

ASIC's proposed reforms to automated order processing

On 1 August 2010, the Australian Securities and Investments Commission (ASIC) took over the responsibility for supervising domestic licensed markets and participants of licensed markets from the Australian Securities Exchange (ASX) and introduced Market Integrity Rules for the ASX market¹.

Two years on, ASIC has released various consultation papers to build on the existing Market Integrity Rules to better deal with changes and risks associated with the electronic trading environment.

Background

In August 2012, ASIC released Consultation Paper 184 which proposed amendments to the Market Integrity Rules of both the ASX and Chi-X (Rules). The Consultation Paper also included a draft regulatory guide (Draft Guide) to a market participant's obligations under the Rules when it operates an automated order processing (AOP) system.

The proposed amendments to the Rules are specific to trading participants that use AOP systems and apply in addition to the general obligations on such participants to have the appropriate infrastructure and technical resources and arrangements for their general trading operations.

The proposed reforms

Greater control of AOP systems

Proposed Rule 5.6.3(1)(d): Where a trading participant's system is used for AOP, the trading participant must ensure its system has in place

controls, including automated controls, that enable immediate suspension, limitation or prohibition of the conduct of all AOP or AOP in respect of:

- one or more persons (including clients) permitted to submit orders into the trading participant's system;
- the automated processing of the orders referred to in the first bullet point above; or
- one or more products (for example, listed securities, warrants and options).

Proposed Rule 5.6.3(1)(e)(i): The trading participant's controls must enable immediate suspension of, limitation of, or prohibition on, the entry into the market of trading messages in a series of related trading messages where the trading participant has identified that trading messages in the series have entered the market and have interfered with or are likely to interfere with the efficiency or integrity of the market.

Proposed Rule 5.6.3(1)(e)(ii): The trading participant's controls must allow for cancellation of trading

The proposed reforms

- are intended to provide greater protection against the risk of automated trading activities disrupting equity markets or exacerbating disruptive price movements
- aim to provide greater public confidence in markets with a view to encouraging investment and greater participation
- aim to streamline existing ASIC's guidance into a single regulatory guide
- do not prohibit certain activities associated with automated order processing (such as high frequency trading and the use of off-market "dark pools"), although ASIC has indicated that such activities will be the subject of future ASIC consultation.

messages in a series that have already entered the market where the entry of further messages in the series have been suspended, limited or prohibited under proposed Rule 5.6.3(1)(e)(i).

Rationale and ASIC guidance on these proposed Rules

The rationale for proposed Rule 5.6.3(1)(d) is that by having in place the necessary controls, including automated controls, the market participant maintains ultimate control over its trading systems. This allows the market participant to immediately respond in an appropriate manner to any market or trading platform interference caused by its AOP system.

The Draft Guide provides that ASIC expects a market participant to rely on such automated controls to suspend, limit or prohibit AOP when the market participant has identified, for example, that trading messages from a particular source (eg a particular authorised person, account or algorithm) are interfering with the efficiency or integrity of the market or do not comply with the AOP requirements. The automated controls required by proposed Rule 5.6.3(1)(d) might include such measures as:

- termination of an AOP system (ie 'kill switches');
- shutdown of responsible AOP subsystem;
- forced logout of an authorised person; or
- a control implemented by amending the parameters of a particular filter to zero or a level that would prevent further trading.

It appears that ASIC, perhaps recognising that the use of kill switches by market participants as a

first response mechanism to market disruption could in fact exacerbate any such disruption, recognises the need for interim measures whereby market participants can simply restrict interfering trading messages that have come from a particular source. In those circumstances, the trading participant's controls would affect only the trading messages arising from that source and would allow the balance of the trading messages generated by the AOP system to enter the market without disruption.

In terms of the controls and requirements of proposed Rules 5.6.3(1)(e)(i) and 5.6.3(1)(e)(ii), ASIC has acknowledged in the Draft Guide that it may be difficult for a market participant to test the impact that trading messages or a series of trading messages may have on the market before those trading messages are submitted to the market.

For example, a trading message or series of trading messages may not necessarily affect the last traded price of a product, but may affect the depth of the order book in that product and give rise to a false and misleading appearance of active trading in the product.

Despite the potential difficulties in identifying the impact of those trading messages, a market participant must have in place the prescribed controls so that once it has identified through its monitoring arrangements a series of trading messages that are having, or are likely to have, an impact on the market, it can suspend (ie isolate for review), limit or prohibit further trading messages in the series from being submitted to the market, and cancel any trading messages in the series that have already entered the market.

Direct control of filters

Proposed Rule 5.6.3(2): where a trading participant's system is used for AOP they must have direct control over all automated filters and the filter parameters for those filters.

Rationale and ASIC guidance on this proposed Rule

Under the existing Rules, there is no requirement for the trading participant to have direct control over automated filters and filter parameters. The risk is that in circumstances where the filters are outside of the trading participant's AOP system (eg where the filter sits between the market operator and market participant or with an independent third party provider, or within another AOP system belonging to the market participant), the market participant may not be able to appropriately monitor and control the filter and its filter parameters and may be delayed in responding in a timely manner to any issues that might arise.

