



## Global Financial Crisis – Supervisory Challenges

Securities & Derivatives Industry Association

12<sup>th</sup> Annual Conference, Sydney

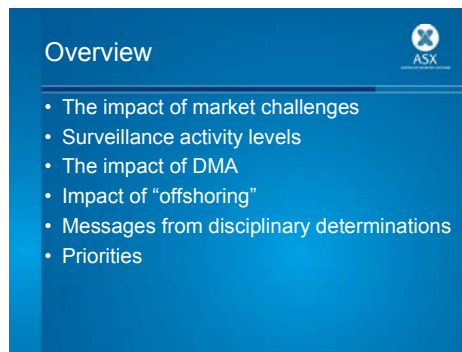
May 2009



Good morning.

I'd like to express my thanks to the SDIA for the opportunity to address its Annual Conference this morning. It's always a pleasure being able to speak here.

The year in review has been a challenging one impacting on your business, your clients and your staff. Certainly we're very conscious of these impacts and the impact which we can have as market supervisors. Nevertheless, from a supervisory perspective, we are all under pressure to do more.



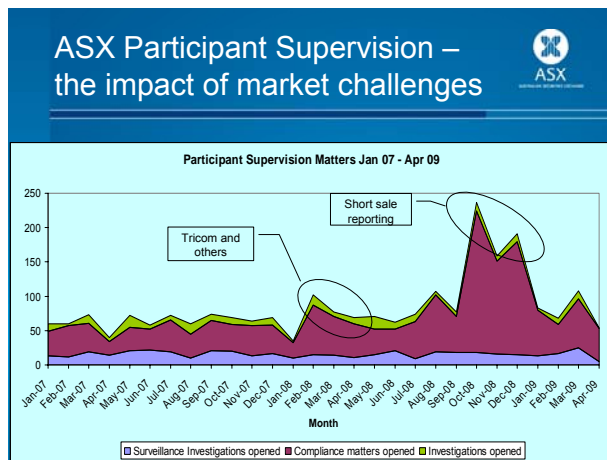
- some of the impacts we have seen from our perspective;
- some of the upcoming challenges as we go through a period of change, consolidation, efficiency optimisation and re-regulation;
- some of the key messages which have been delivered by the Tribunals over the last 12 months. I will spend some time on this as there has been a change in attitude which sends some clear messages and has a direct impact upon your business; and, finally,
- our priorities going forwards.

## The impact of market challenges

There will be regulatory change ahead.

Whilst the prospect of regulatory reform may strike fear into the compliance community, who have already had to deal with significant regulatory reform in the finance industry over the last few years, it is a natural consequence of the recent times. It is interesting to see the changes in regulatory dialect already, with terms such as “right touch” replacing “light touch”, for example, and the FSA talking in terms of “outcomes-focused regulation” based on the outcomes and consequences of actions not on compliance with any given individual rule. Interestingly, “outcomes-focused regulation” is heavily reliant on integrity and an appropriate ethics culture set by the tone at the top, as Eric referred to.

In recent meetings and presentations around the country there are perceptions that the level of enquiry and investigation by ASX has increased significantly over the last 12 months and that more matters are now being referred to our Investigations unit. So let me start by addressing those issues.



Last year I flagged that ASX’s supervisory risk appetite had been reducing and would continue to do so, which would result in a need for Participants to continue to put in place tighter internal compliance controls. I made no apologies for that and that focus continues. But I also said our fundamental approach to facilitate compliance and remediate breaches rather than pursue disciplinary action as a first response would not change. That continues to be the case. The approach we take to issues is not one of “minimal tolerance of breaches” but one of “minimal tolerance of the untreated root cause of breaches”.

There is no doubt that the level of supervisory contact has increased. There have been a number of factors driving this, the most obvious being the introduction of the changes to short sale reporting last year.

