



**Stockbrokers**

**Association of Australia**

Incorporating SDIA

6 June 2013

Mr Daniel McAuliffe  
Manager, Financial Markets Unit  
Markets Group  
The Treasury  
Langton Crescent  
Parkes ACT 2600

Dear Mr McAuliffe,

## Extension of Market Integrity Rules to Shadow Brokers

The Stockbrokers Association of Australia has long been concerned about the activities of **shadow brokers** – namely those that purport to offer the same services as stockbrokers without themselves being market participants<sup>1</sup>. Their activities have cast doubt over the operation and efficacy of the existing provisions of the law relating to market participants and stockbrokers<sup>2</sup>, and they have caused confusion and uncertainty in investors.

It is time for the shadow broking sector to be brought into line with the regulated market participant sector.

As Stockbrokers, our members are subject to higher levels of regulation under the **Market Integrity Rules (MIRs)**<sup>3</sup> than other licensees who may advise and deal in securities. The MIRs

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<sup>1</sup> It is difficult to define **shadow broker**, because (unlike stockbrokers and market participants) they do not have any particular status under the law, other than being licensed (or authorised) to deal in securities. In correspondence with ASIC in 2012 attached, we used the following definition –

*An AFS Licensee (or Authorised Representative) that is authorised to deal in securities, and has an agreement or arrangement, directly or indirectly, with a Market Participant to facilitate the trading of financial products on a licensed market.*

<sup>2</sup> See in particular, sections 761A (definition of *market participant*), 791B (offence of pretending to be stockbroker), and 923B (authorisation necessary to use the term *stockbroker*)

<sup>3</sup> In this letter, *Market Integrity Rules* principally refers to the *ASIC Market Integrity Rules (ASX Market) 2010*. However, it is noted that there are sets of MIRs for each market, e.g. Chi-X, and that the Competition MIRs (*ASIC Market Integrity Rules (Competition in Exchange Markets) 2011*) also apply where securities are traded on more

contain most of the rules on trading on a licensed market that were previously contained in the *ASX Market Rules*, and including –

- management and supervision requirements (including Responsible Executive Requirements),
- prohibition of Unprofessional Conduct,
- liquid capital requirements,
- adviser accreditation,
- client relationships (including rules against excessive transactions),
- record keeping and
- trading.

Further details of the additional requirements and standards that apply to market participants and not to shadow brokers – particularly those in relation to **management and supervision** - are set out in the letter we wrote to the ASIC Chairman in April 2012, attached<sup>4</sup>.

## Terminology

We have previously raised objections to the use of the term ‘Indirect Market Participant’ by ASIC and others. ASIC Officials have used the term Indirect Market Participant in public and industry forums. ASIC has also used it in formal documents. For example, in Consultation Paper 168: *Australian equity market structure: Further proposals* dated October 2011, in which ASIC had a section on indirect market participants (at paragraphs 232-233). However, in speeches and documents now ASIC tends to use the term ‘*securities dealers*’ in reference to shadow brokers, which is an improvement. It is also noted that the final version of the FOFA *Further Stockbrokers Exemptions*<sup>5</sup> (June 2013) refers to such an entity as simply a ‘*financial services licensee that is not a trading participant*’. This was in response to concerns we raised at the use of the term ‘*non-trading participant*’ in an earlier draft of the relevant Bill, since it suggested that they were a form of trading participant when they are not.

The use of terms such as *Indirect Market Participant* or *non-trading participant* gives these parties status and credibility that is not deserved and is potentially damaging, since it has the potential to mislead the investing public. In any extension of the MIRs to this sector, care will need to be exercised in defining the relevant category<sup>6</sup>.

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than one exchange. The Competition MIRs themselves impose additional requirements on market participants, including the duty of best execution.

<sup>4</sup> Letter from DW Horsfield, CEO, Stockbrokers Association to G Medcraft, Chairman, ASIC *Shadow Brokers & Use of the Term ‘Indirect Market Participant’* dated 3 April 2012

<sup>5</sup> *Corporations Amendment Regulation 2013 (No.4)*, which provided exemptions for brokerage from the ban on asset based fees on borrowed funds, and other exemption for white label providers.

<sup>6</sup> We suggest a definition in *Note 1* above.

## Market Supervision Fees

Market Participants also pay **Market Supervision fees**. In the current period of 18 months to 30 June 2013, **\$28m** is to be recovered from market participants by ASIC for market supervision. On average, this is about \$300,000 per Participant, but some high trading firms are paying much more than this, in the millions of dollars. In the forthcoming period of 2 years from 1 July 2013 to 30 June 2015, ASIC expects to recover **\$32.88m** from market participants for market supervision<sup>7</sup>.

Shadow brokers pay **nothing** to ASIC in respect to supervision, and yet are taking-up an increasing amount of the time of the participant supervision team. Indeed, in its 6-monthly reports on supervision of markets and participants<sup>8</sup>, ASIC reports separately on its activities in relation to market participants, and *securities dealers*, namely shadow brokers.

Many shadow brokers were formerly Market Participants, or employed by a Stockbroker. The 'culture' therefore may be similar. However, this should not give the regulators any comfort in dealing with this sector. Most shadow brokers who were Participants chose to give up their participant status in order to **avoid** the additional regulation which only applies to Market Participants. Key drivers for this move are usually concerns over **cost and liability**.

In the interests of **regulatory equivalence**, licensees who provide stockbroking-like services should be regulated in the same manner as stockbrokers. To paraphrase the ASIC Chairman in a recent speech<sup>9</sup>, 'if it looks like a broker, it should be regulated like a broker'.

