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Dark pools and high frequency trading reforms – changes to the Australian market integrity rules

The evolution of technology has fundamentally changed the way markets operate, the strategies of market participants and their clients, and the interaction between them. There has been much reported about this and the affect of automated and algorithmic trading in the Australian (and global) media recently.

Key issues

- The Australian Securities and Investments Commission (ASIC) has amended the Market Integrity Rules, largely focussed on dark pool operators
- the amendments address issues such as disclosure and monitoring requirements and the management of conflicts of interest
- ASIC found that the public's concerns over high frequency trading appeared to be overstated**.**

Background

In July 2012, the Australian Securities and Investments Commission (ASIC) established two internal taskforces to undertake reviews of issues related to dark pool liquidity and high frequency trading (HFT) so as to deepen ASIC's understanding of these technological developments and their impact on market integrity and quality and, where appropriate, to make recommendations to address any problems identified.

In March 2013, those taskforces published their findings and recommendations in ASIC Consultation Paper 202 and Report 331. Rather than try to prohibit HFT and the use of dark pools, and recognising their continued presence in financial markets (and the use of technology generally), the taskforces provided proposals to seek to ensure quality, integrity and fairness in the operation of markets.

In August 2013, ASIC responded to submissions it received from respondents concerning the taskforces' recommendations and ASIC's amendments to the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011 (MIRs). Related amendments were announced to the ASX and Chi-X Market Integrity Rules.

This client briefing outlines recent changes to the MIRs and when they apply.

Dark pools/crossing systems

Given the development of technology and its use in financial systems around the world, it has become easier and more common for market participants to match client orders, or for market participants to trade directly with their clients, away from open (or "lit") exchange markets, in dark pools (or "crossing systems").

Triggers and threshold

ASIC had originally proposed to introduce a trigger for a minimum size threshold for crossing system orders so as combat any deterioration in price formation. However ASIC chose not to proceed with this proposal and will instead monitor the impact of the revised Rule 4.2.3 of the MIRs on meaningful price improvement. Rule 4.2.3 requires off market trades to be made at higher than the best available bid and lower than the best available offer for the relevant product by one or more ticks (price steps) or at the midpoint of the best available bid and best available offer.

Disclosure to the market

Market participants are required to disclose, on a publically accessible website, information about their crossing system such as the crossing system's identification code, the date the system began to operate in

Australia, the types of products traded on the system, criteria determining eligibility to use the system and the identification codes of other systems used to match orders, if any.

Takes effect from 10 November 2013.

Disclosure to users

Market participants are required to disclose to clients, prior to accepting an order from them for the first time, information on the user obligations imposed by the market participant, the types and characteristics of orders available to those who have access to market participant's crossing system, a description of the operation of the system (for example, how orders and cancellations are managed, how prices are determined, how conflicts are managed) and the fees imposed (including an indication of whether those fees differ to the market participant's standard fees).

Takes effect from 10 February 2014.

Trade confirmations to wholesale clients

Market participants are required to confirm to wholesale clients, as soon as practicable, when orders were fulfilled by them as principal and when orders were matched against those in another system. Where orders were matched against those in another system, the market participant is required to identify the other crossing system.

However, with respect to retail clients, ASIC has not proceeded with a requirement for market participants to identify in trade notifications the particular crossing system the trade was crossed with.

Takes effect from 9 May 2014.

Fairness to all users – common procedures

Market participants must ensure that their crossing system is operated by a common set of procedures that balance the interests of all users and do not discriminate between users.

Takes effect from 10 February 2014.

Opting out of the crossing system

Market participants must permit a user of their crossing system to opt out of having its orders sent to the crossing system (and any other crossing system which may be accessible through the market participant's crossing system). Further, a market participant is not permitted to impose on a user that opts out additional operational or administrative requirements as a consequence of opting out. However, market participants are not prevented from allowing opting out at an extra cost.

Takes effect from 10 November 2013.

Monitoring

Market participants are required to monitor the use of its crossing system for compliance with the obligations of users, compliance with the operating procedure and to take action to ensure breaches identified during the course of monitoring do not recur.

ASIC must be notified of all significant breaches identified during monitoring, as soon as practicable after identification of the relevant breach. ASIC's monitoring expectations from market participants are set out in Regulatory Guide 223. Where the crossing system is large and complex and there are large volumes of orders, or orders entering the system from other crossing systems, ASIC has provided guidance that the market participant should consider monitoring activity in real time or at least have in place adequate filters and controls that it will monitor in real time.

Takes effect from 10 May 2014.

Market participants are also required to notify ASIC of suspicious transactions or orders on the crossing system. Those include insider trades or orders, or orders that have or are likely to have the effect of creating an artificial price or misleading appearance of active trading.

Takes effect from 10 November 2013.

Systems and controls

Market participants are required to notify ASIC and all users (other than retail clients) with orders in the crossing system at the time where a system outage may materially affect the efficiency or proper functioning of the crossing system. ASIC considers material outages to include:

- when orders can no longer be entered, amended or cancelled in the crossing system; or
- when the matching facility in the crossing system ceases to function efficiently.

Notification is to be made as soon as practicable after the system outage arises.

