Reforms to the Supervision of Australia's Financial Markets Framework

ASX Submission to Treasury Consultation Paper

22 December 2009

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The Australian Securities Exchange (ASX) is a multi-asset class, diversified exchange group whose activities span the primary market and capital formation process, secondary market trading and price discovery, central counterparty risk transfer, and securities settlement for both the equities and fixed income (including over-the-counter) markets. ASX functions as a market operator, clearing house and payments system facilitator, with its activities organised through a listed holding company and five subsidiary companies which each hold a licence to operate specific financial markets or clearing and settlement facilities. Each licensed business has appointed another (unlicensed) subsidiary, ASX Markets Supervision Pty Limited, as their agent to undertake licence obligations involving monitoring of conduct by the organisations to whom services are provided and enforcement of operating rules by the licensed entities. These arrangements will change as a consequence of the Reforms to the Supervision of Australia's Financial Markets.

1. Executive Summary

- ASX welcomes the opportunity to apply its expertise in operating market facilities and supervising financial market participants to assist Treasury to establish the regulatory framework for the Australian Government's announced changes to the regulation of Australia's licensed financial markets, including providing ASIC with the regulatory tools it will need to undertake its new responsibilities.

- The Government's decision announced on 24 August 2009 to relieve exchanges of current responsibilities to supervise the conduct of brokers (and other market "participants" that arrange execution of trades on exchanges) has the potential to produce both costs and benefits for investors. Among the potential benefits, the Government's decision provides an opportunity to create clearer delineation between regulatory functions – which are the responsibility of the regulator (ASIC) – and the relevant function of an exchange, which is to provide facilities for the trading of financial products that enable brokers to perform their separate intermediation functions.

- It is important that the framework legislation does not squander the opportunity, created by the Government's decision to achieve greater role clarity and associated accountability for exchanges and regulators. There are a number of instances where those opportunities have not yet been fully reflected in the draft legislation and associated commentary.

- The proposal to introduce ASIC rules means ASIC can create common standards across trading venues to protect investors, regardless of where their securities are traded. However, as currently drafted, ASIC's new rule making power would not extend to regulating OTC trading of listed financial products or trading of these products in dark pools. We recommend the Government review this aspect of the draft legislation, given the trends towards off-market trading in overseas markets and the risks of allowing this activity to occur outside the proposed market integrity rules.

- The Government should close the loophole for operators of overseas trade facilities – these operators should be subject to the same ASIC rules as licensed domestic operators so that key investor protection provisions - such as client order priority rules or any best execution rules - apply to participants in all facilities (i.e. across the whole market).

- Provisions relating to investor compensation arrangements need to be revised to remove an anomaly whereby investors receive different levels of protection, dependent on which trade facility executes their order. There can be no justification for an investor being able to claim compensation based on different heads of claim depending on the trade facility to which an order is directed. Such an outcome would create confusion amongst investors about their level of protection and could result in outcomes which unfairly disadvantage some investors.

- It is important that there are adequate accountability mechanisms in place to ensure that the regulator is effectively carrying out its new responsibilities. Under the current regime, ASIC conducts an annual audit of ASX's market supervision activities. This mechanism will not translate to the new regulatory environment, where ASIC is taking over certain previously supervisory functions. Changes should be made to section 243 of the ASIC Act to explicitly extend the duties of the Parliamentary Joint Committee on Corporations and Financial Services to inquire into the extent to which ASIC has performed these functions.

- Treasury and ASIC should expect that trade facility operators will pass on to Participants any additional costs which flow from levies imposed, net of any cost savings which may be achieved. The Parliamentary Joint Committee on Corporations and Financial Services should be required to review the basis upon which ASIC has levied fees to cover the costs of its new market supervision functions.

- More appropriate terminology is needed to reflect the fact that in relation to a particular class of financial product – such as ASX-listed securities – no single provider of trade facilities could be expected to be responsible for the integrity of that entire "market" in an environment where securities may potentially be tradeable on more

than one trade facility. ASX proposes, therefore, that the term “market operator” no longer be used, referring instead to "trade facility operator". This will provide the appropriate context for better determining the scope of licence obligations to be imposed on trade facility operators (namely to operate their facility rather than the whole market) and for ensuring that the powers of ASIC are exercised in a way which is complementary to, and not inconsistent with, the obligations of trade facility operators.

- The licence obligations of trade facility operators need to be clarified to recognise the changed role of an operator in influencing market integrity outcomes following the transfer of supervisory responsibility to ASIC. Appropriate role clarity and accountability should be achieved by imposing an obligation on any licensed (and potentially exempt) trade facility operator to “act consistently with the objects of the legislation” (rather than, as at present, to seek to “ensure” that *some* of those objects are achieved).

- The regulatory objectives underpinning the new regime should be articulated in greater detail in the legislation. The component relating to “market integrity” or “fairness, orderliness and transparency” should be articulated by defining a market which satisfies this test as one with the following characteristics:

  — the prices at which financial products are transacted generally reflect genuine supply and demand;

  — the laws and rules dealing with the operation and regulation of the market appropriately balance the interests of different stakeholders and do not unfairly favour some participants or operators over others;

  — the information that is being reflected in the prices at which transactions occur is reliable; and

  — there is an appropriate level of transparency as to the prices and volumes of transactions, recognising that these will be different for different means of execution.

