



ASIC Consultation 184

**Australian market structure: Draft market integrity rules
and guidance on automated trading**

ASX Submission

14 September 2012

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ASX supports the proposals outlined by ASIC in Consultation Paper 184 which put in place participant level risk controls which complement the risk controls that ASIC has imposed on market operators. These are sensible technical measures which make the controls currently in place to protect against malfunctioning connections in trading activities even more robust. ASIC is rightly focused on managing market stability and ensuring the industry is treating investors fairly.

The increase in automated (or algorithmic) trading delivers some liquidity benefits and also raises a broad range of potential issues which require an understanding of the nature and diversity of algorithmic trading in order to develop an appropriate and balanced response. ASX understands that ASIC is undertaking more detailed assessment of the impact of the growth of high frequency trading (HFT) and dark execution on market quality and market integrity. ASX encourages ASIC to continue to monitor the operation of Australia's financial markets and to inform stakeholders and the broader community about the benefits of market trends and trading behaviours and the policy issues they raise.

ASIC's proposals impose controls that manage the risks of market malfunctions

The technical measures in CP184 will, when combined with controls already in place at market operator level, provide a robust and clear operational compliance framework to manage the risk of aberrant automated trading activity creating significant disturbance in the market. Market operators are required to have automated order entry controls to reject erroneous orders before they enter the market, as well as having a trade cancellation policy aimed at limiting extreme price movements. Each of these measures is clearly and directly targeted at mitigating specific risks that, if not appropriately regulated, will increase with growth in automated trading and HFT.

The growth of strategies which rely on the placement of a large number of orders in the market can potentially create heightened risks if appropriate controls are not in place, due to the speed at which they operate and the volume of orders and trades they produce.

In the US serious market disturbances have been connected with automated trading (the May 2010 flash crash, recent trading errors at Knight Capital, and the impact of automated trading on the Facebook and BATS IPOs). These events have had a detrimental impact on investor confidence in equity markets.

In Australia, instances of trading malfunctions have been limited in their scale and impact – noting that the proportion of algorithmic trading and HFT is currently much lower in Australia. Nevertheless, it is important that policy settings keep pace with the evolution of trading in our markets and as the growth of algorithmic trading and HFT continues.

ASIC proposals are consistent with international policy frameworks

ASX agrees with the outcomes of last year's review by IOSCO¹ which argued for a holistic approach to managing the issues arising from the growth in automated trading. The policy settings and directions which are being put in place by ASIC appear fully consistent with these internationally agreed principles.

The IOSCO policy recommendations made clear that all stakeholders had a role to play in managing these challenges:

- Trading participants should have appropriate controls, including automated pre-trade controls, to manage all order flow they send through to the market.
- Market operators should provide fair, transparent and non-discriminatory access to their markets, products and services. They should also have suitable controls to deal with volatile market conditions and the large volume of messages associated with automated trading.
- Regulators should monitor the impact on market quality and integrity of technology and market structure change and be willing to act if problems emerge. They should be vigilant for new forms of market abuse that may arise as a result of automated trading and update, if necessary, existing laws to deal with them.

¹ IOSCO (2011), "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency".

ASIC can promote understanding of the issues raised by HFT and algorithmic trading

As noted in a recent report in the UK², “the debate on high frequency and algorithmic trading has been hampered by the availability of evidence and analysis. This is of significant concern since regulation that is not soundly based risks being ineffective, or worse, could lead to unhelpful and unforeseen consequences.”

ASX supports ongoing assessment of the impact of trading trends in the Australian market on market liquidity, efficiency, volatility and market integrity. ASIC can play a key role in ensuring debate on these issues are founded on a robust evidence-based foundation and addressing the full range of stakeholder perspectives.

ASX believes it is important that ASIC’s market surveillance continues to monitor the Australian market for the emergence of any trading activities that have an impact on market quality or integrity. Where regulatory change is necessary to restrict such activities, ASX supports remedial action.

It should be acknowledged that algorithmic trading and HFT comes in many shapes and sizes and can provide liquidity that reduces transaction costs for investors. However, the significant increases in orders and trades generated by HFT increases risks to market integrity and have the potential to impair market quality.

The use of algorithmic trading and HFT has been increasing in global markets, driven by the advancement of technology and the fragmentation of equity markets through the introduction of exchange competition and expansion of dark execution. It is clear from overseas experience that regulatory settings can provide incentives for the accelerated growth of activities such as certain types of HFT.

This explains in large part the different penetration rates of HFT in major markets such as the US and Europe at 40-60%, compared to Asia where it is more like 10-30%. Industry feedback suggests that HFT may account for 15–25% of equity market turnover in Australia.

To date, Australia’s regulators have put in place policy settings that are likely to effect the level of HFT activity. Specifically these settings relate to:

- **Market fragmentation** – the fragmentation of liquidity across lit markets began with the commencement of Chi-X in Australia, but fragmentation has not been as widespread as it has been in the US and Europe. However, fragmentation is likely to become more prevalent with the growth of dark pool activity, the increase in liquidity on Chi-X, and the potential for additional market operators to commence operations in Australia.
- **Pricing models** – fee arrangements that involve payment for providing liquidity (e.g. maker-taker pricing) have the potential to fundamentally distort the financial incentives for trading. These are not currently present in Australia.
- **‘Naked’ direct access** - access arrangements which provide unfettered technical access to the market without appropriate risk controls reduce latency but increase the risk of errors. This is not permitted in Australia.
- **Supervisory cost recovery** - the supervisory costs associated with high volume trading activities have been explicitly recognised through the ASIC cost-recovery levy having an element based on the volume of messages as well as trades.
- **Tick Sizes** - market operators have not been allowed to adjust tick sizes before a rigorous assessment of the impact on transaction costs, market depth and liquidity provision has been undertaken by the regulator. Dark execution has also been required to adhere to the same tick sizes available in the lit market.

ASX is committed to working with ASIC to maintain and promote the reputation of Australia’s financial markets and regulatory environment. ASX supports policy settings that ensure that the economics of HFT drive behaviours that are aligned with the interests of the broader market to enhance liquidity and promote investor confidence.

² “Economic impact assessments on MiFID II policy measures related to computer trading in financial markets”, Working Paper commissioned by the UK Government’s Foresight Project on the Future of Computer Trading in Financial Markets, August 2012.

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