REFORMS TO THE SUPERVISION OF AUSTRALIA'S FINANCIAL MARKETS

- ***ASIC Consultation Paper 131: Proposed ASIC Market Integrity Rules - ASX and SFE Markets***

Submission

Introduction

The Stockbrokers Association of Australia is pleased to provide the following comments on CP131 regarding the proposed ASIC Market Integrity Rules (**MI Rules**), and their relationship with the ASX Market Rules (**ASX Rules**). As our Members are predominately ASX Market Participants, in this submission we will concentrate on the MI Rules for the ASX market.

We understand that, due to the short period of transition to the new market supervision arrangements in the third quarter of 2010 – with July 1 the target date - the aim is to cause as little disruption to our Members' businesses as possible. Accordingly, the proposed MI Rules are designed to be as close to the current ASX Rules as possible. While this is the appropriate approach in such a short time-frame, it is inevitable that there will be further matters to be addressed after the commencement of the new supervisory arrangements in the third quarter of 2010 (**Day One**), including matters that can be streamlined and simplified, and the removal of duplication. In Part B of our submission, there are a number of matters which we have identified which we hope will be able to be addressed during the period post-Day One. (We expect that some of the matters raised in Part A may indeed become matters addressed post-Day One if time does not permit their consideration prior to the handover.)

We would also like to note the following matters, which are relevant to the approach that ASIC is taking to preparing for Day One:

- *ASX Market Rule Procedures (& Appendices):* on Day One they will generally be adopted by the MI Rules, but some of the detail from the Procedures (& Appendices) will be included in the substantive MI Rule;
- *Timing:* ASIC is planning for a 1 July commencement, which means the Rules will need to be finished by May. The tight timeframe will mean that there will be a longer period

during which issues and unintended consequences will inevitably arise and need to be addressed;

- *Recognition of ASX Approvals & Notifications:* all approvals given by ASX e.g. RE appointments & DMA systems, and notifications previously made by Brokers, will be recognized by ASIC. This will be set out in the Regulations.

Our comments below are set out in 2 parts;

- Part A: Comments on the proposed MI Rules in CP131, and
- Part B: Further matters for consideration post-Day One

PART A: Proposed ASIC ASX Market Integrity Rules		**Comment**	
1	Awaiting Regulations on Disciplinary Process	There is still a great deal of detail relating to Disciplinary Processes to be provided, via the Regulations, particularly the Infringement Notice regime. These are not expected to be released until after Easter. From discussions with ASIC the Regulations will cover the conduct of hearings, including the requirement that they must be held in private. (This is a welcome improvement on the first draft of the legislation in November, which provided for all disciplinary hearings to be held in public.) In addition there is to be ASIC Guidance on Hearings, which will be the subject of further consultation.	
2	Infringement Notice Regime	The Infringement Notice regime has the potential to increase the cost and complexity of the disciplinary process for cases which can't be resolved by agreement between the broker and ASIC. ASX had the power to fine brokers directly under the terms of its Market Rules (which applied under the contract with the Participant). However, ASIC cannot impose a fine for constitutional reasons (judicial power of the Commonwealth[1]). Hence, if the broker does not agree – notwithstanding the proposed incentive of a 40%	

[1] Constitution s.71

		reduction in penalty - then if ASIC wishes to pursue the matter it will have to go to Court, or to some other properly constituted tribunal like the Takeovers Panel. This will increase litigation costs, cause delay, and it means that the matter will be heard by a judge and not an industry expert. The Stockbrokers Association submits that provisions as significant as the Infringement Notice regime should, as a matter of principle, be set out in Legislation that must go before Parliament (as was the case with the Continuous Disclosure infringement notice regime in the *Corporations Act*), rather than in Regulations (which do not). Proceedings that could result in Fines of up to $1m are too substantial and material to be governed by subordinate legislation.	
3	ASIC Panel membership	ASIC has indicated that its panel of experts to consider disciplinary matters will likely be similar to the current panel ASX uses to select its Disciplinary Tribunal. We trust that ASIC will be able to secure the services of suitably experienced market personnel to sit on the Panel. The Association would be happy to assist in this regard.	
4	Transitional arrangements - Disciplinary Matters (parallel regimes)	ASX has announced that it will be handling all disciplinary matters arising prior to Day One, at which time ASIC will take over. (The figure of 20-30 remaining market manipulation matters has been mentioned by ASX, which may take 12-24 months to process.) This raises the question as to whether it is appropriate that ASX continue to finalise matters that have already commenced being investigated but are not completed. This will mean parallel disciplinary regimes for up to 2 years, in some cases considering similar sets of facts. ASIC has stated that it expects that the membership of its disciplinary panel will be drawn from a similar (if not the same) pool of industry experts as the ASX Disciplinary Tribunal. If that is the case, then consistency of views and determinations across ASX and ASIC decisions	