- The potential for:

  — inconsistency between ASIC rules and legislation should be addressed by ASIC in the formulation of its rules, with Ministerial approval being a control mechanism; and

  — inconsistency between trade facility operator rules and ASIC rules should be addressed by trade facility operators in the formulation of their rules, with ASIC and Ministerial review being a control mechanism.

- Trade facility operators should not be subject to the proposed new “market integrity rules”. An extension of the ASIC rules to operators is unnecessary and may result in confusion, given that to date rules have applied only to Participants in the facilities , the rules being set by the operators and subject to the discipline of a regulatory clearance process. If new trade facilities commence trading ASX-listed securities, then new requirements may be needed which should apply to all facility operators. These requirements (governing whole of market functioning and microstructure) should be imposed by a statutory obligation through legislation, regulations requiring the inclusion of particular provisions in operating rules or universal licence obligations which apply equally to all facility operators. This will create a transparent, equitable playing field. Market participants should be subject to the Corporations Act, rules imposed by ASIC and the operating rules of the trade facility through which they choose to participate in the market.

- The proposed ASIC rules should be subject to a mandated period of public consultation (including consultation with trade facility operators concerning potential inconsistency with operating rules) and a “net regulatory benefit” test. Further, Ministerial consent should be required for all ASIC rules including those that are considered “urgent”.

- Role clarity would be enhanced by various nomenclature changes, most notably by changing the references to “market integrity rules” to better reflect their content. Possible names include: ASIC rules; market conduct rules; market participant rules. In accordance with this objective, we refer to these ASIC-made rules throughout our submission simply as “ASIC rules”.

- Other concepts adopted in the legislation or consultation paper that would benefit from terminology changes include:
  - "market" should be used when the reference is to the economic concept (i.e. encompassing all buying and selling in a particular financial product) and, as discussed above, "trade facility" should be used when imposing obligations on a licensee in relation to matters within their control (i.e. relating to their trade facility);
  - "regulation" should be used (including in the name of the amending bill) in lieu of "supervision", when referring to the functions of the regulator, now that it is envisaged that it will have a complete armoury of powers.

2. The New Rule Framework

ASX recommends that further consideration be given to a number of aspects of the new rule framework, as discussed below.

In summary ASX's proposed adjustments involve:

- clarifying the objects of the legislation and then imposing a principle-based obligation on trade facility operators to act consistently with those objects;
- addressing the risks of inconsistency between ASIC rules and the rules created by various trade facility operators without sacrificing role clarity – by relying on the rule review process and the incentives faced by operators to avoid adverse outcomes;
- ensuring that regulation-making powers are sufficiently broad to enable regulations to be used for exceptional circumstances when all trade facility operators need to have obligations imposed on them that are more prescriptive than their principle-based licence obligations (including to act consistently with the objects of the legislation);
- ensuring that ASIC's rule making power extends to all relevant trading venues equally, including dark pools,
- inviting further elaboration from Treasury of the justification for the proposed approach to penalties;
- ensuring accountability to stakeholders for the exercise of regulatory responsibilities;
- inviting a re-examination by Treasury of the rationale for discriminating in favour of foreign domiciled trade facility operators that operate facilities in Australia in competition with Australian domiciled operators; and
- inviting a re-examination by Treasury of the scope of the proposed "compensation order" regime and the existing "compensation fund" regime.

<u>Lack of clarity concerning trade facility operator licence obligations to ensure market sector is fair, orderly and transparent, and ASIC rules being made only for the purposes of ensuring that markets are fair, orderly and transparent (s.798F(2))</u>

A trade facility operator currently has a licence obligation "to do all things reasonably necessary to ensure that the market is fair, orderly and transparent" (s.792A). Surprisingly, the Exposure Draft does not change this licence obligation. Nor does it extend its application to other entities that will share this responsibility under the new framework, notably ASIC. The requirement that ASIC rules be made only for the purpose of ensuring markets are fair, orderly and transparent is on the one hand too narrow and on the other is confusing as it is so broad that it cuts across this licence obligation:

- it may be too narrow to allow ASIC to regulate the participant-client relations, which according to paragraph 17 of the consultation paper is to be the responsibility of ASIC;
- it may be too narrow to allow ASIC to regulate the higher standards of governance, risk and compliance frameworks required for participants to have an adequate management and supervision structure above those which ordinarily apply under the AFSL requirements; and
- it is confusing as it seems to overlap with the obligation of market licensees under section 792A(a) to ensure that the market is fair, orderly and transparent.

There is potentially a high degree of overlap, and a resulting risk of "demarcation dispute", between ASIC and trade facility operators' rule making powers. For example, matters such as trade errors, cancellations and trade disruptions should clearly be matters for the trade facility operator, and yet will affect the fair, orderly and transparent market. Apart from the inconsistency provision (s.793B(2)), the draft legislation gives no guidance as to how the rule making powers of ASIC interact with the obligations of trade facility operators. It is not clear how it is envisaged that the trade facility operator licence requirements would be harmonised with any ASIC rules. ASX expects that it will be difficult to harmonise, and this is likely to result in a lack of role clarity between ASIC and trade facility operators. This is another reason to keep the regulatory levers which are applied to trade facility operators separate to those which are imposed on market participants (ASIC rules).

