Australia’s Financial Market Licensing Regime: Addressing Market Evolution

Options Paper
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CONSULTATION PROCESS

REQUEST FOR FEEDBACK AND COMMENTS

This paper seeks stakeholder feedback on a range of options to amend the current Australian Market Licensing regime to allow for greater flexibility and recent market developments.

Submissions should include the name of your organisation (or your name if the submission is made as an individual) and contact details for the submission, including an email address and contact telephone number where available.

While submissions may be lodged electronically or by post, electronic lodgement is strongly preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

In addition to seeking submissions, Treasury and ASIC will be conducting stakeholder consultation meetings on this issue. Should you wish to arrange a meeting in relation to the consultation contact Treasury by 21 December 2012.

CLOSING DATE FOR SUBMISSIONS: 1 FEBRUARY 2013

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EXECUTIVE SUMMARY

BACKGROUND

The Australian market licence (AML) system set out under Part 7.2 of the Corporations Act provides the framework for financial market licensing in Australia. The regime was designed in 2001 with public exchanges in mind, and did not anticipate the extent of financial market evolution that has occurred since. As a result the system has not kept up with changing regulatory needs. In particular, the emergence of dark pools has exposed some of the limitations of current arrangements.

Over time, the legislative framework has been stretched to accommodate market developments. This has been necessary due to the lack of flexibility in the Act, with no scope to partially apply the licence obligations under Part 7.2. This has meant that a number of professional markets have received conditional licence exemptions, although the exemption power in the Act was not designed with the systematic regulation of alternative markets in mind. Dark pools are not formally licensed, with operators subject to the market integrity rules only through the fact that they are all market participants in public exchanges and hold an Australian Financial Services Licence (AFSL).

Differences in these arrangements mean that the regulatory landscape is inconsistent between markets that are effectively competitors, for example public exchanges and dark pools. Markets that are unlicensed face fewer compliance requirements, and are also not directly included in the cost recovery regime for market surveillance. This creates a competitive advantage for those outside of the market licensing regime, and also reduces the effectiveness of market supervision.

The Minister has commissioned Treasury to review the market licensing framework and consider how it may accommodate market developments. This paper forms part of early considerations regarding the limitations of the current regime and presents the opportunity to comment on potential changes to create a system better suited to today's marketplace.

Stakeholder comment is sought on all issues raised. Treasury, in consultation with financial regulators will consider feedback from this process before providing advice to the Government as to any reforms that may be warranted. The paper should not be taken as containing concluded views of the Government or Treasury.

REFORM OPTIONS

Two possible options for legislative reform are discussed in this paper. The first of these is to create flexibility in the Corporations Act, augmented by ASIC rules and guidance. This model would create a number of market categories with tailored licensing requirements. It would also likely see a substantial reduction in the number of market licence exemptions granted, although the Minister would retain this power for novel applications.

The second option is to construct an alternative trading systems regime within the legislation. This would involve creating a new, more targeted licensing regime that could cater for the various types of venues and trading systems. Enshrining an alternative regime in the legislation would provide clarity and certainty to the market. However, it could also limit the regime's flexibility to deal with future market innovation.

The relative advantages and drawbacks of these options are considered in the paper. However, both would improve the regulation of existing markets and financial products, and would make the regulatory regime in Australia more closely aligned with those internationally. This international alignment is important as it would help to facilitate mutual recognition of Australia's financial regulation by other jurisdictions such as the US, meeting our G20 obligations and reducing the need for certain Australian operators to comply with both the Australian and US arrangements in order to deal with US businesses.

Treasury is seeking stakeholder views of the relative merits of the two options or, if stakeholders see a preferable third option, details of that option and reasons for their preference.

High frequency trading and market integrity rules

Some high frequency traders (HFTs) are not run by market participants. Instead they are run by the clients of market participants, who provide them with direct access to the market. These non-market participant HFTs are not directly subject to the market integrity rules (MIRs). Instead, the responsibility for compliance falls upon the market participant who provides access, even though they have no direct role in the operation or control of the algorithm.

At present, if the Australian Securities and Investments Commission (ASIC) were to take action for a breach of the MIRs by a non-market participant, any remedial action such as penalties would be imposed upon the market participant providing access. There is an argument that these non-market participants should be made directly subject to the market integrity rules and be liable for their own actions.

Final matters

Treasury invites comments on any of the issues considered in this paper. Some specific questions are highlighted. Treasury will also hold a number of stakeholder meetings to discuss the issues raised in greater detail. The feedback received from submissions and meetings will inform Treasury's advice to the Minister.

Part A — Introductory

Background

Exchange trading has become more sophisticated in recent years, with a wider range of products, technological improvements and new ways of trading. These changes are significantly altering the trading landscape.

Globally, there is a trend for more trading in products that have traditionally been traded over-the-counter (OTC) (for example foreign exchange swaps) to move onto forms of 'markets'. These 'markets' do not neatly fit within the existing licensing framework set out in the Corporations Act (the Act).

At the same time, there is a trend for more equity product trading by fundamental (or long-term) investors to be done away from public exchanges. New forms of alternative 'markets' have emerged, known as 'crossing systems' and 'dark pools', and they are competing with the public exchanges. These alternative trading systems are not regulated as markets as they do not neatly fit within the existing licensing framework.

In addition to these market level developments, technology has led to more automated trading strategies at the broker and client level, as well as new types of high speed traders — known as 'high frequency traders' (HFTs) — which use computer algorithms to make trading decisions based upon price and other market data.

Both dark pools and HFT activity provide benefits to the market. In particular, both facilitate competition in stock trading — dark pools through directly creating rival markets, and HFT through acting as a market maker to smaller public exchanges. Dark pools also provide an alternative trading venue for those looking to execute very large trades that would have a market impact if completed on the public exchange, while HFTs provide liquidity to the market, improving the opportunity for would-be traders to find a counterparty and narrowing spreads.

However, there are also some potential drawbacks that warrant review of the regulatory approach. These include the risk of excessive market volatility and potentially increased scope for market manipulation from HFT activity, and the potential loss of investor protection and lit market price discovery from dark pool trading.

The Australian Securities and Investments Commission (ASIC) has drafted new MIRs to address the risks to price formation and to protect the interests of market participants, investors and financial consumers. ASIC has also established two taskforces on dark liquidity and HFT to examine the impacts of these developments in more detail.

In addition to the regulatory response, a broader legislative review will provide guidance on whether change is needed to make the system more effective and relevant. The Minister has commissioned Treasury to review the market licensing framework and consider how it may accommodate these developments.

This paper forms part of early considerations regarding the limitations of the current regime and presents the opportunity to comment on potential changes to create a system better suited to today's marketplace.

1. Regulatory Framework

1.1 Overview

Australia currently relies upon a combination of requirements to regulate the various kinds of financial markets, including dark pools. These requirements may be imposed via an Australian market licence (AML) or AML exemption conditions, Australian financial service licence (AFSL) requirements, Market Integrity Rules (MIRs) or a combination of these.

Dark pools are not formally licensed, with operators subject to the MIRs only through the fact that they are all market participants in the public exchanges and hold an Australian Financial Services Licence (AFSL). Public exchanges and a number of other markets are regulated through their AML, while a number of professional exempt markets have been formally exempted from the need to hold an AML and are instead licensed through the conditions of their exemption.

1.2 AML regime

Australia's market licensing regime is set out in Part 7.2 of the Act. Section 791A of the Act requires that a person may only operate a financial market in Australia if they either hold an AML or have been provided an exemption by the Minister.

The meaning of a financial market is provided for in section 767A(1) of the Act.[1] A financial market is defined as a facility through which:

a) offers to acquire or dispose of financial products are regularly made or accepted; or

b) offers or invitations are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in:
   i) the making of offers to acquire or dispose of financial products; or
   ii) the acceptance of such offers.

The process to obtain an AML involves lodging an application to ASIC. ASIC provides its recommendations on the application to Treasury, which in turn provides advice to the Minister. Under Part 7.2 of the Act, the Minister decides whether or not to grant a licence. In making this decision, the Minister has regard to both the advice provided by ASIC and advice provided by Treasury.

AML holders must meet a number of obligations. They must:

- ensure that the market is fair, orderly and transparent;
- monitor participant conduct and compliance with operating rules;
- comply with any licence conditions;

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1 Also see section 767A(2) of the Act which details the conduct that does not constitute operating a 'financial market'.

