REFORMS TO THE SUPERVISION OF AUSTRALIA'S FINANCIAL MARKETS

- *Treasury Consultation Paper and Exposure Draft Bill December* 2009

Submission

Executive Summary

While much detail remains to be seen, The Stockbrokers Association **supports** the proposed model of market regulation, especially given the possibility of new entrants as market operators.

The new model needs to support moves to grow Australia as a **financial centre**, encourage investment and market activity.

The transition presents an ideal opportunity to **eliminate regulatory duplication** of the markets and market participants.

The delineation of ASIC Market Integrity Rules from the licensed market Operating Rules is a crucial exercise may **enhance clarity** in regulation.

The proposed **level of civil penalties** for contraventions of the Market Integrity Rules of $5m for corporations is **excessive**, inconsistent with any other civil penalty provision under the Corporations Act, and may lead to serious anomalies in enforcement outcomes.

The new Market Integrity Rules should **remove** the need for the most serious market operator rules, particularly those of ASX.

Public hearings by ASIC for contraventions of the Market Integrity Rules is unjustified, inconsistent with any other disciplinary or administrative hearings held by ASIC, and would not lead to good regulatory outcomes.

Review mechanisms need to be established to ensure that the changes will be **cost neutral** to Participants.

Management and supervision requirements for Participants ought to be the responsibility of ASIC.

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Introduction

The Stockbrokers Association of Australia ('Stockbrokers Association'), formerly known as the Securities & Derivatives Industry Association (SDIA), is the peak industry body representing institutional and retail stockbrokers and investment banks in Australia. The Stockbrokers Association is pleased to provide this initial submission to Treasury on the Exposure Draft and Consultation Paper - *Reforms to the Supervision of Australia's Financial Markets* issued in December 2009.

The Stockbrokers Association's members have a strong commitment to maintaining the integrity and high standing of Australia's markets. One important factor in creating and maintaining this reputation and standing has been the high quality of the market supervision that has been performed under the regime that has existed to date, namely, by ASIC (and its predecessors) in conjunction with the ASX and SFE.

The existing supervisory arrangements have served Australia well until now. However, especially given the possibility of new entrants as market operators, the Stockbrokers Association agrees that the time is now right for a transition to the new model of supervision as outlined in the Exposure Draft and Consultation Paper. This will enable the markets to move into a new phase, including the development of alternative market and execution platforms.

At a time when efforts are being focused on developing Australia as a regional financial centre, it is crucial that the best decisions be made at this point in settling on the new supervisory arrangements. The new arrangements should encourage economic efficiency, should eliminate duplication and unnecessary procedures, and should assist in encouraging participants, including offshore participants, to choose to participate in the Australian market.

The Stockbrokers Association supports the broad thrust of the changes outlined in the Exposure Draft and Consultation Paper. The Association supports the overall framework which has been adopted. There are however a number of matters set out in our submissions below which the Association strongly argues to be necessary for the proposed arrangements to be effective.

We also note that there is still much detail that needs to be developed in the underlying Regulations and ASIC instruments, and issues may potentially arise from the detail of these regulations and rules when they become known in due course.

Removal of 'Parallel' Rules

We note at Exposure Draft [70] that the rules of a market (i.e. the '**Operating Rules**') are to have no effect to the 'extent of inconsistency' with the proposed ASIC **Market Integrity Rules**.

It is important that there be a process of identifying and removing rules from the relevant Market Operator Rules once the corresponding ASIC Rules are introduced. The situation will be ripe for uncertainty if rules in both areas are allowed to continue to co-exist, particularly legal uncertainty on the question of the extent to which rules may or may not be 'inconsistent'. There could be a considerable passage of time before rulings by a Court on the question of whether or not certain rules were inconsistent. This would be detrimental to business certainty.

We understand from initial discussions with ASIC and Treasury that a process is presently envisaged under which those rules which are to be removed by market operators will be identified and their removal required under appropriate ASIC or Ministerial powers, as the case may be. We would be happy to assist in this process should you require, as our Members have for some time sought the removal of parallel or overlapping rules, particularly in the area of client relations[1].

