



**ASIC**

Australian Securities & Investments Commission

## REGULATION IMPACT STATEMENT

# Suspicious activity reporting

July 2012

### **About this Regulation Impact Statement**

This Regulation Impact Statement (RIS) addresses ASIC's proposal to create a requirement for market participants to report suspicious trading activity to ASIC.

## What this Regulation Impact Statement is about

- 1 This Regulation Impact Statement (RIS) addresses the regulatory impact of ASIC's proposal to introduce a requirement for market participants to report suspicious trading activity to ASIC.
- 2 This proposal applies to market participants trading in products on the Australian Securities Exchange (ASX) and the Chi-X market.
- 3 In developing our final position, we have considered the regulatory and financial impact of our proposal. We are aiming to strike an appropriate balance between:
  - maintaining, facilitating and improving the performance of the financial system and entities in it;
  - promoting confident and informed participation by investors and consumers in the financial system; and
  - administering the law effectively and with minimal procedural requirements.
- 4 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:
  - the likely compliance costs; and
  - other impacts, costs and benefits.

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## A Introduction

### Background

#### Responsibilities for ensuring market integrity

##### ASIC's responsibilities

- 5 On 1 August 2010, the Government transferred responsibilities for market supervision from ASX to ASIC.
- 6 Following the transfer of supervisory functions from ASX to ASIC, we are now responsible for:
- (a) supervising trading activities through market surveillance; and
  - (b) supervising conduct of business by market participants in relation to Australian domestic licensed financial markets. These participants are subject to the market integrity rules and are directly supervised by ASIC.
- 7 We supervise conduct of business of market participants according to the *Corporations Act 2001* (Corporations Act) and the ASIC market integrity rules. Our approach in making market integrity rules at the time of transfer of supervision was to not change the substance of the pre-existing obligations that applied to market participants of ASX and ASX 24.

##### *How does ASIC supervise trading activities?*

- 8 As part of its responsibility of supervising trading activities, ASIC ensures the integrity of the Australian market by deterring, detecting and disrupting market misconduct—namely, insider trading and market manipulation. This is achieved through both monitoring orders and trades in the market in real time, and analysing orders and trades in the market on a post-trade basis.
- 9 Possible market misconduct matters are currently identified from a number of sources:
- (a) We have a computerised trade surveillance system that alerts us of certain activity, internally developed market monitoring tools, and data feeds from a variety of sources.
  - (b) We receive intelligence or referrals from the public, regulated entities (including market operators), and other government organisations including the Australian Transaction Reports and Analysis Centre (AUSTRAC).<sup>1</sup>

<sup>1</sup> See Report 277 *ASIC supervision of markets and participants: July to December 2011* (REP 277) for more information about ASIC's market and participant supervisory functions.

- 10 If alerts and referrals cannot be explained by normal market activity, preliminary inquiries are conducted. Should preliminary inquiries suggest further work is required, ASIC will use its compulsory powers to conduct formal inquiries of participants, clients, listed entities and corporate and other advisers.

### **Market operators' responsibilities**

- 11 Despite ASIC's new role as the market supervisor, market operators retain some responsibilities to assist in ensuring market integrity. Aside from individual market licence obligations, market operators have obligations under the Corporations Act to ensure that the market is 'fair, orderly and transparent': s792A.
- 12 Market operators also provide intelligence to ASIC through their obligation under s792B to notify ASIC of certain matters, including if they have 'reason to suspect' that a person has committed, is committing, or is about to commit a significant contravention of the Corporations Act.
- 13 ASX continues to be responsible for monitoring its market for compliance of its listed entities with operating rules relating to continuous disclosure.

### **Market participants' responsibilities**

#### *Responsibilities concerning conduct*

- 14 Under the ASIC Market Integrity Rules (ASX Market) 2010<sup>2</sup> and ASIC Market Integrity Rules (Chi-X Australia Market) 2011, market participants continue to have responsibilities to assist in ensuring the integrity of the market. These include:
- (a) to ensure that a market participant does not do anything which results in a market for a financial product not being both fair and orderly (Rule 5.9.1);<sup>3</sup>
  - (b) to consider the circumstances of an order set out in Rule 5.7.2 to prevent the submission of orders that have the effect of, or are likely to have the effect of, creating a false or misleading appearance of active trading or with respect to the market for or price of a financial product (Rule 5.7.1); and
  - (c) to ensure that a market participant's system for automated order processing does not interfere with the efficiency and integrity of the market or the proper functioning of a trading platform (Rule 5.6.1).