ASIC's rule making mandate should be wide enough to cover everything which in ASIC's view is required to maintain market integrity, other than compliance with the operating rules set by the relevant trade facility operator. ASIC rules will need to include participant-client relations and participant misconduct such as market manipulation and front-running – all of which are wider than the provision allowed for by the Exposure Draft. The ASIC rules could also include rules which need to be imposed on participants across all trade facilities i.e. whole of market (for example, best execution requirements). However, they should not include matters which relate to the way in which particular trade facilities operate.

There should be an objective threshold in determining whether ASIC rules are for the specified purpose, such as a requirement in the legislation that the rules are for the purpose "in the reasonable opinion of ASIC", necessary to meet the objects of the legislation.

An important difference between the current ASX rules and the proposed ASIC rules is that ASIC rules could apply to all trading venues. Currently, ASX rules can only apply to products traded on ASX's platform. The proposal to introduce ASIC rules means ASIC can create common standards across trading venues to protect investors, regardless of where their securities are traded. However, as currently drafted, ASIC's new rule making power would not extend to regulation of OTC trading of listed financial products or trading of these products in dark pools. We recommend the Government review this aspect of the draft legislation, given the trends towards off-market trading in overseas markets and the risks of allowing this activity to occur outside the market integrity rules.

It is important that there are adequate accountability mechanisms in place to ensure that the regulator is effectively carrying out its new responsibilities. Under the current regime, ASIC conducts an annual audit of ASX's market supervision activities. In North America, the supervisory and regulatory functions akin to those being transferred to ASIC are undertaken by self regulatory organisations (SROs). SROs are subject to two levels of oversight: by member firms (e.g. in relation to fees charged under the respective cost recovery regimes) and by the government regulator (e.g. in relation to their role of maintaining market integrity).

These external checks and balances do not translate directly to the Australian environment, where a Government agency is assuming responsibility for what have to date been supervisory functions discharged by private operators. Accordingly, ASX advocates that it is appropriate that changes should be made to section 243 of the ASIC Act to explicitly extend the duties of the Parliamentary Joint Committee on Corporations and Financial Services to inquire into how ASIC has performed these new functions; and the means by which ASIC has levied fees to cover the costs of its new market supervision functions.

Trade facility operators should have a licence obligation to act consistently with the objects set out in s.760A

In a potential multi-operator environment in which ASIC is to be responsible for regulating the conduct of market participants with a view to achieving public policy objectives (and trade facility operators will monitor market participants' compliance with the operating rules of the operator's trade facility), there are three aspects of this existing licence obligation that would be inappropriate to carry forward into a trade facility licence obligation:

- it would be inconsistent with the role clarity which the Government's decision should produce to have the body with responsibility for achieving market integrity outcomes across the whole market (ASIC) in a position to deflect accountability for the exercise of its new powers because of the existence of legislative provisions which meant that the role of regulator was still a shared responsibility with private sector organisations;
- it would be incompatible with the competition objectives underpinning the Government's decision to transfer supervisory responsibilities to ASIC, to persevere with the artificial construct (implicit in s.792A(2)) that a "market" in a listed financial product is synonymous with on-market trading through a particular trade facility; and
- the potential to positively influence behaviour that is embedded in the statement of objects of Chapter 7 of the legislation – set out in s.760A of the Corporations Act – would continue to lie dormant were the responsibilities of key organisations in the regulatory framework to remain disconnected from these objects.

The existing licence obligation – which speaks as if trade facility operators alone are responsible for achieving market integrity outcomes – needs to change in step with the changes foreshadowed to the regulatory structure and should be replaced with a licence obligation to "act consistently with the objects set out in s.760A" (being objects which include a reference to "fair, orderly and transparent markets" but also refer to other objects of Chapter 7).

The objects of the legislation (s.760A) should be clarified

Since s.760A was introduced there has been a disturbing range of "interpretations" of the expressions used in this provision deployed inconsistently by key institutions in the regulatory framework.

Experienced market participants would typically associate one of the key elements of s.760A – "fair, orderly and transparent markets" – with market integrity and market quality. They might think that the objects were relevant when considering: bid/offer spreads; depth; impact costs; block trade facilitation; front running; manipulation; insider trading; ghost/cancelled orders; position duration; two-sidedness; deviation from fair value; maker/taker pricing; etc.

Yet it is not uncommon for the existence of a trade facility operator licence obligation expressed by reference to fair, orderly and transparent markets to be treated as if it were an overarching obligation encompassing whatever public policy objectives were thought relevant to a particular situation. We propose that s.760A be amended to incorporate an additional sub-section which amplifies the intended scope of the concept of "fair, orderly and transparent markets". The additional wording would be derived from internationally accepted interpretations of these concepts.

For the purposes of this section, a fair, orderly and transparent market is one exhibiting the following characteristics:

- the prices at which financial products are transacted generally reflect genuine supply and demand;
- the laws and rules dealing with the operation and regulation of the market appropriately balance the interests of different stakeholders and do not unfairly favour some market users or operators over others;
- the information that is being reflected in the prices at which transactions occur is reliable; and
- there is an appropriate level of transparency as to the prices and volumes of transactions, recognising that this may differ depending upon the means of execution.

A better mechanism is needed for dealing with potential inconsistency between trade facility operating rules and ASIC rules (s.793B)

The provision which nullifies the operating rules to the extent of inconsistency with ASIC rules is a blunt instrument which may have negative consequences in practice. In particular, a participant could use the proposed s.793B to "make the argument" that an operating rule does not apply to it.