As you can see, we have already devoted a great deal of thought, time and effort to these matters. Accordingly, we are in a good position to assist Treasury in any way you may require. Please contact me or Doug Clark, Policy Executive [dclark@stockbrokers.org.au](mailto:dclark@stockbrokers.org.au) should you wish to discuss these matters further.

Yours sincerely



**David W Horsfield**  
**Managing Director/CEO**

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<sup>7</sup> ASIC *Market Supervision Cost Recovery Impact Statement 1 July 2013 to 30 June 2015* page 18

<sup>8</sup> the latest being REPORT 327 *ASIC supervision of markets and participants: July to December 2012* dated February 2013

<sup>9</sup> G Medcraft, ASIC Chairman, Speech to the *2013 Annual Stockbrokers Conference*, Hilton Hotel, Sydney, 30 May 2013

## ASIC Market Integrity Rules (ASX Market) 2010 ('MIR') - *Extension to Shadow Brokers?*

**Background:** The Stockbrokers Association of Australia has long been concerned about the activities of *shadow brokers* – namely those that purport to offer the same services as stockbrokers without themselves being market participants. Their activities have cast doubt over the operation and efficacy of the existing provisions relating to market participants and stockbrokers<sup>1</sup>, and caused uncertainty to investors.

We note that ASIC is seeking to achieve *regulatory equivalence* in the regulation of shadow brokers, initially via the extension of the MIRs to their activities.

The Association does not believe that shadow brokers ought to be accorded any special status under the *Act*. In not being subject to the higher standards which apply to market participants, it will also give these non-participants a status that they do not deserve and expose regulatory risks. However, we would like to provide our views as to the extension of the MIRs to this sector.

**Scope:** The definition of *shadow broker* is difficult to express, because (unlike stockbrokers and market participants) they do not have any particular status under the law, other than being licensed (or authorised) to deal in securities. For the purpose of the exercise, we would define them as –

*An AFS Licensee (or Authorised Representative) that is authorised to deal in securities, and has an agreement or arrangement, directly or indirectly, with a Market Participant to facilitate the trading of financial products on a licensed market.*

We also note that ASIC has a project to achieve harmonisation of similar requirements under the *Corporations Act* and the MIR, which will impact on this exercise. The Association has been a keen proponent of this project for over 6 years<sup>2</sup>, and notes the need for harmonisation in areas such as –

Subject	Corporations Act	MIR
Client Order Priority	S991B	Pt 5.1
Confirmations	S1017F	Pt 3.4
Managed Discretionary Accounts	ASIC CO04/194; PS179	Rule 3.3.2
Principal Trading	s991E; Regs 7.8.20, 7.9.63B(4)	Pt 3.2
Staff Trading	S991F	Pt 5.4
Trading Records	s988E; Reg 7.8.11	Pt 4.1
Trust Accounts	s981C; Reg 7.8.01&02	Pt 3.5

**Table 1.** below sets out all the titles of the MIR, and the Association's view as to whether the particular rule should apply to shadow brokers.

A number of requirements of market participants have not been included by ASIC, because ASIC is of the view that existing requirements are sufficient. These include:

- Capital requirements (MIR Chap.8)
- Supervisory Procedures (MIR 2.1.3)
- Trading as Principal (MIR 3.2).

<sup>1</sup> See in particular, sections 761A (definition of *market participant*), 791B (offence of pretending to be stockbroker), and 923B (authorisation necessary to use the term *stockbroker*)

<sup>2</sup> See our Submissions to Treasury on the *Corporate and Financial Services Regulation Review (aka 'FSR Refinements II')* dated 18 May 2006 and the *Market Supervision Changes Consultation Paper and Bill* dated 23 December 2009

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
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We have commented on this approach in the Table 1. below. Generally, we are of the view that, in terms of effective regulation and enforcement, where matters could be dealt with under the **MIRs**, they should be, rather than under other provisions of the Act or AFSL conditions.

**Table 2.** addresses Other Matters, including those in relation to the Competition in Markets Rules.

Our opinion on each rule is expressed according to the following Key:

Key:	
Yes	Rules we say should be extended to shadow brokers (this includes Rules that ASIC says should be extended)
Yes (ASIC)	Rules that ASIC says should be extended, as per their list in email 3 May 2012
No	Not applicable

**Table 1.**

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
Chapter 1: Introduction		
Part 1.1 Preliminary	Yes	Recommended for ASIC's benefit. Would seem logical, to ensure rules are properly based, and the same definitions and interpretation apply, etc.
1.1.1 Enabling legislation	Yes	"
1.1.2 Title	"	"
1.1.3 Commencement	"	"
1.1.4 Scope of these Rules	"	"
1.1.5 Entities that must comply with these Rules	"	"
1.1.6 Conduct by officers, Employees or agents	"	"
1.1.7 State of mind of a person	"	"
Part 1.2 Waiver	Yes	Recommended for ASIC's benefit. Gives flexibility to ASIC
1.2.1 Waiver of Rules	"	"