- have adequate conflicts management arrangements in place, including arrangements for:
  - i) handling conflicts between the commercial interests of the licensee and the proper functioning of the market; and
  - ii) monitoring and enforcing compliance with the market's operating rules;
- have sufficient resources (including financial, technological and human resources) to operate the market properly;
- have adequate compensation arrangements in place to cover client losses (such as where there is defalcation or fraudulent misuse of a client's money by a participant), and make information about them publicly available;
- take all reasonable steps to ensure no disqualified individual becomes, or remains involved in the licensee;
- notify ASIC if it becomes aware that they may no longer be able to meet, or have breached, their general obligations to operate fair, orderly and transparent markets, comply with their licence requirements and meet a range of other requirements under s792A;
- provide assistance to ASIC if they receive a reasonable request, including giving ASIC reasonable access to market facilities;
- report on compliance; and
- notify people about clearing and settlement arrangements.

AMLs are required to comply with all of these points; there is no ability for the Minister to dis-apply any aspects.

There are currently 11 domestic AMLs and 6 overseas AMLs. Overseas AMLs are held by market operators who operate a financial market in the country that is their principal place of business, and operate that same market in Australia. The overseas AML is used to avoid regulatory duplication for these market operators, and is only used if the other country has regulatory arrangements relating to investor protection and market integrity that are equivalent to those in force in Australia. If these conditions are not met a domestic licence is required.

1.2.1 Operating rules

Licensed markets are required to have operating rules dealing with the matters prescribed by the Corporations Regulations 2001 (the Regulations).[2] Operating rules deal with the activities or conduct of the market or persons in relation to the market.

- For example, rules may be required dealing with access to the market, ongoing requirements for participants on the market, the way in which disorderly trading conditions are to be dealt with and arbitration arrangements.

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2 Corporations Act 2001 Section 793A

- If there is an inconsistency between the market's operating rules (determined by the market operator) and market integrity rules (determined by ASIC), the market integrity rules prevail to the extent of the inconsistency.

- The operating rules (other than listing rules) of a licensed market have effect as a contract under seal between the licensee and each participant in the market, and between a participant and each other participant in the market.

1.2.2 Powers of the Minister and ASIC

The Minister has a range of powers in relation to AMLs under the Act, including:

- the power to give written directions to a licensee to do specified things, if the Minister considers that the licensee is not complying with its obligations under the Act (section 794A);

- the power to require the licensee to give a special report to ASIC on specified matters (which ASIC must also give to the Minister) (section 794B); and

- the power to impose, vary or revoke conditions on an AML (section 796A) or suspend or cancel an AML (section 797B) on the basis of certain conditions.

ASIC's powers under the Act include:

- the power to assess a licensee's compliance under the Act (section 794C);

- the power to give written directions to a licensee or entity, if ASIC is of the opinion that it is necessary, or in the public interest, to protect people dealing in a financial product or class of financial products (sections 794D and 798J); and

- a range of investigative and information-gathering powers where, for example, it suspects a contravention of the Corporations legislation or a law of the Commonwealth (Part 3 of the *Australian Securities and Investments Commission Act 2001*).

1.3 Exempt markets (typically used for professional markets)

Section 791C of the Act gives the Minister the power to exempt a particular financial market or type of financial market from the operation of Part 7.2, as well as the power to impose conditions on the exemption. Normally, exemptions are only considered where particular key regulatory outcomes such as investor protection or financial system stability are either not relevant or may be achieved without regulation under Part 7.2, or the cost of achieving these outcomes significantly outweighs the benefits of those outcomes. However, over recent years exemptions have been granted in situations where Part 7.2 is clearly not appropriate, but where some level of regulation is necessary. The inflexibility of Part 7.2 is a key factor in these exemptions.

For markets that are used specifically by professional investors, ASIC looks for a range of market characteristics to be met, before recommending that the Minister exempt a market, including whether:

- market users are professional investors (as defined in the Act) who participate in the market on their own behalf or on behalf of other professional investors;

- only financial products that are not usually traded on public markets by retail investors are traded on the market;
- trading on the market is not anonymous; and
- the operator (or its associated entity) does not operate a clearing and settlement facility for the market.

The Minister grants an exemption from having an AML by signing a Notice of Exemption, which usually contains conditions that replicate some of the key obligations of AML holders. The conditions are specially tailored to each case and are published in the exemption notice on ASIC's website.

The key obligations arising under the conditions for AML exempt market operators may include:

- complying with the conditions of the Exemption Notice;
- having adequate arrangements in place for managing its conflicts of interest arising from operating the market;
- reporting to ASIC if it becomes aware that its director or secretary, is the subject of a declaration of contravention in relation to a provision of the Act, has been convicted of an offence under the Act, has been banned or disqualified from providing financial services under Division 8 Part 7.6 of the Act, or a director or secretary has been disqualified from managing corporations under Part 2D.6 of the Act;
- holding an AFSL covering the provision of financial services in this jurisdiction in connection with the operation of the Market;
- reporting to ASIC any disciplinary action it takes against participants in the market;
- reporting to ASIC if it has reason to suspect that a participant has committed, is committing, or is about to commit, a contravention of the Act or a significant contravention of obligations under the market operating rules;
- reporting to ASIC within three months of the end of each financial year;
- providing assistance to ASIC on reasonable request;
- complying with Ministers requests to obtain an audit report; and
- reporting on compliance.

There are currently 17 facilities with exemptions from AMLs operating in Australia. ICAP Brokers Pty Ltd, BGC Brokers LP and Tullet Prebon (Australia) Pty Ltd are examples of professional market operators that have been granted exemptions by the Minister. These platforms offer a range of products and asset classes which may be traded by professional investors, including foreign exchange, debt, interest rates, metals and credit. All of these platforms typically operate alongside traditional voice-broking, with market share ranging from close to zero to around 20 per cent of total trading in a financial product.

1.4 AFSL REGIME

Part 7.6 of the Corporations Act provides a licensing regime for providers of financial services (AFSLs). The obligation to hold an AFSL arises if a person carries on a financial services business, which includes the provision of advice about a financial product, dealing in a financial product, making a market for a financial product, operating a registered scheme, or providing custodial or depository services.

AFSL holders must meet key obligations such as to:

- provide financial services efficiently, fairly, and honestly;
- manage conflicts of interests;
- comply with licence conditions;
- comply, and have their representatives comply, with financial services laws;
- have adequate resources to provide financial services and carry out supervisory arrangements;
- maintain, and have their representatives maintain, competence to provide financial services;
- have a dispute resolution system complying with legislative requirements if the AFSL holder is providing financial services to retail clients; and
- have adequate risk management systems (unless regulated by the Australian Prudential Regulatory Authority).

As most dark pools are a type of market that do not fit easily within the AML regime, they are instead regulated under the AFSL regime. All dark pool operators in Australia are participants in licensed markets, making them subject to the market integrity rules (of that market) and the Competition MIRs.[3]

There are several differences in the regulatory regime for dark pools compared with markets licensed under the AML system, which means that dark pool operators face fewer obligations than operators of lit markets when it comes to the operation of a trading facility.

Examples of important differences in the regulation of a market operator under the AML regime and a market participant operating a trading facility subject to the AFSL and MIRs are:

- AML holders are not just required to deliver their own services adequately but must also ensure that users of their service do so as well. For example, AMLs must monitor users' compliance with their operating rules, and are obliged to report to ASIC a suspicion that a user has or is about to breach those rules or rules within the Act. AML holders must also tell ASIC if they become aware of circumstances that may affect the ability of a participant to meet its AFSL obligations. By contrast, the AFSL obligations are targeted at

3 ASIC has to date, asked all crossing system operators to be participants of a licensed market.

self-reporting, with the MIRs extending that focus, but only by requiring participants to take into account the circumstances of their own clients' orders.

- AML holders are required to operate in a transparent manner. For example, they must be transparent about how their market operates and how it assures its users' dealings are transparent. AFSL holders do not have an explicit obligation to be transparent about their operations, and, indeed, there is very little information in the public domain about how many trading facilities operate and how other users of a particular facility interact with it.

Where a market operator does not operate under an AML, they are also not subject to the wider range of directions powers available to ASIC and the Minister under Part 7.2 of the Act. This arguably results in sub-optimal regulatory supervision.

It is important to note that all discussion in this paper around extending licensing regimes to AFSL licence holders applies only to those that are also market operators. No changes to the current regime for AFSL licence holders who are not operators of markets are under consideration.

Table 1 details some key differences in obligations for AML holders and AFSL holders who operate markets (this is not intended to be an exhaustive list).

