Answers to questions on notice to ASIC

ASIC oversight hearing, 22 June 2012

<u>Questions asked at the hearing</u>

Question 1 (Hansard, p. 5)

Topic: Trio Liquidator Funding

Mr FLETCHER: The application is presumably for the amount the liquidator says it needs to conclude its investigation and get to a point where it can reach conclusions—is that correct?

Mr Savundra: Yes, that is right. I am not the decision maker in relation to the assetless administration funding, but from an enforcement perspective we are supportive of the liquidator being funded in the amount that they have requested. That is not a blank cheque, but in relation to the amount they have requested enforcement is supportive of that now. I should stress that enforcement are not the decision makers in relation to whether it complies with the assetless administration rules.

Mr GRIFFIN: Can you get back to the committee on that?

Mr Savundra: I will take that on notice.

<u>Response</u>

ASIC has approved funding for the Trio liquidator from the Assetless Administration Fund. The approval was for the amount of funding sought by the liquidator. The amount has been provided for the purpose of conducting a public examination of a single key witness.

Question 2 (Hansard p. 6)

Topic: ARP Structure

Mr FLETCHER: In the report, the committee reported the opinion of the liquidator that the structure of the ARP growth fund was broadly similar to the structure of the Astarra strategic fund. Does ASIC agree or disagree with that?

Mr Price: I would like to take that question on notice and have a good look at the structure charts.

<u>Response</u>

The Astarra Strategic Fund (ASF) and ARP Growth Fund (ARP) were both registered managed investment schemes.

The investment structure used by ASF contained the following features:

(i) Shawn Richard had control over each entity in the investment structure.

(ii) Astarra Capital Ltd (now known as Trio Capital Ltd) (Trio) entered into a contract with, Astarra Asset Management Pty Ltd (AAM) under which responsibility for investment decisions was outsourced to AAM. Richard controlled AAM.

(iii) It follows that approval of Trio was not required for ASF investment decisions.

(iv) AAM arranged for the custodian of ASF to send funds to EMA International Ltd (EMA);

(v) EMA was an entity incorporated in the British Virgin Islands. It was controlled by Shawn Richard, the CEO of AAM;

(vi) ASF's investment was a “deferred purchase agreement” (DPA) with EMA;

(vii) ASF did not directly invest in hedge funds, rather it had a contractual right whereby it directed EMA to place money with a particular offshore hedge fund;

(viii) EMA would purchase units in the nominated hedge fund as required by the DPA.

The investment structure of ARP (and its predecessor Professional Pensions PST (PPPST) had the following features:

(i) Paul Gresham did not have control over all entities in the investment structure;

(ii) The investment decisions of PPPST/ARP were made by Trio on the recommendation of Gresham;

(iii) Gresham recommended that PPPST invest in Professional Pensions ARP Ltd (PPARP) in 2004. This was the largest investment of PPPST;

(iv) PPARP was an entity incorporated in the British Virgin Islands and was recognised as a Professional Fund under the BVI Mutual Funds Act. Paul Gresham, Philip York and James Sutherland were directors of PPARP at various times;

(v) PPPST (and ARP) held a direct investment in PPARP being non-voting , redeemable shares in PPARP;

(vi) The shares in PPARP were subject to restrictions on transferability and resale;

(vii) PPARP had its own investment manager (associated with York) and investment advisor (associated with York) who made investment decisions on behalf of PPARP;

(viii) PPARP's investment mandate provided that there were no restrictions on the types of investment and trading activities that PPARP could undertake.

Question 3 (Hansard p. 7)

Topic: Collateralised Credit Default Swap

Mr FLETCHER: In forming the views that you have, presumably the documentation you have seen includes the contract. Is that a standard ISDA contract?

Mr Medcraft: The CDS [of ARP Growth Fund] was a standard ISDA contract, wasn't it?

Mr Price: I think we need to take that on notice.

Mr Medcraft: We will take that on notice. It is with Bear Stearns.

Response

The information we have obtained through our overseas counterparts is confidential information.

