15 October 2010

Mr John Hawkins
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Mr Hawkins

Corporations Amendment (No.1 Bill) 2010

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide comments to the Senate Economics Legislation Committee on the Corporations Amendment (No.1 Bill) 2010 (the Bill). Our comments are directed at one aspect of the Bill relating to the amendment of section 1041B. Overall AFMA considers that the Bill implements the Government's announced policy decisions in an effective way.

1. Section 1041B Amendment

AFMA welcomes the proposed amendment to section 1041B in clause 15 of the Bill in clarifying the fault element for criminal offences as it takes partial account of our previous submissions to the Treasury and the Corporations and Markets Advisory Committee (CAMAC) on this issue. However, we are concerned that it does not deal with the more serious problem relating to the need for intention to also clearly apply in respect of civil penalty actions.

AFMA considers this problem needs to be dealt with as a matter of priority because of the transfer of market supervision to the Australian Securities and Investments Commission (ASIC) as part of the changes to the law supporting competition amongst equity market operators. Market Participants are highly concerned about this issue in the current environment of regulatory change. The proposed amendment of section 1041B provides the appropriate opportunity to address this problem.

1.1. Issue

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The transfer of market supervision to ASIC has intensified long standing concerns with the application and interpretation of section 1041B. The effect of section 1041B of the Corporations Act is to prohibit wash trades, which are deemed to create a false and misleading appearance of active trading in a security. Engaging in 'wash trades', as understood in most jurisdictions internationally, is a practice whereby an investor simultaneously buys and sells a financial product through one or more broker(s), the purpose of which is to create the appearance of increased volume and volatility in that financial product. The need to prohibit such conduct is not in question. Wash trading is a manipulative activity which undermines market integrity.

The 'wash trading' provisions in sub-paragraphs (2), (3) and (4) of section 1041B are the source of the problems we wish to raise. Sub-section (2) provides that a person "is taken to have created a false or misleading appearance of active trading" where there has been no change in beneficial ownership (see subsections 1041B(2)(a) and (3)). The provision creates problems where 'inadvertent crossings' occur.

Inadvertent crossings, where beneficial ownership does not change, can arise for a variety of reasons. For instance, in algorithmic trading the execution of multiple independent strategies, each of which may apply a different meaning to new market information, may give rise to inadvertent crossings. That is, one strategy may identify an opportunity to sell a security (for example, on the basis of the security's price relationship to an index) at the same price at which another strategy may identify an opportunity to buy the same security (for example, on the basis of the security's price relationship to a historically correlated security). Here, each strategy is analogous to an independent investor reviewing and acting upon specific market information.

Another cause of inadvertent crossings is technical latency constraints, for instance, as a result of multiple trading systems and or trading software that cannot insert and remove quotes in a sufficiently timely manner. Particularly where a Participant uses both proprietary and third party software systems (for example, to provide market making services), difficulties in preventing crossings between orders placed by those independent systems cannot presently be resolved completely.

It is also important to note that Participants do not profit from inadvertent crossings. Rather, each crossing represents a missed opportunity to capture the prevailing market spread by trading with another party willing to buy or sell at the proposed price. Further, a Participant bears the administrative burden of ensuring that each crossing is identified and cancelled. As such, inadvertent crossings are a statistically small but unwanted by-product of high volume trading that current best practice cannot entirely prevent.

The Australian Securities Exchange (ASX)[1] has observed that there has been a significant increase in trade cancellations, as a result of an increase in the number of wash trades, which it believes is consistent with the increased use of algorithms. The vast majority of trades that are cancelled are crossings, and an increasing number of these are being cancelled after the close of trading (up from 33% in January 2009, to 60% in August 2009). This is a

[1] Algorithmic Trading and Market Access Arrangements Broker Trades, ASX Review, February 2010

continuing trend so the occurrence of inadvertent crossings is likely to increase.

Under section 1041B inadvertent crossings are strictly caught even though there was no intention to manipulate the market. The inadvertent crossing is deemed to have created a false or misleading appearance of active trading, irrespective of the absence of intent and irrespective of the actual appearance created in the eye of a reasonable market observer. Under previous law the presence of an intention element, together with a defence relating to the absence of manipulative purpose, provided the safeguard for separating legitimate trading from illegitimate trading in an effective manner. This issue is explained in detail in section 2.2 dealing with the history of section 1041B.

1.2. Background to Section 1041B

This section provides a brief outline of past developments to explain why the intention element was lost. Section 1041B, according to the Explanatory Memorandum[2], was intended to replace sections 998 and 1260 of the Corporations Law, "based on section 1260", "but applying to all financial products traded on a financial market"[3]. For present purposes it is important to be aware that section 998 of the old Corporations Law required that there be an intention to create a false market, but this element was not included in section 1041B[4]. While the Explanatory Memorandum was silent on the reasoning for the dropping of the intention element, the earlier commentary[5] on the consultation draft of the Bill commented that *"Section 997 currently contains an 'intention' element. Civil contravention of the new provisions will not require that element of intention to be established."* The thinking at the time was that civil penalties would be made strict liability offences. It is this provision to which the civil penalty regime was applied along with criminal liability.

Also of significance, section 998 of the Corporations Law included a defence in subsection 988(6) to a prosecution for entering into a transaction that did not involve a change in beneficial ownership. Under that subsection, a person could avoid liability where he or she could prove the absence of a purpose of creating a false or misleading appearance of active trading in the relevant market. This would have excluded from the ambit of section 988 the type of inadvertent crossings described above.

