

**ASIC MARKET INTEGRITY RULES (CHI-X AUSTRALIA MARKET) AMENDMENT 2012
(NO. 3)
EXPLANATORY STATEMENT**

Prepared by the Australian Securities and Investments Commission

Corporations Act 2001

The Australian Securities and Investments Commission (*ASIC*) makes the *ASIC Market Integrity Rules (Chi-X Australia Market) Amendment 2012 (No. 3)* (the *Instrument*) under subsection 798G(1) of the *Corporations Act 2001* (the *Act*). Capitalised terms used in this Explanatory Statement (e.g. “Market Participant”) are defined in the *ASIC Market Integrity Rules (Chi-X Australia Market) 2011* (the *Rules*).

1. Enabling legislation

Subsection 798G(1) of the Act provides that ASIC may, by legislative instrument, make rules that deal with the following:

- (a) the activities or conduct of licensed markets;
- (b) the activities or conduct of persons in relation to licensed markets;
- (c) the activities or conduct of persons in relation to financial products traded on licensed markets.

2. Purpose of the legislative instrument

The purpose of the Instrument is to amend the Rules to address regulatory issues resulting from recent market developments in Australia, in particular new risks to market integrity resulting from the growth of automated trading.

Automated Trading

The Instrument makes amendments to Chapter 5 of the Rules (Trading) to introduce requirements for Market Participants that use their system for Automated Order Processing to:

- (a) have direct control over the automated filters and the filter parameters for that system;
- (b) ensure that the system has in place controls, including automated controls, that enable immediate suspension, limitation or prohibition of the conduct of all Automated Order Processing, Automated Order Processing in respect of Automated Client Order Processing, or Automated Order Processing in respect of one or more Authorised Persons, clients or Products;
- (c) ensure that the system has in place controls that enable immediate suspension of, limitation of or prohibition on, the entry into the Chi-X Market of Trading Messages in a series of related Trading Messages where the Market Participant has identified that Trading Messages in the series have entered the Chi-X Market and have interfered with, or are likely to interfere with, the efficiency or integrity of the Chi-X Market;
- (d) ensure that the system has in place controls that enable immediate cancellation of Trading Messages in a series that have already entered the Chi-X Market, where the entry of further Trading Messages in the series have been suspended, limited or prohibited;
- (e) conduct an annual review of Automated Order Processing systems and notification of the

Market Participants' compliance with Part 5.6 of the Rules.

The Instrument also removes the transitional arrangement which exempted a Chi-X Market Participant that is also an ASX Market Participant from the Chi-X Rules relating to certification of AOP systems. The transitional arrangement is removed from a date that is 18 months after the day on which the Instrument is registered under the *Legislative Instruments Act 2003*.

The purpose of these amendments to Chapter 5 of the Rules is to manage the risk of potential adverse events (and their effects on market integrity) of automated trading.

There are already robust controls in the Australian equity market to mitigate some of the risks from automated trading. However, these controls need to be updated to fully address emerging risks, as well as to align our regime with IOSCO principles and international best practice.

The amendments to Chapter 5 of the Rules made by the Instrument build a more rigorous framework of systems, filters and controls to guard against potential disruptions from aberrant algorithmic activity and will not disrupt the operation of the market in normal conditions. The amendments will ensure that Market Participants have the ability, in real time, to control and prevent aberrant order flow before it disrupts the market. An aberrant algorithm generates not only costs that are borne by the firms using the algorithms, but also negative impacts for all market participants by impairing the fairness and orderliness of the market.

Rules on Crossings during a Takeover Bid

The Instrument makes amendments to Chapter 6 of the Rules (Takeovers) to replace the reference to a "Market Bid" in Rule 6.4.1(1) with a reference to a "Takeover Bid".

Unamended, Rule 6.4.1(1) prohibits a Market Participant from conducting a Crossing outside of Trading Hours in an Equity Market Product during the Offer Period under a Market Bid, at a price which is at or below the offer price.

