Building and innovating towards stronger, cleaner markets

A speech by Greg Medcraft, Chairman,
Australian Securities and Investments Commission

Stockbrokers Association of Australia Annual Conference, 2013

30 May 2013

CHECK AGAINST DELIVERY

Introduction

Thank you, David [Horsfield], for the introduction.

Good morning, ladies and gentlemen.

Today I've been asked to speak about building and innovating towards stronger, cleaner markets.

This is aligned with ASIC's strategic objectives of:

- confident and informed investors and financial consumers; and
- fair, orderly and transparent markets.

In particular, today I want to highlight how the challenges posed by new technologies are impacting on our strategic objectives.

Combating cybercrime – the challenges of technology

While my speech will focus on ASIC's work in relation to Australia's equity markets, I wanted to start by highlighting ASIC's efforts to combat cybercrime, particularly in the area of investment and share scams.

The development of the internet has enabled cyber crime, and in particular, investment scams, to move online and to become a lot more sophisticated in their deception.

ASIC devotes a lot of time and resources to combating boiler room and investment scams.

The criminal syndicates that operate these scams are sophisticated and often use offshore sites to target Australians.

They are persistent and have fleeced many people of their money – hundreds of millions of dollars over the past 15 years, often with devastating consequences.

This is money that has been lost to Australia and, in most cases, would otherwise have been invested through your industry.

Cybercrime is something ASIC takes very seriously and we will keep fighting against these fraud sites.

One tool we have is the ability to disrupt and block the websites of these criminal operators. Our results show that quick action can have a major impact on the amount of money being lost.

ASIC can request telecommunications providers to block access to scam websites under section 313 of the Telecommunications Act. Over the last 12 months, we have sought this help on ten occasions.

The process works like this:

- we identify a fraud site,
- then, using section 313, we request the local telecommunications providers to block Australians accessing the internet address hosting the site, which is usually overseas.

ASIC has been working hard to shut down these investment scams, and this has led to a situation which has been the subject of recent media reports.

It was recently reported that in ASIC's attempt to block a scam investment website, a number of other sites that shared the same internet address were also blocked.

The circumstances need explanation.

In this case, the issue was that ASIC was unaware that the IP address was also shared by other websites.

This was the first time we became aware we had blocked other sites. We are reviewing our procedures to ensure this does not happen again, as obviously we are not targeting legitimate sites.

We don't apologise for blocking the sites of criminal fraudsters, and we will continue to take action to prevent scammers ripping off Australians. We have seen first-hand the devastating consequences these scams have on Australian investors and their families.

ASIC is all about ensuring investors can be confident and informed and this means cracking down on fraud when we see it.

The Australian public would expect nothing less of ASIC.

I would now like to move on to how we're working towards stronger and cleaner equity markets.

There are three parts to this:

1. Addressing high-frequency trading and dark liquidity,
2. ASIC's surveillance of the financial markets, and
3. FOFA, the Future of Financial Advice reforms.

High-frequency trading and dark liquidity taskforces

Last year at this conference, I announced that ASIC was forming two task forces to examine the impact of dark liquidity and high-frequency trading on Australia's financial markets.

After much work and with the cooperation of industry, the task forces released Report 331 and Consultation Paper 202 in March 2013.

Overall, we did not find any fundamental deterioration of market quality, or systematic abuse which threatens the integrity of our market. Rather, we found the Australian market to be of high quality and integrity.

High-frequency trading: our findings

Our analysis of trading from January to September 2012 showed that 27% of equity market turnover is due to high-frequency trading – the majority (80%) by 20 entities.

On the whole, we found that some of the public perceptions about high-frequency trading appear to have been overstated and were not supported by our findings.

We found that increases in order-to-trade ratios have been moderate compared with overseas markets, and although high-frequency traders' order-to-trade ratios are greater than the rest of the market on average, the difference is not as great as many would expect.

We also found no evidence of systematic manipulation or gaming behaviours (such as layering or quote stuffing) by high-frequency traders.

While a small number of discrete incidents required follow-up, these were the exception rather than the norm.

We did find, however, some basis for the perception that high-frequency trading creates excessive 'noise' in the market, although our analysis revealed that other traders using algorithms contribute to this problem.

It's important that ASIC has published details about how high-frequency traders are impacting our markets, what types of entities they are, and the strategies they employ. By doing so, we have dispelled some of the myths about high-frequency trading.

High-frequency trading: regulation

Since ASIC became the frontline supervisor of the Australian markets three years ago, we have developed a robust regulatory framework of rules and guidance to address electronic trading including high-frequency trading.

This is part of ensuring investors are confident and informed when participating in our markets, and that markets are fair, orderly and transparent.

Companies need to be confident about their ability to raise capital and investors need to be able to trade efficiently and at fair market prices. We are extremely serious about maintaining markets of quality and integrity in Australia.

