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# Government to the rescue: ASIC takes the reins of the stock markets

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*Over the last 20 years stock markets worldwide have changed dramatically and the Australian Securities Exchange (ASX) is no exception. First there was the wave of demutualisations when many stock markets, including the ASX, transformed themselves into public companies. Following these restructures many market operators hived off their surveillance and enforcement functions into organisations independent of the company operating the market. Existing market operators have started to move beyond their geographical boundaries and are becoming global conglomerates. New trading venues continue to appear. In Australia, while there is only one dominant market operator, the ASX, this is likely to change soon. However, despite these fundamental changes to the landscape, ultimately the job of protecting the integrity of the markets and the enforcement of serious market abuse offences still falls primarily on nationally based securities regulators, such as the Australian Securities and Investments Commission (ASIC). In fact, ASIC's grip on the markets has recently increased. From 1 August 2010 ASIC assumed responsibility for the supervision of brokers well as the surveillance of trading on the ASX, existing smaller markets as well as any new trading venues which may emerge. This article considers the impact of these changes and the challenges that will face ASIC in maintaining the integrity of the markets as it attempts to bring them firmly under its control.*

## INTRODUCTION

In most developed economies stock exchanges are fundamental economic institutions which provide a key mechanism by which companies can access finance to expand. They are therefore critical to a country's economic development. However, as the downturn in the markets in 2008 plainly demonstrated, their impact is much broader. Stock market fluctuations spread quickly around the globe. They reach into other markets, such as currency and commodity markets, impacting upon economic growth with effects ranging far beyond listed companies and investors.<sup>1</sup>

The Australian Federal Government has decided that it is time for it, through its regulator, ASIC,<sup>2</sup> to take over control of the supervision and surveillance of its securities markets and market participants. It amended the *Corporations Act 2001* (Cth), via the *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth), to enable this to occur and the change took effect on 1 August 2010.<sup>3</sup> It was not the Global Financial Crisis (GFC) and the associated downturn in the markets which

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<sup>1</sup> As to the interconnectedness of global financial markets see Kingsford Smith D, "Networks, Norms and the National State: Thoughts on Pluralism and Globalized Securities Regulation" in Dauvergne C, *Jurisprudence for Interconnected Globe* (Ashgate Publishing Ltd, 2003).

<sup>2</sup> ASIC is a statutory body corporate incorporated under the *Australian Securities and Investments Commission Act 2001* (Cth).

<sup>3</sup> The Treasurer, Wayne Swan MP and the Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen MP, *Media Releases*, "Reforms to the Supervision of Australia's Financial Markets" (24 August 2009), <http://www.ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/013.htm&pageID=003&min=ceba&Year=&DocType=0> viewed 1 August 2010; and "Minister Announces ASIC to Take Over Supervision of Australia's Financial Markets from 1 August 2010" (8 July 2010), <http://www.ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/086.htm&pageID=003&min=ceba&Year=&DocType=0> viewed 11 August 2010. See also the Explanatory Memorandum to the *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth).



was the trigger for this change. What prompted this change is the likely establishment of new market operators who will compete directly with the ASX in trading in ASX-listed securities and that, if this occurred, it would be inappropriate for the ASX to have the same regulatory role.<sup>4</sup> However, the GFC has arguably made it easier for the Federal Government to introduce such a change as it will help to silence resistance from critics of government regulation, living as we do in a period of history where government regulation is no longer so prone to be viewed as the enemy of efficient markets but rather as a valuable instrument in controlling market excess.<sup>5</sup>

Not surprisingly, ASIC's chairman (who also is a former chairman of the ASX), Mr Tony D'Aloisio, welcomed the move, stating:

I have assured the Government that ASIC can take on these important responsibilities. Following our strategic review in 2007, ASIC is now closer to the market, more accessible, flexible, and able to take emerging trends into account more quickly. We have built up our market skills with a number of senior recruitments with market experience. We will be working closely with ASX to ensure a smooth transition of market surveillance and participant supervision responsibilities to ASIC.

In addition, this will allow for a whole of market approach to market surveillance and participant supervision should the government issue licences for new trading market operators.<sup>6</sup>

This change represents a further widening of ASIC's powers, which have grown since its establishment in 1989.<sup>7</sup> It also represents a fundamental shift away from the co-regulatory model which existed in Australia and still exists in many countries, such as the United States, where there is a heavy dependence on self-regulatory organisations monitoring the markets under the oversight of the government regulator. It also comes at a time when a key objective of securities regulators, namely to protect the integrity of markets by ensuring that they are fair and free of unfair trading practices such as market manipulation and insider trading,<sup>8</sup> is being continually tested by the fragmentation of markets and cross-border trading.

The purpose of this article is to outline some of the reasons behind these recent changes to the regulation of stock markets in Australia and why this shift may be positive for the integrity of Australia's capital markets. However, the article also sets out to highlight the fact that tackling unfair trading practices is difficult no matter who is charged with the responsibility of supervision of the markets and that there are a number of challenges which ASIC will have to overcome if it is to be successful in its new role. The next part of the article outlines the recent transformations of stock markets globally which has led to a re-examination of who should regulate the markets. ASIC's

<sup>4</sup> There are several small exchanges already operating in Australia, such as the National Stock Exchange of Australia (NSX) and the Sim Venture Securities Exchange (SIM VSE) (formerly the Bendigo Stock Exchange), the IMB Share Market and the Asia Pacific Exchange Ltd (APX). However, these exchanges do not compete directly with the ASX as they list and trade in securities listed on their exchanges not ASX-listed securities.

<sup>5</sup> It was also reported that the ASX was given only given one hour's notice of the decision, leaving it no time to engage in last-minute lobbying: Gluyas R, "Divisions Over Extra Powers for ASIC", *The Australian* (Sydney) (25 August 2009), <http://www.theaustralian.com.au/business/news/divisions-over-extra-powers-for-asic/story-e6frg90f-1225765773640> viewed 15 November 2009. As to the recent shift away from deregulation to a view that government regulation is necessary see Posner RA, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (Harvard University Press, 2009).

<sup>6</sup> ASX, "09-156MR ASIC Welcomes Government's Announcement on New Supervisory Arrangements for Financial Markets", *Media Release*, (24 August 2009), <http://www.asic.gov.au/ASIC/asic.nsf/byHeadline/09-156MR%20ASIC%20welcomes%20Government's%20announcement%20on%20new%20supervisory%20arrangements%20for%20financial%20markets?opendocument> viewed 20 October 2009.

<sup>7</sup> ASC was established by the *Australian Securities Commission Act 1989* (Cth) and began operating on 1 January 1991, being responsible for administering and enforcing the *Corporations Law*. On 1 July 1998 it became the Australian Securities and Investments Commission pursuant to the *Australian Securities and Investments Commission Act 1998* (Cth). This Act expanded ASIC's powers so that it was also responsible for consumer protection in relation to financial services. The 1998 Act was replaced in 2001 by the *Australian Securities and Investments Commission Act 2001* (Cth) and the *Corporations Law* was replaced with the *Corporations Act 2001* (Cth). In 2002, as a result of the *Financial Services Reform Act 2001* (Cth), it took over regulation of market conduct and consumer protection for credit from the Australian Competition and Consumer Commission.

<sup>8</sup> See International Organisation of Securities Regulators, *Objectives and Principles of Securities Regulation* (May 2003) p iii (IOSCO), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf> viewed 30 May 2010.



expanded powers in the light of the recent debate as to the importance of public enforcement to market integrity are then considered. This is followed by reflections on some of the likely obstacles that will face ASIC in maintaining and improving the integrity of Australia's markets but also a discussion of the significant advantages to the Australian economy if ASIC proves to be successful in its new role.

