



17 March 2016

Ms Cathie Armour
Commissioner
Australian Securities and Investments Commission
Level 5, 100 Market Street
Sydney NSW 2000

By email

Copy to: Ms Tracy Bradsell, ASIC Perth

Dear Ms Armour

**High-frequency trading (HFT), dark pools and short selling
Concerns held by the Australian Shareholders' Association (ASA)**

At the WA Regional Liaison Committee meeting held on 18 November 2015, one of our members, John Campbell, noted that ASIC, in its Report 452 'Review of high-frequency trading and dark pools', had expressed the view that negative sentiment on that subject appeared to have tapered off. He said that he was aware that our membership was concerned about market inequities generally, and specifically about HFT and dark pools, and did not think that there had been any diminution of that concern. At the end of the meeting, Ms Tracy Bradsell of your Perth Office offered to arrange a video link with ASIC Sydney market surveillance team members so we could discuss our concerns.

A meeting with ASIC took place on 17 February 2016 and was attended by John Campbell, David Brooke and Gerry Pauley (ASA members in Perth), and Anna Lau, our Head of Research, in your Sydney office, together with Jane Gouvernet (Regional Commissioner WA), Tracy Bradsell and Penelope Owen of your Perth team, and Calissa Aldridge and Joseph Barbara from ASIC Sydney.

We are very grateful to ASIC for having given us the opportunity to hold this discussion and to clarify some of the issues on the subject. Time did not permit full discussion of all relevant issues, so we set out hereunder our concerns on the subject of the matters dealt with in Report 452 together with our concerns relating to short selling, which we see as linked to (and perhaps amplified by) HFT and dark pools. Although Report 452 covers futures markets as well, we have restricted our comments to the subject as it relates to equity markets. We note that many aspects of ASIC's report deal with the consequences of HFT and dark pools as they relate to wholesale investors, whereas our focus is on retail investors and the impact of HFT and dark pools on their investing.

We would appreciate a response from ASIC on the matters raised in this letter and that ASIC takes into account our concerns in its ongoing supervision of markets. We would also be happy to participate in any future consultation process in relation to this.

1. HFT

- 1.1. HFT traders are able to place into, and withdraw orders from, the market in a matter of milliseconds, whereas it takes retail investors and traders who do not have access to the sophisticated tools substantially longer. To facilitate such high speed access we understand that (for a fee) HFT traders place their computers in the vicinity of the exchanges' computers. This skews the market to the advantage of HFT traders. We would prefer that HFT traders' computers were separated physically from the ASX/Chi-X computers by a device which provided a delay to their access to the market to equalise it with that available to non-HFT traders and investors.
- 1.2. We note that a feature of HFT which concerns ASIC is the creation of 'noise' through the rapid submission and withdrawal of orders by HFT operators. We further note your finding that this is a very low percentage of total orders submitted (paragraph 80 of Report 452 refers to the percentage having declined from 2.1% to 0.7% since 2012), but we are concerned that this practice should be allowed at all. We note from the information provided that there are spikes in the volume of small and fleeting orders; we believe that the imposition of a 500-millisecond minimum resting time for orders, as previously proposed by ASIC, is desirable as it would greatly reduce the tendency for HFT operators to create 'noise' when it suits them to do so.
- 1.3. Generally speaking, retail clients transact through brokers who impose minimum order conditions (usually \$500) and minimum brokerage charges (about \$20-\$30 for online brokers). HFT operators, wholesale investors, and some traders paying for privileged access, face no such restrictions and this creates an unlevel playing field for retail investors. In particular, the differential is apparent in the case of partial completion of an order, with often only a single share being transacted, but the retail investor is still charged a full transaction fee by their broker. Irrespective of whether it is just one share transacted or a small number of shares, the transaction will usually cost a retail investor the minimum brokerage- which is an unfair imposition, and one which does not apply to wholesale investors. We do not know the full extent of this problem but our feedback is that it is significant. We suggest that all market participants, including HFT operators, should be subject to a minimum order value of say \$500 unless disposing of an entire holding.
- 1.4. During intra-day trading, and subject to the foregoing and our concerns in paragraphs 1.6 and 1.7 below, HFT may not amount to more than computers playing games with each other and providing a degree of liquidity. However, during beginning and end-of-day auctions held by ASX, this amounts to the ability to effectively shut retail investors out of the action. At our meeting, it was conceded that HFT traders employed sophisticated algorithms to "discover" what orders were in queues, thus

allowing them to effectively manipulate the auction. HFT systems are also able to react to bids much faster, with the result that retail investors are shut out of the auction or (perhaps worse) left with only partial completion of an order, but with a full transaction fee. The simplest way in which this inequity could be eliminated is to abandon the opening and closing auctions on the ASX.

