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## LICENSING OF FINANCIAL MARKETS

## Introduction

10.1 In this chapter we deal first with the requirements for licensing of financial markets and clearing and settlement (CS) facilities under Pts 7.2 and 7.3 of the Corporations Act (2001) Cth (Corporations Act); second, with limits on voting power for prescribed licensees and the need for individuals involved in market and CS facilities to be fit and proper persons under Pt 7.4; and third, with compensation regimes for financial markets under Pt 7.5. Chapter 11 deals with market integrity rules and market supervision, and Chapter 12 with the enforcement of Australian Securities Exchange (ASX) listing rules.

The licensing regime for market providers under Pt 7.2 of the Corporations Act is directed to protecting market users, and enhancing market integrity and stability in the financial system.<sup>1</sup> Licensing of market operators and the requirement that they comply with licence obligations is directed to these purposes, and other mechanisms used to achieve these purposes include supervision by the Australian Securities and Investments Commission (ASIC) of market licensees' compliance with their obligations, the regime for ministerial disallowance of changes to the operating rules for licensed markets and obligations imposed directly on financial services licensees (see Chapter 13).<sup>2</sup>

ASIC has identified several objectives of the licensing of financial markets and noted the manner in which Pt 7.2 of the Corporations Act achieves those objectives as follows:

Table 10.1: Objectives of licensing financial markets

Objective	How Pt 7.2 achieves that objective
Market users should be able to use a market on an informed basis. Market users can be confident that the market operates fairly.	Part 7.2 promotes these objectives by requiring a market operator to: ensure that the market is fair, orderly and transparent; monitor the conduct of listed entities and participants in, or in relation to, the market and enforce compliance with market operating rules; and notify ASIC of suspected significant breaches of the law or the market's operating rules. <sup>3</sup>

1. ASIC RG 172: *Australian Market Licences: Australian Operators*, [172.7].

2. *ibid.*, [172.8], [172.10], [172.12].

3. *ibid.*, [172.12].

Market users should be confident about market participants, including their dealings with their clients, their compliance with the law and the market's operating rules and their financial soundness.

Part 7.2 promotes this objective by requiring a market operator to: ensure that the market is fair, orderly and transparent; monitor the conduct of participants in, or in relation to, its market and enforce compliance with the market's operating rules; notify ASIC of disciplinary action against a participant, suspected significant breaches of the law or the market's operating rules by a participant or a participant's inability to meet its obligations as a financial services licensee; and have appropriate compensation arrangements in relation to clients' money and other property held by market participants.<sup>4</sup>

Objectives as to market supervision, market stability and clearing and settlement.

Part 7.2 promotes this objective by requiring a market operator, inter alia, to: ensure that the market is fair, orderly and transparent; have adequate arrangements and resources to supervise the market and for handling conflicts of interest; have sufficient financial, technological, human and other resources to operate the market properly; and have adequate clearing and settlement arrangements.<sup>5</sup>

There have been several important recent developments in regulation of market providers. The Johnson Report recommended that the Australian Government should grant licences for new trading platforms and exchanges, in order to introduce market competition and allow opportunities for niche markets for exchange traded and over-the-counter markets.<sup>6</sup> The government announced its decision to transfer responsibility for supervision of trading on licensed financial markets from current market operators to ASIC. In March 2010, the government announced its support for market competition and its in-principle approval of an application for a market licence by Chi-X Australia, which proposed to offer a competing market for products listed on the ASX. From 1 August 2010, ASIC assumed responsibility for supervision of certain aspects of trading by market participants on licensed markets under the Corporations Amendment (Financial Market Supervision) Act 2010 (Cth). This step was characterised as 'the first step in the process towards considering competition between market operators'.<sup>7</sup> On 29 April 2011 ASIC introduced the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011 (see Chapter 11) and on 4 May 2011 Chi-X Australia was granted a licence to operate a market providing secondary market trading services in ASX-quoted equity market products in competition with the ASX.