## THE TRANSFORMATION OF STOCK MARKETS

### Historical background

For most of the last century stock exchanges around the world operated within their own protected, often monopolistic, environment usually defined by geographic boundaries. Most exchanges were owned and operated by brokers. The exchanges were also self-regulatory organisations, essentially regulating themselves.<sup>9</sup>

Prior to the Great Depression, the markets in the United States were largely unregulated by government. Widespread manipulation and speculation which led to the collapse of the markets in 1929 and which were a large part of the cause of the Great Depression, made apparent the need for government regulation. Accordingly, government regulation of the markets became part of the New Deal agenda in the United States during the 1930s. Nevertheless, the stock markets in the United States were powerful and vigorously resisted regulation at the time, frustrating President Roosevelt and leading him to comment to one of his advisers:

The fundamental trouble with the whole Stock Exchange crowd is their complete lack of elementary education. I do not mean lack of college diplomas ... but just inability to understand the country or the public or their obligation to their fellow men. Perhaps you can help them acquire a kindergarten knowledge of those subjects.<sup>10</sup>

The *Securities Exchange Act 1934* (US) that was eventually passed saw the establishment of the Securities Exchange Commission overseeing the exchanges but a high degree of self-regulation was maintained by the stock exchanges.<sup>11</sup> At the time it was argued by those in Congress putting forward this model that, without self-regulation, any government regulatory body charged with regulating the markets would be too large and could prove to be ineffective.<sup>12</sup> Some commentators have since argued that the self-regulatory model is really a "historical accident" and it was only adopted because it was more convenient for Congress to assign regulatory powers to exchanges as they already had the regulatory infrastructure in place.<sup>13</sup>

This United States model of co-regulation has been very influential in the structure of stock markets and securities legislation in Australia, although it was not fully adopted until some 50 years later.<sup>14</sup> Still, by the beginning of the 1990s, Australia's markets were regulated in much the same way as those of the United States, with ASIC<sup>15</sup> responsible for licensing the markets, supplemented by the ASX regulating its markets and its market participants by enforcing its rules. These rules, known as Operating Rules, comprised Business Rules (rules regulating market participants, primarily

<sup>9</sup> Board J, Sutcliffe C and Wells S, *Transparency and Fragmentation: Financial Market Regulation in a Dynamic Environment* (Palgrave MacMillan, 2002) p 8.

<sup>10</sup> Senate Banking and Currency Committee, *Stock Exchange Practices* (Senate Rep 1455, 73d Cong 2d sess, 1934) as quoted in Parrish ME, *Securities Regulation and the New Deal* (Yale University Press, 1970) p 109.

<sup>11</sup> Parrish, n 10, p 230. See also generally Seligman J, "Cautious Evolution or Perennial Irresolution: Stock Market Self-regulation During the First Seventy Years of the Securities and Exchange Commission" (2004) 59 Bus Law 1347.

<sup>12</sup> Dombalagian OH, "Demythologizing the Stock Exchange: Reconciling Self-regulation and the National Market System" (2005) 39 U Rich L Rev 1069 at 1076.

<sup>13</sup> Gadinis S and Jackson HE, "Markets as Regulators: A Survey" (2007) 80 S Cal L Rev 1239 at 1249; Mendelson M and Peake JW, "'Intermediaries' or Investors': Whose Market Is It Anyway?" (1994) 19 J Corp L 443 at 444; Dombalagian, n 12 at 1093.

<sup>14</sup> Goldwasser VR, *Stock Market Manipulation and Short Selling* (Centre for Corporate Law and Securities Regulation, 1999) p 39.

<sup>15</sup> It was ASIC's predecessor, the Australian Securities Commission, which undertook this role until 2001.



stockbrokers), Listing Rules (rules regulating the conduct of listed companies) and Clearing and Settlement Rules.<sup>16</sup> ASIC was also involved in the process of changing these rules in that the ASX was required to notify ASIC of any rule change which could in turn be disallowed by the relevant Minister on advice from ASIC.<sup>17</sup>

## The impact of technological change on the markets

Towards the end of the 20th century, primarily as a result of new technologies, stock markets came increasingly under competitive pressures from other markets. Trading floors started to disappear and were largely replaced by markets which have similar screen trading systems.<sup>18</sup> As a result, brokers were no longer limited to trading in their own home market. The move to electronic trading lowered the barriers to entry to establishing an exchange or an alternative to an exchange and new trading venues started to appear.<sup>19</sup> These changes in turn created a pressure on established exchanges to raise capital to invest in technological change to increase efficiency in order that they could maintain their competitive position. In response, most major stock markets around the world, including Australia, demutualised, converting their ownership structure from being owned by brokers to becoming public corporations owned by shareholders.<sup>20</sup> Similarly, in Europe, state-owned stock markets converted to publicly traded corporations.<sup>21</sup> Some, like the ASX, also listed on an exchange it operated. Demutualisation was also thought to be desirable in that it would facilitate innovation by changing the incentive structure of the company that operated the market from brokers, who were largely motivated to preserving and promoting their own businesses, to a board of directors focused on maximising profits for shareholders.<sup>22</sup>

## Demutualisation and conflicts of interests

However, the movement to demutualise created a new set of problems primarily related to the stock exchange's dual role of being both a market operator and a regulator of the market. Although this has always given rise to potential conflicts of interests, many believed that this change to a public company structure exacerbated the possibility of potential conflicts of interest.<sup>23</sup> This is particularly acute in markets, such as Australia, where the dominant exchange also controls the clearing and settlement facilities which it could potentially use to engage in anti-competitive behaviour against new entrants. Perhaps more significantly, the switch to a public company results in a shift in priorities. In an exchange owned and operated by brokers, regulating the exchange was usually a key focus in that eliminating unfair trading practices directly benefited the owners who were also the participants. However, a public company's primary motive is profit for its shareholders. Regulation and the elimination of unfair trading practices are only tangentially linked to this profit motive, as an attribute

<sup>16</sup> Goldwasser, n 14, p 43, and Pt 7.2 of the *Corporations Act 2001* (Cth).

<sup>17</sup> *Corporations Act 2001* (Cth), s 793E.

<sup>18</sup> Board, Sutcliffe and Wells, n 9, p 9.

<sup>19</sup> In the United States these are called electronic communication networks (ECNs). In the United Kingdom these are referred to as alternative trading systems (ATSs) or alternative trading platforms (ATPs) and in Europe they are referred to as multilateral trading facilities (MTFs). An example of an ECN is Instinet. See Blair M and Walker G, *Financial Markets and Exchanges Law* (Oxford University Press, 2007) pp xlix, 5, 9, 23 and 24.

<sup>20</sup> For a list of demutualised exchanges see Carson JW, "Conflicts of Interest in Self Regulation: Can Demutualized Exchanges Successfully Manage Them?", *World Bank Policy Research Working Paper 3183* (December 2003), [http://www.papers.ssrn.com/sol3/Papers.cfm?abstract\\_id=636602](http://www.papers.ssrn.com/sol3/Papers.cfm?abstract_id=636602) viewed 7 September 2010.

<sup>21</sup> Avgouleas E, *The Mechanics and Regulation of Market Abuse, A Legal and Economic Analysis* (Oxford University Press, 2005) p 28.

<sup>22</sup> Board, Sutcliffe and Wells, n 9, p 56.