<sup>2</sup> These market integrity rules were derived from pre-existing obligations as a result of the transfer of supervision: see paragraph 7.

<sup>3</sup> In this RIS, 'Rule 5.9.1' (for example) refers to a particular rule of the ASIC Market Integrity Rules (ASX Market) 2010 and ASIC Market Integrity Rules (Chi-X Australia Market) 2011.

- 15 A market participant that is an Australian financial services (AFS) licensee<sup>4</sup> has always had obligations under s912A of the Corporations Act to:
- (a) comply with the financial services laws; and
  - (b) take reasonable steps to ensure that its representatives comply with the financial services laws.
- 16 Market participants design and implement processes to achieve compliance with the obligations outlined in paragraphs 14–15, according to the nature of their business. Procedures are typically documented to demonstrate compliance with these regulatory requirements, which ASIC audits from time to time.
- 17 Typically, these processes will include (but are not limited to) ad hoc or continuous monitoring of the orders submitted through the market participant's (manual or electronic) systems to the market. These monitoring systems may generate exception reports where anomalous activity or orders outside certain parameters are detected. In some instances, an order may be rejected before it is submitted to the market.
- 18 Some market participants will also monitor the orders and trades submitted through their systems to mitigate business and reputation risk, although the parameters and specific variables may be different to the monitoring for compliance purposes.

*Providing intelligence to ASIC*

- 19 Market participants are typically the interface between investors and the market. They act as an agent for investors, and are required under legislation to know certain information about the investors that they act on behalf of.<sup>5</sup> This includes:
- (a) collecting and verifying 'know your customer' information and 'ongoing customer due diligence' under the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act); and
  - (b) obligations to make reasonable inquiries of their client before providing advice under the Corporations Act.<sup>6</sup>
- 20 This information, and the information that market participants ordinarily come across through dealing with clients, may provide useful intelligence to ASIC for its surveillance purposes. Some of this intelligence may be required to be reported under anti-money laundering (AML) legislation and the Corporations Act. This is described in the paragraphs below.

<sup>4</sup> Most market participants that deal with clients are AFS licensees. There may be some exemptions for foreign participants.

<sup>5</sup> Some market participants, such as proprietary trading firms, do not deal with clients.

<sup>6</sup> For example, s945A of the Corporations Act requires AFS licensees to make reasonable inquiries in relation to the personal circumstances of a client when providing advice to the client. Most market participants that deal with clients are AFS licensees—however, there may be some exemptions for foreign participants.

*Suspicious matter reporting to AUSTRAC*

- 21 Market participants have suspicious matter reporting obligations under AML legislation. All market participants that deal in securities on an agency basis are ‘reporting entities’ as defined in the AML/CTF Act, and thereby have a reporting obligation under s41 of the AML/CTF Act. A suspicious matter reporting obligation arises if a reporting entity ‘suspects on reasonable grounds’ any of the matters specified under s41(1), including that information they have may be relevant to the investigation or prosecution of a person for an offence against a Commonwealth, state or territory law (in this RIS, ‘information in relation to an offence’).<sup>7</sup> Section 16 of the *Financial Transaction Reports Act 1988* (FTR Act) imposes a similar obligation on ‘cash dealers’, capturing transactions of proprietary trading activities.<sup>8</sup>
- 22 The phrase ‘suspects on reasonable grounds’ indicates that the test is both subjective and objective. That is, the reporting entity must have a real suspicion of the information in relation to an offence, and the suspicion must be based on matters of evidence that support the truth of the suspicion.<sup>9</sup>
- 23 Market participants with a suspicious matter reporting obligation must submit reports to AUSTRAC. Where relevant, AUSTRAC refers matters to ASIC.