Table 1: Comparison of obligations under AML and AFSL regimes

Requirement	AML	AFSL
Rules requiring fair, orderly and transparent/fair, honest and efficient dealings	Yes	Yes[4]
Adequate arrangements to deal with conflicts of interest	Yes	Yes
Arrangements to properly monitor or enforce compliance	Yes	Yes
Adequate or sufficient resources (financial, technological, human resources)	Yes	Yes
Approved compensation arrangements where required	Yes	Yes
Must take reasonable steps to ensure unacceptable control situation does not exist	Yes	No
Must take reasonable steps to ensure no disqualified individual becomes involved in the licensee	Yes	No
Maintain competence to provide financial services	No	Yes
Must make operating rules dealing with prescribed matters	Yes	No
Requirements for dealing with disorderly trading or disruptions	Yes	No
Requirements to notify ASIC of compliance issues on market (breaches, contraventions, disciplinary actions)	Yes	No
Requirements to notify ASIC of any self-breaches/compliance issues	Yes	Yes

4 The fair, orderly and honest requirements under an AFSL are lower than what is required of AML licence holders.

Requirement	AML	AFSL
Provide ASIC with annual report on compliance, or audit report if requested	Yes	No
Give ASIC assistance or reasonable access in relation to the performance of ASIC's functions or compliance checks.	Yes	Yes

1.5 Market Integrity Rules (MIRs)

The *Corporations Amendment (Financial Market Supervision) Act 2010* established a new rule-making regime in Part 7.2A of the *Corporations Act*. This allows ASIC to make MIRs which apply to market operators and participants, other prescribed entities and financial products traded on a licensed market. Penalties are attached to each MIR. ASIC is responsible for supervising compliance with these rules, and is also responsible for granting waivers from the obligation to comply with provisions of the MIRs. MIRs are delegated legislative instruments, that is secondary legislation. ASIC requires Ministerial consent before making any rules and any rules are subject to parliamentary disallowance.

The MIRs operate in conjunction with each market's operating and listing rules, but prevail over the operating rules to the extent of any inconsistency.

There are currently two types of MIRs:

- Market-specific MIRs — ASIC has made MIRs for licensed markets whose trading activities it supervises.[5] These establish rules for the activities or conduct of the market in question, persons in relation to the market and persons in relation to financial products traded on the market.

- Competition MIRs — ASIC released the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011 ('Competition MIRs') on 29 April 2011. These MIRs are for markets dealing in equity market products admitted to quotation on the ASX market. At present the only two such markets are ASX and Chi-X. Some elements of these rules apply to market operators and other elements apply to market participants.

Because all current dark pool operators are licensed as market participants on the public exchanges, any activity occurring on a dark pool may be captured by the MIRs where it relates to a lit exchange or to financial products traded on the exchange (even if the activity takes place in the dark).

5 MIRs for the ASX, ASX 24, APX, IMB, NSXA and SIM VSE markets were released on 1 August 2010. MIRs for the Chi-X market and for competition in exchange markets were released on 29 April 2011.

2. Problem Identification

2.1 Overview

The AML regime was built around a public exchange model, with provisions heavily geared around the requirements of the ASX. At the time of drafting the Act, such financial market and product innovations that have been seen over the past decade were not anticipated. As a result, over time the licensing regime has had little ability to address changing regulatory needs. This has led to an uneven and patchwork regulatory regime as the legislative framework is stretched to accommodate market developments.

The obligations imposed under Part 7.2 are directed at regulating a large lit public exchange, such as Australian Securities Exchange (ASX). This regime provides limited flexibility to apply different obligations to different types of 'markets' such as markets for professional investors and crossing systems. This differs from the approach of other major jurisdictions such as the US, Canada, Europe and Japan, where there is a regime for alternative markets (see Attachment A).

Under Part 7.2 of the Act, the Minister decides whether or not to grant a licence. The Minister has no discretion to 'part-apply' the legislative obligations. Currently, the obligations that apply to the holder of a market licence do not easily accommodate the (often global) operating models of various types of 'alternative markets'.

The lack of scope to partially apply these obligations often means that these alternative markets must be regulated in a different way, if they are permitted to operate at all. There are currently 17 entities operating numerous trading platforms that are exempted from the market licence regime and 15 that operate crossing systems that are subject only to AFSL and MIR obligations.

In the absence of legislative change, only traditional exchanges will continue to fit neatly within Australia's market licensing regime. This presents a case to review Australia's licensing regime to ensure that it can apply to all market types in Australia and be flexible enough to easily adapt to future developments.

2.2 Alternative Markets (other than dark pools)

As outlined in Section 1.3, under Part 7.2 of the Act, the Minister may exempt facilities from the application of the market licensing provisions. Alternative markets (other than crossing systems) have typically been granted exemptions subject to conditions.

Exempting these markets raises a number of issues.

- The exemption power in the Act was not designed with the systematic regulation of alternative markets in mind. Regulation through exemptions may be suitable for a select few cases, but not for widespread use as is now the case.

- There is a cost to investor protection in exempting markets from the regulatory regime. Where a market is exempt from holding an AML, there is reduced regulatory oversight and investors may suffer as a result. However, the scope for investor harm is one of the factors considered when granting a licence exemption.

- Australia's financial market regulatory licensing arrangements are out of step with the international approach. As a result, it is possible that other regulators will not consider exemptions of Australian markets to be suitably equivalent to formal market licensing obligations in those overseas jurisdictions.

- Exemptions create the perception of an uneven playing field. For example, there are a number of market operators dealing with professional investors in OTC products that are regulated in different ways. This difference in approach is largely due to whether a licence was sought before or after ASIC developed its policy on exempting professional markets.

- The exemption applies to individual markets rather than the operator of the market, which in practice has resulted in different categories of product requiring new exemptions or variations to existing exemptions.

Changes to the AML regime may allow operators of all market types to comply with a single licensing regime in some form, rather than the current patchwork of licensing arrangements. This would be an appropriate step towards refining the regulatory oversight of markets.

2.3 Dark Pools

Dark pools originated as 'upstairs markets' which were used by traders looking to execute very large orders away from the public exchange. This approach was adopted as these large block trades could have a market impact in terms of price, and the darkened approach generally saw the traders receiving a better price. Because of this very large trade focus, the original upstairs market was for the most part used by institutional investors.

Trading in dark pools enables investors to manage the market impact of large trades, may provide a better price or lower fees than the lit market, and provides competition in the trading of securities. These benefits have seen dark pools evolve in recent years to act as markets where technologies automatically match non-broker orders outside an exchange. Increasingly they have moved away from operating solely as a platform for large trades, with dark pools now also facilitating trading for retail investors.

While these are important benefits for traders, there are some concerns around the growth in the number and use of dark pools instead of public exchanges. In particular:

- investors do not receive the same level of protection in dark pools, as the of an explicit requirement for operators to monitor trading means there is greater scope for investors to suffer harm; and

- when a large share of trading activity moves into the dark it may impact upon the integrity of the lit market. The loss of liquidity on lit markets has an impact upon the price discovery function of the market, with prices not as reliably reflecting the underlying value of the stock and potentially wider bid/offer spreads.

ASIC drafted new MIRs to protect the interests of market participants, investors and financial consumers, which have been approved by the Minister and are to be made in November 2012. In particular, meaningful price improvement (with an exception for block trades above certain

thresholds)[6] rules would mean that traders must receive a more favourable price outcome from dark execution than would have been received on a lit market at that time.

Dark pools operating in Australia are financial markets that do not fit easily within the existing market licensing regime. As a result, the practice has been to regulate them completely outside the market licensing framework (that is not licensed as a market or granted an exemption from market licensing) and instead to regulate them under the AFSL regime and more recently also to make them subject to MIRs. While this approach may have been adequate thus far, it is not appropriate over the longer term given the proliferation of dark pools in our market, the possibility that non-participant crossing systems emerge (that is that are not subject to the MIRs) and competitive neutrality concerns arise.[7]

This competitive neutrality issue is important because these dark pools are evolving and adopting more 'exchange market-like' characteristics, such as order types, automated matching technologies and increasingly multi-lateral nature.

The lower regulatory standard arguably provides operators of dark pools with a competitive advantage over the lit market. Importantly, the current licensing arrangements mean that operators are not subject to cost recovery as part of ASIC's market surveillance activities. These lower costs can then be passed on to customers, giving operators the opportunity to undercut public exchanges.

ASIC also has fewer regulatory powers in relation to dark pools than to licensed markets. This means that enforcement of those rules that do apply to dark pools is less effective than for licensed markets. The lower credible threat of regulatory action may increase the scope for improper behaviour by traders.

