Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

29 May – 31 May 2012

Question: BET 267-272

Topic: Trading Reforms

Hansard Page: Written

Senator BUSHBY asked:

267. In the article 'ASIC limits tough trading reforms' in the Australian Financial Review on Wednesday 4th April 2012, ASIC deputy chairman Belinda Gibson is quoted as saying there has been 'phenomenal growth' in dark pools in the last six months of 2011. Can ASIC elaborate on the claims of this growth in dark liquidity, and how they have identified this increase?

268. How does ASIC intend to monitor and deal with the increase of dark pools?

269. As outlined in ASIC's media release, 'key messages from feedback to CP 168,' how much are these regulations expected to cost investors?

270. How much will ASIC spend to implement these new rules?

271. In the AFR article, Belinda Gibson is quoted as saying ASIC will increase stress testing of the market. Can ASIC please elaborate on the additional stress testing processes to be undertaken?

272. Can ASIC outline the additional regulatory requirements these changes will place on market participants?

Answer:

267 & 268.

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

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

b) provide monthly reports to ASIC on activity on the crossing system.

The reports include daily trading statistics for each particular crossing system on a per stock basis. Through these reports ASIC is able to assess and monitor the developments in trading activity in the crossing systems. ASIC has also commissioned an independent academic (an expert in market microstructure) to analyse the aforementioned regulatory data.

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

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

March 2012, up from 3% in June 2011. In addition, the ASX also operates two dark pools. Together, this data provides evidence on the growth of dark liquidity in recent times.

ASIC's policy proposals in CP 168 seek to protect the interests of the investing public in displayed markets against the risks associated with growth in dark liquidity. We proposed that trades in the dark should offer meaningful price improvement[2] compared to the displayed national best bid-offer to:

a) promote the price formation process in the market;

b) protect liquidity of public displayed markets; and

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

269.

In CP145 Australian Equity Market Structure: Proposals (the first formal consultation that considered the issues raised in CP168) and CP 168, ASIC sought feedback from stakeholders on the qualitative and quantitative cost and benefits of the proposed policy changes. We received limited feedback. The costs vary depending on the nature and size of market operators' and market participants' business activities, the extent to which they have already adopted the proposed requirements (many of which reflect international 'best practice'), and other factors. Our analysis of the costs and benefits will be assessed by the Office of Best Practice Regulation (OBPR), and published in a Regulation Impact Statement (RIS) before the proposed market integrity rules are introduced.

The main costs relate to changes to trading systems of market participants and market operators. We do not anticipate the immediate costs directly attributable to the proposed market integrity rules to be passed on to investors, as they mainly stem from one off changes to computer systems.

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

270.

For the majority of the proposed new rules, there will be no material costs to ASIC. The existing framework at ASIC already encompasses a robust market supervision and monitoring system. ASIC will need to make minor changes to its current data feed and surveillance systems to be able to accept and process the data that is additional to the current surveillance system. The impact on ASIC will also be included in the aforementioned RIS.

271 & 272

ASIC expects market operators to stress test their systems, and is in the process of clarifying our expectations in guidance as proposed in CP168.

This draft guidance suggests market operators should have sufficient system capacity to accommodate reasonably foreseeable volumes of trading activity. Market operators should keep capacity requirements under review and conduct capacity stress tests regularly. These systems should be adaptable to manage trading behaviours (such as quote-stuffing) and scalable to allow for changes in response to elevated message levels and/or stressed market conditions that might breach their capacity. We expect market operators to have appropriate testing arrangements to

[2] Meaningful price improvement is defined as one minimum tick or half a tick is the stock is trading at minimum tick.

enable connectivity testing, conformance testing, functional testing and regression testing, including in multimarket scenarios (e.g. order routing, trading suspensions and other market-wide scenarios). Market operators are also expected to have testing environments with sufficient capacity to enable market participants to adequately stress test algorithmic programs and order flow (e.g. in a low-latency, high-message volume, volatile environment).

In addition to stress testing of markets, we are clarifying through guidance our expectations for market participants to appropriately test their systems, filters and controls to protect orderly trading against potential disruptions (e.g. from aberrant algorithms). This includes the ability to manage highly automated trading, and stress testing of order flow. We expect that authorised persons' systems' order flow should also be tested against participant AOP filters.