*Significant breach reporting to ASIC*

- 24 Market participants that are AFS licensees are required to self-report actual or likely significant breaches of the financial services law: s912D. This is for the AFS licensee’s own breaches and does not require the AFS licensee to notify ASIC about the conduct of other parties, such as clients and other market participants.

Note: Some market participants are not required to hold AFS licences, including those that do not engage in trading for clients, and are therefore not subject to this obligation.

**Related concepts****Qualified privilege**

- 25 Qualified privilege at common law, in general terms, is a legal protection from defamation, breach of confidence, and similar proceedings where that person has engaged in conduct in the purported exercise of statutory duty.
- 26 The Corporations Act provides additional sources of ‘qualified privilege’ while discharging obligations under that Act. This statutory privilege does

<sup>7</sup> The obligation in s41 of the AML/CTF Act belongs to reporting entities. These are defined in s5 as providers of ‘designated services’ to customers. This includes market participants that deal in securities on an agency basis: see s6(6), item 33.

<sup>8</sup> AUSTRAC, *Public Legal Interpretation No. 6*, as at 16 March 2010.

<sup>9</sup> AUSTRAC, *Public Legal Interpretation No. 6*, as at 16 March 2010.

not affect any right, privilege or immunity that a person may otherwise have (e.g. under the common law). The protection extends to the officers, employees and representatives of a market participant: see s1100A(3) of the Corporations Act.

- 27 Qualified privilege protection under the Corporations Act would be available in specific circumstances if a person has acted in good faith and solely for the purpose of discharging their obligation to report to us. The person must not have acted maliciously or for any other improper purpose. A person that has qualified privilege under s1100A for the notification is also not liable for any action based on breach of confidence in relation to the notification.

### **Market misconduct**

- 28 In this RIS, the following conduct is referred to as market misconduct:
- (a) a person has placed an order or entered into a transaction while in possession of inside information;
  - (b) a transaction, or an order transmitted to the ASX or Chi-X trading platform, has or is likely to have the effect of:
    - (i) creating an artificial price for trading in financial products on the market;
    - (ii) maintaining at a level that is artificial a price for trading in financial products on the market;
    - (iii) creating or causing the creation of a false or misleading appearance of active trading in financial products on the market; or
    - (iv) creating or causing the creation of a false or misleading appearance with respect to the market, or price, for trading in financial products on the market.

These are also often known as insider trading, front running, and market manipulation.

- 29 Nothing in this RIS considers changing what is market misconduct.



## B Assessing the problem

### Overview

- 30 The essential problem is that the current reporting requirements (under AML legislation and the Corporations Act) do not cover the full range of market activities of interest to ASIC, nor do they apply to all relevant market participants. Moreover, unlike some overseas jurisdictions, there is no general obligation, under the market integrity rules, for market participants to report suspicious activity to ASIC. In practice, these gaps or limitations with the current reporting mechanisms restrict the flow of useful information to ASIC—which, if provided, would assist ASIC to better supervise the market and identify particular market activities.

### Incomplete reporting

- 31 While the existing reporting requirements already cover a range of suspicious matters which are of interest to ASIC in monitoring market integrity, they are fragmented across AML legislation, corporations legislation, and licensing conditions.
- 32 There are varying reporting thresholds across the differing reporting requirements. Reporting under AML legislation does not cover all market misconduct, and the reporting threshold requires that the market participant have facts to support an actual suspicion before making a report.
- 33 Under the significant breach reporting requirements for AFS licensees, only matters that are ‘significant’ are reportable—meaning that some otherwise suspicious matters may not be reported. Further, significant breach reporting only relates to market participants’ own activities.
- 34 The Corporations Act requires people who carry on a business of providing financial services to hold an AFS licence (unless they are covered by an exemption or are authorised to provide those financial services as a representative of another person who holds an AFS licence).<sup>10</sup> This means that not all market participants are covered by the reporting requirements under the AFS licensing conditions—for example, some principal-only market participants and some foreign participants are excluded.

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<sup>10</sup> Exemptions from the requirement to hold an AFS licence are set out in Pt 7.6, Div 2 of the Corporations Act and in Pt 7.6 of the Corporations Regulations 2001.

