

ASIC's proposed reforms to the Australian equity market structure

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LegalTalk Alert

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What would you like to grow?

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Introduction

On 4 November 2010, the Australian Securities and Investments Commission (ASIC) released a consultation paper on the regulation of the Australian equity markets (AEM) and the introduction of competition between exchange markets. The "Consultation Paper 145: Australia, equity market structure: Proposals" (Consultation Paper) provides background on the evolution of the AEM and details proposals addressing key issues confronting the AEM including:

- extreme price movements
- direct electronic access arrangements and algorithmic and high-frequency trading
- best execution obligations of market participants
- obligations in the context of pre-trade and post-trade transparency
- market integrity, and
- reporting requirements of market participants (e.g. brokers) in relation to suspicious activity.

Purpose of the proposed reforms

Equity markets globally are currently undergoing considerable change and they are now overwhelmingly electronic and automated. The broad ranging proposals in the Consultation Paper purport to address the increasing influence of competition and technology on the way the AEM operates.

The proposed reforms are intended to:

- (i) maximise market efficiency and opportunities for innovation
- (ii) mitigate any risks to investor confidence in Australian markets

- (iii) improve confidence in the Australian market and encourage investor participation
- (iv) preserve market quality and the price formation process, and
- (v) address the lessons from the 6 May 2010 "flash crash".

Who will the proposed reforms affect?

The proposals under the Consultation Paper are expected to affect:

- market participants, ASX and prospective operators of markets in equity market products: the proposals apply to them directly
- persons who access exchange markets through a market participant's infrastructure; specifically the relationship between them and market participants
- frequent investors in and issuers of equity market products: the proposals relate to how equity markets in Australia will function
- institutional investors: the proposals are expected to result in increased innovation in products and services, more choice in where and how orders are executed, and lower execution costs, and
- retail investors: the proposals are expected to result in better prices and a new multimarket environment.

Key proposals in response to recent and likely market developments

Extreme price movements

A market operator must have:

- transparent and predictable arrangements for cancelling trades
- capability to automatically suspend trading in a single product and market-wide, and
- pre-trade controls to prevent the entry of anomalous orders.

Direct electronic access (DEA)

A market participant must ensure DEA clients meet certain standards and enter into a legally-binding contract with the market participant. This is intended to ensure that the engagement is of high integrity and that the participant understands the nature of the orders that the DEA client may place. The market participant must additionally have adequate controls and the capacity to disable clients' access.

Algorithmic trading

A market participant must ensure that all systems used to generate orders by it and its DEA clients are appropriately tested, monitored continuously during use, and able to be immediately disabled.

Best execution

Market participants must take reasonable steps to obtain the best total consideration for its clients.

Market participants that deal with clients:

- should ensure incentives and bundled services do not adversely impact execution
- must have policies and procedures for complying with the best execution obligation

- should disclose to clients the venues on which client orders may be executed
- should review the arrangements at least annually
- must be able to demonstrate compliance with their execution arrangements, and
- should publish periodic statistics about order routing decisions and execution quality on their venues.

Pre-trade transparency

A market participant must display orders on a pre-trade transparent market unless:

- the order is large in size, is equal or greater to \$20,000 and there is price improvement, or
- the size is equal or greater than \$20,000 (for undisclosed orders on a pre-trade transparent market), or
- where the order is done outside the normal trading hours of all markets.

Dark pools operators¹ must periodically report to ASIC on the nature and activity of trading on the pool, thereby enabling ASIC to monitor developments.

Market operators must make pre-trade information available immediately on a continuous basis.

Market integrity measures

A market participant must:

- notify ASIC of any suspicious activity relating to market manipulation or insider trading, and
- distinguish on orders and trade reports short sales to ASIC.

¹ Operators of crossing networks that provide liquidity that is not displayed on order books.

Key proposals in response to competing exchange markets in Australia

Post-trade transparency

A market participant must immediately report all trades to a market operator, who must publish the information immediately. ASIC propose to permit delayed publication where the trade meets the \$2 million, \$5 million, \$10 million and \$15 million thresholds.

Market operator cooperation

A market operator must:

- comply with a multimarket protocol
- consolidate data
- synchronise its clocks to a clock nominated by ASIC
- use common market participant identifiers and stock symbols, and
- implement common tick sizes.

Market participant cooperation:

Market participants must not:

- transact by means other than under the rules of a market operator, subject to certain exceptions, or
- trade on a central limit order book² or off-order book during a market-integrity-related trading halt or suspension.

Consolidation of information

ASIC intends to bring about an outcome of consolidated information being available to market users.

² System of aggregate limit orders on all securities received by specialists, market makers, and electronic trading systems.

Recommendations

Market operators

1. Technology: market operators will need systems to:

- incorporate changes to pre-trade transparency arrangements
- control order entry into matching engines
- capture and route additional data for execution quality statistics and for ASIC surveillance
- synchronise clocks in trading and reporting systems to a universal clock, and
- automatically halt trading.

2. Human resources: market operators will need staff to:

- provide training to other staff
- provide investor education about the changes for their market
- cooperate with ASIC and other market operators, and
- consider the implications of the proposals, including the impact on technology.

3. Compliance policies and procedures: market operators will need to:

- review and amend existing policies and procedures where necessary
- implement new policies and procedures for trading halts and trade cancellations, and
- establish procedures for ensuring clocks remain synchronised.

Market participants

1. Technology - market participants will need systems (either their own or those of third parties) that:

- filter client orders and can disable DEA and algorithms
 - capture and route additional data for execution quality statistics (if operating an execution venue), for trade publication and for ASIC surveillance, and
 - can process market data, determine to which execution venue to route orders based on predefined parameters and then route the orders.
2. Human resources - market participants will need staff to:
- monitor compliance with best execution arrangements and review the arrangements
 - consider the implications of the proposals, including the impact on technology
 - make best execution disclosures to clients
 - assess if DEA client agreements are sufficient; and
 - provide training to other staff.
3. Compliance policies and procedures - market participants will need to:
- review and amend existing policies and procedures where necessary, and
 - put in place new best execution policies and procedures.

Implementation

The proposals in the Consultation Paper are intended to be implemented through market integrity rules, which will supplement existing ASIC Market Integrity Rules (ASX) 2010.

It is expected that some proposals may be implemented soon after competition commences, while others may need to be implemented in stages over a longer period of time. This is dependant upon the complexity of the proposal or the investment required in technology, staff and compliance processes.

Feedback

ASIC is seeking feedback on:

- (i) specific proposals for market integrity rules - identified as proposals
- (ii) the [draft market integrity rules](#) that reflect the proposals, and
- (iii) issues that require further consideration.

ASIC's Consultation Paper 145 is open for public comment until **21 January 2011**.

Further information

Sources used in this article:

- [Consultation Paper 145: Equity market structure: Proposals](#)
- [Report 215: Australian equity market structure](#)
- [Australian equity market structure: Background](#)
- [Overview of CP 145 and REP 215: Australian equity market structure](#)

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