



**ASIC**

Australian Securities & Investments Commission

# Market supervision moves to ASIC – what does it mean for brokers?

*A speech by Belinda Gibson, Deputy Chair, Australian  
Securities and Investments Commission*

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Good morning and thank you for the invitation to address your annual conference today.

## Outline

- 1 The background to Greg and my presentations today is that ASIC will assume responsibility from ASX for the supervision of trading on Australia's licensed equity, derivatives and futures markets at some point in Q3 this year – likely August.
- 2 Soon after that ASIC will commence a dialogue with the market about the rules that would apply if the government were to license a third party to compete with ASX. Minister Bowen announced at the end of March this year that the government is supportive of competition for market services and has approved in principle Chi-X as a suitable licensee.
- 3 Our objective today is to look at the proposals from your eyes – to outline what we believe brokers will need to know and do to adapt to the change in supervision responsibility.
- 4 I will outline our progress towards effecting the changeover and explain the principles behind the new regulatory regime for supervision; in other words, what the major differences will be from a structural point of view. I will then discuss the process we propose to adopt in moving towards a framework that would support competition.
- 5 Greg will then talk about the practical implications of the change in market supervision responsibilities. He heads our Market and Participant Supervision Division and is best placed to talk about how we will interact with brokers on a day-to-day basis.
- 6 We plan to talk for about 30 minutes, then take questions.

## A Market supervision

- 7 As I said earlier, ASIC will assume responsibility for market supervision at some point in Q3 this year. The Minister will determine the date when he is satisfied as to readiness.
- 8 We are well advanced in the transition planning process. Our objective has been to manage a seamless transition of supervision responsibilities, so as to minimise disruptions to brokers' daily operations.
- 9 The market rules on Day 1 will be substantially the same as the ASX applies today, and we will adopt the same formal approach as ASX does in its Guidelines to interpretation of them and, to the extent possible, enforcement. We will work with the market over time to refine and develop the rules, particularly as we move towards market competition.

### Readiness

- 10 I might pause here to outline our state of readiness for the transfer:
- ASIC issued draft market integrity rules for consideration in February, marked up against the applicable ASX rules. Substantive changes were minimised. We are close to finalising the rules, and I can say there are few changes from those issued in February. We expect to announce the final rules later in June. At that time, we will issue a regulatory guide about interpretation, which essentially will adopt the approach the ASX has taken.
  - ASIC has recently issued a consultation paper on the approach we propose for enforcement of market integrity rules, through our Markets Disciplinary Panel.
  - ASIC has purchased a SMARTS real time surveillance system, like that of the ASX, and installation will be complete by the end of June.
  - ASIC has agreed for some 26 of the supervision and surveillance staff at ASX to come to ASIC on Day 1. They will add critical continuity and experience to our team. We have had a team of 30 people dedicated to broker supervision for the past 12 months, some 10 of them with senior experience at ASX or the major foreign exchanges. We also have 10 people conducting surveillance in Marketwatch led by Tom Veidners. In other words, this will not be a standing start for us. We will have a strong capability and significant market expertise from Day 1.
  - Finally, we have spent a lot of time during the last six months with ASX, ensuring we understand their approaches to market and broker supervision in order to develop our own detailed plans. These are now being rolled out to the team, which will comprise some 60 people, plus separate deterrence teams.