		could reasonably be expected. However, even assuming that the *same* people sit on both the ASIC and ASX panels, the different processes themselves could lead to inconsistencies arising. For example, as discussed in 2 (*Infringement Notice Regime)* above, ASX matters can be taken directly to the ASX tribunal, which can levy a penalty directly on the broker, subject to a right of appeal to the Appeal Tribunal. Post-Day One, ASIC matters will require a determination or recommendation by the ASIC panel as to penalty. However, that penalty cannot be imposed on the broker unless the broker agrees. There will be a significant incentive for the broker to do so in the form of a 40% discount to what a Court may award. If the broker does not agree, the matter would have to be taken to Court by ASIC. This would not be a quick process, and would be subject to the normal pre-trial and listing procedures of the Court. Legal costs, compared to an ASX disciplinary tribunal hearing, would be significantly higher. If the Court were to find in ASIC's favour, it may order a penalty different to that which the ASIC panel had recommended.[2]. In the live market environment, time is always of the essence. The time taken to dispose of the matter in Court would be longer than the ASX tribunal. This could give rise to two parallel hearings on similar facts, one subject to complicated legal process and costs; the other a relatively informal private administrative proceeding. The differences in timing alone could mitigate against any consistency arising in the parallel regimes during the hiatus period during which ASX disposes of its pre-Day One matters. Differences in penalties could also emerge, particularly at the start of the new regime starts. For these reasons, **we would submit that there be a handover to ASIC of <u>all</u> incomplete matters, from Day One**.	

[2] As an aside, this casts doubt on the efficacy of the ó40% discountô incentive to settle early with ASIC, since it would rely on an early assessment by the ASIC panel of what a Court would order. However, a Court would never be bound to follow such an assessment.

5	Penalties: Tier 1 - 3 grading of breaches	The adoption of the ASX system of hard and fast gradings raises possible questions of fettering the discretion of a decision maker. Unless properly founded in legislation, a Court could choose to ignore the categorization of offences under the Sanction Guidelines. There should be scope for lighter regulatory touch for innocent human error e.g. 'fat finger' matters that are not accompanied by systemic/supervisory failure and that do not threaten market integrity. The existing ASX approach of routinely levying fines of at least $30,000 in such cases is unfair and unjust. The handover of supervisory functions to ASIC presents a good opportunity for the regulator to review the approach to these minor matters, which hopefully may lead to more appropriate levels of penalty.	See A page 6. Also D p18
6	Penalties: non-compliance with condition of Waiver of Rules	The categorization of such a breach as Tier 3 in all cases would seem excessive, particularly in cases of minor non-compliance. It should not be mandatory in all cases.	New Rule 1.2.2 A3-1
7	Management/Supervision Requirements	This is one of the areas of greatest concern to our Members. At the moment there are parallel management and supervision requirements administered by ASX and ASIC. We see the changes in market supervision arrangements as the ideal time to rationalize these requirements. Under the *Corporations Act*[3], our Members are already subject to a range of management and supervisory requirements, including: - acting efficiently, honestly and fairly - managing conflicts of interest - complying with licence conditions and the law, and ensuring that staff do so - having adequate resources	See C p 11 Also, C1Q2, C1Q3

[3] Section 912A

		- maintaining competence - training, and - having adequate risk management systems. Before an AFS Licence is granted by ASIC, the licensee must certify compliance with these and other requirements. Breach of such a certification is an offence. ASIC sets out further detail of management requirements in Regulatory Guide 104 *Meeting the General Obligations* and Regulatory Guide 105 *Organisational Competence* (including Responsible Managers). In addition, the ASX *Market Rules*[4] impose management and supervision requirements, including: - the need for appropriate management structures (including Responsible Executives), and - appropriate supervisory policies and procedures. In the last few years, ASX has placed great emphasis on management plans and supervisory arrangements, with thorough and sometimes excessively detailed reviews taking place. In practice, ASX has taken the lead regulatory role over ASIC in this area, in which ASIC has not been overly active. With the new arrangements, the adequacy of management and supervision arrangements should be determined once only, and logically it should be in the hands of ASIC, under existing licensing requirements, which are wholly appropriate and sufficient to ensure market integrity. Moreover, **a firm's management and**	

