ASX submission to ASIC Consultation 179 – Australian market structure: Draft market integrity rules and guidance

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1. Executive Summary

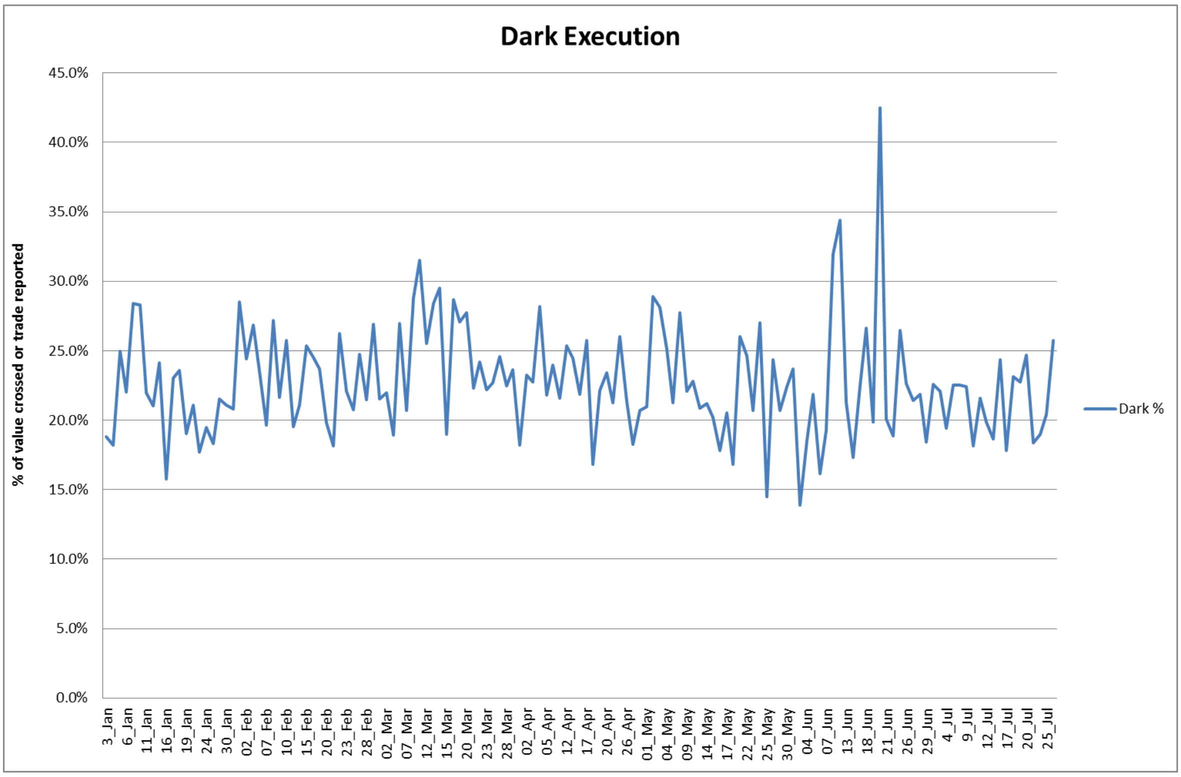
ASIC's Consultation Paper 179 raises important issues for Australian financial markets that if not acted on quickly could result in the undermining of the integrity of Australia's markets and long term investor confidence. ASX believes ASIC should act now with a comprehensive set of measures to protect the quality of the Australian cash equity market rather than risk an incremental approach that may not achieve its objective.

There is clear evidence, both in Australia and overseas, that an increase in dark execution results in widening spreads, higher costs for investors and a negative impact on price discovery. New Australian research demonstrates that fragmentation of the lit market has a major impact on transaction costs in the Australian market where volume and liquidity are low relative to larger markets such as the USA. This reduction in quality of the lit market also undermines the important role of the lit market as a reference point for the broader market.

Moreover, the proliferation of trading venues and algorithmic trading significantly increases the risk of unexpected market movements or disruptions, which can undermine investor confidence. There are now numerous examples of this in the USA, which today is one of the most fragmented markets in the world.

Dark execution has grown significantly in recent years. ASX statistics show that the proportion of dark execution in the current calendar year has varied between 14% and 43% as illustrated in Table 1. This is the relevant measurement as all forms of dark execution take liquidity away from the lit market.

Table 1: Dark Execution 2012



There are two controls that ASIC should put in place to protect against a further decline in market quality:

- Meaningful price improvement - ASX supports ASIC's rule amendments to require meaningful price improvement of one tick size or mid-point for orders below block size which are not pre-trade transparent. This provides a safeguard which ensures that when an investor's order shifts from a lit market to dark execution, the investor benefits from meaningful price improvement. It is important to be mindful that while price improvement may benefit the individual investor, the removal of liquidity from the lit market will negatively impact market quality on which all investors rely. For this reason it is critical that the meaningful price improvement rule is rigorously monitored and enforced by ASIC. It is appropriate that breach of this rule attracts the maximum penalty of $1 million for breach of a Market Integrity Rule and ASIC must resist attempts to water-down implementation of the rule.

- Thresholds of minimum size for dark orders – ASX appreciates that when ASIC first proposed a $50,000 minimum size for dark orders there was no empirical evidence on the impact of fragmentation from dark execution on the quality of the Australian market. ASIC has more recently suggested it would consider a "trigger" that, when reached, would lead to the implementation of a threshold. ASX believes that there is no need for a trigger, as there is clear evidence that supports the implementation of a threshold now. The evidence shows that there is a significant cost – 3 times the ASX transaction fee – if trading in the top 200 ASX-listed securities on the lit market falls by 20% as a result of fragmentation. And since fragmentation in the form of dark execution has already ranged between 14% and 43% in 2012 the "trigger" has effectively been reached. Hence, there is no need to wait and no downside to implementing a threshold. ASX suggests that a threshold of $25,000 be imposed now. ASIC can monitor the effectiveness of this threshold in controlling any further deterioration in the quality of the lit market and adjust the threshold if the evidence indicates that is necessary.

ASX agrees with the proposed introduction of tiered thresholds for large block trades, as part of ASIC's package of measures in relation to market structure. These thresholds recognise that there are good reasons why large block trades need to be executed away from the lit market. ASX analysis suggests that the proposed $1 million threshold is too low for some of the largest stocks in the market. ASIC may therefore want to review the tiering of large block trades in selected securities.