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
1.2.2 Compliance with conditions	“	“
1.2.3 Period during which relief applies	“	“
1.2.4 Register	“	“
Part 1.3 Notice, notification and service of documents	Yes	“
1.3.1 Market Participant to have email	“	Recommended for ASIC’s benefit. ASIC says that they already have sufficient contacts/emails via the AFSL. Need to ensure that they have the right contact for <i>trading inquiries</i> though.
1.3.2 Methods of giving notice in writing	“	
Part 1.4 Interpretation	Yes	Recommended for ASIC’s benefit. Would seem logical, to ensure rules are properly based, and the same definitions and interpretation apply, etc.
1.4.1 References to time	“	“
1.4.2 Words and expression defined in the Corporations Act	“	“
1.4.3 Definitions		“
Chapter 2: Participants and Representatives		
Part 2.1 Management requirements		
2.1.1 Management structure	Yes (ASIC)	
2.1.2 Notification of management structure	Yes (ASIC)	
2.1.3 Supervisory procedures	Yes	Should be covered. Follows from other management & supervision provisions.
2.1.4 Persons involved in the business—Good fame and character requirement	Yes (ASIC)	

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
2.1.5 Unprofessional Conduct	Yes (ASIC)	The Association supports this.
2.1.6 Responsibility for individuals involved in business	Yes	Shadow brokers ought to be responsible for the actions and omissions of their staff for the purpose of the Rules to ensure that they are meaningful.
Part 2.2 Insurance and information requirements	Yes	ASIC says that the AFSL provisions are sufficient.
2.2.1 Insurance requirements—Obligation to have insurance	Yes	
2.2.2 Insurance requirements—Insurance with Related Body Corporate	Yes	
2.2.3 Insurance requirements—Notification of amount and period of cover	Yes	
2.2.4 Insurance requirements— Notification of claims	Yes (ASIC)	Odd for ASIC to have this one but not 2.2.1 – 2.2.3. ASIC says that the rest are covered in the AFSL.
2.2.5 Information Requirements—Obligation to notify of legal proceedings	Yes (ASIC)	
Part 2.3 Responsible Executives	Yes (ASIC)	
2.3.1 Appointment or resignation of Responsible Executives	Yes (ASIC)	The obligation to have RE's will be a positive step in lifting the standards of this sector.
2.3.2 Ongoing responsibilities of Market Participants in relation to Responsible Executives	Yes (ASIC)	
2.3.3 Annual review and representation of Market Participant and Responsible Executives	Yes (ASIC)	
2.3.4 Continuing education requirements for Responsible Executives	Yes (ASIC)	
2.3.5 Annual continuing education and compliance self-assessment	Yes (ASIC)	
Part 2.4 Retail Client Advisor Accreditation	Yes (ASIC)	The move to accredit derivatives advisers is very positive and should increase standards in this sector.

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
2.4.1 Accreditation required	Yes (ASIC)	
2.4.2 Extent of advice to clients—Level One Accredited Derivatives Adviser	Yes (ASIC)	
2.4.3 Covered Call Option Strategy	Yes (ASIC)	
2.4.4 Extent of advice to clients—Level Two Accredited Derivatives Adviser	Yes (ASIC)	
2.4.5 Extent of advice to clients—Accredited Futures Adviser	Yes (ASIC)	
2.4.6 Accreditation—Accredited Futures Adviser	Yes (ASIC)	
2.4.7 Accreditation—Level One Accredited Derivatives Adviser	Yes (ASIC)	
2.4.8 Accreditation—Level Two Accredited Derivatives Adviser	Yes (ASIC)	
2.4.9 Acceptance of application	Yes (ASIC)	
2.4.10 Rejection of application	Yes (ASIC)	
2.4.11 Exemption for other accreditation and experience	Yes (ASIC)	
2.4.12 Examinations	Yes (ASIC)	
2.4.13 Renewal of accreditation	Yes (ASIC)	
2.4.14 Acceptance of application	Yes (ASIC)	
2.4.15 Rejection of application or renewal subject to conditions	Yes (ASIC)	
2.4.16 Effect of non-renewal	Yes (ASIC)	
2.4.17 Automatic withdrawal of accreditation	Yes (ASIC)	
2.4.18 Voluntary withdrawal of accreditation	Yes (ASIC)	
2.4.19 Suspension or withdrawal by ASIC	Yes (ASIC)	



ASIC MIR	Apply Rule to Shadow Brokers?	Comment
2.4.20 Re-accreditation after withdrawal or expiry	Yes (ASIC)	
2.4.21 Continuing Professional Education Requirements for Accredited Advisers	Yes (ASIC)	
2.4.22 Managed Discretionary Accounts—Derivatives Market Transactions and Warrants	Yes (ASIC)	
Part 2.5 Designated Trading Representatives (DTRs)	?	<p>ASIC is of the view that it is the Market Participant's responsibility, since the shadow broker is not connected to the market.</p> <p>Note that manipulation and supervision requirements (including RE's) do apply, which may be sufficient, but it needs to consider whether there should be someone nominated as responsible for <i>trading</i>, and to field trading queries from ASIC in set out in the Rules – see also, comments on 5.9.2</p>
2.5.1 Trading in a Trading Platform	?	
2.5.2 Trading Participant must have a DTR	?	
2.5.3 DTRs may submit Trading Messages	?	
2.5.4 Responsibility of Trading Participant	?	
2.5.5 DTR criteria	?	
2.5.6 Trading Participant must allocate unique identifier	?	
2.5.7 Records—DTRs	?	
Chapter 3: Client relationships		
Part 3.1 Clients trading in products for first time	Yes (ASIC)	
3.1.1 Documents to be given to a client	Yes (ASIC)	