ASIC understands that the liquidator of Trio is in possession of two swap contracts with Bear Stearns. The liquidator may be able to provide a copy of the contracts to the PJC.

Question 4 (Hansard pp 14–15)

Topic: International Comparisons of Registries

Mr TONY SMITH: Perhaps I could ask one last, broad question, which you might want to partially take on notice; I would not imagine that you would take it fully on notice. Have you looked to overseas experience and benchmarked yourself and thought, 'Well, actually, in this particular democratic jurisdiction they do things a bit better, or they're a bit more advanced'? Perhaps it would be the UK or the US or wherever.

Mr Kell: We would have to take that on notice.

Mr Tanzer: I will answer it quickly now. We do benchmark ourselves. We speak a lot to our counterparts in the UK and New Zealand and to a degree in places like Singapore and Hong Kong and so on. Some of that is a little bit difficult, because every regulator has a slightly different structure, has a slightly different set of responsibilities. So from the corporate registry point of view we look at jurisdictions like New Zealand, like Hong Kong, like the UK. For securities regulation purposes we are constantly in discussion with regulators in the US, Europe, Singapore and Hong Kong, as well as other sorts of jurisdictions, like Japan and so on.

Also, the thing about the call centre type of operation is that a number of customers might come to the call centre for transactional support. We mentioned before that there are 1.8 million companies. They need to notify us every time a director changes or their registered office changes. So many of those people now find it much easier to deal with that after hours, when a call centre is not necessarily available. That is why having the website offerings up to date and making that online processing of that type of transaction simple is also important. From the customer experience point of view, there are a lot of people who do want to talk to us and need to talk to us. There are a lot of other people who do not necessarily want to talk to us but want to get their transaction done. The business names registration process, for example, is built very much with that in mind—so, as much as possible, for a simple business names registration you should be able to do it without any human intervention by ASIC, but the system works effectively to get your registration nationwide and to get your money officially too.

Mr Medcraft: On notice, we will come back to you on that. I think we are pretty good.

Response

In the registry space, ASIC given high priority to benchmarking our activities internationally through a number of channels:

- Membership of the International Corporate Registers Forum,

The CRF is an international, not-for-profit, organisation for administrators of corporate and securities registers. The CRF is a unique forum. There is no other international forum of corporate registry agencies that Australia is eligible to join. The CRF provides an opportunity to identify best practice in registry administration. IOSCO does not cover ASIC's registry activities. Over 40 jurisdictions are members of the CRF, and the annual conference is attended by over 200 delegates. ASIC is represented on the Executive Committee. Related to the CRF, the Swedish registry coordinates benchmarking against Asia Pacific, European and American registries. ASIC participates in this and benefits from reviewing results.

- World Bank annual 'ease of starting a business' annual benchmarking studies. Australia currently ranks second, after New Zealand, in ease of starting a business. This indicator has regard to the number of procedures, time , cost and paid-in minimum capital. Canada, Singapore and Hong Kong (China) follow Australia in the rankings.
- World Bank annual 'ease of doing business' annual benchmarking studies. Australia currently ranked fifteenth (15^{th}) , with Singapore, NewZealand and Hong Kong (China) ranking first to third. UK ranks seventh and Canada 13^{th}. A high ranking on the ease of doing business index means the regulatory environment is more conducive to the starting and operation of a local firm. For each economy the ranking is calculated as the simple average of the percentile rankings on each of the 10 topics included in the index in *Doing Business 2012*: starting a business, dealing with construction permits, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency and, new this year, getting electricity.
- Annual liaison meetings with the New Zealand Companies Office. ASIC has visited the Singapore registry for benchmarking purposes. ASIC is also regularly visited by other jurisdictions who benchmark against us. Recently, Canada contacted us for advice in relation to benchmarking their reforms.

ASIC would consider New Zealand, Singapore, Hong Kong, and the UK as key countries to benchmark against.

Although ASIC is different from other international jurisdictions in terms of the legislative and policy framework, departmental structures, geography etc., ASIC has successfully used international benchmarking in developing our registry strategy, in areas such as moving registry business fully online, authentication, social media, how to promote compliance and register integrity etc.

