Stockbrokers Monthly Newsletter, May 2010

The Challenges of a Multiple Market Environment

Everyone would be aware of the Government's decision on 31 March 2010 to allow for competition in the provision of market services, and its approval in principle of the application by Chi-X to conduct an alternative exchange to that provided by ASX.

To lay the groundwork to make additional markets possible, the Government has transferred the supervision of market conduct from ASX to ASIC. ASIC is making strong progress to meet the very tight timetable which has been set for it to assume control of market supervision during Q3 2010.

These changes however are only the beginning. They herald the start in what should prove to be a significant transformation in the landscape for trading listed securities in Australia. The Australian markets will soon more closely resemble those of the US and Europe, where a combination of rapid technological change and competition has created a trading landscape radically different to that which we have become used to in Australia. It is vitally important that brokers in Australia keep themselves up to date with the changes that are taking place so that they can adapt their businesses as needed.

The Stockbrokers Association has been monitoring developments here and overseas, and contributing to consultation with the Government and ASIC and with the market operators. To assist members further, the Association has in the past month convened Member briefing sessions to hear from Ron Gould, CEO of Chi-X; from Richard Murphy, General Manager, Equities Markets, ASX, and from Kirsty Gross and Andrew Walch from IRESS. The purpose of those briefings was to provide a forum for members to hear from each of those groups first-hand as to the new products and services that are about to be rolled out to meet the new market landscape.

From Ron Gould of Chi-X we heard that:

- Planning is well advanced to roll out its alternative market. It is in a position to commence a 'soft launch' using a limited number of brokers in Q4 2010 moving to a full launch in 2011.
- Chi-X expects to offer trading fees more than 25% cheaper compared to current ASX pricing.
- Chi-x will use existing market symbology and clearing will take place through ACH.
- There will be no fees for admission as a participant of CH-X. Their experience overseas is that brokers usually maintain parallel membership

ASX's Richard Murphy updated Members about an impressive range of new Order types and trading facilities:

- On 28 June 2010, ASX will be introducing Undisclosed Orders and Centre Point Orders. Undisclosed orders will be the same as those available in previous times, but with a new Minimum Order size of $500,000. Center Point Orders will enable participants to trade at the centre point between the best bid and offer. This will be useful for stocks where there is a wide bid/offer spread, or stocks where there is a narrow bid/offer spread, but large queues at the best bid/offer. A Centrepoint order would allow parties to 'jump the queue' and trade at the centre point. It will be possible to place a Centre Point order at market or with a limit, to minimize the risk of adverse price movement. It will also be possible to effect a Centre Point crossing.

- Later in 2010, ASX will be introducing Iceberg Orders. These will allow a small part of the order volume to be displayed. When filled, a new order for that amount will go straight into the market at the bottom of the queue at that price point. The maximum ratio of displayed/undisplayed volume will be 1:100 plus the minimum displayed order size will be 5000 shares.
- ASX will also be introducing VolumeMatch, its facility for executing large orders of Special size i.e. greater than $1 million. VolumeMatch will be available between 10.30 am and at 3.30 pm. Under VolumeMatch, there will be a series of 3 minute periods where orders placed into VolumeMatch will trade continuously at a fixed price, being the last traded price taken from the Central Limit Order Book. At the end of 3 minutes, that session is over, followed by a 2 minute purging period, following which the next 3 minute trading session takes place. In all, there should be approximately 60 cycles per day.
- Proprietary-only brokers and Agency-only brokers will be able to get access to VolumeMatch directly. For brokers who carry out both Proprietary and Agency trading, access will be granted only after a Certification Process is carried out. This will involve an initial Certification and an Annual re-certification as to the complete segregation of proprietary and agency systems and staff in order to avoid conflicts of interest. A Second broker ID will be issued to the firm.
- ASX will be introducing ASX Trade, which is the replacement for ITS. ASX Trade will enable trades in 250 micro seconds (the current world's best practice), 10 times faster than present speed (2-3 milliseconds).
- ASX will be offering 2 trading facilities:
- Trade Match – this will consist of the regular ASX Market (CLOB), VolumeMatch, and the Options and Warrants Markets.
- From 2011, PureMatch will be available for High Frequency Trading (HFT). PureMatch will be limited to ASX 200 stocks and ETF's. There will be no Opening/Closing Auctions, no crossings, and no hidden/undisclosed orders permitted. Under PureMatch, there will be Maker/Taker pricing. The Provider of liquidity by appearing in screen will receive rebates for providing liquidity.
- ASX is planning to significantly increase the capacity to provide co-location services, which enables participants and sponsored clients to locate their servers adjacent to the ASX's in order to reduce the speed or latency of orders. ASX will be expanding form the current capacity of 70 racks as at present to potentially 400 racks. This will provide space needed to attract High Frequency Traders into the market. In the US, 40% of order volume now comes via co-location.
- ASX Best is a smart order router to be offered by ASX, probably from mid-2011. ASX Best will route an order to the best venue. This may also extend to routing the order to other markets e.g. Chi-X, depending on the nature of the Best Execution obligations that are decided on by the Government and ASIC.

We heard from IRESS that:

- They expect to roll out their multiple market order routing technology – IOS Plus & IRESS Best Market Router (BMR) – for IRESS customers in June
- IRESS is already operating a multi-market order routing system in Canada, and has had to deal with issues including best execution, differing tick sizes and order types across different exchanges
- The technology is designed to cater for all types of broker and trading, from retail advisory trading to high frequency and algorithmic trading
- The IRESS system also has a 'liquidity pool' function, to assist firms to 'internalize trades', identifying crossings

Once these changes are implemented, our equities market will more closely resemble the US and European markets. We will see some of the features evident in those markets, including an increase in 'High Frequency' and Aglorithmic trading, and the sharing of liquidity between markets, including what are sometimes called 'dark pools'. This will be unfamiliar to those who have not worked overseas or are not familiar with developments there.

