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ASIC

Australian Securities &
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The impact of multiple trading platforms: Assess the impact of multiple trading platforms being introduced in the Australia market. How will multiple trading platforms impact liquidity, transparency, price discovery and cost of execution?

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*'A truth universally acknowledged for some years in Western financial markets has been that a single stock exchange in possession of a good strategy must be in want of a partner'*¹ or as recommended by the Johnson Report: a competitor.

At the time this quote was written, the merger between the Australian Securities Exchange (ASX) and the Singapore Exchange was being contemplated. However jump to the present and the ASX must now view the deal as a far off dream compared to the challenge that will be presented in the form of a new competitor: Chi-X Australia Pty Ltd (Chi-X).

1 Executive Summary

In September 2008, the Australian government commissioned the report: Australia as a Financial Centre – Building on Our Strengths (the Johnson Report). Prior to the release of this report the Government in August 2009 announced changes to the regulatory arrangements in regards to Australia's financial markets. The Australian Securities Investment Commission (ASIC) will now perform supervision of real time trading on all of Australia's domestic markets. The report encouraged increased competition amongst markets through the consideration of granting new licenses for market operators. In response to this ASIC released a consultation paper (CP145) to discuss amongst other things the regulatory framework required to ensure a strong and efficient equity market.² The Market Integrity Rules (MIR) for managing competition in equity markets were developed and released by ASIC in April 2011, and Chi-X Australia Pty Ltd (Chi-X) can now begin trading from the end of October 2011.

In anticipation of the introduction of a trading platform into the Australian financial market the possible impacts has been discussed by ASIC and market participants. The questions surrounding liquidity, transparency, price discovery and the cost of execution have also been debated domestically and in jurisdictions around the world, especially in relation to recent market events. ASIC has the chance to lead the world by ensuring the Australian market is regulated efficiently and that the integrity of a marketplace is maintained for its participants. To truly assess the impact of the introduction of a trading platform into Australia, a thorough market quality framework will be examined by this report. This will include technology, regulation, information, participants and their instruments³. In reviewing the situation with this structure in mind a clearer picture can be provided as to the impact of the introduction of a trading platform upon the Australian financial market.

¹The Economist, *'Marketmaters. The exchanges of Australia and Singapore are not married yet'*, Oct 2010

²Australian Securities and Investments Commission, *'Consultation Paper 145, Australian equity market structure: Proposals'*, November 2010

³ This market framework was taken from the Capital Markets Cooperative Research Centre Limited's response to CP145, p.4

2 Introduction

2.1 Current financial market

Since the merger between the Australian Stock Exchange and the Sydney Futures Exchange there has been one primary stock exchange group in Australia; the ASX. The ASX has functioned as the sole market operator, clearing house and payments system facilitator in Australia. It is hoped that the introduction of a trading platform into the Australian market will encourage and promote efficiencies. This in turn will create new opportunities for innovation while mitigating risk to price formation and delivering the best outcome for investors.

2.2 Chi-X Australia Pty Ltd

Chi-X is a wholly owned Australian subsidiary of Chi-X Global Inc⁴ which provides an alternative equity trading venue to different overseas markets. Chi-X has been granted a license, which allows the company to operate a market in Australia in ASX quoted equity market products. Currently Chi-X is not seeking approval to compete for listings on ASX, which means that issuers will continue to deal solely with the ASX in relation to the listing rules and their continuous disclosure obligations⁵. Based on the company's overseas experience, Chi-X believes that a second trading platform will encourage additional volume growth, reduce overall trading costs and increase activity.

⁴ Chi-X Global is a member of the Instinet group of companies ultimately owned by Nomura Holdings Inc.

