ASIC

Australian Securities & Investments Commission

ASIC's regulatory approach to high-frequency trading and dark pools

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Introduction

As you know, financial markets play a central role in the growth and prosperity of our economy, by facilitating the raising of debt and equity by issuers, and the efficient allocation of resources and risks by investors.

Today I would like to talk about:

- the importance of trust and confidence in markets
- how ASIC is responding to innovation and technological developments that are reshaping our markets
- the work we have undertaken in high-frequency trading (also known as HFT) and dark pools, including:
  - how this fits with our approach to innovation and technological developments
  - how it contributes to promoting trust and confidence.

The importance of trust and confidence in markets

Turning first to the importance of trust and confidence in markets.

Trusted capital markets support growth, innovation and prosperity, and are a hallmark of a well-developed economy. Trust and confidence in capital markets encourages investor participation. However, if investors perceive they are at an unfair disadvantage, they may reduce their exposure to the market, or demand a higher return to compensate for the increased risk they experience.

Reduced investor participation in markets can lead to lower liquidity, and higher costs of capital. We saw this during the GFC when investors lost confidence in the market, and stayed on the sidelines. We have seen this at other times too, where incidents like the 'flash crash' in the United States spooked investors. We see this in emerging markets, and sometimes even in developed markets, where long-term patient capital withdraws because of issues of lack of trust, due to sovereign risk concerns.

When this happens, we all suffer. Therefore, it is critical that we have fair, orderly and transparent markets – and how regulators respond is part of this equation.

How ASIC is responding to innovation

I would like to talk for a moment about how ASIC is responding to innovation.

I see that innovation is crucial to the development of the financial sector and provides the building blocks for economic growth. But innovations in the financial sector can be challenging for regulation and regulators.

Innovations in high-frequency trading and dark liquidity have transformed markets across the world. Rightly or wrongly, they have been the subject of some particularly negative press and sentiment. Elements of high-frequency trading and dark liquidity can drive investor concerns and run the potential risk of undermining the confidence they have in the Australian and other markets.

I think it is true that one of the key challenges of high-frequency trading and dark pools is the added complexity they bring to the market system, through additional trading venues, fragmentation and proliferation of order types to accommodate high-frequency trading. In fact, one of our key challenges that we identify in our Corporate Plan is complexity driven by financial innovation. Another is structural change.

At ASIC, our approach to high-frequency trading and dark liquidity is a reflection of our overall regulatory approach – and particularly our approach to developments in financial technology. This approach to financial technology has four key principles:

- being flexible and adaptable to the speed and nature of change
- resisting the temptation to jump before we properly understand developments

- ensuring that as far as possible our regulatory responses are technology-neutral
- ensuring we have the skills and expertise to be an effective regulator in this space.

Let me unpack each of these a little more.

Flexibility and adaptability

In terms of being flexible and adaptable, we monitor developments closely, and adapt how we might need to respond. We also look to ensure that our regulatory regime is fit for purpose and responds to changes in the market.

Resisting the temptation to jump

As new innovations emerge (and sometimes rapidly), we need to resist the urge to jump before we properly understand developments. This is a very important part of our high-frequency trading and dark liquidity narrative.

As you all know, there was a great deal of controversy around high-frequency trading and the use of dark pools. We saw significant media interest, investor concern and heard many calls for further regulation. However, we undertook the necessary work to understand the market, by identifying the extent and nature of high-frequency trading and dark liquidity in our market, and consulting on the changes to the problems that we identified. We now continue to monitor to developments in this area.

Ensuring our responses are technology-neutral

Remaining technology-neutral is also critical as innovation moves faster and automation increases in financial services.

Having the skills and expertise to be an effective regulator

As technologies have developed, and markets have changed, we as regulators have also had to change how we regulate. At ASIC, we are continuing to develop technology systems to enhance our ability to detect misconduct in the market.

We are focused on tools that help us to monitor and analyse price and volume variations more efficiently to identify insider trading and market manipulation.

We are focused on utilising the strength of data to conduct surveillance and enforcement.

We are now also increasingly looking to overlay behavioural economics principles across our market surveillance work.

ASIC's work on high-frequency trading and dark pools

I would like to turn now to the work we have done, including two significant reviews in the area of high-frequency trading.

