



ASIC

Australian Securities & Investments Commission

Financial innovation-driven complexity: Creating a dynamic landscape

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CHECK AGAINST DELIVERY

Introduction

We are living in a time of rapid innovation and change, and this is only likely to increase.

Change brings opportunity, but also risk.

This rings true for our financial services and markets. Market-based financing is seen as a key source of funding economic growth in the coming decades. The growth of superannuation, digitisation of the economy and globalisation are also driving changes – creating new opportunities and risks.

ASIC's challenges

In this age of innovation, the key external challenges I see for ASIC are:

- balancing growth and stability with a particular focus on deregulation structural change in our financial system through the growth of market-based financing and superannuation
- financial innovation-driven complexity in products, markets and technology – which is what I will be focusing on today, and
- globalisation.

While these are all challenges, they also present opportunities to fund economic growth. We need to continue working together to harvest the opportunities while mitigating the risks.

So how does ASIC carry out our role in the face of these four key challenges?

Our people and our work

People work at ASIC for good reason. Our work makes a positive difference to the wellbeing of Australians. Our people are committed to achieving our strategic priorities of:

- confident and informed investors and financial consumers
- fair and efficient markets, and
- efficient registration and licensing.

A crucial part of our role is in relation to financial services and market misconduct.

Where there is misconduct, to the best of our ability we:

- detect misconduct by gathering intelligence
- understand consumer and market behaviour and identify risks to our strategic priorities by analysing this intelligence, and
- respond to the misconduct and risks we've identified. This could be by:
 - taking enforcement action
 - disrupting harmful behaviour
 - educating consumers and those we regulate
 - providing guidance, and/or
 - providing policy advice to Government.

We are the cops on the beat for financial services and market misconduct.

We keep a close watch on industry through:

- our reactive and proactive surveillance, and
- intelligence gathering.

We do the best we can with our resources to catch those who break the law.

For those who intentionally break it, we will do all that we can to ensure that the ramifications are severe.

Of course, the vast majority of you here today comply with the law and will have nothing to worry about. In fact, you play an important role in contributing to the integrity of our financial markets. This was recognised in the 2013 ASIC stakeholder survey, where perceived strengths of our regulatory system include:

- the orderliness and transparency of our markets, and
- the fact that our financial markets provide a level playing field for investors.

Stakeholders saw ASIC's perceived strengths as including our:

- market supervision, and
- work on keeping markets free from insider trading, and ensuring that companies provide reliable and timely information to the market.

These results indicate that our markets benefit from ASIC and industry working together on our shared goal of fair, orderly and transparent markets.

Financial innovation-driven complexity

Now, let's move on to the main topic for today – financial innovation-driven complexity. I will talk about financial innovation-driven complexity in terms of products, markets and technology.

Products

A good example of financial innovation-driven complexity in products is hybrids. Our work in this area is also a good illustration of our 'detect, understand and respond approach' in making sure that investors are confident and informed in line with our strategic priorities.

There are many reasons why ASIC has proactively focused on the sale of hybrids. A key reason is the potential for misleading conduct – for example, when promoters spruik the returns of hybrids without being upfront about the risks.

Review of promotional materials

ASIC is reviewing the promotional material issued by market participants for issues of hybrids. To date, we have found some promotional material that did not include a balanced disclosure of features and risks. This has been disappointing. In particular, issues we identified include:

- inadequate disclosure of risk
- disclaimers that were not sufficiently prominent
- hybrids being referred to as stocks or shares, and
- hybrids being classified as fixed income in a way that may be misleading.

The entities we have engaged with about their promotional material have been receptive to our recommendations. Where issues were identified, they have implemented changes. This has avoided the need for ASIC to take enforcement action.

Markets

The second area where I see innovation-driven complexity is in financial markets. The financialisation of markets – for example, through high frequency trading, dark liquidity and speculative trading – creates new risks in terms of ASIC's strategic objective of fair, orderly and transparent markets.

We must never lose sight of the fact that – at their core – markets assist in funding the real economy and in doing so help fuel economic growth. Markets do not simply exist to feed on themselves.

We all benefit from having markets that are fair, orderly and transparent. It helps drive growth and creates new opportunities – including for those who participate in and support our markets.

At ASIC, we see ourselves as an important partner with industry in the continued success of our markets. In particular, our work on high frequency trading and dark pools demonstrates that we will roll up our sleeves, constructively engage with the market and adapt our regulatory approach as the market evolves.