## Varying or ambiguous mandatory reporting thresholds

- 35 For the suspicious matter reporting obligation under AML legislation to arise, a market participant must form *both* a subjective and objective view that it has information in relation to an offence. This is a different reporting threshold than for:
- (a) market operators in Australia;<sup>11</sup> and
  - (b) market participants in other jurisdictions.<sup>12</sup>

For the entities in (a) and (b), a reporting obligation arises once facts exist that support an view that the relevant conduct has occurred. There is no need for an actual suspicion to be formed (i.e. a subjective view)—the facts that may form reasonable grounds to suspect are enough to trigger a requirement to report. In many overseas jurisdictions, this is generally required under the market rules. The market rules in Australia (the ASIC market integrity rules) currently do not require suspicious trading activity reporting.

- 36 The reporting threshold under AML legislation (that a market participant must form both a subjective and objective view that it has information in relation to an offence) means that under the current regime in Australia, more active investigating—with no set standard—is required by a market participant before it is obliged to make a suspicious matter report to AUSTRAC.
- 37 This also means that the current reporting regime may not capture instances where the entity, on observing a potentially suspicious matter (or warning signal), does not conduct any, or sufficient, further inquiry to confirm whether it is a suspicious matter that is required to be reported. Such an entity may not form the requisite suspicion on reasonable grounds for reporting. This may occur where the entity takes a permissive compliance approach, which may lead the relevant persons to ignore apparent facts that would require reporting. These entities may rely on whether they have subjectively formed a suspicion in deciding whether to submit a suspicious matter report.

## Little legal comfort for significant breach and voluntary reporting

- 38 As discussed above, in some circumstances, trading misconduct may be captured within the significant breach reporting obligations under the Corporations Act: s912D. However, this would only apply where the market participant is an AFS licensee (which is not the case for some participants

<sup>11</sup> Section 792B of the Corporations Act requires a market operator to report to ASIC where it has ‘reason to suspect’ a matter that would assist ASIC in its supervisory function (objective threshold).

<sup>12</sup> Including in the United Kingdom, United States and Germany.

that engage in trading on a principal-only basis: see paragraph 24), where the participant committed the breach and where the breach is deemed significant.

- 39 Often, significant breaches are not referred to ASIC until weeks after the breach has occurred. Early intelligence and swift investigation of potential misconduct can facilitate successful investigations of insider trading and market manipulation. A referral a long period of time after the incident is not ideal from a surveillance perspective.
- 40 ASIC has received inquiries from market participants that have indicated a desire to voluntarily report information that may be useful for ASIC's surveillance activities, but require some level of comfort that they are protected from legal action for disclosing the information. For example, market participants may possess information about suspicious trading activities of other market participants that they wish to share with ASIC. When market participants (or the public) voluntarily provide information to ASIC, generally they are not afforded privilege protection.<sup>13</sup>
- 41 Conversely, where provision of information is required under legislation—for example, under statutory notice—privilege may be afforded to the provider of the information. Apart from the reporting obligation in AML legislation, market participants are only afforded the protection of privilege when providing useful information to ASIC under statutory notice when requested to do so. This may create a disincentive for market participants to voluntarily provide intelligence about trading activity, even in circumstances where they know it will be useful to ASIC.

## Objectives of government action

- 42 ASIC's intention is to ensure that information or intelligence that may give rise to a suspicion that market misconduct may have occurred is readily made known to ASIC by all market participants.

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<sup>13</sup> ASIC has a statutory obligation, however, to take all reasonable measures to protect certain information from unauthorised use or disclosure.

## C Options and impact analysis

### Implementation options

#### Option 1: Maintain status quo

- 43 Option 1 is to maintain the status quo under which ASIC would continue to rely on the existing reporting obligation under AML legislation, the significant breach reporting obligation under the Corporations Act and voluntary assistance for intelligence from market participants.