- 1.5. At our meeting, we were advised that research had been conducted into alternative ways of opening and closing the market, with the present system deemed the most satisfactory. If it is not practicable to abandon the auction system, there are a number of steps which could be taken to reduce the disadvantage to retail investors and traders stemming from HFT operations. We particularly favour the imposition of a minimum order value of say \$500 together with restriction of the ability to withdraw orders from the market or auction once placed. The imposition of a minimum order value and a mandatory resting time could be viewed by institutions keen to retain the auction process as a trade-off for being allowed to retain it. We do not preclude the imposition of further steps to level the playing field for retail investors vs HFT trading, and we commend the actions taken by overseas regulators referred to in paragraph 33 of REP452.
- 1.6. A fundamental concern is the practice of 'sniffing' where HFT traders ping the market in quiet sessions to search for client stop-loss orders. We have provided ASIC of an example of this which occurred in shares in CWP on Melbourne Cup Day, 5 Nov 2013. Such predatory trading makes retail investors nervous of using conditional contracts to guard against losses ('stop-loss' contracts). We think that this practice may be of particular concern with respect to dark pool transactions and it may not be restricted to HFT traders, but its prevalence may be facilitated by HFT.
- 1.7. Paragraph 51 of Report 452 indicates that HFT traders have found a means to direct trades away from other HFT traders. This is of concern to us, because our research of literature published about US HFT trading suggests that the number of new order types exploded along with HFT. In 2012, 150 different order types were being used in USA. Some order types gave an advantage to HFT over others. Examples of these order types include:
 - Direct Edge: allows HFT to withdraw 50% of its order the instant someone tries to act on it,
 - Post only order: allows order to be acted upon only if the firm is on the passive side & gets a rebate from the exchange,
 - Hide not slide: allowed a HFT to cut in line in front of people who created the line & thus get the rebate,
 - Iceberg orders that hide the actual quantity,

- PrimaryPegPlus enabled HFT firms "to place sub-penny-priced orders that jumped ahead of other orders submitted at legal, whole-penny prices"

Are Australian HFT traders using sophisticated order types to avoid other HFT traders and hence to target other classes of investors including retail investors? How otherwise are HFT traders able to differentiate between parties they wish to trade with as opposed to those they prefer not to trade with? Do such order types result in unfair trading practices?

2. Dark pools

- 2.1. Paragraph 234 of Report 452 indicates that agency transactions in dark pools were on the losing side for 68% of trades; we assume that all retail investors' transactions would be included in the agency figures. HFT traders were on the winning side in 85% of their dark pool trades. ASIC's conclusion in paragraph 194 of Report 452 is that no further regulatory action is needed to counter unfairness. ASA accepts that policy settings may have brought about (relative) improvements, but we are concerned that dark pools are still unfair to retail investors. We note that Canadian regulators have outlawed dark pools and we question why this action is not taken in Australia.
- 2.2. Our concerns relating to dark pool operations centre on the perception that conflicts of interest exist within market participants or their institutional clients which may result in disadvantage to retail investors through dark pool operations carried out by those participants. For instance, we do not think that a participant should be allowed to trade as principal with clients (paragraphs 228-234 of Report 452) through dark pools because of the risk that the client's outcome will be worse than if the transaction was put through a 'lit' exchange. We see risks arising from the institution concerned having better access to information than that made available to its client at the time of the transaction or having information not available to the client about orders in the pipeline.
- 2.3. We have concerns that market participants or their institutional clients with access to dark pool trading may be managing both normal investment funds and hedge funds under one roof – is this an area of concern to ASIC? Is it a case of one section of staff trying to find fundamentally good investments and the other section trying to find and exploit reasons to undermine companies' reputations? We question the effectiveness of Chinese walls arrangements and the ability of any regulator to have sufficient visibility over those arrangements.
- 2.4. We have referred to concerns in paragraphs 1.6 and 1.7 above relating to 'sniffing' and special order types available to institutional clients which are not available to retail investors. We see these concerns as spanning the HFT and dark pool debate such that the combination of the availability of such techniques combined with inside information held about client accounts (such as dormant conditional orders) may severely prejudice retail investors. As stated above, we note that the Canadian regulators have prohibited dark pool operations in that country and thus force all

transactions to be put through the 'lit' exchanges. We would prefer this to be the case in Australia so as to reduce the incidence of adverse outcomes for retail investors.

- 2.5. Also spanning the areas of HFT and dark pools is our concern over the equal access to information. We remain concerned that trading institutions get access to information earlier than retail investors from subscription to IRESS, which is able to communicate messages to subscribers quicker than the ASX is able to make the information available on its website, and in turn further quicker than brokers who relay ASX website information to clients. Retail investors, who trade infrequently, are disadvantaged since they are not privy to information provided by premium service subscribers. We agree with ASIC's comments in paragraphs 124 and 125 of Report 452. We are unsure how ASIC reaches the conclusion in paragraph 126 that these practices 'are not inherently unfair' - our perception is that they disadvantage retail investors as against institutions.