The effect of ASX's recommendations is a clear market structure that gives reasonable protection to all investors and flexibility where it is warranted. Table 2 summarises ASX's recommendations.

Table 2: ASX's recommended structure for equity trading

Order size	Typical means of execution*	Measures to protect market quality	Changes to ASIC oversight
Block orders: above $1m, $500,000 or $200,000 (depending on market capitalisation of relevant company)	Facilitation: • Block trades • Dark pools	Allow execution away from the lit market to avoid price distortion or disorderliness. No meaningful price improvement requirement	No change needed, unless there is systematic matching of orders, in which case there should be ASIC oversight in a similar way to lit markets
Below block order size but above a $25,000 order size threshold	Automated and systemic matching of orders: • Dark pools • Lit market	Meaningful price improvement requirement for dark orders	Orders executed in dark pools or lit markets should be regulated in the same way (see below)
Below a $25,000 order size threshold	• Lit market	Orders below the threshold should be executed on the lit market	Lit markets are subject to full ASIC oversight and disclosure of rules, access arrangements and fees

* subject to best execution rule

A significant proportion of dark execution occurs on dark pools operated without a market licence. Hence, the growth in dark execution means that a growing proportion of trades are occurring on venues which do not have the same regulatory standards as licensed markets. These venues are effectively “private exchanges” as they involve the systematic matching of orders and should be regulated in the same way as public lit markets that perform the same function. ASX commends ASIC’s plan to do further work later this year on dark pools, including reviewing the nature of trading, monitoring, handling of conflicts of interest and misconduct in dark venues, and considering what changes are required to the existing regulatory framework.

It will also be important to understand and manage the risk of clearing and settlement of trades on dark pools outside the regulatory framework for licensed clearing and settlement facilities, and consider whether investors (particularly retail) understand the risks of their trades no longer being novated through a central, licensed and well-capitalised clearing facility.

In relation to extreme price movements, ASIC is seeking to modify and extend the existing controls. ASX supports the introduction of controls that prevent extreme price movements but considers that such controls should not impede an orderly market functioning as an appropriate risk-hedging mechanism during volatile market conditions. The changes proposed in CP 179 give rise to some practical issues, which need further consideration.

The above matters are discussed in this submission. Section 2 explains the importance of safeguards in relation to pre-trade transparency and the increase in dark execution. Section 3 outlines further measures required in relation to the regulation of unlicensed dark pools. Section 4 deals with the practical issues arising from changes proposed in relation to extreme price movements. Section 5 deals with other implementation issues. ASX’s responses to specific questions raised in CP 179 are set out in Appendix 1.

ASX believes that there is neither the time nor the need for further debate or consultation on the need to impose controls to protect the quality of lit markets. Now is the time to provide a clear set of rules that give retail investors confidence, give fund managers the flexibility they require, allow intermediaries and exchanges to focus on serving their clients and growing their businesses, and to provide a clear framework for ASIC to undertake ongoing monitoring of the quality of the equity market.

Key terms used by ASX in this submission

Dark execution	Execution for which there is no pre-trade transparency (including execution on dark pools, dark orders on lit markets and block trades)
Dark order	An order for which price and quantity are not pre-trade transparent
Dark pool	A pool of liquidity which is not pre-trade transparent and which involves systemic matching of orders away from the lit market
Internalisation	Where a market participant systemically matches orders so they are not executed on the lit market
Block order or trade	A large order or trade (above a set threshold) which is executed away from the lit market with no restriction as to price
Lit market	Markets which are pre-trade transparent (ASX and Chi-X)

2. Pre-trade transparency

ASX supports ASIC's rule amendments to require meaningful price improvement of one tick size or mid-point for orders below block size which are not pre-trade transparent. ASX also believes that evidence is now available to support ASIC putting in place a control measure based on a minimum order size. The reasons for this are set out below.

ASX supports the proposed introduction of tiered thresholds for large block-sized trades which recognises that there are good reasons why these large trades need to be executed away from the lit market.

Lit markets provide a reference point for the broader market

Prices set in lit markets are used as a reference point for the meaningful price improvement exception which allows dark execution below block size, and are also used for regulatory purposes such as setting trade cancellation thresholds. It is essential to ensure that a significant proportion of liquidity is transacted on lit markets so that pre and post-trade prices represent a reasonable reflection of supply and demand. A lack of depth in the lit order books may well involve greater price volatility in lit markets – creating a vicious circle where greater volatility is used to argue the case for more dark execution. Controls are needed to ensure the quality of the bid-ask spread is preserved in the lit market. Otherwise not only is there a decline in the quality of the market and an increase in transaction costs, but also other controls such as "meaning price improvement" are eroded.

Further, the lack of pre-trade transparency is a significant gap in the information required by investors to make informed decisions. An order book providing full transparency of the outstanding supply and demand for securities at various price points provides valuable information on the prices at which investors may be able to actually transact.

If a significant amount of informed liquidity is being transacted other than on the lit markets this will limit the ability of all investors to fully assess the price at which they can trade securities, as there is no reference point in which the market can have confidence. This will undermine the broader market. There need to be good reasons for orders to be executed away from the lit market.

Impact of dark execution on market quality

There is evidence in Australia of a widening of spreads as a result of the impact of dark execution on fragmentation of the lit market. Research by Professor Alex Frino shows that if 20% of trading in the top 200 ASX-listed securities moves off the lit market, then this will cause an increase in trading costs on the lit market of almost one basis point. Professor Frino states that "When trading moves off-exchange, trading costs on the lit exchange rise and it becomes more costly for buyers and sellers to find each other. This implies that dark liquidity has a significant negative impact on liquidity, and on price discovery."[i] Professor Frino also points out that this is a particular issue for smaller markets such as Australia where fragmentation of the lit market has a major impact. The lower volume and liquidity compared to larger markets, means that the fragmentation due to removing liquidity from the lit exchanges results in increased trading costs.

This is consistent with research conducted in the USA. The percentage of trades exchanged in dark pools in the USA increased two-fold between 2008 and 2010. Academic studies of internationalisation's impact on market quality in the USA show that at best internationalisation is benign and at worse it is associated with a decline in market quality.

Daniel Weaver, Professor of Finance, Rutgers University, New Jersey, who has published detailed findings of his research, has found strong support for the existence of a negative relationship between the degree of internalisation and market quality[ii]. Significantly, he finds that the impact of internalisation on spread width is measurable. This means that investors pay more per stock per year due to internalisation. Further, Weaver concludes low-priced illiquid stocks are more likely to have trades report through a trade reporting facility (i.e. dark execution). Hence the problem is likely to be more significant for these stocks. Weaver concludes that increased internalisation is associated with degradation of market quality for all market segments in the US. This means there is a market-wide increase in spreads and a reduction in market depth and price discovery.