ASIC has provided guidance to market participants that if their system experiences an outage, and there are orders from another market participant that are affected by the outage, notification should be made to the other market participant.

Takes effect from 10 February 2014.

At all times, market participants are required to have appropriate automated filters designed to ensure the efficiency and integrity of the crossing system.

ASIC has provided guidance that the type of ‘appropriate’ filters will depend on the market participant’s capabilities, the nature, scale and complexity of its business, and the particular risks that the market participant has assessed as relevant to that business, including financial, reputational and regulatory risks.

Market participants must also ensure they have controls that enable immediate suspension, limitation, prohibition or cancellation of orders into its crossing system where the orders have interfered, or are likely to interfere, with the efficiency or integrity of the system.

Takes effect immediately.

Tick sizes of products traded in dark pools

Market participants must not accept, display or queue orders in its crossing system where the tick size is less than:

- A$0.01 for an equity market product priced at equal or greater than A$2.00;
- A$0.005 for an equity market product priced at equal or greater than A$0.10 and less than $A2.00; and
- A$0.001 for an equity market product priced at less than A$0.10.

These are the same tick sizes as those that apply to exchange markets.

Takes effect from 10 November 2013.

Course of sales information to be made available

Market participants must make available Course of Sales Information for each transaction in its system within three business days after the transaction, which includes an identification of the product subject to the transaction, the transaction time, price, volume and value, participant identifier for the buyer and seller, the code applicable to the type of crossing transaction that one trade was, and the code identifying the venue of execution.

Takes effect immediately.

Conflicts of interest

Rather than require market participants to preference client orders over principal orders, market participants must ensure that their crossing system deals fairly and in due turn with clients' orders and an order on a market participants' account. This rule currently applies to ASX and Chi-X platforms.

There are a variety of factors set out in the amended MIRs which are to be considered when assessing whether the crossing system deals fairly. For example, a market participant's principal orders are not to be knowingly interposed between orders of its clients that would otherwise have crossed in its crossing system. ASIC has provided guidance that it considers that a crossing system that systematically matches client orders with principal orders, without considering client orders that are available to match, would be inconsistent with this requirement.

Takes effect from 10 February 2014.

Confidentiality

Market participants are required to take reasonable steps to ensure that their officers and employees do not use or disclose information about orders or transactions unless disclosure is permitted or required under the MIRs or the law.

Under the amended MIRs, information about orders and transactions may be disclosed to a person maintaining or servicing the market participant's crossing system or who provides administrative or analytical services for the market participant in relation to orders and transactions.

Takes effect from 10 February 2014.

Ban on negative commissions

Where a market participant handles or executes an order as the result of an arrangement with another person to direct orders to the market participant, the market participant cannot pay more for order flow than the commission received by the market participant for those orders.

ASIC has said that it will monitor the payments that market participants are making for order flow and will take further regulatory action if it sees that conflicts are not being adequately managed in relation to these payments.

Takes effect from 10 February 2014.

High frequency trading

ASIC's taskforce conducted an analysis of trading on the Australian equity markets from January to September 2012, as well as an analysis of trading entities, and whilst it found instances of problematic behavior and market disorder, it found that those were more strongly associated with algorithmic trading rather than exclusively with HFT. Generally, it found that the public's concerns over HFT appeared to be overstated.

In light of comments by the ASIC Deputy Chairman in an article, "We don't have such deep concerns [about high-frequency trading]" (Australian Financial Review article, "Push for transparency in dark pools", dated 18 March 2013), given in March 2013 when the taskforces findings were released it is not surprising that ASIC's proposed reforms to address HFT are limited.

"Small and fleeting" orders

ASIC originally proposed that a new rule be introduced requiring a minimum resting time of 500 milliseconds for orders of A$500 or less in cash equities. After receiving feedback from respondents on the costs and extent of redevelopment required to their systems and after finding that the number of 'small and fleeting orders' had fallen significantly in recent times, ASIC decided not to implement the proposal at this stage. However, ASIC stated that the proposal remains under consideration should market noise return to problematic levels.

Order to trade ratios

Rather than introducing rules limiting order-to-trade ratios, ASIC provided guidance to market participants that they should ensure due consideration is given to what may be excessive order-to-trade ratios.

ASIC's guidance provides that when monitoring order-to-trade ratios, market participants need to consider factors including:

- whether the value of the transaction(s) relative to the number of orders entered is materially different;
- the order-to-trade ratio relative to current market liquidity;
- whether the order-to-trade ratio is high in a volatile market and whether the volatility in the market is driven by an event or explanation; and
- the impact of the order-to-trade ratio on the price of a security.

Manipulative trading

ASIC has added to Rule 5.7.2 ASIC Market Integrity Rules (Chi-X Australia Market) and ASIC Market Integrity Rules (ASX Market) three circumstances of an order which a market participant must have regard to when considering whether a false or misleading market has been created. These additional circumstances are:

- the frequency with which orders are placed;
- the volume of product that is the subject of each order; and
- the extent to which a person amends or cancels an instruction to purchase or sell a product relative to the number of executed transactions for that person.

Takes effect from 10 February 2014.

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