'Flash Boys'

On high frequency trading, this is something that has recently received significant media attention in the United States. Most of it was driven by the US book *Flash Boys* by Michael Lewis. Lewis claims that high frequency trading firms have effectively 'rigged' US stock markets, and in doing so have made billions of dollars by leaping in front of investors.

Many local media outlets have been quick to try and draw parallels with the Australian market. I would like to stress that any suggestion that predatory high frequency trading is widespread in Australia is simply not supported by the evidence.

In any case, the Australian market is very different from the US market. For instance, our market is far less fragmented. In fact, we were mindful of the level of fragmentation in the United States for on-market and off-market trading facilities when designing our own market competition rules.

Flash Boys also suggests that there is a problem in the United States with limited transparency via dark pools that is to the detriment of investors. ASIC – as the enforcer of market laws in Australia – has not and will not tolerate this type of behaviour.

In 2012 and 2013, ASIC introduced new market integrity rules to ensure there is transparency on the rules of engagement in dark pools. We are monitoring the effect the rules are having in the market and are satisfied that the current regulatory settings are appropriate to address any concerns regarding dark liquidity in Australia.

This is something we noted when we released Report 394 *Review of recent rule changes affecting dark liquidity* earlier this month.

Do not mistake our lack of hysteria for complacency. We continue to be the cops on the beat on this and are actively monitoring high frequency trading and dark liquidity.

We will take swift action where we detect predatory trading.

Confidential information

The second area on markets that I wanted to talk about is the handling of confidential information. The integrity of our financial markets – which is at the heart of our strategic objective of ensuring that our financial markets are fair, orderly and transparent – depends on all investors having access to market-sensitive information about listed entities at the same time.

Leakage of information before market announcements creates opportunities for insider trading and undermines investor confidence. This issue remains a key focus for ASIC.

On Tuesday, ASIC released Report 393 *Handling of confidential information: Briefings and unannounced corporate transactions*. The report outlines the findings of our review of practices employed to handle and protect confidential, market-sensitive information.

Listed entities need to be proactive about the proper handling and dissemination of market-sensitive information. Poor practices can lead to regulatory action for a breach of continuous disclosure laws. It can also create negative perceptions of the entity within the investment community and jeopardise the success of a transaction.

In coming months, we will continue to monitor changes to analyst ratings. This will be to determine whether these changes could have been prompted by an inappropriate disclosure of confidential information.

We also found that practices in relation to soundings in capital raisings need to improve. To prevent information leakage, listed entities should have frank discussions with underwriters about soundings required before a transaction's announcement. This is particularly important where soundings are conducted in a live market.

People should familiarise themselves with industry guidance on best practice for handling confidential information and look to follow this.

Technology

On financial innovation-driven complexity in technology, I wanted to focus on how ASIC uses technology in our surveillance of Australia's financial markets to ensure that they are fair, orderly and transparent.

Our surveillance technology

Sophisticated monitoring tools, combined with staff experienced in trading and trading technology, are enabling us to detect, understand and respond to market misconduct more effectively than ever before.

Our supervision of financial markets has been strengthened by the successful rollout of ASIC's new market surveillance system – Market Analysis Intelligence or 'MAI'.

MAI was purpose built and designed to handle the dynamism of our financial markets. A key benefit of MAI is the ability to run reports for very large trading periods in a fraction of the time of our previous surveillance system. This allows our analysts to identify suspicious transactions and traders more quickly – in minutes compared to hours.

It's also easier for ASIC to identify suspicious trading by connecting patterns and relationships. This is essential for greater levels of detection of insider trading relationships and market manipulation.

In the listed derivatives space, MAI allows ASIC's Market Surveillance Derivatives team to make inquiries into matters that previously we could not pursue because we did not have the information.

The message is simple – we are watching trades on Australia's financial markets and can detect misconduct faster and more easily than ever before.

If we find that you have intentionally broken the law, our response will be severe.

Conclusion

We are living in the age of innovation. This includes innovation in financial products, markets and technology.

In this age of innovation, ASIC wants to ensure that Australians continue to have a resilient financial system in line with our strategic priorities of:

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

This is why, for good reason, ASIC to the best of our ability:

- detects and understands misconduct and risks to Australia's financial services and markets, and
- responds to the misconduct and risks we've identified. We could do this in many ways, including by:
 - taking enforcement action, or
 - disrupting harmful behaviour.

Thank you. I am happy to take questions.