2.4 Comparison with other jurisdictions

Some international jurisdictions have already acted to incorporate dark pools and other alternative markets into their licensing regime. There is no consistent international approach that could be followed, although alternative markets are broadly regulated as distinct from regulated exchanges.

In the US, dark pools and other off-exchange markets are licensed as alternative trading systems (ATS) covered by the Regulation ATS, introduced in 1998. At the simplest level, alternative trading systems with a small market share (less than five per cent of all securities traded) face three core rules:

- File a notice of operation and quarterly reports with the Securities and Exchange Commission.
- Maintain records including an audit trail of transactions.
- Refrain from using the words 'exchange', 'stock market' and the like in their title.

Once the five per cent market share in any security is reached, the ATS must comply with additional requirements. Further obligations again apply if the ATS accounts for more than twenty per cent of

6 There are to be three tiered thresholds: $200,000, $500,000, and $1 million. The tier to be applied to each stock will be based upon liquidity of that stock in the lit market.

7 ASIC has to date asked all dark pool operators to be participants of a licensed market.

trade in any one security on their market. These tiers of obligations aligned with market share increases mean that larger ATSs move closer to the environment faced by regulatory markets as they grow in importance as a competitor.

In Europe the Markets in Financial Instruments Directive (MiFID) provided for regulated markets (public exchanges) and multilateral trading facilities (MTFs), which are multilateral systems operated by an investment firm or market operator that bring together multiple third party buying and selling financial instruments, bound by non-discretionary rules. However, this definition left a number of trading systems that behave like markets outside the regulations, including dark pools and discretionary OTC trading venues such as screen-assisted voice brokers.

Regulation of these types of market platforms is set to be introduced through MiFID II, with the development of organised trading facilities (OTFs). The definition of an OTF is similar to that of an MTF, with the key difference being that the OTF does not require non-discretionary market rules (that is, operators will have some discretionary power in how trades are executed on the OTF). MiFID II was passed in late September 2012.Its date of enforcement is unclear but is expected to be within two to three years.

In addition to the lack of non-discretionary rules, OTFs will face a lower regulatory standard than regulated markets and MTFs in a number of respects.

- OTFs have pre-trade transparency waivers and are not required to give all investment firms market access.
- The market operator may be an investment firm.
- OTFs are not a primary market so there is no requirement for a product disclosure statement before offers of a security can be made on the market.[8]

In addition to these exemptions for OTFs, regulated markets face a generally stricter standard of rules and requirements in relation to authorisation, organisational and capital requirements, rules on access to markets, and the suspension of trade.

One key lesson from alternative market models in overseas jurisdictions is that one size usually does not fit all. For example, in the US, there are multiple forms of alternative markets including alternative trading systems, electronic communication networks, exempt commercial markets and exempt boards of trade. In Europe, while the intention was for one alternative market known as a multilateral trading facility, the European Commission is consulting on another category (organised trading facility) and there are separate requirements for systematic internalisers (trades where the broker forms the counterparty).

The introduction of a market licensing regime that provides for some level of market licence for dark pools, venues for OTC transactions and other currently unlicensed market types would bring regulation in Australia into closer alignment with its international counterparts. Further detail on international regulatory arrangements can be found in **Attachment A**.

2.5 G20 OBLIGATIONS

A market operator licensing regime with minimal exemptions is also likely to assist Australia in meeting its G20 commitments regarding the regulation of OTC derivatives. One of the objectives being pursued as part of this is mutual recognition of Australia's financial regulation by other jurisdictions, such as the US. The US, Europe and others have a market licensing regime with multiple licence categories and only minimal exemptions. This puts the Australian regime out of step with the global norm.

The Government noted the importance of maximising the prospects of Australia implementing a regime that is consistent with major financial centres.[9] This is on account of the need for a consistency across national regimes, and the need for Australian entities to comply with the regulatory regimes of other countries in order to deal with organisations from that country.

A regime that provides stronger regulatory coverage of alternative markets is likely to see improved recognition of the Australian regime for purposes including equivalence assessments and substituted compliance under overseas regulatory regimes. It is likely to be important for showing substituted compliance with the US regime, potentially avoiding the need for relevant Australian trading venues or market participants to comply with overlapping regulatory obligations in order to deal with US businesses.

Your feedback

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?

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9 http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/Over%20the%20counter%20derivatives%20commitments%20consultation%20paper/Key%20Documents/PDF/OTC%20Framework%20Implementation_pdf.ashx.

Part B — Reform Options

3. Overview of reform options

This paper presents two options for amendment of current market licensing and regulatory arrangements in Australia.

The first option is to allow for greater flexibility in the regime and provision for alternative arrangements where appropriate. In short, this would mean that certain aspects of the AML regime could be 'switched off' where appropriate, so that a broader range of market types could be regulated under the AML regime.

The second option is to construct an alternative regime within the legislation. This would involve multiple licence categories, and would be more closely aligned with the approach that has been adopted internationally.

3.1 Option 1 — Flexibility in the Act

This option would create flexibility for Part 7.2 and Part 7.2A to be partially applied to market licenses through giving the Minister discretion when granting a market licence. Those markets where the full AML requirements are not considered relevant could have some provisions under the Act turned off creating flexibility to deal with different market types.

This could be undertaken in one of two ways:

- by specifying the number of market licence 'categories' in the regulations. The regulations would also specify which elements of the regime would not by default apply to each category. The Minister could choose between the categories when granting a licence; or

- providing the Minister with a broad discretion to turn off specified elements of the regime in relation to a given facility, taking account of the structure of the market and other matters in s798A that the Minister must consider when deciding to grant a licence. Guidance on the approach to turning off elements of the regime (for example the classes of facilities and the elements that would be turned off for each) would be provided to stakeholders. For example, ASIC would publish its approach to providing advice to the Minister on granting a making licence, and would clearly articulate the different obligations that it would advise the Minister should apply, to different categories of markets.

Under both options discretion to only partially apply Part 7.2 and/or Part 7.2A would be made by market category rather than on a facility-by-facility basis. This approach would provide regulatory consistency across similar markets while tailoring the regime to different classes of markets. Scope would remain for a bespoke approach to be adopted for any applicants who do not fit under any of the licence categories.

Where a provision in the Act was turned off in relation to a particular category of licensee, there may be a need to impose alternative requirements to deal appropriately with features of that category of market. Under this option the Act would provide for ASIC-made rules to augment the provisions of Part 7.2 and Part 7.2A in relation to each market category. This could be approached through the making of MIRs, as well as through ASIC guidance notes. One question for consideration would be whether ASIC should have power to make MIRs only in relation to those provisions that are turned off, or whether they should have authority to create MIRs more broadly (only where these remain consistent with the provisions of Part 7.2).

It is expected that if ASIC were given a rule making power, ASIC would require Ministerial consent before making any rules as is the case with the MIRs, and in keeping with this any rules would be subject to parliamentary disallowance.

Under the reforms, the Minister would maintain the power to grant an applicant an AML if satisfied of the relevant conditions and matters.[10] Similarly ASIC would continue to make recommendations to the Minister about whether a licence should be granted and if so, which obligations should apply.

If this approach were adopted, ASIC would consult on the relevant MIRs, if any are required, and guidance notes before any rules or guidance was made.

3.1.1 Option 1a — licence categories

Under this option the Minister would have authority for establishing which market category should be applied to each licence application.

It is expected that under this model, any reforms would still provide the Minister will the ability to consider a novel application outside of these market classes as required.

These categories and which provisions of Part 7.2 and Part 7.2A are by default turned off for each category would then be established in regulations. Approaching this through regulation would arguably provide a higher degree of certainty to applicants and licence holders (than Option 1b below).

As categories are set by regulation, a role is maintained for Parliament through the regulation disallowance process.

While consideration of the categories is preliminary, current market conditions point to three distinct market categories.

- Lit retail public exchanges (example ASX, Chi-X) would face similar obligations to those currently under the AML regime. There may be scope for other existing AML holders to have their regulatory burden eased where it is deemed appropriate.
- Professional markets, which are those currently regulated as exempt markets, form a natural second category.
- Dark pools would likely be regulated as a third category.

10 Section 795B Corporations Act 2001.

3.1.2 Option 1b — ASIC guidance

Under this option, guidance (probably by ASIC in the form of a statement of its approach to advising the Minister) would be provided to the market, indicating which provisions should be turned off for the types of market categories. The categories would be settled as per Option 1a. ASIC would advise the Minister which category it considers appropriate for an applicant or, in exceptional circumstances where there is not a suitable category, advise on a bespoke approach.

