

Market Supervision Transferring to ASIC

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1. Background

On 1 August 2010, Australian Securities and Investments Commission (“ASIC”) will take over from the Australian Securities Exchange (“ASX”) the market supervision role.

ASIC has released its Regulatory Guide 214: Guidance on ASIC Market Integrity Rules for ASX and ASX 24 Markets, and the new ASIC Market Integrity Rules (“MIRs”).

In the coming weeks ASIC will issue in-principle MIRs for the National Stock Exchange of Australia, SIM Venture Securities Exchange (previously known as the Bendigo Stock Exchange), Asia Pacific Exchange Limited, and IMB Ltd.

All listed companies, and any planning to list, need to ensure now that they are ready for increased interaction with ASIC, and for a ramping up by ASIC in surveillance of market misconduct indicators.

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2. ASIC Roadshows

ASIC has been on the road during July telling the market that it is ready to take over its new supervisory function from the ASX from August 2010.

ASIC believes it has the staff, systems, tools and the will to take on the job. The ASX has announced that 24 ASX staff have now accepted positions with ASIC to work on the transferred functions at ASIC.

The roadshows are being led by Belinda Gibson (ASIC Deputy Chair), Greg Yanko (NSW Regional Commissioner and Senior Executive Leader, Market & Participant Supervision), and Tom Vienders of the new Market Analysis Team.

3. Civil penalties for breach of new ASIC Market Integrity Rules

The *Corporations Amendment (Financial Market Supervision) Act 2010* (“**Financial Market Supervision Act**”) was enacted on 25 March 2010 and will commence on 1 August 2010.

This means that from 1 August 2010, the *Corporations Act 2001* (“**Act**”) will contain a new area, Part 7.2A, dealing with ASIC’s ability to supervise trading activities and conduct of business by market participants in relation to domestic licensed markets, and take enforcement action. This is an important change because previously the ASX Operating Rules were based on a contractual arrangement between market participants and the ASX, albeit the rules did have recognition in the Act as such a contract.

With the transfer of these functions to the ASIC, the new MIRs will have the force of legislation and their breach will invoke civil penalties.

The remedies for breach of the new MIRs include civil penalties ranging from \$20,000 up to \$1 million.

4. Split from Operating Rules

The changes will mean that ASIC will take over those functions of the ASX Operating Rules that are concerned with market misconduct - the obligation to monitor conduct in relation to listed markets and facilities offered by operators, to supervise the market and ensure compliance, and to investigate any suspected breaches of the law.

ASIC will become the ‘whole-of-market’ supervisor and enforcer, responsible for supervising trading activities on any Australian licensed financial market and enforcing market rules, while individual markets – such as the ASX - will retain responsibility for operating their own markets and supervising the entities listed on them. The intention is twofold: to resolve the issue of the perceived conflict of interest in the ASX supervising its own members by handing those functions to an independent centralised body, and to set the table for introduction of a new era of increased competition in the financial markets.

Helpfully, there is a table at the back of the MIRs setting out a comparison of ASX Operating Rules and the new MIRs.

5. New Markets Disciplinary Panel (MDP)

ASIC will also be responsible for enforcement through the establishment of its own Market Disciplinary Panel (“**MDP**”), and it will have increased powers in relation to conducting investigations and penalties that can be issued.

The MDP is initially modelled on the ASX’s Disciplinary Tribunal in that it will involve peer review, but it will be able to issue infringement notices and obtain enforceable undertakings, as well as impose training obligations. A breach of an infringement notice will allow ASIC to apply to the Court for orders to apply the civil penalty provisions.

ASIC will release its final guidance on the MDP before 1 August 2010.

6. Laying the table for new competitive markets

The reforms are consistent with the recommendations of the Australian Financial Centre Forum report released on 17 November 2009 (“**Johnson Report**”) which found that Australia’s market regulatory system should be reformed to promote a more competitive financial services industry. The Johnson Report found that Australia’s “*exports and imports of financial services are low by international standards*” and that our financial services industry has an “*inward focus*”.

The Johnson Report commented that “*An unusual feature of the market is ASX’s role as a market operator, central counterparty and market supervisor. In the Forum’s assessment, this has been a significant barrier to new competition and innovation.*”

Recommendation 4.5 of the Johnson Report is to increase competition on exchange traded markets by introducing licences for new trading platforms and exchanges.

In his address to the 2010 Annual Stockbroker’s Conference in Melbourne on 8 June 2010, the Hon Chris Bowen MP, Minister for Financial Services, Superannuation and Corporate Law said that “*Obviously, the transfer of market supervision to ASIC is a precursor to allowing competition between markets.*” The Minister also indicated that the Government is currently considering applications for new market licences.

7. Impact on Fees

The introduction of new markets competing with one another for investor dollars should theoretically have a flow-on effect beneficial for Australians in reduced trading fees. On 3 June 2010, the ASX announced that it will be significantly reducing its trade execution fees.

However, the sustainability of reduced fees by the market operators will be tested. The new *Corporations (Fees) Amendment Act 2010* was implemented to support the transfer of supervision by allowing ASIC to levy fees on market operators to cover its costs for supervision. On 18 June 2010, the Government released draft regulations, the *Corporations (Fees) Amendment Regulations 2010* (“**Regulations**”). They provide details of the proposed fees structure. Finalisation of the Regulations will be after a consultation process with industry.

8. Insider Trading

In the *Corporations Amendment (No 1) Bill 2010* (“**Bill**”), released in May 2010, the Government has proposed to amend the Corporations Act 2001 and its regulations by:

- increasing the criminal penalties that can be imposed for breaches of the insider trading and market manipulation provisions of the Act;
- allowing the Australian Federal Police to apply for telecommunications interception warrants in the course of an investigation into these offences; and
- enabling ASIC to apply for a search warrant under the *Australian Securities and Investments Commission Act 2001* without first having to issue a “notice to produce”, which currently gives offenders a window of opportunity to destroy incriminating material.