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
3.1.2 Documents to be given to a client: Options, LEPOs and Warrants	Yes (ASIC)	
3.1.3 Information to be given to a client: Execution arrangements	Yes (ASIC)	
3.1.4 Information to be given to a client: Clearing arrangements for Equity Securities, Loan Securities or Warrants	Yes (ASIC)	
3.1.5 Information to be given to a client: Clearing arrangements for Futures Market Transactions	Yes (ASIC)	
3.1.6 Minimum terms of Client Agreement for Futures Market Contracts	Yes (ASIC)	
3.1.7 Minimum terms of Client Agreement for Options Market Contracts	Yes (ASIC)	
3.1.8 Client Agreement for Warrants	Yes (ASIC)	
3.1.9 Client Agreement for Partly Paid Securities	Yes (ASIC)	
3.1.10 Other terms of Client Agreements	Yes (ASIC)	
3.1.11 Market Participant to keep copy of Client Agreement and disclosures	Yes (ASIC)	
3.1.12 Client agreement where Market Participant is not the Clearing Participant (Options Market Transactions only)	Yes (ASIC)	
3.1.13 Client agreement where Market Participant is the Clearing Participant (Options Market Transactions only)	Yes (ASIC)	
Part 3.2 Trading as Principal	Yes	This requirement should be in the MIR. ASIC says the Corps.Act (sec.991E) is sufficient, but having it in the MIR would be better in terms of effective regulation and enforcement. Also, it is logically inconsistent for ASIC to have included Client Order Priority (Rule 5.1) in its list and <i>not</i> Trading as Principal.
3.2.1 Application	Yes	

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
3.2.2 Disclosure and consent	Yes	
3.2.3 Confirmation must include disclosure	Yes	
3.2.4 Brokerage and commission	Yes	
3.2.5 Extended meaning of dealing as Principal	Yes	
3.2.6 Register of persons who are regarded as Principal	Yes	
Part 3.3 Client Instructions	Yes (ASIC)	
3.3.1 Market Participant restrictions	Yes (ASIC)	
3.3.2 Excessive trading	Yes (ASIC)	
Part 3.4 Reporting to Clients	Yes	ASIC says that the reporting responsibility lies with the market participant. This may be so, but there should be some requirement on the shadow broker, e.g. <i>'...to ensure that it has entered into an arrangement (for proper reporting of transactions, etc.)'</i>
3.4.1 Confirmations—Form and timing	Yes	
3.4.2 Confirmations—Accumulation and price averaging	Yes	
3.4.3 Confirmations—Other than Retail Clients	Yes	
Part 3.5 Client Money and Property		
3.5.1 Trust accounts—Cash Market Transactions and Options Market Transactions	Yes	Not in ASIC's list because covered in Corps.Act (Pt 7.8 Div 2). Once again for more effective regulation and enforcement, where there are duplications between the Corps.Act and the MIR's, the MIR should apply.
3.5.2 Segregated accounts or trust accounts—Futures Market Transactions	Yes	"

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
3.5.3 Bank accounts to be with Australian ADI	Yes	“
3.5.4 Approved foreign banks	Yes	“
3.5.5 Change of rating or approval of ADI	Yes	“
3.5.6 Liquidity requirement—Clients’ segregated accounts—Futures Market Transactions	Yes (ASIC)	
3.5.7 Top up requirement—Clients’ segregated accounts—Futures Market Transactions	Yes (ASIC)	
3.5.8 Reconciliation of clients’ segregated accounts	Yes (ASIC)	
3.5.9 Reconciliation of trust accounts	Yes (ASIC)	
3.5.10 Obligation to notify ASIC in respect of reconciliation	Yes (ASIC)	
3.5.11 Schedule of trust amounts	Yes (ASIC)	
Part 3.6 Prohibition of advice to Client	Yes (ASIC)	Good
3.6.1 Definitions used in this Part 3.6		
3.6.2 Market Participant possesses information that is not generally available	Yes (ASIC)	
3.6.3 Chinese Walls in place	Yes (ASIC)	
3.6.4 Certain actions do not constitute giving advice	Yes (ASIC)	
Chapter 4: Records		
Part 4.1 Trading records	Yes (ASIC)	ASIC says: ‘Aspects of Part 4.1 maintaining trading records as applicable to indirect market participants’ We submit that it’s all applicable.
4.1.1 Records of dealings for clients	“	
4.1.2 Records of dealings on Own Account	“	

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
4.1.3 Records to be made immediately	“	
4.1.4 Records to be retained for prescribed period	“	
4.1.5 Certain records maintained by the Market Operator	“	
4.1.6 Conditions for reliance on the Market Operator records	“	
4.1.7 Records of dealings for clients by a Market Participant who instructs another Trading Participant to execute the dealings	“	
4.1.8 Records of dealings on its Own Account by a Market Participant who instructs another Trading Participant to execute the dealings	“	
4.1.9 Records regarding Authorised Persons	“	
4.1.10 Telephone recording of client dealings—Futures Market Transactions	“	
Part 4.2 Records—General		
4.2.1 General recordkeeping requirements		
4.2.2 Client complaints—Records of complaints and correspondence	Yes (ASIC)	
Part 4.3 Access to records	Yes	For ASIC’s convenience
4.3.1 Records to be in writing and in English	“	“
4.3.2 Records kept outside of Australia	“	“
Chapter 5: Trading		
Part 5.1 Client order priority	Yes (ASIC)	We support this.
5.1.1 Application and meaning of dealing on “Own Account”	“	
5.1.2 Exceptions	“	