In particular, we note the following areas of duplication:

Subject	Corporations Act	ASX Market Rule
Client Order Priority	S991B	7.5
Confirmations	S1017F	7.9
Managed Discretionary Accounts	ASIC CO04/194; PS179	7.10
Principal Trading	s991E; Regs 7.8.20, 7.9.63B(4)	7.3
Staff Trading	S991F	7.8.2
Trading Records	s988E; Reg 7.8.11	4.10
Trust Accounts	s981C; Reg 7.8.01&02	7.11

We trust that the above will be examined in the process of the delineation of the Market Integrity Rules from the Operating Rules. This will reduce ambiguity and compliance costs for market participants, and ensure consistency across different market operators.

[1] 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.*'

In addition, if after the exercise some areas of duplication persist, we trust that there will not be instances of duplication of **enforcement** of the rules. Each set of facts should only give rise to one enforcement action by ASIC or ASX, not both.

Scope of the Market Integrity Rules

It is not clear whether the Market Integrity Rules will apply only to market participants and their responsible executives, as is currently the case with ASX Rules, or whether the rules will apply to a wider group of persons. As the Rules will be enacted as a legislative instrument, there is no reason why the Rules cannot apply more widely than do the ASX Rules. If the Rules only apply to Market Participants as presently defined, then the proposed rules could represent an incentive to entities to resign their Market Participant status, which may be an undesirable result in terms of overall market activity and liquidity.

Level of Penalties – Pecuniary Penalties

The Stockbrokers Association strongly submits that the proposed maximum level for pecuniary penalties of $5 million for a corporation is excessive. The figure should be reduced to a more appropriate level.

We note that the ASX not long ago reviewed the level of its penalties for breach of ASX Rules, and after a period of consultation and analysis, arrived at the present maximum in its Rules of $1 million for market participants effective 1 April 2008. These penalties are imposed under administrative proceedings by the ASX's Disciplinary Tribunal. This level corresponds with the maximum level of civil penalties for a corporation under the *Corporations Act* Civil Penalty regime.

We note that section 798F of the Exposure Draft requires that the Market Integrity Rules must include a penalty amount for breach of each Market Integrity rule, with the amount not to exceed $1 million. This accords with the existing level of maximum penalty in the ASX Rules for breach of its Rules.

However, we note that the 'multiplier' effect resulting from Exposure Draft [230] is to increase the maximum level for a civil penalty imposed by a Court to $5 million in relation to a breach of a Market Integrity Rule in the case of a corporation. Given that in order to become a market participant, it is necessary to be a corporation[2], market integrity matters will normally involve a corporation. Therefore, $5m will be the usual maximum amount for a civil penalty.

[2] In the case of ASX, all new participants must be corporations. At the time of writing, there was only one remaining market participant of ASX that is a partnership.

In our view, nothing has changed in the short period of time since the ASX maximum fines were increased in 2008, to suggest that ASX's consideration of the appropriate maximum was inadequate, or that the maximum amount of $1 million is inadequate. There have been no instances where conduct has occurred which has highlighted a need for even greater penalties. On the contrary, ASX fines in recent times have included some of a very high amount. In the last 18 months, some $2.5m in fines have been levied by ASX, including one recent case where total fines of $1.35 million were imposed for a number of breaches.

In this context, it is difficult to understand the policy rationale for a five-fold increase in the effective maximum civil penalty for a breach of a Market Integrity rule. In our submission, $5 million is an unreasonable amount.

The proposed $5 million penalty would create a **serious anomaly**. Market manipulation, which is regarded as the most serious of market integrity offences, is presently prohibited by section 1041A-C of the *Corporations Act*. Insider trading, which can similarly be expected to be found in Market Integrity Rules, and is of corresponding gravity, is prohibited under section 1043A of the *Corporations Act*.

Each of these sections is a Civil Penalty provision under section 1317E *Corporations Act*. A breach of the sections renders a person liable for a civil penalty of up to $200,000 for an individual or $1 million for a corporation.