[4] Including ASX Market Rules 3&4, and Market Rule Guidance Note 6

		supervisory arrangements ought to be able to be tailored to the firm by the firm, depending on its nature, size and complexity. The imposition by the regulator of detailed internal arrangements – which are the responsibility of the firm in any case – ought to be avoided. This is consistent with ASIC's current approach to licensees' obligations, and we trust that it will continue with the new arrangements. With ASX-ACH maintaining its clearing function, it is appropriate that the clearing house should maintain certain management requirements, but only to the extent necessary to ensure the integrity of the clearing and settlement process. *Multiple Exchanges/CCP's*: With the prospect of additional market operators and clearing functions (central counterparties), having multiple sets of requirements, or even worse, differing interpretations or approaches, by different exchanges and/or clearing/settlement facilities would mean inefficiency and wasteful duplication. These matters should be determined for all operators by ASIC, or at least be subject to strict and consistent protocols. One result of this should be that the Responsible Executive and Responsible Manager regimes should as much as possible be amalgamated into one. We note that this issue is being considered by the Market Rule Advisory Panel. We remain willing to assist in these considerations, since it is important to get them right.	

8	Accidental Crossings (Fair and Orderly markets; False Trading and Market Rigging)	Trading on ASX in over the last few years has seen a significant increase in the use of algorithmic trading by means of Automated Order Processing systems. According to a recent ASX report, in 2009 almost 340,000 trades were cancelled as a result of wash trades, involving no change in beneficial ownership. This is indicative of high levels of algorithmic trading[5]. The Association has, since 2003 raised the issue of 'accidental crossings' as an issue for law reform. This issue arises from the removal of the intention defence from the false trading and market rigging provisions of the *Corporations Act*[6] at the time of the financial services reforms. Each accidental crossing is prima facie a breach of these provisions. We have consistently argued that it should be a defence to a change of false trading that it was purely accidental and via DMA. Pending the possible review of the *Corporations Act* false trading and market rigging offence flagged by the Government for later in 2010, ASIC should issue a no-action letter to provide better comfort for domestic and international investors, and market participants. The increasing volume of DMA means that this problem is not going away, and there is no technical solution that would not have the effect of slowing down DMA orders. Moreover, there should not be the need to cancel the crossing - that can be more harmful than letting it stand. The market has already acted on it - cancelling it later does not assist in a commercial environment There is also a potential issue if as is proposed there is to be a 'fair and orderly market' rule in both the ASX Rules and the MI Rules. It may be difficult to determine which is the applicable rule (and appropriate regulator to enforce the breach). We understand that the Government intends that	See C2

[5] Australian Securities Exchange *ASX Review: Algorithmic Trading and Market Access Arrangements* 8 February 2010

[6] particularly Section 1041B

		ASIC should have primary responsibility to enforce rules relating to market integrity, and ASX would cover purely operational matters. The problem here is that operational/system matters can in the area of DMA trading bear upon the integrity of the market. If both ASX and ASIC are to have a rule requiring the maintenance of fair and orderly markets, there ought to be strict protocols in place to ensure that only one of the regulators takes appropriate enforcement action.	
9	Complaints	The complaints provisions of the current ASX Rules and the *Act* are not exactly the same. For example, the *Corporations Act* requirements (s912A(1)(g); s912B) only apply to complaints by retail clients, while ASX Market Rules on complaints registration and handling[7] apply to <u>all</u> complaints. However, ASIC also expects that licensees have sufficient resources to handle complaints[8]. Since these ASX rules do not appear (from CP131) to be being deleted, it would appear that the ASX requirements are to remain. The Complaints handling and registration requirements under the ASX Rules may be superfluous, in view of the ASIC obligations on complaint handling. Indeed if the intention is to move all client relations matters to ASIC under the MI Rules, it would seem logical to remove rules on client complaints from the remaining ASX rules.	A3-66 New Rule 4.4
10	Insurance	In the same way as Complaints (see 9 above), it would appear that the insurance requirements of the ASX Rules[9] are to remain. It is difficult to see the justification for this. The requirement should revert to ASIC under its general licensing requirements.	

