Stockbrokers Association of Australia
Incorporating SDIA

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The Manager,
Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
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By email: financialmarkets@treasury.gov.au

Dear Sir/Madam

AUSTRALIA'S FINANCIAL MARKET LICENSING REGIME – OPTIONS PAPER COMMENTS BY STOCKBROKERS ASSOCIATION OF AUSTRALIA

The Stockbrokers Association of Australia Limited ("the Stockbrokers Association") appreciates the opportunity to provide these comments on the Options Paper "Australia's Financial Market Licensing Regime: Addressing Market Evolution.

Set out below are some Preliminary Comments which are made before addressing the specific Questions set out in the Options Paper.

PRELIMINARY COMMENTS

The Stockbrokers Association welcomes the decision of the Government to review the framework for Australia's Market Licensing regime ("the ML framework").

It is clear that the existing ML framework was designed to regulate what in previous times was a more straightforward market environment. However, the rate of change in

the market structures globally for dealing in financial products during the last decade has been remarkable.

The factors at work which have driven this change include:

- innovation in the design of financial products,
- innovation in the structure of the trading, clearing and settlement facilities for financial products, including the introduction of competition in the provision of exchange market services, and the growth of alternative trading venues,
- technological advances in computerization of systems for trading financial products in a multi market environment
- technological advances in the computerization of systems for trade matching on markets.

This has most profoundly been seen in the changing market structure for cash equities, however change is by no means limited to that class of product.

There is no reason to believe that further quantum leaps in technology and financial product innovation will not continue to occur.

The Stockbrokers Association believes that the approach that has been followed to achieving flexibility to date, in which certain classes of facilities for trading financial products by way of exemptions and no-action arrangements, has not always resulted in the appropriate level of regulation of those facilities. Some facilities have not been subject to sufficient regulatory requirements in our view.

The Association supports an enhancement of the ML framework so that it is sufficiently flexible to be able to deal with rapid change and innovation in our markets. The enhancement of the ML framework should enable it to appropriately regulate the whole range of financial products.

It is important to establish an efficient ML framework so as to reap the benefits of future change and in order that Australia's markets can continue to compete effectively globally and with our region.

However, the Association is supportive of a ML framework that contains clearly set out fundamental regulatory requirements. In our view, a ML framework that is not sufficiently clear, is open to interpretation, or is based on high levels of discretion, will be more likely to encourage attempts to evade regulation, and/or to lead to poor regulatory outcomes. Flexibility should be achieved by defining an appropriate set of categories of ML in which the appropriate level of regulation is set at the outset.

Concurrent Regulatory Reviews

The Association notes that the Options Paper is directed at enhancing the ML regime for markets in financial products generally.

It is difficult to discuss many of the questions raised in the Paper in isolation from the questions that relate to the appropriate level or regulation of dark pools specifically. We note that the Options Paper seems to acknowledge this by containing specific sections addressed to Dark Pools and High Frequency Trading.

We note that these to the areas are presently the subject of a great deal of regulatory attention and market commentary, not only in Australia but in overseas jurisdictions as well. We note that in Australia, ASIC presently has two Task Forces under way, one in relation to Dark Pools and one in relation to High Frequency Trading.

The outcomes from these Task Forces, including any regulatory requirements, may well have a considerable bearing on approaches to Specific questions being raised in the Options Paper. To a certain extent, the timing of this Options Paper being prior to the outcome of the ASIC Task Forces is known, does complicate discussion of the Questions in the Paper to some extent.

The Stockbrokers Association has grave reservations about the impact of excessive fragmentation of the cash equities market, and of excessive migration of liquidity from the traditional "lit market" to the increasing number of "dark" trading venues including "dark pools".

The Association notes that these issues were considered by ASIC in its Consultation Papers CP 145 and CP 168, giving rise to the ASIC Market Integrity Rules that were subsequently passed.

The Submissions that the Association makes hereafter on the Questions in the ML Options Paper are made bearing in mind the above, and subject to the outcome of the concurrent reviews presently under way.

SPECIFIC QUESTIONS IN OPTIONS PAPER

General Issues and Reform Options

Feedback Sought

1. Do you have any comments on the general form of the current legislative framework for the licensing of financial markets in Australia?