Operating rules should continue to have effect until inconsistency in any given circumstance is proved. The operating rule review process should minimise the prospect of inconsistency, as discussed in relation to s.798F(4) below. At most, participants should be permitted to raise inconsistency as a defence to disciplinary proceedings or monetary sanction for breach of the operating rules. Further, participants should bear the onus of proving that it was impossible to comply with both the operating rule and the ASIC rule.

ASX considers that the potential for inconsistency between ASIC rules and operating rules should be dealt with in the rules of the relevant trade facility operator rather than by the manner set out in the draft bill. A requirement to include a rule dealing with the prospect of inconsistency could be included in the regulations made pursuant to 793A. ASX intends to have an operating rule dealing with this issue (regardless of whether it is also dealt with in the legislation).

The proposed amendments to s.793B should be withdrawn. If s.793B were to remain, we recommend that it be modified to seek to ensure that the ASIC rules and operating rules be read so as to minimise any inconsistency. The following ss.793B(3) and (4) could be added:

> *(3) An operating rule of a licensed market that is of no effect due to inconsistency with an ASIC rule for the purposes of subsection (2) will be of no effect only while that ASIC rule is in force.*
>
> *(4) For the avoidance of doubt, the operating rules of a licensed market are read:*
>
> *(a) subject to the ASIC rules; and*
>
> *(b) with the presumption that no inconsistency between the ASIC rules and the operating rules is intended.*

(Existing sub-section 793B(3) needs to be deleted for other reasons – see below).

ASIC rules should not apply to operators of licensed markets (ss.798F(1) and 798G(1))

There is no need for trade facility operators to be subject to ASIC rules – doing so creates a blurring of roles and responsibilities. ASIC and the Government already have a number of regulatory means by which requirements can be imposed that may affect a market's integrity on trade facility operators. These regulatory "levers" are:

- conditions on the market licence (s.796A);
- power to give directions to market licensee (s.794D);
- mandatory content of operating rules and procedures (s.793A);
- ability to disallow changes to operating rules (ss.793D and 793E);
- obligation to assist ASIC (s.792D); and
- power to require special reports (s.794B).

ASX recognises that if new trade facilities commence trading ASX-listed securities, then new regulatory requirements may be needed which apply to all facility operators. These requirements (e.g. governing market functioning such as post-trade reporting, and market microstructure such as off-market crossing thresholds) should take the form of legislation, regulations or universal licence obligations. This will create a transparent, equitable playing field. In most instances, it will be more appropriate for ASIC to achieve its investor protection mandate by imposing new obligations

directly on Participant s (brokers). For example, a client's ability to achieve the best execution available can only be fulfilled if all brokers are subject to the same ASIC rule in this regard.

It is important to promote role and regulatory clarity under the new arrangements. The best framework to achieve this aim is that trade facility operators are subject to the Corporations Act, associated regulations which can impose requirements on what must be included in operators' rules and licence obligations, while market Participants are subject to the Corporations Act and rules – either as imposed by ASIC or by the trade facility through which they choose to participate in the market (these being set by the operator of the relevant trade facility).

Role clarity will be reinforced simultaneously with there being adequate tools to impose uniform obligations on trade facility operators if the regulation–making power is broadened appropriately. Issues such as how should market data be made available raise fundamental regulatory framework questions that warrant resolution and Parliamentary oversight through the making of regulations (this is especially the case in circumstances where a trade facility operator has an obligation to act consistently with the objects of the legislation).

Further consideration required in relation to penalties (s.798F(3)

Further consideration should be given to whether a penalty of $5 million for the breach of an ASIC rule is justified. The penalty amount for an individual is $1 million but under s.1317G(1B) it will be $5 million for a corporation. It is unclear whether an infringement notice can require a penalty of up to four-fifths (s.798H), which is $4 million for a corporation. These penalties are a significant increase from the maximum penalty which can be imposed by the ASX Disciplinary Tribunal, which was increased to $1 million from 31 March 2008.

The consultation paper does not mention the $5 million penalty, which is unusual given that most trade facility operators and participants are corporations. In relation to the $1 million penalty it states that "This level of penalty is necessary to ensure the continued integrity of Australia's financial markets" (paragraph 23), but does not give further explanation.

If there is to be a higher penalty for corporations some measures may be required to prevent participants adopting a structure other than a corporation for the purpose of avoiding higher penalties.

There should be public consultation and a "net regulatory benefit test" for ASIC rules (s.798F(4))

The proposed ASIC rules should be subject to a mandated period of public consultation (including consultation with trade facility operators concerning possible inconsistency with operating rules) and a "net regulatory benefit" test.

The Legislative Instruments Act 2003 (s.17) contains only "limited" requirements for consultation. The Corporations Act should mandate a minimum period of public consultation in relation to draft ASIC rules to enable potentially affected parties to make submissions to ASIC. The period of consultation could vary according to whether ASIC considers the rules are urgent or not. The Corporations Act should also mandate that ASIC consult with operators of licensed trade facilities, including as to the extent for any potential inconsistency between ASIC rules and operating rules. Further, the Corporations Act should require that an explanatory statement of an ASIC rule set out ASIC's opinion of the extent of any inconsistency between that ASIC rule and operating rules.

The making of ASIC rules should also be subject to a "net regulatory benefit" test. That is, ASIC should be required to demonstrate that the proposed rule will deliver benefits in terms of regulatory outcomes which outweigh the cost of compliance (including the costs of new systems/infrastructure). This could be a pre-condition of Ministerial consent.