## What must you know?

- 11 I want to now turn to a very high-level review of what will change on transition. What are the fundamentals you need to understand about the regulatory framework?
- 12 First, the ASX Operating Rules have been split. ASIC will be responsible for Market Integrity Rules (called MIRs). They will cover the key rules that are relevant to market integrity, as distinct from market operational efficiency.
- 13 How do you know whether particular actions are governed by our rules or ASX? There are principally three classes of market integrity rules:
1. Market misconduct – these are fairly self-evident. Market manipulation is still prohibited, as is trading with the intention of giving a false or misleading appearance. Wash trades fall in this category. Front running is a broker specific type of insider trading that is (still) illegal.
  2. Brokers' relationships and dealings with clients will be regulated by the MIRs. These rules are consistent with ASIC's priority of protecting retail investors.
  3. The third category is the rules for participants' internal management arrangements. Greg will expand on this category more later.
- 14 The ASX will maintain responsibility for the remaining operating rules. ASX has been consulting on these rules since April and we expect they will be finalised in June also. For completeness, I should say that ASX also retains the listing function and responsibility for clearing and settlement.
- 15 The major difference you will notice with the change in responsibility is the consequences of breaches. That follows with the change of legal regime, from broker contract with the ASX to law.
- 16 Breach of the market integrity rules now attracts a civil penalty under the Corporations Act. Civil penalty breaches are ordinarily heard by the courts, on application by ASIC. The penalty varies with the offence. The most serious offences will attract a fine of \$1,000,000. That is in line with maximum ASX penalties.
- 17 However ASIC can elect to have the case for breach of a MIR determined by its Markets Disciplinary Panel. This is a panel of experts from the financial markets. It will be established by ASIC, to act as its delegate, specifically to consider alleged breaches of the MIR. The panel will issue "infringement notices" as an alternative to civil penalties. The maximum financial penalty is \$600,000 for the most serious breaches (e.g. market manipulation) being 6/10ths of the comparable maximum civil penalty. Consistent with the ASX's current approach, ASIC has also set two other tiers for less serious matters – with the maximum civil penalty for each of these being up to \$20,000 and \$100,000 respectively (or \$12,000 and \$60,000 under an infringement notice). The infringement notice can also direct remedial action, such as compensation, and attendance at training courses.
- 18 The conduct of hearings before the Panel will be very similar to that for hearings by ASIC's delegates in licensing matters. This is set out in some detail in consultation paper we issued on 26 May on the deterrence

proposition. That is available on our website and we welcome your comments.

- 19 As I said, recipients have the right to a hearing. It will be held in private. They can elect whether or not to accept an infringement notice. If they elect not to comply, we must take the breach to court and reargue the whole case, but the higher penalty exposure will apply. We will make an announcement when the Panel issues an infringement notice, and indicate if the recipient chooses to comply or not. We recognise that it will be important for us to establish a Panel, which has credibility in the market, so its infringement notice decisions will be readily accepted.
- 20 We expect to announce the initial Panel members at the end of this month and I believe you will see again our wish to ensure consistency with the existing ASX regime.
- 21 For completeness, ASIC is specifically given power to settle claims for breach of an MIR through an enforceable undertaking. The undertaking can cover penalty payments, compensation payments, training and all the things an infringement notice can cover. At the outset, the Markets Disciplinary Panel must approve any enforceable undertaking, to ensure consistency of outcomes and market credibility. I would expect however some greater leniency by the Panel in recognition of the acceptance of breach and the waiver of the need for a hearing.

## **B Competition for market services**

- 22 So far, I have been describing for you our preparedness for Day 1 – the transfer of responsibility for market supervision. Once that is “settled in”, we will move to start discussions about the basis for the introduction of competition for trading in ASX listed shares.
- 23 We have planned a process for consultation with the market, and particularly the broker community, about how competition will be introduced. Consultation needs to occur recognising the experience of other markets where competition between trading venues is commonplace. Competition has resulted in significant innovation, greater and deeper liquidity and tighter bid/ask spreads. We might well expect the introduction of competition to improve the efficiency of our capital markets too.
- 24 However, introduction is not without its challenges. The global financial crisis has provoked a critical reanalysis of market structures in the USA, Canada and Europe. In January this year, the USA Securities and Exchange Commission issued a very thoughtful Issues Concept Release (available at <http://www.sec.gov/news/press/2010/2010-8.htm>). It discusses the balance between the interests of long-term investors and the entities who depend on markets for capital and the interests of the professional investors who now dominate the overseas markets in terms of volume.
- 25 The “flash crash” of 6 May in the USA is another call for close analysis. US regulators are still working through what happened there. The market was in decline during the day, probably in response to concerns over the Greek debt

levels. At 2.40 pm, the market suddenly fell to 9% for the day and some stocks fell to \$0.01. The market closed down 3.2%, having substantially recovered the plunge within 20 minutes. The complex multi-market structure in the USA certainly challenged the regulators' ability to see what is happening in the markets.

