



**ASIC**

Australian Securities & Investments Commission

**REPORT 364**

# **Response to submissions on CP 202 Dark liquidity and high-frequency trading: Proposals**

August 2013

## **About this report**

This report highlights the key issues that arose out of the submissions received on Consultation Paper 202 *Dark liquidity and high-frequency trading: Proposals* (CP 202) and details our responses 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 updated Regulatory Guide 223 *Guidance on ASIC market integrity rules for competition in exchange markets* (RG 223), Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181) and Regulatory Guide 241 *Electronic trading* (RG 241).

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## A Overview

- 1 Since November 2010, ASIC has consulted on market structure issues arising from developments in Australia's financial markets. This consultation was conducted through:
  - (a) Consultation Paper 145 *Australian equity market structure: Proposals* (CP 145);
  - (b) Consultation Paper 168 *Australian equity market structure: Further proposals* (CP 168);
  - (c) Consultation Paper 179 *Australian market structure: Draft market integrity rules and guidance* (CP 179); and
  - (d) Consultation Paper 184 *Australian market structure: Draft market integrity rules and guidance on automated trading* (CP 184).
- 2 On 20 November 2012, as a result of this consultation ASIC introduced new market integrity rules to address risks emerging from developments in market structure, including growth in automated trading and the changing nature of dark liquidity: see Media Release (12-290 MR) *ASIC makes key announcements on market structure, dark liquidity and high-frequency trading* (21 November 2012).
- 3 In July 2012, we established two internal taskforces to undertake thematic reviews of issues relating to dark liquidity and high-frequency trading. The core aim of the two taskforces was to deepen our understanding of these developments on market quality and integrity and, where appropriate, make recommendations to address any problems identified. Both taskforces undertook extensive analysis and consultation with industry through questionnaires, bilateral meetings and roundtable presentations involving market participants, industry representative bodies, offshore regulators and market operators.
- 4 On 18 March 2013, the taskforces published their findings and recommendations in Consultation Paper 202 *Dark liquidity and high-frequency trading: Proposals* (CP 202) and Report 331 *Dark liquidity and high-frequency trading* (REP 331). The recommendations included proposals for new and amended market integrity rules and guidance to address:
  - (a) price formation concerns in securities where there is evidence that dark liquidity has caused degradation;
  - (b) requirements for crossing system operators;
  - (c) tick constrained securities;
  - (d) various conflicts of interest relating to dark liquidity;
  - (e) excessive messaging and market noise issues; and
  - (f) manipulative trading

- 5 This report highlights the key issues that arose out of the submissions to CP 202 and our response 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 202. We have limited this report to the key issues.
- 7 This report should be read in conjunction with the following guidance:
- (a) Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181);
  - (b) Regulatory Guide 223 *Guidance on ASIC market integrity rules for competition in exchange markets* (RG 223); and
  - (c) Regulatory Guide 241 *Electronic trading* (RG 241).
- Note: We will issue a regulatory guide containing guidance on manipulative trading in the coming months.
- 8 For a list of the non-confidential respondents to CP 202, see Appendix 1. Copies of the submissions can be found on the ASIC website at [www.asic.gov.au/cp](http://www.asic.gov.au/cp) under CP 202.

## Responses to consultation

- 9 We received 25 written responses to CP 202 from a range of stakeholders, including market operators, market participants, industry associations, superannuation funds and fund managers, high-frequency trading firms and retail investors.
- 10 A number of respondents provided substantive comments on the proposals in CP 202, particularly on the minimum size threshold for dark orders, changes to tick sizes, minimum resting times for small orders and removal of ‘materiality’ from Rule 5.7.2 of ASIC Market Integrity Rules (ASX Market) 2010 and ASIC Market Integrity Rules (Chi-X Australia Market) 2011.
- Note 1: In this document ‘ASIC Market Integrity Rules (ASX)’ refers to the ASIC Market Integrity Rules (ASX Market) 2010; ‘ASIC Market Integrity Rules (Chi-X)’ refers to the ASIC Market Integrity Rules (Chi-X Australia Market) 2011; and ‘ASIC Market Integrity Rules (Competition)’ refers to the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011.
- Note 2: In this document, ‘Rule 5.7.2 (ASX)’, ‘Rule 5.7.2 (Chi-X)’ and ‘Rule 5.7.2 (Competition)’ (for example) refer to a particular rule of the ASIC market integrity rules for those markets (in this example numbered 5.7.2).
- 11 Based on these comments, and our assessment of the costs and benefits of implementing the proposals, we have decided not to make market integrity rules for these areas at this stage. Instead, we will continue to monitor developments and work with market participants and market operators on a

case-by-case basis to change behaviour and raise awareness where it is appropriate.

- 12 Respondents were generally receptive to the remainder of the proposals in CP 202 that we have proceeded with. We have modified a number of these proposals in response to comments received.

## Timing for implementation

- 13 Based on the feedback received, we have made new and amended market integrity rules and have issued new and amended regulatory guidance for the proposals consulted on in CP 202. The key changes to the rules and guidance, and the timing for implementation, are summarised in Appendix 2.