This is not the only negative effect of increasing dark execution. The proliferation of unregulated trading venues and algorithmic trading significantly increases the risk of unexpected market movements or disruptions, as has been demonstrated in the USA. Moreover, experience has shown that when there is a market disruption it can be difficult for regulators to clearly identify the cause. As a result of several serious disruptions, investor confidence in the USA is now in question. This should not be allowed to happen in Australia.

Recommended structure for equities trading

ASX statistics show that dark execution (transactions that do not occur on the lit markets) has varied between 14% and 43%, averaging 25%, in the period from January to June 2012 (see Table 1 in the Executive Summary).

There is a significant risk that the broader market will be affected if dark execution remains unchecked. Hence, it is important that ASIC introduces safeguards to ensure that real liquidity is informing price discovery in the lit market. ASX recommends the following market structure.

a) Large block orders

ASIC's proposed tiered thresholds for large block trades of $200,000, $500,000 and $1 million give the market ample ability to conduct large trades away from the lit market, with no price restrictions. However, ASX analysis suggests that the proposed $1 million threshold is too low for some of the largest stocks in the market. ASIC may, at some stage, want to review this threshold for selected securities.

b) Meaningful price improvement

ASX supports ASIC's rule amendments to require meaningful price improvement of one tick size or mid-point for orders below block size which are not pre-trade transparent. This provides a safeguard which ensures that when an investor's order shifts from a lit market to dark execution, the investor benefits from meaningful price improvement.

It is important to be mindful that while price improvement may benefit the individual investor, the removal of liquidity from the lit market will negatively impact market quality on which all investors rely. For this reason it is critical that the meaningful price improvement rule is rigorously monitored and enforced by ASIC. It is appropriate that breach of this rule attracts the maximum penalty of $1 million for breach of a Market Integrity Rule and ASIC must resist attempts to water-down implementation of the rule.

If meaningful price improvement is not required (and the existing "at or within the spread" exception continues) investors posting orders at the spread in the lit market may increasingly observe investors with access to dark pools having their orders being filled (at the same price) ahead of them, undermining their confidence in lit markets. To the extent that they may be unable to get their order filled at the price they want they may also decide they need to lower their price expectations and get an inferior price. This is why a meaningful price improvement standard is an important safeguard for retail investors.

ASX also supports ASIC's decision not to change tick sizes at this time. Any weakening of 'meaningful' price improvement by reducing the minimum tick increment or reducing the definition of meaningful (e.g. a half or a quarter tick) is not acceptable as it significantly reduces the effect of the policy and creates a structural advantage for dark pools which can execute orders other than at set tick prices (given that tick sizes for lit markets are set in the Market Integrity Rules). ASX also sees no strong case for considering changes to tick sizes, which may only have the effect of weakening the 'meaningful' price improvement as well as providing a further incentive to high frequency trading activity (HFT). Any consideration of tick-size changes would need to be subject to a thorough review and the development of a robust methodology to assess the issue.

c) $25,000 minimum order size threshold for dark execution

ASX appreciates that when ASIC first proposed a $50,000 minimum size for dark orders there was no empirical evidence on the impact of fragmentation from dark execution on the quality of the Australian market. ASIC has more recently suggested it would consider a "trigger" that, when reached, would lead to the implementation of a threshold.

ASX believes that there is no need for a trigger, as there is clear evidence that supports the implementation of a threshold now. The evidence shows that there is a significant cost – 3 times the ASX transaction fee – if trading in the top 200 ASX-listed securities on the lit market falls by 20% as a result of fragmentation. And since fragmentation in the form of dark execution has already ranged between 14% and 43% in 2012 the "trigger" has effectively been reached. Hence, there is no need to wait and no downside to implementing a threshold.

ASX suggests that a threshold of $25,000 be imposed now. ASIC can monitor the effectiveness of this threshold in controlling any further deterioration in the quality of the lit market and adjust the threshold if the evidence indicates that is necessary.

ASX believes the three tiers of measures discussed above should be implemented now. There is no downside in doing this and the risk of inaction is greater than the risk of action.

3. Further measures required for dark pools which are not regulated like lit markets

Regulation of dark pools

A significant proportion of dark execution occurs on dark pools operated without a market licence. ASX supports ASIC's plan to do further work later this year on dark pools, including reviewing the nature of trading, monitoring, handling of conflicts of interest and misconduct in dark pools, reviewing the existing regulatory framework and considering what changes might be required. ASX also supports ASIC's plan to do further work on high frequency trading.[iii]

Dark pools operate in all material respects in the same way as licensed markets. If operated without a market licence dark pools are not subject to the same regulatory standards as licensed markets. Nor do these dark pools have the disclosure requirements (with regards to operating rules, procedures, access arrangements and fees charged) of licensed markets even though they are performing a similar function. The experience in Canada was that without appropriate visibility into how the dark pools operated, regulators and other stakeholders were not well positioned to observe whether they were operating within the market integrity rules. It has also meant that operators of dark pools have had competitive advantages over licensed lit markets which had to be more transparent in their operations. Canadian regulators introduced (from July 2012) a regime requiring greater public transparency in the operations and order types of non-exchange venues.

The dark pools that are operating without a market licence should be subject to the same requirements as licensed markets to publish their rules (for both lit and dark order types), so that participants in the broader market understand how orders are managed and trades are being executed on those non-exchange venues. Further, dark pools should be subject to the same ASIC surveillance requirements and supervision levy as licensed markets, as there is nothing to suggest that there is no scope for misconduct within dark pools, although the nature of this misconduct may differ from that possible in a lit market. The new requirements for market operator systems and controls in relation to testing, monitoring and business continuity planning[iv] should also apply to dark pools, as these controls should extend to all parts of the market.

ASX recognises that dark pools are not currently subject to an alternative market licensing regime, and are governed by the AFSL regime which was not designed for such activities. The desirable regulatory and market structure outcome is that all "markets" should have equivalent licensing arrangements. However, if that cannot be achieved then ASX considers that ASIC should use its powers under the Market Integrity Rules and financial services licensing regime to require publication of the rules, procedures, fees and other information concerning dark pools (that is currently only available to ASIC), and to ensure there is adequate transparency and surveillance.