2. Do you consider that there are efficiency issues that could be addressed by revising the licensing regime? If so, please provide details.
3. Do you consider that there are market integrity or investor protection concerns that could be addressed by revising the licensing regime? If so, please provide details.
4. Do you agree that regulatory change would be desirable in order to better align Australia's market regulatory regime with overseas regimes?
5. Do you believe such regulatory alignment could increase the prospects of Australian trading venues and market participants being able to seek regulatory recognition in other jurisdictions?
6. Do you consider that more flexibility in the AML regime is warranted, so that a greater number of facilities may be covered?
7. Do you have a preference between Option 1 and Option 2? If so, please provide details.
8. Is there an alternative option that you think would provide a better outcome than either of those presented? If so, please explain this option.

We reiterate the comments made in our Preliminary Submissions above.

An enhanced ML framework needs to be able to adequately regulate markets for the whole range of financial products.

The primary objective is to arrive at a ML framework which strikes the appropriate balance between certainty and flexibility and which delivers the right level of regulation for the maintenance of the integrity and high standing of Australia's markets and for the protection of Australian investors.

Whilst it is important to seek any benefits that may flow from aligning Australia's ML framework with licensing models overseas, this should be done if it accords with the primary objective referred to above, and not if it takes precedence over it.

Sufficient flexibility is needed to be able to efficiently respond to the continued growth and evolution of financial markets and financial products, and to facilitate Australia's ability to respond to developments in other jurisdictions so as to maintain its competitive position and continue to grow as a regional financial centre.

However, the down-side of too much flexibility is inefficiency, uncertainty and, as mentioned previously, the potential for avoidance of key regulatory obligations. From the point of view of ASIC as the body tasked with considering applications for a Market Licences, excessive flexibility would lead to many applications effectively being ad hoc deliberations on a case by case basis, which would be highly inefficient. It would also increase the chances of inconsistency between applications. From the point of view of

applicants, there would be the increased uncertainty of not knowing the regulatory hurdles that would need to be met, resulting likewise in inefficiency and higher cost.

From the point of view of the market, there would be the increased potential that key regulatory obligations might be either inadvertently or deliberately avoided. Stockbrokers Association Members expressed the view that they believed that the existing approach to the granting of Market Licences, Exempt Market declarations, and other forms of relief and recognition of trading venues, has not been optimal and that some regulatory requirements have not been imposed that ought to have been.

For this reason, Stockbrokers Association Members were inclined toward certainty. The Option which found most favour was Option 2. Categories of Market Licence should be settled and prescribed within the legislative framework.

It was not essential however that the Categories need to be set out in the Corporations Act itself. The categories of Licence could be set out in the Regulations, which could be changed more quickly and flexibly, if needed, to respond to developments in local and global markets. This would still achieve the certainty, and the level of Parliamentary oversight, that our Members identified as being significant.

Feedback Questions

9. Is it appropriate for ASIC to have the power to make rules in respect of licensing obligations as indicated in Option 1? What checks and balances should there be on ASIC's rule-making power? Should ASIC's power to make rules be limited to matters in which default requirements in the legislation are 'switched off' or should they have the ability to make rules relating to all provisions in Part 7.2?
10. If Option 1 were adopted, do you think the discretion should be operated through regulations (Option 1a) or through ASIC guidance (Option 1b)? Please provide details.
11. If Option 2 were addressed, how could the limitations to flexibility found in international markets be allowed for in system design?

We refer to our Preliminary Comments and to the answers to Questions 1-8 above. For the reasons that we set out, our preference is for the licensing obligations to be prescribed with certainty under the legislative/regulatory framework, rather than for them to be made by ASIC.

Flexibility could be maintained within Option 2 , the Association's preferred choice, by setting out categories in the Regulations rather than in the legislation, as we indicated above.

If there are cases where there are justifiable merits for a variation of the ML framework in a particular case, but where the step of amending the regulations to prescribe an additional category could reasonably be seen to be unwarranted, then ASIC utilise its existing powers to make a Class Order. In view of the value that the Association places on consistency and certainty, we would urge that such bespoke modifications should be considered in consultation with the appropriate industry body(ies) relevant to that market or facility.