<sup>23</sup> See Carson, n 20, pp 6-17. See also Karmel RS, "Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges" (2002) 53 *Hastings LJ* 367; Fleckner AM, "Stock Exchanges at the Crossroads" (2006) 74 *Fordham L Rev* 2541; Bradley C, "Demutualization of Financial Exchanges: Business as Usual?" (2001) 21 *Nw J Int'l L & Bus* 657; and Gadinis and Jackson, n 13.





of the exchange which may attract trading and listings which seek a fair and transparent market. As a result, this could lead, over time, to a reduction in resources which exchanges will be willing to allocate to this regulatory function.<sup>24</sup>

The solution adopted by many exchanges has been to distance themselves from their regulatory functions by moving their surveillance and regulatory functions into a separate subsidiary or to separate self-regulatory organisations.<sup>25</sup> The ASX did this in 2006 by the establishment of a separate subsidiary, ASX Markets Supervision Pty Ltd.<sup>26</sup> However, at least in the case of the ASX, the result was far from satisfactory as, despite a veneer of independence, ultimately the subsidiary was still controlled and funded by the publicly listed company.

An additional dimension to the conflict of interest problem in Australia is that three new organisations – AXE, a joint venture between the New Zealand Stock Exchange and a group of Australia's major brokers, Nomura-owned Chi-X, and United States stockbroker LiquidNet – have applied to ASIC for licences to operate markets in Australia to trade in ASX listed securities.<sup>27</sup> If these licences are granted, these organisations will operate in direct competition to the ASX but the participants or owners of these organisations may still trade on the ASX. This would create a conflict of interest, or at least the possibility of a conflict of interest, if the ASX was involved in the supervision of these participants.<sup>28</sup> In addition, multiple trading venues for the same securities increase the difficulty of detecting market manipulation and insider trading as perpetrators may be more able to hide such trading by using different trading venues.<sup>29</sup> If it intended to grant the new licences, the Federal Government was left with three options:

- first, notwithstanding these potential problems, it could have maintained the status quo, allowed the co-regulatory model to continue, and authorised these new licensees to regulate themselves under the oversight of ASIC;
- secondly, the Federal Government could have opted to set up a new self-regulatory body to conduct surveillance of the markets and supervise market participants;<sup>30</sup>
- the third option was for it, through its regulator, ASIC, to take over surveillance of the markets and the supervision of market participants.

## ASIC'S NEW ROLE

### Are the justifications for self-regulation still valid?

The Federal Government eventually opted to choose the final option. The Federal Government is no doubt aware of the importance of the stock market to the electorate, given that Australia has one of the

<sup>24</sup> See generally Carson, n 20.

<sup>25</sup> For example, the New York Stock Exchange created NYSE Regulation Inc. This is a subsidiary of NYSE Euronext. NYSE Regulation's board of directors is comprised of a majority of directors unaffiliated with any other NYSE board. See *NYSE Regulation*, <http://www.nyse.com/regulation/nyse/1145313073247.html> viewed 10 December 2009. In 2007 member firm regulatory functions, including related enforcement activities, were moved to the Financial Industry Regulatory Authority (FINRA). NYSE Regulation retained independent regulation functions governing the NYSE trading floor, listed companies, rule development, and market surveillance: see *NYSE Timeline*, [http://www.nyse.com/about/history/timeline\\_2000\\_Today\\_index.html](http://www.nyse.com/about/history/timeline_2000_Today_index.html) viewed 10 December 2009. FINRA will soon take over market surveillance from NYSE Regulation Inc: see *FINRA to Perform NYSE Regulation's Market Oversight Functions* (4 May 2010), <http://www.finra.org/Newsroom/NewsReleases/2010/P121365> viewed 23 May 2010.

<sup>26</sup> See *History of the ASX*, [http://www.asx.com.au/about/asx/history/history\\_ASX.htm](http://www.asx.com.au/about/asx/history/history_ASX.htm) viewed 10 December 2009.

<sup>27</sup> Gluyas, n 5.

<sup>28</sup> See further the Explanatory Memorandum to the *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth) p 20.

<sup>29</sup> See further the Explanatory Memorandum to the *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth) p 20.

<sup>30</sup> For example, in the United States, the Financial Industry Regulatory Authority (FINRA) regulates most brokers and their representatives and will soon take over market surveillance from NYSE Regulation Inc: see *FINRA to Perform NYSE Regulation's Market Oversight Functions* (4 May 2010), <http://www.finra.org/Newsroom/NewsReleases/2010/P121365> viewed 23 May 2010. In Canada the Investment Industry Regulatory Organization of Canada (IIROC) regulates brokers and conducts supervision of the markets: see <http://www.iiroc.ca/English/Pages/home.aspx> viewed 23 May 2010.



highest incidences of public share ownership in the world and that much of the Australian public's wealth is linked to the markets.<sup>31</sup> Still, it does represent a fundamental shift from the co-regulatory model that has persisted since the New Deal in the United States and which also exists in many countries. This co-regulatory model is characterised by self-regulatory organisations (SROs) responsible for the primary regulation of the markets and its participants, with the government regulator's role limited to licensing markets, oversight of SROs and prosecuting serious matters referred to it by the SROs.<sup>32</sup>

In fact, it is this co-regulatory model that is promulgated by the International Organisation of Securities Regulators (IOSCO), which espouses the benefits of SROs to be that:

- SROs may require the observance of ethical standards which go beyond government regulations; and
- SROs may offer considerable depth and expertise regarding market operations and practices, and may be able to respond more quickly and flexibly than the government authority to changing market conditions.<sup>33</sup>

However, given the shift after demutualisation by many stock exchanges to isolate their regulatory and surveillance functions into separate "independent" organisations, this second supposed benefit, being the expertise of SROs in market operations and practices, must be open to question. If the SRO is truly independent, the market knowledge of those employed by the SRO is likely to diminish over time. ASIC believes it can address this issue by recruiting persons with market experience.<sup>34</sup> This may give ASIC a valuable skill base; however, similar to independent SROs, as soon as a person has left the markets to work for ASIC, their knowledge of the current workings of the markets will inevitably begin to diminish. ASIC's remuneration scales will also limit its capacity to recruit people with market experience. Accordingly, keeping in touch with the nuances of what is happening in the markets is likely to be a continuing challenge for ASIC into the future.

An advantage of SROs, not articulated by IOSCO but perhaps the reason why this model has remained popular in the United States and elsewhere, is that the use of SROs frees government from having to fund the supervision of the markets and has the effect that government can concentrate its attention on other issues. It also allows governments to distance themselves from the markets, enabling them to avoid or shift blame when something goes wrong. Accordingly, in transferring these new responsibilities to ASIC, in the future ASIC will be directly in the "firing line" over problems in the markets and, as ASIC is the government regulator, the government will be called to answer for ASIC's actions or failure to act.

However, this assumption of responsibilities by ASIC could prove to be one of the most positive aspects of the change. For too long the co-regulatory model allowed for "buck passing" between the ASX and ASIC in relation to the low level of insider trading and market manipulation prosecutions.<sup>35</sup> ASIC will now have no option but to take steps to ratchet up its enforcement efforts.

The main benefit of ASIC taking over ASX's regulation and surveillance functions is that it should reduce regulatory duplication, improving efficiency and effectiveness. It will reduce to a

<sup>31</sup> ASX, *2008 Australian Share Ownership Study* (2009) p 34, [http://www.asx.com.au/about/pdf/2008\\_australian\\_share\\_ownership\\_study.pdf](http://www.asx.com.au/about/pdf/2008_australian_share_ownership_study.pdf) viewed 26 October 2009.

