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Australian Securities & Investments Commission

Trends in the regulation of financial markets and their participants — a regulator's perspective

An address by Jillian Segal, Commissioner, ASIC, to the ISDA/AFMA Conference in Sydney, 19 October 2000.

1. Thank you for the opportunity to address this combined ISDA / AFMA conference. I am delighted to have the opportunity to speak to you from a regulator's perspective on what the program calls "public policy".
2. When Ken Farrow invited me to speak this morning, I wondered what public policy issues would be of interest and add to the value of a day for professionals in over-the-counter markets. There is much to choose from but my choice is to talk to you about trends in regulation of financial markets and their participants and a few of the challenges facing us. I will naturally enough concentrate on Australia, although I want to argue that Australia is a microcosm for developments in global markets generally.
3. We are not the first place where most major market trends begin, but the structure and ownership of the Australian financial services industry, and the generally outward looking approach of those who work in it, means we are often early adopters of new trends and technologies.
4. In Australia, we have also put much emphasis in recent years to ensuring that the framework of regulation focuses on the future, and can and will adapt not only to the changes that are taking place, but also to those still

- beyond our current line of sight. This thinking applies both to the content of the regulation - who do we regulate and what are the rules - and to the institutional framework - who does the regulation. Let me say just a little about the evolution of this process.
- 5 The present Government put early emphasis on a review of the financial system and commissioned an inquiry into financial services and their regulation soon after coming into office in 1996. You will know the results of that work as the "Wallis committee report" or simply the "Wallis report", published in the first half of 1997.
 - 6 Implementation of the Wallis report recommendations has proceeded rapidly. The institutional structures – ASIC and APRA – have been in place for two years. Those financial institutions that were still regulated at a State level - credit unions, building societies and friendly societies – were brought under the single national regime by 30 June 1999.
 - 7 The third implementation phase is the one we are still in. It focuses on altering the legislative framework so that a single set of consumer protection and market integrity provisions applies to all financial products and services, and that the same set of legislation governs these products and services regardless of product labels and legal definitions. I will have more to say about this process later when I talk about the Financial Services Reform Bill.
 - 8 I can tell you that as Commissioner of ASIC since the latter half of 1997, that these have been exciting times for regulators. We at ASIC have changed our name; expanded our area of responsibility to include almost the whole of the financial services industry; and participated in many of the discussions about proposed major changes to the law. At the same time, we have continued to play our traditional role in the securities and futures industry, and as the Australian corporate regulator, in a period when

technology and globalisation have driven major changes and foreshadowed others.

- 9 Let us now explore some trends in financial markets and in the financial services industry generally.

Market Trends

- 10 This has been a record period for financial market activity. We are constantly reminded that we are in the longest bull run in market history, although of course opinions are divided about when, or even whether, it might come to an end. The volume of activity in both exchange and OTC markets is at record highs. These buoyant conditions - coupled with other factors such as developments in technology – means that new ways of doing business are emerging rapidly; there are new types of participants in financial markets (including OTC markets); and there are changes in the structure and ownership of many significant firms.
- 11 These trends are reflected in AFMA's Australian Financial Markets Report for the year ended 30 June 1999. As an aside, I commend AFMA and those involved in the collection and compilation of those statistics. We have all, I think, had cause to be grateful to them for their initiative in putting together this annual compilation of key statistics in both exchange and OTC financial markets in Australia.
- 12 The AFMA report for 1999 shows that in the five years ending 30 June 1999 the overall Australian financial market grew by some 61%, with the equity market growing by over 140%, the futures market by 42%; and the OTC market 68%. In the year ended 30 June 1999 OTC markets grew 13% to a figure of almost 28 trillion dollars, with the largest single area of growth being non-government debt securities (which grew by 82%).

- 13 I mention these statistics because they indicate a number of trends. Not all of them are important for the regulation of financial markets but some are. Let me mention a few.