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
5.1.3 Fairness and priority in dealing	“	
5.1.4 Relevant factors	“	
5.1.5 Fairness and priority in allocation	“	
5.1.6 Relevant factors	“	
5.1.7 Unexecuted order in Underlying Financial Products—Trading Participant not to make Bids or Offers	“	
5.1.8 Allocation policy and Automated Client Order Processing Crossings—disclosure to Client	“	
Part 5.2 Business connections between Market Participants	“	
5.2.1 Connections requiring ASIC consent		
5.2.2 Access to records		
Part 5.3 Large Order facilitation		
5.3.1 Futures Market Contracts—Action a Market Participant may take when insufficient opposite orders		
5.3.2 Application		
Part 5.4 Transactions by connected persons (including persons connected with other Market Participants)	Yes (ASIC)	Good
5.4.1 Application	“	
5.4.2 Internal consent required for trading by connected persons	“	Good
Part 5.5 Participant’s trading infrastructure		
5.5.1 Knowledge of Trading Participant		
5.5.2 Organisational and technical resources		
5.5.3 Trading management arrangements		

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
5.5.4 Trading management arrangements—Records		
Part 5.6 Automated Order Processing—Filters, conduct and infrastructure	Yes?	ASIC doesn't see the AOP rules as applicable to Shadow Brokers. We note that the fair and orderly market and manipulation rules will apply to shadow brokers, which is supported.
5.6.1 Responsible use of system for Automated Order Processing		
5.6.2 Authorised Persons for Automated Client Order Processing		
5.6.3 Automated Order Processing system requirements		
5.6.4 Review of documentation and systems prior to use of Automated Order Processing system		
5.6.5 Representations as to organisational and technical resources, trading management arrangements and security arrangements, prior to use of Automated Order Processing system		
5.6.6 Certification of Automated Order Processing system		
5.6.7 Material changes		
5.6.8 Material change review		
5.6.9 Material change confirmation		
5.6.10 Material change further certification		
5.6.11 Further certification		
5.6.12 Limitations on Automated Order Processing		
Part 5.7 Manipulative trading	Yes (ASIC)	Good
5.7.1 False or misleading appearance	Yes (ASIC)	
5.7.2 Circumstances of Order	Yes (ASIC)	

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
5.7.3 Obligations apply to Automated Order Processing		
Part 5.8 Prohibition on wash trades, pre-arranged trades and dual trading—Futures		
5.8.1 Application of Rule 5.8		
5.8.2 Wash trades		
5.8.3 Pre-arranged trades		
5.8.4 Dual trading		
5.8.5 Corners—Postponement of deliveries		
5.8.6 Establishment of a fair settlement price		
Part 5.9 Fair and orderly Markets	Yes (ASIC)	Good
5.9.1 Market must remain fair and orderly	“	Good
5.9.2 Representative must be available	Yes	We submit that ASIC should have at least a nominated Representative to whom trading inquiries can be directed.
5.9.3 Must not take advantage of breakdown or malfunction	Yes	Shadow brokers should not be able to take advantage of breakdown or malfunctions, when market participants cannot. ASIC says it’s the participant’s responsibility, but shadows will take advantage wherever they can (e.g. share hawking provisions Reg.2C.1.3). It should be a level playing field.
Part 5.10 Dealing in Cash Market Products		
5.10.1 Trading Participants may not deal in Cash Market Products for which Official Quotation will be sought	Yes	If this rule is not extended, Shadow Brokers may set up <b>grey markets</b> ahead of a new listing. They should not get another regulatory benefit.
5.10.2 When Trading Participants may deal in Cash Market Products for which Official Quotation will be	“	“



ASIC MIR	Apply Rule to Shadow Brokers?	Comment
sought		
5.10.3 Dealings in Securities for which Official Quotation will not be sought	“	“
5.10.4 Dealings in Cash Market Products suspended from Official Quotation	“	“
5.10.5 Disclosure of shortfall—Must disclose to Client	Yes	In case they underwrite and have to take a shortfall, they should have to make the disclosure. They should not get another regulatory benefit.
5.10.6 Expenses—Reimbursement for out-of-pocket expenses	?	
5.10.7 Nominee holdings—Restrictions on when an Equity Security can be recorded in the name of a nominee company	Yes	
Chapter 6: Takeovers		
Part 6.1 Market Bid—Announcements by Market Participant	?	It is not inconceivable that a shadow broker would act as broker to a takeover, not a market participant.  Therefore, noting that transactions would be executed on market, the relative responsibilities of the broker and the shadow needs to be examined, especially as the broker may not be privy to all the information concerning the takeover offer.
6.1.1 Announcement of Market Bid	?	
6.1.2 Announcement of variations to Market Bid	?	
Part 6.2 Acquisition of Cash Market Products During the Bid Period	?	
6.2.1 Acquisition of Cash Market Products by Bidder	?	
6.2.2 Acquisition of Cash Market Products by another Bidder	?	

