



**ASIC**

Australian Securities & Investments Commission

# ASIC's agenda for market integrity

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## Introduction

Much has changed in the law, regulation and our public trading markets over the years. The recent volatility in global markets over the last few weeks, high frequency trading, dark pools, competing exchanges are all indicators of the current pace of change. However, despite these changes the fundamental aim of ASIC's market regulation remains the same—that is, to ensure investors can be confident our public trading markets are fair and efficient.

In doing so, ASIC activities in relation to the public trading markets focus upon ensuring three key outcomes:

- the market infrastructure is robust;
- trading, clearing and settlement of transactions are orderly and efficient; and
- opportunities for market misconduct are kept to a minimum.<sup>2</sup>

## ASIC's market outcomes

Today, I will make some brief comments on ASIC's current market agenda. I will focus primarily on the third of these outcomes: what ASIC is doing to deter market misconduct. This is not to suggest the other two outcomes are less important for ASIC. In fact, in the lead up to competition between market operators and in light of the US 'flash crash', market structure issues are occupying considerable ASIC resources and effort. These market structure issues involve some very challenging public policy considerations and trade-offs between short- term and medium-term outcomes with a wide array of diverse commercial interests of market participants involved.

However, today my focus will largely be on market misconduct as ASIC's work on market structure is deserving of a separate stand-alone discussion.

## Overview of changes in regulatory structure

Before I talk about ASIC activities in this area, it is important to note the fundamental transformation that has taken place in the regulatory framework and structure of the markets over the last few years. ASIC adopted a deliberate strategy of trying to make the transfer 'business as usual' for participants to minimise disruption. It may be that we were too successful—as I am not sure the full extent of the work involved in the transfer or potential impact of these changes is generally well appreciated.

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<sup>2</sup> This is from a useful formulation by the Financial Services Authority (FSA) in the UK in relation to its credible deterrence approach in recent years.

The most notable change in the regulatory structure has been the transfer of market supervision from ASX to ASIC. On 24 August 2009, the Australian Government announced its decision to transfer the responsibility for supervision of certain domestic licensed financial markets from market operators to ASIC. Responsibility for market surveillance shifted to ASIC just over 12 months ago on 1 August 2010.

The Government's decision to transfer supervision to ASIC was designed to create a single whole-of-market supervisor, and in doing so, to streamline supervision and enforcement by enabling the complete supervision of trading on domestic licensed financial markets within one regulatory body. The transfer of responsibility for market supervision from individual market operators to ASIC was also an important first step in facilitating the Government's policy of creating competition between Australia's licensed equity markets.

ASIC has taken on significant additional responsibilities following the transfer of supervision including:

- undertaking real-time market surveillance and post-trade analysis to detect market misconduct (i.e. breaches of the market integrity rules and the *Corporations Act 2001* (Corporations Act));
- monitoring of compliance with the market integrity rules by regulated entities; and
- administering the disciplinary framework for breaches of the market integrity rules (including the creation of a Markets Disciplinary Panel, enforceable undertakings and infringement notices).

The implementation of these policy changes involved considerable background work by ASIC. In order to assume these additional responsibilities, ASIC had to:

- implement an integrated market surveillance system;
- develop and implement market integrity rules across the different domestic licensed financial markets;
- develop a streamlined markets analysis methodology and regulatory compliance relationship management model;
- build a market and participant supervision team (including integration of ASX surveillance staff members who were transferred to ASIC); and
- establish an independent Markets Disciplinary Panel.

In addition, on 31 March 2010, the Australian Government also formally announced its support for competition between markets for trading in listed shares in Australia (market competition). On 29 April 2011, ASIC published market integrity rules to provide the framework for the introduction of competition in equity exchange markets and market integrity rules specifically for the market operated by Chi-X Australia Pty Ltd (Chi-X). These market integrity rules take effect on 31 October 2011.

On 4 May 2011, following detailed review of the application by ASIC, the Minister granted Chi-X an Australian market licence under s795B(1) of the Corporations Act, subject to Chi-X meeting a number of licence pre-conditions.

