# ASIC's outlook ... the road ahead

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

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## Introduction

The Australian Shareholders' Association (ASA) has a long and proud history of shareholder representation, having been an advocate for shareholders and contributing to the corporate governance debate since 1960.

The world has changed a lot since then – who would have imagined we would have high-frequency trading and retail order flow in dark pools in this fast-paced new millennium!

The ASA has kept pace, and continues to remain relevant to shareholders and the community.

As a member of ASIC's Consumer Advisory Panel we value the ASA's contribution and commitment to improving members' financial literacy – an issue very high on the ASIC agenda.

Ladies and gentlemen, I've been asked to speak about the road ahead for ASIC. When I think about what's ahead, I see three things facing ASIC:

- structural change
- ongoing innovation-driven complexity
- globalisation.

These present a major challenge to ASIC's strategic objectives of:

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

If we fail to achieve our strategic objectives, businesses won't have access to cost-effective capital and economic growth will suffer.

I will go through the three challenges in turn.

## Structural change

The global financial system is currently undergoing significant structural change.

Market-based financing is increasing and is now seen as a key source for funding economic growth.

This structural change is being driven by:

- increased banking regulation
- the growth of the pension and superannuation sectors.

New rules to strengthen the banking system are imposing higher capital and liquidity requirements. The net effect of this is often a decreased access to debt capital and an increased cost to business. As a result, many businesses are turning to market-based financing to source their capital.

The second driver of market-based financing is the continuing global growth of the pension and superannuation sectors – much of which is invested in debt and equity capital markets. This global growth is expected to continue in the coming decade, as:

- governments in emerging markets start or expand retirement savings programs
- there is a demographic shift underway in many developed countries, as the population ages and people start to contemplate how to fund their retirement.

A good example is Australia. The rate of super will rise from 9% to 12%. Funds in superannuation are expected to grow from A$1.5 trillion to A$3 trillion by the end of the decade. Baby boomers are beginning to plan their retirement. In addition, the proportion of super in self-managed super funds is increasing (from 33% to 40% in the next five years).

The growing importance of market-based financing presents a challenge for markets regulators to ensure we have the right tools and resources in place, so that debt and equity capital markets can perform their critical role in funding economic growth.

This increase in activity in our capital markets will have a flow-on effect on financial service providers such as financial advisers, investment managers, custodians, research houses, credit rating agencies, and auditors and accountants.

ASIC will need to remain proactive and address emerging risks in order to achieve our strategic objectives of confident and informed investors and fair and efficient markets. Maintaining a dialogue with industry to better understand what is happening in the markets is fundamental in this regard.

## Innovation-driven complexity

The second challenge to our strategic objectives is keeping pace with innovation-driven complexity. It's a constant struggle to monitor new developments and respond in a way that doesn't unduly restrict the benefits of innovation. However, we also need to be mindful that innovation can add complexity and risk.

We see innovation-driven complexity in three areas:

- products
- markets
- technology.

## Complexity in products

A good example of innovation-driven complexity occurred in securitisation in the latter part of last decade. Collateralised debt obligations (CDOs) and CDOs squared were products of financial engineering that were designed during a period when everyone was searching for yield. This was an example of innovation adding complexity and risk, which resulted in both wholesale and retail investors losing a lot of money in many cases because they weren't able to properly value the risks inherent in these products.

The problem of complex products being mis-sold is particularly concerning during periods when people are searching for yield, like the current environment today.

It is important that investors take responsibility for their decisions. They should understand the risk–reward pay off and the concept of diversification. In this regard, investor education remains key.

In fact, I like to say if you don't understand it, you shouldn't buy it, even if your financial adviser recommends it.

However, product manufacturers and product issuers have a role to play. It's not a sustainable business model if the customers are losing money. They need to ensure the products are appropriate for the customer and aren't mis-sold.

My position on this is clear – those selling complex products to unsuspecting investors need to wise up and do the right thing. They might get away with it for a while, but as we saw with the crisis, governments and courts inevitably rule in favour of investors that have been mis-sold these complex products.

ASIC has a working group on complex products which is currently exploring the best ways to regulate these products. This includes considering the whole of the product life cycle, not just distribution and disclosure.

From a self-regulatory perspective, product manufacturers should use new technology such as e-learning modules that explain a product's features and risks could be used to educate investors about a product. This could overcome some of the inherent weaknesses of traditional disclosure. An online assessment could then be used to assess someone's understanding before they part with their cash.

We need to reduce the risk of complex products being mis-sold to investors. This is a perennial challenge.

## Complexity in markets

In recent years globally, we've seen the rise of dark pools and high-frequency trading. Crossing engines and high-frequency trading are 'the new normal', so we need appropriate regulation and a measured response.

For high-frequency trading, ASIC has analysed data from our surveillance feeds from ASX and Chi-X in order to identify the nature and extent of high frequency trading in our market.

We conducted a detailed analysis of trading on equity markets over the nine month period from January to September 2012.[1] The analysis drew on a number of measures that could be consistently and objectively measured, and that related strongly to the characteristic attributes of high-frequency trading.

We also engaged with industry and regulators here and abroad, reviewed relevant research, and identified regulatory gaps.

On the whole, we found that some of the public perceptions about high-frequency trading in Australia appear to have been overstated, with no evidence of systematic manipulation by high frequency traders.