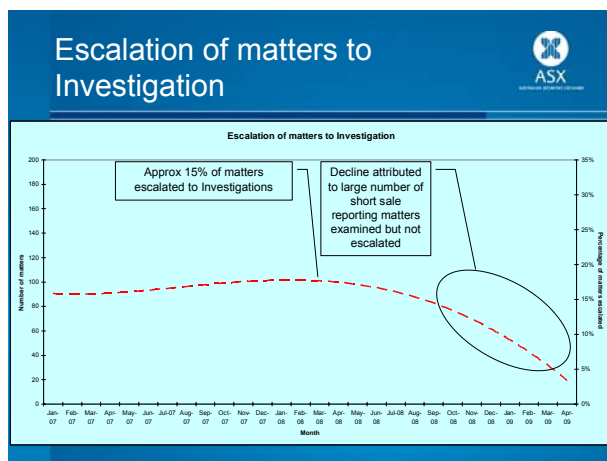
The chart shows the aggregate number of enquiries opened by each of our Surveillance, Compliance and Investigations units since January 2007. Historically, there were about 50 – 60 new matters opened each month. Since February 2008, there have been a number of issue specific “spikes” in the level of activity. These included the

- settlement and stocklending and borrowing enquiries of February to April 2009;
- an increase in T+3 settlement and CHESS holding enquiries in August 2008; and
- the short sale reporting enquiries in October 2008.

Of course there have also been the partly paid securities changes which Eric has already mentioned.

In between those spikes, the tendency has been back to “normal” levels of enquiry.

The number of new Investigations opened does not dramatically change notwithstanding the increased number of enquiries being conducted by the Compliance and Surveillance units.



Looking at the number of which actually transition to the investigation stage (the broken red line), until about August last year the trend was for approximately 15% of matters to be escalated to Investigations. Since then, the trend has declined because of:

- the closure of a significant number of the short selling enquiries for which a very small number of matters were escalated to Investigations; and
- the nature of remedial actions by Participants now being taken sooner to address the root cause of issues which reduces the need to escalate matters to the Investigations stage.

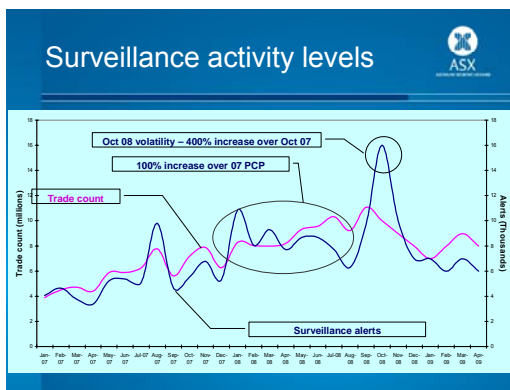
### Surveillance activity levels

I'd like to turn now to our Surveillance function.

Obviously, the surveillance function is the core of our supervision of trading on our markets. It's analogous to a quality control function for the markets we operate. Within the Surveillance function there are essentially 3 stages for the progression of matters, which I will refer to as

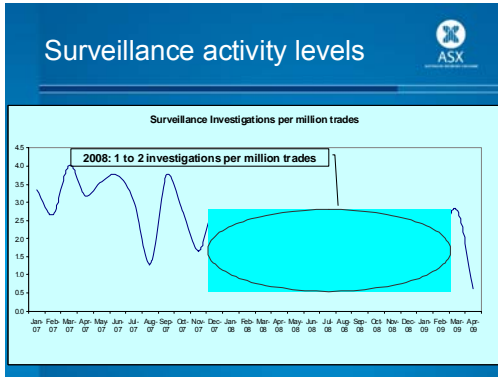
- alerts;
- surveillance investigations; and
- referrals to our Investigations unit and/or ASIC.

An important part of the surveillance function relies upon alerts generated by our systems to identify abnormal trading behaviours. These alerts rely upon analysis of historical price and volume behaviours in every security traded. In times of market volatility, deviations from the historical norms increase, as do the number of alerts generated whilst the system recalibrates to the new trading patterns.



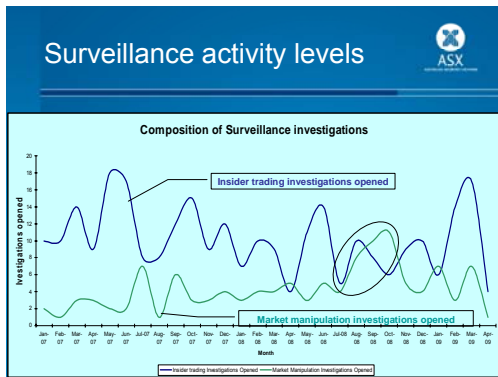
Historically, the number of alerts has tracked the number of trades - until October last year. For most of 2008, the number of trades and the number of trading alerts were about 100% above those of the prior corresponding year. However, in October 2008 the volatility of the market was such that 16,000 alerts were generated for the month, 400% over October 2007. The vast majority of these alerts were readily explainable, primarily as a result of prices moving in line with the general market.