Questions submitted in writing

Further questions on notice were submitted to ASIC in writing and were a response to the following interchange.

Hansard p. 18

CHAIR: Just making sure that we do our job: one of the things we indicated was that with regard to market integrity we were going to seek your advice on a number of issues, and I just put these on the record. I doubt we will have time for all of the questions, but I might just give you these on notice. Firstly, we seek your advice regarding whether the risks posed by non-transparent trading, high-frequency trading and white label/indirect brokers requires additional transfer of responsibilities to ASIC. We would also like to discuss with you—and perhaps we need to get a response from you in writing—the equity market structure framework and how things are going there; whether supervision of the stock market has improved following transfer of responsibilities from the ASX to ASIC; your advice regarding the increased impact of competition on the integrity of the stock market; and finally, the need to keep the derivatives market under active consideration. ......

They are important matters. I would really like to hear from you and perhaps we might need to have a little more time for a discussion on those in Canberra at some time. But I would like to send you a number of questions in writing regarding those matters.

Question 5

Topic: Market Supervision

a. **Best execution laws**
   The committee understands that implementation of the "best execution" laws has been delayed from 1 October 2012 to 1 March 2013. What were the key considerations in delaying the commencement of the "best execution" laws?

Response

- In March 2012 ASIC extended the transitional period for compliance with the best execution Market Integrity Rule 3.1.1 from 31 October 2012 to 1 March 2013. This gave ASX participants more time to consider accessing alternative markets by enabling them to transmit orders only to ASX TradeMatch until 1 March 2013.

- In a multi-market environment participants should consider whether accessing a new order book will provide a better outcome for clients on a consistent basis. The purpose of the transitional arrangement was to allow more time for market participants to consider whether to access multiple markets. It also enabled new competing market operators to commence operation sooner than if they had to wait for all participants to assess whether to access new order books.
- The key considerations in extending the transitional period were as follows.
  - Participants indicated that a lead time of several months was necessary to build multi-market trading capability. If a participant decided to access a new order book from 31 October 2012 they would have needed to start development of appropriate systems from March 2012.
  - In March 2012 the level of liquidity available on alternative order books was not significant and unlikely to result in better outcomes on a consistent basis for the large majority of participants.
  - ASIC indicated it would provide a further update in July 2012 based on dialogue with stakeholders and its ongoing monitoring of trading activity on the order books of licensed markets.
- If a participant decides to utilise the transitional period it must still take reasonable steps to achieve the best outcome on ASX TradeMatch and reflect the arrangements in their policies and procedures.

b. Cooperation with ASX

In March 2011, ASIC informed the committee it was updating its memorandum of understanding with the ASX, and developing a protocol to coordinate enforcement and monitoring activities. Please provide an update on the progress of these activities.

<u>Response</u>

ASX and ASIC executed a new memorandum of understanding on 28 October 2011. ASX and ASIC agreed to two protocols relating to co-ordination of participant compliance activities and co-ordination of market surveillance and price query information activities on 27 February 2012.

c. Supervision of Chi-X

Please provide the committee an update on ASIC's supervision of Chi-X.

<u>Response</u>

- ChiX (CXA) is a new exchange market operator that commenced operation in Australia on 31 Oct-11.
- Since its launch on 31 Oct-11, Chi-X Australia (CXA) has not experienced any major incidents nor reported any systems outages to ASIC.
- ASIC conducts real-time surveillance of the CXA market using the SMARTS surveillance system to detect any instances of serious market misconduct (such as insider trading and market manipulation) and breaches of ASIC Market

Integrity Rules (Chi-X). ASIC's surveillance of the CXA market is conducted in accordance with procedures used to monitor trading on the Australian Securities Exchange (ASX).