<sup>32</sup> The movement to demutualisation has resulted in some countries shifting some regulatory responsibilities back to the regulator. For example, in Hong Kong surveillance duties are shared between the regulatory body, the Hong Kong Securities and Futures Commission (SFC) and the Hong Kong Exchange. See Main A, "Two is Better Than One in Surveillance", *The Australian* (Sydney) (13 July 2009), [http://www.parlinfo.aph.gov.au/parlInfo/search/display/display.w3p?query=MajorSubjectId\\_Phrase%3APV6%20SearchCategory\\_Phrase%3A%22media%22%20Author\\_Phrase%3A%22main.%20andrew%22;rec=0](http://www.parlinfo.aph.gov.au/parlInfo/search/display/display.w3p?query=MajorSubjectId_Phrase%3APV6%20SearchCategory_Phrase%3A%22media%22%20Author_Phrase%3A%22main.%20andrew%22;rec=0) viewed 20 October 2009. The SFC has responsibility for broker regulation but the exchange retains market regulation to the extent of the business rules. The United Kingdom, France and Mexico have also adjusted their regulatory responsibilities: see Carson, n 20, p 23.

<sup>33</sup> IOSCO, n 8, p 10.

<sup>34</sup> ASIC, *Media Release*, n 6.

<sup>35</sup> See Austin J, "A Rapid Response to Questionable Trading: Moving Towards Better Enforcement of Australia's Securities Laws" (2009) 27 C&SLJ 203.



minimum the time lag between the detection of market abuse and the commencement of an investigation. ASIC also has a much broader range of investigation techniques and powers available to it than are available to the ASX (such as obtaining search warrants and information from overseas regulators) which it should be able to utilise relatively quickly after an offence has been detected.<sup>36</sup> Reducing the delay between detection and the investigation increases the possibility of obtaining evidence to support an enforcement action as the longer the delay the more likely it is that evidence will not be secured by the authorities. For example, the longer the delay, the more likely it is that deleted files, which might otherwise be recovered by forensic computer experts, will be overwritten and destroyed.

### The importance of public enforcement

ASIC's expanded role in the supervision of the stock markets and the possibility that this will assist in improving the intensity of public enforcement of stock market offences also accords with some recent studies which have concluded that the level of public enforcement is critically important to the integrity of stock markets.

This debate received momentum in 2006 as a result of a study by Professors Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer to measure the relative importance of disclosure laws, private enforcement laws and public enforcement laws.<sup>37</sup> The study surveyed attorneys from 49 countries to establish a database of rules and regulations in relation to the issue of securities. The study encoded the laws with numbers, eg a country scored a one if the prospectus issued for a newly listed firm had to disclose the compensation of each of the directors and key officers, a half if only the aggregate compensation had to be disclosed and a zero if there was no requirement to disclose the compensation. This method was repeated with a number of elements in relation to disclosure standards in order to produce a "Disclosure Requirements Index". Rules in relation to the civil liability of those associated with the prospectus were treated in the same way to develop a "Liability Standards Index". A "Public Enforcement Index" was also created in the same way, coding laws in relation to the powers of the regulator. Each of these indexes were compared with a number of measures of the strength of the particular stock market, including stock market capitalisation, ownership concentration, the number of initial public offerings (IPOs) and the number of domestic firms.

The study concluded that there was little evidence that public enforcement benefits stock markets but there was strong evidence that laws mandating disclosure and facilitating private enforcement benefited stock markets.

One of the key problems with the study was that the "Public Enforcement Index" measured not how often the regulator brought enforcement proceedings, but only the existence of public enforcement powers of the regulator. Other studies have shown that it is not the existence of laws that is important but how often the regulator uses them, presumably because unenforced laws can simply be ignored and therefore effectively have no impact.<sup>38</sup> This is one of the key reasons why La Porta, Lopez-de-Silanes and Shleifer's findings, particularly in relation to the impact of public enforcement, have been heavily criticised.<sup>39</sup> Subsequent studies led by Professor Howell Jackson came up with an opposite finding to the La Porta study in relation to the importance of public enforcement. Jackson's studies found that public enforcement is as important as disclosure rules for explaining favourable

<sup>36</sup> ASIC may also soon, via the Australian Federal Police, be able to obtain warrants to intercept telephone and other electronic communications in relation to market offences. See Austin, n 35; and Corporations and Markets Advisory Committee (CAMAC), *Aspects of Market Integrity, Report* (June 2009) (CAMAC Report), [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2009/\\$file/Market\\_Integrity\\_Report\\_Jun2009.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2009/$file/Market_Integrity_Report_Jun2009.pdf) viewed 10 December 2009.

<sup>37</sup> La Porta R, Lopez-de-Silanes F and Shleifer A, "What Works in Securities Laws?" (2006) 61 *Journal of Finance* 1 at 1.

<sup>38</sup> See eg Bhattacharya U and Daouk H, "The World Price of Insider Trading" (2002) 57 *Journal of Finance* 75 who found that the existence of insider trading laws did not impact upon the cost of capital but this changed after the first prosecution.

<sup>39</sup> See Jackson HE and Roe MJ, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence 33", *Harvard Pub Law Working Paper No 08-28*, p 7, <http://www.ssrn.com/abstract=1000086> viewed 7 September 2010; and Coffee JC, "Law and the Market: The Impact of Enforcement" (2007) 156 U Pa L Rev 268. La Porta et al's findings have been also criticised on the basis that using mathematical modelling for analysing countries' laws is too simplistic. Such methodology fails to take into account differences in how laws operate and does not discriminate between what may be the relative importance of each of the



financial market outcomes and more important that rules governing private liability.<sup>40</sup> Rather than using the existence of rules as a proxy for public enforcement, he used the existence of staffing and budgets and enforcement intensity. Jackson's findings suggest that high levels of resources committed to public enforcement correlate with robust capital markets, as measured by market capitalisation, trading volume, the number of domestic firms and the number of IPOs.<sup>41</sup>

One notable feature of Jackson's data is that the United States was found to be an outlier in terms of both the amount the SEC spends on enforcement, the number of enforcement actions brought and the magnitude of the sanctions imposed. Based on Jackson's data, Professor John Coffee has argued that this is the reason why the United States has the lowest cost of capital and why non-United States firms exhibit a listing premium when they list on a United States exchange.<sup>42</sup>

Interestingly, ASIC seems to be the only other regulator studied by Jackson that has a large enforcement budget relative to its capital market, although Jackson's figures do not seem to take into account that, in addition to being the national securities regulator, ASIC is also the national corporate regulator and so part of its enforcement budget is directed towards this function. Nevertheless, Jackson's study may suggest that if ASIC can translate its enforcement budget into strong enforcement outcomes, it may be able to lower the cost of capital on Australia's markets attracting listings.

One cautionary note expressed by Jackson is that, just because higher resources for securities regulators correlate with better market outcomes, it does not prove that one causes the other, as it may be that stronger financial markets increase the call for better-resourced regulators and governments respond.<sup>43</sup> Another suggestion as to the reason why the United States, and also perhaps Australia, invest substantial resources in enforcement is that both have a high proportion of retail investors. It may be that, as the number of retail investors increases and the ownership of companies becomes more dispersed, this creates a political demand for investor protection through increased enforcement efforts.<sup>44</sup>

## CHALLENGES FACING ASIC GOING FORWARD

Although the takeover by ASIC of the surveillance of markets and supervision of market participants should increase the level of public enforcement of securities laws by reducing the delays in investigations and reducing regulatory duplication, ASIC does face a number of difficulties in maintaining and improving the integrity of Australia's markets into the future. These principally relate to two different but closely related objectives. ASIC must first improve the detection of market offences. Secondly, ASIC must increase the number of enforcement actions against those who breach both the law and the rules of the market and obtain significant penalties for these breaches to deter those considering engaging in similar activities.

### Reducing market manipulation

It is perhaps unrealistic to expect that this shift in responsibilities to ASIC will result in a dramatic increase in the number of new criminal prosecutions, at least in relation to stock market manipulation offences. Although there are a number of provisions in the *Corporations Act 2001* (Cth) which make such conduct a criminal offence,<sup>45</sup> these are currently very complex and in need of amendment.<sup>46</sup>

laws. See Siems MM, "What Does Not Work in Comparing Securities Laws: A Critique on La Porta et al's Methodology" (2005) *International Company and Commercial Law Review* 300.