ASIC MIR	Apply Rule to Shadow Brokers?	Comment
Part 6.3 Market Participant acting for Bidder or Issuer	?	
6.3.1 Market Participant to advise seller if acting for Bidder or Issuer	?	
Part 6.4 Limitations on Late, Overseas and Overnight Crossings During a Takeover Bid or Scheme	?	
6.4.1 Late, overseas and overnight Crossings in Cash Market Products	?	
6.4.2 Crossings after Trading Close in Derivatives Market Contracts	?	
6.4.3 Late, overseas and overnight Crossings and Crossings after Trading Close in Combinations	?	
Part 6.5 Special Crossings Prohibited During Offer Period	?	
6.5.1 Special Crossings in Cash Market Products (excluding Warrants)	?	
6.5.2 Special Crossings in Warrants	?	
6.5.3 Special Crossings in Derivatives Market Contracts	?	
6.5.4 Special Crossings in Combinations	?	
Part 6.6 Limitations on Crossings during buy-back conducted On-Market	?	
6.6.1 Special Crossing in Cash Market Products (excluding Warrants) on behalf of Issuer	?	
6.6.2 Crossings after Trading Close and Special Crossings in Derivatives Market Contracts	?	
6.6.3 Crossings after Trading Close and Special Crossings in Combination	?	
Chapter 7 Rules applying to Market Operators	?	
Part 7.1 Data feeds		
7.1.1 Provision of live electronic data from the Trading Platform	No	

<b>ASIC MIR</b>	<b>Apply Rule to Shadow Brokers?</b>	<b>Comment</b>
7.1.2 Notification	No	
Part 7.2 Information		
7.2.1 Provision of information about Market Participants	Yes	

## **Table 2. Other Matters**

Suspect Transaction Reporting	Yes (ASIC)	ASIC says the 'pending rule' on suspicious transaction reporting should apply. Breach reporting?
Market Supervision Fees	Yes	Shadow brokers should have to bear their fair share of supervision fees, given that they will be subject to a significant new regime. ASIC surveillance and enforcement in the area, including cases at the MDP, should increase considerably, making it more costly than at present.

<b>ASIC Competition in Markets MIR</b>	<b>Apply Rule to Shadow Brokers?</b>	<b>Comment</b>
3.1 Best Execution	Yes	We note that ASIC has said the obligation only applies to the Participant.  However, this position may need to be reconsidered in the light of developments in the sector.
7.2 Suspended Trading Prohibited	Yes	Shadow brokers should not be allowed to trade when brokers are not – they may take the regulatory advantage. This would include matching orders off-market.

**Stockbrokers Association of Australia**  
21 May 2012

3 April 2012

Mr Greg Medcraft  
Chairman  
Australian Securities & Investments Commission  
100 Market Street  
Sydney NSW 2000

Dear Mr Medcraft,

## Shadow Brokers & Use of Term '*Indirect Market Participant*'

We would like to raise concerns about the use of the term '*Indirect Market Participant*' by ASIC. This term is being used to refer to firms which, while they may be licensed to advise and deal in securities, are not Market Participants.

ASIC Officials often use the term Indirect Market Participant in public and industry forums. ASIC has also used it in formal documents. For example, in Consultation Paper 168: *Australian equity market structure: Further proposals* dated October 2011, ASIC have a section on indirect market participants:

### **Indirect market participants**

232 Where an order originates from the client of an AFS licensee who, in turn, provides trading instructions to a market participant, we propose that the market participant identify the AFS licence number of the intermediary on orders and trade reports. We recognise that this form of identification will be easier where transactions are not entered manually by the market participant but are entered into the market participant's order management system by the indirect market participant or by the client.

233 Over recent years, the number of indirect market participants has grown significantly and information relating to this segment's contribution to the market is limited. Identification of indirect market participants on transactions will allow ASIC to accurately map this important market segment and provide efficiencies for our trading inquiries. All active indirect market

participants will be identified, and trading information will be used to assist us to oversee these organisations.

At best, these parties are merely clients of Market Participants, on whom they rely for execution and advice. The use of the term indirect market participant gives the impression that they offer the same services as Market Participants. Accordingly, in this letter, we will refer to them as **Shadow Brokers**.

The use of the term Indirect Market Participant is giving these parties status and credibility that is not deserved and is potentially damaging, since it has the potential to mislead the investing public.

## Market Participants and Use of the term 'Stockbroker'

As you would be aware '**Stockbroker**' is a restricted term under the Corporations Act. Under section 923B, it is an offence to use unless authorised the expression -

'...**stockbroker** or **sharebroker**, or any other word or expression (whether or not in English) that is of like import to that expression'.

A person must be authorised by its licence or another licensee by ASIC to use the term 'Stockbroker'. Moreover, ASIC must only authorise Market Participants to use the term. Therefore, only Market Participants of licensed exchanges may call themselves Stockbrokers. For the vast majority of Stockbrokers in Australia, this means that you must be a Market Participant of ASX before you can be recognized as a Stockbroker.

Being a Market Participant carries additional obligations that do not apply to normal AFS Licensees. There are important consequences in dealing with a Stockbroker in term of investor protection. As Stockbrokers, our members are subject to higher levels of regulation under the **Market Integrity Rules** (MIRs) than other licensees who may advise and deal in securities. The MIRs contain most of the rules on trading on a licensed market that used to be contained in the *ASX Market Rules*, and including –

- management and supervision requirements (including Responsible Executive Requirements),
- prohibition of Unprofessional Conduct,

- liquid capital requirements,
- adviser accreditation,
- client relationships (including rules against excessive transactions),
- record keeping and
- trading.

The Management and Supervision requirements on Stockbrokers are far in excess of other AFS licensees.