Need to understand and manage risks of clearing and settlement

ASX suggests that ASIC's further work should also extend to the need for investors and market users to understand and manage the risk of clearing and settlement of trades on dark pools outside the licensed clearing and settlement regulatory framework. Trades on dark pools and block trades are required to be reported to a licensed market as crossings. Unless such a trade is directed to different clearing participants by the buyer and seller it is not novated to the central counterparty. Settlement of the trade can occur within the offices of the broker that operates the dark pool through the movement of stock and funds between the transacting clients (or their nominees) or as a non-novated transaction in the daily multilateral settlement batch.

This means that clearing and settlement of a significant portion of equity market activity may occur within a small number of large clearing participants, outside the regulatory framework that applies to licensed clearing and settlement facilities. Given the growth in activity that is occurring in dark pools, a key risk consideration for clients transacting in dark pools should be that they are exposed to "fellow client" settlement risk in a way that does not apply to trades that are novated to a central counterparty. There is a risk that a dark pool operator may be unable to manage in a timely way a failure to settle by one side of a non-novated crossing. The question of whether investors, particularly retail investors, understand these risks needs to be addressed by regulators.

Given the importance attached by CPSS-IOSCO to prompt settlement in its recently finalised principles for financial market infrastructures (FMIs)[v], there is a significant gap in the coverage of those principles, if a significant proportion of equity market settlements could occur without externally enforced T+3 settlement discipline or settlement finality, as explained below.

A licensed clearing and settlement facility has:

- publicly available and legally enforceable multilateral operating rules;
- approvals under the Payment Systems and Netting Act that give legal certainty to settlement netting and the finality (irrevocability) of settlement;
- monitoring and enforcement of T+3 settlement discipline, with failure fees and automatic close-out requirements;
- CS facility licence obligations to act fairly and efficiently, and to comply with internationally accepted principles for FMIs (Financial Stability Standards); and
- regular and systematic regulatory oversight of CS facility technical, operational and risk management performance and service delivery.

Trades executed on unlicensed dark pools, on the other hand, are more likely to be cleared and settled outside of a licensed clearing and settlement facility and therefore can have:

- no operating rules governing clearing and settlement – the bilateral contractual terms (if any) are known only to the dark pool operator and its clients;
- no legal certainty regarding settlement finality (for example, settlements may be at risk of being unwound in the event of insolvency of the dark venue operator or one of the transacting clients – there are potential knock on implications);
- uncertain settlement discipline where the buyer or seller is short of funds or stock – do buy-in or automatic close-out requirements apply, and how is poor settlement performance by clients dis-incentivised and managed on a consistent and effective basis?
- no CS facility licence obligations; and
- no regulatory oversight of technical, operational and risk management aspects of settlement performance or service delivery.

In view of the increasing proportion of dark execution, the lack of transparency of clearing and settlement arrangements becomes a real concern particularly for retail orders. Transparency of the operation of dark pools should include disclosure of the differences in clearing and settlement arrangements for trades on lit markets and dark pools and the risk considerations for clients whose transactions are executed on dark pools.

4. Extreme price movements

ASX supports effective volatility controls that arrest extreme price movements. The effectiveness of volatility controls is basically determined by the calculation of appropriate Anomalous Order Thresholds and a relevant Reference Price.

Importantly, volatility controls should not impede an orderly market functioning as an appropriate risk hedging mechanism during volatility. Volatility controls must also be effective across transactions at all price points. ASX has been engaged with ASIC since the introduction of the Competition Market Integrity Rules in October 2011 regarding improvements that can be made to the regime. ASX has concerns with the current ASIC proposals on a number of levels – cost for participants and market operators, complexity, and market integrity. ASX has set out in detail the basis of our concerns and solutions that build on the existing regime and can be readily implemented (Appendix 1).

5. Implementation of proposals in CP 179

ASX is able to implement a number of the changes proposed in CP 179 in the suggested timeframes. However, there are some changes for which further details are required, or for which ASX does not consider the implementation timeframes to be achievable.

The changes required in relation to extreme price movements for ASX Equity Market Products are proposed to be effective in October 2012 when the proposed Market Integrity Rules become effective. As outlined in Appendix 1, there are a number of technical changes that would need to made or developed. In addition, there are a number of gaps in the proposed Market Integrity Rules and guidance that need to be addressed prior to the scoping and implementation of any technology development. This makes the October 2012 effective date very difficult to achieve. Further, while there is a longer implementation timeframe for the ASX SPI 200 changes additional technical specifications are required to be able to fully assess the development required.

ASX requires further information in relation to the requirements for the collection and provision to ASIC of regulatory data. At this stage ASX considers that these changes will require considerable development work and will not be achievable in the timeframe proposed.

Further details of these implementation issues are set out in Appendix 1.

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[i] 'Monsters in the Dark Pools – CMCRC', press release issued 27 June 2012

[ii] D Weaver, *Off-exchange reporting and market quality in a fragmented market structure*, comment on Concept Release *Equity market structure* (Release No. 34-61358), 16 April 2010, www.sec.gov/comments/s7-02-10/s70210-127.pdf. Note that ASIC discusses this research in Consultation Paper 168: Australian equity market structure: Further Proposals, October 2011, paragraph 283

[iii] ASX considers that there are issues which need to be considered in relation to high frequency trading. For example, recent research in the USA from Pragama Securities has provided evidence that even in the most liquid stocks the profitable trading by high frequency traders has come at the expense of more traditional investors.

[iv] *Addendum to Regulatory Guide 172, Supplementary guidance on market licensee systems and controls* (draft), ASIC, June 2012

[v] *Principles for financial market infrastructures – April 2012*, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, http://www.bis.org/publ/cpss101a.pdf

Appendix 1: ASX responses to specific questions

<table>
<tr><th>ASIC Proposal</th><th>ASX Response</th></tr>
<tr><td>Draft market integrity rules

A1 We propose to make a number of new or amended market integrity rules.</td><td>ASX’s submissions on a number of the substantive issues raised in CP 179 are set out in the covering submission. In addition ASX makes the following submissions.