- In keeping with its statutory obligations, ASIC is currently conducting its annual assessment of CXA's performance against its licence obligations for the 2011/12 financial year.
- The assessment covers the period 4 May-11 to 31 Mar-12, reflecting the date on which CXA's Australian Market Licence was granted by the Minister and CXA's year-end.
- For the purpose of CXA's assessment, ASIC intends to focus on the following areas, they are consistent areas of focus with ASIC's assessment of other retail markets : (1) the sufficiency of its financial, technological and human resources to operate its market properly; (2) its conflict handling arrangements; (3) the operation of its participant admission process; (4) its plans and procedures to conduct all aspects of monitoring of its market and enforcement of its operating rule ; and (5) its compliance with its licence requirements.
- To gather the relevant information required to perform the CXA assessment, ASIC has issued two notices to CXA under s30 of the ASIC Act. ASIC will also be utilising the information that CXA has provided in its s792F annual report, which it submitted to ASIC in late Jun-12.
- Following the review of the notice materials and annual report, ASIC plans to conduct onsite interviews with key CXA staff in mid August.
- ASIC intends to publish a report of our assessment of the CXA market later this year.

d. Accounting firms and confidentiality

In the context of monitoring trading activities, Report 227 notes ASIC's concerns with the segregation of confidential information by two major accounting firms that provided advice on mergers and acquisitions. What were the outcomes of ASIC's discussions with the two major accounting firms?

Response

- Doug Niven, Senior Executive Leader Financial Reporting and Audit and Greg Yanco, Senior Executive Leader Market & Participant Supervision met with senior executives from the two accounting firms involved.
- In each case we were concerned that the internal systems and procedures of the firms did not adequately protect the confidential information related to corporate activity held by the firms and that staff at the firms with access to the information were persons of interest in relation to insider trading. For example, in one case a staff member in the tax area was able to access information relating to planned corporate actions even though he was not working on the matters.

- Each of the accounting firms acknowledged that the controls in place at the time could have been better. However both firms were taking steps to address the issues of concern.
- ASIC will follow up to confirm that the firms have made changes to their systems and implemented appropriate controls to processes to address the concerns noted.

e. False Positives
Report 227 noted that ASIC's market surveillance team is continuing to refine alert parameters to reduce the amount of "false positives". What percentage of alerts are currently "false positives"? What resources have been allocated to this team, and what level of resources is required to assess and process the alerts?

Response

- Approximately 90% of all trade surveillance alerts are explained by reference to fundamental information in the market – these are known as "false positives". For example, a company may make an announcement which refers to positive drilling results from an exploration well, this may then result in the share price rising significantly after the announcement.
- As a result of the announcement and the share price movement, ASIC will receive a price alert which is then "explained". In the absence of any further information, the alert will not be further investigated.
- ASIC has a dedicated Surveillance Technology team which works closely with the Surveillance operations team, in order to constantly review alert parameters, report design and the creation of new customised alerts.
- The Surveillance Technology team has three dedicated full-time employees whose role it is to refine existing alerts and develop new Surveillance tools to reduce false positives, increasing efficiency and reducing costs.
- The Surveillance operations team has 5 staff dedicated to real-time market surveillance monitoring. Importantly, ASIC has recently received $43million in funding over 5 years to allow it to build new trade surveillance system, including data mining and advanced analytical capabilities

Question 6

Topic: Over-the-counter derivatives

a. MF Global Australia
Did the collapse of MF Global Australia highlight any loopholes in client money laws?

Response

The collapse of MF Global reinforced the existence of risks to client money that exist under the current client money and property provisions (**client money rules**) in Division 2 of Part 7.8 of the *Corporations Act 2001* (**Corporations Act**). ASIC explains these risks in ASIC Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* [RG 212] and our Investor Guide *Thinking of trading contracts for difference (CFDs)?*

The client money rules require, among other things, that Australian financial services (**AFS**) licensees pay client money into an account maintained for that purpose (see s981B(1) of the Corporation Act). At RG 212.5 ASIC explained that generally a client money account is operated as a trust account. However, if a licensee is required to call margins from a client under the operating rules of a licensed market or a licensed clearing and settlement facility, the licensee may operate the client money account as either a clients' segregated account or a trust account. We further explained the permitted deposits to and withdrawals from client money accounts and permitted investments of client money.

At RG212.14 we outlined the counterparty risks clients are exposed to with respect to client money.