⁵ ASIC, '*Background Paper: ASIC's regulatory framework on competition in exchange markets*' 29 April 2011, p.6

3 Liquidity

Traders choose the market with the best liquidity, and the most liquid market is the one with most participants because it offers the highest probability of order execution and the most competitive prices.⁶ One of the benefits of a monopoly is that the ASX has never had a liquidity problem. Meanwhile Chi-X has an enormous task in regards to attracting⁷ traders to an unknown trading platform as opposed to the incumbent ASX. The discussion of liquidity will therefore be one drawn mostly from overseas experiences.

3.1 Fragmentation

Market liquidity provides us with an indication as to the depth of the market. It is said the best execution by market participants now involves the consideration of multiple sources of liquidity for equity securities⁸. This has been seen in overseas markets where exchange and non exchange platforms exist. When fragmentation does occur the loss of the benefits of liquidity can emerge and through that, price discovery can be impaired. With this in mind it is possible that the introduction of a trading platform into the Australian market has the potential to fragment trading markets due to the spread of liquidity across the trading platforms. If fragmentation happens then there could be a negative impact. One reason for this is that market participants would be able to split their trading across markets and avoid the scrutiny that would exist if there were only one market. The Capital Markets Cooperative Research Centre says it has supplied research evidence, consistent with this view, to the UK regulator and the Committee of European Securities Regulators (CESR). This should not be allowed to occur and should be monitored by ASIC.

⁶Haim, Mendelson, 'Consolidation, Fragmentation, and Market Performance', Journal of Financial and Quantitative Analysis, 1987, 22(2), 189-207

⁷Fifteen institutions have confirmed that they have signed up with Chi-X: Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, Instinet, ITG, J.P. Morgan, Macquarie, Merrill Lynch, Morgan Stanley, Nomura, Pension, RBC Capital Markets, RBS, and UBS

⁸Technical Committee of the International Organization of Securities Commissions, 'Issues raised by dark liquidity', October 2010, p.4

4 Transparency

The International Organisation of Securities Commission (IOSCO) states ‘in an efficient market, the dissemination of relevant information is timely and widespread and reflected in the price formation process.’⁹ Efficient and fair markets are grounded in transparency, and to assess the market impact of introducing a trading platform into the current environment, it is important to review the model and procedures put in place to guarantee this transparency and promote confidence in the market.

4.1 Pre-trade and Post-trade transparency

Pre-trade and post trade information is central to the fairness and efficiency of the market, in particular to its liquidity and quality of price information¹⁰. It is important for investors to have full confidence in the market and the trading opportunities as they arise with either trading venue. While this is covered by the Corporations Act¹¹ an erosion of the quality of price formation would degrade the quality of the market information. ASIC in response to this negative impact proposed the introduction of a tiered block regime and for pre-trade transparent orders to take priority over fully disclosed orders. While ASIC found that the responses to the proposals were mostly favourable, further investigation is to be undertaken with more changes to be announced in 2012. ASIC has harmonised the previous market rules with the MIR which were released in April.

An additional proposal suggested by ASIC, with the intention of ensuring market integrity was the provision of consolidated information (which would comprise of both pre-trade and post trade information). It was proposed that preparing consolidated data in a market may mitigate market fragmentation and could limit the arbitrage opportunities that may arise with the introduction of Chi-X. However a new trading platform may not caused market fragmentation and therefore will be no need to implement these data measures. While the consolidated data approach has been successfully overseen by overseas regulators, ASX does not support the proposed execution plan for mandatory quality reporting by operators, and suggested that it stifled innovation. In the current trading market the ASX is the main provider of data and in the absence of a Government appointed market information consolidator, the question of who would be performing this task should be raised. ASIC will monitor the market to ensure that data consolidators comply with best practice and at present will look to the market to provide an overall solution.

⁹International Organization of Securities Commission, ‘*Objectives and Principles of Securities Regulation*’ May 2003, p.6.

¹⁰IOSCO Report, Technical Committee of IOSCO ‘*Transparency and market fragmentation*’ (IOSCOPD124), November 2001.