Ministerial consent should be required for all ASIC rules (s.798F(5)-(7))

There is no good reason why the discipline of Ministerial consent should not apply at all times. Indeed, it is all the more necessary when new rules are considered "urgent". Regulatory change in the heat of the moment, without the discipline

imposed by the Ministerial disallowance process and Legislative Instruments Act 2003, may result in rules which do not properly achieve their purpose or have unforeseen consequences. Potential adverse consequences are likely to be exacerbated in a more complex multi-market environment. ASIC has other regulatory mechanisms available to it to act immediately when needed.

Exclusion of overseas markets may damage market integrity and undermine a level playing field (s.798G(2))

It is not clear what public policy objective would be achieved through the proposed exclusion of overseas markets from the ASIC rules, or how that objective would justify both the confusion that would arise from inconsistent rules across trading facilities and the potential damage to the integrity of Australia's markets.

The exclusion would mean that the ASIC rules – which are intended to maintain market integrity – will not apply to all trade facilities. The practical implication is that key investor protection provisions - such as client order priority rules or any best execution rules - would not apply to participants in all facilities (i.e. across the whole of market). Market integrity would be undermined if – as it currently appears – rules relating to broker misconduct (including manipulation and front-running) only applied to some trade facilities but not others.

If ASIC rules do not apply to overseas trade facilities, then ASIC will need to exercise vigilance to ensure that trading on these facilities does not erode the integrity of Australia's financial markets. It will also be necessary to ensure that there are no incentives for trade facility operators to move offshore to take advantage of the lack of a level playing field.

It is difficult to see how there can be a level playing field if the operators of overseas trade facilities are not subject to the same ASIC rules as licensed domestic operators.

Compensation orders should not apply to trade facility operators (s.1317HB)

If the ASIC rules were to apply to trade facility operators, the imposition on trade facility operators of liability to pay compensation would disproportionately affect them and may give rise to indeterminate liability. This is made more acute by the proposed exclusion of overseas markets from the ASIC rules.

The proposed provision which relates to compensation orders in relation to ASIC rules (s.1317HB) seems to be based on the current s.1317HA which allows a person to be compensated for another person's contravention of a financial services penalty provision (e.g. insider trading, market manipulation). The circumstances relating to trade facility operators are significantly different.

The proposed imposition of liability on trade facility operators to pay compensation for damage resulting from breach of an ASIC rule fails to recognise that:

- unlike market participants, who are potentially exposed only to claims by their clients, trade facility operators are at the centre of the financial system and are potentially exposed to claims by all participants and all of their clients. Trade facility operators are therefore disproportionately affected by the proposed imposition of liability to pay compensation; and
- at present, trade facility operators are able to manage their exposure to third parties through their operating rules. This will no longer be possible when sections of operating rules are excised and become "ASIC rules".

Further, the Act proposes no test of remoteness in relation to claims for compensation. A trade facility operator could be ordered to pay compensation to any person if the damage "resulted from the contravention", potentially extending to consequential and pure economic loss. The person who suffered the damage does not have to make an application to the court. Noting the "central position" occupied by trade facility operators (first bullet point above), this potentially spells liability in an indeterminate amount to an indeterminate class.

Foreign operators are not exposed to the potential liability created by this regime. Ensuring that ASIC rules are used to impose obligations on market participants and their clients, but not trade facility operators (for the reasons relating to role clarity set out above), will reduce this discriminatory aspect.

3. Cost Recovery

Treasury and ASIC should expect that trade facility operators will pass on any additional costs which flow from levies imposed net of any cost savings which may be achieved. In overseas jurisdictions where SROs undertake supervisory activities, the costs of these activities are passed on to market participants. The process is transparent. In order to ensure that costs incurred are reasonable and that only appropriate costs are levied, member organisations (trading facilities) generally have the opportunity to nominate an external auditor to verify the cost-recovery process. There is no parallel oversight mechanism proposed, presumably because supervision will be undertaken by a Government agency. As noted earlier in this submission, it is important that such an accountability mechanism exists. Accordingly, changes should be made to section 243 of the ASIC Act to explicitly extend the duties of the Parliamentary Joint Committee on Corporations and Financial Services to inquire into the means by which ASIC has levied fees to recover the costs of its new market supervision functions.

The consultation paper foreshadows a separate legislative amendment process in relation to ASIC's ability to levy fees. There are a number of important issues that will need to be considered in the consultation process which accompanies those legislative amendments. These issues include how the mix between fixed and variable costs should be determined, what mechanisms should exist for changing the mix over time; and what will be the key driver for each of the fixed and variable components. For example, consideration must be given to the different measures of market activity which could form the basis of the variable component. Possible measures include number of orders submitted to a facility, number of trades executed on a facility, and percentage of market share (based on value or volume of securities traded on a facility). ASX's preliminary view is that cost recovery of the variable component should be based on number of orders submitted to a trading facility. The rationale for this approach is that two major costs that ASIC will incur are the technological capacity to capture and interrogate large amounts of market data, and the people to follow-up indications of misconduct. Order volume is the key driver of these activities.

Paragraph 32 of the consultation paper states that: "*The Government's decision to transfer supervisory responsibility to ASIC will remove the regulatory obligation on market operators to supervise their markets. It is expected that this saving to operators will be offset by their need to pay the ASIC fees.*"

This statement assumes that the saving to operators will be equal to the fees payable to ASIC. Treasury should be aware that to date ASX has had vertically integrated activities. The cost efficiencies that flow from such a structure may be lost in the new arrangements.