## Management and Supervision Requirements of Market Participants

Market Participants must have appropriate supervisory policies and procedures to ensure compliance with the **ASIC Market Integrity Rules, ASX Operating Rules** and the **Corporations Act**<sup>1</sup>. Failure to do so can incur a penalty from ASIC of up to **\$1m**. This does not apply to non-market participants. As well as the management requirements set out in ASIC policy<sup>2</sup>, ASIC has stated<sup>3</sup> that it won't vary significantly from the previous ASX approach to regulating market participants. In particular, ASIC will '*take into consideration*' the following standards (which were prescribed by ASX for compliance):

- AS3806 2006 *Compliance*
- ASNZ 4360 2004 *Risk Management*
- AS ISO 10002 2006 *Customer Satisfaction*
- ASIC RG104&105
- SDIA/SIA *Best Practice Guidelines for Research Integrity*

Market Participants' management and supervision requirements are reinforced by the **Responsible Executive (RE)** regime. RE requirements only apply to Market Participants, not to other licensees like financial planners. The Regulatory Objectives of RE Regime are that they:

- complement the firm's obligation to be responsible for acts and omissions of employees
- ensure 'identifiable people' are responsible for supervision
- ensure those responsible for supervision and control are 'competent' and of 'good fame and character', and

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<sup>1</sup> ASIC Market Integrity Rule ('MI Rule') 2.1.3; ASX Clear Operating Rule 3.5.1 (for Clearing Participants)

<sup>2</sup> ASIC Regulatory Guides 104&105

<sup>3</sup> ASIC Regulatory Guide 214.76

- reinforce personal responsibility for the firm's operations and compliance with rules by making them accountable and bound by the rules<sup>4</sup>.

Responsible Executives must pass a compulsory examination<sup>5</sup>, comply with continuing education requirements and sign an annual declaration to their firm<sup>6</sup> that they have -

- maintained their currency of knowledge of the Market Integrity and ASX Rules, and the Corporations Act
- reviewed supervision & control procedures
- controls over their allocated areas that are functioning and achieving compliance, and
- documentation which proves the above.

The firm must in turn make an annual declaration to ASIC that its RE's have complied with their obligations<sup>7</sup>.

RE's are a key part of the management structure that Market Participants must have to ensure that it has operations and processes to ensure compliance with the Market Integrity Rules, ASX Operating Rules and the Corporations Act. Breach of this Market Integrity rule carries a maximum penalty for the firm of \$1m.<sup>8</sup> Management failures are also likely to attract a charge of '**unprofessional conduct**'<sup>9</sup> which under ASIC Market Integrity Rules (and the former ASX rules), is a **very serious matter**, and which also carries a \$1m maximum penalty.

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<sup>4</sup> ASX Market Rule Guidance Note 27, adopted by ASIC in RG214

<sup>5</sup> ASIC MI Rule 2.3.1(2)(c)

<sup>6</sup> ASIC MI Rule 2.3.3; ASXC Rule 4.22.1(l)

<sup>7</sup> ASIC MI Rule 2.3.5

<sup>8</sup> ASIC MI Rule 2.1.1; ASXC Rule 4.8.1

<sup>9</sup> ASIC MI Rule 2.1.5; Defined in MI Rule 1.4.3, '**Unprofessional Conduct**' includes:

(a) conduct which amounts to impropriety affecting professional character and which is indicative of a failure either to understand or to practise the precepts of honesty or fair dealing in relation to other Market Participants, clients or the public;

(b) unsatisfactory professional conduct, where the conduct involves a substantial or consistent failure to reach reasonable standards of competence and diligence; and

(c) conduct which is, or could reasonably be considered as likely to be, prejudicial to the interests of the Market Operator or Market Participants,

by a Market Participant, or an Employee, whether in the conduct of the Market Participant's business as a Market Participant or in the conduct of any other business, and need not involve a contravention of these Rules or any law.

A record of the firm's management structure must be lodged with ASIC, and the structure is subject to review and scrutiny by the regulator<sup>10</sup>. Any significant changes must be notified to ASIC.

Failures in management and supervision attract substantial fines. There are only two published decisions of the ASIC Markets Disciplinary Panel, neither of which included a penalty for management failures. However, there are a number of decisions of the ASX Disciplinary Tribunal which include high penalties in respect of management failures.

For example,

- the highest ever total penalty imposed by ASX was a fine of \$1.35m on *Tricom Securities* in 2009<sup>11</sup>. As well as covering breaches of the settlement, capital liquidity, and market manipulation rules, the total included a fine of \$250,000 (the maximum at the time) for failure to have appropriate management structures to ensure compliance,
- in 2010, *Findlays* was fined a total of \$280,000<sup>12</sup>, including a fine of \$150,000 for unprofessional conduct in failing to have management structures in place to ensure compliance with the rules, and
- in 2009, *StateOne stockbroking* was fined a total of \$235,000<sup>13</sup>, including \$100,000 for unprofessional conduct in failing to have management structures to ensure compliance.

These obligations are far in excess of the requirements for other AFS licensees. Moreover, contraventions of the MIRs can carry a maximum fine of up to \$1m.

## Regulation by ASIC (and ASX) of Market Participants

As well as the stricter rules which apply to Market Participants and not to other licensees set out above, Market Participants are more closely regulated by ASIC and ASX than other licensees. On the hand-over of market supervision to ASIC in 2010, ASIC created a new Market Supervision Division, exclusively for the regulation of Market Participants and Market Operators. It is fair to say that

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<sup>10</sup> ASIC MI Rule 2.1.2

<sup>11</sup> ASX Circular to Participants 230/09 *Disciplinary Matters*

<sup>12</sup> ASX Circular to Participants 111/10 *Disciplinary Matters*

<sup>13</sup> ASX Circular to Participants 172/09 *Disciplinary Matters*



Market Participants receive far more attention from ASIC Market Supervision than other AFS licensees receive.

Market Participants also pay **Market Supervision fees** - \$22m in the current period of 18 months to 1 July 2013. On average, this is about \$300,000 per Participant, but some high trading firms are paying much more than this, in the millions of dollars. Other licensees that are not Market Participants pay **nothing** to ASIC in respect to supervision.