Key aspects of the trading landscape will depend on some fundamental decisions that are yet to be made by ASIC. The most important decision is the nature of the best execution model that will be adopted for Australia. Will best execution be based on price alone, or price and volume, or which other considerations? Will Australia opt for a US style national model, involving a National market system (the Reg NMS) model, with a national best bid/offer, and a best execution obligation on exchanges such that an exchange has an obligation to route an order through to another market if there is a better price to be obtained on the other market. Or will Australia prefer the MIFID model employed in Europe?

Another important feature will be consolidated trade data. It is important that data across market be available and be up to date, in order to be in a position to obtain best execution. Given the extraordinary trading speeds that will soon be available, it is important that consolidated data not be stale, or that there be any perception that people relying on the consolidated data will be at a disadvantage compared to those who may be able to pay for access to better quality trading and price information direct from market operators or other vendors with faster systems.

Australia is embarking on these changes at a time when overseas there is a process of reassessing equity market structure, access to markets, and algorithmic/high frequency trading. There is presently a Consultation Paper issued by the SEC seeking the views of the market on the whole range of these issues, including the adequacy of the existing rules in place in the US. The Committee of European Securities Regulators has likewise recently commenced its own process of review of market structures in the European Union.

One way of looking at this is that Australia is having to decide on its framework at a time when the approach in comparable jurisdictions is under some uncertainty. Another way of looking at it is that there is nothing to stop Australia developing its own model, one which could become the world leader.

It is hoped that the benefits that are put forward as being the rewards of these changes will be experienced. More liquidity, narrower spreads, better ways of execution and a reduction in transaction costs would benefit all. Significantly faster trades should make Australia's markets more attractive as a trading venue. Together with a world leading regulatory framework, these changes could all contribute to significant degree in assisting Australia's efforts to strengthen itself as a regional financial centre. It is important however that we get it right – any perceptions that liquidity is fragmented, about a loss of transparency, or inequality of access to the market between large and small investors, would not help Australia's standing.

Market Supervision Arrangements

In April, ASX released its new operating rules, which will apply post-handover to ASIC. In these draft rules, the 'Responsible Executive' and the management and draft supervision requirements of rule 3.6.3 have been removed, as they will be covered in the ASIC Market Integrity Rules (MI Rules). 'Designated Trading Representative' requirements have also disappeared from the ASX rules. ('Participant Trading Message Representatives' will have to be appointed, but this is merely a contact for trading disputes and enquiries.)

We made a written submission to ASX commenting on the draft rules in April, noting the following points:

- **Management & Supervision:** While awaiting any more detail of the ASX's requirements for 'organisational competencies', the draft ASX rules appear to be generally consistent with our submissions to the Government and ASIC that management and supervision requirements should be left to ASIC
- **Rule Duplication:** Consistent with our previous submissions we welcomed the removal of overlapping rules and duplication
- **DTR's:** we noted some Members' concerns that the removal of appropriately qualified and independently accredited specialist operators may impact negatively on the integrity of the market.
- **Type 2 AOP Access:** clarification is required about the operation of Type 2 AOP Access, including the position of clients who use a panel of brokers.
- **Disciplinary Process:** the streamlined SFE-style disciplinary process challenges the well established system of 'peer review'.
- **Maximum penalty:** with the removal of some of the most significant rules, like prevention of market manipulation, from the ASX rules, we question why ASX will require the power to impose a fine of up to $1,000,000.
- **Pre-handover/Post-handover disciplinary matters:** measures should be put in place for the setting of a 'cut-off date' of say, 1 year post-handover date, after which the ASX Tribunal will cease to hear matters which arose pre-handover.

In May, the Government released draft Corporations Regulations which cover the Infringement Notice and Enforceable undertaking regimes, and some transitional arrangements. The main points are:

- Infringement Notices:
  - ASIC can issue infringement notices against entities for breaches of the MI Rules. Like the ASX rules, the maximum penalty is $1m (with a 40% discount), together with other remedial measures. However, the list of 'entities' against whom the MI Rules can be enforced is much broader than the ASX rules. While the ASX rules could only be enforced against the Participant, RE's and DTR's, under these new Regs, ASIC can enforce the MI Rules against 'employees, representatives, agents and contractors' as well as the Participant. This substantially broadens the scope of the MI Rules, so that for example, an RE or adviser could be fined $1m. The Association will be approaching the Government on this matter.
  - The infringement notice must set out the reasons for the breach, and the penalty, which must not exceed three-fifths of the penalty in the MI Rules for that rule
  - The entity has 27 days in which to comply with the notice
  - The entity can during that time apply to have the notice withdrawn
  - If the notice is not withdrawn, and/or not complied with, ASIC can then seek to enforce it in Court by way of a civil penalty action. This is the same as the continuous disclosure regime.
- Enforceable Undertakings: as before, enforceable undertakings can be given to ASIC to resolve disciplinary matters
- Transitional arrangements: all lodgments with ASX and waivers, accreditations, consents, etc or given by ASX prior to handover to ASIC will have effect after the handover as if they were lodged with or given by ASIC (so no new action will be required by brokers)

At the time of writing, we await more information from ASIC on its Disciplinary Panel and disciplinary regime. As the MI Rules released so far only apply to ASX and SFE, more Rules for other potential new market operators will also be issued later in the year.