## General comments on high-frequency trading and crossing systems

- 14 CP 202 broadly focused on proposals to protect the quality of the price formation process, promote integrity and fairness of crossing systems, and improve market confidence by addressing concerns about market ‘noise’ from excessive orders and manipulative trading.
- 15 Many submissions agreed with the concerns we raised about the impact of dark liquidity on price formation. However, given the introduction of revised Rule 4.2.3 (Competition) which requires dark trades to be conducted with meaningful price improvement, the majority of respondents urged ASIC to monitor the impact of revised Rule 4.2.3 (Competition) and reconsider the proposal for a trigger to introduce a minimum size threshold for dark orders at a later point if necessary.
- 16 There was considerable support for the majority of proposals in relation to crossing system operators. Most respondents believed greater transparency, disclosure requirements and proper management of conflicts of interests in crossing systems would have a beneficial impact on market confidence. However, operators of crossing systems were less supportive.
- 17 Although some respondents agreed that ‘small and fleeting’ orders can lead to excessive market noise, other respondents highlighted that the cost of implementing our proposal would far outweigh the associated benefits. Many submissions commended the work of the taskforces in raising awareness on this issue in CP 202 and through bilateral meetings and roundtable discussions. Respondents strongly believed that our approach to date, to address market noise issues on a case-by-case basis, was substantially successful in changing behaviour and reducing market noise.

- 18 Most respondents supported the majority of proposals to address manipulative trading. However, respondents did not support the removal of ‘materiality’ from the market integrity rules due to the cost of implementing effective monitoring of trades which do not have a material impact.
- 19 Where respondents did not support our proposal, they submitted that our case-by-case approach was a more cost effective way of preventing deterioration in market quality and integrity. Respondents supported a ‘wait and see’ approach in light of recent changes to market structure through the minimum price improvement market integrity rule and changes to the supervision levy. Respondents urged ASIC to continue monitoring developments in markets and reassess data once these measures and their impacts have had time to take effect.

*ASIC’s response*

We will continue to monitor developments in markets, including the impact of revised Rule 4.2.3 (Competition) on meaningful price improvement and the impact of changes to the supervision levy on excessive messaging and market noise issues.

We will implement the majority of proposals for crossing system operators to ensure our strategic priorities of fair and efficient markets and confident and informed investors are maintained.

We will issue guidance for a number of areas as proposed in CP 202 and to support the new and amended market integrity rules.

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

### Key points

In CP 202, we outlined three recent developments in dark liquidity, these were:

- the growth in the number of dark trading venues;
- the shift of fundamental investors into the dark; and
- the shift from block size dark trades to below block size dark trades

In addition to these developments, our analysis of market data showed that a significant number of securities had undergone an increase in the volume of below block size dark trades, and that this was contributing to a widening of bid–offer spreads in a number of these securities.

While we expect revised Rule 4.2.3 (Competition) on meaningful price improvement, which took effect on 26 May 2013, to mitigate these developments, we have proposed triggers for implementing a minimum threshold for dark orders to guard against possible future degradation of price formation.

### Proposed trigger and threshold

- 20 In CP 202, we sought feedback on two (alternative) triggers which may indicate that dark liquidity has impaired price formation for a security or group of securities.
- 21 While respondents supported the level of analysis we had undertaken on the impact of dark liquidity on price formation, there were mixed views on the proposal. The majority of respondents were of the view that revised Rule 4.2.3 (Competition) on meaningful price improvement would mitigate the migration of liquidity from lit markets into the dark. They encouraged ASIC to delay implementing any triggers until the impact of the revised Rule 4.2.3 (Competition) could be assessed.

#### *ASIC's response*

We will not proceed with the proposal for a trigger to introduce a minimum size threshold for dark orders at this stage.

Instead, we will monitor the impact of revised Rule 4.2.3 (Competition) on meaningful price improvement and work with industry to implement triggers if there is further deterioration in price formation.



## C Dark liquidity: Proposals for crossing system operators

### Key points

Crossing systems are rapidly evolving and have become more 'market-like': see CP 202. Accordingly, we believe there is a need for appropriate regulation of crossing systems to ensure that:

- the Australian market continues to work efficiently;
- investors are adequately informed about their own dealings; and
- the regulatory framework caters for future developments.

The International Organization of Securities Commissions (IOSCO) released the *Principles for dark liquidity* report, to provide guidance on the minimum expectations for 'dark pools'. In line with this guidance, we have sought feedback on proposals we made in CP 202, which would require crossing system operators to:

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

### Transparency for the wider market

- 22 There are currently no market integrity rules in place requiring crossing system operators to disclose to the market and the potential users of crossing systems key information about their facility: see CP 202. We sought feedback in CP 202 on a proposal for a new rule to require crossing system operators to make information about the facility publicly available on a website, including information on order types, fees (where they differ from standard broking fees and commissions), and monthly aggregate turnover statistics.

- 23 The majority of respondents—market operators, fund managers, superannuation funds and retail investors—supported greater transparency measures that would enhance market confidence by increasing understanding of the number and scope of crossing systems and how they operate. It would also increase understanding of market structure. Most of the respondents did not see any reason why all of the proposed information should not be publicly available and believed the information should be consolidated on our website.
- 24 Crossing system operators challenged the need for transparency for a number of reasons, including:
- (a) associated costs;
  - (b) disclosure of proprietary information; and
  - (c) materiality of information.
- 25 Of particular concern to crossing system operators was public disclosure of order types and fees—which are usually subject to bilateral client contracts. These respondents submitted that crossing systems operate in a highly competitive environment and that clients have a number of options available to them. Respondents also indicated that a one month timeframe for implementation of this proposal was not sufficient.

#### *ASIC's response*

We have changed the scope of crossing system proposals from applying to all market participants of licensed markets to applying only to market participants of the ASX, ASX 24 and Chi-X markets. The new market integrity rules for crossing systems are not relevant to products on other markets yet. We will consider broadening the scope as part of our work on harmonising the market integrity rules.

