



**CHARTERED SECRETARIES  
AUSTRALIA**

*Leaders in governance*

31 January 2013

Manager  
Financial Markets Unit  
The Treasury  
Langton Crescent  
PARKES ACT 2600

By email: [financialmarkets@treasury.gov.au](mailto:financialmarkets@treasury.gov.au)

Dear Treasury

***Australia's Financial Market Licensing  
Regime: Addressing the Market Evolution***

Chartered Secretaries Australia (CSA) is the peak body for over 7,000 governance and risk professionals in Australia. It is the leading independent authority on best practice in board and organisational governance and risk management. Our accredited and internationally recognised education and training offerings are focused on giving governance and risk practitioners the skills they need to improve their organisations' performance.

Our members are all involved in governance, corporate administration, legal practice and compliance with the *Corporations Act 2001* (the Act) with their primary responsibility being the development and implementation of governance frameworks in public listed and public unlisted companies, private companies, and not-for-profit organisations.

CSA welcomes the opportunity to comment on the Options Paper, *Australia's Financial Market Licensing Regime: Addressing Market Evolution* (the options paper). CSA Members have been observing the changes to the financial market for some time, with particular alertness to the effects on public listed companies and their shareholders of the emergence of dark pools and high frequency trading. CSA Members have also been in discussion with the Australian Securities Exchange (ASX) concerning these matters.

***General comments***

CSA Members believe that the important issue is retaining confidence in the market. Regulation must support an efficient and effective market, and it must be an equal playing field for investors.

CSA Members support action to ensure that Australia's market licensing regime can apply to all market types in Australia and be flexible enough to adapt easily to future developments. CSA Members are of the view that:

- exempting alternative markets (other than crossing systems) from the application of the market licensing provisions creates the potential for investor harm, given the reduced regulatory oversight where a market is exempt from holding an Australian Market Licence (AML)

- regulation through exemptions should not operate as the default system of regulation for alternative markets
- trading off-market remains as valid as ever, as dark pools ensure that large block trades do not distort the market and disrupt trading (for example, a large, institutional block trade would send a disproportionate price signal to the market and be difficult to match with the liquidity available at the time if sent to the lit market or a large shareholder could exit their holding in a small company with an illiquid stock, and the use of a dark pool can decrease disruption to the share price)
- dark pools, however, have implications for confidence in the market, given the proliferation of dark pools, the evolution of more 'market-like' characteristics attaching to them and the fact that dark pools are regulated outside the market licensing framework, which provides them with a competitive advantage over the lit market.

CSA has concerns that:

- all trades are not being executed in the one market place to which everyone has equal access, which is the lit market (unless there is a good reason not to execute it there) — that is, small orders are not necessarily going to the lit market, which means that not all retail investors have access to the same matching process and the same commercial terms
- because dark pools are facilitating a number of smaller trades, they are looking more and more like exchanges, yet they are not regulated in similar fashion — Australian listed companies depend on the lit market to understand the value of their securities
- there are queries as to whether there is a material improvement to the price of securities being traded in dark pools — the price at which the investor can trade in a dark pool is important, so that off-market trading is returned to the purpose for which it was intended, which was large transactions.

CSA is of the view that dark pools must be regulated on a level playing field with lit markets. CSA can see no public policy argument as to why a dark pool should be able to be operated on a less regulated basis than a market operator.

### ***Specific concerns held in relation to Australian public listed companies and their shareholders***

#### **Market manipulation**

The company cannot be assured that market manipulation of its shares is not taking place, thereby creating an environment that is not conducive to the company and its shareholders.

Dark pools create a lack of transparency, making it difficult for companies to have clarity as to who is undertaking what trading. This can create fertile ground for market manipulation.

#### **Lack of transparency**

There is a lack of transparency in a dark pool, if it functions as a private exchange, as it is impossible to see which party or parties have information. This differs from the lit market where all market participants are fully and equally informed. The absence of the same rules of disclosure as apply to the lit market could result in an uneven playing field for investors.

Public listed companies do not know who is trading in their shares or, ultimately, who owns the shares. While the beneficial tracing notice regime exists, it is slow and cumbersome. Despite the fact that the same post-trade transparency mechanisms operate, when trading occurs in dark pools, listed entities could receive a price query from ASX about an unusual trading or share price movement of which the entity has no knowledge, as it is being conducted without transparency.