This approach would likely provide a greater deal of flexibility than Option 1a, to adapt arrangements as product innovation occurs and new markets emerge. This is because on one view, ASIC guidance can react more swiftly and responsively to changes in market structure, than may be the case if new regulations are required to accommodate a new market type. However, the greater level of licence-by-licence discretion may create scope for inconsistent provisions between like markets, although in reality it is likely that ASIC would build detailed category-by-category guidance that should be used across the board. If well-designed, the flexibility would be used primarily to create additional licence categories as the market develops, rather than on an individual licence basis. It is also unclear whether the threshold for changing arrangements may be too low if done through guidance.

3.1.3 Professional markets

The number of markets exempted from the AML regime could be minimised. These types of markets could fall within the AML regime with the appropriate obligations or conditions 'switched off'.

The decision on whether to issue a domestic or overseas AML would be made in the same way is it is under the current AML regime. This would mean that only those operators domiciled overseas, who operate an equivalent market in their country of principal business (if it is a country with equivalent regulation) would be considered for an overseas AML. All other professional markets would be covered by domestic licenses.

Arrangements to licence professional markets may see the operators of these markets continue to monitor trading on their own markets rather than ASIC performing this function.

3.1.4 Dark pools

Dark pool operators could be licensed under the AML regime rather than using the AFSL regime and MIRs for participants. However, only the relevant obligations under the AML regime would need to be imposed on this type of facility. For example, operators could potentially obtain an AML without the need to have approved compensation arrangements in place under Division 3 of Part 7.5 (where the licensee would otherwise have been required to).

Arrangements to licence dark pools may see the operators of these markets continue to monitor trading on their own markets, rather than ASIC taking over the supervisory load. If this approach were adopted ASIC would continue to expect these markets to report to the reporting facility of a lit retail public exchange (example ASX or Chi-X) and ASIC would perform monitoring based on the real-time post-trade reports it receives about trading on these markets. This would preserve the existing ASIC market surveillance arrangements.

If this approach were adopted ASIC would consider additional MIRs relating to dark pools. Some of the broad themes that would be considered for inclusion in these would be transparency of operations, disclosure to users about their operations and trade outcomes, and more explicitly

obligations about monitoring of trading activity on the dark pool. These matters are all currently provided for under the AML regime.

3.2 Option 2 — Construct an alternative regime within legislation

This option involves constructing one or more alternative regimes within legislation, akin to the approach adopted in the US, Canada and Europe. There would be a single set of high level obligations that would apply to professional markets, crossing systems and any other forms of markets. Beyond these basic provisions, additional obligations would be applied in a tiered fashion to different licence classes. This option would amend Part 7.2 of the Act to incorporate multiple licence classes and the obligations applying to each.

Enshrining an alternative regime or regimes in the legislation would provide clarity and certainty to the market, although if Option 1 were adopted guidance notes and rules would be used to provide clarity. However, it could also limit the regime's flexibility to deal with the rapidly changing nature of markets, as has been seen with the need to amend the MiFID regime in Europe to include additional licence categories within a decade of commencement (see Attachment A). The response to changing markets may be more manageable if the licence classes were defined in regulation rather than the Act, making the addition of new classes a simpler matter. This option would also require considerably more work before introducing the regime into the Act.

In particular, this option would:

- amend Part 7.2 of the Act to introduce one or more alternative market categories;
- allow the Minister to retain the power to grant an applicant a licence. ASIC, as is currently the practice, would make recommendations to the Minister about whether a licence should be granted and if so, whether any license conditions should apply;
- require ASIC to release guidance to articulate the circumstances in which it would recommend the Minister grant a licence to an alternative market; and
- make the market operator responsible for monitoring trading in real-time on its market, rather than ASIC. ASIC would monitor post-trade information reported through other AMLs.

It is not immediately clear how many licence classes there may be, although as with Option 1 a possible natural categorisation may be three initial classes, one of lit public exchanges, a second of exempt professional markets and dark pools in a third separate grouping.

Your feedback

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.

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?

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.

4. ADVANTAGES OF REFORM

Either option would help to facilitate mutual recognition of Australia's financial regulation by other jurisdictions such as the US and the EU.

- This is in part due the fact that both options would substantially lower the number of exemptions to market licensing.
- Licensing reform would establish a regime of licensed markets for products such as swaps,[11] which is likely to be important in ensuring that Australia is better positioned to meet its G-20 commitments to have OTC derivatives traded on exchanges or electronic platforms.
- If Option 1 were adopted, some of the difficulties that other jurisdictions, such as the European Union and the United States, have had in administering their more prescriptive tiered market licensing frameworks would be avoided. While the prescribed tiered approaches have worked well in providing an alternative regime to exchange-type regulation, the prescriptive nature of the alternative regimes means that they have also encountered concerns of inflexibility when seeking to accommodate the rapidly changing market place.
  - However, the flexible approach would mean that the Australian regime was distinctly different from what has been adopted in comparable countries. This is a key benefit of Option 2. As detailed above, it may be possible to learn from the international experience and build an alternative licensing regime that provided greater adaptability.

Providing licensing arrangements for alternative markets could remove key distortions in the development market for trading facilities. This would occur irrespective of the option adopted.

Either option would also create efficiencies as separate approvals would not be required for each product, as is often the case with the existing exemptions arrangements. The expected reduction in the number of exemptions issued would streamline the process for applicants and for ASIC.

Licensing dark pool operators within the market licence regime — through either option — may also have the effect of facilitating more equitable cost recovery. Dark pools are currently not directly subject to cost recovery for ASIC's market surveillance activities, until the point at which crossing system participants report a trade on ASX or Chi-X. This has raised concerns that the cost recovery regime may have the effect of driving activity off the lit market and onto crossing systems in order to minimise the imposition of cost recovery fees.

If dark pools were licensed this concern may be addressed by making activity on dark markets subject to cost recovery similarly to activity on lit markets. The Government would consult separately on any possible changes to the current cost recovery regime.

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11 Because of the inflexible AML framework, most platforms of this type in Australia currently operate under an 'exemption' from the regulations imposed by the AML framework.

The primary advantage of Option 1 over Option 2 is that a broader range of trading platform and market operators would be able to be more effectively regulated, in a tailored manner.

- Only relevant parts of the licensing rules would be applied to market operators or categories of operators, avoiding unnecessary regulation.
  - This may include reducing or modifying the regulatory burden on some operators that are currently subject to full AML obligations, although likely not for full public exchanges.
- The arrangements could impose greater regulatory and market integrity obligations on operators of crossing systems where necessary.
- This would also provide for greater ability to cater for new developments as financial markets evolve.

Your feedback

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

5. POTENTIAL DRAWBACKS

Either option may give rise to concerns about the prospect of increased regulation, particularly among those who operate currently unlicensed markets (such as in the case of crossing systems or currently exempted markets).

- However, neither option would seek to increase the level of regulation unnecessarily. Under each option the aim would be to impose regulatory obligations that are appropriate to the entity and remove those that are irrelevant or unnecessary.
- For some market-types, this may mean an increase in obligations in order to provide more effective regulation and greater transparency.

The primary drawback of Option 1 is the risk that legislative flexibility may create regulatory uncertainty. Granting ASIC the power to amend compliance levels for each licence holder as it sees fit (within the bounds of Ministerial approval) has the potential to result in a high administrative burden to remain compliant.

- However, this risk of regulatory uncertainty could be mitigated through the use of MIRs and guidance providing industry with detail of what compliance levels can be expected for different market categories.
- If future changes to the regime were required, ASIC would undertake further consultation with industry on the obligations that should apply before drafting and releasing proposed MIRs and guidance.

The lower level of uncertainty associated with Option 2 is its key advantage compared with Option 1, although this occurs at the cost of flexibility to address future market evolution. However, either option, if adopted, would be designed with a careful balance between regime flexibility and market certainty.

A key drawback of Option 2 compared with Option 1 is the lead time that would be involved in developing the new regime. It may take around twelve months longer to implement Option 2, which is undesirable for some of the objectives of this process, including international recognition of the Australian regime.

Any change to the licensing regime may lead to additional regulatory work for ASIC. However, this additional regulatory work may be partially mitigated by improved efficiencies from streamlining the licensing arrangements and improvements in the ability of the licensing regime to cope with new products and markets.

Your feedback

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.

