



ASIC

Australian Securities & Investments Commission

REPORT 290

Response to submissions on CP 168 Australian equity market structure: Further proposals

June 2012

About this report

This report highlights the key issues that arose out of the submissions received to Consultation Paper 168 *Australian equity market structure: Further proposals* (CP 168) and details our responses in relation to those issues.

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.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see draft updated Regulatory Guide 223 *Guidance on ASIC market integrity rules for competition in exchange markets* (draft updated RG 223) and the draft addendum to Regulatory Guide 172 *Australian market licences: Australian operator* (RG 172), issued with Consultation Paper 179 *Australian equity market structure: Draft market integrity rules and guidance* (CP 179).

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A Overview/Consultation process

- 1 On 20 October 2011, ASIC released a second-phase consultation package which canvassed equity market structure issues arising from developments in Australia's financial markets. The consultation package included:
 - (a) Consultation Paper 168 *Australian equity market structure: Further proposals* (CP 168); and
 - (b) *Australian equity market structure: Further draft market integrity rules*.
- 2 CP 168 canvassed a number of proposals and market integrity rules that were considered to be necessary to keep pace with technological and market developments. It sought views on:
 - (a) enhanced controls for an increasingly automated trading environment;
 - (b) volatility controls to automatically limit market activity during periods of extreme price movement;
 - (c) enhanced regulatory data requirements for ASIC's surveillance capability;
 - (d) broadening the scope of best execution so investors have the same protection for both equity and non-equity products listed or quoted on the market operated by ASX Limited (ASX); and
 - (e) exceptions to pre-trade transparency and mechanisms for promoting pre-trade transparency to address the impact of dark liquidity on the price formation process.
- 3 CP 168 built on the findings of Consultation Paper 145 *Australian equity market structure: Proposals* (CP 145) issued in November 2010, which canvassed issues relating to the introduction of competition to exchange markets in Australia and the release on 29 April 2011 of ASIC Market Integrity Rules (Competition in Exchange Markets) 2011. Those rules provided a robust regulatory framework that enabled the introduction of competition.

Note: In this document 'ASIC Market Integrity Rules (Competition)' refers to the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011.
- 4 On 3 April 2012, we issued Media Release (12-61MR) *ASIC provides direction on market structure reforms* outlining our direction and timetable for implementation of the proposals, refined following the consultation process, to maximise the opportunity for industry to prepare for the proposed changes.
- 5 This report highlights the key issues that arose out of the submissions received to CP 168 and details our responses to those issues.

- 6 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 168. We have limited this report to the key issues raised by industry.
- 7 This report should be read in conjunction with the draft updated Regulatory Guide 223 *Guidance on ASIC market integrity rules for competition in exchange markets* (draft updated RG 223) issued with Consultation Paper 179 *Australian equity market structure: Draft market integrity rules and guidance* (CP 179) on 28 June 2012. Draft updated RG 223 gives guidance on the intended application of rules for market-level volatility controls, enhanced data for surveillance and pre-trade transparency.
- 8 We are currently consolidating our guidance on proposed new market integrity rules for automated trading with updated guidance currently in ASX guidance notes. We intend to release draft market integrity rules and consolidated draft guidance on this topic early in the third quarter of 2012. We have issued for consultation, draft guidance on systems and controls for domestic market licensees: see the draft addendum to RG 172 issued with CP 179.

Responses to consultation

- 9 We received 28 written submissions to CP 168 from a broad range of stakeholders, including market operators, market participants, fund managers, associations, high-frequency trading firms, law firms and a data vendor and technology firm.
- 10 We had over 50 meetings with stakeholders since the consultation paper was published on 20 October 2011 and held information sessions for members of the Australian Financial Markets Association, the Financial Services Council and the Stockbrokers Association of Australia.
- 11 For a list of the non-confidential respondents to CP 168, see Appendix 1 of this report. Copies of these submissions are available on the ASIC website at www.asic.gov.au/cp under CP 168. We are grateful to respondents for taking the time to send us their comments.

General comments

- 12 Apart from responding to the specific proposals in CP 168, respondents also provided general comments.
- 13 Respondents were generally appreciative of ASIC's holistic approach to consulting on the market structure framework. Some respondents commended ASIC on the breadth of our vision for the regulatory reform of Australia's financial markets and for engaging with a variety of stakeholders and global financial markets.

- 14 There was widespread support for ASIC to focus on the rules most necessary considering the current financial pressure in the industry, and for ASIC to issue guidance rather than make new rules where possible.
- 15 Respondents were generally supportive of measures to address risks created by the increasingly high-speed and automated nature of markets. However, they also stressed that such measures should be straightforward, transparent and flexible, to ensure legitimate trading is not inhibited, and suggested that ASIC should continue to monitor developments in the market and respond where necessary. On some proposals, respondents suggested that competition between exchange markets should be allowed to develop further before introducing further regulatory change.
- 16 Some submissions stated that the proposals are likely to impose a significant cost burden in an environment where there is already financial pressure on industry. A number of respondents questioned the impact of some proposals on Australia's international competitiveness and questioned whether the benefits of ASIC's proposed approach outweighed the costs.
- 17 Respondents also sought certainty via a public timetable to allow them to allocate resources and to prepare for the proposed changes. The majority of market participant respondents suggested they require more than six months after the rules are settled to prepare for the changes required by the rules.
- 18 There was limited feedback received on the appropriate maximum penalty to be imposed for the proposed new market integrity rules. Responses received were generally in agreement with the maximum penalty, although one respondent noted that it was inappropriate to apply the same maximum penalty across the board for rules that apply to market operators and those for market participants, as incentives to breach the rules were not the same.
- 19 Some respondents continued to express caution about the pace of change in the Australian market and, in particular, the impact of high-frequency trading and dark pools on the fair and efficient functioning of the market.

ASIC's response

As confirmed by 12-61MR, the proposals in CP 168 have been substantially refined after further dialogue with industry and analysis of costs and benefits, while continuing to meet ASIC's regulatory objectives.

We will focus more on guidance rather than rules and most rules will have between 9- and 18-month implementation periods from the date the rules and guidance are settled.

For a comparison of proposals in CP 168 with our intended approach, see Appendix 2 of this report.

We are very aware of the changes occurring in the Australian market and abroad, particularly the increasingly automated nature of trading and the proliferation of dark pools. We intend to do further work on high-frequency trading and dark pools. This work will include:

- continuing to analyse the prevalence and impact of dark pools and high-frequency trading in the Australian market and abroad;
- reviewing the nature of trading, monitoring, handling of conflicts of interest and misconduct in dark pools;
- reviewing the nature of trading by high-frequency traders including impacts on orderliness of trading in dark pools and on markets, and possible misconduct;
- reviewing the existing regulatory framework and considering what changes might be required, including relevant 'market operator-like' obligations applying to broker crossing systems (e.g. transparency of access and processes, management of conflicts of interest and appropriate supervision); and
- identifying any existing conduct that we consider may warrant a regulatory response.

We expect to report on our findings, and any regulatory response, in the fourth quarter of 2012.

Impact on systems and business models

- 20 Before making the rules, we will comply with the requirements of the Office of Best Practice Regulation (OBPR), including publishing a Regulation Impact Statement (RIS).
- 21 For a high-level summary of what we understand will be the potential impacts of the draft market integrity rules and guidance on stakeholders' systems and/or business models, see Appendix 3 of this report. We would appreciate your comments on the issues discussed in this appendix as well as the points raised in Section C of CP 179 'Regulatory and financial impact'.

B Automated trading environment

Key points

In CP 168, we proposed to build on the existing ASIC Market Integrity Rules (ASX Market) 2010 and ASIC Market Integrity Rules (Chi-X Australia Market) 2011 with requirements for automated order processing (AOP) and algorithmic programs.

We also proposed minimum controls for direct electronic access (DEA) and clarification, through guidance, of our expectations for market operators' systems and controls.

Feedback was also sought on market making in the Australian cash equity market, including the basis for providing short selling relief to market makers.

In relation to testing algorithms and minimum controls for DEA, industry argued that the existing rule framework was sufficiently robust, and there was a preference for guidance rather than rules where possible.

Submissions broadly supported our proposals to clarify our expectations for market operator systems and controls through guidance.