ASIC is now well and truly into the implementation stage with Chi-X due to commence operations sometime after 31 October this year. As you will appreciate from the quick run through above of the work involved, the last couple of years have been an extremely busy time for ASIC markets staff and market participants as we transition to the new regulatory regime.

## Changing market structure

There are also fundamental shifts occurring in the structure and operation of equity and derivative trading markets around the world. The traditional exchange monopolies are breaking down with competition between multiple, diverse and often fragmented trading venues. The public equity and derivatives markets are now overwhelmingly electronic and automated. This has opened the door for new types of market participants with innovative trading strategies, including so called high frequency traders. Technology is fundamentally reshaping our markets by increasing the speed, capabilities and reach of trading for market operators and market participants.

This is all a bit abstract for those not involved day-to-day in trading on the markets. So let me attempt to try to make a bit more concrete by providing a few illustrations.

### Speed of trading

One key indicator is that the speed of trading continues to increase dramatically. ASX's latest trading engine is capable of processing one trade every 300 microseconds compared to one trade every 10 milliseconds in 2010. Some overseas markets are capable of trading at 250 microseconds and the latest discussion in some IT circles is about trading in nanoseconds.<sup>3</sup>

This means issues such as latency (the time delay in a message being transmitted), co-location of participants' computers with those of the trading system and accurate clock synchronisation take on new importance. For those who witnessed the hurly, burly of the trading floor, everything seemed to take place at speed. However, by today's standards, transactions were concluded at a relatively leisurely pace.

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<sup>3</sup>A nanosecond (ns) is one billionth of a second ( $10^{-9}$  s). That is, a nanosecond is to one second as one second is to 31.7 years. (Source: Wikipedia).

For example, on the trading floor, tickets were physically time stamped. Today, our market integrity rules require trading operators and participants to synchronise their clocks to a specified accuracy.<sup>4</sup> This is for consistent and accurate 'time-stamping' of trades essential for ensuring consistent time and price priority across multiple venues and also to enable us to reconstruct the trading history for supervision and investigation purposes.

Our current tolerance is +/- 20 milliseconds based on Co-ordinated Universal Time (UTC) maintained by the National Measurement Institute (NMI). This is a relatively generous tolerance and we anticipate as the speed of trading increases, we will have to adjust accordingly.

### **Trading capability**

Trading systems are now capable of generating large numbers of trading messages in search of trading opportunities. A simple indicator of the extent of these changes is the number of messages per trade. Currently in Australia, there are on average seven messages per trade compared to four messages per trade in 2007. However, we can see the direction of change based on the dramatic increases in message rates overseas. In Canada and the US, the message rate per trade is now around 100 messages per trade, with peaks of 250 messages per trade.

This vast increase in number of messages poses technical challenges for operators, participants and also the systems regulators need for market surveillance. For ASIC, this means we will need to continue to upgrade the processing capabilities of our surveillance systems.

### **Increase in trading reach**

Finally, the *reach* of trading has increased dramatically. Trading is now global. Many institutions have sophisticated order entry and management systems that can directly connect to the trading engine of the market operator. Increasingly, markets participants permit clients to have direct market access (DMA).

As a regulatory matter, ASIC does not allow naked or unfiltered direct access to our markets by customers. Under our rules, we hold the regulated market participant responsible for all trades put through to the market, whether by means of DMA technology or otherwise. Accordingly, market participants are required to have appropriate controls to ensure trading by their customers does not involve market misconduct and all trading is conducted in accordance with market rules. As part of ASIC's review of market participants, we periodically check the adequacy of these controls.

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<sup>4</sup> See, for example, Rule 6.3.1 of the ASIC Market Integrity Rules (ASX Market) 2010.

## Technology driving changes

Fundamentally, technology is driving these changes in our public market structures.

When you think about it, most of us today carry hand phones capable of searching through a million documents in a few seconds; locating, sorting and then advising on restaurants by type, location, review and other criteria; scanning a barcode in a shop to provide a best price comparison with similar goods locally or even globally; or being able to locate goods and services and purchase them all with a few keystroke entries. If you buy or sell goods on eBay, you will be familiar with the ability to use so-called 'bots' to bid for you, based on specified time and price criteria.