Even though the client money account is a separate account subject to a statutory trust, clients are exposed to counterparty risk with respect to client money. That is, the risk that in the event of the failure of another client or the licensee, a client will not receive all of their client money back. This arises because:

(a) the licensee is permitted to use client money to meet obligations incurred by the licensee in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the licensee, including dealings on behalf of people other than the client;

(b) the licensee may make a withdrawal from a client money account of money to which it is entitled and that entitlement may be created under the terms of its client agreement by specifying when margin is due and payable; and

(c) the licensee may make a payment out of client money if it has obtained a written direction from the person entitled to the money—we understand that the client agreements of AFS licensees dealing in derivatives may contain a broad authorisation from clients for the licensees to make withdrawals from client money for any purpose whatsoever.

Further explanation the counterparty risks to client money is given in Section D of RG 212 and in our Investor Guide.

Whilst it is the case that the Market Integrity Rules and central counterparty operating rules have provide some additional measures to protect client money and mitigate client risk, some of the weaknesses in the Corporations Act client money rules equally affect exchange-traded derivative clients.

In the case of MF Global, the risk to clients was magnified by the complexity of that company's operations. MF Global Australia's business model involved paying Australian client money and margins to other MF Global entities overseas, and also using services, such as futures clearing services, provided by overseas MF Global entities. These amounts are now subject to complex insolvency proceedings across several jurisdictions.

b. Client money laws

When did ASIC first raise issue of client money laws with Treasury? What has been Treasury's response to ASIC's concerns?

Response

ASIC first wrote to Treasury in December 2008, setting out various risks to clients that arise by operation of the client money provisions in Division 2 of Part 7.8 of the Corporations Act. In this letter, we also advised Treasury that we intended to prepare a Regulatory Guide concerning the client money provisions. In July 2010 ASIC published Regulatory Guide 212 *Client money relating to dealing in OTC derivatives*.

On 30 August 2010, Treasury emailed to ASIC for comment a draft consultation paper that would propose legislative reforms to the client money rules. ASIC provided comments to Treasury on the draft consultation paper by letter dated 23 September 2010.

Treasury and ASIC then corresponded on the draft consultation paper in October 2010 and from April 2011 until Treasury released its Discussion Paper *Handling and use of client money in relation to over-the-counter derivatives transactions* in November 2011. On 20 April 2012, ASIC made a confidential submission to Treasury's Discussion Paper.

Treasury continues to liaise with ASIC about the responses to the Discussion Paper.

c. Non-compliance with contracts for difference

In light of the findings of ASIC's review into over-the-counter contracts for difference, what action will ASIC be taking in areas of non-compliance, such as the client money provisions?

Response

ASIC's surveillance review of client money handling practices in the CFD sector is ongoing. On 30 May 2012, ASIC issued Media Release 12-108MR *ASIC highlights compliance concerns in client money handling*. This media release noted that ASIC had identified that:

- eight licensees failed to pay client money into a properly designated trust account, when no exception applied, and
- six licensees failed to pay client money into a compliant account on the day it was received or within one business day.

ASIC worked with affected licensees to resolve these issues. ASIC also followed up with licensees to improve client money accounting and reconciliation practices. In the release, ASIC foreshadowed taking strong action against licensees who breached client money rules in future.

ASIC will consider appropriate action on a case by cases basis taking into account the nature and severity of any breach. In the most serious of cases, ASIC may:

- apply for a court order to freeze accounts where there are reasonable grounds for believing there is a deficiency in a client money account; or

- recommend criminal charges be brought and seek court fines of up to $110,000 (for a company) for failure to pay client money into a compliant account or unauthorised payment of client money from a client money account; or
- ban an AFS licensee or individual from providing financial services.]

d. Please provide an overview of ASIC's involvement in the *Implementation of the framework Australia's G20 over-the-counter derivatives commitments*.

<u>Response</u>

ASIC, APRA, RBA and Treasury prepared and delivered to the Treasurer and Deputy Prime Minister the *Council of Financial Regulators report on over-the-counter derivatives*. This report was released by the Treasurer on 18 April.