Many respondents advocated that market making should be supported by conditional short sale relief.

Note: In this document 'ASIC Market Integrity Rules (ASX)' refers to the ASIC Market Integrity Rules (ASX Market) 2010 and 'ASIC Market Integrity Rules (Chi-X)' refers to the ASIC Market Integrity Rules (Chi-X Australia Market) 2011.

Trading behaviour of concern

- 22 In CP 168, we confirmed our intent to use our powers to enforce the existing rules for market manipulation and disorderly trading, where necessary, and to keep the provisions under review, rather than seeking to expand our powers. We considered that other proposals in CP 168 would help to manage, and deliver more efficient analysis and detection of, trading behaviours of concern. Feedback was sought on this approach.
- 23 Many respondents agreed that the current regulatory regime is sufficiently robust and adequate to combat undesirable market behaviour. They considered that the current market manipulation provisions were sufficiently broad and capable of flexible application as technology used behind orders evolves.

ASIC's response

We do not propose to make any changes to existing rules on market manipulation or disorderly trading. We are closely monitoring trading behaviours that may raise concerns for the fair and orderly operation of the market. We will use our powers to enforce the existing rules, where necessary, and will keep the market manipulation and disorderly trading rules under review.

Algorithmic programs and automated order processing

Testing of systems before connection

- 24 In CP 168, we proposed a new market integrity rule to require a market participant to ensure that, before using an algorithm that generates trading messages for the first time (or before implementing a material change to it), it is tested to ensure that it will function in compliance with the ASIC market integrity rules and all applicable market operating rules.
- 25 A number of respondents agreed that a more robust and realistic ‘end to end’ test environment should be established to facilitate algorithm testing.
- 26 However, general feedback was that the existing regime is sufficient and there was no evidence to suggest existing rules dealing with AOP are flawed or require supplementation.
- 27 Most respondents had a preference for guidance or a ‘best practice’ regime rather than new rules. They suggested that guidance provides more flexibility and clarity, including about the types of filters needed to prevent a series of orders from adversely impacting the market.
- 28 Respondents also supported a greater focus on the quality and integrity of filters as opposed to targeting algorithms. Filters can more efficiently control for a broader range of activity and inhibit orders that might disrupt the market, irrespective of where and how those orders are entered. It is impractical to expect market participants to test algorithms for every possible scenario, especially scenarios that depend on the responses of other algorithms, systems or traders, or unforeseen market events.
- 29 Other respondents expressed concern about the complexity and limitations of a testing environment where not every scenario can be tested. Some respondents submitted that regulatory requirements in this area must be in line with other jurisdictions, especially regions in which Australia’s markets compete.

ASIC’s response

We intend to refine our proposal taking into account industry’s preference for guidance, while still meeting ASIC’s objectives of ensuring there are robust filters and controls.

We will not proceed with a new rule on testing of algorithms. Instead we intend to publish guidance under existing rules to clarify our expectations for testing of systems.

The guidance will focus on:

- testing systems, filters and controls (rather than individual algorithms);
- managing highly automated trading; and
- stress testing of flow.

We intend to clarify our expectation that authorised persons' systems order flow should be tested against market participant AOP filters. Such testing should occur before use (i.e. at the developmental stage) and before implementing any material changes.

We intend to publish draft guidance on this topic for consultation early in the third quarter of 2012.

Control over messages and monitoring

30 In CP 168, we proposed a new market integrity rule to require a market participant to have direct and immediate control over all trading messages submitted through a market participant's system, including pre-trade controls, real-time monitoring and post-trade analysis.

31 There were mixed views on this proposal. Some respondents supported it, noting that comprehensive trading filter systems and controls were already in place: see Rule 5.6.3 of the ASIC Market Integrity Rules (ASX) and ASIC Market Integrity Rules (Chi-X). Other respondents thought the requirements placed an unreasonable monitoring burden on market participants in an environment where their resources are already stretched.

Note: In this document 'Rule 5.6.3 (ASX)' (for example) refers to a particular rule of the ASIC Market Integrity Rules (ASX) and 'Rule 5.6.3 (Chi-X)' (for example) refers to a particular rule of the ASIC Market Integrity Rules (Chi-X).

32 A number of respondents thought that the existing rule framework is adequate. Many respondents suggested ASIC publish guidance to clarify our expectations of conduct under the existing rules, rather than make new rules. In particular, guidance was requested to elaborate on recommended practices for pre-trade controls and filter settings, real-time monitoring and post-trade analysis.

ASIC's response

We intend to proceed with a market integrity rule requiring 'kill switch' capability and direct control over pre-trade filters.

We will not make a new rule for real-time monitoring and post-trade analysis. Rather, we intend to publish guidance clarifying our expectations for these trading system controls under existing rules.

We intend to continue to work with industry to consolidate our guidance on this topic with the aim of publishing draft market integrity rules and guidance for consultation early in the third quarter of 2012.

Business continuity planning and annual review of systems and connectivity

- 33 In CP 168, we proposed a new market integrity rule to require a market participant that uses its system for AOP to have in place adequate business continuity arrangements to ensure that connectivity to the execution venue is maintained, and be able to recover its normal business operations as soon as practicable after an emergency or other significant disruption to its business. To improve the efficiency of the certification process without affecting market integrity, we also proposed an annual attestation by market participants and the removal of the requirement for ASIC to have a role in acknowledging a market participant's certifications and confirmations.
- 34 Responses from market operators were generally supportive of the business continuity planning initiative. However, some market participants and one association did not support the proposal on the basis that business continuity planning is considered to be part of normal business, where there is a significant commercial interest to ensure robust business continuity procedures are in place. They submitted that commercial considerations should not be affected by a market integrity rule.
- 35 Most respondents did not support our proposal for a new requirement for market participants to review their AOP systems annually and provide annual attestations to ASIC. While they did not disagree in principle, they questioned the need to change existing AOP certification rules.
- 36 Alternatively, one respondent suggested the proposal be modified to require certification for systems if there have been significant cumulative changes in the system or the environment in which the system operates since the last attestation.
- 37 A small number of respondents supported the annual review and attestation proposal, noting minimal changes would be needed to support the annual attestation requirement. They added that while the proposal will require additional processes and testing to be implemented and written into procedures, this was not perceived as a major issue.

ASIC's response

For business continuity arrangements, we do not intend to proceed with a new market integrity rule

Instead we intend to publish guidance clarifying our expectations for adequate business continuity arrangements. We intend to focus on trading management arrangements with a greater emphasis on capacity. We would expect business continuity planning to reflect the nature and complexity of market participants' businesses.

For annual reviews of AOP systems, we intend to proceed with a new market integrity rule requirement of annual review of systems and documentation, policies and processes around AOP systems.

For annual notifications to ASIC, we propose to proceed with removing the requirement for notification to ASIC following review of material changes, and make a new market integrity rule requiring an AOP system annual notification to be submitted to ASIC to demonstrate that an internal review has been conducted.

We intend to publish draft market integrity rules and guidance on this topic for consultation early in the third quarter of 2012.

Direct electronic access

Minimum standards for direct electronic access

- 38 In CP 168, we proposed specified minimum standards to require market participants to understand the nature of their AOP client's business, ensure the AOP client has the required adequate financial resources to meet its obligations and ensure the AOP client's order management system and any algorithms used through the AOP are tested before use and before implementing material changes.
- 39 Industry was generally opposed to our proposal on the basis that it would be too onerous, costly and could potentially reduce the competitiveness of the Australian market due to added administration. Most respondents considered the existing rule framework sufficient to address the risks the proposal attempts to mitigate. They noted that market participant and market operator filters are the key controls.

ASIC's response

We do not intend to proceed with a new rule for additional minimum standards for direct electronic access.

We intend to publish guidance clarifying our expectations for market participants to have an adequate understanding of their client's business such that the market participant can comply with their obligations under existing rules for setting filters and controls. The guidance will make it clear that Chapter 5 (ASX) and Chapter 5 (Chi-X) does not permit sponsored access.

We would also expect market participants' filters and controls to take into account any credit limits set by the participant.

We intend to publish the draft guidance for consultation early in the third quarter of 2012.