Since then our systems have adjusted to the increased volatility inherent in the current market. As the volatility has reduced somewhat, the level of alerts for aberrant prices and volumes has returned to more normal levels and are again tracking trade count. The fact that the number of alerts has increased is not an indication that the amount of market misconduct has increased. It is an indicator of increased price and volume activity outside the norm.



The next stage is for our Surveillance unit to make enquiries, where warranted, of the broker or listed company.

Looking at the number of surveillance enquiries opened as a result of trade alerts and other indicators, whilst the absolute number of both alerts and investigations into potential insider trading and market manipulation opened has been increasing, the resultant number of surveillance investigations opened per million trades (as shown on the chart) remained consistently in the range of 1.5 – 2.0 investigations per million trades for the 2008 calendar year. There was, however, a bit of a spike in March this year, which I will come to later. The decrease since the 2007 calendar year is explained by better targeting of the matters we make enquiries into.

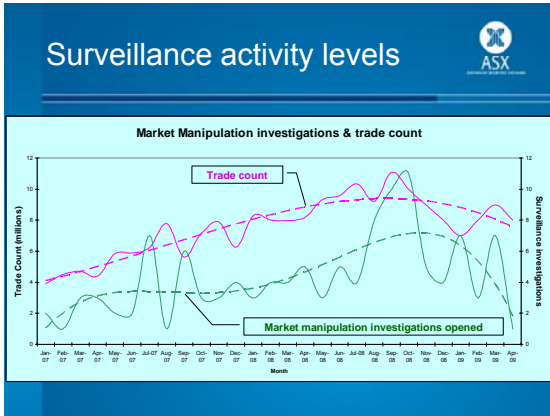


Breaking this down further into the number of insider trading and market manipulation investigations commenced, the first thing that stands out is that, in general, there are more enquiries opened into insider trading than there are into market manipulation.

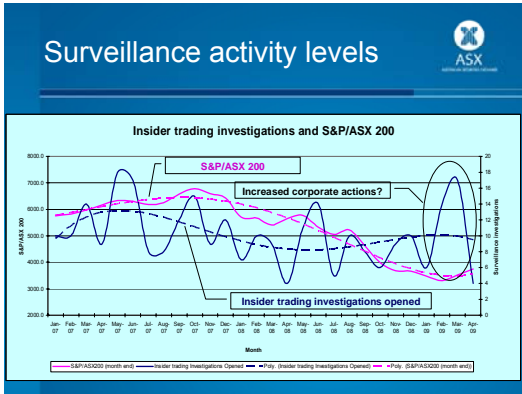
The second thing that stands out is the gradual increase in market manipulation enquiries from January 2008 leading to the significant increase in the period August to October 2008. Many of these matters related to apparent price support enquiries and coincides with the decline in the market and the increase in pressure on margin loans and other financial arrangements.

Since October, the number of market manipulation enquiries has declined and the number of insider trading related enquiries has increased, that increase being quite marked in the January – March period.

The next 2 charts are of interest regarding matters which initiate investigations into market manipulation and insider trading in relation to market conditions.



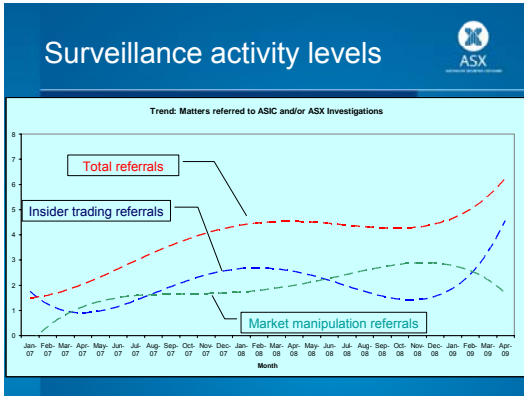
First, market manipulation investigations loosely track the behaviour of trade numbers. This is unusual given the rise of algo trading and the influence it has on trade numbers. Our experience to date suggests that manipulative activity is generally undertaken by way of human order entry rather than algo order entry. So, whilst we can't isolate and exclude algo orders specifically, I could speculate that apparent manipulative activity as a proportion of human entered orders has been on the increase until recently. Again, this would be consistent with our experience to date.



