Future priorities for ASIC and the financial system: Building trust and confidence in our financial markets

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CHECK AGAINST DELIVERY

Introduction

Thank you, Michael, and good afternoon everyone.

Thank you for inviting me to speak at this CEDA lunch today.

I've been asked to speak on the future priorities of ASIC and the financial system.

There are five points I would like to make upfront to set the scene for talking about this.

- ASIC's fundamental objective is to allow markets to fund the real economy and, in turn, economic growth. In doing so, we contribute to the wellbeing of all Australians.
- We seek to achieve that objective through our twin strategic priorities of promoting investor and financial consumer trust and confidence and ensuring fair, orderly, transparent and efficient markets.
- How we achieve these twin strategic priorities in the future will be influenced by the key challenges we face. These challenges are:
  - conduct risk and the balance between a free market-based system with investor and financial consumer protection
  - digital disruption and cyber resilience in our financial services and markets
  - structural change in our financial system through market-based financing, which is driven by the growth in superannuation

  - complexity in financial markets and products driven by innovation, and
  - globalisation of financial markets, products and services.
- We have set out our future strategy for dealing with these challenges in our four-year Corporate Plan, *ASIC's Corporate Plan 2015–2016 to 2018–2019*, which we published in August last year. And this August we will publish our Corporate Plan for a further four years.
- As you know ASIC's activities are focused on both financial services and markets. But today my comments are primarily focused on markets. Financial markets play a central role in the growth and prosperity of our economy by facilitating the raising of debt and equity capital by issuers, and the efficient allocation of resources and risks by investors.

So today I would like to talk in detail about:

- the importance of trust and confidence in markets, and
- how ASIC is focusing on building that trust and confidence across three particular areas:
  - equity markets
  - debt markets, and
  - derivatives markets.

The importance of trust and confidence in markets

Turning first to the importance of trust and confidence in markets. Trusted capital markets support growth, innovation and prosperity and are a hallmark of a well-developed economy. Trust and confidence in capital markets encourages investor participation. This in turn:

- contributes to liquidity, and
- leads to a lower cost of capital.

However, if investors perceive they are at an unfair disadvantage, they may reduce their exposure to the market or demand a higher return to compensate for the increased risk they experience. Reduced investor participation in markets can lead to lower liquidity and higher costs of capital.

We saw this on a grand scale during the global financial crisis when investors lost confidence in the market and stayed on the sidelines. We have seen this at other times too, where incidents like the 'flash crash' in the United States spooked investors. We see this sometimes in emerging markets, and sometimes even in developed markets, where long-term patient capital withdraws because of issues of lack of trust due to sovereign risk concerns. When this happens, we all suffer.

I want to emphasise that trust and confidence is something that can take decades to build – and particularly in our fast-paced markets today – and minutes or sometimes seconds to destroy.

Our focus on building trust and confidence in three areas

So how does ASIC help with continuing to build trust and confidence in our markets? As I said, I would like to mention our work across three areas:

- equity markets
- debt markets
- derivatives markets.

Equity markets

To ensure market integrity we need market infrastructure that is robust, where trading, clearing and settlement of transactions is fair, orderly and transparent, and where market misconduct is minimised.

Some of the recent work we have undertaken that continues to build trust and confidence in markets includes:

- cyber resilience
- listing standards, and
- technology systems.

Cyber resilience

The increasing incidence, complexity and reach of cyber-attacks can undermine businesses, destabilise fair, orderly and transparent markets and erode investor and financial consumer trust and confidence in the financial system.

In March 2015, we published Report 429 *Cyber resilience: Health check* (REP 429) to help our regulated population improve their cyber resilience.

And in March 2016, we also released Report 468 *Cyber resilience assessment report: ASX Group and Chi-X Australia Pty Ltd* (REP 468). This report covers a wide range of related topics including questions all boards should consider asking to ensure they are appropriately positioned.

Listing standards

Effective listing standards support the Australian equity market to fund growth and innovation which, in turn, promotes the wellbeing of all Australians. The ASX plays a key role by administering the process for listing and ensuring listed entities meet their ongoing obligations to investors.

For these reasons, in June 2016, we released Report 480 *Assessment of ASX Limited's listing standards for equities* (REP 480). Through this report, we highlighted a number of good practices that may assist all Australian listing markets to ensure their listing standards continue to support markets that are fair, orderly and transparent.

Technology systems

We are also continuing to develop technology systems to enhance our ability to detect misconduct in the market. We are focused on tools that help us to monitor and analyse price and volume variations more efficiently to identify insider trading and market manipulation.

Since taking over market supervision from the ASX in 2009, we introduced our surveillance system named Market Analysis and Intelligence – or MAI – which was developed by First Derivatives and enables us to more quickly and efficiently identify insider trading and market manipulation.

MAI replaced the SMARTS system that we inherited from the ASX. The SMARTS system served us well but did not provide the flexibility that we now have in designing and refining targeted alerts.

In combination with additional data transmitted to ASIC from market operators, MAI now enables us to watch and tag individual investors and gives us greater flexibility to filter data and modify alerts.

MAI uses purpose-built algorithms and sophisticated data analytics to identify suspicious trading, and allows greater levels of detection of insider trading and market manipulation.

MAI also allowed us to expand our capabilities and extend monitoring to futures markets and over the counter (OTC) derivatives markets, including contracts for difference.

MAI has given us a greater capacity to evaluate market integrity on a more holistic level and to spot recurrent, suspicious behaviour on the part of individuals.