Note: In this document 'Chapter 5 (ASX)' (for example) refers to a particular rule of the ASIC Market Integrity Rules (ASX) and 'Chapter 5 (Chi-X)' (for example) refers to a particular rule of the ASIC Market Integrity Rules (Chi-X).

Legally binding agreement with AFS licensees

- 40 In CP 168, we proposed that a market participant must have a legally binding agreement with the DEA client that is an Australian financial services (AFS) licensee. Industry was generally opposed to this requirement noting that it imposes unnecessary cost and compliance burdens at a time when market participants are facing significant costs.

ASIC's response

We do not intend to proceed with this proposal.

Market operator systems and controls

- 41 In CP 168, we proposed to clarify through guidance our expectations for market operator systems and controls.
- 42 There was strong support among market participants for our proposal, particularly for release management schedules and orderly implementation of changes, and co-ordinated user acceptance testing environments across operators.
- 43 Most market participants supported extending the guidance to all market operators, noting that the same regulatory framework should extend across all markets.
- 44 Submissions from market operators cautioned against overly granular guidance on platform testing and technology release management. They indicated that guidance should allow scope for relative levels of operator sophistication and product offerings, and preferred further engagement before guidance is issued.

ASIC's response

We intend to proceed as proposed, applying the guidance to all domestic market licensees. Application of the guidance will be proportionate to the nature, size, complexity and degree of automation of the market operator: see the draft addendum to Regulatory Guide 172 *Australian market licences: Australian operator* (RG 172) issued with CP 179.

Market making in the cash equity market

Should ASIC promote market making in the Australian cash equity market?

- 45 In CP 168, we asked for views on whether market makers (electronic liquidity providers (ELPs) and high-frequency traders) add to market efficiency and on what basis.
- 46 Industry was generally supportive of market making, noting that market makers provide liquidity and visibility which leads to better price discovery, especially for less-liquid mid-cap securities. One respondent submitted that market making narrows price spreads, which benefits superannuation funds, institutions, retail investors and all other market participants.
- 47 Many respondents advocated that market making should be supported by conditional short sale relief. However, there were mixed views about whether the relief should be granted only to firms that have market making agreements in place.

ASIC's response

We do not intend to change our current position on short selling relief. However, we will keep the issue under review, and may consult further with industry.

Licensing of market makers

- 48 In CP 168, we sought feedback on the requirement to hold an AFS licence for ELPs in equity markets that informally make a market within the meaning of s766D of the *Corporations Act 2001* (Corporations Act).
- 49 There were mixed views about whether ELPs should be required to hold an AFS licence. Respondents in favour of this requirement indicated that the holder of an AFS licence is subject to specific requirements for compliance and risk management arrangements, which are critical in ensuring that market making activities are conducted in an efficient manner.
- 50 Respondents opposed to this requirement argued that benefits are not apparent and that it would unnecessarily increase the regulatory burden. They suggested that an AFS licence should only be necessary for market participants that provide a financial service to arms' length clients, and should not be required for traders whose strategy happens to meet the broad meaning of s766D. These respondents said further regulatory intervention may discourage investors who act as liquidity providers and may affect market quality and efficiency.

ASIC's response

We do not intend to change our current position on requiring licensing of a person who makes a market within the meaning of s766D of the Corporations Act. However, we will keep this issue under review and may consult further with industry.

C Extreme price movements

Key points

In CP 168, we proposed to require market operators to implement an automated limit up–limit down volatility control for S&P/ASX 200 products and associated domestic index ETFs and for the ASX SPI 200 Index Future (ASX SPI 200 Future).

For the ASX SPI 200 Future, we proposed market integrity rules to require market operators to implement anomalous order thresholds.

Overall there were limited submissions received on these proposals with no consensus for volatility controls for S&P/ASX 200 products and associated domestic index ETFs or for the ASX SPI 200 Future.

In relation to anomalous order entry controls for the ASX SPI 200 Future, there was general support for this proposal.

Controls for extreme price movements in equities

- 51 In CP 168, we proposed new market integrity rules to require a market operator to have an automated limit up–limit down volatility control that would prevent trades from occurring in any S&P/ASX 200 product and associated domestic index ETFs outside a specified price band when there is a significant price movement over a short period of time.
- 52 Many of those who responded were supportive of measures to address risks associated with the increasing use of technology in trading. Notwithstanding this, some noted that it was important to adopt a response that is flexible and would allow ASIC to respond to market developments as they arise. There was also support for measures to be straightforward and transparent, to ensure legitimate trading is not inhibited.
- 53 One respondent suggested the proposal should be implemented by way of a pilot program, and to follow international leads to ensure compatibility and leverage technology and experience.
- 54 Based on the submissions received, there was no consensus on the 15% limit band and 1-minute limit state for an automated limit up–limit down volatility control. Most agreed with the 5-minute trading pause.
- 55 A small number of respondents who did not support the proposal said existing order limit and extreme cancellation range controls should be monitored over a longer period before introducing more complex controls and costs. They also said the Australian market has not reached the point

where volatility controls are required, and the proposal was overly complicated and needed to be simplified.

ASIC's response

We do not intend to proceed with the limit up–limit down proposal.

Instead, we intend to amend existing rules on anomalous order thresholds (AOT) and extreme cancellation range to require that market operators should effectively minimise the incidence of transactions executing in this range (i.e. the process will be preventative rather than reactive). The rules now refer to 'extreme trade range' rather than 'extreme cancellation range' and the new process may trigger a 10-minute pause to align with that already used for price sensitive announcements: see draft rules in Chapter 2 of the ASIC Market Integrity Rules (Competition) and Section B of draft updated RG 223.

Waivers [11/1113] and [11/1253] were granted by ASIC under the ASIC Market Integrity Rules (Competition), to allow Chi-X and ASX respectively to determine an alternative reference price for the extreme cancellation range in certain circumstances. When the new framework takes effect, these waivers will no longer be necessary.

Note: In this document 'Chapter 2 (Competition)' (for example) refers to a particular Chapter in the ASIC Market Integrity Rules (Competition).

Controls for extreme price movements in futures index

- 56 In CP 168, we proposed to require the operator of ASX 24 (i.e. Australian Securities Exchange Limited) to have an automated limit up–limit down volatility control that would prevent trades from occurring in the ASX SPI 200 Future outside a specified price band when there is a significant price movement over a short period of time. If a limit up–limit down volatility control was implemented, we also proposed to require the operator of ASX 24 to have anomalous order entry controls for the ASX SPI 200 Future.
- 57 Responses to this proposal were mixed. Most of the respondents supported the objective of the proposal. There were a number of respondents who suggested it was more appropriate to implement a percentage price movement rather than a fixed limit as a parameter. They argued that a fixed limit would need to be adjusted over time to maintain relevance.
- 58 Those respondents who did not support the proposal submitted that order entry controls along with a dynamic ECR reference price is a more appropriate volatility control for the futures market and is less complex.
- 59 In relation to anomalous order entry controls for the ASX SPI 200 Future, there was general support for this proposal. Reasons included that it

maintained consistency with equities, and was easy to understand and implement.

ASIC's response

We do not intend to proceed with the limit up–limit down proposal.

We intend to extend the amended rules for AOT and extreme trade range to the ASX SPI 200 Future: see draft rules in Chapter 2 (Competition) and Section B of draft updated RG 223.

Order entry controls—Expansion of scope

- 60 In CP 168, we sought feedback on the scope of the current requirement in Part 2.1 (Competition) for market operators to have order entry controls to be extended to take into account factors other than price, and whether it should apply to other products and markets.

Note: In this document 'Part 2.1 (Competition)' (for example) refers to a particular Part in the ASIC Market Integrity Rules (Competition).

- 61 There was limited feedback on this proposal. Based on the responses, there was no consensus. Some respondents who supported this proposal noted that for illiquid stocks, there would be difficulty in determining a dynamic reference price and meaningful order entry limit.
- 62 There was support from some respondents to extend order entry controls to other markets provided adequate lead time was given for implementation.

ASIC's response

We do not intend to alter the scope of the current order entry controls requirement, other than to apply the AOT to the ASX SPI 200 Future contract as already noted.