Notwithstanding the above point, ASIC has asked ASX to provide a commitment, and ASX has provided a commitment, to pass on any cost savings realised as a result of the supervision transfer to ASX and SFE Market Participants.

4. Disciplinary Panel

<u>Breach of ASIC rules</u>

While it is not clear from the explanatory document and the draft legislation how the ASIC disciplinary process will operate, ASX assumes that ASIC will have the ability to obtain alternative outcomes, such as Enforceable Undertakings and/or monetary contributions to industry education, in addition to those outcomes established in proposed section 798H. On this basis, ASIC will have 3 remedies available to them, these being:

- alternative outcomes, such as Enforceable Undertakings and/or monetary contributions to industry education;
- Infringement Notices as established in proposed section 798H; and
- civil remedies through the courts.

ASX assumes that, in the case of the Infringement Notice regime, ASIC staff will be making recommendations to the Disciplinary Panel which will hold its hearings in public. The Disciplinary Panel, if it determines a contravention is made out, will recommend the issuance of an Infringement Notice. The relevant person may then decide to accept the Infringement Notice (which may be a penalty pursuant to proposed section 798H(1) or (3)). If the Infringement Notice is not accepted, then it will be a matter for ASIC to determine whether or not to commence civil proceedings.

While an escalating process for dealing with contraventions is supported, ASX has identified the following issues in relation to the proposed disciplinary processes:

- It is proposed (paragraph 38) that Disciplinary Panel hearings will be held in public. If the Disciplinary Panel is to be the party which recommends the Infringement Notices and the hearings are to be held in public, that process will have three potential adverse consequences:

  First, it may encourage participants towards the alternate outcomes (i.e. EU),

  - which is a less transparent process;
  - in which no contravention is determined or recorded;
  - for which no substantive details of the circumstances of the contravention may be published, thereby losing educative value; and
  - by which the internal controls and reporting of global participants can be avoided.

  Second, it may defeat the intent of the Infringement Notice proposal to expedite proceedings and encourage "non-contested" resolution of matters where ASIC desires a contravention to be found and recorded as, if the matter is to be public, the participant may elect to have the matter proceed by way of court processes.

  Third, while ASX fully supports transparency in the Disciplinary Panel processes, ASX has a number of reservations about the holding of hearings in public for breaches of an ASIC rule. This is based on ASX's current understanding of what will be addressed by ASIC rules. As breaches of ASIC rules are likely to address matters that involve either real-time trading activities and conduct in relation to the participant/client relationship these breaches will likely include material being considered such as:

  - Confidential client information being made public in the course of submissions to the disciplinary panel.
  - Confidential trade facility operator correspondence and/or information being made public in the course of submissions to the disciplinary panel.
  - Commercial-in-confidence information may be disclosed.

  ASX Disciplinary Tribunal matters are not held in public. ASX encourages the framework to either not hold Disciplinary Panel hearings in public, or to recognise scope for "in camera" hearings to be held in certain circumstances.

- A significant component of the value of the existing disciplinary regime is the publication by ASX of the circumstances of a contravention (i.e. the "how" and "what" elements). This provides significant educative value to the industry, promotes a culture of compliance and enhances preventative measures to avoid future breaches. It is an element of the process the industry places significant importance on. ASX is concerned that if the disciplinary process by the Disciplinary Panel) results in less transparency of the circumstances of a contravention (i.e. the "how" and "what" elements) there will be a diminution in the value of the disciplinary process from that which currently exists. ASX recommends that the legislation set out, by way of Regulation, what the Disciplinary Panel must publish in its findings.

- It appears from the explanatory document that the Disciplinary Panel can determine a penalty of up to four-fifths of the maximum penalty a court can impose. Proposed section 1317(1D) states that the court may impose up to five times the amount set out in the ASIC rules. On one reading, therefore, the Disciplinary Panel may levy

penalties of up to $800,000 against an individual and $4 million against a corporation. An Infringement Notice penalty that is up to 80% of the maximum penalty that a court could award may preclude entities from ever satisfying the notices on the grounds that the penalties are significant and may be in excess of what a court would be likely to award for a breach of an ASIC rule. ASX submits that the maximum penalty which the Disciplinary Panel may impose should be four-fifths of the amount set out in the ASIC Rules, not four-fifths of the amount a court may impose.

- Safeguards in relation to the Infringement Notice regime should be included in the Bill. There are a number of procedural and other safeguards in relation to Infringement Notices for the breach of continuous disclosure obligations, which are set out in the Corporations Act (s.1317DAC to DAE). For example, the decision to issue an Infringement Notice must be on "reasonable grounds" and ASIC must provide a written statement of reasons for the notice and other relevant details. The Act also deals with the effect of compliance with, or failure to comply with, a notice and the withdrawal and publication of notices (s. 1317DAF to DAJ). Similar safeguards are not currently provided in relation to infringement notices for the breach of ASIC rules. These are important safeguards and should be provided for in the Corporations Act rather than left to the regulations as suggested in the Consultation Paper (paragraph 4.13).