The consequence of these changes was to make section 1041B an enduring problem both for regulators and market participants and the subject of continuing requests for its reform by industry to deal with circumstances where legitimate market transactions breach the law.

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[2] Financial Services Reform Act 2001, Explanatory Memorandum

[3] Idem, paragraph 15.14

[4] See Attachment 2 for legislative history of section 1041B

[5] Commentary on the draft provisions of the Financial Services Reform Bill 2000 issued by Treasury in February 2000, see paragraph 11.10

1.3. ASX Supervision and New Market Integrity Rules

The ASX has been conscious of the problematic nature of section 1041B and their previous ASX Market Rule 13.4 incorporated 'intention' and ameliorating 'Circumstances of the Order' that allow for consideration of the commercial reasoning behind the order in the case of orders placed by a Market Participant on behalf of another person (a client). However, in the case of orders placed by a Market Participant as principal, the Market Rule necessarily conforms to the Corporations Act by incorporating an "effects test". That is, it prohibits the placement of a Bid or Offer that has the effect of creating a false or misleading appearance of active trading in a Product (ie, a financial product) (13.4.1(a)(ii)). The absence of a manipulative purpose may be relevant to the penalty for breach of this rule, but will not absolve a Participant from liability for the breach.

However, notwithstanding this strict prohibition, inadvertent crossings do occur on a regular basis, as noted above. The resulting practical question relates to the number of such crossings that will be considered "material" in the view of the administering body (to date, ASX) and therefore warrant enforcement action. The previous ASX Market Rules provided some guidance to Participants on transactions involving no change in beneficial ownership in the context of ASX Market Rule prohibitions on manipulative trading. ASX advised Participants to consider all of the factors surrounding the circumstances of an order to assist them in avoiding contravention of Market Rule 13.4. Whether a transaction involves a change in beneficial ownership is one factor Participants must have regard to under Market Rule 13.4.2. The ASX then noted that Participants should be cautious about such transactions even though their purpose does not appear to be manipulative. This is because transactions may nonetheless create a false or misleading appearance with respect to the market for, or price for trading/actively trading in, a security, regardless of their purpose.

The ASX's practical market approach and understanding allowed the problems created by section 1041B to be handled in a pragmatic way that takes account of the difference between intentional market manipulation and legitimate orders that cross inadvertently because of the large volumes of principal and/or client orders being handled at high speed. However, this has also given rise to considerable uncertainty, as ASX is not in a position to advise Participants as to the number of inadvertent crossings (wash trades) that will be tolerated before enforcement action is taken. To do so would necessarily have required ASX to condone breaches of the s1041B Corporations Act.

As part of the transfer of supervision, ASIC has created ASIC Market Integrity Rule (MIR) provisions 5.7.1 and 5.7.2 which are analogous to the old ASX Market Rule 13.4.2. The wording of the MIR creates a real regulatory dilemma for ASIC because the elements in MIR 5.7.1 and 5.7.2 that allow for consideration of the intention of the Participant, in relation to client orders, are not consistent with section 1041B as it would be even after the amendment. Further, in relation to orders of Participants as principal, the same questions of materiality and intention that arise under Market Rule 13.4.1(a) are not addressed by section 1041B and will lead to significant

regulatory uncertainty in the market. To the extent of inconsistency, ASIC is bound to apply the law over its subordinate market integrity rules, unless it has the power to exercise a discretion. Its power to exercise such a discretion is not clear.

This situation has turned a long standing problem that has been dealt with by pragmatic market supervision into an urgent problem requiring legislative change.

1.4. Civil Penalty Intention Needed

Where civil penalty liability is concerned there is clearly no 'intention' element required where a civil penalty action is being pursued by the regulator. As civil penalty actions are likely to form the bulk of proceedings arising from ASIC investigations this is a matter of serious consequence.

Under section 1317S, in a civil penalty action, if the court thinks that the defendant has acted honestly and the circumstances of the case call for a relief from liability for contravention, the court has discretion to relieve the defendant from such liability. Therefore, if the defendant can establish that he or she carried out the impugned transactions for legitimate purposes, a relief of liability may be available under section 1317S. While the 'honesty' defence in section 1317S may be regarded as providing a relief from liability in civil penalty proceedings against market manipulation it is our contention the primary liability should not arise in the first instance with regard to legitimate market orders.

AFMA is of the view that ASIC will face a serious market supervision problem with section 1041B in its present form because it does not incorporate an intention fault element to allow for appropriate distinction between mischievous market manipulation and legitimate trading when inadvertent crossings occur. This creates a high level of regulatory risk for Market Participants. Such risk undermines market efficiency. The ideal solution to the problem lies in reintroducing an intention fault element back into section 1041B with application to both civil penalties as well as the proposed criminal penalty clarification. The reintroduction of intention would be fully consistent with existing common law.

An alternative, less ideal way to deal with this issue is to sanction ASIC's use of administrative discretion to apply the statutory rule in a way which is consistent with its MIR 5.7.1 and 5.7.2 by recognizing that there are circumstances where ASIC needs to apply the law to assist the operation efficient markets. A recommendation from the Committee along these lines could provide comfort to ASIC that in applying the law in a sensible way it is doing so consistent with the intention of the Parliament.

2. Close

Thank you for considering these comments on this important matter. Please contact me at dlove@afma.com.au or (02) 9776 7995 for further clarification or elaboration as required. I would be happy to respond at your convenience.

Yours sincerely

David Love
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