D Enhanced data for market surveillance

Key points

In CP 168, we proposed that:

- market participants capture and provide additional data on orders and trades for exclusive use by ASIC for regulatory purposes;
- market operators synchronise their system clocks to a higher standard than the current requirement;
- market participants synchronise their system clocks; and
- transaction records data provided to ASIC be in a standard format and contain standardised information.

While there was support, in principle, to have more efficient data to assist ASIC's market monitoring function, many respondents raised concerns about significant costs involved and substantial time required to implement the proposals. They queried whether the information could be provided on a post-trade basis, rather than real-time. Industry noted its willingness to work with ASIC to provide additional data that can be readily provided.

In relation to synchronisation of system clocks, there was no consensus among market operators, and market participants were strongly opposed to the proposal on the basis that it would be costly and difficult to implement.

Most market participants submitted that it would be difficult and costly to implement our proposal requiring a standard format when sending ASIC transaction-related trading records.

Data to assist ASIC with surveillance

63 Enhanced regulatory data allows regulators to detect and investigate matters such as market manipulation and insider trading with greater efficiency and may assist market participants' risk management. In CP 168, we proposed a new rule to require market participants to provide additional regulatory data on order messages and/or trade reports submitted to market operators. We also proposed new market integrity rules to require market operators to record regulatory data received from market participants and pass it on to ASIC's market surveillance system.

64 While there was in-principle support to have more efficient data to assist ASIC's market monitoring function, many respondents were opposed to the additional data fields proposed. They raised concerns about costs involved and the amount of time required to implement the proposal. Other issues raised included administrative difficulties, privacy concerns, drag on innovation and the likely impact on performance and capacity particularly around speed of execution. They noted that additional data requirements would decrease system performance and require increased data capacity requirements.

- 65 A number of respondents suggested that additional data could be provided on a post-trade basis which would be more cost effective and aligned with most international practice. Industry noted its willingness to work with ASIC to provide additional data that could be readily provided.
- 66 To reduce the cost of implementation for market participants, one respondent suggested the proposal be deferred to take advantage of global initiatives such as the Global Legal Entity Identifier standard of identification. Another respondent suggested that ASIC review the new suspicious activity reporting regime before requiring market participants to invest in significant technology requirements.

ASIC's response

After further dialogue with some members of industry, we have refined our proposal and intend to proceed with a rule to require a smaller set of data and client information to the extent it is available: see draft rules in Chapter 5A (Competition) and Section H of drafted updated RG 223.

We will work with market participants and system vendors to minimise the impact of these changes.

This rule would apply to market operators 10–11 months from the date the rules are made and 18 months for market participants. Market participants upgrading their systems prior to this date should take account of these proposals at the earlier date.

Synchronised clocks

- 67 In CP 168, we proposed to require market operators to refine the precision of their clock synchronisation to 1 microsecond, and accuracy of +/- 1 millisecond. We also proposed to require market participants to synchronise their trading, compliance monitoring and reporting system clock with a timestamp to a precision of 1 millisecond, and accuracy of +/- 20 milliseconds, or, where the systems are co-located, with a precision of 1 microsecond and accuracy of +/- 1 millisecond.
- 68 There was no support for this proposal on the basis costs would outweigh benefits.

ASIC's response

We do not intend to proceed with this proposal. However, we will keep the issue under review.

Providing records to ASIC—Standard format

- 69 In CP 168, we proposed to require market participants to use a standard format when sending ASIC transaction-related trading records requested under the Corporations Act or *Australian Securities and Investments Commission Act 2001* (ASIC Act).
- 70 There was limited feedback received in relation to this proposal. While there was some recognition of the objective being worthwhile, most market participants submitted that it would be difficult and costly to implement. They noted that the proposed fields do not reflect the many underlying and unconnected systems on which the information may be stored. As such, extracting these fields from various source systems for all standard requests would be very burdensome and would require considerable time and resources.
- 71 Alternatively, to achieve the objective of the proposal, a number of respondents suggested that ASIC work with market participants to see what information can be readily supplied without significant overhead. They suggested a cheaper and simpler implementation may be possible by reducing the data requirements to information obtainable from back office systems.

ASIC's response

We do not intend to proceed with a new rule for market participants to use a standard format when sending ASIC trading records requested under the Corporations Act or ASIC Act.

We intend to publish guidance clarifying our expectations for market participants to provide specific information and in a defined format. Guidance will define minimum expectations for information typically sourced from back office systems. We will continue to work with the industry on developing this guidance with the aim of publishing it later in 2012.

We will keep this issue under review and may propose a new market integrity rule if the guidance does not meet ASIC's need for standardised data that can be readily analysed and manipulated.

E Best execution

Key points

In CP 168, we proposed to expand the product scope of the best execution obligations in Chapter 3 (Competition) so that they apply to trading in ASX-quoted interest rate securities, options, warrants, and AQUA products (to the extent these products are not already within the scope of Chapter 3 (Competition)).

We also sought feedback on whether any additional data was required to assist investors in assessing execution quality.

Most of the respondents did not support this proposal as they considered there was little benefit from extending the obligation to products traded only on a single market.

A majority of the respondents also agreed that the publication of reports on best execution quality was unnecessary.

Best execution obligation and expansion of product scope

- 72 In CP 168, we proposed to extend the scope of the best execution obligations to apply to ASX-quoted interest rate securities, options, warrants, and AQUA products (to the extent they are not already within the scope of Chapter 3 (Competition)).
- 73 Most of the respondents did not support this proposal as they considered there was little benefit from extending the obligation to products traded only on a single market. Most respondents submitted that the proposal would increase costs and resource efforts during a time when market participants are still embedding changes arising from the introduction of market competition.
- 74 The few respondents who supported the proposal indicated that the best execution obligation should apply to direct and indirect market participants. One respondent supported the proposal because it extended the best execution obligations to other products that are largely retail investor products, but suggested that client opt-out should remain possible under the rules. Another respondent acknowledged that market participants should already be aiming for best execution in accordance with the Corporations Act requirements and reasonable client expectations for all products they trade on their client's behalf.

ASIC's response

We do not intend to proceed with this proposal at this stage. We will separately consider whether best execution should apply to Commonwealth Government Securities (CGS).

Public reporting on order routing and execution quality

75 In CP 168, we indicated that we do not propose to require market participants to publish a monthly report on order routing and execution quality. However, we sought feedback on whether there were any benefits from execution venues and market participants publishing additional best execution data on order execution and handling, or the quality of execution.

76 The majority of the respondents agreed that the publication of reports on best execution quality was unnecessary. A small number advocated additional best execution data to enable market participants to make an informed decision on whether to connect to a new order book.

ASIC's response

We do not intend to require best execution public reporting at this stage, but intend to keep it under review.

F Pre-trade transparency and price formation

Key points

In CP 168, we proposed a package of amendments to the existing exceptions to the pre-trade transparency requirements in the ASIC Market Integrity Rules (Competition), including:

- modifying the 'at or within the spread' exception to require meaningful price improvement;
- narrowing the scope of orders to which the minimum size threshold would apply and introducing a trigger at which point the minimum size threshold would increase from \$0 to \$50,000;
- replacing the \$1 million threshold for block trades with a tiered model; and
- granting waivers for certain existing ASX exceptions to pre-trade transparency that fall outside the ASIC Market Integrity Rules (Competition) and are still considered necessary.

There was support from some respondents, particularly market operators, for the meaningful price improvement proposal. Feedback received from market participants was mixed.

While industry stakeholders recognised ASIC's concerns about pre-trade transparency and price formation, there were widely divergent views on the appropriate minimum size threshold. Some respondents supported the objective of the proposal but suggested alternative approaches to address the issue.

There was general support for the remaining proposals.

Meaningful price improvement

- 77 In CP 168, we proposed to modify the 'at or within the spread' exception that allows preferencing of client orders over some disclosed orders to require that market participants obtain meaningful price improvement.
- 78 There was support from some respondents, particularly market operators, for the meaningful price improvement proposal. One market operator suggested an acceptable price improvement would be a minimum of half a tick and agreed that the regulatory framework should support an outcome where both buyer and seller meet their trading objectives on a lit venue with meaningful price improvement (including dark orders on lit venues).
- 79 Feedback received from market participants was mixed. While some respondents agreed there should be price improvement, others did not concur with the proposed one tick size. Suggestions from respondents ranged from 10% of spread to half a tick size. There were also suggestions that minimum

price improvement should only apply to orders executed by way of a dark venue and an exemption should apply for instances where a market participant executes as principal against a client order for facilitation purposes.