In relation to the proposed increased penalties for insider trading, for individuals an offence can result in up to 10 years imprisonment and fines of up to \$500,000 (three times the profit gained or loss avoided). For a corporation engaged in insider trading, it could face a fine of up to \$5 million (up from \$1 million), or 10% of annual turnover in the year the offence occurred.

9. Restricted Access to share registers

In releasing the Bill, the Government also introduced amendments to the Act and its regulations which are designed to “*stamp out unsolicited, below-value share offers....*”.

The proposed legislation requires anyone seeking a copy of a member register to state what their intended use for the information and enables companies to refuse if the request is not for a proper purpose. Certain improper purposes will be defined in associated regulations, and will include seeking access to a register for the purpose of making an unsolicited offer for shares in a listed company (other than as part of a genuine offer).

It will be an offence under this proposed legislation to make a false statement when requesting a copy of the register, with an associated penalty of up to 12 months' imprisonment.

10. New Competition Rules

Once the transfer of the supervisory and enforcement functions has commenced at ASIC, the next step for ASIC will be to focus on introduction of the new competition rules. ASIC proposes to develop draft rules for competition across various markets and issue these for comment. ASIC has said it will release a consultation paper in September 2010, and there will be a consultation process which is expected to run to the end of 2010. In the recent ASIC roadshows, Belinda Gibson has said the new rules will represent a "*significant change*" for the financial services industry, but until the consultation paper is released in September 2010, the market will need to wait to see what that means.

11. Summary of Changes

From a legal viewpoint, while market participants may initially notice little change, it is expected that ASIC will make its impact felt with more extensive investigation powers and use of those powers. There will also be an increase in Court supervision as the Court will play an increased role in interpretation of the MIRs and determining if they have been breached following applications by ASIC for non-compliance with infringement notices.

On a practical level, the main changes that ASIC is saying will be noticed by the market are:

- (a) From "Day One", market participants will need to contact ASIC for enquiries and breach reporting relating to the MIRs. The dedicated address is market.participants@asic.gov.au.
- (b) There will be a new relationship team, led by Amanda Mark. ASIC will assign a relationship manager to each market participant and will write to market participants to give them the contact details of their relationship manager. The relationship managers will not be treating every business as a one size fits all proposition, but will be tasked with becoming familiar with their assigned market participant's business and will weigh up how 'risky' each particular business is. On that basis, ASIC will determine how frequently it will make site visits to market participants, and what it will expect when it makes those visits. Presumably, that assessment will also have some flow-on effects in terms of market surveillance activities on 'risky' businesses, although ASIC has not said that will be the case.
- (c) It is proposed that on-site surveillance of each market participant will be conducted at least every 3 years by ASIC, but a 'risky' business will probably find it is being visited more frequently than that. When ASIC visits, it will expect to find that the business conforms with all requirements related to:
 - an appropriate management and compliance culture;
 - ensuring that all representatives including corporate Authorised Representatives are complying (are not impacting on non-compliance by the market participant);

- client protection;
- adviser education;
- automated order processing controls; and
- internal controls.

- (d) A focus by ASIC on market surveillance will include actively seeking to identify “*unusual and potentially damaging*” practices. ASIC has appointed Jonathan Coultas as its head of market surveillance. Mr Coultas is a former senior executive of Macquarie Bank and has been involved in the trading side of the industry for about 20 years. ASIC, in its roadshows, is indicating it has strong expectations that Mr Coultas’ long experience will give ASIC’s market surveillance team an advantage because of his practical experience in his pre-ASIC career. In addition, ASIC says it has recruited many other ex fund managers and traders to the team to ensure that there are experts running the new functions.

ASIC will use the existing “SMART” system used by the ASX for market surveillance, but ASIC is indicating that refinements to surveillance techniques (that including sophisticated methods for data mining and pattern recognition) will result in faster identification of possible misconduct, and quicker investigations. The technology should mean that identifying and investigating potential market misconduct won’t rely mostly on market participants providing information, but can also be initiated by ASIC.

- (e) The new Market Analysis Team (“**MAT**”) will be headed up by Tom Viedners. In reality, this is the team that will investigate market misconduct reported to it by the market surveillance team where further investigation is warranted. It is an ‘escalation’ level team. ASIC says that MAT will focus primarily on a quick response to investigation of market misconduct, particularly insider trading and market manipulation, by:

- assessing breach notifications and market surveillance matters;
- answering enquiries about market matters; and
- using triage (prioritising matters) to act quickly as necessary.

The emphasis of MAT, according to the ASIC roadshows, is on implementing a shorter period between notification and assessment (and enforcement action).

ASIC says that MAT will be able to go in at the early stages to gather information and interview people. If the new Bill is passed (see above), ASIC will have new tools that will allow it to use evidence from telephone conversations, emails and text messages, and to apply for search warrants without giving offenders an opportunity to destroy evidence.

Breaches of the new MIRs will be required to be reported to ASIC, not ASX, using the FS80 form.

- (f) ASIC will set the education and accreditation requirements for designated trading representatives. Although initially there are not expected to be any changes from the current requirements, ASIC will take over this responsibility and may make some changes. However, each market participant will have the obligation of ensuring that its people are suitably trained to be a designated trading representative.

- (g) A requirement will be on market participants to provide transactional reporting for short selling to ASIC. This is intended to produce an audit trail for market surveillance and investigations by ASIC into allegations of misconduct, and greater transparency on short selling with the information to be released to the public.

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