RBA, APRA and ASIC has also provided advice to Treasury in relation to the consultation paper, *Implementation of the framework Australia's G20 over-the-counter derivatives commitments*. This included advice concerning the proposal relating to derivatives transaction rules, the options for implementing mandatory obligations and the proposal relating to licensing of trade repositories.

e. Resourcing
Is it likely ASIC will require further resources for the development and oversight of the derivative transaction rules?

<u>Response</u>

If the Government’s proposed legislative framework outlined in *Implementation of the framework Australia's G20 over-the-counter derivatives commitments,* is passed by Parliament, the appropriate Minister will have the ability to issue a determination which imposes a mandatory obligation (to centrally clear a derivatives contract, to report data about a derivatives contract to a trade repository, or to execute a derivatives contract on a designated exchange or trading platform) in respect of a specified class of derivatives contracts.

After the Minister issues a determination, ASIC will be able to write derivatives transaction rules in respect of the mandatory obligation and the class of derivatives contracts. Derivatives transaction rules will be subject to parliamentary disallowance in accordance with the *Legislative Instruments Act 2003*.

The level of resources required for the development and oversight of derivatives transaction rules will depend on factors such as the number of determinations issued by the Minister, the mandatory obligation which is imposed and the scope of derivatives contracts specified.

ASIC is considering the potential level of resources that may be required to develop derivatives transaction rules. ASIC is discussing with Treasury the potential level of resources that may be required, noting that the actual level of resources required will vary as outlined above. ASIC continues to consider the most effective and efficient method to apply oversight of the derivatives transaction rules. If ASIC issues guidance on the interpretation of the legislation, the guidance will be subject to consultation in accordance with usual practice.

Question 7

Topic: High-frequency trading

a. Response to increase high-frequency trading
What steps is ASIC taking to respond to predictions that increased competition is likely to increase high-frequency trading?

<u>Response</u>

Interest from high frequency traders has increased with the introduction of competition.

There are already obligations on market operators and participants to manage the risks of computer-based trading such as through participant 'filters' and exchange level order entry controls and extreme cancellation ranges, to filter out unusual orders.

We have announced our intention to create a rule requiring participants' automated trading systems to have a 'kill switch' (i.e. capability to immediately disable algorithms) and to require additional 'circuit breakers' on the markets to reset the market where unusual volatility occurs (e.g. after a sudden significant drop in price).

We are seeking out poorly designed algorithms through our ongoing surveillance function and confirming our expectations on system testing to industry. We are about to issue updated guidance on our automated order processing rules.

We have established a cross ASIC taskforce to consider things like is the current definition of market manipulation still valid in this new electronic world? Is the regulatory framework appropriate for HFTs, for example:

- HFTs are typically not required to hold an Australian Financial Service Licence because they trade on their own behalf (and in doing so, don't provide a 'financial service" to others); and
- those HFTs that are not direct market participants (meaning that they access the market instead through the system of an existing direct market participant) are not subject to the market integrity rules).

We are closely monitoring fee structures to ensure they create the right incentives. Exchanges are required to notify ASIC of proposed changes.

b. Fees and high-frequency trading
Has ASIC considered the use of a fee being charged to high-frequency traders based on a ratio of orders placed to orders cancelled?

<u>Response</u>

ASIC's current market supervision cost recovery arrangements comply with the Australian Government's Cost Recovery Guidelines and were developed over a period of several months in 2011 with input from both Treasury and the Department of Finance and Deregulation. Treasury consulted with industry after the August 2011 release of their Consultation Paper "Proposed financial market supervision cost recovery model".

Prior to the current Fees Regulations being settled, many fee options were considered, including suggestions from industry and the one posed in this question. We are currently working with the Minister's Cost Recovery Stakeholder Panel (chaired by Treasury), to discuss industry feedback on market trends and issues relating to cost recovery in the period leading up to the development of the next Fees Regulations to apply from 1 July 2013.

c. Work with Chi-X

In 2011, ASIC informed the committee it was working closely with Chi-X on high-frequency trading. What is the progress of this work?