## Shadow Brokers

Many Shadow Brokers were formerly Market Participants, or in the case of individuals, employed by a Stockbroker. The 'culture' therefore might in some cases be similar. However, this should not give the regulators any comfort in dealing with this sector. We understand that most Shadow Brokers who were Participants chose to give up their participant status in **order** to avoid the additional regulation which only applies to Market Participants as described earlier. Key drivers for this move are usually **cost and liability concerns**.

Shadow brokers are just **clients** of Market Participants, upon whom they rely to trade. However, it is a concern that shadow brokers often market themselves as offering the **same services** as stockbrokers, and in some cases, actually **as** stockbrokers. We regularly advise ASIC of firms who appear to be marketing themselves as stockbrokers or Market Participants without proper authorization.

The collapse of *Sonray Capital* was an example of the confusion that can be created when these terms are loosely used. Reports described this firm as a 'stockbroker' when it was not a Market Participant. Accordingly, the public thought that this collapse was due to a 'failed stockbroker', not just a fringe player<sup>14</sup>.

These examples show that the misconduct of "indirect market participants" unfairly reflects badly on Market Participants.

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<sup>14</sup> For example, *Sonray to face \$9m claim* Australian Financial Review 9 August 11 p.6 described Sonray as a 'failed stockbroker'

## Conclusion

Stockbrokers, being Market Participants, ought rightly to be accorded the status which comes from being highly regulated and capitalized, a status which is reflected in the legislation. There is a clear distinction with other sectors (like the so called '**shadow brokers**') who – while they may be licensed or authorised to advise and/or deal in securities - are not Market Participants, and are not subject to the Market Integrity Rules.

The use of the term Indirect Market Participants is potentially misleading in that the investing public may think that they are dealing with someone who is just like a Stockbroker. It is according shadow brokers status and credibility that they do not deserve. Accordingly, in order that the public not be misled, the use of the term Indirect Market Participant ought to cease. We ask ASIC to ensure at the very least that its own staff does not use the term.

We are grateful for your time in considering this matter and look forward to further discussions.

Yours sincerely



**David W Horsfield**  
**Managing Director/CEO**  
**Stockbrokers Association of Australia**

CC Mr Elmer Funke Kupper  
Managing Director/CEO  
Australian Securities Exchange

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# Sonray to face \$9m claim

Patrick Durkin

Prominent property developers the Deague family have flagged a \$9 million legal claim against failed stockbroker Sonray Capital Markets which threatens to derail a global settlement for other investors.

The move follows a \$6.9 million claim by another of Sonray's largest investors, former Patrick Stevedores chief Chris Corrigan, who is suing the Copenhagen-based Saxo Bank, which financed the broker. *The Australian Financial Review* also understands authorities are close to charging Sonray founder Russell Johnson.

Last month former chief executive Scott Murray pleaded guilty to 10 criminal charges and prosecutors called for a sentence of up to 6½ years, with a non-parole period of 4½ years. He is awaiting sentence.

The court development came as the Sonray liquidator was close to completing a global settlement with Saxo Bank and auditors HLB Mann Judd, which would have meant some investors might have received their original investment in full.

The liquidator already holds \$9 million in client funds and a global deal means investors could be paid a substantial portion of the \$47 million they lost when the company collapsed in June last year.

But the deal has been complicated by the legal claim in excess of \$9 million by Will Deague, who was introduced to Sonray — which traded on risky contracts for difference — through his friendship with Scott Murray, a school friend from Melbourne Grammar school.

Last week lawyers for the Deagues told the Federal Court in Victoria they were preparing to bring the \$9 million-plus claim after the family's Asian Pacific Building Corporation received thousands of alleged bogus financial statements from Sonray over a six-year period.

"On the faith of the veracity of the information [the family] continued to trade, and it had faith in the value of its investment and it refused to take the money out and place it elsewhere," counsel for the Deagues, Joshua Wil-

## KEY POINTS

- The failed stockbroking firm's financier already has a \$6.9 million case against it and the broker's former CEO is awaiting sentence.
- The latest \$9 million claim could deprive some other investors of a full settlement.

son, SC, told the court. "So on any number of legal bases — not the least of which are misleading, deceptive conduct, claims, and such like — [the family] says that it's entitled to stake a claim against the company in liquidation," Dr Wilson said.

The Deagues' account evaporated in May 2009 after \$1.99 million was deposited with Sonray. While the money was provided for trading, Sonray used it to form part of a \$5.2 million "equity injection" that was passed off to auditors as coming from "a network of family and friends".

Sonray client Roland Ward is arguing in court that those investors who did not invest through Saxo Bank should be entitled to 100¢ in the dollar, leaving other investors with less.

The corporate regulator is undertaking an unprecedented examination of 650 indirect brokers, amid concerns that the sector is plagued by poor governance and inadequate risk management.



Sonray founder Russell Johnson.

AFR Letters 12/8/11

■ Once again we see the incorrect description of a non-market participant as a “stockbroker” (“Sonray to face \$9m legal claim”, August 9). Under the Corporations Act, only market participants licensed by ASIC can use the term. Clients dealing with a stockbroker have the added protections of the Market Integrity Rules (enforced by ASIC and carrying million-dollar penalties), higher capital requirements and the National Guarantee Fund as back-up if a default should occur.

**David W Horsfield**  
CEO Stockbrokers Association of  
Australia Sydney NSW