As regards Question 10, in view of our concerns about consistency and certainty, then in the event that Option 1 was to be adopted, the Association's preference would be that discretion should operate through the Regulations rather than through ASIC Guidance.

Feedback Questions

12. Do you have any general comments in relation to the types of obligations which should or should not apply for particular entities under either option (noting that this will be consulted on in more depth at a later stage)? Please provide details.

With one proviso, the categories of market that have been identified in the Options Paper seem to be the correct ones at present.

The proviso that we mention is that a distinction should be drawn between a facility for automating broker crossings on an Exchange, and dark pools generally. Whilst crossings effected by the former are considered to be "dark" trades under the Market Integrity Rules because they do not result from matching two pre-trade transparent orders on a lit market, this type of facility is an automated version of on-market crossings which stockbrokers have been executing for many years. Provided that they are operated by a Market Participant, such broker crossing facilities do not represent the same level of risk and do not require the same level of regulation as other dark pools.

A mandatory obligation that should apply to all markets without exception is that they be fair, orderly and transparent. This is not an obligation that should not be "switched off".

In relation to Dark Pools, a number of regulatory issues have been identified by overseas regulators so far. These issues should be addressed in the ML framework to be adopted here. The issues include:

- Management of conflicts of interest
- Transparency
- Rules of Participation
- Fairness

- How are clients/participants treated - any preference given
- Use of indications of interest
- Potential for manipulation
- Actions of the operator of the facility

We note ASIC's Dark Pool Task Force is currently considering this area, and is scheduled to issue a report some time in March 2013. It is hoped that the outcome of the Task Force will address these and any other issues that have been identified, and suggest appropriate a regulatory response.

The Stockbrokers Association notes that a key regulatory issue under close consideration by regulators globally is the level of migration of liquidity from the lit market to dark markets. There is a widespread concern that an excessive migration of liquidity from lit to dark will damage market quality in the lit market(s), and regulators around the world, including ASIC, are actively monitoring this and looking to determine what can be regarded as being excessive.

An important consideration in relation to the design of the ML framework is that it not inadvertently create an incentive in regulatory terms for migration of liquidity from lit to dark. Whilst the level of regulation that is specified for each particular category of Market Licence in the proposed ML framework should be appropriate for the nature of the activities carried out on each such category of market, care should be taken so that the ML framework does not create an un-level playing field as between categories of market through any regulatory gaps that would give one category of market an unfair advantage (and at the same time, give rise to greater risk to investors and intermediaries participating in that market).

Feedback Questions

13. Do you have any comments in relation to the perceived advantages of a more flexible market licensing regime? If so, please provide details.

14. Do you have any comments in relation to the potential drawbacks of the proposed licensing reform? Please provide details of any concerns you have.

These issues are dealt with in our Preliminary Comments and previous Answers above.

High Frequency Trading

Feedback Questions

15. Do you think that making HFTs (including non-market participant HFTs) directly subject to market integrity rules would assist in safeguarding market integrity? Should these rules be limited to those which relate specifically to HFT?

16. Do you have any concerns in relation to making non-market participant HFTs subject to MIRs? If so, please provide comments.

17. Do you have any comments on how HFT should be defined and how it should be measured?

Defining High Frequency Trading

Turning first to the question of the definition of High Frequency Trading ("HFT"), there has been a great deal of comment both locally and overseas regarding the difficulties of reaching a precise definition of the term. However the term has been defined, there are potentially a wide range of trading activities and strategies that may demonstrate some or all of the characteristics in the definitions that has been proposed, including some which would not ordinarily be thought of as HFT.

Likewise, some forms of trading that would ordinarily be thought of as HFT might not display one or some of the elements of the definition, and therefore not be captured when as a matter of substance they should.

The definition that appears to have gained the widest acceptance has been that set out in the IOSCO HFT Study of 2011. To the extent that there needs to be a definition of HFT, the Association would also favour that definition, although we note that it has the same potential shortcomings indicated above as all other definitions as regards capture of all relevant forms of trading.