- 80 Market participants that rejected the proposal stated it was unnecessary to displace the current ‘at or within the spread’ exception, and that there was no compelling argument to support dark liquidity intervention at this point in time. Other submissions noted that the proposal:
- (a) should not be applied to securities where pre-trade transparency is not under threat, particularly in cases where significant cost savings may be provided to investors;
 - (b) restricts a market participant’s ability to provide best execution where factors (other than price improvement) have priority for wholesale clients; and
 - (c) constituted a substantial policy change that should be led by government.
- 81 The majority of respondents preferred meaningful price improvement to refer to top-of-book rather than volume-weighted averaging, suggesting that volume-weighted averaging would be too complex, costly and susceptible to gaming.
- 82 It was clear from a number of the responses that there may be a tick size issue for certain stocks (i.e. the depth on the order book at the best bid and offer is so deep that there are delays in getting filled). This is encouraging some to trade in the dark to obtain time priority (i.e. jump ahead of those waiting in the queue at the same price).
- 83 We asked whether fully hidden orders should be permitted in an order book and whether they should be subject to meaningful price improvement. Most respondents agreed that these order types should be permitted if they are treated equally to other dark liquidity and are subject to meaningful price improvement.
- 84 There was limited feedback on consequential amendments to the existing framework surrounding restrictions to activities during takeovers and buy-backs. There were contradictory views on whether takeovers and buy-backs should be subject to meaningful price improvement. One respondent indicated that rules should be amended if inconsistencies exist, while another noted concerns and suggested clarity be provided regarding limitations on late, overseas and overnight crossings during a takeover bid. Another respondent suggested that ASIC should separately review the regulatory framework surrounding activities during takeovers and buy-backs.

ASIC’s response

We intend to proceed with replacing the ‘at or within the spread’ exception with a requirement to obtain price improvement of one tick size or mid-point. The reference price for both on-order book hidden orders and off-order book transactions will be the top-of-

book national best and bid offer (NBBO): see draft Rule 4.2.3 of the ASIC Market Integrity Rules (Competition) and Section D of draft updated RG 223.

We consider the combination of proceeding with meaningful price improvement while not going ahead with the proposed \$50,000 minimum threshold for dark orders strikes an appropriate balance that will facilitate continued innovation while maintaining fair and efficient financial markets.

We intend to continue to engage with the industry on tick sizes, including considering whether there are certain products that would benefit from smaller tick sizes to minimise incentives to trade in the dark.

Note: In this document 'Rule 4.2.3 (Competition)' (for example) refers to a particular Rule in the ASIC Market Integrity Rules (Competition).

Minimum size for dark orders

- 85 In CP 168, we proposed to increase the minimum size threshold for passive dark orders from \$0 to \$50,000 if the value of dark liquidity below block size increases by 50% or more within three years from July 2011.
- 86 While industry stakeholders recognised ASIC's concerns about pre-trade transparency and price formation, there were widely divergent views with respect to the appropriate minimum size threshold.
- 87 One market operator was of the opinion that the threshold should apply immediately at \$50,000 to both passive and aggressive orders. Another market operator supported a more gradual and progressive increase and suggested a lower threshold should be applied to dark orders on a lit book.
- 88 Some respondents supported the objective of the proposal but suggested alternative approaches to address the issue such as:
- (a) a tiered threshold based on stock liquidity, as a threshold that is set too high may make it impossible to trade in relatively large volumes with respect to some financial products;
 - (b) the use of a 'relative' rather than an 'absolute' trigger which would provide the necessary time to monitor the effects of trading activity occurring in the dark; and
 - (c) a smaller minimum size for less liquid financial products.
- 89 Rather than mandating a threshold, one respondent suggested that ASIC should require market participants to set their own minimum order size to provide flexibility and allow thresholds to be implemented at different levels for different groups of financial products.

- 90 A small number of respondents disagreed with the proposal on the basis that it would conflict with best execution obligations, introduce ongoing and unjustified uncertainty and may make dark pools unviable. Others did not consider there to be supporting evidence of actual deterioration of pre-trade price formation or market quality in the Australian market and suggested that the proposal should be given further consideration at a later time when the need for intervention becomes more definitive.
- 91 There was mixed feedback on the display rule option described in paragraphs 354–356 of CP 168. Some thought that it should not be pursued on the basis that it does not offer price improvement and does not protect priority lit orders. Respondents also suggested that it would lead to a more complicated execution model. Some respondents supported the display rule option, but did not agree with a minimum size and display time, noting that it would be impractical with orders that are amended and would adversely impact speed of execution for best execution purposes.

ASIC's response

We do not intend to proceed with this proposal at this stage.

We will continue to monitor developments in the Australian market and abroad, including the impact of the new meaningful price improvement rule.

We will also continue to discuss with industry potential triggers for future application of a minimum size threshold for dark orders.

Block trades

- 92 In CP 168, we proposed to change the existing static \$1 million threshold for block trades with a tiered block trade regime, as part of the package with the meaningful price improvement proposal.
- 93 Respondents supported the need for block trades to continue to be able to be done in the dark to manage market impact. The majority supported the proposed tiered block thresholds with some noting that it is a sensible extension to the existing regime to improve liquidity with respect to illiquid financial products. There were two respondents who suggested that the thresholds should be higher at \$2.5 million, \$1 million and \$500,000. A small number of respondents preferred no change to the threshold.
- 94 Based on the responses, there was no consensus on how frequently the average daily volume (ADV) should be calculated to allocate stocks to tiers. Respondents who supported the calculation on a quarterly or six-monthly basis noted that more constant review and change would create confusion, and would only add more complexity to the execution model. One respondent supported ADV calculation on an annual basis as a starting point.

Submissions on the notice period required for respondents to give effect to the ADV varied from one week to a minimum of three months.

ASIC's response

We intend to proceed with the change as proposed and in combination with the meaningful price improvement rule: see draft Rule 4.2.1 (Competition) and Section D of draft updated RG 223.

We intend to calculate the ADV and allocate stocks to tiers on a quarterly basis. The new tiers will take effect 10 business days from the date they are published.

Based on the average daily value traded for the 12 months to 30 April 2012:

- the \$1 million tier had 22 products (BHP, CBA, RIO, WBC, ANZ, NAB, TLS, NCM, WPL, FMG, WES, WOW, QBE, WDC, CSL, ILU, LYC, MQG, STO, ORG, AMP, NWS);
- the \$500,000 tier had 23 products (BXB, IPL, SUN, SGP, ORI, AMC, TCL, CCL, WRT, QRN, OSH, WOR, AWC, MCC, LEI, IAG, AGO, GPT, COH, AIO, ASX, AGK, OZL); and
- the \$200,000 tier had all other products.

Review of other pre-trade transparency exceptions

95 In CP 168, we proposed to withdraw the relevant pre-trade transparency exception waivers for certain ASX order types which we considered to be rarely used or redundant, extend relevant waivers for transactions that were frequently used or relate to relatively new products and introduce a new market integrity rule to confirm that primary market transactions and stock lending are not subject to the pre-trade transparency obligation.

96 There was widespread support for the changes proposed.

ASIC's response

We intend to retain waivers for orders on the VolumeMatch book, ETF special trades and crossings of derivative/cash combinations and to make a market integrity rule confirming that primary market and stock lending transactions are not subject to the pre-trade transparency rules: see draft Rule 4.1.9 (Competition) and Section D of draft updated RG 233.

Record keeping

97 In CP 168, we proposed a new market integrity rule to require market participants to keep, for a period of seven years, records that enable the participant to demonstrate compliance with any pre-trade transparency exceptions relied on.

- 98 Based on the limited feedback received, the majority of respondents supported the proposal, indicating that they already comply with the proposed requirement. Respondents who disagreed with the proposal considered that the existing requirements regarding record keeping were sufficiently broad. One respondent noted that the data storage costs may be significant.