By contrast, insider trading investigations had a loose alignment to the behaviour of the index. In fact, there is an indication of insider trading behaviour marginally leading the index. However, the trend significantly changed from the end of 2008 to March 2009.

What is interesting is the rapid increase in insider trading investigations commenced in the first 3 months of this year, which roughly coincides with the increase in the number and size of capital raisings in the market. That is not to say that there was an actual increase in insider trading, but there was an increase in the indicators of insider trading. I think that is an important distinction to be aware of when commentators comment upon apparent trends in insider trading based upon observed patterns of trading alone.

I need to emphasise that at this point we have distilled down from “alerts” to “indicators which initiate investigations”. The key data is the number of investigations where we have reason to believe there has been a significant breach of our Rules or the Act and which actually result in referrals to our Investigations unit and/or ASIC.



What the broken green and blue lines in this chart indicate is a clear alternating trend between manipulation and insider trading.

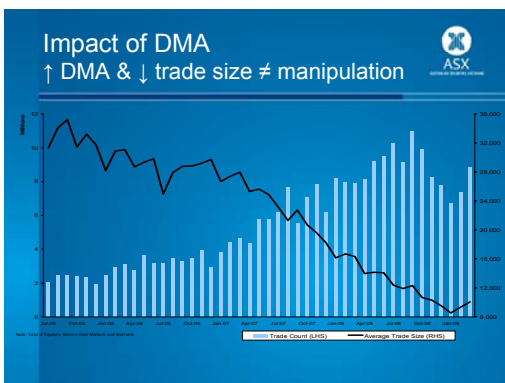
The broken red line represents the aggregate trend, which you will see shows an increase in the number of instances where we have reason to believe there has been a significant breach of our Rules or the Act.

### All IT & MM referrals to ASIC

	Insider Trading	Market Manipulation
2007/2008	25	16
2008/2009 YTD (Jul – Apr)	22	14
2007/2008 PCP (Jul – Apr)	20	15

Isolating the number of referrals to ASIC alone, you will see that the numbers are not dissimilar than for the same period last year, but the number of referrals for both market manipulation and insider trading this year will exceed the last full year's numbers. I'd like to move now to some specific issues.

The impact of DMA



The advent of more algorithms in the market has resulted in the average trade size decreasing noticeably in recent years. Over that time we have also received a significant number of queries from investors and brokers concerning perceived low execution trade sizes in the market. Those making these queries often suggest that low execution trade sizes must constitute market manipulation.

Algorithmic trading is normally unremarkable and has no noticeable impact on the price of liquid stocks. However, in less liquid stocks, you may see small volume orders being submitted to the market which result in small volume trades. This does not necessarily mean that a low execution trade size, even as low as one share, is manipulative for the purposes of the Market Rules. Even repeated one share executions may be part of a broader legitimate algorithmic execution strategy.

ASX's experience indicates that when a client seeks to manipulate a stock, and has a particular motive for doing so, manipulative trading is more likely to be carried out if the client has control of their orders to submit orders to the market manually at the time and price at which they will achieve maximum price impact. Algorithmic trading usually does not allow that given that it is programmed trading.

ASX monitors trading across the markets in both real time and post trade. All likely cases of market manipulation will be investigated.

One indirect impact of DMA we have seen is an increase in the number of disorderly markets initiated by DMA (not algo) orders, rejected by DMA filters to a DTR, being entered by the DTR without proper care and diligence and subsequently having a significant price impact thereby creating a disorderly market. Once the error is made, algos may exacerbate the problem. There are a number of such matters recently and currently before the Tribunal and I'll come to the Tribunal's views in this respect.

We cannot emphasise enough the need for DTRs to take appropriate care when handling rejected DMA orders or when faced with warning messages about the distance of an order from the current market. Disorderly markets will be increasingly harshly dealt with.

The other development we are closely watching is international developments, specifically the IOSCO discussion regarding DMA and the development of enhanced DMA rule frameworks evolving in the USA and currently being considered by the SEC. Our supervisory framework for DMA will be reviewed as a result.

### Impact of "offshoring"



Another emerging issue for us is foreign participation and “offshoring”.

We currently have 2 offshore participants in the market. We have received an increasing number of enquiries about participation by overseas entities as Market Participants in our markets.