<sup>40</sup> Jackson and Roe, n 39, p 2; Gadinis and Jackson, n 13 (comparing foreign enforcement regimes); Jackson HE, "Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications" (2007) 24(2) *Yale Journal on Regulation* 253.

<sup>41</sup> Jackson and Roe, n 39.

<sup>42</sup> Coffee, n 39. For a criticism of Coffee's findings see Ferran E, *Capital Market Competitiveness and Enforcement* (2008), [http://www.papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1127245](http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1127245) viewed 30 May 2010.

<sup>43</sup> Jackson and Roe, n 39, p 3.

<sup>44</sup> Coffee, n 39 at 293.

<sup>45</sup> *Corporations Act 2001* (Cth), ss 1041A-1041G.





Furthermore, while some forms of manipulation may be quite straightforward for ASIC to establish, such as the spreading of false rumours, other forms of manipulation can be very difficult to prove. This is because they involve actual trades made with “manipulative” intent and so require the prosecutor to prove the state of mind of the accused.<sup>47</sup> Alternatively, or in addition to proving an accused’s state of mind, the trading may take place over an extended period of time. For example, the practice commonly known as “painting the tape” involves traders engaging in a series of transactions to create an appearance of activity in a stock with a view to inducing others to invest. As such, this practice can consist of multiple transactions taking place over an extended period.<sup>48</sup> In the absence of a guilty plea, the facts in relation to any criminal prosecution have to ultimately be explained to a magistrate or jury. As a result, a prosecutor may feel compelled to reduce the number of transactions which comprise the manipulative scheme to make the scheme comprehensible to a lay jury and thereby increase the likelihood of a conviction. However, if the prosecutor adopts this course of action this will almost inevitably reduce the unlawful benefit gained by the perpetrator. In such a scenario, even if a conviction is ultimately obtained, the penalty will probably be small. This may in turn lead some to question why the regulator commenced a criminal prosecution in the first place.

However, there are other ways to tackle manipulation besides criminal prosecution. Some of the provisions in the *Corporations Act* which deal with manipulation are civil penalty provisions.<sup>49</sup> The Corporations and Markets Advisory Committee (CAMAC) has recently recommended to the Federal Government that the other market manipulation provisions be amended so that they are also civil penalty provisions.<sup>50</sup> Now that ASIC is responsible for market surveillance and the supervision of market participants, ASIC can bring civil penalty proceedings in relation to a failure to comply with rules prescribed by ASIC known as “Market Integrity Rules”.<sup>51</sup> These rules, which came into effect on 1 August 2010, deal with the activities and conduct of markets, and persons trading on those markets.<sup>52</sup> Some of these rules prohibit some types of manipulation.<sup>53</sup> The maximum penalty that ASIC can set for a breach of a market integrity rule is \$1 million.<sup>54</sup> In addition, the offender may also have to pay compensation equal to the profits of the scheme.<sup>55</sup> Although a jail sentence cannot be imposed for a breach of a civil penalty provision, in reality jail for market manipulation is rare and civil penalty provisions have the advantage that the standard of proof is lower and the matter is heard

<sup>46</sup> See Armson E, “False Trading and Market Rigging in Australia” (2009) 27 C&SLJ 411; and CAMAC Report, n 36.

<sup>47</sup> See generally Fischel DR and Ross DJ, “Should the Law Prohibit ‘Manipulation’ in Financial Markets” (1991) 105(2) Harv LR 503.

<sup>48</sup> For a list of common manipulation techniques see Cumming D and Johan S, “Global Market Surveillance” (2008) 10(2) *American Law and Economics Review* 454 at 462.

<sup>49</sup> *Corporations Act 2001* (Cth), ss 1041A-1041C.

<sup>50</sup> CAMAC Report, n 36, p 121. See also Armson, n 46 at 423.

<sup>51</sup> See *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth) which introduced s 798G and s 1317G(1B) into the *Corporations Act 2001* (Cth).

<sup>52</sup> *Corporations Act 2001* (Cth), s 798G. For a list of the Market Integrity Rules see <http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Market%20integrity%20rules> viewed 11 August 2010.

<sup>53</sup> See eg ASX Market Integrity Rules (ASX Market) 2010, r 2.1.5, which provides that a market participant must not engage in “unprofessional conduct” and r 5.7.1, which prohibits a market participant from trading with the intention of, or knowing that a person intends to create, a false or misleading appearance of active trading in securities or with respect to the market for, or the price of, any securities: [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-ASX-Market-Integrity-Rules-20100801.pdf/\\$file/ASIC-ASX-Market-Integrity-Rules-20100801.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-ASX-Market-Integrity-Rules-20100801.pdf/$file/ASIC-ASX-Market-Integrity-Rules-20100801.pdf) viewed 11 August 2010.

<sup>54</sup> *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth) which introduced s 798G(2) and s 1317G(1B) into the *Corporations Act 2001* (Cth).

<sup>55</sup> *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth) which introduced s 1317HB into the *Corporations Act 2001* (Cth).



before a judge alone rather than a lay jury. It is perhaps, then, no coincidence that one of ASIC's major successful actions in a complex manipulation scheme was a civil action it brought against Nomura International plc in 1998.<sup>56</sup>

ASIC will now also have a third option in tackling manipulation. ASIC can issue an infringement notice for a breach of the market integrity rules requiring the payment of a penalty of not more than four-fifths of the maximum penalty for the market integrity rule and/or the instigation of remedial measures (including education programs).<sup>57</sup> Alternatively, ASIC can accept a legally enforceable undertaking from a person alleged to have breached a market integrity rule agreeing to a sanction for their conduct. Although these powers to issue infringement notices and approve enforceable undertakings are vested in ASIC, it has delegated these powers to a new body, the Market Disciplinary Board.<sup>58</sup> Accordingly, ASIC can now seek an infringement notice or enter into negotiations with the alleged offenders with a view to accepting an enforceable undertaking before commencing civil penalty proceedings. Many offenders may elect to comply with the infringement notice or negotiate a settlement rather than risk a higher penalty being ordered by a court and the additional possibility that the court will also order that it pay compensation.<sup>59</sup>

Obviously, due to the risks and potential costs involved in instigating a civil penalty proceeding, ASIC will only wish to resort to the instigation of such proceedings as a last resort and will, if possible, resort to these remedies of infringement notices and enforceable undertakings.<sup>60</sup> Certainly, the ASX was usually successful at negotiating a settlement as the ASX brought 15 disciplinary actions for creating a false or misleading appearance on the market between June 2001 and June 2009 and only one of these was contested.<sup>61</sup> There is, however, a risk that ASIC, either at its own instigation or the instigation of defendants, may too readily engage in negotiations to settle a matter rather than take the more costly and riskier path of seeking a higher penalty for market misconduct by either taking civil penalty action or commencing a criminal prosecution. This may have the result that penalties become insufficient to deter offenders from engaging in manipulation, given the large profits that potentially can be made from this activity.<sup>62</sup> For example, in *Australian Securities Commission v Nomura International plc* (1998) 89 FCR 301; 29 ACSR 473, while it is not clear from the judgment

<sup>56</sup> *Australian Securities Commission v Nomura International plc* (1998) 89 FCR 301; 29 ACSR 473. ASIC was successful in a civil action brought under s 998 of the *Corporations Law* (the predecessor of s 1041B of the *Corporations Act 2001* (Cth)) in relation to \$600 million of trades placed by Nomura in the last half hour of trading on the ASX on 29 March 1996. The trades were designed to assist Nomura unwind futures contracts it held on the All Ordinaries Index. This matter was heard before the provision was made a civil penalty provision and accordingly the court was limited to the making of declarations and injunctions and imposing costs on the defendant: see ASIC, "Federal Court Orders Against Nomura", *Media Release* (19 February 1999), [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/99-036.pdf/\\$file/99-036.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/99-036.pdf/$file/99-036.pdf) viewed 16 November 2009.

