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ASIC's Market Integrity Group's strategic priorities 2018–19

- ASIC's strategic priorities are detailed in ASIC's Corporate Plan 2018–19 to 2021–22.
- This letter outlines the priorities of the Market Integrity Group (MIG) for 2018–19 that relate to market intermediaries.
- Plan for the year ahead by assessing your firm's risk management framework against these priorities.

Market intermediaries include investment banks, market participants, securities dealers, corporate advisers and providers of retail over-the-counter (OTC) derivatives.

Our priorities and activities for market intermediaries address the changing market dynamics and emerging risks that, if not properly addressed, could undermine our vision for a fair, strong and efficient financial system for all Australians.

Our key strategic priorities for 2018–19 are:

1. **Conduct**
2. **Technology risk and resilience**
3. **Effective capital markets**

While our priorities are like last year's, we've made considerable progress and changed the range of activities for each priority.

Strategic priority 1: Conduct

- We're regulating poor conduct as it harms our financial system and results in adverse consumer outcomes.
- Culture and conduct directly affect a firm's ability to put the client first. Good culture and conduct should be embedded in your organisation.

We're changing our approach to overseeing the highest risk firms in our market, with a greater focus on governance, and the systems and controls that prevent poor conduct.

We expect all firms to have a professional and robust approach to conduct – to operate with integrity and to act in the best interest of their clients.

This includes:

- proactively identifying conduct risks
- encouraging accountability for conduct across all areas of the firm
- supporting staff to improve conduct
- board and executive oversight of conduct and a focus on the conduct implications of the decisions that they make.

We'll periodically test these themes and we expect firms to demonstrate how they've addressed them.

Wholesale OTC markets

We're intensifying our strategic focus on the wholesale OTC sector – primarily fixed income, currencies (FX) and commodities (altogether known as 'FICC') and equity derivatives. This includes:

- **Testing practices** – continue testing firms' FX practices, systems and control functions against the expectations in Report 525 *Promoting better behaviour: Spot FX* and the FX Global Code. We'll also test how firms are implementing these standards across other FICC business areas. This includes:
    - the management of confidential client information and conflicts, for example the disclosure of confidential client information, order management and trading practices
    - the practice of 'last look', where a liquidity provider isn't bound by its quotes to investors
    - mark ups and margins in FX trading.
- **Bank bill swap rate (BBSW)** – closely monitoring contributions to the BBSW rate set and the administrator's calculation of the rate set based on the new methodology that was introduced in May 2018.
- **Trade reporting** – working with trade repositories and firms to improve the quality of OTC derivative transactions reporting. We've identified ongoing issues with the accuracy and completeness of reported transactions. This will be a key area of focus for us as inaccuracies in the data affect transparency and market integrity.

Retail investor protection

Retail investor protection is always an area of focus for us. We'll continue to undertake a range of work, including:

- **Retail OTC derivatives** – in June 2018, we published Report 579 *Improving practices in the retail OTC derivatives sector* (REP 579). The aim of the report was to raise awareness of our concerns about the high proportion of investor losses, misleading marketing materials and inadequate controls in this sector, and to highlight the need for improved industry standards and compliance. Our focus on this sector will continue this year, including through targeted surveillance activities to test suspected misconduct and to address the issues identified in REP 579.
- **Cryptocurrencies** – there's been rapid growth in the range of cryptocurrency and other initial coin offerings (ICOs) globally. Poor sale and distribution practices of ICOs

may adversely affect investors and the integrity of our markets. Misleading and deceptive conduct in this area is a key focus for us now and in the future. Information Sheet 225 *Initial coin offerings and cryptocurrency* outlines how we apply the law to ICOs. This includes the powers to act under the Australian consumer law which have been delegated by the Australian Competition and Consumer Commission for this purpose. These powers enable ASIC to address misleading or deceptive conduct in marketing or selling of ICOs irrespective of whether the ICO involves a financial product.

- **Fraud prevention** – several intermediaries have recently unintentionally facilitated fraudulent share sales. We've issued guidance about the necessary precautions to properly manage this risk and we intend to sample industry risk practices this year. We expect to see robust procedures for verifying clients (particularly where there's no pre-existing relationship), and vigilant identification and escalation of any risks.
- **Quality of advice** – financial advisers are expected to act in the best interests of their clients. We're conducting a thematic surveillance to identify and respond to poor financial advice by intermediaries – for example, advice to investors which is inappropriate considering their financial circumstances, objectives and risk profile. We'll act against poor conduct, including where it results from missing or inadequate risk frameworks and supervisory controls.
- **Client money** – we'll monitor compliance of retail OTC derivative providers with the new client money reforms. ASIC has released guidance on these reforms and related obligations in Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* and Information Sheet 226 *Complying with the ASIC Client Money Reporting Rules 2017*.

Strategic priority 2: Technology risk and resilience

- We're overseeing the development of robust market infrastructure and market intermediaries.
- Our focus is to support the opportunities and economic benefits of innovation in financial markets, while managing the risks.

Technology governance and operational risk management

Market intermediaries rely heavily on technology to deliver their services. Robust technology governance and operational risk management is central to their effectiveness.

This is particularly important in an increasingly automated environment, and with growth in artificial intelligence and machine learning. It's important that these tools are carefully scoped, implemented and monitored. We expect compliance personnel to have sufficient understanding of the technologies used in their firms, so they can meaningfully challenge practices and activities, and test the adequacy of controls. This will be a theme in our reviews and engagement with you.

Cyber security

Cyber security continues to be a key priority for us. Increased reliance on data, digital connectivity, outsourcing of key services to third parties and sophistication of cyber criminals creates an increased risk of a cyber-attack. Information technology disruption or incidents at intermediaries may have broader systemic implications. Intermediaries need to be vigilant in protecting their systems against unauthorised intrusions and disruptions, and in protecting investor data.