The Stockbrokers Association strongly submits that it is of utmost importance to distinguish between underlying strategies being used, and the technical means by which the strategies are traded. It is not the speed of trading, or that trading is electronic or computer generated, that creates a problem for market integrity. Rather, it is the strategy that is being employed, including those built into computerised algorithms, that needs to be focused on, to assess whether it is appropriate or not in terms of market integrity.

The Association submits that it is more important to focus on the particular trading strategy being employed by an organization, rather than focusing on whether they fall within the definition of HFT. Not all organisations that would fall within the definition of HFT would follow the same trading strategy.

The Stockbrokers Association has previously called for more academic research into High Frequency Trading (subject to the definitional issues) and the impact of the various forms of HFT on market quality in order to inform regulatory responses. Recently, noteworthy studies have been release in the UK (the 2012 Foresight Report by the UK Chief Scientist) and in Canada (Phases I and II of the IIROC HOT Study).

In addition, in Australia, ASIC has convened a High Frequency Task Force which is reviewing the area of HFT concurrently with this review of Market Licensing. It is worth noting that these reviews are beginning to focus more on High Order to Trade ("HOT") ratios as a key indicator of the nature of trading, rather than focusing on whether or not the trading is HFT.

It is our understanding from preliminary comments made by ASIC that some of the trading patterns that have led to market concern, including high numbers of orders and cancellations and order sizes of a few shares, have in fact been caused by algorithmic trading by entities, some of whom are traditional institutional investors, who would not fall within the class of entities ordinarily thought of as HFTs.

This in our view corroborates the Association's approach of focusing on trading strategies rather than on HFT labels. It is likely, in our view, that the issue of defining HFT may become less significant as the debate progresses, and the analysis of patterns of order placement will assume the greater significance that it deserves.

Bringing HFT within the ML Framework

Further to our comments immediately above, the issues arising out of the present concerns relating to HFT and market quality generally are predominantly conduct issues.

Therefore, the Stockbrokers Association submits that the focus should be on a relevant extension of the Market Integrity Rules and, if necessary, the Corporations Act, rather than the Market License framework.

The Association would not see that a HFT would be likely to warrant being required to take out a Market Licence or some form of ML exemption, absent some specific circumstances. Therefore, the section dealing with HFT in the Options Paper does not sit squarely with the main focus of the Paper, namely enhancing the ML framework.

There are likely to be areas where there will be implications for what needs to be included in the Operating Rules of Licensed Markets to address regulatory responses to HFTs, HOT behaviour, and algorithmic trading. However, this will be likely to flow from regulation of conduct and trading behaviour through Market Integrity Rules and/or Corporations Act.

As regards extending the Market Integrity Rules, the Stockbrokers Association has consistently argued in favour of extending the MIRs to other groups beyond only to Market Participants. There are many other classes of entity whose conduct has a key bearing on the integrity, fairness and orderliness of markets, and the MIRs should be relevantly extended to those entities as well. ASIC should have the full suite of rules and powers available to it to deal with the behaviour of all such entities. At present, it only has that suite of powers in relation to Market Participants.

Therefore, the Stockbrokers Association has argued for an extension of the MIRs to "shadow brokers" and to major institutional investors. The same grounds would support a relevant extension of MIRs to HFTs (and/or HOTs, as the case may require).

Having said this, the Association notes that Market Participants are responsible for the orders and trading which they execute on behalf of clients. Market Participants discharge these responsibilities on a daily basis, and have robust and well developed procedures and competencies for handling client orders. It would not be necessary to extend the full set of MIRs to HFTs, only to the extent that the MIRs would be relevant to ensure market integrity and proper standards of market conduct.

In addition to the above, in relation to market-making HFTs (to the extent that this group can be defined), it would be appropriate to set out the regime for market making in the Market Integrity Rules. This regime would apply to any entities qualifying as a market maker, whether they could be said to satisfy the definition of a HFT or not.

Exempt Markets

Feedback Questions

18. Do you have any concerns with this proposed option? If so, please provide comments.

Stockbrokers Association members did not have any views one way or another on this proposal.

We would be happy to discuss any issues arising from our submissions on this issue. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3200 or email pstepek@stockbrokers.org.au.

Yours sincerely,

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