<sup>57</sup> See *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth) which introduced s 798H and s 798K into the *Corporations Act 2001* (Cth).

<sup>58</sup> See generally ASIC, *Regulatory Guide 216 Markets Disciplinary Panel* (July 2010), [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg216-29July2010.pdf/\\$file/rg216-29July2010.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg216-29July2010.pdf/$file/rg216-29July2010.pdf) viewed 11 August 2010.

<sup>59</sup> *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth) which introduced s 1317HB into the *Corporations Act 2001* (Cth).

<sup>60</sup> Civil penalties actions are also not always quick and cheap for ASIC as the recent unsuccessful action brought by ASIC against Jodee Rich demonstrates. This action was commenced in December 2001, was subject of multiple procedural challenges and the hearing of the substantive issue was not concluded until August 2007 after 232 hearing days. The decision was not handed down until 19 November 2009. Some estimate that the cost to ASIC of this failed action will be in the order of \$35 million. See Sexton E, "Many Unhappy Returns", *Sydney Morning Herald* (Sydney) (25 August 2007); Moran S, "One.Tel Chase a \$35m Flop", *The Australian* (Sydney) (19 November 2009), <http://www.theaustralian.com.au/news/nation/onetel-chase-a-35m-flop/story-e6fgr6nf-1225799512526> viewed 19 November 2009. As to difficulties with civil penalty proceedings see generally Austin J, "Does the Westpoint Litigation Signal a Revival of the ASIC s 50 Class Action" (2008) 22 AJCL 8 at 19.

<sup>61</sup> Armson, n 46 at 413. The maximum fine amount payable under the ASX Market Rules is \$1 million, increased from \$250,000 in 2008, so the majority of the actions where the fine was paid without contest was when the maximum fine was set at the lower level.

<sup>62</sup> See also Armson, n 46 at 423.



what the ultimate benefit was to Nomura from the scheme, Nomura held a basket of securities worth about A\$600 million which it used to manipulate the share price index to unwind futures contracts it held on the All Ordinaries Index.

### Cross-market surveillance

One enduring reality which will face ASIC in its new role is the continuing fragmentation of the markets. There are now multiple venues for traders to trade the same security, similar securities or derivatives of the securities. In addition, large brokers can cross trades within their own firm and other securities are traded over the counter.<sup>63</sup> In both of these latter cases the trades take place outside formal exchanges, although some such trades need to be disclosed to the exchange. This fragmentation creates opportunities to engage in manipulation across markets. Accordingly, no longer is it sufficient for regulators to conduct surveillance on a single market: they must conduct surveillance across multiple markets if they are to see the “big picture” of what trading is actively taking place by particular individuals or organisations.

The technology for such cross-market surveillance is still being developed and is expensive. ASIC now and into the future will have to invest heavily in such cross-market surveillance technology and be actively engaged in sharing and obtaining information from other regulators around the world conducting surveillance of markets to effectively detect manipulation across markets.

However, if ASIC does make such cross-market surveillance a priority, it is likely to result in significant advantages to Australia’s markets. Although conducting cross-market surveillance is still a relatively new practice by regulators, a study by Professors Cumming and Johan in 2005 across 25 jurisdictions showed that where cross-market surveillance was undertaken, this was correlated with higher trading volumes, greater numbers of listed companies and higher market capitalisation.<sup>64</sup> Like the Jackson study, this study did not prove causation and it may be that larger markets are more likely, and have the resources, to invest in cross-market surveillance. Nevertheless, the results of the study make sense; that is, the greater the cross-market surveillance, the more unfair trading practices are going to be detected and therefore the integrity of the market is going to be enhanced.

Furthermore, and of particular interest given ASIC’s new role, the same study also found that cross-market surveillance is more effective when it is conducted by securities commissions than SROs.<sup>65</sup> The authors speculate that this is because securities commissions have a higher incentive to engage in cross-market surveillance and are more likely to engage in information-sharing with other regulators and exchanges than SROs who may see other markets as competitors.<sup>66</sup> This suggests that it may be in Australia’s best interests for ASIC to be responsible for surveillance rather than the ASX or an SRO because of ASIC’s ability and willingness to share information.

The main international organisation involved in coordinating information-sharing across exchanges is the Intermarket Surveillance Group (ISG).<sup>67</sup> Its purpose is to

provide a framework for the sharing of information and the coordination of regulatory efforts among exchanges trading securities and related products to address potential intermarket manipulations and trading abuses. The ISG plays a crucial role in information sharing among markets that trade securities, options on securities, security futures products, and futures and options on broad-based security

<sup>63</sup> An “over the counter” market is where securities are not traded on an exchange but via telephone or computer negotiations between the buyers and sellers, eg the market in government bonds.

<sup>64</sup> Cumming and Johan, n 48.

<sup>65</sup> Cumming and Johan, n 48 at 503.

<sup>66</sup> Cumming and Johan, n 48 at 458.

<sup>67</sup> Other bodies which may play a role are the World Federation of Exchanges (<http://www.world-exchanges.org>), multilateral organisations such as Asian and Oceanian Stock Exchanges Federation (<http://www.aosef.org>). Individual exchanges may also have memoranda of understandings to share information.



indexes. The ISG also provides a forum for discussing common regulatory concerns, thus enhancing members' ability to efficiently fulfil their regulatory responsibilities.<sup>68</sup>

Of concern to ASIC is that membership of the ISG is restricted to SROs and non-governmental associations.<sup>69</sup> Furthermore, although information obtained may be used in pursuing a regulatory-related inquiry or investigation, it is a condition of membership that "an ISG member may not convey information obtained through such request to any third party (including any governmental entity) without the specific written permission of the information provider, or as otherwise specified in the Agreement".<sup>70</sup>

ASIC will have to lobby the ISG to change this organisation's membership requirements if it is to utilise its information-sharing capabilities. Alternatively, ASIC will have to enter into bilateral agreements with other exchanges or encourage IOSCO to play a more significant role in coordinating the international surveillance of markets. Perhaps because of the existence of the ISG, IOSCO has not, to date, focused on coordinating the exchange of cross-market surveillance information. Yet IOSCO's objectives clearly envisage that it will play a more significant role, its aims being to:

- cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;
- exchange information on their respective experiences in order to promote the development of domestic markets;
- unite their efforts to establish standards and an effective surveillance of international securities transactions; and
- provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offences.<sup>71</sup>

ASIC is an active member of IOSCO and the Secretary General of IOSCO is a former ASIC employee.<sup>72</sup> As it will be one of the few regulators in the world that also is in charge of market surveillance, ASIC should take a lead role in having IOSCO take a larger part in improving global market surveillance.

### International information-sharing and enforcement

Cross-market surveillance aside, going forward ASIC will have to invest more resources in detecting and taking action against market offences where the perpetrators intentionally structure their contravention between countries and/or markets.<sup>73</sup> Given that ASIC is often under political and media pressure to produce results quickly, it is likely that it more readily pursues the "soft" targets of purely domestic offenders and ignores investigations where the trail leads overseas because it is too difficult, complex, expensive or time-consuming. However, with the increasing globalisation and fragmentation of securities markets, it could reasonably be predicted that contraventions of securities laws that straddle jurisdictional boundaries must be on the rise and will continue to increase. The SEC has said that it has detected this as a trend.<sup>74</sup> It is also perhaps occurring in Australia because, according to ASIC's latest annual report, ASIC has been steadily increasing its surveillance and enforcement

<sup>68</sup> Intermarket Surveillance Group, *Organisational Overview*, <http://www.isgportal.org/isgportal/public/overview.htm> viewed 25 November 2009.