26 We have a unique ability to position our markets from Day 1 of competition, drawing on this type of experience in the overseas markets.

27 ASX and ASIC have been reviewing the impact and regulation of algorithmic trading in particular, on our markets in the past 12 months, and we are participating in an IOSCO study of practices. We have now commenced a detailed study into what we can learn from the 6 May event. That will inform our consultation on the competition rules.

## C Our criteria assessment

28 I want to next outline ASIC's key criteria for analysing the market structure and the effects of specific rules for competition in secondary trading services. There are a number of criteria to balance and they are consistent with ASIC's overall priorities:

- To promote market integrity and a fair, orderly and transparent market – these of course are critical attributes for a competitive market.
- To ensure an overall increase in market efficiency, but balanced against the detriment to integrity.
- To reduce systemic risk. It will never be possible to eliminate systemic risk altogether. This is not the nature of our regulatory system, but our regulations should seek to reduce risk.
- To promote investor protection, so retail investors can be confident and informed and willing to participate in the markets.

## D The road to competition

29 That leads me, in closing, to outline the necessary steps to progress to competition. As I have said, consultation with all the market, and particularly your own broking industry, is critical.

30 At this point, I wish to thank in public our Market Supervision Advisory Panel. We formed the Panel late last year to assist us to assemble our rules and disciplinary processes. They have been of great assistance. We are expanding that Panel to address competition. I know a number of Panel members are here today, and so would like to mention them all by name: Brad Usasz, David Dixon, Grahame Pratt, Lisa Gay, Ross Freeman, Stewart Adams. More recently, April Mountfort and Scott Webster have joined the

Panel. I also wish to thank your executive for their ready support and engagement on these issues.

- 31 First, we will need new market integrity rules to cover the interplay of multiple markets. What is the “best execution” rule – in other words what is the obligation of a broker to find the best trading outcome for their client across all markets? To do this, the market needs price information. What are the obligations to disclose orders and trades to the market? What should be our approach to so-called “dark pools”? Fragmentation of trading can affect price discovery and our rules need to be conscious of that.
- 32 We estimate there are a number of issues that need to be resolved in the lead up to competition. We propose to start that consultation once the supervision transfer has occurred, probably in late August or September. The issues are complex and there will be a full two-month consultation.
- 33 Once we publish our rules, then the ASX will need to revisit its rules. New licence applicants, namely Chi-X at this point, will need to finalise its rules and complete its licence application. It will need to finalise its clearing and settlement arrangements. At that point, we will be able to make recommendations to the Minister regarding the grant of the licence.
- 34 In doing so, we will have to consider market readiness. Brokers will have a lot of work to do to get ready. There will be three key elements. First, and perhaps most costly, are the IT systems that enable brokers to see and trade across all markets.
- 35 The competing markets will also need to have some protocols for handling events and to test their systems for interconnectedness. This will be critical to minimise systemic risk. Of course ASIC too will need to manage its surveillance systems to look at the multiple market scenarios.
- 36 Secondly, brokers will need to develop new processes for dealing with clients. Their disclosures about their trading practices and how they will fulfil obligations such as best execution will be important. Finally, brokers will need to train their staff to deal with these changes. These developments will be critical to protect investors.

## **E Conclusion**

- 37 In short, and in summation, we are ready to assume responsibility for supervision of the market. Our aim on Day 1 is to stand in ASX shoes to the extent practicable. There is a lot of work to be done to make introduction of competition occur, and benefit the market. We at ASIC look forward to working with you at the Stockbrokers’ Association of Australia to achieve that.