#### Option 2: Introduce a general requirement for market participants to report suspicious activity

- 44 Option 2 is to introduce a general requirement under the market rules (the ASIC market integrity rules) for all market participants to report any and all suspicious trading activity. This is in addition to the existing reporting requirements under AML legislation.
- 45 The obligation in Option 2 would also provide an overlay of the existing reporting required by AML legislation and the Corporations Act, to capture the trading activity that these do not—that is, trading by other market participants and clients of other market participants, and transactions that do not yet reach the threshold of a significant breach. By extending the scope of what is reportable to include all market misconduct, any doubt about whether a particular matter is reportable would be removed.
- 46 While this may mean that some suspicious activity would be reported under two different reporting requirements, it would create a standalone requirement to report suspicious activity in the relevant market backed by the Corporations Act. To minimise the burden on market participants of double reporting under Option 2, where participants report information to AUSTRAC under AML legislation, the same information would not be required to be reported to ASIC.
- 47 This option could be implemented along with Option 3, which is about reporting thresholds.

#### Option 3: Clarify reporting thresholds

- 48 ASIC does not want to require market participants to undertake proactive measures to detect market misconduct, but instead wants to facilitate and encourage market participants to report information already known to them.

- 49 Currently, some information may be known to a market participants but it may be unclear whether the market participant is required to report it. Similarly, market participants—despite having significant information potentially available to them about their clients, such as electronic trading records—may never subjectively form a view that their clients may have engaged in market misconduct.
- 50 ASIC’s objective is to facilitate and encourage suspicious trading activity reporting by market participants—while not requiring market participants to undertake further proactive measures to detect market misconduct offences.
- 51 This proposal would require a market participant to report suspicious activity when it has reasonable grounds to suspect that market misconduct may have occurred.
- 52 This option could be implemented along with Option 2, which is about the scope of the general reporting requirement.

### **Knowledge threshold**

- 53 A market participant would be required to notify ASIC when it has reasonable grounds to suspect that there is market misconduct. We would not expect a market participant to put in place systems or begin investigations solely to identify matters for the purposes of reporting under this requirement.
- 54 If a market participant comes across information in the course of its business that raises a warning signal or, in the course of complying with its existing obligations (e.g. to ensure that the trading that occurs by it or through it does not interfere with the efficiency and integrity of the market, breach its obligations to maintain client order priority, and is not manipulative) discovers facts that give rise to reasonable grounds to suspect that market misconduct has occurred, the knowledge threshold would be met.

### *What does ‘reasonable grounds to suspect’ mean?*

- 55 Establishing ‘reasonable grounds to suspect’ requires both a suspicion and a just cause for that suspicion.
- 56 The test is satisfied by circumstances that would create in the mind of a reasonable market participant an actual apprehension or fear that a reportable matter exists. The suspicion has to be honest and reasonable, and must be based on facts that would create suspicion in the mind of a reasonable market participant.
- 57 A reasonable suspicion can exist without the market participant conducting exhaustive and conclusive investigations into the matter and we would not expect a market participant to conduct external inquiries for this purpose.

Nor would we expect a market participant to undertake extensive legal analysis to determine whether a contravention of the Corporations Act or market integrity rules has occurred.

- 58 In some instances, there may be legitimate reasons or trading strategies behind conduct that, based on a system alert, suggests that a reportable matter exists. For example, clients may legitimately request the deletion of their orders if they believe the market is falling. However, this may be a less plausible explanation if orders are repeatedly entered into the market and deleted. A market participant would need to exercise judgement in determining whether it should notify ASIC.
- 59 By setting the standard at a level that is commensurate with the actual knowledge, experience and business practices of market participants, this element would capture all material known or suspected by the market participant within the course of conducting its business, without requiring further detection or compliance procedures, or activities to be implemented or carried on.
- 60 Other higher thresholds have not been considered as they would require the market participant to depart from its usual analysis of market transactions and business practices, or to undertake investigative activities.

#### **Option 4: Amend AML legislation**

- 61 ASIC has the capacity to make market integrity rules to assist it in supervising financial markets. ASIC notes that the AML legislation is designed to achieve a different—albeit related—purpose, and is administered by another agency. Therefore, it would be inappropriate for ASIC to seek to use this mechanism to implement rules for the activities and conduct within the markets it supervises.
- 62 ASIC considers the most appropriate mechanism for enhancing suspicious trading activity reporting to be through ASIC’s own market integrity rules. Option 4 will not be considered further.