Technology

- 14 It is now a cliché that we are in a new economy shaped by the huge advances made in information technology and its applications. I need only mention the internet - not yet ten years old as a widespread commercial application but pervading our workplaces and homes to an astonishing degree.
- 15 At August 2000, over half of all Australian households had a home computer and one third had home Internet access by May 2000. And these numbers continue to grow. Around 12% of the ASX's 70,000 daily trades are conducted through online brokerages.¹ And tomorrow we'll be able to do more.
- 16 We are said to be on the brink of an extension of that technology and that wireless or similar applications will mean we can get information and communicate literally on the run, without the clutter of modems, lines and laptops. And we have not yet, in my view, seen nearly all there is to see from the advances made in the digitisation of information and images.
- 17 How does this play out in financial markets? You can all probably give me many more examples than I am aware of, but let me hazard a general proposition.
- 18 Technology has had, and will continue to have, profound implications for the way market activity takes place. For example, consider the idea of a centralised market. Information can be centralised without any physical centralisation of people, so markets are no longer places, they are systems or facilities. Without too much imagination, it is possible to

- conceive of a situation in which all buying and selling orders for a particular financial product (a security or a derivative, say) go directly from individuals to a single, global, electronic market and are executed there, with bank accounts and registers of ownership being simultaneously updated. Or the model might be a plethora of specialist market places, each with a separate existence, but linked for some purposes (such as cross margining, or credit assessment).
- 19 I would not want to predict what new varieties of market activity might look like. My point is that technology developments have unleashed this potential, and at the same time changed the costs of entry to some forms of market activity in a way that is likely to continue to attract new ideas, new participants and new structures.
- 20 What I can predict with some confidence is that, as a result of these developments, market structure issues will be in the forefront of industry participants and regulators' minds in the next few years.

Globalisation

- 21 One aspect of this new, technology-facilitated, world is the increase in cross border financial market activity. Financial markets have always to some degree looked beyond national borders. But now global ownership, and global activity, have in significant ways become the norm. Indeed, the idea of cross border activity might itself be dated in a world where the norm is becoming a single global book, moving across timezones.
- 22 At ASIC we are keenly aware of this dimension. ASIC staff who deal with markets issues could tell you of the steady flow – threatening to become a major stream – of applications and inquiries for proposals to create links between Australian and offshore markets, for offshore markets to have

¹ KMPG Internet Financial Services Survey

- some presence in Australia, or for Australian markets to establish themselves in other jurisdictions.
- 23 The issue here is that borders still exist for individual regulators because this is how they draw a line on the limit of their responsibility. 'In our jurisdiction' and 'outside our jurisdiction' remain meaningful concepts - and rightly so. We may be moving to a single global market but we are still a long way from a single global market regulator.
- 24 This has forced regulators to think hard about how the regimes they administer at national levels interact with another; and how to preserve essential tenets of individual domestic regimes without the result being regulatory overburden or duplication. A good deal of this hard thinking has occurred through the forum of the International Organisation of Securities Commissions (IOSCO).
- 25 As many of you will be aware, ASIC hosted the annual IOSCO conference in May this year which brought together more than 500 participants from 90 countries. The theme, "Global Markets – Global Regulation", provided an opportunity for participants to discuss the regulatory challenges thrown up by globalisation. More generally, IOSCO's activities and work program throughout the rest of the year allow regulators world-wide to address those challenges in a concerted and consultative manner.
- 26 The focus on global activity has highlighted the number of regulatory regimes and the differences between them - some large; some small and all of them potentially a headache for market participants. A clear example for me is the work that was done under the auspices of the Joint Forum on Financial Conglomerates that revealed that one major financial market participant with a strong global presence employs some 600 lawyers across the globe – most working full time - to complete different reports to different regulators (provided, of course, that nothing goes wrong and regulators do not ask for additional or special reports).

Broader direct participation in financial markets

27 The final trend I want to note is one that as a consumer protection regulator, as well as a market integrity regulator, we have taken particular interest in. In recent years we have seen very significant increases in the amount of direct participation in financial markets by ordinary, retail level, investors. The figures illustrate the point: in 1991 the total number of adult Australians who directly owned shares was 1.2 million. By January 2000, it was 5.7 million. In all, this is an increase from 10.2% in 1991 to almost 41% by January 2000. It is true that much of the increase can be attributed to IPOs of government owned business and mutuals in the insurance industry. But it is also true that average Australians seem to be much more active as direct participants in financial markets than they have been historically. The success of the relatively new on-line broking industry is further evidence.

Regulatory responses

28 What has been the response of regulators generally to these developments? At the risk of oversimplifying, let me suggest a few. Before I mention concrete examples, I should identify one trend in the thinking of regulators that has become increasingly common over the last few years. Regulators throughout the world, including Australia, have had to move from the comfort of their traditional approach to financial market regulation to articulating some more fundamental thinking about market activity and its regulation. Three crucial questions demand answers:

- what are the key objectives of market regulation;
- what activity should be regulated as market activity;
- what tools are best used to achieve key regulatory objectives.