The purpose of the amendment to Rule 6.4.1(1) is to extend the prohibition in that Rule to Off-Market Bids. As amended by the Instrument, the prohibition will apply to relevant Crossings conducted during the Offer Period for a Takeover Bid, whether the bid is a Market Bid or Off-Market Bid. The policy rationale for prohibiting a Market Participant from conducting the specified Crossings in an Equity Market Product during the offer period under a Takeover Bid at a price which is at or below the offer price for that product applies equally during the Offer Period under an Off-Market Bid.

The purpose of the Instrument is described in more detail in the Regulation Impact Statement (*Australian equity market: Further proposals*).

Details of the Instrument are contained in Attachment A.

3. Consultation

ASIC has consulted on the amendments effected by the Instrument as follows:

- (a) ASIC Consultation Paper 179 *Australian market structure: Draft market integrity rules and guidance* (CP 179) seeking feedback on amendments to the market integrity rules and guidance to address market structure issues arising from recent and anticipated developments in Australia's financial markets;
- (b) ASIC Consultation Paper 184 *Australian market structure: Draft market integrity rules and guidance on automated trading* (CP 184), seeking feedback on proposed draft rules and guidance on participant-level controls for automated trading; and

- (c) Meetings with stakeholders and information sessions for members of the Australian Financial Markets Association (AFMA), the Financial Services Council (FSC) and the Stockbrokers Association of Australia (SAA).

4. Penalties

Subsection 798G(1) of the Act provides that market integrity rules are legislative instruments for the purposes of the *Legislative Instruments Act 2003*.

Subsection 798G(2) of the Act provides that market integrity rules may include a penalty amount for a rule. A penalty amount must not exceed \$1,000,000. The penalty amount set out below a Rule is the penalty amount for that Rule.

5. Commencement of the Instrument

The Instrument will commence in accordance with paragraph 3 of the Instrument.

6. Statement of Compatibility with Human Rights

This statement is prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* because it does not engage any of the applicable rights or freedoms.

7. Regulation Impact Statement

A Regulation Impact Statement (*Australian equity market: Further proposals*) has been prepared in relation to the Instrument.

ATTACHMENT A

Capitalised terms used in this Attachment (e.g. “Market Participant”) are defined in the Rules.

Paragraph 1 – Enabling Legislation

This paragraph provides that the Instrument is made under subsection 798G(1) of the *Corporations Act 2001*.

Paragraph 2 – Title

This paragraph provides that the title of the Instrument is the *ASIC Market Integrity Rules (Chi-X Australia Market) Amendment 2012 (No. 3)*.

Paragraph 3 – Commencement

This paragraph sets out the commencement dates for the items in Schedule 1 of the Instrument.

Paragraph 4 – Amendments

This paragraph provides that Schedule 1 amends the *ASIC Market Integrity Rules (Chi-X Australia Market) 2011*.

Schedule 1 Amendments

Item [1] Rule 1.4.3, after the definition of “AFSL”

Item [1] of Schedule 1 to the Instrument amends Rule 1.4.3 to insert, after the definition of “AFSL”, definitions of “AOP Annual Notification”, “AOP Annual Review”, “AOP Annual Review Date”, “AOP Initial Certification” and “AOP Material Change Review”.

These defined terms are used in amended Part 5.6 of the Rules (see items [2] to [32] below).

This amendment, and all amendments effected by the Instrument other than Items [33] to [36] commence 18 months after the day on which the Instrument is registered under the Legislative Instruments Act 2003.

Item [2] Rule 5.6.3

Item [2] amends Rule 5.6.3 by inserting “(1)” before “A Market Participant.” This amendment changes existing Rule 5.6.3 to subrule 5.6.3(1), to accommodate the amendment made by item [7], which introduces a new subrule 5.6.3(2).

Item [3] Rule 5.6.3(b)

Item [3] amends Rule 5.6.3(b) by, after “;”, omitting “and”. This amendment is consequential on the insertion of new paragraphs (d) and (e) after paragraph (c) (see items [5] and [6]).

