15 May 2013

Dior Loveridge and Joseph Barbara
Australian Securities and Investments Commission
Level 5, 100 Market Street
Sydney NSW 2000

Submitted via email to marketstructure@asic.gov.au

Dear Dior and Joseph,

Consultation Paper 202: Dark Liquidity and high-frequency trading: Proposals

On behalf of our members, the CFA Societies of Australia welcome the opportunity to comment on the Australian Securities and Investments Commission's (ASIC) consultation paper on the impact of dark liquidity and high-frequency trading ("consultation"). We commend ASIC for such a comprehensive review of the topic in response to market concerns.

The CFA Societies of Sydney, Melbourne and Perth are not-for-profit associations of more than 1,500 investment professionals formed to lead the investment profession in Australia by setting the highest standards of education, integrity and professional excellence. Our members are engaged in a wide variety of roles across investment management and advice. Most of our members are holders of the Chartered Financial Analyst (CFA) designation.

Together we represent the three Australian chapters of CFA Institute[1]. CFA Institute stands for ethical excellence in the global financial community. It is a leading voice on global issues of fairness, market efficiency, and investor protection. CFA Institute offers a range of educational and career resources, including the Chartered Financial Analyst (CFA) and the Certificate in Investment Performance Measurement (CIPM) designations, as well as a new program called the Claritas Investment Certificate[2].

Our comments on this consultation represent an independent voice without the conflicts of interest that may face any particular industry association. We thank you for the opportunity to provide these comments and contribute to the development of your recommendations concerning dark liquidity and high-frequency trading ("HFT").

CFA Institute recently published a study ("CFA Institute study") on dark pool activity in the USA, specifically looking at the relationship between dark trading and market quality. The purpose of the research was to inform public policy issues related to undisplayed liquidity and to address market integrity rules. Our comments herein draw from and supplement the findings of that report[3].

General Comments

Over the past decade there has been significant changes in the way in which investors and other market participants interact. Increased automation, and the dependence on speed of execution have eroded the dominance of the incumbent exchanges. As a result liquidity has fragmented with a growing number of equity market transactions taking place over numerous trading venues which include dark pools.

The issues related to dark liquidity and HFT upsets the efficient functioning, integrity and fairness of the financial markets. Some of the specific regulatory concerns cited in the Report 331 include:

- Growth in below block size orders in dark pools resulting in wider bid-ask spreads and impaired price discovery on lit exchange markets;

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[1] CFA Institute is a global, not-for-profit professional association of more than 116,000 investment analysts, portfolio managers, investment advisors and other investment professionals in 130 countries of which more than 100,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 countries and territories.

[2] For more information please see http://www.cfainstitute.org/programs/Pages/index.aspx

[3] See CFA Institute, 2012, *Dark Pools, Internalisation, and Equity Market Quality* (October): http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2012.n5.1

- Limited visibility of the operations of crossing systems and other dark pools by clients; and
- Increased trading messages created by HFT and the effects on market stability.

We broadly agree with this assessment. In general we support measures designed to improve the transparency of equity markets, and the quality and accessibility of information which is critical for the efficiency of the investment decision-making process.

The consultation outlines a number of proposals on both dark liquidity and HFT. We address a selection of these proposals in the next section.

Specific Comments

Dark Liquidity: Proposal for a minimum size threshold for dark orders

Trading in dark pools has its advantages if trading occurs in the way it was primarily intended. One of the key benefits of using dark pools is to reduce information leakage and minimise market impact costs. As such, these facilities are popular for the execution of large block orders because it enables traders to anonymously access a deep pool of available liquidity while minimising the impact on price.

As outlined in REP 331 and the CFA Institute study, there has been a shift from block size to non-block size trades in dark pools. This shift from lit to dark trading venues has raised concerns among investors because of the widening of bid-ask spreads and decreased liquidity on the lit market.

We support the proposal to implement a minimum size threshold as a 'safety net' if dark trading is still having a negative impact on price formation and liquidity after the introduction of the meaningful price improvement rule. This rule is a good first step towards helping to preserve the integrity of price discovery carried out by lit markets and mitigating the potential for misuse of dark trading. A minimum size threshold would likely restrict the dark trades forcing them back to what they were initially intended. The CFA Institute study recommends that,

> *"Regulators should monitor developments with respect to internalization and dark pool activity. Regulators should consider introducing measures to restrict the use of dark orders and dark trading facilities if such activity becomes excessive, such as if the share of dark trading exceeds 50%."*

We believe the immediate focus should be on determining the effects of the minimum price improvement rule when it is implemented in May 2013. This rule is going to help prevent dark orders being filled before orders on the lit market at the same price, thereby minimising the disincentive to post lit orders on the exchange. This will help improve investor confidence in the lit market and uphold market integrity. Providing meaningful price improvement is also a recommendation in the CFA Institute study.

The CFA Institute study analysed the relationship between market quality and the level of dark trading. It found that market quality improves as dark trading increases but the relationship declines beyond a certain threshold. The estimated threshold for US securities was reached when dark trading exceeded 50%. Beyond this threshold the benefits of dark trading dissipate as most orders are filled away from the lit exchange and traders withdraw quotes because of the reduced likelihood they will be filled. ASIC proposes a trigger if dark liquidity for a security exceeds 10% based upon the Australian study by Comerton-Forde and Putnins (2012). We do not comment on the appropriateness of a 10% threshold for the Australian market.

Dark Liquidity: Proposals for crossing system operators

Proposal C1-C4: Transparency for the wider market and disclosure to users

CFA Societies of Australia supports ASIC's proposal to increase transparency of crossing systems and their operations to the wider market. It is important that market participants understand how dark orders on crossing systems are handled and executed.