We have also had an increasing number of discussions with Participants about “offshoring” some or all of their operations to regional centres such as Hong Kong, Singapore, Mumbai, etc.

Both of these present a new range of new opportunities to increase liquidity in the market or increase operational efficiency making the market more attractive.

They also present a number of challenges from a supervision perspective. These include such issues as exemptions from the requirement to hold an AFSL whilst many of our rules are predicated on the Participant holding an AFSL and access to operations for supervision purposes. These are challenges which we are currently working through.


I think it also presents a challenge to the stockbroking industry. It is unfortunate that whilst it is desirable to make Australia a regional financial centre, operations are moving offshore. We may also see an experience and knowledge drain over the next few years, especially in back office operations, which will potentially diminish the availability of quality and knowledgeable people available to the industry when the market next takes off. It also has potential to further shrink the local profession. Retention is something SDIA needs to give thought to.

#### Messages from disciplinary determinations

Over the last 12 months there have been some significant views expressed by the Tribunals on a range of matters. I'd like to take the opportunity to recap on some of the key messages from the Tribunals.

There continues to be a perception in some quarters that disciplinary circulars set out the views of ASX Management. This is not the case. The views expressed in disciplinary circulars are the views of the Tribunals, comprising experienced industry practitioners having taken into account the facts of the matter, the views of the parties and their own expectations of industry practice and appropriate standards of conduct in the market.


On issues regarding the importance of some rules their views will coincide with the views of ASX Management. After all, if ASXMS did not think a rule was important it would not take the matter forward in the first place - another outcome may well be appropriate.



Messages from disciplinary determinations: capital

- ... the Risk Based Capital Requirements are a fundamental aspect of ASX's prudential regulation of its Participants. The failure to comply with those requirements has the potential to adversely affect the financial stability of Participants, the financial security of clients, and the integrity of the market. Accordingly, the Tribunal views breaches of the Risk Based Capital Requirements as a matter of serious concern.

We have seen a number of capital breaches over the last 12 months. On a number of occasions the Tribunal has reinforced that the risk based capital requirements are a fundamental aspect of ASX's prudential regulation and that breaches are a matter of serious concern, especially in times of market volatility.

Messages from disciplinary determinations: T+3 settlement 

- ... the strict obligation imposed upon Trading Participants to settle each market transaction to which they were a party on the third Business Day following the date that the transaction was created on or reported to the market, is a fundamental and core measure for ensuring the efficiency and integrity of the system for the settlement of market transactions.
- ...the Tribunal is mindful of the fact that Market Participants should expect that penalties for non-compliance with ASX Market Rule 5.7.3 ... will be substantial.

We have also seen a number of determinations in relation to T+3 settlement issues. Whilst we would expect the number of T+3 matters proceeding to the Tribunal to diminish now that the mandatory close-out arrangements are in place, the Tribunal's view is aligned with that of ASX that the obligation to settle by T+3 is a fundamental and core measure for ensuring the efficiency and integrity of the settlement system.

It is the Tribunal's view that Market Participants should expect penalties for non-compliance with the T+3 obligation will be substantial.

Messages from disciplinary determinations: confirmations 

- ... the timely sending of confirmations to clients is a fundamental client protection safeguard against possible unauthorised trading activity .... any failure to comply with the confirmation requirements under the Rules has the potential to adversely affect the financial security of clients and the integrity of the market.

Issues relating to despatch of confirmations are not ones we see all that frequently any more. But once again, the Tribunal has confirmed its view that the timely sending of confirmations to clients is a fundamental client protection safeguard.

## Messages from disciplinary determinations: order records



- ... The purpose and objective of ASX Market Rule 4.10.1 is to place a strict onus and obligation upon Market Participants to maintain and ensure accurate records of dealings for clients. The Rule is of fundamental importance and serves to both protect trading participants in circumstances of dispute, and to enable the ASX to properly perform its regulatory role including the conduct of inquiries and investigations. The failure to maintain sufficient order records has the potential to adversely affect the integrity of the markets that ASX operates.

It wouldn't be an SDIA conference if I didn't mention order records and I am not going to miss the opportunity this time.

Once again, the Tribunal has quite strongly re-iterated the fundamental importance of the maintenance of accurate order records. Order records are a key issue for us in our supervision of the markets and the Tribunal has recognised this and how the failure to maintain order records can adversely impact on the integrity of the markets.