ASIC's response

We intend to proceed with a market integrity rule as proposed: see draft Rule 4.1.1(3) (Competition) and Section D of draft updated RG 223.

Validation of trades relying on pre-trade transparency exception

- 99 We proposed to expand existing rules to confirm our expectation that market participants and market operators must have systems and controls in place to verify and validate that trades reported by them or to them, based on a pre-trade transparency exception, actually meet the criteria for the relevant exception. We proposed that a market operator must not accept a report of a trade that does not meet the criteria, and a market participant must take appropriate measures to deal with a rejected trade report.
- 100 There was general support for this proposal. However, one market participant noted that there are some practical difficulties associated with validation controls. A number of respondents suggested that validation measures should allow some tolerance for order book changes given that market prices could change quickly.
- 101 Another respondent submitted that arrangements should be simple to build and administer, as it considered current tolerances for timing differences to be complex to implement and do not provide an effective cross-check to market participants.

ASIC's response

We intend to proceed with the rule as proposed: see draft Rules 5.1.1(4A) and 5.1.4A (Competition) and Section F of draft updated RG 223.

Execution of client orders as expeditiously as possible

- 102 In CP 168, we proposed to issue further guidance to confirm our expectations about the obligation to execute non-discretionary client orders as expeditiously as possible or display them on a pre-trade transparent order book immediately.

- 103 Respondents generally supported the proposal to issue further guidance clarifying our expectation for market participants to execute client orders as expeditiously as possible.

ASIC's response

We intend to clarify in guidance that non-discretionary client orders should be executed as expeditiously as possible or displayed on a pre-trade transparent order book immediately.

We are in the process of converting the substance of pre-existing ASX guidance notes, as appropriate, into ASIC regulatory guides. We intend to incorporate the guidance on execution of client orders as expeditiously as possible when we convert the substance of ASX Market Rules Guidance Note 11 *Client order priority* (GN 11) into an ASIC regulatory guide.

Appendix 1: List of non-confidential respondents

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- ASX Limited
 - Australian Financial Markets Association
 - Australian Risk Policy Institute
 - Chi-X Australia Pty Limited
 - Financial Services Council
 - Getco Australia Pty Limited
 - Instinet Australia Pty Limited
 - Saunders, Ben, Macpherson + Kelley Lawyers
 - Securities Industry & Financial Markets Association
 - Simonoff, Jerry CHAX, Inc.
 - Stockbrokers Association of Australia
 - Vanguard Investments Australia Limited
 - Yieldbroker Pty Limited
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Appendix 2: Comparison of proposals in CP 168 with intended approach

Proposal in CP 168	Our intended approach
<p>C3: Algorithmic programs and automated order processing</p> <p>We proposed new market integrity rules to require a market participant to:</p> <ul style="list-style-type: none"> • test algorithms before use and before implementing material changes; • have direct and immediate control over all its trading messages, including pre-trade controls (e.g. the ability to prevent trading messages), real-time monitoring and post-trade analysis; • have in place adequate business continuity arrangements; and • annually review systems and connectivity, and provide a notification to ASIC that it has done so. <p>This proposal applied to activities or conduct of persons in relation to products quoted on ASX.</p> <p>For feedback on this proposal and our response, see Section B of this report.</p>	<p>We intend to:</p> <ul style="list-style-type: none"> • supplement existing guidance to clarify our expectations of testing of systems and filters/controls rather than individual algorithms. This includes the ability to manage highly automated trading, and stress testing of order flow. We expect that authorised persons' systems' order flow should also be tested against market participant AOP filters. • proceed with a market integrity rule requiring direct control over filters. We will also require appropriate automated controls to suspend or prohibit AOP for one or more authorised persons, or to suspend a series of related messages, that, once identified, may interfere with the efficiency and integrity of the market. We will issue guidance to clarify expectations for monitoring and post-trade analysis and review to ensure ongoing compliance with AOP rules. • supplement existing guidance to emphasise system capacity. We expect business continuity arrangements to reflect the nature of the market participant's business. • proceed as proposed to remove the requirement for review and notification of material changes to ASIC and add annual internal review and notification to ASIC. <p>We will continue to work with the industry to develop the draft guidance with the aim of publishing draft rules and guidance early in the third quarter of 2012.</p> <p>We propose the guidance and rules would apply 18 months from the date the rules are made.</p>
<p>C4: Direct electronic access</p> <p>We proposed new rules to require a market participant, before permitting an AOP client to submit trading messages into the market participant's system, to ensure that:</p> <ul style="list-style-type: none"> • it understands the nature of its AOP client's business and the nature of any proposed delegation of this access before granting the client access; • the AOP client has the required adequate financial resources to meet its obligations to the market participant; 	<p>We intend to:</p> <ul style="list-style-type: none"> • supplement existing guidance—for example: <ul style="list-style-type: none"> – market participants should have adequate understanding of clients' business; and – filters and controls should take into account any credit limits set by the market participant; • update existing guidance to clarify that authorised persons should have an understanding of the order management system of the market participant and the market integrity rules of the market;

Proposal in CP 168	Our intended approach
<ul style="list-style-type: none"> • all persons who use AOP understand the order management system and the requirements of the dealing rules and the market operator; • the AOP client has adequate procedures to monitor all trading through its order management system; • the AOP client's order management system is tested before use and before implementing material changes; and • any algorithms used through the AOP are tested before use and before implementing material changes. <p>We also proposed that a market participant must have a legally binding agreement with each AOP client that is an AFS licensee.</p> <p>This proposal applied to activities or conduct of persons in relation to products quoted on ASX.</p> <p>For feedback on this proposal and our response, see Section B of this report.</p>	<ul style="list-style-type: none"> • rely on the market participant's filters and controls rather than requiring the AOP client to monitor its trading; and • rely on testing done by a market participant of its systems and controls rather than require an AOP client to test order management systems and algorithms. <p>We are not proceeding with a rule to require an agreement between a market participant and its AOP AFS licensee clients.</p> <p>We note that under Rule 5.5.1 (ASX) and (Chi-X), a market participant remains ultimately responsible for a trading message submitted with its unique identifier.</p> <p>We will continue to work with the industry to develop the draft guidance with the aim of publishing draft rules and guidance early in the third quarter of 2012.</p> <p>We propose the guidance will apply 18 months from the date of its release.</p>
<p>C5: Market operator systems and controls</p> <p>We proposed to clarify through guidance our expectations for market operators in relation to their systems and controls.</p> <p>This proposal applied to all products traded on markets operated in Australia by Australian market licensees.</p> <p>For feedback on this proposal and our response, see Section B of this report.</p>	<p>We intend to proceed with updating our guidance as proposed. In assessing compliance with the guidance, our expectations will reflect the nature, size and complexity of the relevant market operator. The updated guidance would apply from the date of its release.</p> <p>See the draft addendum to Regulatory Guide 172 <i>Australian market licences: Australian operator</i> (RG 172).</p>
<p>C6: Market making in the cash equity market</p> <p>We sought feedback on market making in the cash equity market and licensing for electronic liquidity providers.</p> <p>For feedback on this issue and our response, see Section B of this report.</p>	<p>We have decided not to change our current position (e.g. short selling relief, licensing requirements). This issue will remain a focus for our continuing review. We intend to re-consult as appropriate.</p>