Item [4] Rule 5.6.3(c)

Item [4] amends Rule 5.6.3(c) by omitting “markets provided by the Market Participant” and inserting “the Chi-X Market.” This amendment clarifies that Rule 5.6.3(c) applies to the activities or conduct of the Market Participant in relation to the Chi-X Market.

Item [5] Rule 5.6.3(c)

Item [5] amends Rule 5.6.3(c) by omitting “.” and substituting “;” This amendment accommodates the amendment made by item [6], to introduce new paragraphs (d) and (e).

Item [6] Rule 5.6.3, after paragraph (c)

Item [6] amends Rule 5.6.3, after paragraph (c) by inserting new paragraphs (d) and (e). New paragraph (d) provides that a Market Participant that uses its system for Automated Order Processing must ensure that the system has in place controls, including automated controls, that enable immediate suspension, limitation or prohibition of the conduct of all Automated Order Processing or Automated Order Processing in respect of one or more Authorised Persons or clients, Automated Client Order Processing, or one or more Products.

This amendment ensures that a Market Participant has in place controls, including automated controls, that enable the Market Participant to suspend, limit or prohibit Automated Order Processing, where the Market Participant has identified, for example, that Trading Messages from a particular source (such as a particular Authorised Person, account or algorithm) are interfering with the efficiency or integrity of the Chi-X Market. Examples of such controls include controls that terminate the activity of the Automated Order Processing system, shut down the responsible sub-system, force the logout of an Authorised Person or change the parameters of a filter to zero or another level that would prevent further trading.

New paragraph (e) provides that a Market Participant that uses its system for Automated Order Processing must ensure that the system has in place controls that enable immediate:

- suspension of, limitation of, or prohibition on, the entry into the Market of Trading Messages in a series of related Trading Messages where the Market Participant has identified that Trading Messages in the series have entered the Chi-X Market and have interfered with -or are likely to interfere with the efficiency or integrity of the Chi-X Market; and
- cancellation of Trading Messages in a series that have already entered the Chi-X Market where the entry of further Trading Messages in the series has been suspended, limited or prohibited.

This amendment ensures that a Market Participant has in place controls so that once it has identified, through its monitoring arrangements, that a series of Trading Messages (e.g. Trading Messages generated by a common user, account or algorithm that occur in close succession) submitted through its system is having, or is likely to have, an impact on the Chi-X Market, it can suspend, limit or prohibit further Trading Messages in the series from being submitted to the Chi-X Market, and cancel any Trading Messages in the series that have already entered the Chi-X Market.

Item [7] Rule 5.6.3

Item [7] amends Rule 5.6.3, by inserting, after (new) subrule (1), a new subrule 5.6.3(2). New subrule 5.6.3(2) provides that a Market Participant that uses its system for Automated Order Processing must have direct control over all automated filters and the filter parameters for those filters.

This amendment ensures that Market Participants that use their system for Automated Order Processing retain direct control over the application of the filters and filter parameters to trading by Authorised Persons through the Market Participant’s system. This amendment is designed to ensure that Market Participants are able to prevent aberrant algorithmic activity from interfering with the efficiency and integrity of the Chi-X Market.

Item [8] Rule 5.6.4

Item [8] amends Rule 5.6.4 by omitting "Subject to Rule 5.6.6A, before" and substituting "(1) Before". This amendment recognises that the transitional certification provision for participants of ASX and Chi-X in Rule 5.6.6A is omitted by item [22] of the Instrument. This amendment also changes existing Rule 5.6.4 to subrule 5.6.4(1), to accommodate the amendment made by item [9], which introduces a new subrule 5.6.4(2).

Item [9] Rule 5.6.4

Item [9] amends Rule 5.6.4 to insert after "these Rules." a new subrule (2) and a note following that new subrule. New subrule 5.6.4(2) provides that a Market Participant that was not required to comply with Rule 5.6.4 in relation to a system for Automated Order Processing because of the operation of Rule 5.6.6A is not required to conduct the review referred to in subrule 5.6.4(1) in relation to that system for Automated Order Processing. Item [9] also inserts a note describing the effect of Rule 5.6.6A and explaining how, and when it is omitted from the Rules.