## Messages from disciplinary determinations: responsibility



- ... Market Participants have a privileged role in the market, and it is the vulnerability of those without those rights that the Rules seek to protect.
- The Tribunal notes that ASX Market Rule 13.3.1 covers a Trading Participant's responsibility for the accuracy, the integrity and bona fides of all orders entered into the market, and a Trading Participant's responsibility to ensure the efficiency and integrity of the markets and the proper functioning of the Trading Platforms.

During the last 12 months the Tribunal has come out with some strong statements on the responsibility of market participants to ensure the efficiency and integrity of the market.

The Tribunal has clearly expressed the privileged role that Market Participants have in being able to access the market, a privilege which others in the community do not have. That privilege carries with it responsibilities to comply with rules which are designed to protect the interests of those who do not have the benefit of that privilege.

The Tribunal has expressed a strong view on the market "gatekeeper" role of Participants by explicitly conveying the responsibility of Participants to ensure the efficiency and integrity of the markets.

## Messages from disciplinary determinations: orderly markets



- ... the onus and strict obligations imposed and placed upon Participants under ASX Market Rule 14.1.1 which requires that Participants must not do anything which results in a market for a Product not being both fair and orderly

Another aspect of responsibility on which the Tribunal has expressed a strong view is in relation to orderly markets, where the Tribunal has drawn attention to the “onus and strict obligation” to not do anything which results in a market not being both fair and orderly.

We had a number of instances of disorderly markets and in a number of these the role of the DTR was brought into focus.

## Messages from disciplinary determinations: DTRs



- ... the requirement that Trading Messages be entered into the Trading Platform by DTRs (in the absence of trading conducted in accordance with automated order processing requirements) is a critical and important measure for maintaining the integrity of the market and facilitating the conduct of an orderly market.
- ... importance of the role of a DTR in reviewing and preventing the entry of orders into the trading platform that could result in a market that is not both fair and orderly.

The Tribunal has highlighted the critical and important role that DTRs play in the maintenance of the integrity and orderliness of the market. So when an instance of a disorderly market arises, the focus immediately switches to the broker’s primary obligation to not do anything which results in a market not being both fair and orderly; the internal controls; the operation of filters to prevent an occurrence; and the role of the DTR in creating that disorderly market.

## Messages from disciplinary determinations: AOP



- In an AOP environment, filters provide the principle means by which each order is checked to ensure compliance with the ASX Market Rules requirements. Filters should be enabled at all times, to detect erroneous orders and monitor trading that may be deemed manipulative.

Whilst on the subject of filters, the Tribunal has reminded the market that AOP filters should be enabled “at all times” to detect erroneous orders and monitor trading that may be manipulative.

## Messages from disciplinary determinations: manipulation



- ... The requirement to prevent manipulative trading is imperative to maintain a fair and orderly market. Deliberate attempts to interfere with the free and fair operation of the market to create artificial, false or misleading appearances with respect to the price of, or market for, a security is considered by the Tribunal to be a Very Serious Contravention of the ASX Market Rules. Manipulative trading directly affects the reputation of the ASX and the integrity of the markets it operates.

This leads into the issue of manipulation.

In what has been a very strong message from the Tribunal which sends a clear message on how it will approach matters of market manipulation in future, the Tribunal has stated that the requirement to prevent manipulation is “imperative”.

It has also re-iterated that manipulation is a Very Serious Contravention. Under the Disciplinary Rules introduced last year, a Very Serious Contravention ordinarily carries a penalty in the range of \$100,000 to \$1,000,000.

## Messages from disciplinary determinations: put on notice



- ... unprofessional conduct because it did not respond adequately when ASX Surveillance first brought the ... transactions to its attention

If I go back to what I said at the beginning, we would rather prevent and remediate issues rather than pursue disciplinary action. In a wide range of instances, when our Surveillance function identifies some aberrant trading, it will bring that to the notice of the participant involved as early as possible.

The Tribunal has recently expressed its view on the importance of that early warning. In a recent matter it found that an element of unprofessional conduct is a failure to adequately respond once that behaviour is brought to attention by Surveillance.

Our position and, (I believe) that of the Tribunal, is that breaches should not happen in the first place. When there continues to be contraventions after notification by ASX it is no excuse to say that those contraventions were fewer. In the eyes of the Tribunal, a single breach can be more significant (in the sense of being large or weighty) once notice is given by Surveillance.

