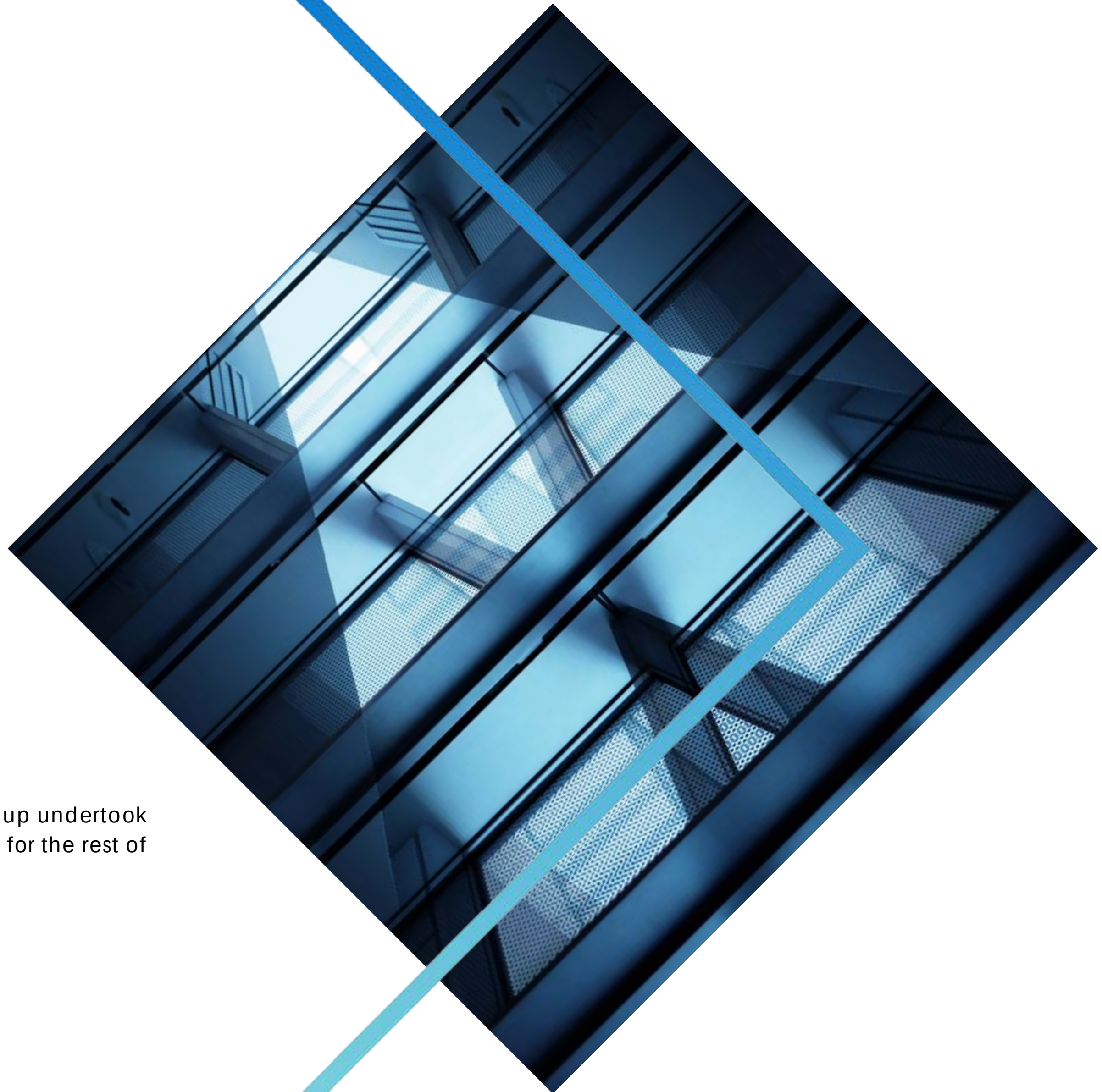
Market integrity report: July to December 2018

Report 619 | May 2019



About this report

This report highlights some of the activities the Market Integrity Group undertook between 1 July and 31 December 2018, and includes our priorities for the rest of the financial year.

Market Integrity Group—six months at a glance

Overview

ASIC's vision is for a fair, strong and efficient financial system for all Australians.

We are driving the integrity, confidence and innovation of Australian markets so firms can thrive and investors can participate with confidence.

We will identify the most significant harms to consumers, investors and markets. Where we identify misconduct, we will take regulatory action.

Criminal actions

- **2** people charged in criminal proceedings
- **4** criminal charges laid against 2 people
- **1** person found guilty of 2 charges

Civil outcomes

- **$3.65** million in civil penalties
- **3** court enforceable undertakings
- **$15.5 million** in community benefit payments

Bannings and infringement notices

- **2** infringement notices issued
- **$153,000** in infringement notices paid
- **3** people banned from providing financial services
- **2** Australian financial services licences cancelled

Standards and education

We look closely at the effect of different behaviours on our markets. Our observations inform the standards we set and how we educate our stakeholders.