6. Impacts of options

6.1 Impacts on industry

6.1.1 Transition

Any changes would create the potential for new or different obligations to apply to some market operators, compared to the obligations they have now. If changes are made to the licensing regime then consultation will be undertaken on the need for grandfathering and transitional arrangements and what these arrangements should be.

Change to the regulatory arrangements would involve some conversion costs for currently unlicensed markets to become compliant with Part 7.2 of the Act as required as well as other relevant regulations or rules. IT infrastructure upgrades are an example of the sort of expense that may be involved.

6.1.2 Ongoing compliance

There may be a higher ongoing compliance burden for professional markets and dark pools, requiring additional staff resourcing or further IT infrastructure expense. Given that there is already a level of reporting from these operators to ASIC, any additional cost is unlikely to be significant.

6.1.3 Fees for new market licenses

The fee for an AML and an exemption from an AML is the same — currently $1,448.[12] This would mean that exempt markets would not face a change in market licence fees compared to what they have paid historically. However, there is currently no fee for dark pools, meaning that any moves to licence dark pools would lead to a new fee.

6.2 Impacts on ASIC

ASIC does not expect its processes to alter materially for professional markets, regardless of the approach adopted. It does not currently monitor these markets in real-time and this is not expected to change. However, there has been rapid growth in the number of professional markets over the past few years and this growth is expected to continue.

ASIC has not previously undertaken any licensing activity relating to dark pools, and any moves to licence these would create additional work. There are currently 15 dark pool operators in Australia, with recent rapid growth in numbers. Market innovation in dark pool product offerings is ongoing, which ASIC would need to keep abreast of. However, the additional workload associated with any change would be at least partially offset by efficiencies from a streamlined approach to licensing.

12 http://www.asic.gov.au/asic/asic.nsf/byheadline/Schedules+of+corporations+fees?openDocument.

Part C — Regulating automated trading

7. High frequency trading

7.1 Overview

Automated trading, where computers trade in accordance with rules around prices and other data has been used in Australia for much of the last two decades, as an improvement to market efficiency compared with manual trading.

In recent years, a new form of automated trading has evolved in the form of high frequency trading (HFT), which is very rapid trading in and out of positions in stocks and futures to earn small but consistent profits. Such traders execute many small trades over the course of a trading day, holding these for just seconds in order to profit, and generally ending the trading day with a zero net position. The trading is based upon human-designed trading instructions, using pre-programmed trigger points in prices and interpreting market data faster than humans are able to do manually. While HFTs are able to reach the market first in these situations, they are not infallible, losing money if the market does not move in the direction that the algorithm would indicate.

Initially these HFTs were operated by market participants. However, there are an increasing number of HFTs in Australia that are operated by non-market participants, who receive direct electronic access through a market participant. These HFTs are typically smaller and may not be domiciled in Australia.

As the number of HFTs operating in Australia has grown, so too has the market share. The share of HFT on a day-to-day basis on Australian lit markets has increased to 25-30 per cent, with some individual days showing a spike in share above this. This remains well below the rate seen in the US, where HFT accounts for more than half of lit market trading activity, but is substantially higher than the five to 10 per cent seen in Asian markets where a strict regulatory regime and exchange market monopolies create an undesirable environment for HFT.

HFT provides some important benefits to the market. In particular, HFT provides the market with liquidity, with so-called HFT 'market makers' offering constant buy and offer prices on each stock, increasing the opportunity for would-be traders to find a counterparty. This market making activity and regular trading also narrows buy-offer spreads. In stocks (rather than futures) HFTs also help to foster competition through the transmission of pricing information across exchanges, and through acting as a market maker for new markets.

However, there are some risks with HFT that must be managed. In particular, HFTs arguably increase the risk of market volatility. This may occur as an HFT causing volatility, particularly through erroneous trading as was seen by Knight Capital in the US in August 2012, although it has been argued in the academic literature that the case for HFTs causing volatility is overstated, and that the liquidity HFT brings to the market in fact reduces market volatility.[13]

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13 See for example Brogaard (2011), Avramovic (2012).

Concern around HFT and market volatility may be greater in the potential for exacerbating existing volatility, in a so-called 'domino effect'. That is, as the price rises or falls, the pre-programmed orders from HFTs may exacerbate the rise or fall. This is commonly cited in discussion around the 'Flash Crash' of May 2010, although the literature examining the role of HFT in this case notes that, while HFT may have exacerbated the problem, the trading volumes involved mean it could neither have caused nor prevented the crash.[14]

There is also a potentially increased scope for market manipulation from HFT activity. A range of manipulative activities may be utilised by HFTs, including quote stuffing, where an HFT issues many orders or messages in order to slow other rival systems, or spoofing, where the HFT issues many orders on one side of the book to cause a price change, followed by one on the other side of the book which is executed. However, while it is clear that the potential for market manipulation by HFTs exists, it is less clear that any such activity is being conducted on Australian markets.

7.2 Regulatory response to HFT

There are currently two types of MIRs that market participants are subject to — market specific MIRs and competition MIRs. The ASX and Chi-X specific MIRs include requirements relating to management of automated trading, which require market participants to comply with rules relating to market manipulation, and broad automated trading requirements for filters, security arrangements to prevent unauthorised access to the system, and compliance with any instruction from ASIC to cease trading.

In response to common concerns around HFT activity, in particular the impact on market volatility, ASIC has developed additional MIRs relating to HFT activity, which will apply to HFT on ASX and Chi-X as well as eventually on the ASX24 futures market. These rules were agreed to by the Minister on 5 November 2012 and will be formally made by ASIC in November. These rules introduce mandatory testing for systems before they are implemented and a kill switch capability which will immediately suspend systems as required. The rules are to come into force over the next 18 months.

ASIC has also established an HFT Taskforce which is closely monitoring HFT activity on the market and considering the benefit or harm to the market of this, and what (if any) additional regulatory response is appropriate. This taskforce is expected to report in early 2013.

14 Kirilenko, Kyle, Samadi, & Tuzan, 2011, February.

8. Reform issues

8.1 Identification of the problem

Non-market participant HFTs are not required to hold an AFSL, with the AFSL held by the market participant providing access. Consequently the HFT itself is not subject to the MIRs, with the rules applying to them dictated by their agreement with the relevant market participant.[15] This leads to a regulatory liability issue, as any penalties for breaches of the MIRs by the HFT would fall upon the market participant in the first instance. This occurs in spite of the fact that the market participant acts as a 'gatekeeper', and while some penalties could rightfully be imposed upon that gatekeeper others would relate to activity over which they have no control. Penalties relating to failure to control the algorithm or conducting market manipulation would more rightly sit with the HFT operator as they had the ability to prevent the breach.

While the market participant may pass these penalties on to the HFT client, some of these non-market participant HFTs are based internationally, potentially making pursuit of compensation from the client overly expensive or difficult for the market participant.

There is an argument that changes to the regulatory framework should be made so that the HF traders themselves bear the regulatory burden directly, and provide some improved protection to market participants that are providing market access for HF traders. This would improve the effectiveness of MIRs relating to HFT activity, and would more fairly share the compliance load.

8.2 Reform option

One option for more effective regulation would be to make HF traders directly subject to the MIRs that apply to automated trading activity (including those proposed by ASIC but not yet in force). Direct imposition of the rules would likely improve compliance by and risk management within non-market participant HF traders. It would also ensure that ASIC's enforcement activities are directed toward parties directly responsible for disruptive or manipulative trading.

This option would involve an amendment to section 798H of the Corporations Act, or the making of a regulation under that section, to require HF traders that access an Australian market to comply with the MIRs regardless of whether they are direct market participants.

There are likely to be challenges with this approach. For example, some non-market participant HF traders are not domiciled in Australia, so there are likely to be issues relating to jurisdictional reach in enforcing MIRs on these HF traders.

A further challenge would be to develop an appropriate definition of who is and is not an HF trader and as such would become subject to the MIRs. There is not a well-established definition of what constitutes an HF trader compared with a trader that simply uses automated order processing. The international experience provides some guidance.

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15 The exception to this is the market manipulation provisions in the Act, which apply to anybody dealing in the Australian market.

- BaFIN in Germany considers HF traders to be any entity that engages in the purchase or sale of financial instruments by using computers, which are able to recognize changes in the market price in a split second, make autonomous market decisions following predefined rules and choose and transfer the adequate order-parameters, even when not offered as a service for others.

- In the US, the Commodity Futures Trading Commission considers HFT to be a form of automated trading that uses algorithms for decision-making, order initiation, generation, routing or execution, for each individual transaction without human direction. HFTs further use low-latency technology to minimise their response times, and have high message rates (for orders, quotes or cancellations).