Response

Our Commission's objective in its work on high-frequency trading is to look at the impact on all markets, and accordingly early in 2012 it was stated publicly that ASIC was forming a small taskforce to look at the impact of high-frequency trading on market quality and market integrity.

This work is getting under way and the taskforce will be working toward objectives such as:

- Identification of misconduct
- Assessing whether high-frequency trading is appropriately regulated and to propose new rules or law reform if necessary
- Assess whether the best interests of clients are being undermined
- Review the impact on clients and whether their best interests are being undermined
- The price formation process is efficient
- Consider whether high frequency trading adds genuine liquidity and/or creates stability in volatile markets. Also whether there is a point where HFT departing a lit market will cause spreads to widen.
- Developments with high-frequency trading do not adversely affected the desirability of the Australian market for companies to raise capital and fundamental investors to invest (i.e. the core purpose of markets).

Question 8

Topic: Dark pools and indirect brokers

a. The effect of off-market trading

What measures is ASIC taking to follow the trends and to gauge the effect of off-market trading?

Response

ASIC monitors off-market trading in our market, including trading done on broker crossing systems (i.e. systems that automatically match orders without first displaying them on a licensed market) and other off-market trading. ASIC also has ongoing dialogue with industry on these issues and is closely following developments abroad. This enables us to keep abreast of trends and the effect of off-market trading in our market.

Crossing system reports and other off-market data

In May 2011, ASIC introduced Market Integrity Rules Part 4.3 for market participants that operate crossing systems[1] to:

a) notify ASIC about details of the crossing system prior to the commencement of the system; and

b) provide monthly reports to ASIC on activity in the crossing system. The reports include daily trading statistics for crossing systems on a per stock basis.

We also receive details about off-market trades in real-time into our surveillance system. Through the crossings system reports and surveillance data, ASIC is able to assess and monitor the developments in the nature of off-market trading activities as well as trading volumes. We have commissioned an independent expert in market microstructure (ANU Professor of Finance) to analyse this regulatory data set and gain insights into developments in our market.

The commission has set up a dark liquidity taskforce involving staff from across ASIC, which examines trends and conduct in dark pools. This taskforce is considering the appropriate regulatory framework for crossing systems and is assessing the impact of off-market activities, such as payment for order flow,[2] on trading outcomes for investors.

Dialogue with industry

ASIC has ongoing dialogue with industry to keep abreast of developments with off-market trading, including with our Market Supervision Advisory Panel. We have undertaken extensive formal consultation on the issue of dark liquidity since 2010, including issuing consultation papers in November 2010, October 2011 and June 2012. [3] As part of this process we have had over 100 meetings with stakeholders and held numerous information sessions for members of the Australian Financial Markets Association (AFMA), the Financial Services Council (FSC) and the Stockbrokers Association of Australia (SAA).

In addition, ASIC maintains ongoing dialogue with international regulators and industry to evaluate overseas experiences regarding the effects of off-market trading on market quality. For example, Commissioner Gibson recently met with regulators

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[1] A crossing system is an electronically accessible pool of pre-trade non-transparent liquidity relying on one or more of the pre-trade transparency exceptions.

[2] Payment for order flow refers to the compensation that a broker receives, not from its client, but from a third-party who wants to influence how the broker routes client orders.

[3] In November 2010, *CP 145 Equity market structure: Proposals* (in addition to facilitating the introduction of competition) ASIC consulted on issues relating to dark liquidity. In October 2011, *CP 168 Equity market structure: Further proposals* refined proposals on dark liquidity to reflect comments received to CP145. On 28 June 2012, we issued *CP179 Australian market structure: Draft market integrity rules and guidance,* to seek feedback on the draft rules and guidance.

and industry in the US, where there is evidence that the proliferation of dark liquidity can be detrimental to liquidity and price formation.[4] We also have ongoing engagement through IOSCO.

b. Reasons for reviewed approach
The committee understands ASIC is reviewing its approach to regulating off-market trading. What has prompted the reconsideration and what steps is ASIC taking, for example public consultation, to develop a new regulatory strategy?