The overseas experience with market competition, particularly in the United States, Europe and Canada, suggests that the introduction of competition between exchanges will result in reduced transaction costs and potentially increase liquidity, but also has the risks of fragmentation of liquidity and increased volatility. The

4. *ibid.*

5. *ibid.*

6. Australian Financial Centre Forum Report, *Australia as a Financial Centre: Building on Our Strengths*, November 2009, pp 92–3.

7. Joint Media Release of the Treasurer and the Minister for Financial Services, Superannuation and Corporate Law, announcing that decision, 24 August 2009; Explanatory Memorandum to the Corporations Amendment (Financial Markets Supervision) Act 2010 (Cth) [2.9]–[2.18].

introduction of competing markets also raises challenges for market regulation, since it may be more difficult to detect market manipulation (see Chapter 16) and trading by intermediaries on the knowledge of client trades ('front running': see 17.28) where trading occurs on more than one market. At the same time, increased opportunities for off-market trading arising from technological developments (sometimes referred to as 'dark pools') raise challenges for transparency, price discovery and market liquidity.

### When a licence to operate a financial market is required

#### Scope of licensing requirement

10.2 In this section we deal with the licensing requirements for financial markets under ss 791A and 791B of the Corporations Act and the associated concepts of 'financial market', 'facility', 'through which', 'offer' and 'invitation'.

A person may only operate, or hold out that it operates, a financial market in the jurisdiction if it has an Australian market licence that authorises it to operate the market in the jurisdiction, or is exempt from the operation of Pt 7.2: s 791A. A contravention of s 791A is a strict liability offence. A person is prohibited from holding out that it has an Australian market licence, or that the operation of a financial market by that person in the jurisdiction is authorised by such a licence, or that a financial market is exempt from the operation of Pt 7.2, or that the person is a participant in a licensed market, if that is not the case: s 791B.

#### What is a financial market?

10.3 The term 'financial market' is defined as a 'facility through which offers to acquire or dispose of financial products are regularly made or accepted; or 'offers or invitations' are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in the making of offers to acquire or dispose of financial products or the acceptance of such offers: s 767A(1).

#### What is a facility?

10.4 The term 'facility' is not separately defined. An integrated infrastructure on which the relevant offers or invitations are made would constitute such a facility: *Carrageen Currency Corporation Pty Ltd v Corporate Affairs Commission* (1986) 7 NSWLR 705; 11 ACLR 298 at 312-13. An integrated facility may constitute a financial market even if its component parts do not do so when considered in isolation, and factors which may indicate that a number of component parts constitute a single facility include that those component parts are owned or controlled by the same entity or are part of the same corporate group, or that those component parts together enable the making or acceptance of offers or invitations and no component part is a regulated market.<sup>8</sup>

8. ASIC RG 172: *Australian Market Licenses: Australian Operators*, [172.18]-[172.19].

In order to fall within the definition of 'financial market', a facility must be one 'through which' the relevant offers or invitations are made or accepted. It is not intended that general communication services be regulated as financial markets.<sup>9</sup> ASIC has expressed the view that the phrase 'through which' should be construed narrowly and that a facility is only a financial market if the offers or invitations are made or accepted by means of that facility, in the sense that the offers or invitations are actually made on that facility.<sup>10</sup>

#### Examples

10.5 Whether conduct amounts to operating a financial market will require a determination of whether the elements specified in s 767A(1) (see 10.3) are present. For example, ASIC Regulatory Guide (RG) 172 gives an example of an internet portal which hosts advertisements of licensed advisers, brokers, fund managers and market operators, where the internet portal contains a prominent disclaimer indicating that its operator does not endorse services or markets which may be accessed through the site, that portal is clearly separated from linked websites, and the operator of the portal does not exercise control over the content of material on it other than to remove material which it considers may be illegal or defamatory. ASIC expresses the view that such an internet portal operator is not operating a financial market, since offers or invitations are not made through the facility operated by that operator, but rather on the financial markets that may be accessed through that portal.<sup>11</sup>

Conversely, ASIC expresses the view that, if a person operates an internet site where licensed dealers indicate their willingness to deal in financial products or provide firm prices for financial products, and that site permits investors to submit price inquiries concerning financial products listed on that site which are then forwarded to those dealers, or permits investors viewing it to indicate interest in a dealer's firm price posted on the site which is then notified to the dealer, that person would be operating a financial market (being a facility through which offers or invitations are made) even if the relevant contracts were negotiated directly between the investor and dealer.