Your feedback

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?

PART D — MISCELLANEOUS PROVISIONS

9. EXEMPT MARKETS

The Minister is currently able to grant exemptions to particular markets or clearing and settlement facilities from the requirements of the Corporations Act under section 791C(1) or section 820C(1). In general, this means granting an exemption from the requirement to hold a licence. Under the current regime, this is done at the market or facility level, meaning an operator of multiple exempt facilities would have multiple exemptions, often with different conditions on each. This can increase the regulatory workload for operators seeking to run multiple markets.

One means of addressing this would be for exemptions to be provided on an operator rather than market or facility basis. An operator would only apply for an exemption once, with this covering all of their markets or facilities. Conditions for all markets or facilities with the same operator would be consistent, except where there was some compelling reason for a difference.

If adopted, this amendment would require all existing exemption documentations to be re-written so that exemptions are granted to the entities rather than the operations. However, this should involve minimal costs to the exempt entities, as ASIC would be responsible for preparing new exemption documentation.

If more substantive changes discussed in Part B of this paper were to proceed then this provision would have little to no impact as most of the types of markets that currently hold exemptions would instead move to some form of licence for alternative markets.

Your feedback

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

10. ANNUAL REGULATORY REPORTS

ASIC is currently required to provide the Minister with a copy of the annual regulatory report submitted by each market licensee under section 792F(5) of the Act. This includes reports where ASIC is satisfied with the findings and the annual regulatory report is submitted on time and in accordance with requirements.

ASIC has requested that arrangements be changed so that, while they will continue to review these submitted reports, they would only send a copy of the report to the Minister where there are reservations with the report. These instances would be determined on a risk-based assessment. The Minister and Treasury would continue to be notified that the annual regulatory report has been completed in all cases.

This amendment would not affect market operators or participants.

Your feedback

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

11. LICENCE FEES

The application fee for an AML or an exemption from an AML is currently $1,448. This fee is very small in the context of operating a market in Australia, and does not reflect the level of work on the part of ASIC involved in considering a licence application. There are no ongoing fees in relation to keeping a market licence in Australia.

Licence fees in Australia are very low by international standards. In the UK, the FSA considers an application for an MTF licence to be a complex case, with an associated fee of £25,000[16] that is intended to reflect the cost incurred by the FSA in considering the application. Ongoing fees associated with the licence vary by licence holder, but typically start at £5,000 for smaller MTFs for the 2012-13 UK financial year.[17]

Likewise in Canada the fee for attaining an ATS licence starts at $CA25,000, with the final rate charged based upon the actual hours of time spent considering the matter by the regulator.[18] There are additional fees on top of this in IT system training and other matters. Ongoing fees of $CA5,000 per annum also apply.[19]

This raises the question as to whether Australian licence fees should be reviewed and amended in order to better reflect the cost of granting a financial market licence. If such a move were to occur, it is not clear what the fee for a market licence would be, although it could be expected to increase.

Your feedback

20. Do you consider the fee for a market licence in Australia needs revision? If so, please provide comments.

21. Do you see cost recovery as an appropriate approach to levying licence fees? Please provide details.

22. Would a change in the fee level have any impact on the decision whether to operate a market in Australia? Does the current rate influence this decision?

16 http://www.fsa.gov.uk/pubs/hb-releases/rel114/Rel114_FEES.pdf.
17 http://fsahandbook.info/FSA/html/handbook/FEES/4/Annex10.
18 http://www.iiroc.ca/industry/registrationmembership/Pages/Becoming-a-Regulated-Marketplace.aspx.
19 http://www.iiroc.ca/Documents/FeeModel_en.pdf.

PART E — NEXT STEPS AND FEEDBACK

12. NEXT STEPS

This paper has outlined the proposal to amend the current AML regime to allow for greater flexibility and provision for alternative arrangements, particularly crossing systems, where appropriate.

Treasury and ASIC will be conducting stakeholder meetings on the issues set out in this paper during the consultation period. Stakeholders are invited to express their interest in arranging such meetings through the contact point given on page iii of this paper.

Following the consultation process, Treasury will consider the feedback provided by stakeholders and prepare advice for the Minister on whether there is any need for reform and, if so, what the recommended approach should be. If changes are to be made an exposure draft of any Bill and regulations or rules would be subject to a further period of consultation in early 2013.

At this preliminary stage it is expected that any proposed legislative reform would be considered by the parliament in the Winter 2013 sittings. Any necessary action by ASIC, including consultation on rules or guidance if Option 1 is adopted, is likely to take a minimum of six months beyond any legislative change made.

13. Feedback sought

An index to these questions and the context in which they have been posed is provided below.

Section	Feedback questions	Page
3. Problem identification	Q1. Do you have any comments on the general form of the current legislative framework for licensing of financial markets in Australia?	13
	Q2. Do you consider that there are efficiency issues that could be addressed by revising the licensing regime? If so, please provide details.	
	Q3. 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.	
	Q4. Do you agree that regulatory change would be desirable in order to better align Australia's market regulatory regime with overseas regimes?	
	Q5. Do you believe that such regulatory alignment could increase the prospects of Australian trading venues and market participants being able to seek regulatory recognition in other jurisdictions?	
4. Overview of reform options	Q6. Do you consider that more flexibility in the AML regime is warranted, so that a greater number of facilities may be covered?	18
	Q7. Do you have a preference between Option 1 and Option 2? If so, please provide details.	
	Q8. Is there an alternative option that you think would provide a better outcome than either of those presented? If so, please explain this option.	
	Q9. 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 it 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?	
	Q10. 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.	

Section	Feedback questions	Page
	Q11. If Option 2 were addressed, how could the limitations to flexibility found in international markets be allowed for in system design?	
	Q12. 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.	
5. Advantages of reform	Q13. Do you have any comments in relation to the perceived advantages of a more flexible market licensing regime? If so, please provide details.	20
6. Potential drawbacks	Q14. Do you have any comments in relation to the potential drawbacks of the proposed licensing reform? Please provide details of any concerns you have.	21
9. Reform issues	Q15. 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 non-market participant HFTs?	26
	Q16. Do you have any concerns in relation to making HFTs subject to market integrity rules? If so, please provide comments.	
	Q17. Do you have any comments on how HFT should be defined and how it should be measured?	
10. Exempt markets	Q18. Do you have any concerns with this proposed option? If so, please provide comments.	27
11. Annual regulatory reports	Q19. Do you have any concerns with this proposed option? If so, please provide comments.	28
10. Licence fees	Q20. Do you consider the fee for a market licence in Australia needs revision? If so, please provide comments.	28
	Q21. Do you see cost recovery as an appropriate approach to levying licence fees? Please provide details.	
	Q22. Would a change in the fee level have any impact on the decision whether to operate a market in Australia? Does the current rate influence this decision?	

Attachment A: Review of Licensing Regimes in other key markets

Europe

The European regulatory regime for markets and multilateral trading facilities was established in 2004 through MiFID I. The regime covers all European Union members, as well as Iceland, Norway and Liechtenstein. MiFID established three types of market:

- Regulated markets (RM) — primarily incorporating public exchanges.
- Multilateral Trading Facilities (MTF) — a multilateral system operated by an investment firm or a market operator, which brings together multiple third party buying and selling interests in any financial instruments bound by non-discretionary rules. These are alternative trading platforms to exchanges, often created by banks to process their trades.
- Systematic internalisers — an investment firm which on an organised, frequent, and systematic basis acts as the counterparty to client orders.

It is worth noting that while Europe has one category of MTF for all products, the level of regulation may differ depending on the market. For example, Chi-X is an MTF that is regulated much like a regulated market (in terms of obligation to supervise the market, etc), while a lighter touch is applied to less systemically important MTFs. The differences in approach are not always transparent.

Not all trading systems that function as markets were regulated under the 2004 regulations, with many forms of dark liquidity, including most crossing systems and over-the-counter transactions, exempted from market licensing and associated regulations. Changes to address these issues were made in MiFID II, as passed by the European Parliament in September 2012, likely to be enforced in the next two to three years. MiFID II is intended to introduce a new category of market platform that covers these execution venues as so-called organised trading facilities (OTFs).[20]

The definition of an OTF is similar to that of an MTF, with the key difference being that the OTF is not required to have non-discretionary rules. Broadly speaking, an OTF is any facility or system that is not an RM or MTF, operated by an investment firm or market operator in which multiple third party buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract. This definition is deliberately broad in order to allow for market innovation in a way that MiFID I did not, aiming to reduce the need for further revisions. The European Parliament Economic and Monetary Affairs Committee voted for OTFs to apply to OTC derivative transactions, but for it not to apply to broker crossing networks.

