

Manager, Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
Parkes ACT 2600

By email: financialmarkets@treasury.gov.au

1 February 2013

Dear Sir or Madam,

Australia's Financial Market Licensing Regime: Addressing Market Evolution Submissions in respect of the Options Paper November 2012

We refer to *Australia's Financial Market Licensing Regime: Addressing Market Evolution – Options Paper November 2012 (Options Paper)* and your request for feedback by 1 February 2013.

We are financial services lawyers specialising in managed funds. We act for a range of financial services providers in the Australian market place, including responsible entities, trustees, investment managers, financial advisors, custodians and administrators. Please refer to **Annexure 1** for a summary of the principal's expertise.

The Options Paper requests feedback in relation to 22 specific questions. These questions are largely aimed at traditional market operators (like ASX), exempt market operators, dark pool operators and, to a lesser extent, HFTs. We anticipate you will receive detailed submissions from these stakeholders.

The questions you have posed, however, are largely irrelevant to the persons who use the dark pools (e.g. responsible entities, trustees and investment managers of various managed funds and individual mandates). The purpose of this letter is to explain why fund managers are moving away from lit markets such as the ASX to dark pools. Understanding these reasons may assist you to fine tune, and hopefully moderate, the inevitable regulation of dark pools.

Capitalised terms used in this letter that are not specifically defined have the meaning given to them in the Options Paper or the *Corporations Act 2001 (Cth) (Corporations Act)* (as appropriate).

1. Summary feedback

In summary, our feedback is as follows:

- a) HFTs are a fact of life and are here to stay.

- b) If one accepts that ASX (the monopoly market operator) is permitted to sell low latency solutions to HFTs (and indeed profit handsomely from such sales), then there must be a viable, competitive alternative for those investors seeking better execution and to minimise the impact of HFTs on their longer term portfolios.
- c) Dark pools are currently providing a much welcome alternative market for many larger, traditional fund managers (that is, responsible entities, trustees and investment managers who are looking to invest in listed securities for the longer term). In this letter we refer to these investors as ***Traditional Investors***.
- d) It is not appropriate to allow the monopoly player (i.e. the ASX) to profit from sales of low latency solutions to HFTs yet hinder the competition (being dark pools). Therefore any proposed regulation of dark pools must be “light touch” and not so intrusive that they cease to be a viable alternative for Traditional Investors seeking better execution to that available on the lit market.

More detailed explanations are in the remainder of this letter.

2. Dark pools

Dark pools are not new

Dark pools are not new. They have existed since the 1980s. In more recent years, the broker-dealers have transformed the traditional “upstairs” dark pools operated by the market exchanges and now operate pools that allow continuous crossings. But even these newer creatures pre-date the *Financial Services Reform Act 2001 (Cth)*.

Why are dark pools increasingly popular?

Traditional Investors are increasingly using dark pools to trade around 20 to 30 percent of their portfolios. They are moving towards dark pools because HFTs are making efficient trading on the lit market more difficult. When large trades are executed on the lit market, the HFTs are running ahead of the trades on the buy side driving prices up and then, on the sell side, driving the prices down. The momentum caused by HFTs clearly impacts the performance and transaction costs of a portfolio.

We do not agree with the proposition in the Options Paper that HFTs provide genuine liquidity to the market. Rather, HFTs provide turn over. By having no open positions at the end of the trading day HFTs make it very difficult for Traditional Investors to trade in the market efficiently. But we acknowledge that HFTs are legitimate players and do not support calls to ban them.

Dark pools provide Traditional Investors with an environment in which trades in more liquid stocks can be executed without adverse price movements. Some dark pools will prohibit HFTs from participating in the pool. These pools are more attractive to Traditional Investors. Larger crossings can therefore be executed in the pools without the same volatility that occurs on the lit market and the impact of HFTs is significantly reduced. Trades are generally done within the bid/offer spread of the lit market (unless there is a genuine premium to be paid) and then reported to the lit market once completed. Crossing fees are paid.

Generally only larger Traditional Investors are permitted within the dark pools (i.e. those who’s portfolios are in excess of say \$3 to \$5 billion dollars). So contrary to suggestion in the Options Paper, no retail investors participate in the pools (and nor should they participate).

Traditional Investors choose their dark pools carefully. They generally only participate in a pool operated by a reputable investment bank and trusted broker. The participants in the pool may be kept anonymous but if HFTs are specifically excluded from the pool then this is made known to the participants. If any HFTs (or suspected HFTs) inadvertently make their way into a pool in which they ought to be excluded, the operators move swiftly to eject them from the pool upon detection.