3. Short selling

- 3.1. We note that Report 452 does not cover the topic of short selling at all, whereas we see the issues of HFT and dark pools as potentially related to those of short selling. We anticipate that many of the market participants (or their privileged institutional clients permitted to use their own algorithmic systems to trade shares) using HFT and participating in dark pool trading are also facilitating or engaging in short selling. We suspect that a substantial volume of short selling is conducted by algorithmic systems without human intervention such that computers are deciding to sell shares on receipt of information suggesting a downturn in the price of those shares; that might be within parameters involving a limit on the extent of such orders but without constraint as to whether the institution concerned has present stock cover for such a sale.
- 3.2. We also understand from Report 452 that most HFT positions are zeroed within the day. We are concerned that naked short sales may be taking place during the day, but which are not reported in the end of day disclosures. This is on the basis that the computerised system would generate information to a controller who/which has the ability to instigate negotiation with another party to put in place the cover needed to comply with short selling rules, perhaps before market close but after the event! If this is the case, we would like ASIC to review its desirability as we see it as a dangerous situation which could lead to market distortions. Does ASIC currently have any way to monitor the occurrence of this practice?
- 3.3. In our view, it is arguable that the very activity of short selling adds to market volatility. We think that research into the correlation of short selling activity and individual company share price volatility would disclose a positive link; it would be helpful to know if ASIC has ever looked into this, or whether research on this has been done either in Australia or overseas. Many ASA members would perceive increased volatility as a detraction from investing – why does ASIC permit short selling at all? Does it

really add liquidity or is it simply market manipulation, perhaps based on insider information, and predatory trading?

- 3.4. We have noted that the value of shares short sold in larger companies is often in billions of dollars (eg Woolworths and Santos recently). This leads us to assume that, given compliance with rules requiring short sold shares to be covered generally by borrowing the stock from an investor, the source of the stock being lent to the short selling trader must be an institutional managed fund in most instances. We see three concerns with this:
- The lending institution is holding the shares on behalf of unit-holders in a managed fund; these shares are held in a trustee capacity and should be subject to normal trustee considerations regarding safe investment. Lending them on an unsecured basis to a hedge fund could be viewed as a breach of this trust and should not in our view be permitted.
 - The lending institution must expect to see the price of the security being lent falling as a result of the short selling activity contemplated in the loan. The loan would attract a fee for the lender but would this fee compensate for the loss in value of the security? Who benefits from the fee – the lender or the underlying investor in the managed fund? What limits and parameters do the trustees of lending funds set; are investment managers inappropriately motivated by pay incentives to increase short term portfolio earnings from such practices, but to longer term detriment? Can APRA/ASIC demand evidence to support the assertion that the stock loans are (overall) in fund members' best interests? Is there an unacceptable conflict of interest involved? Has APRA looked at this situation from the viewpoint of propriety in the conduct of public superannuation funds?
 - We also query whether the managed funds lending the shares and the hedge funds short selling them are under one roof. If so, this raises concerns as to conflicts of interests within the institution concerned which should be addressed by prohibiting such conduct. Are they also under the same roof as those facilitating placements and IPOs? We question the effectiveness of Chinese wall arrangements in these cases. A suspicious mind might worry that there could be a conspiracy to drive down the price of shares in susceptible companies, so as to pressure boards into raising more capital via a placement, to the advantage of all three arms of the business and the further disadvantage of retail investors.
- 3.5. During our brief conversation on this subject at the video conference, we understood Mr Barbara to say that security for short selling was provided by a 'stock-swap' in some instances – we presume this means that a hedge fund owning shares in company A might provide those as security to a lending institution for a loan of the shares in company B which it intended to short sell. If so, it may address some of our concerns

regarding breach of trust but not those relating to conflict of interest and would raise further questions about enforceability in the event of the insolvency of the security being lent and the value of the security stock falling at the same time. Does ASIC have a record of instances where short sellers have defaulted on these security arrangements; if so could this be provided in any future ASIC report on short selling? We think it is in the interests of market integrity for such instances to be publicised unless trivial, and for ASIC and/or APRA to provide regulatory guidance on what practices are acceptable and those which are not.

3.6. Why are short sold positions released on a T+4 basis rather than on a transacted basis?

4. ASIC's powers

There are several references in Report 452 to ASIC detecting practices it considered inappropriate, talking to the relevant market participants and seeing the practices cease. This is good but it may fall short of the deterrent needed to stop another participant trying the same practice in the future? Does ASIC have the power to declare practices in contravention of the relevant laws, regulations and market rules, and to prosecute participants engaging in such practices? Are ASIC's powers adequate?

We are grateful to ASIC for providing us with the opportunity to discuss some of the above issues with you and look forward to receiving a response in due course.

Please contact Ms Anna Lau (by email to annalau@asa.asn.au) if further information is needed with respect to the foregoing.

Yours sincerely,



Diana D'Ambra
Chairman