The same conduct if carried out by a market participant would be likely to breach the current ASX Market Rules, rendering the participant liable to penalties which include a fine up to $1m. The conduct would presumably also breach the relevant Market Integrity Rules adopted by ASIC following the takeover of market supervision from ASX.

The situation may therefore arise that the same conduct carried out by a corporation [3]could give rise to potential civil penalties under two provisions under the same law, one provision giving rise to a maximum civil penalty of $1 million and one of $5 million. This is anomalous.

Unless the Market Integrity Rules are drafted so as to apply to investors and not just to market participants, then a further anomaly would result. A client or investor who is responsible, say, for manipulating a market, would only face a maximum civil penalty of $1 million for breach of section 1041A-C, notwithstanding that they engineered the manipulation, whereas a market participant who carried out the trading on the client's

[3] The licensee (corporate or otherwise) is liable for the acts and omissions of its representatives under Pt.7.6 Div.6, Sections 917A-F of the *Act*

behalf could potentially face a civil penalty of up to $5 million if action were taken against them for breach of a Market Integrity rule. This disparity is difficult to justify.

The existing maximum $1 million amount for breach of an ASX rule was introduced recently to deal with the most serious of those rules, including market integrity matters. This is consistent with the current maximum civil penalty for corporations under the Act. Accordingly, the maximum civil penalty applicable under the proposed new arrangements should be set at a level no higher than this, in the absence of any evidence to show that the existing level has proven to be ineffective.

Level of Infringement Notice Penalties - Insufficient Discount

Matters disposed of by way of Infringement Notices under the proposals will attract a 20% discount to the maximum civil penalty.

It is important to offer an incentive to encourage parties to settle matters and avoid lengthy and costly disputation. The Stockbrokers Association does not believe that the 20% discount which is built into the infringement notice arrangements is adequate. This does not represent sufficient incentive to parties to settle a matter. On the contrary, 80% of the maximum penalty is likely to encourage parties to contest a matter until the end, as it does not represent much down-side risk in the event of loss.

Level of penalties – Discretion

The level of penalties should be commensurate with the nature of the particular Market Integrity Rule breach. Minor rules should not be the subject of unduly high penalties. There should also be sufficient discretion to adjust penalties to reflect the particular circumstances of a matter. In particular, the imposition of high or mandatory penalties in cases such as 'fat finger errors' or other innocent mistakes is harsh and unfair, and penalty guidelines should permit the appropriate level of discretion to be exercised in the absence of countervailing factors such as negligence or lack of supervision. Indeed, these sets of circumstances beg the question whether regulatory action is required at all.

Review of ASX penalties

Upon assumption by ASIC of supervision of market integrity matters, a review of the level of ASX maximum fines for breach of its Rules should be required. As mentioned earlier, a four-fold increase in the level of maximum fines was introduced by the ASX in 2008, largely in order to provide sanctions in respect of serious cases of market misconduct. Now that these matters are to be transferred for supervision by ASIC, to the extent that ASX Rules become more operational in nature, the maximum level of

ASX fines should be reviewed and reduced in order to reflect the nature of the Rules that remain.

For example, the ASX Disciplinary Tribunal Sanction Guidelines[4] require the Tribunal to categorise a contravention as Level 1, 2 or 3. Level 3 'Very Serious Contraventions' are the most serious, attracting a fine of $100,000 - $1m. While the detail remains to be seen of the scope of the ASIC Market Integrity Rules, it may be that most of these 'Level 3' contraventions will pass to ASIC, meaning that very few of them remain, removing the need for fines of this magnitude by ASX.

ASIC Hearings in Public

The Stockbrokers Association submits that the proposal that ASIC hearings in relation to market supervision matters should be public is not appropriate. In our submission, the hearings should prima facie be held in private, with the power for a direction that they be held in public only if there is a determination made that there is a substantial public interest supporting a public hearing.