So it should come as no surprise that market operators and participants are seeking to harness the speed, information processing and decision-making capabilities of this new technology in search of profitable trading opportunities. In some ways, despite the ambivalence sometimes seen in the media about these developments, the public trading markets seem to me to be in catch-up mode to developments in other areas. Accordingly, I consider the changes in the public trading markets driven by information technology will only accelerate over the next few years.

## ASIC's deterrence activity

Let me turn to what ASIC is doing in deterring market misconduct, given our continuing and new responsibilities and the changes in our markets. Despite all these changes, credible deterrence remains at the heart of the ASIC market agenda.

ASIC continues to consider effective deterrence a key strategy in reducing the incentives for, and incidence of, market misconduct. While most public and media attention is focused on the matters ASIC brings before the courts or the Markets Disciplinary Panel, this represents only a subset of the range of deterrence activities ASIC undertakes.

In summary, the focus of our deterrence activities is threefold:

- ensuring that market participants have controls in accordance with the required standards;
- supervising markets and market participants to detect market misconduct quickly; and
- conducting timely investigations of market and market participant misconduct, leading to appropriate penalties.<sup>5</sup>

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<sup>5</sup> ASIC publishes a six-monthly report on its market supervision activities that details ASIC's activities in each of these areas. ASIC published its second report in July 2011: see *ASIC supervision of markets and participants: January to June 2011* (REP 243) at [www.asic.gov.au/reports](http://www.asic.gov.au/reports).

## Participant controls

Market participants play an important gatekeeper role in preventing misconduct. ASIC establishes the standards of conduct the law requires and we monitor, by means of participant inspection and other supervision work, the adequacy of the controls and compliance procedures of market participants.

We are currently formalising a requirement for participants to report to ASIC suspected market misconduct. This supplements the current suspicious transaction reporting obligation for anti-money laundering purposes. The new obligation is consistent with the requirements in other major jurisdictions, such as the UK, where early identification and reporting of suspected market misconduct by market participants has proved to be an important source of investigations by the regulators. We are also working with participants on the standards of testing for new trading algorithms, to ensure they are fit-for-purpose before they begin trading, and on the filters they need to allow trade access by other participants through their systems.

## Real-time surveillance

ASIC also undertakes real-time surveillance of trading using a system integrated with the markets to ensure timely detection of potential misconduct. In a six-month period, the surveillance system produces more than 20,000 alerts. In the period 1 January to 30 June 2011, this led to 121 preliminary inquiries, with 35 of these subsequently referred to the ASIC market integrity team for investigation. Since 30 June 2011, there have been another five matters referred to Deterrence for formal investigation.

We continue to refine our surveillance system alerts (referred to as 'calibration') so that the conversion rate between alerts and matters identified for further follow-up by ASIC review teams is improved. This is to eliminate too many 'false positive' alerts that can be explained by general market developments. We are also seeing some good early results in the speed with which matters identified by our market surveillance team are assessed and referred to our Deterrence staff for formal investigation.

A recent example is the matter involving Mr Justin O'Brien who on 19 July 2011 pleaded guilty in the Downing Centre Local Court to four charges of insider trading. The alleged trading was identified by ASIC's Market Surveillance team in mid-January 2011. The charges arose out of an investigation commenced by ASIC in February 2011.

## Early intervention

ASIC also takes early remedial and pre-emptive action to prevent more serious issues arising. For example, from 1 January to 30 June 2011, ASIC took remedial or pre-emptive action in 22 cases. This action included identifying problematic algorithms and mispriced exchange-traded funds, which may indicate the absence of appropriate filters to prevent potentially anomalous trades being entered into the market.

## Deterrence outcomes

This combination of more speedy referrals to Deterrence and regular routine proactive queries when we notice some unusual trading are intended to send a clear message about ASIC having a very active and visible market presence. As part of the strategy to reduce the incidence of market misconduct, we want to send a clear message that 'if you engage in market misconduct, you will be detected and ASIC will take action'. This is all about ensuring that ASIC as the real-time market supervisor is seen as the very visible 'cop on the beat'.