Concerns about high-frequency trading and dark liquidity

Prior to these reviews, and even continuing more recently, dark liquidity and high-frequency trading have been the subject of significant public commentary and concern, both in Australia and overseas. In particular:

- there were concerns about the changing nature of dark liquidity and its impact on optimal price discovery
- there were also questions about the fairness of dark venues for investors, with concerns that they are not regulated as markets and 'free ride' on the pricing and information set on exchange markets
- there were questions about the value that high-frequency trading brings to fair, orderly and transparent markets, and in turn, trust and confidence
- there were concerns about the 'noise' created from excessive trading messages and concerns that high-frequency traders are predatory or that they 'game' the orders of fundamental investors, manipulate prices and may impact trust and confidence.

However in 2012, we felt that we did not have a sufficient evidence base to assess the public commentary and concerns that were being highlighted.

ASIC's reviews

Our first step was therefore to look to understand the market and identify the extent of high-frequency trading and dark liquidity and to analyse if and how it may be undermining trust and confidence in the Australian market.

In 2012 we undertook two reviews, and in March 2013 we released Report 331 *Dark liquidity and high-frequency trading* (REP 331). These reviews examined the impact of dark liquidity and high-frequency trading on Australia's financial markets. We found that public concerns over high-frequency trading appeared to have been overstated and could be attributed to the increasing use of trading technology by investors generally. Overall, we found that while there were some regulatory gaps to be filled, the overall framework was robust, and that markets and participants were adapting to the faster pace of change.

Following our 2012 review, we therefore made changes to the ASIC market integrity rules to:

- enable wholesale clients to request that participants disclose when they have traded with their clients as principal. This helps to manage participants' conflicts of interest and has been widely used by institutional clients
- improve transparency around 'crossing systems' (transaction data and disclosure about crossing system operations).

As a result of the changes we made to the rules, there has been considerable improvement in relevant disclosure and transparency. Investors are now able to make more informed choices about where and how their orders are managed, and listed entities are more informed about where their securities are being traded.

During 2015, we undertook two further reviews of high-frequency trading and dark liquidity. From these reviews, we released Report 452 *Review of high-frequency trading and dark liquidity* (REP 452), which updated and built on our earlier analysis of equity markets and assessed the effect of high-frequency trading on the futures market. We found that the regulatory settings (including the reforms we introduced in response to the 2012 reviews) were largely adequate and effective. We found that the current levels of high-frequency trading and dark liquidity in our markets do not appear to be affecting the function of our markets or their ability to fulfil their role for businesses and investors in the economy.

Recent stakeholder feedback indicates that industry is now generally less concerned about dark liquidity in our markets compared to 2012. Market users appear to be more equipped to operate within an electronic and high-speed environment.

Looking forward

Understanding the market, and using innovative tools to identify and assess conduct, is a key part of our strategy to ensure that high-frequency trading and dark liquidity do not adversely impact the integrity of our markets. Our evidence-based reviews have enabled us to dispel some myths about the problems associated with high-frequency trading and dark liquidity, as well as identify and address some activities that were of concern.

We will continue to monitor automated, high-frequency and dark pool trading in Australia's cash equity and future markets. Where we identify risks or misconduct in the system, we will use our regulatory toolset to respond in order to deliver better outcomes for investors.

Conclusion

In conclusion today, I want to say that markets can only properly fund the economy if investors and issuers have trust and confidence in them. Issuers should have confidence that share prices reflect their true value, and that they are able to efficiently raise capital. Similarly, investors should have confidence that they will be able to buy and sell shares at a fair and efficient price on an orderly market.

High-frequency trading and dark liquidity can make valuable contributions to the market as long as they are not compromising the integrity of the market.

We will continue monitoring high-frequency trading and dark liquidity – and harnessing the increasing power of data and technology in our surveillance and enforcement – so that investors and issuers can continue to have this trust and confidence. We are currently conducting a forward-looking review of the purpose of markets and their fundamental role in an environment of rapid change. As regulators, we want to make sure we have a robust evidence base, so we can make sound regulatory decisions with the benefit of good data, considered analysis and informed consultation. With this, we can enhance trust and confidence in our markets.