¹¹Corporations Act 2001 (cth), S792A(a)

4.2 Dark Pools

The introduction of trading platforms in markets overseas has seen an increase in the number of dark pools. Dark pools assist large institutional participants to move block trade or large volumes between wholesale investors, away from the central exchanges. The emergence of dark pools has raised concerns about transparency, liquidity and their effect on price discovery.

At present Chi-X is not proposing to operate a dark execution venue; however as seen in overseas financial markets the introduction of competition in trading platforms has increased the number of dark pools¹². In overseas markets the handling and use of these dark pools have become more efficient. This is due to innovative technology and the tightening of market rules, which were required with the introduction of trading platforms. An advantage in using these venues is that liquidity can be added to the market and the execution of large orders can be made easier. Conversely the true value of prices and liquidity of the displayed market can be distorted by larger traders using these venues to move large trades. Another concern that has arisen due to the increase of dark pools is information leakage. This in turn can cloud the transparency that is valued as central to the fairness and efficiency of the market, in particular to its liquidity and quality of price formation.¹³

Dark pools are already present in Australia's financial markets and while it seems unlikely that we will see the same growth as experienced overseas, it falls to the regulators to ensure that the appropriate amount of care to regulate this trading market is taken. In America it appears that these trading venues have impacted on price formation and have resulted in less depth in liquidity in displayed markets. Nevertheless it is believed that the same drivers of dark pool growth in the United States and Europe which is the search for low-cost and low impact platforms could also drive growth in Canada, Australia and Asia¹⁴.

Overseas regulators such as the Canadian Securities Administrators (CSA), the Securities and Exchange Commission (SEC) in America and the Committee of European Securities Regulators have published consultation papers¹⁵ that discuss regulatory issues surrounding dark pools. Predominately the use of dark pools seems to be in South America and the America as reported by SEC, where there has been an increase from 10 to approximately 29 dark pools in the period from 2002 to 2009. The major concern which has been highlighted by these papers is that the lack of transparency allowed by

¹³ IOSCO Technical Committee report, '*Transparency and Market Fragmentation*' November 2001, page 3

¹⁴ Water Asia Report, '*Leapfrogging Dark Pools*', June 2008

¹⁵ CSA/IIROC Consultation Paper 23-404; SEC Release no. 34-60997, '*Regulation of Non-Public Trading Interest*', November 2009, and SEC Release no. 34-61358, '*Concept Release on Equity Market Structure*', January 2010, and CESR/10-394, '*CESR Technical Advice to the Commission in the Context of the MiFID Review - Secondary Markets*', April 2010.

these dark pools could create a two tiered market that deprives the public of information regarding pricing and liquidity¹⁶, and where some investors have little or no access to dark pools.

Like Asia, Australia has not seen the growth in dark pools that has been witnessed overseas in developed financial markets. In CP145, one of the key proposals indicated that undisclosed orders below \$20,000 would not be able to be executed in dark pools or internal markets and would need to be transmitted to a transparent market. However in the MIR¹⁷, ASIC have, while noting that responses to CP145 were wide ranging and that their research is continuing, set the threshold at zero. This means that smaller or medium size investors may be able to benefit from the advantages provided by dark pools.

¹⁶ Securities and Exchange Commission, Open Meeting ‘*Strengthening the Regulation of Dark Pools*’, October 21, 2009

¹⁷ ASIC, ‘*Market Integrity Rules (Competition in Exchange Markets) 2011*’, April 29, 2011

5 Pricing

5.1 Price Discovery

Currently price discovery takes place across multiple venues, where market participants can aggregate real time price streams from multiple venues and execute on any one¹⁸. The SEC describes this as a ‘minimum essential component of a unified national market system¹⁹. The introduction of Chi-X has triggered improvements and delivered innovative technology. This in turn has led to greater transparency in regards to pricing and information.