<u>Response</u>

ASIC is reviewing the regulatory obligations for non-pre-trade transparent orders, including off-market orders.

There has been significant growth in the number of "dark pools" – market participant operated crossing systems have trebled since 2009 to 16. They account for 5% of trading value as of March 2012, up from 3% in June 2011. In addition, the ASX also operates two dark pools. There has also been a rapid decline in average trade size in dark trading venues in recent times. Together, this evidence points to the growth of dark liquidity and a shift away from its traditional functions of minimising price impact for large trades.

Evidence from overseas and local markets suggests that dark liquidity can be harmful to market quality. Dan Weaver from Rutgers University examine the impact of dark liquidity on market quality in the U.S. and found that stocks with 40% of its volume traded in the dark will on average have a dollar spread that is $0.0128 wider than a similar stock with minimal dark trading. This amounts to a transaction cost difference of around $3.9 million per stock per year to investors. Professor Alex Frino from The University of Sydney has suggested that 'Australia's market would be too small to handle the volume of dark trading that occurs in larger markets such as the US, and that if dark trading continued to grow it could severely damage market quality, while raising the cost of trading'.[5] His research suggests that if 20% of our trading activity in less liquid stocks went dark, transaction costs on the main exchange would increase about 1 basis point, which is approximately three times the ASX exchange fee.

ASIC is concerned that if investor order flow in our market continues to migrate into the dark, it can create material negative externalities for the wider market by diverting

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[4] D Weaver (2011), *Off-exchange reporting and market quality in a fragmented market structure*, Rutgers Business School, Rutgers University working paper, 2 May 2011

J D'Antona, Jr, '*Nasdaq frets over internalization*', TradersMagazine.com, 24 February 2010, www.tradersmagazine.com/news/nasdaq-internalization-dark-pools-level-direct-edge-sec-105265-1.html;

F Hatheway, Testimony of Dr. Frank Hatheway, Chief Economist, NASDAQ OMX, Senate Banking, Housing and Urban Affairs Committee, Securities, Insurance and Investment Subcommittee, Wednesday, October 28, 2009, Testimony presented to US Senate Committee on Banking, Housing and Urban Affairs, 28 October 2009, banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=7fea4a79-e829-44d6-831f-44c7e1640e4d

[5] Gareth Hutchens, Dark pool growth 'may harm markets', The Age (Monday, 2nd July 2012).

liquidity away from pre-trade transparent venues, impairing efficient price formation, increasing transaction costs and allowing dark orders to jump the time-priority queue.

ASIC's policy proposals in CP179 on dark liquidity seek to protect the interests of the investing public in displayed markets against the risks associated with growth in dark liquidity. In formulating our policies, ASIC has undertaken extensive consultation domestically and abroad (see answer to 4a).

The core element of our proposal is that trades in the dark (other than large block trades) should offer meaningful price improvement[6] referencing the national best bid-offer. That is, dark trading of this type can only occur if the price of the trade is a meaningful improvement on the price that would have otherwise been obtained if the trade had been executed in the lit market. We think that this provides the right incentives to ensure that limited amounts of this dark trading takes place.

ASIC expects the proposed regulatory framework to benefit investors, through promoting a fair, orderly and transparent market by:

a) promoting the price formation process in the market;

b) protecting liquidity of public displayed markets; and

c) preventing dark trades from jumping the time priority queue of the displayed orders.

c. White label/indirect brokers

ASIC has previously informed the committee that it was advising Treasury of the need for policy development in the area of white label/indirect brokers. Please provide an update on the progress of regulatory development in this area.

<u>Response</u>

ASIC is in the process of finalising its position on the appropriate manner of regulation of securities dealers that are commonly referred to in the media as "white label" or "shadow" brokers). They will generally hold an AFSL license but are not formally market participants. One option is extending market integrity rules to them. Another is modification of AFSL license conditions. ASIC anticipates finalising this position at the end of September.

[6] Meaningful price improvement is defined as one minimum tick or at the mid-point.