may be manipulation. Trades at those prices have virtually no chance of taking place and they are removed at the end of each day and put in again the next morning. While ASA and its members are concerned about the large order to trade ratios, the quality of the trades is much more important – are they genuine or are they put into the market to mislead? In the above example, why is a "buyer"

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repeatedly putting in a bid at $3.60 for a share that last traded at 48 cents and why is it not being refused entry or questioned?

We certainly agree with ASIC in trying to clarify what constitutes manipulation and in bringing in rules to make it more difficult to do so. In section 154 of Consulting Paper 202, ASIC defines the terms Layering, Quote Stuffing, Quote Manipulation and Spoofing. We see these definitions as an explanation of High Frequency Trading itself. We can see no advantage for investors, public companies or Australia in allowing these trades to continue. Those advantaged are the Stock Exchanges, ASX and Chi-X, and the High Frequency traders themselves.

ASA and its members seek the removal of algorithmic computers from the ASX trading floor and for regulators to make entry times as equal as possible for all market participants. Alternatively, remove the auctions and the arbitrage that gives HFTs, and others, unfair advantage.

Apart from the issues that ASIC has raised in its Consultation Paper and its March Report, there are several related issues which concern the ASA and our members and we would like them to be considered:

In its last annual report, ASX's Managing Director reported that revenue from Technical Services was larger than_revenue received from Cash Market Trading. We believe there are strong signs that suggest unfair advantage may have been created for those who pay ASX directly for products or information.

Here are some features of the market that our members see as unfair.

* Some of the larger investors, (e.g. clients of Iress), obtain market sensitive announcements before ordinary investors who access the announcements on the ASX website. You can read the document on Iress, go to ASX and request the same document and regularly get the message "This document is being processed". If ASX cannot provide these documents to the general market at that time, how does Iress get access to them? Clearly the longer period that ASX's paying customers have access to a price sensitive document before the general public gets access to it, the more valuable the information is and the more they are likely to pay ASX for it.

* Important company information is released by Iress but not by ASX e.g. when trading ceases for 10 minutes because of the release of market sensitive information, Iress advises of this halt and of the time when trading resumes. ASX does not tell the general public of these short trading halts at all, yet we presume that it has advised paying customers of the time schedules. Also when companies are out in trading halts for a longer period e.g. several days, Iress advises the exact time that the trading halt will be lifted. The ASX does not.

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**** Iress advises its customers of all the stocks that have gone ex dividend. Presumably Iress gets this information from the ASX but it is much more difficult for retail investors to find this information on the ASX site or on many of the broker sites.

Query the above. On the ASX website each company listed has a note regarding dividends ???

* Retail investors are generally required by their brokers to limit orders to marketable (minimum) parcels whereas HFT traders and other large investors have no such restriction. The ASX does not have a minimum limit on trade size. There are a huge number of unmarketable trades going through the market.

* The ability of HFT traders to place and withdraw trades within milliseconds, the use of trading algorithms, the introduction of exchange competition via Chi X and Dark Pool Trading gives HFT's the ability to "read" other market orders before they reach the markets and thus provides them with the opportunity to beat them to the trade. We have seen examples where large bids put in by our members have been beaten into the market at the same price by a fraction of a second and we suspect that this is due to those original bids being hawked around the dark pools and the different markets before going into the formal ASX market. It does appear that High Frequency traders do see large bids coming and can beat them into the open market at the same price.

* Retail shareholders can be charged for full trade brokerage triggered by an HFT probing the market with minute parcels e.g. when a Commsec order triggers a $19.95 minimum commission for the purchase of 2 shares even though the order may have been for 100,000 shares and the balance of the order may never be fulfilled.

* Pre-opening and post-close trading takes place and is not accessible to retail shareholders.

* The opening and closing auctions provide a large portion of the market turnover and since the introduction of HFTs and algorithmic trading, those auctions provide unfair competition for retail traders. High Frequency Traders can and do change their bids within a fraction of a second to react to retail bids which generally take many seconds for the manual investor. Those retail shareholders who are not live traders are unaware of this.

The formula for the final auction share price is quite complex. The details are available at http://www.asx.com.au/products/calculate-open-close-prices.htm An example of how it is used by HFTs, is shown in the following situation:

Buyer's volume	Buyer's Price	Seller's Price	Seller's Volume
100000	10c	10c	100000

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At the close of the auction the deal would go through at 10c. But say another bidder puts in a buying bid as follows:

Buyers volume	Buyers Price	Sellers Price	Sellers Volume
99,999	10.5c		
100,000	10c	10c	100000

Because the new bidder's volume is lower than the seller, he will get the shares at the sellers price of 10c and the original bidder ends up with 1 share at 10c and a full brokerage. If any one of these traders is a High Frequency Trader then he could alter the final result to suit himself. For example if it is the seller he can very quickly change his price to 10.5c and then the deal goes through at 10.5c. Small shareholders who don't trade live, don't even see what is happening and those who do trade live cannot compete against a competitor who can respond in milliseconds.

* There have been several new market services such as Centre Point trading and Iceberg orders which are not available to retail investors. Centre Point trades allow large investors to go ahead of the queue at prices that are not available to retail investors. For example if a stock has a highest buyer at 10c and a lowest seller at 10.5c, a retail investor cannot bid inside this range but centre point trades go through at the midpoint of 10.25c.

Conclusion

ASA believes the following issues need to be addressed:

1. If ASX is selling price sensitive information to companies such as Iress it should be compelled to release this information to all interested parties at the same time.

2. All participants should have access to details of when companies are halted from trading due to market sensitive information and advised when trading will resume. Iress supplies this information to its customers but the ASX does not release it to the general public.

Items 1 and 2 lead us to believe that there is a case for a government body such as ASIC to take charge of receiving and publishing company statements and ensuring that they are made available to all participants at the same time. If this is not possible then ASX must be required to do so.

3. Minute sized bids should not be allowed. Either introduce a charge on every trade or market bid, or disallow bids that are not of a reasonable size such as a marketable parcel. This seems a simple way to prevent claims of market manipulation.

4. High frequency traders and others should not be allowed to manipulate auction prices in the opening and closing markets. Bids are removed and altered in the final seconds in a way that is totally inequitable to retail and institutional shareholders. The investors at the top of the queue at the start of the auction frequently end up buying or

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selling 1 or 2 shares while the bulk of the sales go to those able to dictate the final price and the buyer. Unless the opening and closing auctions are transparent, they should be removed. Retail shareholders cannot compete in the current circumstances.

5. If these small orders are allowed to continue, disallow or discourage brokers from charging full brokerage on a normal marketable bid when only a miniscule portion is obtained.

6. Disallow or discourage brokers from charging full brokerage for an internal dark pool trade. The broker gets the brokerage from both the buyer and the seller and does not have to pay ASX anything for the trade. Investors should be informed when some of their contract has been achieved via a cross trade.

7. Centre Point trading appears to be a method of allowing large shareholders and High Frequency Traders to gain an advantage. Some of our members have tried to take part in centre point trades and been unable to do so. It is not at all clear who can take part in these trades.

8. No information or advantageous methods of trading should be available to one group and disallowed to others.

At the present time we believe the market is not a level playing field for retail investors and we ask ASIC to examine and rectify the matters we have raised.

ASA acknowledges the valuable contribution by the Chairman of ASIC during his presentation at our conference held in early May. This has provided more information on this difficult subject. However we believe our comments require further examination.

Yours sincerely

Ian Curry
Chairman