We will proceed with an adaptation of the proposal to require information about crossing systems to be made publicly available on a website (a link to this website will be made available from our website).

In response to industry feedback we will not require public disclosure of order types and fees to access the system. Instead, these disclosures will need to be made to clients of the crossing system operator.

We will not proceed with requiring public disclosure of monthly aggregate turnover statistics for each financial product. We are satisfied that adequate information will be made publicly available through the revised course-of-sales disclosure: see paragraphs 54–55.

In light of feedback received, we will lengthen the implementation timeframe to three months rather than one month as initially proposed in CP 202.

## Disclosure to all users

- 26 In CP 202, we outlined our concerns about gaps in the information provided to users and prospective users of crossing systems, including:
- (a) how orders are executed;
  - (b) whether there is principal trading or high-frequency trading presence in the crossing system; and
  - (c) when there are material changes made to the crossing system.
- 27 We sought feedback on our proposal to make a new market integrity rule requiring crossing system operators to provide written disclosure to their existing users and ASIC, to new users before accepting an order for the first time, and when there is a material change, about:
- (a) all the matters listed in the proposal for transparency for the wider market (see paragraphs 22–25 and proposal C1 of CP 202);
  - (b) any obligations imposed on users;
  - (c) execution risk, as distinguished from any other risks on an exchange market; and
  - (d) more granular details about the operation of the crossing system.
- 28 The majority of respondents, including investors and fund managers, supported the proposal to provide greater disclosure. Some respondents believed the proposed measures may be too prescriptive and that a principles-based approach or guidance may be more appropriate than introducing new market integrity rules.
- 29 We received mixed responses from crossing system operators. Some were supportive, stating that they were already providing sufficient disclosures relating to the proposals while others expressed concerns that the proposal is a ‘one size fits all’ approach that does not take into account differences in materiality, cost and the competitive environment that crossing systems operate in.

### *ASIC’s response*

We will proceed with the proposal to require crossing system operators to provide written disclosure with the exception of disclosure about execution risks (proposal C2(b)), which we will not proceed with.

In addition, as outlined in paragraphs 22–25 of this report, we will extend this disclosure to include information about order types and fees (where they differ from standard broking fees and commissions).

We will maintain an implementation timeframe of six months as proposed.

- 30 In CP 202, we also proposed a new market integrity rule requiring disclosure for crossing systems operated by a different entity when a crossing system operator uses the second entity for order execution.
- 31 There were seven responses to this proposal. Although respondents expressed general support for the proposal, some submitted that it would be costly to implement and others stated that the transparency proposals were adequate: see proposals in C1 of CP 202. There was some support for guidance rather than a new market integrity rule.
- 32 We also proposed an amendment to the market integrity rules to clarify that a crossing system operator must disclose to ASIC whether it receives orders from other crossing system operators.

#### *ASIC's response*

We will not proceed with the proposal requiring crossing system operators to provide sufficient information to clients on other crossing systems used because it would be complex to implement and may create confusion for clients. We will monitor whatever relevant information could be largely obtained through the transparency proposal.

However, we will proceed with the proposal to amend Rule 4.3.1 (Competition) to clarify, for the avoidance of doubt, that crossing system operators must disclose to ASIC whether the crossing system receives orders from other crossing systems.

The timeframe for implementation of this proposal has been revised to three months from six months, given the simplification of the proposal.

## Trade confirmations

- 33 In CP 202 we proposed that the existing obligation for a market participant (or an associated entity) to identify to retail clients when it trades as principal and when a trade is crossed be supplemented with an obligation to identify the relevant crossing system. As there is no existing obligation to include this information in trade confirmations to wholesale clients, we also proposed that confirmations to wholesale clients should identify when the trade was made as principal and the crossing system on which it was done.
- 34 Responses to this proposal were mixed. The majority of respondents supported the view that clients should be notified when a market participant trades with them as principal, and the crossing system on which the trade was made.
- 35 Some respondents noted that the existing obligations for retail clients were adequate and that the costs to amend confirmation systems would outweigh

the incremental benefit of uniquely identifying the crossing system. It was also noted that there is not always an equivalent '1 for 1' relationship between an order and trade.

- 36 Respondents noted that at present most wholesale clients receive real-time fill notifications instead of trade confirmations. It was submitted that this proposal should not result in a requirement to provide trade confirmations to wholesale clients. Some respondents also maintained that this information was already available on request and that general disclosure to clients listing potential crossing systems on which their orders could be executed would be sufficient information.
- 37 One respondent stated that this behaviour should simply be prohibited because it creates a conflict of interest.

#### *ASIC's response*

We will not proceed with proposal C4(a) to identify crossing systems on trade confirmations for retail clients at this stage. However, we will continue to monitor the need for this type of disclosure as crossing systems and their connections to one another evolve.

We will amend proposal C4(b) which requires market participants to confirm for wholesale clients when trading as principal and the crossing system on which the trade was made. Instead of requiring this information be disclosed in a trade confirmation, we intend for market participants to make the information available to clients the day of the trade unless otherwise agreed with the client. We will provide guidance outlining options available—for example, the use of FIX tags 29 and 30 on fill notifications.

We will increase the implementation time to nine months from the proposed three months.

## **Fairness to all users**

- 38 In CP 202, we noted that crossing system operators have considerable discretion over who has access to the crossing system, and the terms in which their orders execute. We sought feedback on our proposal to make new market integrity rules requiring crossing system operators to ensure that their crossing system is operated by a common set of procedures that:
- (a) appropriately balances the interests of all users;
  - (b) does not unfairly discriminate between users; and
  - (c) ensures adequate disclosure to clients about the price consequences of certain order types.