For example, the taskforce found that increases in order-to-trade ratios have been moderate compared to overseas markets, and have not been driven entirely by high-frequency traders. In fact, we found their trading strategies are commonly adopted by the buy-side.

More broadly, we found that high-frequency trading is not something that investors should be afraid of. Rather, it represents what is 'the new norm', and consumers and investors should continue to have confidence in the integrity of our financial markets.

In relation to dark pools, ASIC has proposed new rules to provide more choice to investors about how and where their orders are executed.[2] At the same time, these rules will provide sufficient investor protection from the impact of conflicts of interest and poor transparency that may result from excessive dark trading.

Excessive dark trading can impact the price investors pay for securities. We have proposed a trigger for a minimum dark order size that will provide an

[1] See Report 331 *Dark liquidity and high-frequency trading* (REP 331).
[2] See Consultation Paper 202 *Dark liquidity and high-frequency trading: Proposals* (CP 202).

additional safety net for investors.[3] In conjunction with existing measures and the new price improvement rule, we believe this will address the risk of excessive dark trading and provide greater flexibility for investors to trade in larger sizes in the dark.

Dark pools are part of the new norm, and ASIC will continue to monitor their use.

While our markets have been becoming more complex, ASIC has been stepping up its market surveillance. Since the transfer of supervision from ASX to ASIC, we have seen a dramatic fall in the time taken for matters to be referred to formal investigation. In the ASX days, this took approximately three months. Today, the average is six to seven weeks.

We have also been focusing on insider trading and have been sending more people to jail than ever before.

At the moment, we are rolling out our new and enhanced market surveillance system. This will allow us to keep pace with advances in market technology. ASIC's surveillance team is loaded with bright, clever people who understand the intricacies of markets technology. They are people with first-hand experience, who are able to keep up with the ongoing innovation in our markets.

We will continue to monitor these issues and consider what is a 'safe level' of high-frequency trading. Does it provide phantom liquidity?

As I said before, we need appropriate regulation and a measured response.

## Complexity in technology

Advances in technology have led to the rise of cybercrime in the financial system globally.

Computers and the internet permeate our lives today. While there are many benefits, unfortunately this means:

- there are online scams promoting 'bogus' investments
- equity trading accounts are at risk of being hacked.

ASIC is working to shut down scams and educate potential victims. We also provide warnings on our website MoneySmart.gov.au. While we won't be able to eliminate this behaviour, we will do our best to alert people in a timely manner.

[3] See proposal B1 in CP 202.

### Responding to innovation-driven complexity

In summary, innovation-driven complexity of products, markets and technology will continue to raise challenges in meeting our strategic objectives.

To meet these challenges, we will need to be forward looking and proactive.

Industry can play its part through self-regulation and better practices. Thinking laterally and using different tools, such as new media, can lead to more effective communication and better outcomes for investors.

Ultimately, investors need to take responsibility for their decisions and actions. Regulation can help them by ensuring accurate information is provided and not misleading. But investors will need to take the final step themselves.

Innovation is inevitable. We need to ensure it does not outpace regulation or compromise our strategic objectives of confident and informed investors, and fair and efficient markets.

## Globalisation

The third and final challenge facing ASIC is globalisation.

Globalisation raises two issues.

### Interoperability of markets

The first is the interoperability of markets.

Australia is a net importer of capital and therefore needs access to capital in other jurisdictions. Currently, each jurisdiction has its own set of rules and regulations. This can create obstacles to cross-border capital flows, reduce access to markets and add to the cost of capital.

Given regulators globally already have common objectives, it makes sense to work toward the global harmonisation of regulation. Global principles and a global rulebook are a good starting point. This would minimise market fragmentation and facilitate cross-border capital flows. However, policy-makers in each country will inevitably take different approaches to implementation for various domestic reasons.

I've been fortunate to be appointed Chair of the Board of the International Organization of Securities Commissions (IOSCO).

IOSCO has now formed a task force on cross-border regulation to develop a tool kit of measures to overcome regulatory differences between jurisdictions. The tool kit will include measures such as mutual recognition and substituted compliance which recognise that the same regulatory outcomes are being achieved, just in different ways. Equivalence of regulatory outcomes ensures regulation remains appropriate for each market while facilitating cross-border activity.

### Global misconduct

The second issue with globalisation is global misconduct. The fact that markets are global means misconduct is now occurring across borders.

Ponzi schemes can be based in offshore tax havens with parties in different jurisdictions. Regulators will need to cooperate and help each other in both investigations and enforcement matters. This is a real challenge.

Globalisation is here to stay, and global issues require a global response – we need to think globally, while acting locally. Organisations such as IOSCO have a key role to play in promoting equivalence of outcomes, a global rulebook and facilitating cooperation between regulators.

ASIC will play its role in developing a global approach to market regulation.

## Conclusion

I see these three challenges – structural change, innovation-driven complexity, and globalisation – as the three major global challenges facing ASIC on the road ahead. Particularly with respect to our strategic objectives of ensuring investors are confident and informed and markets are fair and efficient.

Market-based financing will have an increasingly important role to play in the funding of economic growth.

This means ASIC will need to be alert. We will need to be forward looking and proactive. But most importantly, we will need to cooperate at a global level.

With the right people and infrastructure and the right level of cooperation, I am confident that we will meet the challenge.