In summary, the enforcement outcomes achieved by ASIC over the period 1 July 2009 to 30 June 2011 are as follows:<sup>6</sup>

- **8 *bannings***: Eight advisers were banned from providing financial services for periods ranging from three to seven years.
- **7 *insider trading verdicts and judgements***: These include individuals who have pleaded guilty to insider trading where sentences have not yet been handed down (two matters), and sentences of up to four years and six months imprisonment.
- **3 *continuous disclosure infringement notices***: Three infringement notices were issued, one for \$33,000, one for \$66,000 and one for \$100,000.
- **3 *other sanctions***: A pecuniary penalty was imposed for misleading and deceptive conduct by a director, and 200 hours community service, a \$5000 fine for providing false and misleading information to ASX and an enforceable undertaking requiring a company to engage an independent external consultant to review its financial reporting and disclosure systems.
- **4 *market manipulation verdicts and judgements***: The outcomes include pecuniary penalties up to \$80,000 and jail sentences for up to 22 months upon being found guilty of market manipulation by the court.

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<sup>6</sup> See also the summary table in the appendix to this speech.

There are also another eight matters before the courts. ASIC continues to be very active in bringing enforcement action to send a general deterrence message as to the seriousness with which we regard insider trading and market manipulation. These activities damage investor confidence in a fair and efficient market.

### **Some practical deterrence challenges**

While we will continue to strongly focus on market integrity in our deterrence activity, ASIC continues to face a number of practical challenges in bringing successful enforcement actions. Let me mention a couple of current challenges and then move on to discuss some emerging issues.

### **Expert evidence**

We continue to face difficulties in obtaining expert evidence in market misconduct prosecutions. As a practical matter, expert evidence is almost always required for insider trading and market manipulation matters to be able demonstrate, for instance, that the information in question would have reasonably influenced common investors to acquire or dispose of financial products under s1042D. ASIC continues to struggle to identify willing and suitably qualified experts. The courts seem to prefer market practitioners rather than those from *academe*, which further limits the available pool of experts given potential conflicts that arise for many market participants.

In addition, not many practitioners relish the prospect of vigorous cross-examination by counsel in such cases. Doing so may not be a reputation-enhancing experience. The task of giving evidence is not made easier by the fact that they are often asked to give opinion evidence as to a hypothetical enquiry—that being whether the information in question would or would likely influence common investors to acquire or dispose of financial products. For insider trading prosecutions, given the ‘common investors influence test’, this is the only way in which materiality can be established. Getting good expert witnesses remains a very challenging area for ASIC.

As a further matter that illustrates the way in which changes in market structure are playing out in other areas, there are also issues around the meaning of ‘common investors’ that experts need to address. Who are ‘common investors’ or are there different classes of common investors? To date, the approach seems to have focused on ‘retail investors’, which makes sense in the context of a single trading venue and liquidity pool on ASX’s TradeMatch. However, when market operators, and increasingly participants themselves, offer different specialist venues catering for specific classes of investors such as high frequency traders, algorithmic traders and institutional investors, the issue of what is meant by a ‘common investor’ for those venues may need to be more explicitly addressed by expert evidence.

## Access to telephone intercepts

Much has been made in the media of new powers for ASIC to undertake telephone intercepts in market misconduct cases under the amendments in *Corporations Amendment (No 1) Act 2010* amending the *Telecommunications (Interception and Access) Act 1979*. However, it is important to note that ASIC is not an 'interception agency' for the purposes of this legislation. While ASIC is able to request an intercept agency (for example, the Australian Federal Police) to conduct an intercept, this information can then only be used by that agency for the purposes of its own investigation.

Accordingly, ASIC is not able to directly intercept telecommunications or ask another agency to do so on our behalf. We are also not able to receive or use interception evidence obtained by other agencies for the purposes of ASIC's own investigations. While there may be a public perception that ASIC now has extensive new powers in this area, as a practical matter, the current provisions are of limited usefulness to ASIC in its deterrence activity.