- 39 The majority of respondents supported the proposals as an important investor protection measure which would align requirements with those applying to licensed markets. Some respondents requested guidance on whether establishing categories of users is acceptable practice.

*ASIC's response*

We will proceed with the proposal to require crossing system operators to ensure that the crossing system is operated by a common set of procedures, which appropriately balances the interests of all users and does not unfairly discriminate between users.

We will also proceed with the proposal for adequate disclosure to clients on different types of orders and their price consequences.

The implementation time will be three months for all proposals in this section as outlined in CP 202.

## Opting out

- 40 In CP 202, we proposed a new market integrity rule to require crossing system operators to give clients the choice to opt out of their crossing system(s) or any other crossing system that may be accessible through the crossing system at no extra cost and without additional operational or administrative requirements.
- 41 The majority of respondents had no objections to the proposed market integrity rule and were of the opinion that clients should have control over where their orders are executed—all but one crossing system stated that they were already complying with the proposal. However, some respondents expressed concerns about limiting future innovation, fee arrangements and providing alternative routing options to clients that choose to opt out.
- 42 One respondent opposed this proposal, stating that clients always obtain an equal or better price on a crossing system than on lit markets and that opting out would not make sense for clients. The respondent also stated it had received no requests to date to opt out from clients.

*ASIC's response*

We will proceed with the requirement for crossing system operators to offer clients the option to opt out of using the crossing system. However, we will not proceed with the requirement to do this at no extra cost.

The implementation time will remain three months as proposed.

## Monitoring

- 43 In CP 202, we proposed a new market integrity rule that would require crossing system operators to:
- (a) monitor order and trade activity on the crossing system(s) to ensure compliance with the crossing system's user obligations and operating procedures;
  - (b) report to ASIC any significant non-compliance with these obligations and procedures;
  - (c) take action to ensure breaches of the user obligations do not recur;
  - (d) keep records of the monitoring activities, identified breaches, and reports to ASIC; and
  - (e) replicate market integrity rules on suspicious activity reporting.
- 44 Responses to the proposal were mixed. Crossing system operators objected to the proposal, concerned that it would require real-time monitoring, which would be costly and require more than six months to implement.
- 45 Respondents were largely silent on the suspicious activity reporting proposal: see subparagraph 43(e). Meetings with industry indicated market participants were already applying existing market integrity rules to crossing systems to report suspicious activity and that implementing this proposal would not be burdensome.

### *ASIC's response*

We will amend proposal C7(a) to require monitoring for compliance with the crossing system operator's own procedures, which would not necessarily involve real-time monitoring of every order and trade. We will issue guidance to confirm our expectations are proportionate to the nature and size of the relevant business.

The implementation time for the monitoring proposal will be extended to nine months from six months.

We will proceed with proposal C7(b) to apply suspicious activity reporting for crossing systems. However, the implementation time will be reduced to three months.

## Record keeping

- 46 In CP 202, we proposed a new market integrity rule which would require crossing system operators to keep records for seven years of all orders, including principal orders, in the crossing system as well as any parameters set for the orders. We proposed that crossing system operators be required to maintain a clear trail of orders in an order book so that we are able to trace

orders and replay incidents in a dark crossing system. We also proposed to issue guidance that records produced in response to a request from ASIC under this rule must be in a particular comma-separated values (CSV) file format.

- 47 While some respondents supported the proposal to maintain records, the majority were against it arguing that existing record-keeping obligations were adequate to trace orders and replay circumstances surrounding market events. They noted concerns about the cost to industry, technical challenges in capturing all relevant information and the extensive storage that would be required.

*ASIC's response*

We will not proceed with this proposal at this stage.

## Systems and controls

- 48 In CP 202, we proposed to amend Rules 5.6.1 and 5.6.3 (ASX) and (Chi-X) on the responsible use of automated order processing and associated system and control requirements, to cover conduct which interferes with the integrity of a crossing system. We also proposed a new market integrity rule which would require crossing system operators to notify ASIC, and all users with orders in the crossing system, as soon as practicable, and at least within 60 minutes of any material system issues. We also proposed to issue guidance to reinforce that crossing system operators should have adequate resources during stressed market conditions and adequate disaster recovery and capacity management.
- 49 Concern was expressed by the majority of respondents with the 60 minute timeframe, noting that it may be insufficient to notify *all* users of any material system issues. Some respondents stated that it was already current practice to notify all *affected* users. One respondent submitted that crossing systems operate in a highly competitive environment and that a self-regulating mechanism ensured that affected users were notified appropriately or the operator risked losing clients.
- 50 There were no responses from industry in response to our proposal to issue guidance to reinforce that crossing system operators should have adequate resources during stressed market conditions and adequate disaster recovery and capacity management.

*ASIC's response*

We will modify the notification timeframe from 60 minutes to 'as soon as practicable'.



We will also issue guidance clarifying our expectation that we do not expect notifications to be provided to retail investors whose orders may be eligible to enter a crossing system.

We will proceed with guidance on adequate resourcing for crossing system operators during stressed market conditions, including disaster recovery and capacity management.

The implementation time for both these proposals will be six months as indicated in CP 202.