High-frequency trading

Our latest review of high-frequency trading revealed it has reduced over the past three years but still retains a substantial footprint across our markets.

Report 597 *High-frequency trading in Australian equities and the Australian–US dollar cross rate* was the result of our 2018 review (REP 597), which assessed the impact of high-frequency trading on our equity and foreign exchange markets. REP 597 built on our 2015 analysis of equity and futures markets.

The overall level of high-frequency trading in Australia's equity markets has fallen from a high of 33% in late 2015, to a low of 25% in March 2018. Pockets of growth exist but are confined to the lower volume small-cap market where high-frequency trading continues to expand over a much lower base.

The report also found substantial high-frequency trading activity in the Australian-US dollar cross rate. High-frequency trading of the Australian dollar peaked at 35% in early 2013 but has since fallen and now accounts for around 25% of trade.

Allocation practices in equity raising transactions

We made a number of recommendations to improve how allocations are conducted in equity raising transactions, following our review of a range of large and mid-sized Australian-based licensees.

Report 605 *Allocations in equity raising transactions* details the findings from our review, highlights areas of concern and sets out better practices.

A range of discretionary factors are considered in an allocation recommendation, including the objectives of the transaction, investor types and the investor bidding into the bookbuild. The issuer's objectives should be the primary driver of allocation recommendations.

> “The fair and efficient allocation of securities in equity raising transactions promotes market integrity, improves market efficiency and increases investor confidence.”
>
> **Cathie Armour** | ASIC Commissioner

Changes to reporting for several derivatives products

We're implementing our proposed changes to the way transactions in contracts for difference (CFDs), margin FX and equity over-the-counter (OTC) derivatives must be reported. The changes will provide better reporting to help us monitor market misconduct.

The changes involved making an excluded derivative determination, requiring these types of transactions to be reported to derivative trade repositories using a 'life cycle' method, rather than an end-of-day 'snapshot' method.

Following consideration of feedback received on the proposal, an excluded derivative determination for CFDs, margin FX and equity OTC derivatives was made on 30 November 2018, effective from 1 July 2019.

Regulatory framework adjustments enable new products on Chi-X

We adjusted our regulatory framework to allow market participants to trade in transferable custody receipts (TraCRs) and exchange traded funds (ETFs).

TraCRs are investment products that trade on the Chi-X market and provide holders with a beneficial interest in shares that trade on overseas stock exchanges, such as NYSE and NASDAQ.

We also amended various class orders to extend existing relief that facilitates the quotation and trading of ETFs on the ASX market to also include the Chi-X market, including relief for product issuers, authorised participants and market makers.

Entity identifier requirement under OTC derivative transactions reporting rules

From 1 April 2019, financial entities that are required to report trades in OTC derivative transactions under the ASIC Derivative Transaction Rules (Reporting) 2013 must report a standard identifier for any company or other entity (excluding individuals) that is a counterparty to a transaction in an OTC derivative, including CFDs and margin FX.

The standard identifiers to meet this requirement are:

› Legal Entity Identifier (LEI)
› if no LEI or interim entity identifier is available for the entity, an international business entity identifier issued by Avox Limited (AVID)
› if no AVID is available, a Business Identifier Code (BIC).

A conditional short-term extension of relief has been granted.

Behavioural change

Achieving behavioural change is an important part of our work. By changing behaviour, we may be able to avoid future instances of risky conduct and breaches, and prevent investor losses before they occur.

Enhanced supervision

We have enhanced our approach to supervising the most significant market intermediaries so that we can:

› gain a deeper understanding of their business models, cultures and behavioural drivers, and

- engage directly—and at the most senior levels—to facilitate early detection of potential harms and foster constructive and timely behavioural change.

While we are continuing to conduct annual compliance liaison meetings with these market intermediaries, we have increased our engagement with them through:

- additional onsite visits
- requests to meet with a wider range of people within the businesses, and
- requests for demonstrations of systems and processes, and for books and records.

This enhanced supervision approach aligns with our broader shift to close and continuous monitoring of significant financial institutions and other initiatives.

ASX Group's risk standards

We published our review of the Australian Securities Exchange (ASX) Group's technology governance and operational risk management arrangements, which identified a number of recommendations.

Report 592 *Review of ASX Group's technology governance and operational risk management standards* acknowledges that ASX's arrangements have historically served the Australian market well and sets out identified areas for improvement and recommendations for ASX to address these.

The review found that ASX's practices were more comparable to those of other global exchanges but lagged behind better practices in the broader financial services sector. ASX is undertaking an extensive work program to implement all the recommendations and had started work on almost half of them before the review started or before the recommendations were finalised.