Proposal in CP 168	Our intended approach
<p>D1 and D2: Controls for extreme price movements in equities and futures index</p> <p>We proposed new rules to require a market operator to have an automated limit up–limit down volatility control that would prevent trades from occurring in any S&P/ASX 200 products and associated domestic index ETFs.</p> <p>We also proposed new rules to require the operator of ASX 24 to have anomalous order entry controls for the ASX SPI 200 Future and an automated limit up–limit down volatility control that would prevent trades from occurring in the ASX SPI 200 Future outside a specified price band when there is a significant price movement over a short period of time.</p> <p>This proposal applied to equity market products and the ASX SPI 200 Future.</p> <p>For feedback on this proposal and our response, see Section C of this report.</p>	<p>We have decided not to proceed with the limit up–down proposal. Instead, we intend to amend existing rules for equity market products on anomalous order thresholds and ECRs to require that market operators should effectively minimise the incidence of transactions executing in the extreme trade range. The new process may trigger a 10-minute pause. We intend to make market integrity rules requiring the operator of ASX 24 to:</p> <ul style="list-style-type: none"> • have anomalous order thresholds for the ASX SPI 200 Future; and • for the ASX SPI 200 Future, introduce an extreme trade range and to prevent trades from executing in the range. <p>For equity market products, these rules would apply from the date the rules are made. For the ASX SPI 200 Future, these rules would apply 18 months from the date the rules are made.</p> <p>See draft rules in Chapter 2 (Competition) and Section B of draft updated RG 223.</p>
<p>E1: Data to assist ASIC with surveillance</p> <p>We proposed new rules to require market participants to provide the following data to market operators and for market operators to record the data and pass it on to ASIC’s markets surveillance system:</p> <ul style="list-style-type: none"> • the execution venue (e.g. dark pools, ASX’s Centre Point); • the category of client (e.g. principal, wholesale client, or retail); • the origin of the order, including the client account identifier allocated by the participant; • the AFS licensed intermediary acting for the client, if applicable; and • the algorithm that generated the order, if applicable. <p>This proposal applied to activities or conduct of persons in relation to products quoted on ASX (excluding futures and options).</p> <p>For feedback on this proposal and our response, see Section D of this report.</p>	<p>We intend to proceed with a new market integrity rule for the following data to be provided, recorded and passed on to ASIC:</p> <ul style="list-style-type: none"> • the execution venue; • the capacity of market participant (e.g. principal or agent only); • a reference indicating the origin of the order, to the extent that information is available to a market participant taking reasonable steps to ascertain it; • the AFS licence number where an order originates from an indirect market participant and the information is readily available; and • flagging of directed wholesale orders. <p>This rule would apply to market operators from around 10–11 months from the date we expect to make the rules. It would apply to market participants from around 18 months from the date we expect to make the rules. The date for market participants would align with the implementation date for the new short sale tagging rule that we consulted on in CP 145 and that we intend to make soon.</p> <p>See draft rules in Chapter 5A (Competition) and Section H of draft updated RG 223.</p>

Proposal in CP 168	Our intended approach
<p>E2: Synchronised clocks</p> <p>We proposed to amend existing rules to require a market operator to synchronise its trading, compliance monitoring and reporting system clock to the UTC(AUS) with a precision of 1 microsecond, and accuracy of +/- 1 millisecond.</p> <p>We proposed a new rule to require a market participant to synchronise its trading, compliance monitoring and reporting system clock to the UTC(AUS) with a precision of 1 millisecond, and accuracy of +/- 20 milliseconds, or, where the systems are co-located, with a precision of 1 microsecond and accuracy of +/- 1 millisecond.</p> <p>This proposal applied to activities or conduct of persons in relation to products quoted on ASX</p> <p>For feedback on this proposal and our response, see Section D of this report.</p>	<p>We are not proceeding with these proposals. However, we will continue to keep this subject under review.</p>
<p>E3: Providing records to ASIC—Standard format</p> <p>We proposed a rule to require market participants to use a standard format when sending ASIC transaction-related trading records requested under the Corporations Act or ASIC Act.</p> <p>This proposal applied to activities or conduct of persons in relation to products quoted on ASX.</p> <p>For feedback on this proposal and our response, see Section D of this report.</p>	<p>We intend to issue guidance outlining a revised set of information for these reports that is easily sourced from broker back-office systems. We will continue to work with the industry to develop the guidance with the aim of publishing it later in 2012.</p>
<p>F1: Best execution obligations—Expansion of product scope</p> <p>We proposed to extend the scope of the best execution obligations to apply to the following ASX-quoted products: interest rate securities, options, warrants and AQUA products.</p> <p>For feedback on this proposal and our response, see Section E of this report.</p>	<p>We have decided not to proceed with this proposal. However, we intend to include a best execution obligation proposal for retail trading in CGS in a separate consultation paper.</p>

Proposal in CP 168	Our intended approach
<p>G2: Meaningful price improvement</p> <p>We proposed to modify the ‘at or within the spread’ exception to require that market participants obtain meaningful price improvement (improvement of one tick on the volume weighted best bid or offer, or trade at midpoint).</p> <p>This proposal applied to equity market products.</p> <p>For feedback on this proposal and our response, see Section F of this report.</p>	<p>We intend to proceed with making a new market integrity rule, but with the reference price of top-of-book national best and bid offer (NBBO). This rule would apply 9 months from the date the rule is made.</p> <p>See draft Rule 4.2.3 (Competition) and Section D of draft updated RG 223.</p>
<p>G3: Minimum size for dark orders</p> <p>We proposed to issue guidance that we would increase the minimum trade size for passive dark orders from \$0 to \$50,000 if there is a significant shift of liquidity into dark forms of liquidity (i.e. if the value of dark liquidity below block size increases by 50% over three years or less from July 2011).</p> <p>This proposal applied to equity market products.</p> <p>For feedback on this proposal and our response, see Section F of this report.</p>	<p>We do not intend to change the current market integrity rule with \$0 threshold.</p> <p>However, we will keep this rule under review. We may introduce it if the price discovery function of the market is likely to be compromised.</p>
<p>G4: Block trades</p> <p>We proposed to amend rules to replace the \$1 million threshold for blocks with a tiered model.</p> <p>This proposal applied to equity market products.</p> <p>For feedback on this proposal and our response, see Section F of this report.</p>	<p>We intend to proceed with the proposed change to the market integrity rules. However, we will only do so if we proceed with our proposal on meaningful price improvement: see proposal G2. This rule would apply 9 months from the date the rules are made.</p> <p>See draft Rule 4.2.1 (Competition) and Section D of draft updated RG 223.</p>
<p>G5: Review of other pre-trade transparency exceptions</p> <p>We proposed to withdraw certain waivers for exceptions to pre-trade transparency and extend other waivers.</p> <p>We also proposed a rule to confirm that primary market transactions and stock lending are not subject to the pre-trade transparency obligations.</p> <p>This proposal applied to equity market products.</p> <p>For feedback on this proposal and our response, see Section F of this report.</p>	<p>We intend to proceed with making new market integrity rules and amendments to existing market integrity rules as proposed. The rules and amendments would apply from the date the rules are made.</p> <p>See draft Rule 4.1.9 (Competition) and Section D of draft updated RG 223.</p>

Proposal in CP 168	Our intended approach
<p>G6: Record keeping</p> <p>We proposed a rule to require market participants to keep, for seven years, records that enable the participant to demonstrate compliance with any pre-trade transparency exceptions relied on.</p> <p>This proposal applied to equity market products.</p> <p>For feedback on this proposal and our response, see Section F of this report.</p>	<p>We intend to make a new market integrity rule as proposed. This rule would apply from the date the rule is made.</p> <p>See draft Rule 4.1.1(3) (Competition) and Section D of draft updated RG 223.</p>
<p>G7: Validation of trades relying on pre-trade transparency exceptions</p> <p>We proposed a rule requiring market participants and market operators to have in place systems and controls to ensure that they validate and verify that trades executed in reliance of a pre-trade transparency exception meet the criteria for the exception.</p> <p>This proposal applied to equity market products.</p> <p>For feedback on this proposal and our response, see Section F of this report.</p>	<p>We intend to make a new market integrity rule as proposed. We also propose to extend this rule to validate trades entitled to delayed publication: see Proposal B7 in CP 179. This rule would apply from the date the rule is made.</p> <p>See draft Rules 5.1.1(4A) and 5.1.4A (Competition) and Section F of draft updated RG 223.</p>
<p>G8: Execution of client orders as expeditiously as possible</p> <p>We proposed to clarify through guidance that non-discretionary client orders should be executed immediately or displayed on an order book.</p> <p>This proposal applied to equity market products.</p> <p>For feedback on this proposal and our response, see Section F of this report.</p>	<p>We intend to proceed to issue regulatory guidance as proposed. This guidance will be incorporated in a new regulatory guidance when we convert the substance of GN 11 into an ASIC regulatory guide.</p>