The announcement of Chi-X’s imminent introduction into the market has already caused improvements to be made. The ASX has observed overseas innovations and have pursued more efficient forms of technology. The announcement of the granting of a new trading platform licence has required the ASX to become more competitive. In March the ASX introduced a new trade acceptance service (TAS), which will be utilised²⁰ by Chi- X to provide clearing and settlement services (which may hamper their efforts to increase market share and revenue). Investors will be able to clear and settle transactions from both Chi-X and ASX with trades executed in the same manner. The monopoly that the ASX has maintained in the equity market will be disrupted; however, they will continue to control the clearing and settlement facilities in Australia.

In addition ASX launched TradeMatch, ASX Trade, ASX Best and Net and are due to launch ASX Purematch²¹ in late 2011. The ASX has also implemented enhancements to its current trading system in response to demands for greater speed and capacity. This has been done in response to the introduction of Chi-X and is an attempt to weaken the competitive edge Chi-X may have when it commences trading. This upgrade in technology may decrease arbitrage opportunities between the two platforms while providing a faster and more efficient service to investors²² although, arguably, the difference in share price means that arbitrage could always occur. It can be argued that sophisticated technology allows greater arbitrage opportunities for high-volume professional traders. These traders will endeavour to make profits from short-term price differences in the two exchange platforms without actually increasing the aggregate amount of capital flowing into the market overall. This is a good impact as it takes advantages of price inequities and helps to make a ‘perfect market’. Better technology enables a liquidity provider to adjust prices quickly in response to market dynamics. To

¹⁸Alexandra Heath and James Whitelaw, ‘*Electronic Trading and the Australian Foreign Exchange Market*’ Bulletin , June Quarter 2011

¹⁹SEC, ‘*Commission Request for Comment on Issues Relating to Market Fragmentation*’ Release No. 34-42450; File No. SR-NYSE-99-48) February 23, 2000

²⁰ Which involved Chi- X agreeing to a five year pricing option and a non-exclusive arrangement, which includes an initial fee for access and an annual service fee

²¹ A new streamlined order book which will complement ASX TradeMatch and is aimed at attracting HFT investors

²² Knowledge@Australian School of Business, ‘*Trading Places: Bringing on Stock Market Competitors*’ May 18, 2010

maintain confidence in the market ASIC needs to ensure that there is a stable information technology environment. There is the risk that market participants may face significant challenges each time a market operator system is upgraded. An unstable market will undermine market integrity to the detriment of investors and market participants.²³

5.2 High Frequency Trading (HFT)

The lessons learnt by the SEC in America after the ‘flash crash’²⁴ has ensured that regulators are keenly aware of the potential outcomes that can be sparked by HFT. The increase in this type of trading overseas has raised concerns about the strength and integrity of the Australian trading market once Chi-X is introduced. While ASIC has made clear that they will not tolerate any form of market misconduct, irrespective of whether it originates from HFT or other source, it received mixed responses to CP145 as to whether HFT was prevalent in Australia or whether it had a negative effect on trading. The impact HFT will have due to the improvements and innovations in technology is still to be seen. On the negative side traders may use HFT to detect and profit from buy-sell imbalances in the market. On the positive side HFT can benefit some market participants by providing liquidity and can reduce trading costs. HFT is not a strategy in itself, rather it can be used to implement a range of complex trading strategy through automation and which liquidity providers can use to create efficiencies and reduce trading costs for investors.

The SEC has implemented new market wide circuit breakers in response to the crash to restore certainty and investor confidence. The ASX have queried whether these are necessary for Australia and noted that a market operator can make an assessment at any time if the market should be suspended from trading. This risk has so far been handled by the ASX and there has not been a need to impose any price limits or circuit breakers. However the establishment of uniform market wide controls to protect against a trigger may ensure market integrity and preserve investor confidence in both trading platforms.