From our perspective, this reinforces the importance of acknowledging, investigating and acting on those "heads up" calls from Surveillance. If anyone has any doubts about what constitutes manipulation, what the indicators are and what enquiries should be made I strongly recommend getting along to a training session, such as those currently being run by SDIA.

## Messages from disciplinary determinations: management




- ... unprofessional conduct because it ... did not have appropriate management structures to ensure that it had operations and processes in place that were reasonably designed and implemented and functioned so as to achieve compliance with ASX Market Rules.

For some time, we have been focussing on and drawing Participant's attention to the importance of appropriate and demonstrable management and supervision. For the first time the Tribunal has expressed a view on the issue.

In a recent matter it found that an element of unprofessional conduct is failure to have appropriate management structures to ensure operations that are "designed, implemented and functioning" so as to achieve compliance. Whilst in this case this was an element of unprofessional conduct, it should be noted that failure to have appropriate management structures to ensure operations that are "designed, implemented and functioning" so as to achieve compliance is a breach of Market Rule 3.6 in its own right.

Our view and, (I believe) that of the Tribunal, is that once a breach is identified, it is not an appropriate response to say that from that point forward a downward trend of contraventions indicates that changes to management systems work. Management systems work when contraventions stop. Until that time they clearly do not. Again, when there continue to be contraventions it is no excuse to say that those contraventions were fewer.

It is not a defence to say that management was ignorant of a non-compliance issue. If management is ignorant of a problem then it clearly does not have in place operations and processes that are reasonably "designed, implemented, and functioning" so as to achieve compliance with the Rules.



Messages from disciplinary determinations: penalties

- The ASX Market Rules are intended to reflect the high standards of commercial probity that are expected of licensed Market Participants. Participants are in a position to influence the operation of the market. Their responsibilities to the ASX and the market are significant. They should expect that contraventions involving any dishonesty, lack of probity or unprofessional conduct will result in very substantial penalties.

Finally, on penalties, the Appeals Tribunal has sent a very clear message on the role and scope of penalties. It reflected the expectation that Market Participants exhibit high standards of commercial probity and that they have significant responsibilities to the market. In a very clear message on penalties it stated that contraventions involving any dishonesty, lack of probity or unprofessional conduct will result in very substantial penalties. In general, contraventions of this type will be in the \$100,000+ range.

## Messages from disciplinary determinations: penalties



- First, the penalty should constitute a real punishment proportionate to the deliberation, or degree of recklessness, with which the contravention occurred. A “punishment”, by definition, involves pain or loss.
- Second, the penalty should have a deterrent quality. It should be set at a level that is capable of influencing, and is genuinely intended to influence, the conduct of other Participants.

The Appeals Tribunal further expanded on its view on the purpose of penalties to be imposed.

First, the penalty should constitute a real punishment proportionate to the deliberation. A punishment, by definition, involves pain or loss.

Second, the penalty should have a deterrent effect genuinely intended to influence the conduct of others.

This represents a significant hardening of the position of the Tribunal in relation to ascribing of penalties to breaches of the various Operating Rules. The clear message coming from the Tribunals is a declining tolerance for breaches of the rules and increased penalties designed to deter others from future breaches and to reinforce the integrity of the markets.

### Priorities

It won't be a surprise that many of the matters I have referred to in the context of Tribunal outcomes align with our current supervisory priorities.

## Priorities



- Disorderly Markets (ASXMR 14.1)
- Market Manipulation (ASXMR 13.4)
- Management and Supervision (ASXMR 3.6 and ACHCR 4.8)
- Unprofessional Conduct (ASXMR 4.1.1(w))
- T+3 Settlement Failure (ASXMR 5.7)

Our key focus areas at present and going forward will be:

- Disorderly Markets
- Market Manipulation

- Management and Supervision
- Unprofessional Conduct
- T+3 Settlement Failure

As previously mentioned, I expect that the incidence of T+3 breaches will now decline.

I haven't included insider trading in the list as, from an enforcement perspective, it is not within our domain. However, identification of it will continue to be a priority for our Surveillance unit.

Our priorities and the messages from the Tribunals are all directed at market integrity. After all, the integrity of the markets is key to the rebuilding of investor confidence. The rebuilding of investor confidence is key to the emergence of the next bull market and the emergence of the next bull market is key to the return of a prosperous stockbroking industry.

Thank you