## **Impact analysis**

### **Option 1: Maintain status quo**

#### **Impact on industry and consumers**

- 63 There would be no direct impact on industry and consumers as there is no change to the status quo. However, not enhancing the reporting regime to ensure we can monitor trading in the changing market environment would

impede our ability to perform our surveillance function and may cause industry and consumers, over time, to lose confidence in the market.

#### **Impact on Government**

- 64 We are concerned that this option would not enhance ASIC's supervisory function and places us well behind our international counterparts. Not enhancing the reporting regime to ensure we receive relevant information from participants to assist us in monitoring trading in the changing market environment would impede our ability to perform our surveillance function.

### **Option 2: Introduce a general requirement for market participants to report suspicious activity**

#### **Impact on industry**

- 65 This option would remove any uncertainty about whether or not suspicious activity is required to be reported to AUSTRAC or ASIC.
- 66 Under Option 2, the costs to market participants would be negligible because participants should already have procedures and processes to comply with existing reporting obligations under AML legislation, licensing conditions and obligations to market operators, and the substance of what is to be reported would not be changed.
- 67 This obligation to report suspicious trading activity under a market integrity rule would afford market participants a qualified privilege protection when they notify ASIC under this rule. We expect, therefore, market participants would be more forthcoming in providing useful and meaningful information about client and non-client related trading to assist in market supervision and promoting market integrity, some of which is currently provided under a specific requirement to report, or voluntarily.
- 68 Market participants would be able to provide as much information to ASIC as possible in one notification, with the protection of privilege over all the subject matter in the report; this avoids the scenario of providing information to the extent that ASIC requests under notice, and going through multiple ASIC notice requests for documents in order to be afforded privilege under each notice.

#### **Impact on consumers**

- 69 Retail investors would not see any change to their trading experience under this option. Retail investors may have a higher level of confidence in the integrity of the relevant markets.

#### **Impact on Government**

- 70 Option 2 would expand the suspicious activity reporting regime to all areas of trading—including client-related trading, trading on a principal basis,

trading by other market participants and other market participants' clients—so that ASIC would receive notification of the full range of suspicious trading activity to assist its market supervisory function.

- 71 Insider trading and market manipulation offences are difficult to prove. We have found recently that the more successful cases are those where the investigation has been able to begin soon after the time of misconduct. Receiving information from market participants—those closest to clients, traders and the market—about suspicious trading activity would allow ASIC to identify possible instances for investigation sooner, leading to more effective enforcement of the law, which would in turn have a deterrent effect on these activities.
- 72 Reporting under a legal obligation affords qualified privilege to market participants. With this mechanism, market participants would likely be more forthcoming in providing useful and meaningful information to assist in market supervision and promoting market integrity.
- 73 This option would impose a range of direct (one-off and ongoing) costs on ASIC. In the main, these would comprise supervisory and surveillance costs associated with the anticipated rise in the number of inquiries that ASIC would make as a result of additional intelligence. This may include additional staffing requirements. However, estimates may be unrealistic due to the difficulty of predicting the actual increase in the number of reports that ASIC would receive under this option.
- 74 Where market participants report to AUSTRAC as a result of the obligation in Option 2, there may be ongoing costs for AUSTRAC to deal with an additional number of reports to process.

### **Option 3: Clarify reporting thresholds**

#### **Impact on industry**

- 75 By setting the knowledge element of the reporting requirement commensurate with the level of knowledge about a client and the client's activity that a market participant would already have, there would be no direct impact on industry from adopting this threshold.
- 76 There may be some need to change existing processes, but we do not expect these would impose significant direct costs on market participants. Any costs for market participants arising from this rule would be comprised of compliance costs.
- 77 Most market participants agree that any changes required would be largely procedural rather than technical systems changes. The creation and documentation of the processes for this rule would be a one-off cost for market participants. In some cases, market participants that deal on behalf of



clients may be able to improve on existing documentation that they may have for complying with the reporting obligation under AML legislation. However, because the threshold test is different, some variances to existing processes are probable. Consultation has indicated that this would impose a one-off cost, taking one full-time equivalent (FTE) one to two weeks to amend existing processes and procedures and train relevant staff. One large market participant, however, anticipated that it would cost its business, at most, one FTE.