The Financial Services Council also found that their members were sceptical as to the benefits suggested by ASIC; which were that HFT would contribute to liquidity, lower transaction costs and provide greater access to capital. While HFT can provide benefits to the market and add enhancements to automated trading, the questions posed by ASIC on price formation, data, risk controls and investor confidence in the market are yet to be answered, and have been deferred until further investigation is completed.

²³ Australian’s Financial Markets Association’s response to CP 145, p.7

²⁴ [SEC](#), and the [Commodity Futures Trading Commission](#) ‘Findings Regarding the Market Events of May 6, 2010’ September 30, 2010

5.3 Model

Chi-X intends to introduce maker-taker pricing, which provides a rebate to persons who submit passive orders (e.g. with a limit price) and charges a fee to persons who submit aggressive orders (e.g. market orders)²⁵. This model has been a feature of global markets for a number of years. The ASX believes this model can create pricing inefficiencies and distortions. This is due to the maker-taker providing incentives irrespective of the size of the order and resulting trade and that the financial incentive is targeted at one side of the trade. The ASX believes that due to competitive pressures this model could be adopted by all market operators, and may result in a decline in market quality and integrity. However it was also argued that maker-taker pricing was no different from ASX having differential charging models for access to various liquidity pools. Chi-X has argued that maker-taker pricing will result in a reduction in overall costs of execution, due to tighter spreads and a reduction in transaction costs. It could also be argued that this is evidenced by ASX revising its trading fees and activity rebates from 1 July 2010. It is suggested that the pressure already placed on ASX with the introduction of Chi-X may force the ASX to reduce their tick sizes further. Tighter spreads means a better execution price for all clients in the market.

²⁵ ASIC, *Background Paper: ASIC's regulatory framework on competition in exchange markets* 29 April 2011

6 ASIC

6.1 Supervisory Powers

To assess the impact of the introduction of Chi-X into the market the change in regulators²⁶ should be examined. To ensure that competition between multiple trading platforms is monitored appropriately ASIC have created one set of rules²⁷ intended to harmonize the market. In response to feedback ASIC has implemented a new market surveillance system which will allow it to monitor all trading systems simultaneously. This still leaves open issues of how a new market entrant will affect participants' ability to engage in prohibited trading behaviours²⁸. Nevertheless the change of regulation by the Government, by appointing an independent authority should ensure better transparency and stronger confidence in the market²⁹. A positive impact in the change of regulators is that ASIC has reported a reduction in the time taken to commence an investigation into suspicious conduct. ASIC has been building on the results obtained in the first five months or so of supervision and in results published and shown in the table below this action seems to have produced positive outcomes.

Table One, Pre-emptive supervision action³⁰

Pre-emptive action relating to:	Current period (1 Jan–30 June 2011)	Previous period (1 Aug–31 Dec 2010)
Execution strategy	7	3
Algorithmic trading and filter issues	14	10
Miscellaneous	1	1
Total	22	14

²⁶ The Hon Chris Brown MP, Minister for Financial Services, Superannuation and Corporate Law and the Hon Wayne Swan, Treasurer, Media Release No.013 Reforms to the supervision of Australia's financial markets, 24 August 2009

²⁷ ASIC, 'Market Integrity Rules (Competition in Exchange Markets) 2011', April 29, 2011

²⁸ Knowledge@Australian School of Business, 'Trading Places: Bringing on Stock Market Competitors' May 18, 2010

²⁹ It was Janet Austin (a former federal crown prosecutor on insider trading) who suggested the changes to the federal government: "The changes present ASIC with the opportunity to improve on its enforcement outcomes through faster investigations of market offences and reducing regulatory duplication"

³⁰ ASIC, 'Report 243 ASIC supervision of markets and participants: January to June 2011', July 2011, table 6, p. 10

7 Cost of Execution

7.1 Market Reaction

Chi-X is successfully trading in 14 markets across Europe and has developed a 13% market share in Canadian local stocks within 18 months. In each market it has declared its strengths as: the ability to reduce transaction costs, a new trading venue to boast liquidity, and faster technology systems. Ronald Gould, the Chief Executive of Chi-X Asia Pacific stated the average cost of executing a trade in Australia is almost five times higher than in Europe and North America, suggesting that with improved economies of scale this could be dramatically reduced. It was stated by the chairman of Chi-X Global that the monopoly controlled by ASX meant that its operating margin was about 80% when the average for the companies quoted on its exchange was about 25 per cent.