## D Dark liquidity: Other proposals

### Key points

In CP 202, we sought feedback on the following issues and proposals:

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

### Tick sizes

- 51 A security that is often tick constrained appears to have the effect of driving trading activity off lit exchange markets into the dark. In CP 202 we sought feedback on two alternative options to address this issue.
- 52 Responses were diverse and fell into three broad categories:
- (a) some respondents agreed that certain stocks were tick constrained and that this was driving liquidity to the dark and supported a pilot program of tick reduction on specific pilot stocks;
  - (b) some respondents agreed that certain stocks were tick constrained but that this was not the reason for migration of liquidity into the dark and did not support changes to tick size; and
  - (c) some respondents did not agree that stocks were tick constrained or did not agree that tick constraint was an indication of market failure.
- 53 Overall, respondents suggested that given the associated costs, technical difficulties and complexities, we should wait for other market structure proposals to take effect and continue monitoring migration of liquidity into the dark and its impact on price discovery.

#### *ASIC's response*

We will not proceed with this proposal at this time. We propose to continue monitoring tick constrained securities and will work with industry on an optimal tick regime if necessary.

## Course-of-sales disclosure

- 54 In CP 202, we proposed to make a new market integrity rule requiring market operators to make available (on the same terms as required by Rule 5.1.5 (Competition)) a minimum number of items as part of the information required to be reported three business days after a trading day (T+3) (current market practice). As part of the minimum information required, we also proposed to require the specific market or venue on which a transaction takes place to be identified.
- 55 Most respondents supported the proposal noting that the reports are already public and would only require relatively minor amendments to add the venue. One respondent noted that the market is best placed to determine the most efficient outcomes in this area.

### *ASIC's response*

We will proceed as proposed in CP 202.

## Conflicts of interest

- 56 In CP 202, we proposed new and amended market integrity rules and guidance to address current deficiencies in identifying and managing conflicts of interest in the handling and execution of client orders. In particular, the proposals focused on requiring market participants to:
- (a) protect client information;
  - (b) ensure market participants preference client orders over principal orders;
  - (c) not interpose principal trading between client trades that otherwise would have crossed; and
  - (d) not charge retail clients commission when dealing as principal.
- 57 Responses to the proposals were mixed. Some respondents were supportive of the proposal to require market participants to protect client information, stating that this was a sensible and measured response to protect client interests, while others believed that it could prevent trade analytics being conducted and the administration of execution services across related bodies corporate, even when the client had consented.
- 58 Industry expressed concern in response to the proposal to ensure market participants preference client orders over principal orders. Many noted that this would have an impact on client-driven principal trading activities, closing out error trade positions and raise issues of pulling orders from lit markets to give clients preference. A number of respondents stated that the current framework is appropriate and highlighted concerns about the impact

of the proposal on specific strategies, including index arbitrage, facilitation and hedging.

- 59 In response to the proposal to require market participants not to interpose principal trading between client trades that otherwise would have crossed, respondents argued that trading desks operating independent strategies have the potential of leading to incidental crossings and that this proposal would be difficult to implement.
- 60 For the proposal to remove any ambiguity that market participants must not charge retail clients commission when dealing as principal, one respondent pointed out that this may be an issue when the related body corporate is a fund manager.

#### *ASIC's response*

We will amend proposal D3(a) and (b) to introduce a carve-out where a client consents to order information being used for administrative or analytical purposes. We will extend the implementation time to six months for this proposal.

We will amend proposal D3(c). Rather than require market participants to preference client orders over principal orders, we will make it clear that the obligation to deal fairly and in due turn with clients' orders, and an order on a market participant's own account, applies to all orders that a market participant enters into a crossing system. We will extend the implementation time to six months for the amended proposal.

We will amend proposal D3(d) to introduce the element of 'knowingly' when determining whether a market participant has interposed between two orders that would have otherwise crossed. We will extend the implementation time to six months for the amended proposal.

We will amend proposal D3(e) to introduce a carve-out for any related body corporate of the market participant that is acting as a trustee of a trust in which it has no direct or indirect financial interest. We will proceed with an implementation timeframe of three months for this proposal.

## **Payment for order flow**

- 61 Conflicts of interest are created when a market participant directs orders to a crossing system operator that provides incentives to the market participant rather than the best outcome for the client. To address this, in CP 202, we proposed a new market integrity rule to provide a clear framework about how to appropriately and fairly manage incentives. The proposal included introducing a rule to expressly prohibit a market participant from paying

direct cash payments for order flow and only permitting soft dollar incentives in circumstances where:

- (a) best execution outcomes are maintained;
- (b) there is full client disclosure; and
- (c) the incentives enhance the quality of the financial service to the client.

- 62 We received a mixed response to these proposals. Some supported the proposal to ban hard dollar payments. Others were of the view that we were attempting to introduce regulation without a clear requirement for it, or that we had not given enough consideration to how industry currently operates. We received feedback that payments for order flow currently take place in our domestic market and that these can be of commercial benefit to clients. For example, while fund managers are not generally paid hard dollar cash payments for their order flow, they are provided trading discounts at times of index re-balancing, or for services relating to dividend reinvestment plans.
- 63 In response to the proposals on soft dollar incentives, there was limited feedback from industry. Some respondents raised concerns as to whether the draft market integrity rule would require disclosure before each order and whether soft dollar benefits need to enhance the quality of each order or a number of orders.

*ASIC's response*

We will amend proposal D4 to prohibit negative commissions.

We will issue guidance on payments for order flow in updates to RG 181 and RG 223.

In light of industry feedback to CP 202, we will monitor the payments that market participants are making for order flow and take further regulatory action if we see that conflicts are not being adequately managed in relation to these payments.

## Indications of interest

- 64 At present, there are no market integrity rules specifically governing the use of indications of interest in the Australian market and the confidential information that they contain. We sought feedback in CP 202 on whether there is a need for rules governing disclosure requirements for market participants in relation to who the proposed order is on behalf of (client or principal) and the timing of the disclosure.
- 65 Responses to this issue were mixed with the majority of respondents indicating that guidance would be beneficial to address the concerns outlined in REP 331 on this issue.