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20 http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/716&format=HTML&aged=0&language=EN&guiLanguage=en.

To be registered as an OTF, the operators must provide a detailed explanation demonstrating that they do not correspond to and could not act as a regulated market, MTF or systematic internaliser. Beyond certain trading thresholds, OTFs will be required to register as MTFs.[21]

Under the new system, MTFs face a lower level of overall regulation than regulated markets, while OTFs in turn face a lower level of regulation than MTFs. A comparison of the requirements for each market type is presented in Table 2.

Table 2: Comparison of Regulated Markets, MTFs and OTFs

	RM	MTF	OTF
Non-discretionary rules for the execution of orders in the system	Yes	Yes	No
Application of pre- and post-trade transparency requirements	Yes	Yes	Yes
Some transparency waivers for large transactions	No	Yes	Yes
Required to give all investment firms market access	Yes	No	No
Compliance with principal investor protection relating to informing clients, assessment of suitability/appropriateness, and best execution and client order handling	No	Yes	Yes
Adoption and publication of clear rules regarding access to the facility or system	Yes	Yes	Yes
Arrangements for sound management of technical operations, including contingency arrangements to cope with the risk of disruptions	Yes	Yes	Yes
Effective monitoring of users and clients to identify market abuse, significant breaches of rules or disorderly trading conditions	Yes	Yes	Yes
Compliance with instructions from authorities to suspend or remove an instrument from trading	Yes	Yes	Yes
Required to suspend trading in an instrument if another RM, MTF or OTF does so except with justifiable exceptional circumstances	Yes	Yes	Yes
Keep data relating to orders for five years	Yes	Yes	Yes
Can be a party in a transaction	No	No	No
Rules regarding who is suitably qualified and has adequate time to be part of management body	Yes	No	No
Market operator may be an investment firm	No	Yes	Yes
Primary market for equities admitted to listing and trading	Yes	No	No
Obligation to publish a prospectus before offer of securities on the market can be made	Yes	No	No
Rules relating to conflict of interest between market and/or operator and sound functioning of market	Yes	Yes	No*

*OTFs are subject to these rules in relation to their role as investment firm to client only, not as a market operator.

Regulated markets also face a generally stricter standard of rules and requirements in relation to authorisation, organisational and capital requirements, rules on access to markets, and the suspension of trade.

At the same time as MiFID II comes into force the Markets in Financial Instruments Regulation will be enacted. As a regulation rather than a directive, this will reduce the ability for national variations in

[21] http://www.bnai.com/EuropeanCommissionFinancialInstruments/default.aspx.

the licensing regime. This will see the licensing regime across all 30 signatories to MiFID move to essentially a uniform system over the coming years.

United States

Regulation in the US is divided between the Securities Exchange Commission and the Commodity Futures Trading Commission.

Securities Exchange Commission (SEC)

In 1996 the Securities Exchange Act (the Exchange Act) was amended to give the SEC broad authority to exempt any person from any of the provisions of the Exchange Act. This amendment allowed the SEC to introduce a model for alternative trading systems (ATSs) within the National Market System without jeopardising commercial viability of these markets. However, by 1997 there were concerns that this was leading to poorer outcomes for investors.

Rules regulating crossing systems and other ATSs were made in late 1998. These gave market operators three licensing alternatives.

- Register as a national securities exchange under Sections 5 and 6 of the Exchange Act.
  - The definition of 'exchange' is broadened under Regulation ATS to incorporate new ATSs that are used by market participants as equivalents to an exchange.
- Register as broker-dealers and comply with additional requirements from the Regulation ATS.
  - However, the SEC has the authority to determine that a dominant ATS should have to register as an exchange, and any self-regulating system must register as an exchange.
- Operate as an unregistered ATS (only if below certain trading caps).

An ATS faces lower regulatory requirements than an exchange. ATSs dealing solely in government securities are exempt and regulated solely as broker/dealers. Other ATSs are lightly regulated, with no obligation to surveil the market, other than for compliance with its own rules. ATSs can be lit or dark.

- For those ATSs with less than five per cent market share in all securities traded, the requirements are very limited.
  - File a notice of operation and quarterly reports with the SEC.
  - Maintain records including an audit trail of transactions.
  - Refrain from using the words 'exchange', 'stock market' and the like in their title.
- Once an ATS has five or more per cent share in at least one security traded on their market, additional obligations are imposed.
  - The ATS must be linked with a registered exchange so that the best priced orders flow into the public quote stream.

  - The ATS must also comply with some market rules regarding transparency, execution priorities and obligations that apply to members of the linked registered exchange.

- Beyond a 20 per cent market share the standards are further increased.
  - The ATS must grant or deny access based solely on objective standards that are established by the trading system and applied in a non-discriminatory fashion.
  - The ATS must establish procedures to ensure adequate systems capacity, integrity, and contingency testing.

There is another category of alternative market that the SEC regulates — Electronic Communication Networks (ECNs). An ECN is like an ATS but it must be lit and quotes are posted on NASDAQ. ECNs are also agents only, that is, an ECN operator cannot trade as dealer or market maker (principal).

Commodity Futures Trading Commission (CFTC)

In addition to exchange markets, there are two types of exempt markets that are regulated by the CFTC — exempt board of trade and exempt commercial market. They are quote based, agency only markets exempt from most 'exchange' requirements. Exempt markets are not registered, approved or licensed by the CFTC.

- Exempt Board of Trade — Only lower-risk contracts defined as 'excluded commodities' (example no securities contracts and only other contracts where there is no cash market or the cash market has huge supply) are eligible for trading.
- Exempt Commercial Market — Only exempt commodities (that is any commodity other than an 'excluded commodity' or an 'agricultural commodity') are eligible. Exempt commodities include, among other things, energy products and metals.

Canada

In Canada, trades must be done on an exchange market or on an ATS. Off-market crossings (including large blocks) are not permitted in Canada in the way they are in Australia. A number of exchanges offer broker referencing, which automatically matches orders from the same broker, allowing them to jump the queue.

In Canada, crossing systems are regulated as ATSs. The level of regulation for an ATS is lower than that applying to a regulated exchange, with issuers not required to enter an agreement with the ATS operator to have their securities traded. ATSs in Canada do not:

  - guarantee a two-sided market;
  - set requirements for governance relating to conduct; or
  - discipline subscribers for breaches other than by exclusion from the marketplace.

ATS are subject to the same need to provide regulators with advance notice of operations or a substantial change to them, as well as ongoing information regarding trading activities.

ATS are subject to information transparency requirements, though dark pools may avoid pre-trade transparency requirements. However, they must report and settle all trades through a clearing agency.

There are strict rules regarding business continuity and disaster recovery plans, IT controls, and capacity and systems testing procedures, which apply equally to ATSs and regulated exchanges.

Japan

Under the Financial System Reform of 1998, the no off-exchange trade rule which had been imposed on the sale of securities listed on stock exchanges such as the Tokyo Stock Exchange and the Osaka Securities Exchange was abolished. The concept of Proprietary Trading Systems (PTS) was introduced in Japan as pre-trade transparent alternative trading venues that operate similarly to the exchange.

The Financial Instruments and Exchange Act requires PTS operators to be authorized by the regulator. PTS cannot account for more than ten per cent of the market share, beyond which they will need to apply to become an exchange. The Security and Exchange Surveillance Commission and self-regulator organisations conduct daily surveillance.

The Financial Services Authority (FSA) authorises changes to rules and maintains close supervision of operations by way of reports, ongoing dialogue and inspections. The FSA does not require exchanges or PTS to submit an annual assessment report, nor does the FSA have a process to formally assess operations on these markets.

14. Glossary

AFSL	**Australian Financial Services Licence**
AML	**Australian Market Licence**
ASIC	**Australian Securities and Investments Commission**
ASX	**Australian Securities Exchange**
ATS	**Alternative Trading System**
CFTC	**Commodity Futures Trading Commission**
CSFL	**Clearing and Settlement Facility Licence**
FSA	**Financial Services Authority**
HFT	**High Frequency Trading**
MiFID	**Markets in Financial Instruments Directive**
MIR	**Market Integrity Rules**
MTF	**Multilateral Trading Facilities**
OTC	**Over-The-Counter**
OTF	**Organised Trading Facility**
PTS	**Proprietary Trading Systems**