Item [10] Subrule 5.6.5(1)

Item [10] amends subrule 5.6.5(1) by omitting "Subject to Rule 5.6.6A, before" and substituting "Before". This amendment recognises that the transitional certification provision for participants of ASX and Chi-X in Rule 5.6.6A is omitted by item [22] of the Instrument.

Item [11] Subrule 5.6.5(1)

Item [11] amends subrule 5.6.5(1) by omitting the words "their Automated Order Processing system meets the requirements of each of paragraphs 5.6.3(a), (b) and (c)" and substituting "the Market Participant has in place organisational and technical resources, arrangements and controls in relation to the system for Automated Order Processing that meet the requirements of Rule 5.6.3."

This amendment recognises that the requirements of paragraphs 5.6.3(a), (b) and (c) have been supplemented by new requirements (see items [6] and [7] above), and those requirements are together more aptly described as "organisational and technical resources, arrangements and controls".

Items [12] and [13] Subrule 5.6.5(2) and Paragraph 5.6.5(2)(a)

Item [12] amends subrule 5.6.5(2), by inserting after the words "subrule (1)", the word "must".

Item [13] amends paragraph 5.6.5(2)(a) by omitting the word "must."

These amendments together clarify the intended operation of subrule 5.6.5(2) – that is, that the representations referred to in subrule 5.6.5(1) must meet all of the requirements of paragraphs 5.6.5(2)(a) to (d).

Item [14] Paragraph 5.6.5(2)(a)

Item [14] amends paragraph 5.6.5(2)(a), by inserting, after the word "the" (first occurring), the words "organisational and technical resources, arrangements and".

This amendment complements the amendments made by items [6] and [7] (see above), recognising the requirements of Rule 5.6.3 are together more aptly described as "organisational and technical resources, arrangements and controls".

Item [15] After subrule 5.6.5(2)

Item [15] inserts, after subrule 5.6.5(2), a new subrule 5.6.5(3). New subrule 5.6.5(3) provides that a Market Participant that was not required to comply with Rule 5.6.5 in relation to a system for

Automated Order Processing because of the operation of Rule 5.6.6A is not required to obtain the representations referred to in subrule 5.6.5(1) in relation to that system for Automated Order Processing. Item [15] also inserts a note describing the effect of Rule 5.6.6A and explaining how, and when it is omitted from the Rules.

Item [16] Subrule 5.6.6(1)

Item [16] amends subrule 5.6.6(1) by omitting "Subject to Rule 5.6.6A, before" and substituting "Before". This amendment recognises that the transitional certification provision for participants of ASX and Chi-X in Rule 5.6.6A is omitted by item [22] of the Instrument.

Items [17], [18] and [19] Rule 5.6.6

Item [17] amends paragraph 5.6.6(1)(a) by adding the words “(**AOP Initial Certification**)” after the word “certification”.

This amendment introduces the defined term “AOP Initial Certification” for ease of reference in the Rules.

Item [18] amends paragraph 5.6.6(1)(b) by omitting the word “certification” and substituting the words “AOP Initial Certification”.

Item [19] amends subrule 5.6.6(2) by omitting the words “written certification” and substituting the words “AOP Initial Certification”

These amendments recognise the new defined term inserted by item [17] into subrule 5.6.6(1).

Item [20] Subparagraph 5.6.6(2)(d)(iii)

Item [20] amends subparagraph 5.6.6(2)(d)(iii), by inserting after word “the” (third occurring), the words “organisational and technical resources, arrangements and”.

This amendment complements the amendments made by items [6] and [7] (see above), recognising the requirements of Rule 5.6.3 are together more aptly described as “organisational and technical resources, arrangements and controls”.