[7] ASX Market Rule 7.16 (register of complaints); in addition, ASX Market Rule 3.6.3 and Procedure 3.6.3 prescribe compliance with Australian Standard AS ISO 10002 2006 *Customer Satisfaction* (complaints handling)

[8] Regulatory Guide 104.92

[9] ASX Market Rule 4.6

11	Breach Reporting	The current dual obligations to report significant breaches to ASIC (s912D) and to ASX (Rule 28.2.3) should be streamlined. Immediate improvement could be achieved by making ASIC the lodgement point for all ASIC and ASX notifications, with protocols for information sharing. Also, this opportunity should be taken to remove the requirement to report market related matters to AUSTRAC.	
12	Compliance with *Corporations Act* & Licence	It would also appear that the ASX Rule (4.14.1) requiring compliance with the *Corporations Act* and the firm's AFS licence is to remain. It is difficult to understand, when supervision is transferring to ASIC, why this rule is being retained by ASX.	
13	Other reporting	Other reporting in ASX Market Rule 4.3 and 4.4 e.g. changes in directors, are already the subject of reports and filings to ASIC and should not be required separately.	
14	Designated Trading Representatives (return of *Operators*?)	In the MI Rules, DTR's are referred to as *Participant Market Trading Representatives.* While still to be registered by ASX, the MI Rules on AOP still mention them. Care will be needed to avoid confusion between to the MI Rules and ASX Rules in referring to these persons. We would submit that the term *Operator* - a term well known and used in the industry - should be restored to the rules.	

PART B: Matters to address Post-DAY ONE		**Comment**	
1	Extension of Application of Market Integrity Rules	We would support any moves to extend the application of the MI Rules to additional parties e.g. white label, non-market indirect participants, given the growth of this sector, which provides securities advice and dealing in a similar manner to stockbrokers, but without proper, market-based	

		regulation. Stockbroking is a recognized term in the Act – its use requiring the licensee to be a market participant - and only those properly regulated ought to be able to use the term and provide like services.	
2	DMA Filters	Some more definitive guidance on filters than is available at present would be of assistance, and would provide more certainty to participants in building DMA infrastructure in this rapidly growing area.	
3	Duplication/inconsistency - Confirmations - MDA - Staff Trading - Trading Records - Trust Accounts - Client order priority - Principal trading - Complaints - Financial Records & Audit - Breach Reporting	As noted in our submission to Treasury on the Draft Bill in December 2009, duplication and/or inconsistency has existed between the *Corporations Act* and ASX Rules for a number of years, which the Association has been active in lobbying for resolution[10]. Post-Day One, this will convert to duplication between the *Act* and the MI Rules. This is the ideal opportunity to streamline and rationalize these various requirements, including the following areas (with the relevant ASX Market Rule and *Corporations Act* provision shown in parenthesis): - Confirmations (Rule 7.9/s.1017F) - Managed Discretionary Accounts (Rule 7.10/CO04/194) - Staff Trading (Rule 7.8/s.991F) - Trading Records (Rule 4.10/s.991D) - Trust Accounts (Rule 7.11/Pt 7.8 Div 2) - Client order priority (Rule 7.5/s.991C) - Principal trading (Rule 7.3/s.991E) - Complaints (Rule 7.16 – see A.9 above) - Insurance/compensation (Rule 4.6 – see A.10 above) - Financial Records & Audit (Rule 4.9/Pt 7.8 Div 6)	

[10] For example the *Corporate and Financial Services Regulation Review* (aka 'FSR Refinements') Consultation Paper dated April 2006, Item 1.25, consistent with our earlier submissions, examined:

> '*The rationalisation by the ASX of the overlapping requirements in the Corporations Act and the ASX Market Rules relating to client order priority, confirmation of trades, managed discretionary accounts, principal trading, staff trading, trading records and trust accounts.'*

		- Breach Reporting (Rule 28.2.3/s.912D – see A.11 above)	
4	Trade Cancellations	If additional market operators commence, there will need to be cross-market consistency about the handling of errors, maintenance of fair orderly and transparent markets, and trade cancellations.	
5	National Guarantee Fund	We look forward to details of how the NGF will operate in a multi-exchange environment.	

These proposals mark a fundamental change to the architecture of market regulation in Australia. ASIC is to be congratulated for its management of the handover of functions by ASX to ASIC – a very complex project.

The Stockbrokers Association is grateful for the opportunity both to discuss the proposals in meetings with us and our Members, and to provide these written submissions. We trust we can be of further assistance to ensure the smooth transition to the new arrangements.

Stockbrokers Association of Australia
26 March 2010