The CFA Institute study recommends improved reporting and disclosure around the operations of dark trading facilities.

> *"Insufficient information about the operations of dark pools, internalization pools, the types of orders that are accepted within those systems, and the process by which orders are matched makes it difficult for investors to make informed decisions about whether or how to utilize dark trading facilities. It also makes it harder for regulators to monitor their growth and to evaluate how dark pools affect price discovery and liquidity. Dark trading facilities should, therefore, voluntarily reveal greater information about their operating mechanics and report more information on the volumes they execute. Such disclosures would improve transparency and enable all stakeholders to better understand their relative benefits and drawbacks.*

Implementation of these considerations would help protect displayed orders while offering meaningful savings to retail investors executing away from public markets, maintain competition, and further transparency. More fundamentally, these measures would enhance market integrity and underpin investor confidence in the equity market structure."

Dark Liquidity: Other Proposals

Proposal D1: Tick sizes

We agree that for some very liquid, low priced securities the bid-ask spread can be driven down to the minimum tick size. The high amount of trading interest in these securities leads to a build up of liquidity at the top of the order book.

The high queuing time creates a situation where trading in these securities might shift off the lit exchange to dark pools. Dark trading of these securities becomes more appealing because the dark order has the potential to be filled ahead of the lit order due to the possibility for price improvement in the dark beyond the minimum tick size. However, the movement off the lit exchange might be reduced with the new meaningful price improvement rule to be implemented.

If the tick size was reduced it may allow more trading on the lit exchange because there is further price improvement possible in the order book. However, there are some limitations that need to be considered.

- Reducing the tick size on the lit exchange could reduce the depth of liquidity at any given price point. Traders needing depth and liquidity may find it difficult to execute large orders without negatively impacting on price. This in turn could lead them back to dark pools.
- Reducing the tick size could also weaken the meaningful price improvement rule as the 'meaningful' improvement in price will be smaller if the tick size is smaller. This would diminish the intended effect of the rule.

Whether there will be less dark trading of tick-constrained securities or whether these potential limitations will actually be a problem is hard to answer, that is why we support the need for a pilot study for tick-constrained securities. It is important to weigh up the potential benefit of limiting dark trading against the potential risk of limiting depth, which has consequences for traders needing to trade volume.

A pilot program will give ASIC and market participants the opportunity to study exactly how this type of change will affect the market structure. We believe Option D1.2 is best as it is the most conservative option given it only looks at the most severely tick-constrained securities. By limiting the sample to these securities, the cost to implement the pilot should be less and the results obtained are less likely to be affected by other factors, therefore they will be more useful for ASIC's analysis of the issue.

High Frequency Trading

Proposal E1: Excess messaging and market noise

We agree that 'small and fleeting' orders can lead to excessive messaging and 'noise', however we do not believe that imposing a minimum resting time is the best method to correct this market instability. Therefore, we do not support ASIC's proposal to prevent small orders being cancelled or amended within 500 milliseconds of being submitted.

It is important to understand that HFT itself is not necessarily 'bad' for markets. We do know that HFT can exacerbate risks associated with errant technology such as rogue algorithmic trading. Therefore, it is our view that regulators should focus on making the system safer from an infrastructure and risk control perspective rather than intervening in the trading process itself, which could ultimately harm the end investor.

The expansion of HFT has coincided with a significant reduction in bid-ask spreads, fees, and commissions. This has ultimately benefited the end investors as trading costs have fallen. The reduction in the bid-ask spread and the subsequent fall in trading costs is because of the faster ability to trade. The faster the ability to trade leads to a more immediate transfer of risk, therefore the lower the compensation required by the market maker in the form of the bid-ask spread.

Given the speed at which high-frequency traders operate is critical to the overall reduction in costs, imposing a minimum resting period can have unintended consequences. Processing times are typically less than five milliseconds and even a one-tick spread can be profitable to a trader given the number of times that spread can be captured within one trading day. If a longer resting time was required it might discourage high-frequency traders from submitting limit orders on lit exchanges - as the longer the order takes to be completed, the greater the risk associated with it and hence higher its cost. Therefore, the trader will either decide to take the order to a non-lit trading venue or it will quote a wider bid-ask spread to compensate for the higher risk and associated cost. Ultimately the end investor might be harmed in either scenario.

We do agree that the average trade size has decreased and there is a significant increase in overall message traffic. This is also shown through higher order to trade ratios. The increased 'noise' not only increases the large amount of data that market participants, operators and ASIC need to store and manage but it can also lead to market instability if systems and infrastructure do not have the necessary capacity. We believe that the most effective way to mitigate the technological and operational risks while ensuring the benefits of HFT are preserved is through exchanges taxing (through higher fees) excessive message traffic, rather than arbitrary restrictions on order submission set by regulators. Combined with robust filters and controls over algorithms and a consistent circuit-breaker policy applied across exchanges, these measures can bolster investor confidence and help restore integrity to financial markets.

Concluding remarks

The CFA Societies of Australia are pleased that ASIC is looking at the impact of developments in dark liquidity and HFT on the quality, integrity and fairness of Australian financial markets. As an organisation that prides itself on upholding the highest ethical standards and promoting investor protection, we are very supportive of reforms that promote similar ideals.

If you have any questions in regards to this letter or the enclosed report, please feel free to contact Richard Brandweiner at president@cfas.org.au or Angela Pica at advocacy@cfas.org.au.

Yours sincerely,

Brandweiner

Pica

Richard Brandweiner, CFA
President
CFA Society of Sydney

Angela Pica, CFA
Head of Advocacy, Australia & New Zealand
CFA Institute

Enc: CFA Institute, 2012, *Dark Pools, Internalisation, and Equity Market Quality* (October) (by mail)