#### Other licensing requirements

10.6 The holder of an Australian market licence must also obtain an Australian CS facility licence before it can operate a CS facility: see 10.18ff. A market licensee does not require any additional licence to provide financial services that are incidental to its market operation activities: s 911A(2)(d). However, a market licensee would also be required to hold an Australian financial services licence (AFS licence) if it provided financial services which could not be characterised as incidental to its market operation activities: see 13.2ff. An Australian CS facility licence or AFS licence could be included in the same document as an Australian market licence: s 795D.

9. Explanatory Memorandum to the Financial Services Reform Bill, para 7.14.

10. ASIC RG 172: *Australian Market Licenses: Australian Operators*, [172.20].

11. *ibid.* [172.175].

### Jurisdictional scope of licensing requirements

10.7 Section 791A prohibits the operation of a financial market 'in this jurisdiction' unless the operator has the relevant licence or the market is exempt. A financial market is taken to be operated 'in this jurisdiction' if it is operated by a body corporate that is registered under Ch 2A: s 791D(1). A financial market conducted by a body corporate which is registered in Australia is therefore taken to operate in the jurisdiction, even if its activities are offshore. The purpose of this extension is to prevent Australia's reputation as a global financial centre being compromised by operators of markets which incorporate in Australia to operate elsewhere.<sup>12</sup> That provision does not limit the circumstances in which a financial market is operated in the jurisdiction for the purposes of Ch 7: s 791D(2). ASIC has expressed the view that a financial market will also be operated in Australia if it is located in Australia, in that it has a trading floor in Australia or all or a significant part of the market infrastructure is located in Australia; or the market has one or more participants<sup>13</sup> in Australia and is targeted at Australian investors.<sup>14</sup>

### Exemptions from licensing requirements

10.8 A person's making or accepting offers or invitations to acquire or dispose of financial products on his or her own behalf, or on behalf of one party to the transaction only, does not constitute 'operating' a financial market for the purposes of Ch 7, unless the regulations specify circumstances in which such conduct constitutes operating a financial market and the person's conduct occurs in those circumstances: s 767A(2)(a). This provision is intended to exclude offers or invitations made or accepted in circumstances involving direct negotiation between parties each of whom accepts the credit risk on the other, and will exclude transactions which are typically undertaken on the 'over the counter' market.<sup>15</sup> A person conducting treasury operations between related bodies corporate; a licensed auctioneer conducting an auction of forfeited shares; and any other conduct of a kind prescribed by regulations does not constitute 'operating' a financial market for the purposes of Ch 7: s 767A(2)(b)-(d).

The Minister may also exempt a particular financial market or type of financial market from the requirement to hold an Australian market licence under Pt 7.2, and that exemption may be subject to conditions: s 791C. This exemption provision will be used in limited circumstances; for example, in relation to a facility where there is no policy reason to regulate the market.<sup>16</sup>

12. Explanatory Memorandum to the Financial Services Reform Bill, para 7.19.  
 13. The term 'participant' is defined in s 761A as 'a person who is allowed to directly participate in the market under the market's operating rules'. In ASIC RG 172: *Australian Market Licences: Australian Operators*, [172.95], ASIC indicates its view that a person directly participates in a market if he or she has unintermediated access to the market's trading system or has direct legal responsibility for an offer or invitation made through the market.  
 14. ASIC RG 172: *Australian Market Licences: Australian Operators*, [172.38]–[172.39]. RG 172: *Australian Market Licences: Australian Operators* also indicates factors to which ASIC will have regard in determining whether a financial market is targeted at Australian investors.  
 15. Explanatory Memorandum to the Financial Services Reform Bill, para 7.15.  
 16. *ibid.*, para 7.27; see also ASIC RG 172: *Australian Market Licences: Australian Operators*, [172.51]–[172.52].

