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14 May 2013

Dior Loveridge and Joseph Barbara  
Australian Securities and Investments Commission  
Level 5  
100 Market Street  
Sydney NSW 2000

Dear Dior and Joe

#### **SUBMISSION ON CP 202 – DARK LIQUIDITY AND HIGH FREQUENCY TRADING: PROPOSALS**

Chi-X is grateful for the opportunity to comment on the proposals contained in the above Consultation Paper (CP202). Chi-X has comments on general issues raised by the CP, which are set out in this covering letter, and responses to some of the questions asked, which are set out in **attachment one**.

Chi-X has comments on the following general issues raised by the CP:

1. the context to the proposals that is provided by the conclusions contained in Report 331;
2. trigger points for minimum order sizes;
3. the regulatory framework for tick sizes;
4. minimum resting times;
5. the cost benefit analysis.

#### **1. Context**

Chi-X commends ASIC for the evidence based approach to the development of policy that is contained in Report 331, *Dark liquidity and high frequency trading*, and CP202. The confidence of investors in the fairness and efficiency of Australia's markets is well served by policy development that focuses upon evidence based analysis. Without this type of approach, it is not possible to properly identify and

prioritise regulatory issues, nor is it possible to consider proposed solutions in a fully developed cost benefit framework.

In particular, Chi-X notes the following conclusions that have been reached by ASIC:

- (i) concerns over HFT appear to have been overstated<sup>1</sup>;
- (ii) the value-weighted average holding period of securities traded by high-frequency traders, during the nine-month period analysed by the ASIC HFT Task Force, was approximately 42 minutes<sup>2</sup>;
- (iii) increases in order-to-trade ratios in Australia have been moderate and are relatively low compared with overseas markets, and algorithmic traders operate at similar levels to those of so called high frequency traders<sup>3</sup>;
- (iv) investors are significantly better off due to the decrease in spreads which has arisen since the commencement of competition between Chi-X and ASX trading platforms and that these benefits may be worth \$300million per year<sup>4</sup>.

These findings provide an appropriate evidence based backdrop for the consideration of the proposals in CP 202 and the further analysis of the cost and benefit of any measures. They provide a valuable reinforcement on the soundness of Australia's markets and a notable contrast with some of the ill-informed commentary on high frequency trading and the cost of competition in the trading of Australian securities.

Given the ASIC findings, a measured and steady regulatory agenda seems appropriate at this stage of the regulatory cycle and this view underpins this submission.

## 2. Minimum Order Sizes – Hidden Orders on a Lit Order Book

Chi-X is of the view that there are sound investor focused reasons for distinguishing hidden orders executed on a lit market from hidden orders on a dark platform. The rationale outlined in the CP for providing an “advantage” to lit orders is to protect those lit orders from queue jumping by dark liquidity. In this context, it is worth noting that hidden orders on the Chi-X market cannot “queue jump” and only operate to provide price improvement for aggressive orders: that is, hidden orders on the CXA market can

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<sup>1</sup> See ASIC Media Release 13-052MR at <http://www.asic.gov.au/asic/asic.nsf/byheadline/13-052MR+ASIC+reports+on+dark+liquidity+and+high-frequency+trading?openDocument>

<sup>2</sup> Paragraph 306 of Report 331 at [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep331-published-18-March-2013.pdf/\\$file/rep331-published-18-March-2013.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep331-published-18-March-2013.pdf/$file/rep331-published-18-March-2013.pdf)

<sup>3</sup> Paragraph 288 Of Report 331, ibid.

<sup>4</sup> Internal analysis by ASIC's Strategic Intelligence unit to 30 January 2013 cited on page 32 of the Treasury Market Supervision Cost Recovery Impact Statement at

[http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2013/ASIC%20Market%20Supervision%20Cost%20Recovery/Key%20Documents/PDF/Consultation\\_draft\\_CRIS.ashx](http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/2013/ASIC%20Market%20Supervision%20Cost%20Recovery/Key%20Documents/PDF/Consultation_draft_CRIS.ashx)

only ever execute with aggressive orders that cross the spread on a lit market. As such they are interacting with the lit market in a way that other dark trading does not. This interaction takes place in a way that can only provide better execution for the participants involved: a buy/sell order crossing the spread only pays half the spread. In circumstances where a 3 basis point reduction in the cost of trading represents savings to traders of over \$300m a year, this can provide substantial benefits to all those investors taking liquidity from a lit order book. On the Chi-X market, this trading flows predominantly from retail investors and buy side firms.