Report 555 *Cyber resilience of firms in Australia's financial markets* identifies key trends from self-assessment surveys completed by firms and highlights good practices and areas for improvement. We'll re-issue these surveys this year to monitor progress. This will also be a key area of focus during our surveillances.

Additionally, we'll continue to focus on technology-enabled offending this year, with a focus on proactive surveillance to identify computer hacking, related market activity and potential interference.

Strategic priority 3: Effective capital markets

- We're promoting effective and innovative markets in the interest of investors.
- Our vision is to protect the integrity and success of the Australian financial system.

Governance and controls

Effective governance focuses on the quality, independence and reliability of the internal processes to manage a firm and the firm's risk and compliance with the law. It includes the responsibilities and functioning of the board, and the adequacy of the internal structures, operational controls, and procedures to manage risk and compliance throughout the firm.

We expect firms to continually assess whether controls are appropriate and effective. As part of our reviews we may test whether firms are adequately fostering a risk and compliance management culture. This would include established and robust risk management and compliance systems, and an active and empowered second and third line of defence (where operations warrant this model). We may look at internal reporting, monitoring and management information systems that are used to identify, escalate and remediate misconduct, and minimise other risks.

We may also look at broader corporate governance arrangements, including the role and responsibilities of the board, board committees and executives, and engage with them directly.

Capital raising

Last year, we published Regulatory Guide 264 *Sell-side research.* We'll review how firms have implemented this guidance during the year.

We're conducting a review of allocation practices in capital raising transactions, including conflicted business models. Allocations in keenly sought-after transactions have value, which may incentivise intermediaries to allocate securities to parties that can further their business or personal interests.

We're engaging with a range of stakeholders and reviewing a selection of capital market transactions to understand how allocations are being conducted and the disclosure that is provided to investors. Our work on allocations is ongoing, and we're considering whether a regulatory response is warranted. We'll publish our findings during the year.

Market structure

We've monitored developments with high-frequency trading (HFT) and dark liquidity closely over several years. We've repeated our analytics to test the impact of HFT on the quality and integrity of equities markets. We've expanded the analysis to also examine the prevalence of HFT in FX markets. We'll publish our findings in the coming months.

The leaders of the Group of Twenty (G20) pledged to strengthen the international financial regulatory system following the global financial crisis and called for reforms to improve practices in OTC derivatives markets. These reforms included the:

- mandatory reporting of OTC derivative transactions to trade repositories (see also the 'Wholesale OTC markets' section on page 2)
- mandatory central clearing for standardised OTC derivatives.

Australia implemented the first two reforms in 2013 and 2015 respectively. We've been monitoring developments abroad on mandated platform trading and are assessing their merits and options for the Australian market. We're working closely with other Government agencies and will engage with the industry before making any recommendations.

Market integrity

Maintaining the integrity of our markets is critical for promoting investor confidence and trust. ASIC's market integrity rules are an important part of our regulatory framework for maintaining market integrity. Since taking over primary market responsibility for supervision in 2011, we've retained many of the obligations previously imposed by market operators. More recently, we've commenced the process of consolidating and reviewing these obligations.

- ASIC's consolidated securities markets and futures markets rule books substantially commenced in May 2018. Over the next 12 months, we'll consider and consult on a range of potential further revisions and reforms to the market integrity rules, including reforms proposed in submissions to our earlier public consultations.
- In July 2018, we released Consultation Paper 302 *Proposed changes to ASIC's capital requirements for market participants*. We're proposing to simplify and improve the rules, including consolidating the capital rules into a single rule book, introducing a capital charge for underwriting and sub-underwriting activity, mandating liquidity risk management practices and increasing the minimum amount of capital a market participant must hold. We propose to finalise and implement the rules in 2019.

We'll continue to monitor market participants' compliance with their suspicious activity reporting obligations particularly in the case of participants that have submitted few, if any, reports. These reports are an important source of information about potential market misconduct for ASIC.

We also intend to re-test the cleanliness of our listing markets. This work will build on our analysis and findings published in August 2016 in Report 487 *Review of Australian equity market cleanliness* (REP 487). REP 487 considered possible insider trading and information leakage ahead of material, price-sensitive announcements by analysing price movements or shifts in trading behaviour before these announcements. We'll publish the findings of our updated review during the year.

Approach to supervision

We're adapting the way we work to be more future-focused, including being more proactive in our approach to supervision and to balance our focus across exchange and OTC markets. This will result in practical changes to our interaction with firms.

- Firms that have the most significant market presence or pose the greatest risk to our priorities should expect a more intensive level of supervision across all areas of their business.
- We intend to have a greater on-site presence in some firms, which may involve meetings, reviewing books and records, and inspections or 'walk-throughs' of systems and processes.
- We'll continue to undertake thematic and sector reviews. They help to determine 'what good looks like', and to inform future surveillance work and the establishment of regulatory expectations.
- We've restructured the Market Conduct team to better align with this approach and our strategic priorities, including creating two separate compliance teams – Exchange Intermediaries team and OTC Intermediaries team.

We'll also continue to develop and strengthen our existing relationships with overseas regulators. The interconnection of markets and mobility of capital highlights the importance of this cooperation.

There have also been changes to the way we're funded and how our costs are recovered from industry. Please refer to the industry funding page on our website for further information.

Conclusion

We encourage you to use this letter as a reference tool for your compliance, supervisory and risk management programs, and to prepare for your interactions with us. We also recommend that you subscribe to our free monthly Market Integrity Update to stay informed of regulatory developments and issues affecting market intermediaries.

Yours sincerely,

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