To enhance our ability to capture, share and use the data we need, last year we rolled out Microsoft Dynamic CRM. This allowed us to establish an online portal, called the Market Entity Compliance System (MECS). MECS has made the process for lodging, reviewing and tracking ASIC forms and notices simple and efficient. It also enables our markets teams to provide more coordinated and integrated relationship management to our stakeholders and again speeds up our ability to respond to issues in the market and better connect the dots.

We are focused on further strengthening our capabilities in investigative data analytics. We are implementing new SAS software known as Enhanced Investigative Analytics (EIA) for use in investigation and enforcement matters. EIA allows pattern matching across our extensive evidence databases, using algorithms. It allows us, for example, to map target relationships and create chronologies, well beyond traditional word or enhanced word search capabilities.

These initiatives demonstrate ASIC's focus on using data analytics to conduct surveillance and enforcement.

We are now also looking to overlay behavioural economics principles across our market surveillance work to better detect, understand and respond to misconduct.

Debt markets

Debt markets are vital to the funding of the real economy and financial stability. Investors need to have trust and confidence that the markets they invest in have the degree of sustainable liquidity that they expect. And by sustainable liquidity, I mean the ability in a normal market confidently execute a given volume in a security immediately and with limited price impact.

Perceptions that bond markets are increasingly illiquid may negatively affect the use of those markets as a funding source. Given the decline in traditional lending, this perception could further restrict sources of funding for companies and entrepreneurs, and so adversely affect real economic growth.

The challenge, as I see it, is to create the right environment for sustainable liquidity to develop. This will involve considering the structure of markets and how they operate and ensuring that investor trust and confidence is further developed and maintained.

Measures to help create this environment could include, for example, market structure measures such as:

- increasing pre- and post-trade transparency to improve price discovery
- derivatives markets to allow hedging of risk, and
- developing new electronic trading platforms.

Reflecting the trend towards electronification, the majority of applications that ASIC received in 2016 to operate electronic trading platforms in Australia were from platforms specialising in fixed income trading such as BrokerTec and MarketAxess. These platforms have the potential to benefit end investors by providing them with direct access to increased price transparency and dealer competition.

Some of these platforms present truly innovative ways to assist in price discovery, and they have approached ASIC's Innovation Hub to better understand the regulatory requirements that apply to them. For instance, we have seen platforms that rather than matching bids and offers, aim to create information-sharing networks between participants. These increase the opportunities for large and illiquid voice trades between sales people, traders and investors. These kinds of advances may also facilitate enhancing liquidity over the longer term.

The second kind of measures are investor- and issuer-focused steps, such as:

- standardisation of documentation and reporting
- maturity dates that match liquid benchmark indices like treasuries, and

- issuance that is eligible for inclusion in indices against which fund managers are measured.

Initiatives that expand the investor base can also contribute to a deeper, more liquid, secondary debt market.

In 2014, the simple corporate bonds legislation was introduced to encourage the issue of corporate bonds and establish a liquid retail debt market in Australia while ensuring that investor protections are maintained.

A number of companies and market operators are also starting to develop other solutions to enable non-wholesale clients to trade corporate bonds, on and off exchange.

In addition, market mutual recognition is an important measure to expand the investor base.

Derivatives markets

Turning to derivatives markets, I would like to talk specifically about:

- the futures market
- benchmarks, and
- counterparty risk.

Futures markets

Australia boasts one of the most liquid and mature futures markets in our region. Ensuring market integrity and trust and confidence in these markets is essential whether you a risk taker or a hedger.

As mentioned earlier, we've clearly invested heavily in our technology in order to better capture, share and use data and, in particular, allow us to better detect, understand and respond to misconduct in our markets.

Financial benchmarks

Financial benchmarks are also important in supporting the smooth functioning of Australia's financial markets. Benchmarks affect the pricing of financial products including OTC and exchange-traded derivatives, equity and bond index futures and other investments and risk management products.

ASIC has been working with the Council of Financial Regulators (CFR) on initiatives to ensure the resilience and robustness of our financial benchmarks. In 2015 and 2016, the CFR undertook a consultation process on the bank bill swap rate benchmark calculation methodology to ensure it remains a trusted, reliable and robust benchmark going forward.

In the international space, ASIC has also taken a lead role on the IOSCO Principles for Financial Benchmarks. These principles underscore sound benchmark administration including around governance, methodology and audit.

Counterparty risk

One of the most significant of the G20 commitments is the use of centralised infrastructure to mitigate counterparty risk on derivatives and reduce systemic risk, mandating the use of trade repositories and centralised counterparty clearing houses (CCPs).

CCPs played a critical role in the recovery of financial stability following the financial crisis. That experience demonstrated that properly governed clearing houses strengthen the markets they serve, particularly in periods of extreme market stress and volatility.

This was again demonstrated in the days following the Brexit referendum result in the United Kingdom, after which European Union and global financial markets and CCPs again continued to function and withstand the ensuing extreme market volatility.

Implementing new regulatory reforms can be challenging for industry. However, our approach has been to ensure that the Clearing Rules recognise and accommodate the global nature of OTC markets and participants. Adopting this approach, we have seen a smooth and relatively fast implementation for industry, raising trust and confidence in the operation of Australia's OTC derivatives markets.

Conclusion

In conclusion, markets can only properly fund the real economy if investors and issuers have trust and confidence in them.

And as I've outlined, ASIC plays a key role in continuing to build trust and confidence in our financial markets, particularly in detecting, understanding and responding to misconduct in markets.

We are absolutely committed to continuing to play that role in our financial markets. The Australian public would expect nothing less.