### LICENSING OF MARKET PROVIDERS

#### Criteria for grant of Australian market licence

10.9 A body corporate may apply for an Australian market licence by lodging an application with ASIC that includes information required by the regulations; is accompanied by any documents required by the regulations; and complies with the requirements of s 881B relating to compensation arrangements (see 10.34): s 795A(1). The information and documents required as part of an application for an Australian market licence are specified in Corporations Regulations 1999: 7.2.11–7.2.12. Section 795B(1) provides that the Minister may grant an Australian market licence if he or she is satisfied of certain matters, including that:

- the applicant will comply with the obligations that will apply if the licence is granted (see s 792A and 10.11);
- the applicant has adequate arrangements for operating the market and monitoring compliance with the market's operating rules;
- the applicant has adequate clearing and settlement arrangements for transactions effected through the market, if the Minister considers that it should have such arrangements;
- neither s 881D(2) nor s 882A(2) (relating to compensation arrangements) requires the Minister to reject the application (see 10.34); and
- no unacceptable control situation is likely to result if the application is granted and no disqualified individual appears to be involved in the applicant (see 10.32).

The Minister is also required to have regard to specified matters in deciding whether to grant an Australian market licence under s 795B: s 798A(1). Those matters are:

- the structure or proposed structure of the market;
- the nature of the activities conducted or proposed to be conducted on the market;
- the size or proposed size of the market;
- the nature of the financial products dealt with or proposed to be dealt with on the market;
- the participants or proposed participants in the market, and whether those participants will be providing financial services to other persons, will acquire or dispose of financial products as retail clients or as wholesale clients, and will also be participants in any other financial market;
- the technology used or proposed to be used in the operation of the market;
- whether it would be in the public interest to grant the licence; and
- any relevant advice received from ASIC.

Matters relevant to the public interest may include, for example, any increase in competition, product innovation or other benefit to market participants, and any adverse impact on liquidity as a result of fragmentation of the existing markets, which might arise from granting the application. The Minister may also have regard to any other matter that he or she considers relevant: s 798A(2). We have referred above to the recent approval of Chi-X Australia as a competing market for secondary trading of ASX-listed products: see 10.1.

### Grant of licence to overseas market operators

10.10 Alternative criteria are specified for the grant of a licence to an entity that operates a financial market in a foreign country in which its principal place of business is located and seeks to operate the same market in Australia. In that case, the Minister must be satisfied of the matters specified in s 795B(2). The purpose of those requirements is to 'facilitate competition and avoid duplicated regulation, while paying due regard to investor protection and market integrity'.<sup>17</sup> An overseas market operator licensed under s 795B(2) is subject to a number of obligations imposed under s 792A (see 10.11) and to reporting requirements under s 792B; see 10.12. However, the provisions relating to the content of operating rules and procedures, the disallowance of operating rules under s 793A(3) (see 10.14) and compensation arrangements under Pt 7.5 (see 10.34) do not apply to an overseas market which obtains an Australian market licence under s 795B(2). The Minister may suspend or cancel an Australian market licence issued to such an operator if it ceases to be authorised to operate in the jurisdiction of its principal place of business or the Minister decides that the overseas regime is no longer equivalent to the Australian regime: s 797B(d).