Enhanced Data for Market Surveillance

Market Integrity Rules
• ASX Surveillance should receive some or all of the “Regulatory Data” provided by a participant to an alternate market operator under MIR 5A.1.2, where this information will assist the listing market in the conduct of its continuous disclosure monitoring obligations. ASX notes, that as currently drafted, an alternate market operator will be prohibited from providing that data to ASX under the proposed MIR 5A.1.3(2). We submit that this draft rule should be amended.
• ASIC should also amend the definition of “Post Trade Information” in MIR 5.1.4(1) and its interplay with MIR 6.2.1(1) and (3)(b) so that it is clear that an alternate market operator is obliged to provide ASX Surveillance with the broker IDs and references for all trades done on their market for the purposes of continuous disclosure monitoring.
• Access to, and use of, this data would be restricted to ASX Surveillance for the purpose of conducting market monitoring for continuous disclosure purposes.

System changes
• ASIC wants market operators to have systems changes in place by August-September 2013 (with participants systems changes a month or two after). At this stage, ASX considers that these changes will require considerable development work and will not be achievable in the timeframes proposed.
• ASX will need detailed technical specifications to determine the likely timeframe for implementing these changes

There are also a number of technical points and clarifications which ASX would like to discuss with ASIC separately.</td></tr>
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ASIC Proposal	ASX Response
Draft guidance **A2** New or amended guidance has two elements: (a) RG223 *ASIC market integrity rules for competition in exchange markets*: to give guidance on the draft new or amended market integrity rules for extreme price movements, enhanced data for market surveillance, pre-trade transparency and price formation, and post-trade transparency. There are a number of minor updates to reflect competition commencing. (b) Addendum to RG172 *Australian market licences: Australian operators:* on systems and controls for holders of an Australian market licence.	ASX's submissions on a number of the substantive issues raised in CP 179 are set out in the covering submission.
Anomalous order threshold **B1** Amend Part 2.1 (Competition) - order entry controls for anomalous orders—to apply only during continuous trading times.	**Anomalous Order Threshold** ASX currently applies the Anomalous Order Threshold (AOT) on all Equity Market Products, subject to the existing exclusion of certain order types, during continuous trading only and supports this clarification.
Definition of 'anomalous order' **B2** Amend the definition of 'anomalous order' in Rule 1.4.3 (Competition) to clarify that an anomalous order means a *buy order* for which the price is above the maximum, or a *sell order* which is below the minimum order threshold for the relevant equity market product or ASX SPI 200 Index Future (ASX SPI 200 Future).	ASX currently applies the AOT to aggressive orders, subject to certain exclusions, and supports this definition if it intends to exclude "passive" orders.
Extreme trade range **B3 Q1(a)** Amend Part 2.2 (Competition)—extreme cancellation range:	**Extreme Trade Range - Equity Market Products** ASX supports the name change.

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<tr><th>ASIC Proposal</th><th>ASX Response</th></tr>
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B3 Q1(b) for reference prices of:

(i) 0.1–9.9c, the extreme trade range will be >5c rather than ≥21 price steps;
(ii) 10–99.5c, the range will be >30c rather than ≥ 61 price steps;
(iii) 100–199.5c, the range will be >50c rather than ≥ 101 price steps;
(iv) 200–499c, the range will be >50% rather than ≥50.1%;
(v) 500–699c, the range will be >40% rather than ≥ 40.1%;
(vi) 700–999c, the range will be >35% rather than ≥35.1%;
(vii) 1000–1999c, the range will be >30% rather than ≥30.1%;
(viii) 2000–4999c, the range will be >25% rather than ≥25.1%; and
(ix) ≥5000c, the range will be >20% rather than ≥20.1%.
</td><td>
ASX also supports a revision to the Extreme Cancellation Ranges (now referred to as Extreme Trade Range in CP 179) because of the large number of cancellations that have been imposed on stocks priced below ten cents when there has been no impact on market integrity. However, ASX is concerned with the methodology proposed by ASIC.

ASIC has proposed that the ranges for Equity Market Products priced under $2.00 will be measured in absolute values of whole cents instead of the tick ranges (or price steps) currently applied. Our concern is that this change will result in, amongst other things:

i) an increased variance for the Extreme Trade Range (ETR) for stocks that are priced around the threshold price of 10 cents; and
ii) stocks priced between 10 cents and 30 cents will have no lower ETR.

To understand the implications from a market integrity perspective, ASX has outlined some examples of trading and cancellation scenarios that this proposal would result in.

<table>
<tr><th>Stock price</th><th>Price steps (or tick value)</th></tr>
<tr><td>0 – 9.9 cents</td><td>0.1 cents</td></tr>
<tr><td>10 cents and above</td><td>0.5 cents</td></tr>
</table>

The upper ETR for a 9.9 cent stock will be 14.9 cents (currently it is 20 cents).
The ETR for a 10 cent stock will be 40 cents (currently it is 40.5 cents) – there will be a 25 cent gap between the ETR for a 9.9 cent stock and a ten cent stock;
There will be no lower ETR for stocks priced between 10 cents and 30 cents. Therefore, a stock trading at 30 cents can be taken down to 1 cent due to an erroneous trade. Trades will not be cancelled as they fall outside the ETR range, (greater than 30 cents) even though the stock has been taken down 132 price ticks, approximately 97%;
A stock trading at 9.9 cents can be taken down to 4.9 cents due to an erroneous trade. This will be cancelled as the trades fall within the ETR (5 cents). The stock has only been taken down 51 price ticks, approximately 50%.

The diagram at Attachment 1(a) illustrates the above.