78 Overall, based on feedback from market participants and our understanding of the processes that are currently in place, ASIC considers the costs to be low and, given existing reporting requirements, expects that these may not involve any (or minimal) additional permanent staffing.

79 Industry would benefit from enhanced market integrity as a result of efficiencies and improvements to ASIC's surveillance function if this option were to be implemented.

#### **Impact on consumers**

80 Retail investors would not see any change to their trading experience under this option. Retail investors may have a higher level of confidence in the integrity of the relevant markets.

#### **Impact on Government**

81 This option would impose a range of direct (one-off and ongoing) costs on ASIC. In the main, these would comprise supervisory and surveillance costs associated with the anticipated rise in the number of inquiries that ASIC would make as a result of additional intelligence. This may include additional staffing requirements. However, estimates may be unrealistic due to the difficulty of predicting the actual increase in the number of reports that ASIC would receive under this option.

82 Where market participants report to AUSTRAC as a result of the obligation in Option 3, there may be ongoing costs for AUSTRAC to deal with an additional number of reports to process.

## D Consultation

### CP 145

- 83 On 4 November 2010, we released a consultation package on enhancing regulation of Australia's equity markets, including proposals to address risks associated with the introduction of competition between exchange markets and from recent market developments.
- 84 The consultation package included a detailed consultation paper, Consultation Paper 145 *Australian equity market structure: Proposals* (CP 145), an overview summary document (reproducing Part 1 of the consultation paper), draft market integrity rules and a supporting economic report on Australian equity market structure, Report 215 *Australian equity market structure* (REP 215) (November 2010).
- 85 Proposal II of CP 145 canvassed the issue of suspicious activity reporting and proposed for consultation a draft market integrity rule to impose a suspicious activity reporting requirement on market participants. The consultation paper also proposed market integrity rules to address a number of other issues relating to market developments and additional regulatory issues resulting from the introduction of competition.
- 86 This RIS only considers issues in relation to suspicious activity reporting (Proposal II of CP 145).

### Additional consultation and advisory assistance

- 87 Before releasing CP 145, we spoke to domestic and international market operators, market participants and industry associations to better understand market and technology developments and ways to improve market supervision. We also spoke to a selection of buy-side, sell-side, retail groups, high-frequency traders, research houses, data or technology providers and regulators in the United States, Canada, the United Kingdom and Germany to broaden our understanding of overseas market structure issues and the impact competition has had in those jurisdictions.
- 88 An industry advisory group to the Commission has been in place since before the transfer of supervision from the ASX and throughout the entirety of the competition implementation process, which has helped inform the policy development and now informs implementation and practical issues. The industry advisory group is made up of representatives from market participants that service both retail and institutional clients, investment management businesses, and the legal profession. We have discussed with

the advisory group our intentions to introduce a suspicious activity reporting requirement since early 2010.

- 89 AUSTRAC has been actively engaged throughout the policy development process.
- 90 We have had meetings on suspicious activity reporting with 14 market participants since the consultation paper was published. Industry associations, the Australian Financial Markets Association (AFMA), and the Stockbrokers Association of Australia (SAA), have also been engaged.

## Overview of responses to CP 145 in relation to the proposed suspicious activity reporting market integrity rules

- 91 We received 14 written responses to the suspicious activity reporting proposal in CP 145 from a broad range of stakeholders, including Chi-X, industry associations, market participants, and others from the data vendor and technology sectors.
- 92 Respondents generally sought more clarity on the draft market integrity rules proposed in CP 145 for suspicious activity reporting. In June 2011—since the consultation paper was published—we shared and consulted on draft guidance on the proposed rules with 14 market participants, as well as AFMA and SAA. Feedback on the draft guidance was generally positive, and the market participants consulted generally believed the concerns raised in the feedback on CP 145 were addressed. We will provide final guidance on the proposed rules through an ASIC regulatory guide, available on ASIC’s website, once the market integrity rules are made.
- 93 Some respondents to CP 145 noted the potential for overlap between the proposed suspicious activity reporting requirement and the reporting requirements under AML legislation. Therefore, we have provided further guidance on how this obligation will work in practice. Some respondents submitted that the potential for costs of compliance could be significant if clear guidance was not issued, and that the proposal was unnecessary and unduly burdensome. We have provided further guidance to industry, clarifying what the proposed market integrity rules would require.
- 94 Other respondents understood the need for suspicious activity reporting, broadly supported the proposals and did not see significant costs or changes to existing systems. One respondent stated that they already have measures in place to escalate and report any patterns of suspicious activity.
- 95 The submissions provided valuable feedback and suggestions. We have considered concerns about the interpretation and practical application of the market integrity rules. We have consulted with a range of stakeholders since receiving the submissions to seek further comment and to provide some background and guidance to the proposed rules.