*ASIC's response*

We will issue guidance on indications of interest through an update to RG 181. This guidance will outline our expectations about:

- managing conflicts of interest that may arise between clients, or between principal trading and client interests;
- adequately managing confidential client information; and
- ensuring indications of interest represent a bona fide interest in transacting.

## E High-frequency trading: Proposals

### Key points

In REP 331, the high-frequency trading taskforce identified trading algorithms as being responsible for the majority of excessive messaging and noise in our markets—in particular, ‘small and fleeting’ orders and high order-to-trade ratios. REP 331 also highlighted the extensive work of the taskforce to address these concerns by raising awareness and changing behaviour on a case-by-case basis. To address these concerns, we proposed to introduce a small order resting time to reduce market noise and issue guidance on order-to-trade ratios: see CP 202.

REP 331 also outlined industry concerns around predatory trading strategies dependent on technology and speed. While we did not find systematic manipulation or abuse of markets, to address concerns we proposed introducing additions to the circumstances of an order to consider when determining whether a false or misleading market had been created. We also proposed to harmonise market manipulation market integrity rules across equity and futures markets and issue guidance on trading practices considered to be manipulative.

We sought feedback from industry on our proposals to address these issues.

### Excessive messaging and market noise

#### ‘Small and fleeting’ orders

- 66 Our proposal to address concerns around ‘small and fleeting’ orders included introducing a new market integrity rule requiring a minimum resting time of 500 milliseconds for ‘small’ orders in our markets—defined as \$500 or less in cash equities.
- 67 A number of respondents agreed that ‘small and fleeting’ orders can lead to excessive market noise. However, responses were mixed on how best to address the issue. Respondents argued that the cost of systems development would far outweigh the benefits of a reduction in noise. Larger market participants suggested that development of up to five to six systems would be required to ensure orders at or below the threshold do not rest for less than 500 milliseconds. Some respondents also indicated that market operators may be best placed to implement systems to assist market participants in meeting their obligations. However, this may result in a substantial financial burden on market operators.
- 68 Many respondents were of the view that our work in raising awareness of the issue has already had a positive impact on reducing the levels of small

volume fleeting orders. These respondents argued that a case-by-case approach was a more effective way to address market noise issues, particularly as implementation of our proposal was seen as both complex and costly.

#### *ASIC's response*

Market participants have been receptive to both ASIC's and industry's concerns around market noise. We have already seen considerable reduction of noise created by 'small and fleeting' orders, and expect there will be even further improvement. 'Small and fleeting' orders had fallen to 1.6% of all untraded orders by the end of May 2013, down from 3.6% in the July–September 2012 quarter: see REP 331.339.

This has been achieved by raising awareness and through our work with market participants to address the issue where exceptions were identified. This process has been supported by many of the respondents and we will continue to work with industry where we see problematic levels.

In addition, the supervision levy has already had an impact on the volume of message traffic in our market and this is expected to continue.

We have listened to feedback, in particular to concerns raised about the costs to industry and the number and extent of systems that will require redevelopment to comply with new requirements. Accordingly, we have decided not to implement this proposal at this stage.

We remain committed to ensuring investors have confidence in our markets and that noise from excess messages remains at manageable levels. Our proposal remains under consideration should market noise return to problematic levels.

We will continue to work closely with industry particularly where we see excess or problematic message levels—including a small number of firms whose contribution to message volumes remains at significant levels.

### **Order-to-trade ratios**

- 69 We do not currently believe it is appropriate to impose market-wide maximum order-to-trade ratios because we do not see problematic or systemically high order-to-trade ratios in our markets: see CP 202. Imposing market-wide maximum order-to-trade ratios may have unintended consequences, such as causing an adjustment to algorithms to meet the threshold level and creating a competitive disadvantage for one market operator over another.



- 70 However, we do believe this can be an area of concern as has been experienced overseas. Accordingly, we proposed to update RG 241 to provide guidance to market participants on order-to-trade ratios.
- 71 We sought feedback on our proposed guidance to market participants around ensuring they pay due consideration to what may be excessive order-to-trade ratios. Industry largely agreed that order-to-trade ratios were not at problematic levels at present and that introducing a market integrity rule to curb excessive order-to-trade ratios was not appropriate. Some respondents highlighted poorly designed or configured algorithms as being the main cause of small order proliferation, and that guidance would be beneficial in these instances, combined with the ‘on exception’ approach that we had undertaken to date.

*ASIC’s response*

We will proceed as outlined in CP 202 with additional guidance on factors to consider when considering order-to-trade ratios.

## Manipulative trading

- 72 In REP 331, we noted that some trading practices—such as layering, quote stuffing, abusive liquidity detection and momentum ignition—are of concern and may be considered predatory. These strategies constitute market abuse and we will investigate all instances where such strategies are suspected to be in use, and take enforcement action if appropriate: see REP 331.
- 73 To further strengthen the current regulatory framework and address concerns about manipulative trading activities, we proposed certain amendments to the market integrity rules in CP 202. In particular, we proposed:
- (a) to remove the reference to materiality and include consideration of the impact of the order in Rule 5.7.2(b) (ASX) and (Chi-X);
  - (b) the inclusion of additional circumstances of orders to consider when determining whether a false and misleading market had been created;
  - (c) the harmonisation of market manipulation rules for equities and futures markets; and
  - (d) to issue guidance on trading practices that may be indicative of market manipulation.
- 74 Industry did not support the proposal to remove the reference to ‘materiality’ from Rule 5.7.2(b) (ASX) and (Chi-X). A number of reasons were given in the responses, including the prohibitive cost of systems development to enable effective monitoring of trading that merely had an impact (rather than

a material impact) and concerns that we could progress manipulative trading matters regardless of their impact (on the basis that a much larger proportion of trading has an impact).