In ASX’s submission, the proposed changes will not address the issue of legitimate orders being unnecessarily cancelled.
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ASIC Proposal	ASX Response
	It is anticipated that a greater number of Regulatory Halts will need to be activated to reset the ETR Reference Price for stocks priced just below ten cents and so the current problem is not resolved. Secondly, applying the ASIC proposed ranges will result in values that do not exist in ASX Trade, for example 10.1 cents. It is not clear from the ASIC proposal how such values are to be rounded. For example, it is not clear whether values such as 10.6, 10.7, 10.8, 10.9 cents will be required to be rounded up to 11 cents or down to 10.5 cents. Likewise with 10.1, 10.2, 10.3, 10.4 cent values, it is not clear whether these will be required to be rounded up to 10.5 cents or down to 10 cents. This rounding issue requires additional system development to facilitate and adds an additional layer of complexity to the imposition of the ETR and an AOT. In ASX's view, the preferred approach is to increase the current tick range for sub ten cent stocks to 51 or 61 ticks and to impose a tick based AOT. ASX has previously suggested this approach to ASIC and requests that it is reconsidered. ASX's approach creates none of the market integrity issues as outlined above and could be implemented with minimal cost and technological development. ASX also reiterates its requests that ASIC reconsider the concept of a **dynamic ETR reference price**. As discussed in more detail below (see Trading Pause and a fixed Extreme Trade Range), the issues created by the ASIC proposals would be addressed with the introduction of a dynamic ETR reference price. Responses to the previous market consultation CP 168, indicated that the market has no objections to this concept.
(c) the extreme trade range for the ASX SPI 200 Future means all prices which are greater than 250 price steps away from the reference for the ASX SPI 200 Future.	**Anomalous Order Threshold and Extreme Trade Range - ASX SPI 200** ASX supports both an AOT and an ETR for the ASX SPI 200, bearing in mind that an ETR has been in place on the ASX SPI 200 for a number of years under the ASX 24 Operating Rules, albeit not an automated ETR. ASX supports an ETR of 250 points (the range currently imposed by ASX 24) but only where ETR is based on a dynamic reference price. ASIC has proposed a fixed reference price for the ETR. Currently, the ASX 24 reference price is not fixed at the start of the day but is assessed by taking into account relevant information immediately prior to the trade in question as well as other relevant market information. The ASIC proposal does not have this flexibility. The consequences of not adopting a dynamic ETR reference price for the ASX SPI 200 has far more dire consequences than not adopting a dynamic ETR reference price for Equity Market Products for the following reasons: • Unlike halting a single Equity Market Product, halting the ASX SPI 200 has the effect of a market wide circuit breaker. During times of extreme market volatility, such as the terrorist attacks of 11 September 2001 in the US and 7 July 2005 in London, financial markets will seek to hedge the inevitable equity market declines that will be experienced. This hedging cannot occur if the ASX SPI 200 market is paused. In a falling market the ASX SPI 200

ASIC Proposal	ASX Response
	would be required to be paused for ten minutes each time the dynamic AOT met the static ETR. It is likely that in these circumstances each time the market re-opened the ETR would again be reached and another pause required. • A dynamic reference price for the ETR that is the same as the dynamic reference price for the AOT, as suggested by ASX and either supported or not objected to by other respondents to CP 168, will ameliorate this issue while allowing an orderly, not rapid, decline in pricing.
Cancellation of transactions executed within the extreme trade range **B4 Q1** Remove the requirement for a market operator to include in its policies and procedures a time limitation setting out the period from the time of execution in which a transaction must be identified by or to the market operator as occurring in the extreme trade range for it to be cancelled. Policies would need to state that any transactions executed in the extreme trade range will be cancelled.	**Removal of time limit on Extreme Trade Range cancellations - Equity Market Products and ASX SPI 200** ASX is concerned by the ASIC proposal to remove the time limit on ETR cancellations. Imposing a time limit is necessary for the following reasons: • **Reduction in trade certainty** – the facilitation of trade cancellation without a time limit results in trade uncertainty for the party seeking the cancellation and any counterparty that has traded on the back of the contentious trade. Currently there are strict time limits on when a trade needs to be identified by or to ASX for a trade cancellation to occur (within 10 mins for QCR trade and 30 mins (or 10 mins from end for CSPA) for an ECR trade), with trade cancellation decisions being made generally within 15 minutes of such notification ie trade cancellation decisions are generally made or notified within less than 45 minutes of the relevant trade. • The proposal is contrary to ASIC's stated rationale at paragraph 22 that ASIC "would expect market operators to identify and cancel all transactions in the extreme trade range automatically and as soon as possible". • **Knock on effects for trade counterparties** – a cancellation that occurs at some time after trade execution would have knock-on effects for trade counterparties who have hedged or otherwise traded on the back of existing trades. • **Reduction in market certainty** – cancellations without time limits may have a deleterious effect on market certainty with respect to published trade prices. • **Impact on operation of clearing and settlement of trades** – there will be clearing and settlement impacts of cancelling a trade. Also, note that the clearing and settlement facility may, under its Operating Rules, refuse to give effect to a decision to cancel a trade in order to maintain the orderly operation and integrity of the facility. • **Potential clearing risk implications** – depending on the size and timing of a cancellation decision, this may raise ASX clearing risk implications and exposures to the trade counterparties (or their clearer).

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	• **Inconsistency within cancellation policy for all products** - ASX will need to retain strict and consistent time limits for cancellations for all products (whether covered by the Competition MIRs or not) where there is no AOT or automated ETR. Market and trade certainty should be the key criteria.
Draft Rule 2.2.2C and Reg Guide 223.50 Impose Trading Pause of 10 minutes per ETR event	**Trading Pause and a fixed Extreme Trade Range – Equity Market Products** ASX is concerned with the application of the proposed ten minute Trading Pause. Under the current regime, ASX created a Regulatory Halt session state to deal with the fact that legitimate trading occurring within a dynamic price AOT range will inevitably meet a fixed ETR. ASX has previously proposed to have a dynamic ETR so that the imposition of the Regulatory Halt will not usually be required. There are no apparent market objections to this. Again, this can be easily implemented without additional cost to ASX or Participants on the following basis: • The dynamically moving reference price for the AOT would be the same as the ETR reference price rather than one dynamic and one fixed reference price; • Interruptions to trading, when there is no price sensitive announcement to warrant a trading halt, would be reduced; • Under the proposed ASIC regime it is predicted that Regulatory Halts will continue to be imposed throughout the day, particularly as the ASIC proposed ETR for stocks priced just below ten cents will be narrower than the current ETR. It is not clear whether the ASIC proposed Trading Pause of ten minutes is in addition to the ASX created Regulatory Halt or instead of it. ASIC appears to be seeking to impose a ten minute Trading Pause on the basis that ten minutes is the length of the trading halt imposed when a price sensitive announcement is made. ASX contends that the proposed Trading Pause should not be equated with a price sensitive announcement because no new information about the company is released. There have been 79 Regulatory Halts imposed 1 January – 30 June 2012. If the Trading Pause is intended to replace the Regulatory Halt then ten minutes is too long. ASX in many situations is able to restart trading in an Equity Market Product in a minimum of one minute to minimise disruption to the market. An additional trading halt also adds another layer of complexity to the system. Further, there may be an issue with stocks that are placed into a Regulatory Halt within the ten minutes leading up to the daily closing auction and whether those stocks can then participate in the closing auction. **Trading Pause and a fixed Extreme Trade Range – ASX SPI 200** The consequences of a ten minute Trading Pause for the ASX SPI 200 are outlined above.