We have introduced new market integrity rules for automated trading.

- These new rules are designed to strengthen the regulatory regime and mitigate potential market disorder.
- They enhance market operator controls for extreme price movements, and market participant filters and controls for automated trading.
- This includes a ‘kill switch’ to immediately shut down problematic algorithms.

As a result, we found that minimal additional requirements were necessary.

In relation to small and fleeting orders, they are causing two issues.

1 They create excessive noise in our markets and offer little economic utility, and

2 they undermine investor confidence, as there’s a perception that small and fleeting orders can be used in a predatory manner.

ASIC’s taskforce has been changing behaviour in the markets through close engagement with industry.

- We have educated and raised awareness about the impacts of algorithmic trading in our market with the buy-side.
- We have escalated discrete matters directly with market participants, particularly, those with problematic order-to-trade ratios or excessive messages. In some circumstances, this has resulted in them decommissioning their trading system.
- Our Enforcement teams are also looking at cases of potential misconduct.

Already, we have seen considerable lessening of noise created by small and fleeting orders, and expect there will be even further improvement.

Since March, small and fleeting orders have reduced by 55% – from 3.6% to 1.6% of all untraded orders.

The supervision levy has already reduced the volume of message traffic in our market, and while cost recovery is not a regulatory tool, the cost per message will increase by 37% from July. This is expected to further reduce messaging levels.

ASIC has listened to your concerns, in particular, the costs to industry, and the number and extent of systems that will require redevelopment to comply with new requirements.

Accordingly, ASIC has decided not to implement the proposal for a Small Order Resting Time, at this stage.

However, I want to be very clear that we remain committed to ensuring investors have confidence in our markets and noise from excess messages remains at manageable levels. Our proposal remains ‘on the table’, should market noise return to problematic levels.

We will continue to work closely with industry, particularly where we see excess or problematic message levels, and this includes a small number of firms whose contribution to message volumes remains at significant levels.

On a related topic, order-to-trade ratios also are not at systemically problematic levels in our markets currently.

We want to ensure that participants remain vigilant about them – that they don’t become excessive.

Accordingly, we are proposing to introduce guidance to the market on order-to-trade ratios.

These rules will help promote a more fair, orderly and transparent market.

Dark liquidity

On dark liquidity, we found an inherent tension between the short term private advantage for a subset of the market, and the long term public good of contributing to the price formation process.

Price formation is critical as it gives investors confidence, and promotes the interest of listed entities and the broader community, through an efficient secondary market for capital.

In some securities, we found that growth in dark trading has contributed to a widening of bid–offer spreads which has affected price formation. This correlation is strongest in the 200 largest and most liquid securities.

To help address the impact of dark liquidity on price formation, we introduced a new market integrity rule which commenced this week.

The new rule will require all dark trading to be done at a meaningfully better price than is available on a lit exchange market. Otherwise, the trade must be done on a lit exchange market.

Canada introduced a similar rule in October 2012 and has seen a significant and sustained decline in the volume of dark trading.

We expect to see a similar decline in dark trading in our markets – in fact we are already seeing early signs.

As you know, we had proposed to introduce a trigger for a minimum size threshold for dark trading. Feedback from industry is overwhelming – we should wait to assess the impact of the new price improvement rule.

Accordingly, we have decided not to proceed with our proposed rule to implement a trigger, at this stage.

Instead, we will monitor price improvement and work with industry on triggers if there is further deterioration in spreads.

While dark pools or broker crossing systems are here to stay, they also need to be appropriately regulated.

They have grown significantly in number and have become increasingly ‘market-like’ and interconnected.

While the term ‘dark’ refers to their orders not being transparent, we found that their operation and accessibility are also not transparent.

We have proposed a number of rules to address these issues:

On transparency and disclosure, we have proposed that clients should be informed:

- when trades have been done on a crossing system, and
- when the counterparty was the broker acting on its own behalf.

We have proposed rules to ensure there is no undue discrimination between clients, and clients must be able to opt out of using a crossing system.

1. We have proposed minimum expectations about brokers monitoring activity on their crossing systems, and
2. we have also proposed enhanced systems and controls.

The new rules are designed to provide more choice to investors about how and where their orders are executed. At the same time, they’ll provide sufficient protection from the impact of conflicts of interest and poor transparency that may result from excessive dark trading.

While we will adapt our proposals to take account of industry feedback, they still need to achieve the same or similar outcomes. We intend to announce our intentions more fully in coming weeks.

This goes to ASIC's strategic priorities of:

- fair, orderly and transparent markets, and
- confident and informed investors and financial consumers.

Our markets have changed, algorithms have reduced trade sizes and a large proportion of trading is done by professional traders who would not be described as long-term investors.