Shareholders have the right to manage their affairs in the way they deem fit, including the use of custodians or through dark pools where they may never be the registered holder. However, the increasing use of intermediaries between the ultimate holder and the listed company means that, inevitably, engagement with those ultimate holders will be more difficult and those holders should

be aware that because of the use of an intermediary, they do not have that essential contractual relationship with the listed company (and the rights and remedies that go along with it) as set out in s 140 of the *Corporations Act 2001*. We have seen consultations (including the recent Corporations and Markets Advisory Committee consultation on the future of the annual general meeting) asking the question as to whether there should be obligations on listed companies vis-à-vis ultimate shareholders not on the register. CSA is of the strong view that the central relationship as set out under s 140 should not be undermined and that through general privity of contract, listed companies should not have obligations vis-à-vis ultimate beneficial shareholders.

CSA also has concerns about the impact of trading in dark pools on setting prices for capital raisings. While block trades from the ASX's block trading facility are excluded from calculating VWAPs, and thus may protect the share price from one-off fluctuations arising from one-off large trades using the facility, concerns remain that prices set using VWAPs over the lit market may not be representative of the real share price over both markets, as well as the possibility of increasing the opportunity for market manipulation.

### **Impact on liquidity**

Dark pools could be having a material impact on the liquidity of the lit markets, by draining liquidity from the lit market. It is unclear what the net benefits to the Australian market are, particularly given the size of the market, of fragmenting liquidity. While the US is a fragmented market, it is also a huge market. While there might be benefit for particular investors from trading outside the lit markets, because trading in the dark pools, crossings and internalisation of trades are priced by reference to the lit markets, the emergence of multiple pools of liquidity and non-transparent trading could result in lower liquidity in those markets and wider spreads and damage the interests of the vast majority of investors. There could be a significant cost if trading in top ASX listed securities falls by a large percentage due to fragmentation of liquidity.

An increase in dark execution, where trading takes place away from the central, public market (the lit market) is showing increasing evidence of widening spreads and higher costs for investors.<sup>1</sup> ASX advises that average values of trades have decreased to around \$5,000 for the ASX lit market and \$3,000 for trades in the dark (below block size). The lower average price is being driven by high frequency trading (HFT) which trades a single share at a time (hundreds of times a second if need be).

Any regulation of financial markets needs to ensure that investors are not at risk of large falls in trading due to the fragmentation of liquidity.

### **Undermining confidence in and the principle of the market**

Dark pools can see smaller investors or fund managers acting on behalf of smaller investors affected negatively if the business of matching genuine buyers and sellers of company securities in a lit market (a transparent and regulated market) becomes smaller and that taking place in private exchanges becomes larger.

The privileging of one pool of investor over another undermines confidence in the market and undermines the principle of the market.

It is the price at which the investor can trade in a dark pool that is important, so that off-market trading is returned to the purpose for which it was intended, which was large transactions. There must be a material improvement to the price. CSA believes that small orders should not be traded in dark pools.

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<sup>1</sup> Elmer Funke Kupper, Retail Investors Should be Heard, *EQUITY*, December 2012/January 2013, pp 4—6

**CSA recommendations**

CSA recommends that small orders should not be traded in dark pools and that dark pools be regulated on a level playing field with lit markets.

CSA recommends that a threshold be implemented, below which all orders must be executed on the lit market. We note that ASX has previously recommended a threshold of \$25,000, below which all orders must be executed on the lit market, and CSA is in accord with this recommendation.

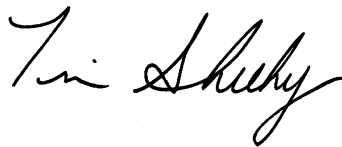
This would ensure that off-market trading is returned to the purpose for which it was intended, which was large transactions.

**Changes to market infrastructure**

The options paper presents two options for amendment of current market licensing and regulatory arrangements in Australia.

CSA leaves it to other bodies to comment on these two proposals.

Yours sincerely

A handwritten signature in black ink, appearing to read "Tim Sheehy". The signature is written in a cursive, flowing style.

Tim Sheehy  
CHIEF EXECUTIVE