In particular, it is not clear that the conclusions reached by Comerton-Forde and Putins<sup>5</sup> take into account:

- (i) the diminished impact of hidden orders on a lit market to price formation on those lit markets;
- (ii) the benefit for retail investors and buy side firms in having the transaction cost of crossing the spread decreased by interacting with a mid-point order<sup>6</sup>; and
- (iii) the impact on attracting liquidity to a lit market that occurs as a result of this type of order.

In these circumstances, Chi-X would encourage ASIC to consider different triggers for hidden orders on a lit platform.

If ASIC does implement the trigger proposals then while setting triggers at a symbol level may involve more work for market operators, this option would, in the view of Chi-X, deliver better outcomes than grouping securities together. However, Chi-X notes that ASIC does not expect the proposed triggers for hidden order liquidity to be met in the near term and therefore queries why any potential benefits of this measure justify the risks posed by legislating today for a problem that is not extant. There are significant industry resources that will be dedicated to considering the impact of this proposal, which seems incongruous if ASIC acknowledges that it is not a present issue.

### 3. Tick Sizes

Chi-X is generally supportive of steps to decrease tick sizes as they can make up a significant proportion of the transaction cost for investors. However, Chi-X is also conscious that inappropriately decreasing tick sizes may decrease liquidity while having inappropriately large tick sizes may increase trading costs for investors.

Chi-X is strongly of the view that the most efficient regulatory regime for tick sizes would allow market operators to respond to market demand on a timely basis, and produce immediate savings for investors, without requiring ASIC to undertake the process of changing regulations. For example, a regulation that increased the middle tick tier for equity market products in the \$2 to \$5 price range seems to be a very broad brush approach: it is not clear that all stocks within that range would be suited to a decrease in tick size nor that those outside would not be. In these circumstances, Chi-X is strongly of the view that if ASIC is to take regulatory mandated action on tick sizes, it would be appropriate to implement those

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<sup>5</sup> Paragraph 103 of Report 331.

<sup>6</sup> Hidden orders will provide a part of the \$300m in benefits for investors referenced in footnote 4 above.



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proposals only in respect of a pilot group of tick constrained stocks rather than grouping securities by price range. Chi-X would also ask that ASIC consider a pilot scheme that was driven by market operators under umbrella principles enunciated by ASIC and which would allowed a market operator to respond flexibly and dynamically to market outcomes.

#### 4. Minimum Resting Times

ASIC has estimated 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<sup>7</sup>. These figures include those small volume orders entered into the ASX market pursuant to its priority crossings rule, which will cease on 26 May.

Changing the Chi-X trading system to implement a validation or rejection control on minimum resting times would cost Chi-X at least \$530,500. This is in addition to the costs that market participants would incur. Chi-X estimates that the likely cost to industry would be well in excess of \$10 million and would require resources that are already stretched<sup>8</sup>. The following would also have to be included in any holistic cost benefit analysis:

- (a) the opportunity cost of lost development and enhancements that would otherwise be delivered by resources tied up on a minimum resting time project;
- (b) the increased system risk introduced by requiring changes to trade matching engines and participant systems.

As ASIC is aware, minimum resting times are yet to be implemented in any other jurisdiction in this manner, notwithstanding that the 'market noise' in those centres may be far more significant than the 3.6% of orders referenced above. There are legitimate alternatives to minimum resting times that may address the issues raised by small and fleeting orders. As is acknowledge within Report 331, low volume orders are primarily an issue raised by algorithms operated by or for the benefit of buy side clients. In these circumstances, Chi-X queries whether a more cost effective approach to minimum resting time may involve ASIC conducting a targeted campaign and working with all stakeholders to address the issue. There are many instances where public campaigns and/or targeted supervision methods have delivered positive changes in behaviour and Chi-X suspects that the ASIC attention on this issue is already delivering results in this area. Chi-X has observed an increased focus at participants on this type of trading and changes to trading behaviour. Chi-X would be prepared to assist in any ASIC campaign or targeted supervision aimed at addressing these issues.

Chi-X is also concerned that the structure of the proposed rules leaves unanswered many questions on implementation and system controls. It may be enormously expensive and potentially risky to require exchange trading systems to have controls in this area that address the issues relating to universal

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<sup>7</sup> See paragraphs 333 and 339 of Report 331 and paragraph 100 of CP 202.