- 75 Industry was broadly supportive of the additional circumstances proposed in CP 202 when considering the creation of a false and misleading appearance of active trading. However, some respondents did argue that order behaviour and trading patterns can be too complex to fully define by circumstances and should be defined using a principles-based rule.
- 76 There were no concerns raised in response to the proposed harmonisation of market manipulation rules across equities and futures markets.
- 77 Respondents were broadly supportive of ASIC issuing guidance to market participants about trading practices that may be considered manipulative.

*ASIC's response*

In light of industry feedback, we will not proceed with the proposal to remove the reference to 'materiality' from Rule 5.7.2(b) (ASX) and (Chi-X). We will, as part of issued guidance, recommend that market participants should consider the impact of any order, not only those that are material, when assessing the circumstances of an order that indicate an intention to create a false and misleading appearance of active trading.

We will proceed with the proposal to introduce additional circumstances when considering the creation of a false and misleading appearance of active trading.

We will proceed with the harmonisation of equities and futures market manipulation rules.

We will issue guidance on trading practices considered manipulative.

## Appendix 1: List of non-confidential respondents

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- Association of Superannuation Funds of Australia Ltd
  - ASX Limited
  - Australian Financial Markets Association
  - Australian Shareholders' Association
  - CFA Society Sydney
  - Chi-X Australia Pty Limited
  - Financial Services Council
  - GETCO Australia Pty Limited
  - Graham, Lorraine
  - Group of 100
  - IMC Pacific Pty Ltd
  - Industry Super Network Pty Ltd
  - Investment Company Institute
  - Liquidnet
  - Stockbrokers Association of Australia
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## Appendix 2: List of proposals and our intended approach (including timing for implementation)

Proposal in CP 202		Our intended approach
<b>B1: Minimum size threshold</b>	We proposed two (alternative) triggers at which point a minimum threshold should be applied to dark trading.	We are not proceeding with this proposal. We will monitor impacts of meaningful price improvement and continue to work with industry to consider appropriate triggers if the need arises in future.
<b>C1: Transparency for the wider market</b>	<p>We proposed to require crossing system operators to make publicly available on a website sufficient information so that market users can understand how their orders may be handled and executed, including:</p> <ul style="list-style-type: none"> <li>• the identity of the operator of the crossing system;</li> <li>• date the operations commenced;</li> <li>• types of financial products;</li> <li>• order types;</li> <li>• access criteria;</li> <li>• whether the crossing system connects to other crossing systems;</li> <li>• fees for access;</li> <li>• monthly aggregate reports; and</li> <li>• material changes to this information.</li> </ul>	<p>We will proceed with the proposal with an amendment to not require fees and order types to be made publicly available (they will only be required to be made available to users). We will also not proceed with the proposal to require aggregate monthly reports. We will require the information to be published in a standard format and our website will provide links to crossing system operator websites.</p> <p>The implementation timeframe is three months (two months additional time).</p>
<b>C2-C4: Disclosure to users</b>	<p>We proposed disclosure to users and ASIC about all the matters to be made publicly transparent, as well as:</p> <ul style="list-style-type: none"> <li>• any obligations imposed on users;</li> <li>• risks associated with trading in the dark; and</li> <li>• details about the operation of the crossing system.</li> </ul>	<p>We will proceed as proposed, but not require disclosure about risks associated with dealing in the dark.</p> <p>The implementation timeframe is three months.</p>
	We proposed that if an order may be routed to a crossing system operated by a different entity for order execution, information about the other crossing system should be provided to users.	We will not proceed with this proposal.
	We proposed to amend Rule 4.3.1 (Competition) to clarify, for the avoidance of doubt, that crossing system operators must disclose to ASIC whether the crossing system receives orders from other crossing systems.	We will proceed as proposed. Given that no system changes are required, we will reduce the implementation timeframe to three months, down from six months.

Proposal in CP 202		Our intended approach
	We proposed that retail clients should be informed of the crossing system where a trade is made. This is in addition to the existing requirement to be informed when a trade is crossed (off-market) and when the market participant trades with them on its own behalf or on the behalf of an associated entity.	We will not proceed with this proposal. We will consider revisiting it if we decide to require unique identification of the market a trade takes place on (ASX or Chi-X) for retail clients.
	We proposed that wholesale clients should be informed of the crossing system where a trade is made and when the market participant trades with them on its own behalf or on the behalf of an associated entity.	We will proceed with the amendment to require market participants to make information available to clients on the day of trade, unless otherwise agreed with the client.  The implementation timeframe is nine months.
<b>C5: Fairness to all users</b>	We proposed that crossing systems be operated by a common set of procedures that appropriately balances the interests of all users and does not unfairly discriminate between users.	We will proceed as proposed.  The implementation timeframe is six months (three months additional time).
<b>C6: Opting out</b>	We proposed that crossing systems give clients the choice to opt out of using the crossing system at no extra cost.	We will proceed with requirement to offer the option to opt out, but will not constrain cost.  The implementation timeframe is three months.
<b>C7: Monitoring</b>	We proposed that crossing systems monitor orders and trades for compliance with the crossing system procedures.	We will proceed with the amendment to take focus away from 'real-time' monitoring, and to be more principles-based. We will issue guidance to confirm that are expectations are proportionate to the nature and size of the business in relation to monitoring for compliance.  The implementation timeframe is nine months (three months additional time).
	We proposed that if suspicious activity is identified in a crossing system, it must be reported to ASIC. A similar market integrity rule already exists for exchange trading.	We will proceed as proposed.  The implementation timeframe is shortened to three months.
<b>C8: Record keeping</b>	We proposed to enhance record-keeping requirements for crossing systems (i.e. to allow a dark order book to be replayed).	We will not proceed with this proposal.