Developments in automated trading have been by far the largest contributor to this change, and this has been from all facets of the industry, including the buy-side.

While we feel it is important that this evolution is understood, we do not believe there should be widespread concern because there are many positive outcomes attributed to automated trading enjoyed by the investing community, including greater liquidity and depth, and narrower bid–offer spreads in many securities.

However, we will continue to monitor these issues and respond to any emerging issues.

ASIC is committed to having a strong regulatory framework so that investors are confident when participating in our markets, and that markets are fair, orderly and transparent.

ASIC's surveillance of the financial markets

In order for a regulatory framework to be effective, it needs appropriate supervision.

ASIC has built a strong surveillance team with highly qualified staff. We have the systems, the people and the powers to track down insider trading. If someone is found guilty, there is a good chance they will go to jail.

Since the transfer of supervisory powers to ASIC, not only is market misconduct more likely to be caught, but the time taken from detection to formal investigation has fallen. We are catching more people, more quickly.

Later this year, ASIC will switch over to a new integrated market surveillance system. The new surveillance system will provide enhanced capability to detect market misconduct.

It will allow ASIC to efficiently and flexibly adapt to a future which will include:

- greatly increased message traffic,
- new technologies and trading techniques, and
- increased competition between trading venues.

ASIC's new surveillance system will allow for enhanced data analytics to identify suspicious trading by connecting patterns and relationships.

This will be essential for greater levels of detection of insider trading relationships and patterns of manipulation, as well as flexibility to deal with cross-market misconduct.

The new surveillance system will be able to cope with the continued increase in high-frequency trading and algorithmic trading. It will give us enhanced capabilities to monitor the behaviour of algorithms and market participant messaging levels.

The system will have the capacity to handle significantly higher volumes of messages than current systems – thought to be in the vicinity of 1 billion messages per day.

This will enable us to promote cleaner markets so that investors can be confident when participating in our markets, and that markets are fair.

New Participant Portal

As part of promoting efficient markets, a new Participant Portal is being developed.

The Participant Portal will create efficiencies for market participants for the lodging of documents and the updating of registers. It will also enhance information flows between ASIC and market participants.

Participants will have access to information, applications, notifications and names lodged with ASIC, all in one place.

This will be of particular benefit to participants when they are required to provide additional data on orders and trades when complying with the new rules relating to enhanced data for supervision.

These new obligations are part of the competition market integrity rules commencing on 10 March 2014. This means ASIC will make fewer initial inquiries of participants about their trading.

The system will also allow for the real-time surveillance of the futures market, which is currently conducted manually and on a post-trade basis.

This is a worthwhile development which will help improve the efficiency of our markets.

Cost recovery

In relation to cost recovery, you can be assured that ASIC's projects have a strong focus on cost discipline. We ensure that spending is aligned with the benefits.

The cost of market supervision as a percentage of market turnover is favourable to comparable jurisdictions.

It is important to note that costs reflect the increased requirements of supervision, given the speed and complexity of trading across dispersed venues.

However, these costs will be outweighed by the medium to long term benefits of not only competition, but of fair and efficient markets. Orderly and supervised markets allow for greater confidence, which in turn reduces the cost of raising capital.

You can be pleased to note that we have come in under budget in the first year by approximately $5 million, or about 10% of appropriation. This means we won't need to cost-recover this money as was originally planned.

I will now turn to my third and final topic – the FOFA reforms.

FOFA reforms

For the first twelve months from the start of FOFA, ASIC will take a facilitative compliance approach. This recognises that FOFA requires businesses to undertake major work so that IT systems and compliance requirements are in place for the new regime.

To assist with the raising of capital, the Government has listened to industry concern and allowed carve-outs for brokerage as well as stamping fees on IPOs and fundraising. It will also relax the ban on asset-based fees on borrowed amounts so that brokerage can be charged, where trading is linked to margin loans.

Given the broad scope of the exemptions that will be provided in relation to stockbroking activities, all stockbroking related exemptions are subject to review.

The purpose of the review would be to ensure that the exemptions relating to stockbroking are working as intended.

As it may take time to identify if there are unintended outcomes of these exemptions, the review will be undertaken by 2015.

The review will look at any unwelcome changes to the business models of securities dealers that were undertaken with the purpose of falling within the carve-outs.

Stockbrokers will still have duties around conflicted remuneration, and the provision of broader financial advice.

Careful attention needs to be paid to the new 'best interests duty' – this is a positive obligation that in the instances of a conflict, requires the interests of the client to be placed ahead that of the adviser.

The FOFA reforms are aimed at promoting confident and informed investors.

In fact, all the changes that I've mentioned today, are designed to ensure investors and consumers can be confident and informed when participating in our financial markets. They will help promote fair, orderly and transparent markets.

These are ASIC's objectives.

Thank you. I would be happy to take questions.