ASIC Proposal	ASX Response
Crossings during normal trading hours **B5** ASICs interpretation of the Corps Act is that a transaction that is prearranged is not 'on market' and is not entered into in the 'ordinary course of trading' for the purposes of the takeover bid and on-market buy-back provisions of the Act. Transactions of this nature on behalf of the bidder in relation to bid class securities under a takeover bid or on behalf of a listed corporation conducting an on-market buy-back of its own shares are not permitted. Market participants and market operators should already be applying this interpretation to off-order book 'at or within the spread' transactions referenced to the NBBO and CentrePoint crossings. ASIC want to would apply this interpretation to priority crossings from the date the rule on MPI takes effect.	**Takeovers** • At present ASX does not allow any Special Crossings or NBBO trades to be reported during a takeover. ASX does not currently restrict CentrePoint Crossings or Priority Crossings during a takeover. • ASX seeks clarity as to whether a market operator is expected to restrict all NBBO trades, Centre Point Crossings and Priority Crossings during a takeover. **Share Buybacks** • ASX does not currently restrict any crossing types during an on-market buyback. • ASX understands that the Corporations Act only limits such activity when it is conducted by a participant on behalf of the company repurchasing its own shares. • As such ASX believes the responsibility for ensuring such off-market trades are not reported should be with the participant acting on behalf of the company. • A market operator would not have access to such information to enable it to restrict only trades that are not permitted. The market operator could restrict all reporting of crossings when a company is undertaking a repurchase but this would be a much broader restriction than envisaged by the Act. ASX assumes that ASIC does not want a market operator level control in this instance.

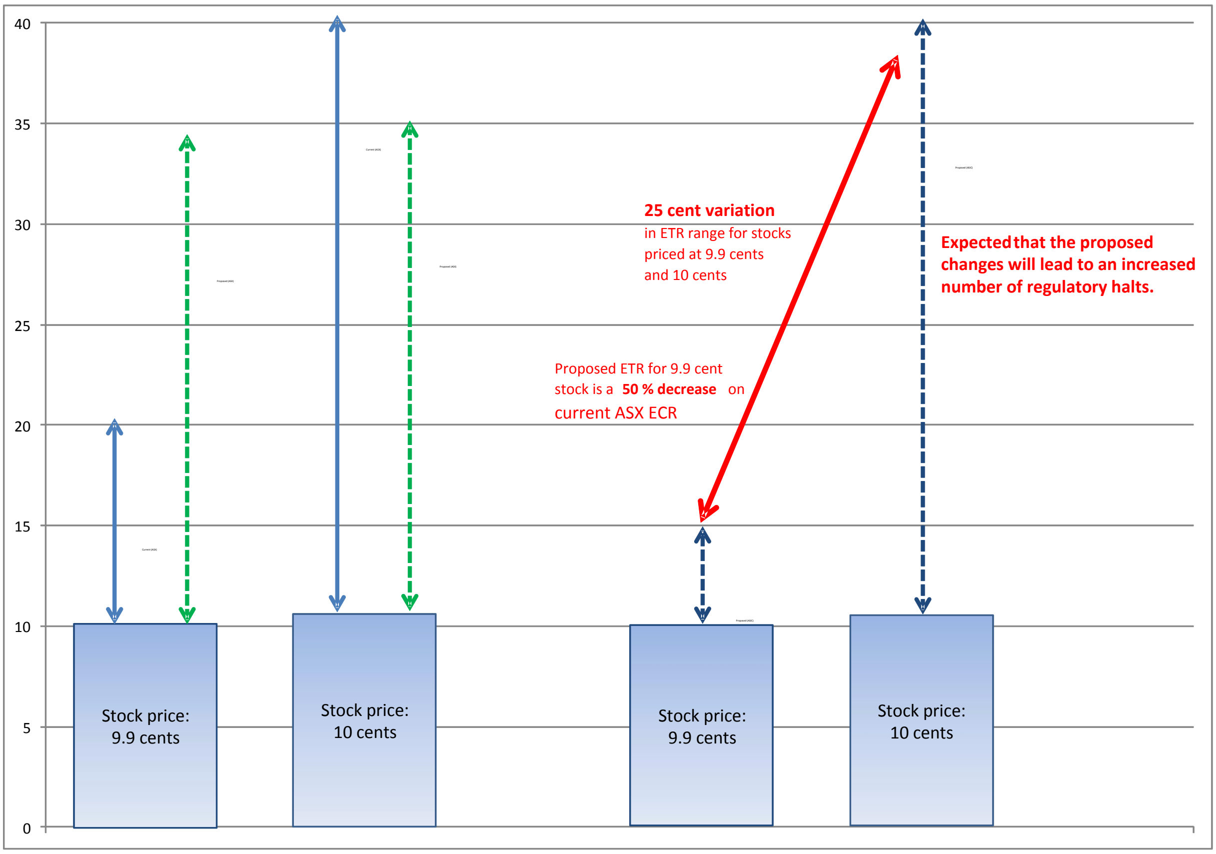
ASIC Proposal	ASX Response
Crossings conducted late, overseas and overnight **B6** Amend Rules 6.4.1(1) (ASX) and 6.4.3(1) (ASX) and Rule 6.4.1(1) (Chi-X) so it is clear that a participant conducting a late, overseas or overnight crossing in a cash market product or cash only combination during the offer period under a takeover bid (and schemes under s411) must not do so at a price which is at or below the offer price for that product. To effect this change, we propose to amend these rules to refer to a 'Takeover Bid' rather than a 'Market Bid'. Special crossings, are already prohibited at any price during a takeover bid or a scheme under s411. Market participants acting on behalf of a bidder must not enter into a crossing for a product that is subject to a bid.	• ASX does not currently restrict any after-hours crossing types during takeovers. • We note ASIC wants a market operator level control, to ensure such crossings are not reported when the price quoted is below the offer price. • This would require a manual verification process to ensure that these crossing types are not conducted at a price below the offer price of that product. • ASX believes that if all off-market crossings are restricted during a takeover in normal trading hours then the same approach should apply to these classes of crossings as well.