A number of high profile cases in the US have shown that 'wire tap' evidence has been essential to establish to the required level of proof both about the source and passing of inside information. In the absence of such clear and direct evidence of the conversations in which the inside information was deliberately and systematically passed, it seems doubtful whether the prosecutions would have succeeded, given the 'mosaic of available' information defense used by defendants.

## Impact of technology

Turning now to some emerging issues, I mentioned earlier the way technology was transforming trading on the public markets. Trading systems are now capable of generating thousands of orders per second across multiple venues. The challenge for regulators is to ensure both our understanding of market practices and capabilities of our systems to detect misconduct keep up. Regulators around the world are very actively looking at how the capabilities of technology may be used to facilitate new forms of market misconduct.

Some of the more common trading strategies regulators are reviewing in a number of jurisdictions include:

- ***Ping orders***—entry of small orders aimed at triggering a reaction by other participants in order to gain information about their positions and expectations;
- ***Quote stuffing***—entry of small variations in position in the order book so as to create uncertainty for other participants, slow down the order process and hide their own strategy;

- ***Momentum ignition***—entry of aggressive orders so as to start or exacerbate a trend, hoping for other trend followers to bring the trend further and then enable the trader to unwind their own position at a profit; and
- ***Layering and spoofing***—submitting multiple orders at different prices on one side of the order book slightly away from the touch, then submitting an order to the other side of the order book (which reflects the true intention to trade) and following the execution of the latter, rapidly removing the multiple initial orders from the book.

ASIC is also actively looking into these issues. We consulted on the impact of changes in technology on potential market misconduct in November 2010<sup>7</sup> and we propose to do so again in the third quarter of this year. ASIC's current view is that the relevant corporations provisions apply, where relevant, to the conduct irrespective of the technology used. However, the challenge will be in detecting and proving in court that an offence has been committed to the standard required by the legislation.

To illustrate, let me give some examples of the types of trading strategies the new technology can facilitate. In many ways, these are your traditional market misconduct practices dressed up in new form.

One example is the use of an algorithm that generates very short-term orders that are rapidly cancelled, designed to trigger a response by another algorithm programmed to respond to specific price or volume movements. In a sense, the aim is to provoke the other computers into a specific response. This strategy is more likely in less liquid stocks.<sup>8</sup> This is the modern version of the age-old practice of 'spoofing'.

Another traditional technique being reinvented in new form by use of the new technology is so called 'layering'.

In November 2010, the Financial Industry Regulatory Authority (FINRA) in the US took disciplinary action against Trillium Brokerage Services LLC, its Director of Trading, Chief Compliance Office and nine traders, fining them a total of US\$2.26 million for using an illicit high-frequency trading strategy. FINRA described the conduct as the entering of numerous layered, non-bona fide market moving orders to generate selling or buying interest in specific stocks. The strategy induced other traders (and algorithms) to execute against limit orders previously entered by Trillium traders, who would then cancel the orders entered to create the appearance of trading. This resulted in Trillium getting better prices on 46,000 occasions.<sup>9</sup>

<sup>7</sup> See Consultation Paper 145 *Australian equity market structure: Proposals* (CP 145) at [www.asic.gov.au/cp](http://www.asic.gov.au/cp).

<sup>8</sup> O'Hara, M., 2010, 'What is a quote?' *Journal of Trading*, Vol.5 (2).

<sup>9</sup> Disciplinary actions reported by FINRA, November 2010, pp. 43–44.

A number of overseas regulators have recently provided guidance to the market on these issues. For example, in August 2009, the Financial Services Authority (FSA) in the UK provided guidance to the market about 'layering and spoofing'<sup>10</sup>. It described the following types of potential abusive behavior:

- layering the order book, in which multiple orders are submitted at different prices on one side of the order book slightly away from the touch;
- submitting an order to the other side of the order book (which reflected the client's true intention to trade); and
- following the execution of the latter order, rapidly removing the multiple orders from the book.

The FSA expressed its concern that such behavior may give a false and misleading impression about the supply and demand for securities and constitute market abuse (manipulating transactions) under s118(5) or market abuse (misleading behavior/distortion) under s118(8) of the *Financial Services and Markets Act 2000*.