This kind of principles-based, and outcomes-based, thinking seems to me a hallmark of the new way regulators approach market regulation.

- 29 From this fundamental analysis flows a wish to ensure that the regime for market regulation is flexible enough to apply across a whole spectrum of activity. Some activity will continue to be regulated as market activity; some will end up being regulated as intermediary activity rather than market activity. In this way of thinking, you do not start from the presumption that markets are things provided by exchanges owned by their member-participants, or that all trading activity takes place in a similar way. You focus on the articulation of core principles, and even there you recognise that not every principle applies to every market situation.

Responses to technology developments

- 30 All regulators have been responding to technology developments in the way they administer their regulatory regimes. I do not have time this morning to outline the work being done by ASIC's counterparts on these issues in the North America, UK and Europe. I will, however, briefly outline some of ASIC's work.
- 31 To illustrate the range of e-commerce developments ASIC is seeking to respond to, let me list our current work book of e-commerce policy issues:
- online information and advice about financial products and services
 - regulation of internet portal arrangements
 - account aggregation
 - multimedia disclosure documents
 - codes governing financial products and services provided electronically

- on line provision of advisory services
- cross border, electronic, markets
- regulation of internet discussion sites (chat rooms).

And that is only what we are working on right now – not what we have completed, or will move to in the future.

Changes in the legislative framework and its administration

32 For Australia, of course, the most important response to the trends I have identified is the major reworking of the legislation that applies to the provision of financial products and services generally – the work embodied in the Government's Financial Services Reform Bill.

33 As I mentioned earlier the FSR Bill (FSRB) is the third implementation phase of the Government's financial sector reform program. The reforms in the FSRB reflect the trends I have just discussed. I know our Minister the Federal Treasurer the Hon. Peter Costello MP spoke recently on just these issues. He made the point that the extensive program for reforms is about ensuring that Australia is well placed to take advantage of these globalisation and technological advancements.

34 Given where we are in that process I do not propose to spend a great deal of time on the content of the Bill. As you know, the material released by the Government earlier this year sets out a draft of most, but by no means, all the draft provisions of the new law.

35 It may be useful for me simply to note those provisions which we know are likely to be of most interest to you today. Here is my list of things in that category:

- the draft legislation provides for a single regime for licensing of those who operate financial markets – the law being the same for

all operators and not, as now dependent on whether the instruments traded on the market are securities, futures contracts, or something else. Nor does the law distinguish between exchange markets and other forms of market;

- the draft legislation provides for licensing of all operators of clearing and settlement facilities for financial products – unlike the present law which requires a form of licensing for futures clearing houses but not for securities clearing facilities (other than the special case of the CHESSE facility);
- what is regulated as a "market" will change. The focus of market regulation will be "multilateral" markets – markets where there are a number of both buyers and sellers. This is different from the position now where a market might have a single seller to multiple buyers.
- as a consequence, some activity that is now regulated as market activity – notably through exempt futures market declarations – will cease to be regulated as "market" activity. It will be regulated through the intermediary provisions. If you are a "market making" dealer, you will need to hold a market maker's dealers licence. This will apply to most if not all OTC derivatives dealers, including those in the electricity market;
- the new regime has a specific regime for markets that are regulated in other jurisdictions but seek to operate in Australia;
- the new regime in a systematic way distinguishes between the regulatory rules that apply at the retail level and those that apply at the non-retail level. The rules are at their most intense at the level of retail activity. In some cases, such as the rules dealing with

advice, there are strict obligations if retail consumers are involved, and no obligations at all if non-retail customers are involved.

Next steps: looking forward — the FSR Bill and our future work program

- 36 Finally, I would like to comment on the implementation of these key legislative reforms on the near horizon.
- 37 From our perspective as a regulator we are concerned not just with the regulatory framework but how together with industry we can make it work in practice. So our submission on the FSRB covered a number of practical administrative and implementation issues which we believe should be addressed in the final legislation. The changes we suggested are all designed to assist ASIC more effectively to implement and administer the Government's proposed reforms as set out in the draft Bill.
- 38 I thought it might be useful to talk to you today about two aspects of FSRB. First, how we are going about ensuring that when the FSRB is enacted we are ready to implement it; and second to touch on three policy issues of particular concern to your industry: namely the wholesale/retail distinction; the role of industry bodies and how FSRB will impact on our traditional light touch to regulation of wholesale financial markets.
- 39 As you are aware there has been some uncertainty over the timing of the release of the next stage of the draft legislation. The Minister has however indicated that the likelihood is that FSRB will not commence until 1 July next year. This still means that ASIC has to commence preparing now so that we can be ready to administer the legislation when it is law.