<sup>8</sup> See, for example, the AFR article *Credit Suisse profit shrank two thirds in 2012*, published 14 May 2013 and in which it is stated "Many European and US investment banks with local operations faced strong headwinds last year, amid lacklustre trading volumes and corporate activity". The article is accessible at:

[http://www.afr.com/p/business/companies/credit\\_suisse\\_profit\\_shrank\\_two\\_m64j4dIQ8RsxVkWUgsSRjl](http://www.afr.com/p/business/companies/credit_suisse_profit_shrank_two_m64j4dIQ8RsxVkWUgsSRjl)



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timing, participant responsibility and precisely defining what orders are caught (eg how to manage stubs, amendments, tolerance levels for market impact).

In these circumstances, Chi-X is strongly of the view that ASIC's proposed use of minimum resting times, to address the market noise issues articulated in Report 331 and CP 202, cannot be justified on any objective cost benefit analysis.

#### **5. Cost Benefit Analysis**

Chi-X commends ASIC for seeking to outline the impact of the proposals in CP202 in some detail and is appreciative that it can be difficult to put a dollar figure on measures that may still be at a germinal stage. However, Chi-X is of the view that it may be beneficial for ASIC and industry to work together on an ex ante basis to arrive at a cost approximation of CP proposals so that a more informed cost benefit analysis may take place as part of the CP process. Chi-X accepts the difficulties in gaining traction with industry participants in this regard but is of the view that Australia will benefit if this becomes an enduring aspiration and feature of policy development. This issue is illustrated in the present consultation by the difficulty stakeholders have in assessing whether the benefit of combating the "market noise" of 3.6% of orders would justify the cost of implementing and monitoring any such control.

Please do not hesitate to contact us if you have any queries.

Yours sincerely

A handwritten signature in black ink, appearing to read "Michael Thomas".

Chi-X Australia Pty Ltd



Discussion paper question	Chi-X response
B1Q1 Do you agree that a safety net proposal like this is necessary?	Chi-X can see the merit in allowing the price improvement measures to have an impact before ASIC makes any further rules in this area. The price improvement measures are a significant change for the Australian market place and it may be worthwhile to delay legislating the trigger points until the impact of those proposals can be assessed.
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?	Chi-X is of the view that hidden orders on a lit market should be the subject of different trigger points given that they provide price improvement for orders that are already on a lit market. Chi-X is further of the view that additional study is warranted of the new market structure once the price improvement rules apply.
B1Q3 Do you have a preference for either option? Please explain your rationale.	Chi-X is of the view that a security by security approach is far preferable and that the flexibility of allowing market operators to set those sizes under an appropriate umbrella regulation made by ASIC would be appropriate.
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?	Chi-X is of the view that there is no basis for implementing the threshold immediately.
B1Q5 Do you have any views on the proposed implementation timeframe of 40 business days for the thresholds if triggered?	It is difficult for a market operator to estimate the time for implementation without precise details on what is required. It is possible that quite complex mechanisms would be required to implement the required controls in which case 40 days may be too short a timeframe.



C1Q1 Are there any reasons that the proposed information should not be made public?	No.
C1Q2 - C1Q5	Chi-X has no comment on the remainder of the proposals in this area.
<i>Your feedback</i> 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?	Chi-X has no comment.
C3Q1 - C3Q2 Is six months sufficient time to amend disclosures for existing and new clients?	Chi-X has no comment on the proposals in this area.
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?	Chi-X has no comment.
C5Q1 Do you have any comments on our proposed approach?	Chi-X has no comment.



C6Q1 - C6Q3	Chi-X has no comment on the proposals in this area.
C7Q1 - C7Q2	Chi-X has no comment on the proposals in this area.
C8Q1 - C8Q2	Chi-X has no comment on the proposals in this area.
C9Q1 - C9Q2 ls	Chi-X has no comment on the proposals in this area.