ASIC Proposal	ASX Response
Validation of delayed reported off-order book trades **B7** Market participants and operators must have systems and controls in place to verify and validate that trades reported by them or to them, based on a pre-trade transparency exception, meet the criteria for the exception. Propose expanding it to verification and validation of trades entitled to delayed publication under Rule 5.1.1(2) (Competition) to ensure: (a) the consideration meets the relevant threshold in Rule 5.2.1 (Competition) (i.e. $2 million, $5 million, $10 million or $15 million) depending on the equity product; (b) they are reported to a market operator within the timeframes set out in Rule 5.1.1(3) (Competition); and (c) they are not executed during a trading suspension.	• ASX believes that the new block special tiered thresholds can be introduced consistent with ASIC's intention that they be in place by mid-2003. • ASX notes that it is a participant's responsibility to comply with the specific exceptions they claim to the pre-trade transparency requirements. This is explicitly addressed in ASIC's Regulatory Guide 223 where it is clearly stated there is zero tolerance for errors (RG223.206). • Any market operator validation process which includes a 'tolerance' to address the inherent latency involved in the period between executing an off-market order and reporting it to a market operator, cannot meet the 'zero tolerance' test. Again this is recognised in Regulatory Guide 223, where it is noted that a participant "cannot rely on a market operator's acceptance of a trade as evidence that a trade complies with the exception" (RG223.206). • ASX assumes that ASIC will be devoting resources to regularly auditing participants' compliance with the MPI exception, in order to satisfy itself that the zero tolerance benchmark is achieved. • ASX would like to discuss the validation requirements further with ASIC.

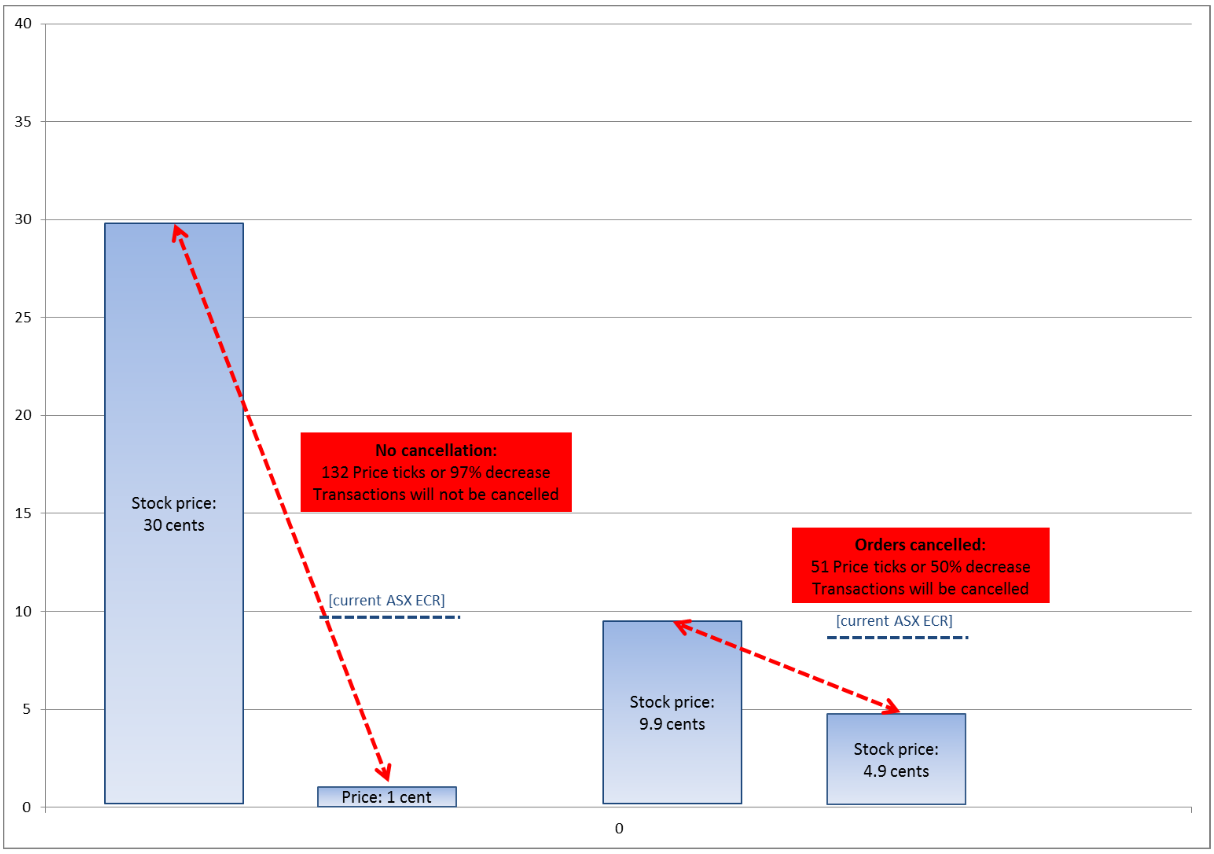
ASIC Proposal	ASX Response
Definition of 'executing participant' **B8** Amend Rule 5.1.2(2) (Competition) to clarify the definition of 'executing participant'. Under Rule 5.1.2(1) (Competition), where both parties to an off-order book transaction are market participants, the executing participant must report the transaction to a market operator. Rule 5.1.2(2) (Competition) currently defines the executing participant as any one of: (a) the market participant that executes the trade (e.g. on its own crossing system); or (b) the seller; or (c) as agreed between the parties. Amend so that 'executing participant' is defined as the market participant that executes the trade (e.g. on its crossing system). Only where both market participants to a transaction meet this definition would the other options be available (seller report the transaction or as agreed between the parties).	• No comment from ASX
Market operator's obligation to make available trading information **B9** Amend Rule 5.1.6 (Competition) to clarify the trading info that a market operator must make available on a website on a delayed basis of no more than 20 minutes: last traded price, bid, offer, high and low include only on-order book info of the market operator. Volume includes all trades on an order book or reported to a market operator.	• ASX supports the view that price information published on a market operator's website should only reflect those orders/trades entered into on a market operator's order books. • With regard to trade volume, ASX believes that both on-market activity and off-market activity reported to a market operator should be published. However, we believe the two sources of volume should be clearly distinguished when published. • ASX believes these data requirements should apply not only to material published on the market operator's public website – but also to any summary data disseminated by the market operator.

ASIC Proposal	ASX Response
Definition of 'Large principal transaction' **B10** Amend the title of Rule 5.2.1 (Competition) from 'Exceptions—Large Principal Transaction' to 'Delayed reporting—Large Principal Transaction' to reflect that this rule contains a definition rather than an exception.	• Agreed

Attachment 1(a) Extreme Trade Range Scenarios



Current and Proposed ASX cancellation ranges **Proposed ASIC cancellation ranges**



Proposed ASIC regime