How we are implementing FSRB

- 40 Our FSRB implementation will be run as a single national implementation project. Given the breadth of regulatory changes to be brought about by

- the Bill, we have divided the project into four sub projects - licensing, disclosure, markets, and finally codes, dispute resolution and credit. Many of the staff who are working on the project will be familiar to you, so it will really be a question of dealing with some old faces in their new roles.
- 41 As you will see we have already recognized how important it is that we have a specialist group that is dealing just with the FSRB impact in relation to markets. That team will be headed by Malcolm Rodgers whom many of you will know already.
- 42 It is also very important to us that we develop our systems and policies in a way which works on the ground for you as our stakeholders. To support this approach, we are ensuring that our operational staff are closely involved in working with our policy staff on all the key projects.
- 43 We want to communicate with you about priorities, issues and implementation details and seek widespread industry views on practical implementation issues. To do so we are using our website www.asic.gov.au.
- 44 Our website contains a section called FSR NEWS. This section currently contains information about how the FSRB will effect existing ASIC policy. It also contains a special section which deals with markets which we will be updating on a regular basis.
- 45 I would also like to mention an innovation that allows you to interact directly with us. You can register your email address to receive e-mail alerts from us about our FSR updates, proposals and news. We like to think that you can find out what's happening at ASIC in Australia, from anywhere that you can access the Web!

Some specific issues raised by FSRB for the financial markets

46 I referred earlier to three specific issues I wanted to mention. I mention them not to say we have reached any conclusions, but specifically to acknowledge that they are topics we would expect to be early priorities in the discussions we intend to have with OTC market participants and their representative bodies, and AFMA and ISDA in particular.

Wholesale/Retail

47 The trends I spoke about pose some real issues in relation to wholesale/retail distinctions. The new legislation, as I have mentioned, makes a systematic distinction between the regime that applies to retail dealings and that applying where there is no retail component.

48 This suggests the need for close dialogue with industry. In particular, we need to take up the discussion we have had with AFMA over a number of years about how this distinction plays out in OTC markets that are increasingly accessible, or likely to become accessible, to retail level participants. In this context we will also need to think about the concept of "indirect" access to wholesale markets, for example through intermediaries, or through managed funds or superannuation arrangements such as DIY funds.

"Light touch regulation" in a new environment

49 Traditionally, ASIC has sought to use the distinction between retail and wholesale market as the basis for a conclusion that regulation of wholesale markets might be "light touch" compared to the regulation that needs to apply to full public markets accessible to retail participants – light touch meaning less rules and a lesser regulatory presence, especially on a day to day basis. This is the way we approached regulation of the derivatives markets in the mid 1990s, and issues such as short selling in OTC fixed interest markets.

50 We will need to have close discussion with industry to ensure that this approach – which is to some degree now embedded in the legislation itself – can continue to be an important building block in our approach to market regulation. I expect we can bring to the table a continuing commitment to being as unobtrusive a presence in genuinely wholesale markets as our statutory remit allows us to be.

Role of Industry Bodies

51 Industry bodies such as ISDA and AFMA have had an important influence on how we do our job as a regulator in OTC and wholesale markets. ISDA played a considerable role in the debates we were engaged in on the regulation of derivatives and OTC markets generally in the mid 1990s. AFMA has also played a vital role in debates about the regulation of derivatives, OTC fixed interest markets, short selling and a number of other issues. I want to take the opportunity today to acknowledge the value we think has been added to our work by these contributions.

52 I hope this engagement between your industry and our work as a regulator continues. It is particularly important as we get further into the details of our role as the administrator of a new regulatory regime.

Conclusion

53 I began by talking about the legislative framework being put in place through the Wallis Inquiry. I have also spent some time talking about trends in the financial markets, technological and global forces and regulatory responses, in particular how we will be implementing FSRB.

54 But it would be a mistake to think that the "work is done" that the legislative reforms signal an end to a process. We are all on a journey, at ASIC we want you to be partners with us on that trip.

55 So thank you for your time this morning I look forward to continuing a strong and rewarding relationship with your organizations and with you the members.