Breach of operating rules

ASX notes the invitation to trade facility operators to enter into an agreement with ASIC for using ASIC's disciplinary mechanism, instead of establishing (or continuing to use) their own disciplinary mechanisms. We can see the value of having one forum and process which will have efficiencies for participants, trade facility operators and ASIC. We suggest that consideration also be given to making such an arrangement available to operators of clearing and settlement facilities. ASX would be interested in pursuing an agreement with ASIC to provide an appeal mechanism in respect of sanctions applied for breaches of its operating rules by participants in circumstances where the trade facility operator is required to have an appeal mechanism (if any). On the basis of ASX's current understanding of what will be in its operating rules, the nature of these breaches is likely to be factual and will not involve consideration of confidential information. ASX believes that the imposition of sanctions for breach of an operating rule may not need an appeal mechanism.

5. Directions Power

ASX notes that, although not included in the draft legislation, Treasury is considering expanding the scope of s.794D (ASIC's power to give directions) in unspecified ways. ASX does not consider that the justification advanced to date – "to enable ASIC to take quick action where necessary" – is satisfactory.

An unlimited directions power should be seen as an alternative to a pre-vetting process (whether in relation to content of rules or products in the case of an operator, or in relation to content of contracts with customers or products in the case of market participants).

ASX acknowledges that having taken a decision to vest primary responsibility in ASIC for aspects of financial market regulation that were previously shared with ASX and other trade facility operators, it is important that the Government provide ASIC with the appropriate tools to exercise the new responsibilities.

ASX submits that the ASIC directions power currently in 794D should not be expanded. The roles, responsibilities and supervision of market participants and trade facility operators should be separated. The existing powers in 794D are adequate to allow ASIC to deal with circumstances of trade facility operators. It is appropriate that ASIC has powers to give directions to market participants. However, this should be contained in s.798 rather than s.794D. It would be appropriate to adopt a new section 798I to the following effect:

s.798I
(1) If ASIC is of the opinion that it is necessary, or in the public interest, to protect people dealing in a financial product or class of financial products on one or more licensed markets by:
(a) giving a direction to a market participant to cease dealings in a financial product or class of financial products; or
(b) giving a direction to a market participant to cease dealings in a financial product or class of financial products on behalf of a person or class of persons; or
(c) giving some other direction in relation to those dealings;
ASIC may give the market participant a written direction with a statement setting out its reasons for making the direction.

(2) [Period of effect] The direction has effect for the period specified in it (which may be up to 21 days). During that period, the market participant must comply with the direction and must not allow any dealings to take place contrary to it.

(3) [Court may order compliance] If the market participant fails to comply with the direction, ASIC may apply to the Court for, and the Court may make, an order that the market participant comply with the direction.

(4) [ASIC's obligations when making or varying a direction] As soon as practicable after making or varying (see subsection (5)) a direction, ASIC must give a copy of the direction or variation to the operator of each licensed market in which the market participant deals in those securities or class of securities.

(5) [Varying a direction] ASIC may vary a direction by giving written notice to the market participant if ASIC is of the opinion that the variation is necessary, or in the public interest, to protect people dealing in a financial product or class of financial products.

(6) [Revoking a direction] ASIC may revoke a direction by giving written notice to the market participant. ASIC must also give written notice of the revocation to the operator of licensed market in which the market participant deals in those securities or class of securities.

ASX submits that adoption of a directions power in s.798I, in conjunction with the existing direction power in s.794D, negates the need for the proposed s.798F(5) and (6) as they give ASIC the capability to move swiftly when required while allowing appropriate new market integrity rules to be developed, considered and approved in a more appropriate manner.

6. Terminology

The existing legislature creates an artificial construct of “market” that bears no relationship to what actually constitutes a market. It creates the notion of a provider of IT systems and associated rules and enforcement being an operator of “the market” constituted by trades executed through that particular IT system.

In reality “the market” for, say, ASX-listed securities comprises not only trades executed through ASX’s IT system but also through other execution forums, whether licensed or OTC.

The prospect of additional organisations being licensed to operate their IT systems, coupled with the transfer to ASIC of the tools to achieve “whole of market” integrity outcomes, will render it impractical to persist with the current artificial construct of “markets” being defined by reference to trade facilities rather than by reference to whether activities are substitutable.

At the most basic level this needs to be reflected in adjustments to the legislation to reflect the fact that operators of trade facilities do not operate “the market”. As discussed above, ASX recommends that the term “trade facility operator” be adopted.

A second terminology change relates to the need for clarity around ASIC’s supervisory and regulatory functions, and the residual role of trade facilities in monitoring and enforcing Participant compliance with trade facility operating rules.

The exposure draft and consultation paper refer in a number of instances to removal of the obligation for trade facility operators to "supervise the market" (see for example paragraphs 14.1 and 15). There is also reference to the ongoing requirements for operation of the market and supervision and enforcement of the operating rules. It is important that the changes introduced by these reforms do not create confusion about the ongoing role of trade facility operators with respect to the monitoring and enforcement of the operating rules.

It appears the intent of the legislation is to remove the obligation for trade facility operators to "supervise participants in the market" in connection with their activities on that facility and the conduct of those participants with regard to their clients. We therefore suggest that in the interests of clarity going forward, reference to trade facilities should relate to "monitoring and enforcing" adherence with their rules, instead of referring to "supervision" or "regulation" – given these roles are now performed by ASIC.