Dark pool operators understand that reputation is key – they cannot afford to engage in inappropriate conduct else they will lose the valuable business of the Traditional Investors. This incentive assists the operators to self-police and keeps the dark pools clean.

Dark pools are here to stay

The competitive advantage HFTs gain from using low latency technology should not be further enhanced by forcing Traditional Investors back onto the lit market. Traditional Investors will continue to seek alternative markets to achieve better execution. Dark pools seem to be the best available alternative. We therefore anticipate that the growth of dark pools will continue provided they do not become overly regulated and therefore inefficient to operate.

3. Light touch regulation of dark pools is appropriate

The Options Paper focuses on the “competitive advantage” dark pools seem to enjoy due to their under-regulation compared to traditional exchanges. While we agree that some regulation of the pools is appropriate, we are concerned not to regulate the pools to the advantage of the ASX. The ASX enjoys a private monopoly position. It profits from HFTs through its sale of low latency solutions and turn over. One must be careful not to over regulate the dark pools (whose primary users are those stakeholders wishing to avoid the impact of HFTs as well as those placing large orders wishing to minimise adverse price movements). Over regulation is likely to reduce the efficiency of dark pools and therefore preserve ASX’s monopoly position.

From the Traditional Investors’ perspective, we consider the best approach to regulating dark pools includes:

- a) **Restricted membership.** Ensure that only genuine wholesale clients are permitted in the pools. We have no reason to doubt only wholesale clients do in fact participate in the pools, but a specific rule to this effect will put it beyond any doubt.
- b) **Publication.** Traditional Investors need enough information to make informed choices between dark pools by making the pools' owners disclose their operating procedures and membership criteria. This puts dark pools on a similar playing field to traditional exchanges.
- c) **Protect information.** Ensure pool operators each have appropriate rules and measures in place to assist them to interact with other pools when attempting to fill orders that cannot be matched within a pool without leaking price sensitive information.
- d) **Disclose profits from sale of low latency solutions.** Market operators who sell low latency solutions to HFTs ought to clearly disclose the profits associated with this in their accounts. This would assist both ASIC and Traditional Investors to understand how prevalent HFTs are in the market place. It may also assist Traditional Investors to make informed decisions about whether to trade on particular lit markets.

- e) **Amend the cost recovery regime.** ASIC is concerned that it is not collecting appropriate supervision fees from dark pools. Perhaps consider amending the current crossing fees so that ASIC collects a more equitable supervision fee.

4. Conclusions

Provided dark pools can continue to offer Traditional Investors with a viable, alternative to the lit market for crossings, then the precise regulation adopted by Treasury and ASIC is of limited concern to Traditional Investors. But for so long as HFTs are permitted to prosper on the ASX, and the ASX is permitted to profit from selling low latency solutions to HFTs, Traditional Investors will continue to seek out viable alternatives to the lit market for trading portions of their large portfolios. This competition is healthy and should be encouraged – not hindered by over regulation.

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We would be pleased to discuss any aspect of our submissions with your further. Please do not hesitate to contact Paula McCabe of our offices to discuss.

Yours sincerely,



Paula McCabe
Lawyer

Encl.

Annexure 1

Paula McCabe – bio



Paula McCabe

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Experience

Paula is a financial services lawyer with specialist expertise in managed funds. She has over 10 years experience in the Australian funds industry advising responsible entities, investment managers, investment banks, custodians, administrators, financial advisors and other key stakeholders in the funds industry.

Paula advises on a full range of matters including funds establishment and offerings (both Australian and offshore and wholesale and retail offerings), fund rationalisation and closures, Australian financial services licensing matters, regulatory and compliance issues, interactions with the ASIC and general corporate and commercial law matters.

Paula has helped establish and launch funds specialising in equities, fixed interest, property, infrastructure, carbon and alternative assets (including hedge funds and private equity) as well as capital protected and highly structured funds using a range of synthetic instruments (such as swaps, deferred purchase agreements and note programs). Her funds experience extends to establishing funds in Australia, Cayman Islands, Singapore, Ireland, Luxembourg and the United States. She has been named in the Asia Top 500 lawyers.

In 2011, Paula established her own legal practice, PMC Finservices Consulting. With a young family, Paula enjoys the challenge of running her own business and providing personal and professional services on mutually agreeable terms with her clients. Paula was previously a partner in the Sydney offices of global law firm Baker & McKenzie where she was the firm's managed funds expert.

Paula currently sits on the Regulatory Committee of the Alternative Investment Management Association (AIMA).

Education

Bachelor of Laws (Hons), Bond University, Australia

Bachelor of Arts, Bond University, Australia