Appendix 3: Impact on systems and business models

Extreme price movements

- 104 Paragraphs 105–109 consider the high-level impact of the key proposals relating to extreme price movements, specifically:
- (a) the requirement for ASX and Chi-X to automate the extreme trade range to prevent trades in equity market products from executing beyond the range (see draft Part 2.2 (Competition) and Section B of draft updated RG 223); and
 - (b) the requirement for the operator of ASX 24 to have anomalous order thresholds, and introduce an extreme trade range to prevent trades in the ASX SPI 200 Future from executing beyond the range (see draft Parts 2.1 and 2.2 (Competition) and Section B of draft updated RG 223).
- 105 ASX and Chi-X have already automated their systems to prevent trades from executing in the extreme trade range. We are proposing to build this automation into the rules so that any new market operators would need to meet the same standard.
- 106 We think an automated extreme trade range will protect Australia’s public markets from damaging trading errors, and it will help ensure that our markets operate efficiently and in an orderly way, even when there is volatility. We think this would benefit the orderliness of the Australian equity market by:
- (a) removing the risk of a clearly errant order from being executed;
 - (b) standardising any rule-based differences between how the different exchanges deal with extreme volatility;
 - (c) offering, compared to the current human-based protections in the futures market, a more immediate, transparent and fair process to deal with extreme volatility; and
 - (d) giving markets the benefit of a unified guide on these frameworks, potentially avoiding discrepancies and duplication of systems.
- 107 We are also proposing to extend the rules on anomalous order thresholds (AOT) and extreme trade range to the ASX SPI 200 Future. Introducing an automated extreme trade range into the futures market will improve consistency between cash and derivatives contracts, and minimise extreme price contagion. We do not believe the proposed rules will interfere with, or impede, legitimate price discovery in the market. Given the width of the parameters, we feel the chances of a legitimate order being placed outside the extreme trade range are remote.
- 108 Market operators and market participants will benefit from the extra protections offered by the automated extreme trade range. The proposed range will mitigate the likelihood of an extreme volatility event occurring. We expect the automated volatility control afforded by this arrangement to

improve the hedging and risk management ability of market participants, by pre-emptively preventing trades in the range rather than having a trade cancelled against them later. Market operators would also benefit from improved operating efficiency, as the proposal would eliminate the need to cancel trades in the extreme trade range after the transaction.

- 109 We expect limited costs for changes for equity market products on ASX and Chi-X. The anticipated costs for market participants in either the cash equity or futures markets should be small. There will be costs for the operator of ASX 24 to automate its AOT and extreme trade range for the ASX SPI 200 Future. We note ASX has expressed support for this proposal.

Enhanced data for market surveillance

- 110 Paragraphs 111–116 consider the high-level impact of the key proposals relating to enhanced data for surveillance, specifically the requirement for market participants to provide additional data on execution venue, capacity of market participant, origin of order, intermediary, AFS licence number and directed wholesale flag: see draft Chapter 5A (Competition) and Section H of draft updated RG 223.
- 111 The revised policy proposals would aid ASIC in its efforts to limit abusive market behaviour such as insider trading and manipulation of security prices.
- 112 We believe the proposed rules would help to preserve the integrity of the Australian equity market, by enhancing ASIC's surveillance capabilities to keep up with the developments in automated order processing (AOP) and the fragmentation of trading venues. We expect improved market efficiency to increase investor confidence, and potentially benefit market liquidity and capital formation.
- 113 The enhancement of surveillance data would allow ASIC to more effectively fulfil its objective to detect, investigate and deter illegal trading activity. The proposal will benefit surveillance functions by improving the ability to conduct timely and accurate trading analysis, reconstruct market events and perform more complex surveillance tasks. Timely pursuit of potential contraventions can be important in, among other things, seeking to freeze and recover any profits received from illegal activity. The proposed origin of order reference requirement, in particular, will significantly strengthen our oversight of markets by enabling the quick identification of persons making trading decisions and to systematically detect misconduct.
- 114 We anticipate market participants will need to amend their current order management and other systems to be able to collect and report the enhanced surveillance information to ASIC as required by the proposed rules. These changes to market participants' systems will impose costs. Changes will also be required for IT systems and infrastructure of market operators through which

the enhanced information is routed. ASIC will modify its current surveillance system to extend the surveillance capabilities afforded by the additional data.

115 The proposal for market participants to provide the additional data on the existing interfaces to market operators avoids the expense of implementing a new regulatory reporting infrastructure between market participants and ASIC specifically for this purpose.

116 To minimise the impact on market participants and other stakeholders, we require the enhanced data to be provided to the extent that it is available to a participant who takes reasonable steps to ascertain it. We propose an extended and staggered implementation approach to allow some flexibility for market participants and market operators to upgrade their systems.

Pre-trade transparency and price formation

117 Paragraphs 118–127 consider the high-level impact of the key pre-trade transparency and price formation proposals, specifically:

- (a) the requirement for dark trades below block size to receive meaningful price improvement and, reference the NBBO (see draft Rule 4.2.3 (Competition) and Section D of draft updated RG 223); and
- (b) the replacement of the \$1 million block size threshold with a tiered structure of \$1 million, \$500,000 and \$200,000 for stocks with different levels of trading activity (see draft Rule 4.2.1 (Competition) and Section D of draft updated RG 223).

118 ASIC expects that the proposed rule for dark orders below block size to offer meaningful price improvement will enhance the fairness and transparency of the Australian equity market.

119 While dark liquidity plays an important role in minimising information leakage and the market impact of large orders, it can create negative effects for the wider market by diverting liquidity away from pre-trade transparent venues, impairing efficient price formation and jumping the time-priority queue of lit orders.

120 Under our proposal, market participants that match client orders away from a lit order-book must offer meaningful price improvement to their clients or route the order to a lit order-book. Orders that are displayed in an order-book would no longer be stepped ahead by trades executing at the same price in the dark. This should encourage more investors to display their orders, contributing to price formation and narrowing of spreads, which ultimately means more accurate valuations and lower transaction costs.

121 Clients whose orders are to be executed away from a lit order book and are below block size must receive a better price (by one tick size or the mid-point) than the prevailing best price on any order book (i.e. than the NBBO). This applies to both counterparties to a trade. This means the client will

receive a better price than under the current rule, under which market participants may cross at the best price and not offer price improvement. Under the proposed amendment, if price improvement is not available for an order away from a lit order-book, the order must be routed to a lit order-book, where the order will follow ordinary price time priority (i.e. go to the back of the queue at that price).

- 122 Market participants that currently cross client order flow below block size and capture the spread themselves, including facilitated trades, will be required to share the spread with their clients or route the order to a lit order-book. This will impact the market participant's profit margin from crossed trades.
- 123 This may result in more orders being routed to a lit order-book, and consequently improve price formation and liquidity in that market. Market participants may incur higher aggregate exchange fees because the cost of executing an order on market is generally higher than the cost of reporting a crossing.

Note: The ASX on market trading fee is 0.15 basis points (bps) and the NBBO crossing reporting fee is 0.10 bps. The Chi-X on market trading fee is 0.12 bps for aggressive orders and 0.06 bps for passive orders (average 0.09 bps) and the NBBO crossing reporting fee is 0.08 bps.

- 124 Any market participant that does not already offer meaningful price improvement or market operator whose hidden orders do not offer meaningful price improvement will need to make one-off amendments to their order matching algorithms or manual processes. Market operators will also need to make one-off amendments to their systems (potentially trading and post-trade reporting systems) to reflect the requirement that dark trades below block size must only be executed with meaningful price improvement (by referencing the NBBO). Changes will also impact the validation that market operators undertake on post-trade information reported to them.
- 125 In relation to the proposed changes in block size thresholds, the feedback from industry is generally supportive. The proposed tiered threshold structure will take into account the difference in size and liquidity of the listed stocks. This makes the block-sized exceptions to pre-trade transparency more relevant and effective.
- 126 We expect the tiered thresholds will allow more trading to take place in block size in less liquid stocks than is currently the case. It will enable market participants facilitating trades to better manage their risk by trading in block-sizes off-market. There may be an impact on pre-trade transparency to the extent that large orders above the proposed new thresholds but below the current \$1 million are taken off-market.
- 127 To implement the change to the block thresholds, market participants may need to make one-off changes to systems and processes, including order management and algorithms that make order routing and execution decisions. Market operators may need to amend their validation of post-trade information reported to them.