In September, ASIC proposes to consult on whether some further guidance on the issues of 'layering', 'spoofing' and forms of abusive quote stuffing would be useful to clarify what kinds of behavior ASIC might regard as contravening the market integrity rules or relevant market misconduct provisions of the law.

Finding ways to present matters in court involving highly sophisticated trading strategies and large numbers of transactions in very short periods of time will also prove very challenging for prosecutors in Australia and overseas.

## Handling confidential information

Another issue on ASIC's radar is continuing concerns about the handling of confidential information. In ASIC's market supervision report for January to June 2011, we noted an increase in referrals to our Deterrence team relating to potential misuse of confidential information by persons employed by companies that provide advice on mergers and acquisitions and other significant corporate transactions.<sup>11</sup> This covered organisations such as investment banks, consultancy and other firms that are privy to confidential information before transactions are publicly announced.

One of these was the action relating to Mr O'Brien, mentioned earlier, a former Director of Business Development of the strategic shareholder consulting services company, Georgeson, who pleaded guilty to four charges of insider trading. The charges related to the purchase of shares by Mr O'Brien in four separate ASX-listed companies (North Queensland Metals Limited, Westfield Group, Crane Group Limited and RP Data Limited) between 30 June 2010 and 11 January 2011.

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<sup>10</sup> FSA, Market Watch, Issue No.33, August 2009.

<sup>11</sup> See REP 243 at [www.asic.gov.au/reports](http://www.asic.gov.au/reports).

ASIC alleges that, at the time Mr O'Brien acquired the shares, he possessed inside information he obtained in the course of his employment concerning major corporate transactions relating to each of the companies that were subsequently announced to the market.

ASIC considers there is room for advisers to improve their practices in handling confidential information. Chartered Secretaries Australia and the Australasian Investor Relations Association have in the last 12 months published principles of good practice for issuers (listed companies). Currently, there is no similar guidance on common good practice standards for the professional advisers advising on such transactions.

This is a clear gap which ASIC considers should be filled. In keeping with ASIC's focus on the important role of gatekeepers in our regulatory system, we consider this is an area the industry should take steps to address in the near term. In the absence of robust industry standards consistent with good international practice, ASIC would need to consider stepping in and issuing some form of guidance to industry on this important topic.

## Conclusion

During this talk, I have outlined some of the fundamental changes in the structure of regulation and markets over the last few years. I have briefly outlined aspects of ASIC's current agenda relating to market misconduct and some of the issues on ASIC's radar.

In concluding, it is important to remind ourselves why fair and efficient markets free from market abuse are important for all of us. Much of the discussion on market regulation tends to be driven by specialists in the area—market operators and traders—based around their particular commercial interests.

However, it is important to remember that the public markets play an important role in allowing listed companies to raise capital to undertake new business activities, and provide a basis for the valuation of entities that underpins a multitude of commercial transactions. As the concerns about the impact of the current volatility of markets highlights, the quality of our public trading markets is also important to the long-term financial security of ordinary Australians via their superannuation funds.

While we have witnessed considerable change over the last few years, I consider we are just at the start of a period of rapid, fundamental change in the structure of our markets. This will be challenging for ASIC, market operators such as the ASX and Chi-X, and market participants (share brokers and certain other entities that offer opportunities to participate in markets) alike as they all seek to adjust to the new realities and new rules of the game.

Thank you.

## Appendix: Outcomes for the period 1 July 2009 to 30 June 2011

Table 1: ASIC's significant market integrity-related outcomes for the period 1 July 2009 to 30 June 2011

| Investigation and deterrence outcomes:<br>Significant market integrity-related outcomes | No.       |
|---|-----------|
| Bannings  | 8         |
| Insider trading verdicts and judgements   | 7         |
| Continuous disclosure infringement notices  | 3         |
| Other sanctions (enforceable undertakings and pecuniary penalties)                      | 3         |
| Market manipulation verdicts and judgements   | 4         |
| <b>Total</b>  | <b>25</b> |