<sup>69</sup> Intermarket Surveillance Group, n 68.

<sup>70</sup> Intermarket Surveillance Group, n 68.

<sup>71</sup> See <http://www.iosco.org/about> viewed 30 May 2010.

<sup>72</sup> The current Secretary General of IOSCO is Mr Greg Tanzer: <http://www.iosco.org/news/pdf/IOSCONEWS107.pdf> viewed 7 September 2010.

<sup>73</sup> ASIC can generally take action if the offence occurs partly in Australia. See the *Criminal Code Act 1995* (Cth), s 1308A, and s 1042A of the *Corporations Act 2001* (Cth).

<sup>74</sup> See comments of Thomsen LC (Director of Enforcement at the SEC), "US Experience of Insider Trading Enforcement Actions", Speech by SEC Staff: Remarks before the Australian Securities and Investments Commission 2008 Summer School, Melbourne, 19 February 2008, <http://www.sec.gov/news/speech/2008/spch021908lct.htm> viewed 30 May 2010.





requests to international regulators.<sup>75</sup> ASIC will have to increasingly invest resources in tackling this problem as failure to do so may, over time, undermine the integrity of Australia's markets.

ASIC does have the ability to obtain information and assistance from overseas regulators in relation to such cross-border offences via the IOSCO *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (MOU).<sup>76</sup> This MOU is one of IOSCO's main successes to date and now covers more than 95% of the world's capital markets.<sup>77</sup> The MOU sets up a standard form to request information from another regulator. The information requested can be documents and/or the taking of witness statements or testimony.

However, the terms of this MOU are very limited. There are, for instance, no provisions dealing with the sharing of intelligence or protocols in relation to regulators working together on a matter. This is probably a reflection of the fact that IOSCO is a voluntary organisation with only the ability to create "soft law" by obtaining the agreement of its members. Apart from persuasion, censure and possibly expulsion, IOSCO has no real powers of enforcing compliance. It also has scant resources and is heavily dependent on its members to do the substantial work of projects it undertakes.

Given the pace of change in the markets, there seems to be a real need for IOSCO or another body to increase international cooperation and regulatory coordination with a view to improving the integrity of the world's capital markets. Although some academics believe that this is not necessary and competition between regulators will result in regulatory regimes which compete for listings by companies,<sup>78</sup> others have pointed to the fact that this will lead to a regulatory "race" or at least a "stroll to the bottom".<sup>79</sup> Opponents of the regulatory competition theory point to the fact that it ignores the agency problem, which is that corporations are run by directors rather than shareholders. Because directors choose the listing venue for the company's shares, this "allows the foxes to establish the rules that govern the henhouse" and directors may be inclined to choose venues with low levels of regulation and enforcement.<sup>80</sup>

If markets free of unfair trading practices is the aim, the fostering of improved regulatory cooperation and coordination seems to be the only way in which a race to the top will be achieved. ASIC could, and should, be encouraged to take an active role in promoting further regulatory cooperation and coordination to protect the long-term interests of Australia's capital markets. Although there are a number of ways in which further regulatory cooperation could be achieved, ASIC could look at working towards:

- standardising laws and market rules for common forms of market abuse, such as insider trading and market manipulation which would assist in cross-border enforcement as all regulators would be "working off the same page";
- establishing intelligence centres or networks to exchange intelligence in relation to possible market abuses; and
- establishing protocols and coordination of joint task forces with the skills and resources necessary to tackle cross-border offences.

<sup>75</sup> In 2009 ASIC's international enforcement and surveillance requests to foreign regulators increased by 13% to 181: see *ASIC 2009 Annual Report*, p 33, [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC\\_Annual\\_Report\\_08-09\\_full.pdf/\\$file/ASIC\\_Annual\\_Report\\_08-09\\_full.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_Annual_Report_08-09_full.pdf/$file/ASIC_Annual_Report_08-09_full.pdf) viewed 30 May 2010.

<sup>76</sup> IOSCO, *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (May 2002), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf> viewed 30 May 2010.

<sup>77</sup> Diplock J (Chairman, IOSCO Executive Committee and Chairman, Securities Commission, New Zealand), "Panel 1 – Future of the Financial Regulatory Framework Role of Market Regulations and Regulators", 5th IOSCO Technical Committee Conference, Basel, Switzerland, 8-9 October 2009, <http://www.iosco.org/library/speeches/pdf/IOSCOSP009-09.pdf> viewed 20 October 2009.

<sup>78</sup> See eg Choi S, "Channelling Competition in the Global Securities Market" (2002-2003) 16 *Transnational Lawyer* 111.

<sup>79</sup> Prentice RA, "Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred" (2005) 66(6) *Ohio State Law Journal* 1155 at 1157.

<sup>80</sup> Prentice, n 79 at 1158.



## Costs

One thing is certain: for ASIC to be effective in its new role it is going to need to invest heavily in personnel and technology. ASIC has been given the capacity to recover the full costs of its surveillance and regulatory activities from market operators.<sup>81</sup> This is justified because, although the move was resisted by the ASX, the ASX stands to benefit from the change as it can now focus on its business activities rather than its regulatory role. This may give it a competitive edge over similar exchanges which must still devote significant attention to their regulatory activities. For example, although the Hong Kong Stock Exchange is a listed public company like the ASX, it is subject to a corporate governance structure where it must balance its public functions in acting in the interests of the investing public with its commercial profit-making objectives.<sup>82</sup>

Furthermore, the ASX and its competitors are the ones that will profit from improvements in market integrity. Studies have shown that high-quality markets with low levels of unfair trading practices have lower costs of capital for the participants.<sup>83</sup> A lower cost of capital should, in turn, result in the exchange attracting a higher number of IPOs and the associated listing fees. In fact, this was the reason that the ASX resisted the takeover of its surveillance and regulatory functions, arguing that “long-term sustainability or the shareholder value of this business has to be inextricably linked to operating markets of maximum integrity”.<sup>84</sup>

However, in the short term, at least, the interests of the market operators and the interests of the public may diverge. The public interest always lies with having markets of high integrity where the cost of capital is low, and this should also benefit market operators who should be able to attract listings seeking a low cost of capital. However, in the short term, market operators may believe reduced costs and reduced enforcement may increase trading.<sup>85</sup> As such, there may be pressure either now or in the future on the Federal Government and ASIC to reduce fees and regulatory enforcement based on contentions that these costs and perceived over-regulation are driving trading overseas. However, for the reasons stated above, it is unlikely that a relaxation of regulatory standards will be in Australia’s long-term interests.

Furthermore, failure to pay attention to market integrity will weaken markets and might even cause the collapse of markets. For example, in 1989 large-scale market manipulation in Brazilian equities led eventually to the bankruptcy of the Rio de Janeiro Stock Exchange.<sup>86</sup> Apart from attracting higher-quality listings, strong markets free of unfair trading practices should also be able to withstand future shocks, or at least more easily attract investors back after the crisis has passed. Australia withstood the GFC better than most countries partly because of the strength of its regulation over its banks. This lesson of the benefits of a strong regulatory framework should not be forgotten.

## Is market integrity a problem anyway?

The above discussion assumes that market offences such as insider trading and market manipulation are, and will continue to be, a problem for Australia’s markets. It assumes that such unfair trading

<sup>81</sup> See the *Corporations (Fees) Amendment Act 2010* (Cth). The Explanatory Memorandum to this Act states (p 3): “The Government will incur capital costs of approximately \$6 million associated with the acquisition of the relevant market supervision software and fitout requirements. The total operating costs associated with ASIC’s new responsibility are expected to be \$53.5 million over the five years to 2013-14.”