Item [21] Rule 5.6.6

Item [21] amends Rule 5.6.6, after subrule 5.6.6(3), by inserting a new subrule 5.6.6(4). New subrule 5.6.6(4) provides that a Market Participant that was not required to comply with Rule 5.6.6 in relation to a system for Automated Order Processing because of the operation of Rule 5.6.6A is not required to give the certification referred to in subrule 5.6.6(1) in relation to that system for Automated Order Processing. Item [21] also inserts a note describing the effect of Rule 5.6.6A and explaining how, and when it is omitted from the Rules.

Item [22] Rule 5.6.6A

Item [22] omits Rule 5.6.6A.

This amendment removes the transitional arrangement which exempted a Chi-X Market Participant that is also an ASX Market Participant from the Chi-X Rules relating to certification of AOP systems.

Item [23] Rule 5.6.7

Item [23] omits Rule 5.6.7. This amendment complements the amendments made by items [31] and

[32] (see below), by recognising that Rules 5.6.9 and 5.6.10 (the requirement to provide ASIC with a confirmation or further certification in relation to a “material change”) will be removed.

Item [24] Rule 5.6.8

Item [24] amends the heading of Rule 5.6.8 by omitting “Material change review” and substituting “AOP Material Change Review.” This amendment recognises the new defined term “AOP Material Change Review” which is used for ease of reference in the Rules.

Item [25] Rule 5.6.8

Item [25] amends Rule 5.6.8 by inserting, before the word “Before”, the number “(1)”. This amendment changes existing Rule 5.6.8 to subrule 5.6.8(1), to accommodate the amendment made by item [29], which introduces a new subrules 5.6.8(2) and (3).

Item [26] Rule 5.6.8

Item [26] amends Rule 5.6.8 by inserting, after the word “resources”, the words “arrangements or controls.” This amendment complements the amendments made by items [6] and [7] (see above), recognising the requirements of Rule 5.6.3 are together more aptly described as “organisational and technical resources, arrangements and controls”.

Item [27] Rule 5.6.8

Item [27] amends Rule 5.6.8 by omitting the words “, for the purposes of providing the confirmation referred to in Rule 5.6.9 or the further certification referred to in Rule 5.6.10.”. This amendment complements the amendments made by items [31] and [32] (see below), by recognising that Rules 5.6.9 and 5.6.10 (the requirement to provide ASIC with a confirmation or further certification in relation to a “material change”) will be removed.

Item [28] Rule 5.6.8

Item [28] amends Rule 5.6.8 by inserting, after the word “review”, the words “(“**AOP Material Change Review**”)”. This amendment introduces a new defined term “AOP Material Change Review” for ease of reference in the Rules.

Item [29] Rule 5.6.8

Item [29] amends Rule 5.6.8 by inserting, after the words “these Rules.” (i.e. at the end of (new) subrule 5.6.8(1)), new subrules 5.6.8(2) and (3).

New subrule 5.6.8(2) provides that, before implementing a material change the subject of an AOP Material Change Review the Market Participant must, for the purposes of providing the AOP Annual Notification, obtain written representations from the person who performed the AOP Material Change Review that nothing came to the attention of the person during the course of the AOP Material Change Review that would indicate that the Market Participant is unable to comply with Part 5.6 of the Rules.

New subrule 5.6.8(3) provides that the representations referred to in subrule 5.6.8(2) must include the name of the person making the representation and be signed and dated by the person making the representation. These amendments replace the previous requirements in Rules 5.6.7, 5.6.9 and 5.6.10 (omitted by items [23], [31] and [32]) to provide ASIC with a confirmation or further certification in relation to a “material change” (and receive a written response from ASIC) with a requirement to conduct an internal review, and obtain written representations in relation to the outcome of that review, before making a material change.

Item [30] After Rule 5.6.8

Item [30] inserts, after Rule 5.6.8, a new Rule 5.6.8A and Rule 5.6.8B.