Wholesale FX onsite reviews

We commenced our onsite reviews into the management of conflicts of interest and confidential information in wholesale FX businesses in Australia. The onsite reviews are an opportunity to review the conduct and operational practices of several firms.

These reviews form part of a broader strategic program of work on wholesale FX markets, which includes:

- reviews of last look practices, margins and mark-ups, and high-frequency trading, and
- close monitoring of the implementation of commitments made in previous court enforceable undertakings by several firms.

Increasing our focus on FICC market operators

We made recommendations for Yieldbroker Pty Ltd (Yieldbroker) to improve its arrangements for conflicts and governance, supervision and enforcements, and systems and controls, in Report 601 *Market assessment report: Yieldbroker Pty Limited.*

The assessment was part of our increased strategic focus on the wholesale OTC sector and enhanced use of onsite surveillance and inspections.

We encourage other specialised market operators that we regulate to review the findings and recommendations to determine what's applicable to their market operation.

BBSW surveillance

We continued to develop our supervision and surveillance of the Bank Bill Swap Rate (BBSW) benchmark process, following the introduction of a new calculation method in May 2018.

This involves close monitoring to ensure the benchmark is calculated correctly, and in the process, interrogating specific quotes and discrepancies where transactions reported for the purpose of BBSW calculation appear anomalous.

We particularly examined transactions that appeared to unduly influence the formation of BBSW through discrepancies in pricing, were cancelled once the calculation period was completed or appeared collusive.

Disruption

> **Poor conduct harms our financial system and results in adverse consumer outcomes. Where we see poor conduct, we will take action.**

Civil penalty and court enforceable undertaking accepted from CBA

We accepted a court enforceable undertaking from Commonwealth Bank of Australia (CBA) in relation to their bank bill trading business and their participation in setting the BBSW.

We commenced legal proceedings in the Federal Court against CBA in January 2018, alleging that CBA traded in a manner that created an artificial price and a false appearance in relation to certain financial products that were priced or valued off BBSW.

CBA admitted to attempting to influence the BBSW set on five occasions in 2012, and also failing to do all things necessary to ensure they provided honest and fair financial services and adequately trained traders. CBA made a $5 million pecuniary penalty payment and a $15 million community benefit payment during the reporting period.

> “that sum … should be an adequate denouncement of and deterrence against the unacceptable trading behaviour of individuals within CBA that ought to have known better, and a bank that ought to have better supervised its personnel.”
>
> **Justice Beach** | Federal Court

FX margin practices

We commenced a project to verify bank stakeholders are adhering to the FX Global Code, by acting honestly and fairly in their dealings with FX clients regarding the margins or mark-ups they charge.

We used data from multiple sources to better understand the steps the banks have taken toward adhering to this principle. We looked at FX OTC data in conjunction with data collected from Bloomberg on the prevailing FX spot and forward rates to determine if there were any outsized margins charged.

We also sent notices to a number of banks to collect more detailed FX trading data, and also information on their internal policies which govern how mark-ups are determined.

Acting against misleading ICOs and crypto-asset funds

We reminded investors that initial coin offerings or token-generation events (together, ICOs), are highly speculative investments that could be a potential blockchain project or scam. While the potential returns may look attractive, these projects are mostly unregulated and the chance of losing your investment is high.

Before investing in an ICO, we advised investors to do a lot of research, particularly on forums or websites that explain the product in detail and present a balanced perspective.

We intervened to disrupt several ICOs, after identifying misleading or deceptive statements in whitepapers and marketing and promotional materials.

Retail OTC providers

We cancelled the AFSL of two retail OTC derivatives providers and disqualified their former directors from providing financial services for a period of time.

Our investigations found:

- one provider disregarded key conduct requirements and had unmanaged conflicts of interest, and
- one provider failed systemically to comply with reporting requirements, and failed to have adequate financial and human resources to provide efficient, honest and fair financial services.

We're also pursuing a just and equitable winding up of one of the providers through the courts.

What's next?

We will focus on the following existing and emerging risks during the remainder of the year.

1. **Conduct governance** – we are enhancing our supervision of the highest-risk firms, with a greater focus on governance, and the systems and controls that prevent poor conduct. Our focus includes fixed income, commodities and currencies, retail OTC derivative providers, ICOs and client money.
2. **Technology risk and resilience** – our focus is on poor technological controls, including for cyber security and the use of artificial intelligence. We support the opportunities and economic benefits of innovation in financial markets, while managing the risks.
3. **Effective capital markets** – we are reviewing high-frequency trading in FX markets, retesting the cleanliness of our markets and continuing to enhance our market integrity rules.

Read the Market Integrity Group's strategic priorities 2018–19 for more information about each of these priorities.

For regular updates on the markets work ASIC is doing, subscribe to our monthly Market Integrity Update.