<sup>82</sup> See Hong Kong Stock Exchange, *Public and Corporate Responsibility*, [http://www.hkex.com.hk/exchange/cg/public\\_corp\\_responsibility.htm](http://www.hkex.com.hk/exchange/cg/public_corp_responsibility.htm) viewed 23 November 2009.

<sup>83</sup> See eg Bhattacharya U and Daouk H, “The World Price of Insider Trading” (2002) 57 *Journal of Finance* 75; and Hail L and Leuz C, “International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?” *ECGI – Law Working Paper No 15/2003* (2005), <http://www.ssrn.com/abstract=641981>.

<sup>84</sup> ASX, *Edited Transcript of ASX HY 2008 Media Briefing* (14 February 2008) p 3, [http://www.asx.com.au/about/pdf/hy2008\\_media\\_qa\\_14feb08.pdf](http://www.asx.com.au/about/pdf/hy2008_media_qa_14feb08.pdf) viewed 25 November 2009.

<sup>85</sup> Coffee, n 39 at 308.

<sup>86</sup> Carvajal A and Elliott J, “The Challenge of Enforcement in Securities Markets: Mission Impossible?”, *IMF Working Paper No 09/168* (August 2009) p 7, [http://www.papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1457591](http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=1457591) viewed 25 November 2009.



practices impact on the integrity of the market by deterring investors who are wary of investing in a market which is not considered fair for all participants.

However, until recently there was no real way to empirically measure how badly corrupted stock markets were by unfair trading practices. Any attempt to estimate the level of unfair trading practices or whether they were increasing or decreasing by questionnaires directed to those in the market yields results that are at best anecdotal and at worst pure conjecture.<sup>87</sup> Measuring the number of prosecutions undertaken by a regulator year to year is also flawed as variations could be due to multiple factors, eg the quality of the investigators, the willingness of witnesses to assist investigations, the complexity of the matters, or the views of the person whose role it is to commence an investigation as to whether there is or is not sufficient evidence to proceed.

However, some regulators and academics in the finance discipline are attempting to develop proxies to measure market integrity. For example, the Financial Services Authority of the United Kingdom commissioned a study which measured price movements ahead of trading statements and takeover announcements made by companies included within the FTSE index.<sup>88</sup> Price movements before announcements might indicate insider trading. The project found that, at least in relation to takeover announcements, there was an increase in price movements before announcements between 2000 and 2004 followed by a decline between 2004 and 2005, but the level remained high. Similarly, a study by Professor Michael Aitken, Amy Kwan and Professor Thomas McInish measured significant price-sensitive movements prior to the release of price-sensitive announcements on the ASX for the years 2004 to 2007 and compared these to three Chinese exchanges. This study found that the integrity of the ASX had declined over that time but remained high relative to the Chinese exchanges.<sup>89</sup> Aitken and Siow have also measured the incidence of what could be manipulation in the form of share price ramping, by measuring the incidence of share price movements towards the end of the day which were quickly reversed the next day.<sup>90</sup>

Such proxies are not without their limitations. For example, measuring price increases before announcements does not distinguish between true insider trading and trades triggered by rumours or by persons who merely follow the lead of others. Nevertheless, they may start to form an empirical basis for measuring changes in market integrity.

This work will no doubt continue and the development of such proxies for market integrity should prove of assistance to regulators to show whether their enforcement efforts are effective or not and perhaps also eventually enable them to determine what regulatory mix is most effective at maintaining an acceptable level of market integrity. It may also prove to be important in relation to regulators being able to demonstrate to the public that they are meeting their objectives as most regulators have the maintenance of fair and efficient markets as one of their key objectives.<sup>91</sup>

Furthermore, although traditionally markets were said to only compete based upon liquidity, if markets such as the United States attract a low cost of capital because of a strong regulatory and enforcement regime, perhaps markets also compete in relation to integrity. If investors do choose markets now based partially on the integrity of the market, as proxies for market integrity are

<sup>87</sup> For example, Tomasic attempted to estimate the level of insider trading in Australia in 1988 by interviewing brokers, lawyers and regulators: see Tomasic R, *Casino Capitalism? Insider Trading in Australia* (1991). His methodology was heavily criticised, one commentator comparing it to the investigation of witchcraft in New England: see Black A, "The Reform of Insider Trading Law in Australia" (1992) 15 UNSWLJ 214 at 218.

<sup>88</sup> Dubov B and Monteiro N, *Measuring Market Cleanliness* (Financial Services Authority, Occasional Paper Series, 23 March 2006), <http://www.fsa.gov.uk/pubs/occpapers/op23.pdf>; and Monteiro N, Zaman Q and Leitterstorf S, *Updated Measurement of Market Cleanliness* (Financial Services Authority, Occasional Paper Series, 25 March 2007), <http://www.fsa.gov.uk/pubs/occpapers/op25.pdf> viewed 7 September 2010.

<sup>89</sup> Aitken M, Kwan A and McInish T, *Trading Prior to Price Sensitive Announcements* (2009), <http://www.fma.org/NY/Papers/TradingPriorToPSA.pdf> viewed 7 September 2010.

<sup>90</sup> Aitken M and Siow A, "Ranking World Equity Markets on the Basis of Market Efficiency and Integrity", *The HP Handbook of World Stock, Derivative & Commodity Exchanges* (2003).

<sup>91</sup> See IOSCO, n 8. One of ASIC's key priorities is to "build confidence in Australia's capital markets": see ASIC, *Our Role*, <http://www.asic.gov.au/asic/asic.nsf/byheadline/Our+role?openDocument> viewed 28 December 2009.



developed and become well known, it is likely that investors, and perhaps in particular institutional investors, will consider this in deciding where to trade. This will, in turn, increase the attractiveness and the competitive advantage of markets which can demonstrate high levels of market integrity. For this reason market integrity may become increasingly important in the future. ASIC will need to be mindful of these developments.

Even at a purely domestic level, it is important that market integrity be maintained. Australians are probably going to continue to predominately invest in Australia's markets, if not directly then at least indirectly through their superannuation funds. Given that many of the largest superannuation funds are associated with trade unions, it is likely that these superannuation funds will always have a bias towards investing in Australian companies.

## CONCLUSION

The Federal Government's decision to transfer the surveillance of the markets and the supervision of market participants to ASIC presents ASIC with the opportunity to improve on its enforcement outcomes through investigating market offences more efficiently and reducing regulatory duplication. Although the Federal Government's decision is a rejection of the co-regulatory model that exists in many parts of the world, this model was a product of United States history rather than any demonstrated superiority. That it continues to exist in many countries has more to do with it being convenient for governments to focus their activities elsewhere. In fact, what is said to be the main benefit of this model, which is that the SROs are "closer" to the market and are thereby better able to detect problems quickly, is in fact questionable as publicly owned markets distance themselves from their regulatory functions.

However, the Federal Government's decision is not without its risks. ASIC is now front and centre of market regulation and will be answerable for any future problems in the markets. As such, it will need to obtain sufficient funds from the markets and invest these resources in enhancing both the detection of market offences and the enforcement of breaches that are detected. If it fails in this goal, there may be calls for it to be replaced with some other organisation or perhaps even a reversion to the co-regulatory model.

But perhaps more fundamentally, if ASIC fails to curb market misconduct, this will threaten the integrity of the markets, deterring investors and increasing the cost of capital for Australia's listed companies. In a world where markets are fragmenting and trading is global, investors, and in particular large institutions, will increasingly look for markets of high integrity free from unfair trading practices. ASIC needs to ensure that Australia's markets are just such markets.