AOP Annual Review

New subrule 5.6.8A(1) sets out the requirement for a Market Participant to ensure that an appropriately qualified person performs a review (“**AOP Annual Review**”) of Automated Order Processing systems. The AOP Annual Review must include a review of the Market Participant’s policies, procedures, system design documentation, including the Market Participant’s procedures for implementation of changes to Automated Order Processing software, filters and filter parameters and other relevant documentation concerning the Market Participant’s compliance with Part 5.6 of the Rules. A Market Participant is not required to perform an AOP Annual Review if it has performed an AOP Material Change Review in the 12 months before the AOP Annual Review Date (defined in Rule 1.4.3 as 1 November each calendar year).

New subrule 5.6.8A(2) provides that the Market Participant must, for the purposes of providing the AOP Annual Notification obtain written representations from the person who performed the AOP Annual Review that nothing came to the attention of the person during the course of the AOP Annual Review that would indicate that the Market Participant is unable to comply with Part 5.6 of the Rules. Those representations must include the name of the person making the representation and be signed and dated by that person (new subrule 5.6.8A(3)).

The AOP Annual Review must be performed, and representations obtained, for the purposes of providing the AOP Annual Notification.

AOP Annual Notification

New Rule 5.6.8B provides that a Market Participant must, within 10 Business Days of each AOP Annual Review Date (defined in Rule 1.4.3 as 1 November each calendar year), give a written notice to ASIC (the “AOP Annual Notification”), signed and dated by two directors of the Market Participant that includes the following information:

- the name of the Market Participant; and
- the version number and name of the Market Participant’s Automated Order Processing system; and
- a confirmation by the Market Participant that nothing came to the attention of the Market Participant during the 12 months before the AOP Annual Review date that would indicate that the Market Participant is unable to comply with Part 5.6 of the Rules; and
- the name of the two directors of the Market Participant that signed and dated the AOP Annual Notification.

Items [31] and [32] Rules 5.6.9 and 5.6.10

Items [31] and [32] amend the Rules by omitting Rules 5.6.9 and 5.6.10.

These amendments, along with the omission of Rule 5.6.7 (see item [23] above) reflect that ASIC will no longer require Market Participants to provide ASIC with a material change confirmation, or further certification, each time the Market Participant performs a material change review. However, Market Participants will be required to conduct an internal review, and obtain written representations in relation to the outcome of that review, before making a material change under new subrule 5.6.8(2) (see item [29] above).

Item [33] Rule 6.4.1

Item [33] amends Rule 6.4.1 by omitting “Market Bid” and substituting “Takeover Bid.”

This amendment prevents a Market Participant from conducting a Crossing (other than a Special Crossing) outside of Trading Hours during the offer period under a Takeover Bid (whether an Off-Market Bid or Market Bid) at a price which is at or below the offer price for that product.

Items [34] and [35] Subparagraph 7.1.1(2)(g)(vi) and after paragraph 7.1.1(2)(g)

Item [34] amends subparagraph 7.1.1(2)(g)(vi) by omitting the word “and”. Item [35] amends Rule 7.1.1 by adding, after paragraph 7.1.1(2)(g), a new paragraph 7.1.1(2)(ga).

Existing subrule 7.1.1(1) provides that Chi-X must deliver, or procure delivery of, a live feed of the electronic data items set out in subrule 7.1.1(2). New paragraph 7.1.1(2)(ga) adds a new data item to subrule 7.1.1(2), being information for the order or trade recorded by the Market Operator in accordance with subrule 5A.2.2(1) of the *ASIC Market Integrity Rules (Competition in Exchange Markets) 2011* (Competition Rules).

This amendment supplements new Chapter 5A of the Competition Rules on data for market supervision. Under Chapter 5A, specified “Regulatory Data” on orders and trades must be provided by the relevant market participants to the relevant market operators. Under subrule 5A.2.2(1) of the Competition Rules Market Operators offering trading services in these products must record the regulatory data they receive. This amendment requires that Chi-X must also provide this regulatory data to ASIC.

Item [36] At the end of Rule 7.1.2

Item [36] inserts, at the end of Rule 7.1.2, “Note: There is no penalty for this rule”.

This amendment corrects an oversight in the existing Rules and clarifies the existing position that there is no penalty for Rule 7.1.2.