Proposal in CP 202		Our intended approach
<b>C9: System and controls</b>	We proposed to extend existing system and control requirements for automated order processing to crossing systems. We proposed that crossing system operators notify users and ASIC about system issues within 60 minutes.	We will proceed with the amendment by removing the 60 minute timeframe and replacing it with 'as soon as practicable'.  The implementation timeframe is six months.
<b>Other</b>	We clarified in REP 331 that orders that enter a crossing system must only be valid tick sizes or possible midpoints. This is to level the playing field with market operators and to avoid circumvention of the tick size rule. We subsequently undertook soft sounding on applying the existing market integrity rule to crossing systems.	We will replicate the existing tick size rule, which applies to market operators, and apply it to crossing systems.  The implementation timeframe is three months.
<b>D1: Tick sizes</b>	We proposed an option to increase the middle tick tier or to reduce tick size for severely constrained stocks.	We will continue to monitor and work with industry on an optimal tick regime if necessary in future.
<b>D2: Course-of-sales disclosure</b>	We proposed to embed the existing market practice of market operators publishing trade-by-trade information three days after a trade. This information already includes an identifier for a market participant. We proposed extending it to identify the crossing system where a trade was done.	We will proceed as proposed.  The implementation timeframe is one month.
<b>D3: Conflicts of interest</b>	We proposed that market participants protect client information, including order routing instructions.	We will proceed with the amendment and introduce a carve-out where a client consents to order information being used for administrative or analytical purposes.
	We proposed that market participants must preference client orders over principal (i.e. a market participant trading on own their account or on behalf of a related body corporate) orders at the same price.	We will not proceed with this proposal. Instead, we will broaden the scope of the existing market integrity rule that requires fairness and priority in dealing to apply to crossing systems and not just trading platforms of the ASX and Chi-X markets.
	We proposed that market participants do not interpose principal trading between client trades that would otherwise have crossed.	We will proceed with the amendment to introduce the element of 'knowingly' when determining whether a market participant has interposed between two orders that would have otherwise crossed.

Proposal in CP 202	Our intended approach	
We proposed to clarify, for avoidance of doubt, that existing market integrity rules prohibit the charging of commission to retail clients when dealing as principal (including on behalf of a related body corporate).	We will proceed with the amendment and introduce a carve-out for any related body corporate of the market participant that is acting as trustee of a trust in which it has no direct or indirect financial interest (currently this carve-out is only available when the market participant itself acts as trustee).	
	We will increase the implementation timeframe to six months for all proposals we are proceeding with in this section (three months additional time).	
<b>D4: Payment for order flow</b>	We proposed to prohibit a market participant from paying direct cash payments or cash rebates to other market participants or Australian financial services (AFS) licensees for the opportunity to handle or execute their orders.	We will amend the proposal to narrow the scope to negative commissions only, and to permit certain facilitation business.
		We will increase the implementation timeframe by six months.
<b>D5: Indications of interest</b>	Indications of interest raise a number of regulatory concerns, including the leaking of client information to other traders without the client's consent. We sought feedback on the issues.	We will issue guidance on how conflicts can be managed.
<b>E1: Excessive messaging and market noise ('small and fleeting' orders)</b>	We proposed a new market integrity rule requiring a minimum resting time of 500 milliseconds for small orders of \$500 or less.	We are not proceeding with this proposal. However, we will continue to monitor developments and this proposal remains under consideration should market noise return to problematic levels.
<b>E2: Excessive messaging and market noise (order-to-trade ratios)</b>	We proposed to issue guidance to market participants around ensuring they pay due consideration to what may be excessive order-to-trade ratios.	We will issue guidance outlining factors to consider.
		The implementation timeframe is six months.
<b>E3: Manipulative trading</b>	We proposed to amend Rule 5.7.2(b) (ASX) and (Chi-X) to remove the reference to 'materiality' and include a requirement to consider the impact of the order.	We are not proceeding with the proposal to remove the reference to 'materiality'.

Proposal in CP 202	Our intended approach
<p>We proposed to amend Rule 5.7.2 (ASX) and (Chi-X) to include the following additional circumstances when considering whether a false or misleading market has been created:</p> <ul style="list-style-type: none"> <li>• the frequency with which orders are placed;</li> <li>• the volume of products that are the subject of each order; and</li> <li>• the extent to which orders made are cancelled or amended relative to the orders executed.</li> </ul>	<p>We will proceed as proposed.</p> <p>We will proceed with the proposed changes to harmonise manipulative trading provisions across the market integrity rules for the ASX, Chi-X and ASX 24 markets.</p>
<p>We proposed to amend Rule 3.1.2 (ASX 24) to harmonise manipulative trading provisions across the market integrity rules for the ASX, Chi-X and ASX 24 markets.</p>	<p>We will issue guidance to market participants on trading practices illustrative of market misconduct.</p>
<p>We proposed to issue guidance to market participants on trading practices that are illustrative of manipulative activity.</p>	<p>The implementation timeframe is six months for all proposals that we are proceeding with in this section.</p>