### Obligations of Australian market licensees

10.11 Section 792A sets out a number of obligations of market licensees. We deal with these obligations in this section.

#### 'Fair, orderly and transparent market'

10.12 A market licensee must, to the extent that it is reasonably practicable to do so, do all things necessary to ensure that the market is a fair, orderly and transparent market: s 792A(a). The Explanatory Memorandum to the Financial Services Reform Bill notes that all words in the phrase 'fair, orderly and transparent' should be considered together, and recognises that tensions between the three objectives may need to be resolved sensibly; for example, transparency may on occasions be in conflict with liquidity, while liquidity is necessary for an orderly market.<sup>18</sup> The notion of a 'fair, orderly and transparent' market is also found in Securities Act: 1934 (US) s 11A, and United States authority indicates that a 'fair' market is free from manipulative and deceptive practices and affords no undue advantage to any participant, and an 'orderly' market is characterised by regular, reliable operations with price continuity and depth, in which price movements are accompanied by appropriate volume and reasonable price variations between sales are avoided: *Transmarket Trading Pty Ltd v Sydney Futures Exchange Ltd* (2010) 188 FCR 1; 78 ACSR 507 at [92]. This requirement involves two core concepts, one relating to market participants being placed in an equal position such that there is a level playing field, and the second being 'the notion of reliable market operations displaying price continuity and depth in which unreasonable price variations between sales are avoided': *Transmarket Trading Pty Ltd v Sydney Futures Exchange Ltd*, above, at [95]. It appears that the words 'to the extent that it is reasonably practicable to do so' in s 792A(a)

17. Explanatory Memorandum to the Financial Services Reform Bill, para 7.100.  
18. *ibid.*, para 7.38.

qualify the words 'all things necessary', so that a market licensee must do everything reasonably practicable to ensure that the market is fair, orderly and transparent.<sup>19</sup> A market licensee must also comply with the conditions on its licence: s 792A(b).

#### Other requirements for market licensees

10.13 A market licensee must also:

- have adequate arrangements for operating the market, including arrangements for dealing with conflicts and monitoring and enforcing compliance with the market's operating rules: s 792A(c);<sup>20</sup>
- have sufficient resources (including financial, technological and human resources) to operate the market properly and for the required supervisory arrangements to be provided: s 792A(d);
- ensure that there are approved compensation arrangements in relation to the market, if such arrangements are required under s 881A (see 10.34): s 792A(e);
- take reasonable steps to ensure that information about compensation arrangements that are in place under Pt 7.5 is available to the public free of charge: s 792I;<sup>21</sup>
- if the licensee, or a holding company of it, is a widely held market body (within the meaning of Pt 7.4 Div 1), take all reasonable steps to ensure that an unacceptable control situation, within the meaning of that Division, does not exist in relation to that body: s 792A(h); and see 10.32;
- take all reasonable steps to ensure that no disqualified individual becomes, or remains, involved in the licensee: s 792A(i); and see 10.32;
- notify ASIC of certain matters under ss 792B and 792C;
- provide assistance to ASIC under s 792D;
- allow ASIC reasonable access to the market's facilities under s 792E;
- give an annual report and other information to ASIC under s 792F; and
- disclose specified matters in relation to its clearing and settlement arrangements under s 792G.

#### Content, legal effect and enforcement of operating rules and procedures of licensed markets

10.14 The operating rules of a licensed market must deal with the matters prescribed by regulations, which may also prescribe matters in respect of which a licensed market must have written procedures: s 793A(1)–(2). The term 'operating

19. ASIC RG 172: *Australian Market Licenses: Australian Operators*, [172.84].

20. This section was amended to take its present form by the Corporations Amendment (Financial Market Supervision) Act 2010 (Cth) in connection with the transfer of market supervision responsibilities from the ASX to ASIC: see Explanatory Memorandum to the Corporations Amendment (Financial Markets Supervision) Act 2010 (Cth) [1.6]–[1.9].

21. This could occur by that information being made available on the market's website: Explanatory Memorandum to the Financial Services Reform Bill, para 7.65. ASIC RG 172 sets out ASIC's view of the scope of the information which a market licensee must make publicly available concerning the compensation arrangements that are in place under Pt 7.5: at [172.112].