<p>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?</p> <p>D1Q2 Do you agree that we should target the most affected securities rather than a complete overhaul of the tick size regime?</p> <p>D1Q3 Do you have a preference for Option D1.1 or Option D1.2? Is there an alternative model we should consider?</p> <p>D1Q4 Is a pilot desirable and is six months sufficient time to introduce it?</p>	<p>Chi-X agrees that tick sizes are constraining some security prices and that this will be a factor in deciding where and how execution should take place. Chi-X is of the view that queue times are another significant factor. Market Operators and properly controlled competition should not be disregarded as an effective method of delivering tailored cost effective solutions for investors in this area.</p> <p>Chi-X is of the view that the regime should allow market operators to compete to a degree on tick size so that investors are provided with an option that delivers the most efficient outcome.</p> <p>Chi-X is of the view that ASIC should consider the alternative model of market operators setting tick sizes under the umbrella of ASIC regulations that contain appropriate principles that will ensure appropriate industry consultation and that there is no "race to the bottom". Chi-X is strongly of the view that any ASIC or industry concerns can be addressed through a measured approach containing these features. It would allow the Australian market to derive the benefit of competitive tick sizes without the cost that has been observed in other jurisdictions.</p> <p>Chi-X is of the view that there is merit in a six months concerted consultation on all options, including market operators setting the tick size.</p>
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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)?	Chi-X is of the view that the market is best placed to determine the most efficient outcomes in this area. ASIC has not identified any need for a new regulatory measure in this area, indeed the CP acknowledges that market licensees work well, and that Australia is better placed than other financial centres. Regulation is not "costless" so ASIC should not be under a misapprehension that there are no additional costs if ASIC makes a new regulation requiring the publication of information that is already being provided. Regulatory obligations must be the subject of review, controls, reports and risk management. All this imposes a cost on firms that, if the information is being provided on an efficient basis already, may not be justified. If ASIC does proceed with regulation in this area then Chi-X is of the view that participants trading as principal should be able to elect to for their identifiers to be excluded from reports.
D2Q2 Do you agree that there is benefit in disclosing the particular crossing system where a trade has been matched?	In keeping with the response to D2Q1, Chi-X Is of the view that the market is best placed to determine these outcomes. The confirmation and contract note requirements in the Corporations Act and Market Integrity Rules provide a baseline of consumer protection in this area and Chi-X queries whether there is a benefit in raising that baseline as outlined.
D3Q1 - D3Q3	Chi-X has no comment on the proposals in this area.
D4Q1 - D4Q4	Chi-X has no comment on the proposals in this area.
D5Q1 - D5Q3	Chi-X has no comment on the proposals in this area.

E1Q1 Do you agree that we should discourage small and fleeting orders? If not, why not?	Chi-X is of the view that orders of inappropriately small volumes should be the subject of proportionate discouragement.
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?	It is not possible to comment on this in isolation of specific details on what orders will be caught and the way in which the measures are implemented. For example, if the requirement is expressed as a goal for participants that will be the subject of quarterly reporting and monitoring then that is a different issue to requiring market operators and participants to undertake fundamental changes to important trading systems and matching engines. Requiring a change to the Chi-X matching engine may cost up to \$530,500.
E1Q3 Do you think the proposed sizes for a 'small order' are appropriate, or too small or too large?	Chi-X is of the view that the appropriateness of the size of the order is directly linked to the nature of the measure that restricts the size (ie whether the obligation to meet the size requirement is imposed on participants and measured at the time an order leaves the participant systems or if it is imposed on a market operator and measured at the time it is received into an operator's systems). Definitely if the size was to increase beyond \$500 then it may become more problematic.
E1Q4 Do you think there is a better way to address excessive small and fleeting order messages and trades in the Australian market?	Chi-X is of the view that ASIC has already had an impact on small volume orders by giving them the publicity it has. Further the work of market operators and participants to discourage this activity may also have had an impact. In these circumstances, Chi-X is of the view that a targeted campaign on small volume orders may provide the most cost effective solution to this problem.
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.	It is difficult to comment without further specifics on how the rule will be implemented, supervised and enforced. ASIC's expectations in this regard are key to estimating the full impact of the proposals.
E1Q6 Does the six-month period for commencement of these rules allow sufficient time to make the appropriate system changes?	Chi-X is of the view the rule and specifics of the proposals are insufficient for market operators and participants to properly implement controls to satisfy any requirements.
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E2Q1 Do you have any comments on our proposed guidance?	Chi-X has no comment on the proposed guidance
E2Q2 Do you think there is a need to address order-to-trade ratios in the Australian market?	Chi-X is of the view that order-to-trade ratios are not of themselves an issue in Australia. The rules currently governing automated order processing are measured and the evidence is that they work well. In these circumstances it is not clear that further regulatory measures are necessary.
E3Q1 - E3Q4	Chi-X has no comment on the proposals in this area.