- 96            We will work with industry to enable the objectives of the obligation to be achieved without unnecessary costs borne by industry. We propose to allow market participants six months from the commencement of the relevant market integrity rules to change existing processes to comply with this obligation. This will be achieved in part by the grant of an ASIC waiver from the rules when they are registered.

## E Conclusion and recommended options

97 We recommend adopting Options 2 and 3.

### **Option 2**

98 Option 2 would remove any uncertainty about whether suspicious activity should be reported to ASIC. It would also extend qualified privilege to all reports of suspicious activity provided to ASIC—including information that is currently provided voluntarily.

99 Option 2 would involve only minor costs to industry and no costs to consumers. ASIC may receive more, and better, market intelligence.

### **Option 3**

100 Option 3 makes it mandatory to report all suspicious activity where a market participant has ‘reasonable grounds to suspect’.

101 Because the reporting threshold turns upon whether or not a market participant (e.g. trader or compliance executive working at the market participant) reasonably suspects that market misconduct may have occurred, it does not impose on market participants a requirement to gather further information or perform further analysis.

102 The reportable information is already defined within existing laws, and this option merely prevents market participants from ignoring or otherwise failing to report suspicious trading activity known to them.

## F Implementation and review

### Mechanisms for implementing the proposals

- 103 We intend to implement our proposals through market integrity rules. This is a rule-making power that ASIC received as a result of its new supervisory function under the *Corporations Amendment (Financial Market Supervision) Act 2010*.
- 104 Market integrity rules are legislative instruments. ASIC requires Ministerial consent before making any rules, and any rules are subject to Parliamentary disallowance.<sup>14</sup>
- 105 The proposed market integrity rules would supplement ASIC Market Integrity Rules (ASX Market) 2010 and ASIC Market Integrity Rules (Chi-X Australia Market) 2011.
- 106 ASIC would work with industry on the interpretation of the ‘reasonable grounds to suspect’ test and provide detailed guidance on how we intend to interpret and enforce the obligation. We would also delay commencement of the market integrity rule to allow market participants time to comply.

### Implementation and transitional arrangements

- 107 We expect that most proposals to enhance market supervision will take time and investment to implement. We have consulted on whether transitional arrangements are necessary and have tailored our proposal to take into account the feedback received. We found that parts of the industry have differing views on the coverage of the existing obligations under AML legislation, which helps to clarify what the changes would mean in practice. The other main concern raised in the feedback is the interpretation of the threshold test for reporting. We propose to allow market participants six months from commencement of the relevant market integrity rules to comply to allow for process change and education of traders and clients, and for ASIC to work with industry in understanding the threshold test for reporting. This will be achieved, in part, by the grant of an ASIC waiver when the rules are registered.

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<sup>14</sup> A House of Parliament may disallow a market integrity rule within 15 sitting days after it is tabled in the House if a motion to disallow has been given and within the 15 days: a resolution to disallow is passed, the motion is not withdrawn or the motion is not acted upon.

- 108 To minimise duplication, we propose that, where market participants report information to AUSTRAC under AML legislation, the same information is not required to be reported to ASIC.

## **Regulatory guidance**

- 109 We propose to publish a detailed regulatory guide on ASIC's website, including indicators and examples of when we would expect market participants to report to ASIC, to assist industry to comply with the new market integrity rules.
- 110 This regulatory guide has been written in consultation with industry stakeholders and takes into account industry feedback.

## **Review of regulatory framework**

- 111 We intend to review on an ongoing basis the market integrity rules to make any adjustments as a result of developments in the market and the international regulatory environment. We expect to consult comprehensively on any future proposed amendments.