In accordance with the Draft Guide, ASIC expects direct control of these filters and filter parameters at the 'administrator' level, allowing the trade participant control to activate or deactivate the filter and change the filter parameters. ASIC will permit filter parameters to be changed by a person permitted by the market participant "within a defined range" but no further guidance is given by ASIC on the scope of this allowance.

ASIC considers that filters which sit outside the AOP system will be in the direct control of the market participant so long as the activation or deactivation of the filter, and changes to the filter parameters are only made with the authorisation of a qualified person of the market participant.

In the Draft Guide, ASIC does not consider a market participant to have direct control where:

- there is no 'administrator' level control;
- changes to filters or filter parameters are made by a client and merely copied to the market participant for authorisation or information purposes; or
- an authorised person deals directly on a market through the market participant but independent of the market participant's controls.

Annual review and ASIC notification of AOP systems

Proposed Rules 5.6.8A and 5.6.8B:

A review of a trading participant's AOP systems must be conducted once every 12 months (in the period ending 1 November of each year) if a review was not conducted in that period by reason of there being a material change to the system. The review must be in relation to the policies, procedures, system design documentation, including procedures for implementation of changes to the AOP software, filters, filter parameters and other relevant documentation concerning the trading participant's compliance with the Rules regarding their AOP system (for example, the requirement to have direct control over AOP filters and filter parameters).

Within 10 days of the annual review date, written certification must be given to ASIC that nothing came to the attention of the trading participant during the 12 month period that would indicate an inability to comply with the Rules regarding their AOP system.

Under the current Rules there is no requirement for a regular AOP system review, with reviews only needing to

be completed and notified to ASIC when a material change to the system was proposed. The requirement for material change reviews and notifications will remain in addition to the annual review requirements included in the proposed Rules.

Rationale and ASIC guidance on these proposed Rules

In ASIC's view, the proposed requirement for AOP systems to be reviewed annually will generate greater accountability, improve governance, and protect the orderly operation of the market without relieving market participants of their internal responsibilities to continuously review systems, policies and procedures.

As the requirement to undertake reviews and notifications following material changes to AOP will remain, ASIC recognises in the Draft Guide that 'material' is a broad concept that should be considered in the context of the nature, scale and complexity of the AOP business being conducted by the market participant.

A market participant will need to take a practical approach when determining whether a particular change or series of changes to the AOP system constitutes a 'material' change and the market participant should consider, at a minimum, the following factors when making such an assessment:

- the ability of the market participant to meet the requirements of Rule 5.6.3 after the change is made
- the potential for a change to result in trading activity that may interfere with the efficiency and integrity of the market provided by an operator

- the potential for a change to result in a breach of Part 5.7 (manipulative trading)
- the potential for a change to result in trading activity that may interfere with the proper functioning of the relevant market.

Consolidation of ASIC guidance

The Draft Guide on electronic trading contains new guidance and where appropriate incorporates aspects of ASX Guidance Notes 19 (Automated Order Processing: Certification), 21 (Automated Order Processing: Authorised Persons) and 22 (Automated Order Processing: Operational Requirements).

Those ASX Guidance Notes are intended to be superseded by the Draft Guide, which will operate as a single regulatory guide. Consequently, ASIC intends to remove any references to AOP from existing ASIC regulatory guides on market integrity rules for ASX and Chi-X.

The additional guidance currently in place – which reinforces ASIC's expectations for market participants to know and understand their clients' business – will also help market participants to identify unusual activity and minimise market misconduct.

Further ASIC regulatory response to high-frequency trading and "dark pools"

ASIC has noted that in response to the proposals made in previous consultation papers, respondents expressed concern about the impact of high-frequency trading (HFT) and

off-market “dark pool” trading activities on the fair and efficient functioning of the Australian market.

ASIC has said that it is aware of the increasingly automated nature of trading and the proliferation of dark pools occurring in the Australian market and abroad and that it intends to do further work on HFT and dark pools, including:

- analysing the prevalence and impact of dark pools and HFT in the Australian market and abroad
- reviewing the nature of trading, monitoring, handling of conflicts of interest and misconduct in dark pools
- reviewing the nature of trading by high-frequency traders, including impacts on the orderliness of trading in dark pools and on markets, and possible misconduct
- reviewing existing regulatory framework and considering what changes might be required. ASIC has noted these include relevant ‘market operator-like’ obligations applying to broker crossing systems (e.g. transparency of access and processes, management of conflicts of interest and appropriate supervision)

- identifying any existing conduct that may warrant a regulatory response.

ASIC expects to report on its findings, and any regulatory response, in the fourth quarter of 2012.

¹ *Market Integrity Rules for the Chi-X market were introduced by ASIC in April 2011. These Rules were modeled (as far as possible) on the Market Integrity Rules for the ASX market.*

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