7. Transitional Arrangements

At the time of transfer of responsibility to supervise and enforce the new ASIC rules, ASX will have on hand a number of potential investigation and enforcement matters, namely:

- matters scheduled for hearing before the ASX Disciplinary Tribunal and/or Appeals Tribunal relating to potential breaches of the ASX operating rules (ASX, SFE, ACH, SFECC, ASTC, Austraclear);
- matters referred to ASXMS Enforcement for potential reference to the Disciplinary Tribunal but for which a Contravention Notice has not been issued (i.e. not yet formally commenced proceedings before the Disciplinary Tribunal);
- matters referred to ASXMS Investigations for potential reference to the ASXMS Enforcement unit for review and the possible issue of a Contravention Notice;
- matters within other supervision units (e.g. Compliance, Surveillance, Capital Monitoring, Futures Supervision) which may result in a potential breach being referred to Investigations or Enforcement for disciplinary action; and
- potential breaches not yet identified.

The legislative amendments must contain provisions which recognise and facilitate the management of these issues.

For rule breaches which occur prior to the transition date ASX proposes, subject to there being a suitable arrangement in place with ASIC (as envisaged in paragraph 37) and the ASIC Disciplinary Panel being able to address clearing and settlement operating rules in addition to trade facility operating rules, that:

- Matters scheduled for hearing before the ASX Disciplinary tribunal and/or Appeals Tribunal relating to potential breaches of the ASX Group operating rules (ASX, SFE, ACH, SFECC, ASTC, Austraclear) be heard by those bodies after the transition date in accordance with the ASX rules in effect on the transition date. These matters should all be finalised by a specific date (such as 31 December 2010). To facilitate this, no matters will be scheduled for hearing after 30 September 2010.
- The remainder of the matters which relate to supervisory issues or which need to be heard by a Tribunal to be referred to ASIC pursuant to the arrangement. ASX proposes that the ASIC Disciplinary Panel would determine the matter by reference to the relevant operating rules (rather than the ASIC rules) and that the applicable penalty regime be determined by reference to the relevant operating rules (rather than the ASIC Rules). Although consideration could be given to whether the participant should have the ability to elect to have apply the disciplinary process and penalty regime under the ASIC rules.

In this regard, the provisions of the proposed s.793B may have an adverse impact on these arrangements.

As discussed above, on the basis of ASX's current understanding of what will be in its operating rules the nature of these breaches is likely to be factual and will not involve consideration of confidential information. ASX believes that the imposition of sanctions for breach of an operating rule may not need an appeal mechanism.

8. Consequential Amendments

Amendment required to clarify application of compensation arrangements

The proposed amendments highlight a problem with the investor compensation arrangements under the Corporations Act, which has been raised by ASX and Securities Exchanges Guarantee Corporation Ltd previously.* The ASX recommends that Treasury make an amendment to the Corporations Act to address this problem, as outlined below.

A scenario may arise where a number of licensed trade facility operators establish and maintain their own compensation arrangements. In the context of there being multiple trade facility operators and compensation arrangements, there are potential scenarios in which a client claim may arise in circumstances where it is not ascertainable which facility, and hence compensation arrangement, is applicable. For example, where client assets (tradable on multiple facilities) have been lost prior to the execution of a trade on any particular facility or where the participant has transferred securities (tradable on multiple facilities) without authority.

At present, compensation arrangements for the ASX market consist of the National Guarantee Fund ("NGF") and are governed by Division 4 of the Act. Markets other than ASX are required to have compensation arrangements under Division 3 of Part 7.5 of the Act (known as "Division 3 arrangements").**

As we stated in the earlier submission, there can be no justification for an investor being able to claim compensation based on different heads of claim depending on the trade facility to which an order is directed. This will occur if a new facility operator is permitted to provide for compensation merely against fraud, whilst ASX is required to provide for compensation against a complete different set of heads of claim, including claims involving the insolvency of the intermediary. Such an outcome would create confusion amongst investors about their level of protection. We believe the Government should correct this regulatory anomaly.

The NGF covers loss that is connected with the ASX market (s.888A(1)). "Connected with" is defined broadly as loss caused by a participant or past participant of ASX. This broad definition is no longer appropriate in circumstances where participants of ASX may also be participants of other markets. The problem is now compounded by the fact that the participant conduct which gives rise to loss (e.g. unauthorised trading or misappropriation of property) is no longer supervised by ASX.

The Corporations Act seeks to ensure there is a connection between loss and a particular market in s.885D. However, the effect of this provision is that if the loss is connected with ASX and another facility operator but it is not clear which, the client may be entitled to compensation from the NGF (s.885D(2)). Further, this provision picks up the definition of "connected with" in s.888A.

To address this problem, ASX suggests that s.888A be amended to state that "A loss is connected with a financial market [or facility] if it is caused by a participant, or past participant, in relation to effecting a transaction, or proposed transaction, executed or reported in accordance with the provisions of the operating rules of that facility operator or money or property held or controlled by the participant in relation to such a transaction." This is consistent with Division 3 arrangements where the loss is required to be linked to the particular market (see s.885C(b)).

* Most recently see Submission in response to ASIC Consultation Paper 86: Competition for market services - trading in listed securities and related data, August 2007 and Submission by ASX Limited in response to the Australian Securities and Investments Commission Consultation Paper 86, 17 August 2007.

** Note that the ASX market also has Division 3 compensation arrangements for futures.

Going forward, we suggest that the compensation arrangements be reviewed to consider if there is a more appropriate structure in circumstances where trade facility operators no longer supervise participant conduct which gives rise to claims.