The proposal that the hearings take place in public would be inconsistent with all other existing ASIC administrative hearing provisions, including hearings for:

- banning orders
- licence suspensions or terminations
- takeover panel determinations, and
- continuous disclosure infringement notices.

There is no logical reason which would justify treating ASIC market integrity hearings differently to the other hearings listed above.

On the other hand, there are substantial reasons why hearing should ordinarily by in private. Matters will in all likelihood touch on relations with clients or other investors, who may have a legitimate reason for their affairs to not be ventilated in public, and who will usually not be a party to the hearing. Matters will usually involve very technical subject areas relating to trading of securities or other instruments. Whilst there would be a public interest in the determinations and the reasons for them being made public, the same could not always be said for the proceedings at a hearing.

Lastly, there is a practical consideration that it is not always easy to find qualified and experienced industry figures who are prepared to take on the difficult task of participating as a tribunal members. There is the potential that this may become even harder still if individuals felt that that they would themselves be put under the spotlight through the hearings being ordinarily conducted in public.

[4] Set out in the ASX Disciplinary Processes and Appeals Rulebook *Procedures* Annexure A

Suspicious Conduct Reporting (EM#20.2)

There should not be multiple and duplicated levels of suspicious conduct reporting. The opportunity should be taken to rationalize reporting obligations so that Participants be obliged to report conduct in relation to market integrity matters once only, namely to ASIC.

Currently, such matters are also required to be reported to ASX. There is also a very broad requirement under section 16 of the Financial Transactions Reporting Act 1988 to report to AUSTRAC information that may be relevant to an investigation or prosecution of an offence against a law of the Commonwealth. This is sufficiently broad to include breaches of any section of the *Corporations Act*, although query why there should be any need for such matters to be reported to AUSTRAC.

Multiple reporting obligations are inefficient and potentially confusing. A single requirement to report market integrity matters to ASIC should suffice, and the other obligations should be removed.

Cost recovery (EM#33)

The Stockbrokers Association strongly submits that the proposed changes to supervision should enhance economic efficiency, not the opposite. There should be no net increase in cost to participants resulting from the changes.

The Association understands the need for there to be a mechanism for recovering the cost of the new supervision obligations being undertaken by ASIC. There needs to be a transparent process for setting levies or other fees to be passed on to participants in the markets. The process needs itself to be efficient and not unduly add to costs.

There should be a requirement for appropriate reductions in market operator fees to compensate for the levies or fees to be introduced to fund supervision by ASIC. Otherwise, the transfer of supervision to ASIC will potentially result in an additional cost to business in the Australian Market, which will not assist in Australia's competitiveness or its objective to become a regional financial centre.

Management and Supervision Requirements

Management Supervision requirements should in all likelihood be considered highly relevant to ASIC in relation to its supervision of 'market integrity' matters under the new arrangements. They would already be relevant to issues of licence competency under the AFS Licencing regime.

The Stockbrokers Association submits that there should not be parallel and duplicated requirement being prescribed by both ASIC and by each Market Operator. It is logical, and efficient, for there to be one set of management and supervision requirements to be satisfied by a market participant, and that these should be administered by ASIC. These matters should therefore be included in those matters to be 'transferred' to ASIC under the new arrangements.

This would also ensure consistency across all market operators, including any new operators which may come into the market.

Content of Market Integrity Rules

It would be preferable in the interests of minimizing uncertainty for the new Market Integrity Rules to reflect the language and drafting of existing rules. This would enable to transition of supervision arrangements to occur as smoothly as possible. The existing drafting is largely well understood, and there is a body of decisions that have been delivered to assist in understanding them.

In our view, any radical redrafting of the rules, for example, introducing concepts such as 'market distortion' or 'market abuse', which are currently not defined or the subject of Australian case law, would add an element of uncertainty or destabilization at a point in time when this is best avoided.

Thank-you for the opportunity to present our Members' comments in response to the Consultation Paper and Bill, and for your time and willingness to discuss issues with the Association in recent meetings and discussions.

Yours sincerely

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The Stockbrokers Association of Australia
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