Another benefit for investors is the reduction in costs and the increase in choice for traders and businesses and this can be seen from Chi-X's success in Europe and America. Studies in America found that a continuing benefit of competition was that 'transaction costs continue to find the US costs amongst the lowest in the world.'³¹ While it appears transaction costs will drop, it seems likely that due to settlement costs negotiated with the ASX, that this may not be as dramatic a reduction as seen in overseas markets. Brokers however, have already seen the benefits of competition with the ASX reducing costs by nearly 50%. The lengthy licence approval process has allowed the ASX to react quite comfortably to the threat of competition within the equity trading platform. In a recent client note released by a broker at Deutsche Bank Australia, it was reported that while competition was estimated to cut the ASXs' market share in equity trading by 25%, earnings would still grow 12% over the next three years. It also stressed that the ASXs' ability to lower fees showed it to be the most efficient exchange globally in regards to equity trading fees. 'Revenue prospects then for any new entrant are minimal in our view.' In a Macquarie Private Wealth report in February 2011 the further announcements as to the upcoming competition saw the ASX trading revenues fall by \$5m only to be clawed back by increases in technology charges. This quick time response showed the ability of ASX to respond to competition by reducing trading fees only to recover the value lost from customers through higher charges in other income lines

³¹ James J. Angel, Lawrence E Harris, Chester S. Spatt, '*Equity Trading in the 21st Century*', February 23, 2010. pg 5

8 Australia's Financial Strategy and Conclusion

The Government's aim in introducing competition into the financial trading market is to promote Australia as a financial services hub. This is not being done to cripple the ASX rather to encourage more liquidity and encourage the stability of the Australian economy as it continues to hold strong as opposed to other countries that are fighting to remain financially viable.

In the short term, at least, ASX will remain entrenched as Australia's main trading platform, with potentially a 25% drop in volume³². The introduction of a competitor into the Australian financial market may also encourage competition into the clearing, data and technology space. This has been confirmed by a paper³³ released by ASIC which was in anticipation of companies who run clearing and settlement facilities looking to operate in Australia. Although establishment costs in Australia are high, the current lack of competition and ability to obtain significant market share means Australia's financial market is an attractive prospect. The Johnson report³⁴ focused on the policies that would introduce more competition, improve efficiencies and encourage international investment into Australia's financial markets. The introduction of Chi-X into the financial market is one step in promoting openness to new entrants as it is understood that competition is an essential condition to promote efficiency and innovation in Australia's financial market.

ASIC has stated that Australia is well positioned for the introduction of competition.

The success of Chi-X seamless entrance into the Australian financial market will play an important role in ensuring that competition is successfully promoted as possible in Australia's financial market. Until now the ASX has had an unchallenged monopoly and maintained technology platforms without innovation or major growth. Due to a lack of competition there has been a stagnation in developing new technology platforms resulting in constant price execution costs and limited improvements in price discovery. To predict how successful Chi-X will be may be difficult in the Australian financial environment. However if overseas experiences are to be replicated here, the ASX is set for an intense competitive battle as the trading platforms fight it out hopefully to the benefit of investors and market participants. Once monopolies are completely removed from the Australian market, competition can truly thrive on a level playing field, which will drive growth, innovation and improve the quality of service for market participants.

³² Professor Peter Swan, 'Why the ASX needs the X-Factor', July 04, 2011

³³ ASIC Regulatory Guide 211, 'Clearing and settlement facilities: Australian and overseas operators' April 2010

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