The changing perimeter of securities regulation: The perspective from Australia

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Introduction

Thank you for inviting me to speak today.

I've been asked to speak about the changing perimeter of securities regulation.

When I think about what's ahead for securities regulation, I see three things:

- structural change
- innovation-driven complexity
- globalisation.

These present a major challenge to securities regulators globally. Securities regulators have common strategic objectives of:

- ensuring financial markets are fair, orderly and transparent
- ensuring investors are confident and informed when they participate in the market
- mitigating systemic risk in the financial system.

These strategic objectives are critical in having an efficient financial system where business has access to cost-effective capital in order to fund economic growth.

I will go through the three challenges in turn, but as an Australian regulator, I will be speaking from an Australian perspective.

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, and
- following a demographic shift underway in many developed countries, as the population ages and people start to contemplate how to fund their retirement.

Australia provides a good example of this growth in super because:

- the rate of mandatory super contributions 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.

The growing importance of market-based financing presents a challenge for 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 services providers such as financial advisers, investment managers, custodians, research houses, credit rating agencies, and auditors and accountants.

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

Market regulators cannot and should not prevent all investor losses. We are not prudential regulators. But there is a clear need to identify and address market problems earlier, to minimise the risk of market failures leading to widespread losses and systemic weaknesses. This is a theme for securities regulation going forward.

Innovation-driven complexity

The second challenge is keeping pace with innovation-driven complexity.

It’s a constant struggle to monitor new developments and respond in a way which doesn’t unduly restrict the benefits of innovation.

However, we also need to be mindful that innovation can add complexity and risk. In other words, the question of how and when to be proactive in this context can be challenging.

We see innovation-driven complexity in three areas:

- products and distribution
- markets
- technology.

Complexity in products and distribution

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 which 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. As a result there was a fundamental misalignment of risk – misalignment between how much investors thought they had compared to how much they actually had.

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 is very important.

In fact, if they don't understand it, they shouldn't buy it, even if their financial adviser recommends it. ASIC's financial literacy and education work is becoming more direct to convey these sorts of messages.

However, product manufacturers and product issuers have a role to play and carry very significant responsibilities. 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.

Those selling complex products to unsuspecting investors need to wise up and do the right thing. Short-term gains may be achieved, but as we saw with the crisis, governments and courts can rule in favour of investors that have been mis-sold these complex products – the recent cases in Australia involving local councils being a case in point.

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. In other words, the perimeter of securities regulation is also changing in terms of the regulatory tools that are being considered. More disclosure is not the only approach.

You can see some of this in the recent Future of Financial Advice (FOFA) reforms in Australia. Rather than relying purely on disclosure, certain types of conflicted remuneration, notably commissions, have been prohibited going forward. A clearer legal requirement to prioritise the interests of retail investors has also been introduced – the 'best interests' duty. We will certainly be interested to see how this is applied when advising on complex products.

From a self-regulatory perspective, product manufacturers should educate investors about a product. This could overcome some of the inherent weaknesses of traditional disclosure.

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.

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 'the new normal'. 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. 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 additional safety net for investors. 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 are 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 because, 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 consumer website, www.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.

In summary, innovation-driven complexity of products and distribution, markets and technology will continue to raise challenges for securities regulators.

To meet these challenges, we will need to be forward looking and proactive. We need to identify emerging risks earlier. Of course, this is not straightforward. But one example is our renewed emphasis on targeting advertising and marketing, to ensure that aggressive and inappropriate promotions that may mislead consumers and investors are addressed earlier.

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 good outcomes for investors.

Investors also need to take responsibility for their decisions and actions. Regulation can help them by, for example, ensuring accurate information is provided, that suitable standards are met, and that advertising is not misleading. But investors will need to ensure that they are also vigilant.

Innovation is inevitable and desirable. But we need to ensure it does not outpace regulation or compromise our strategic objectives of confident and informed investors, and fair and efficient markets. We need to make sure that innovation occurs in markets that work well and contribute to better outcomes for end-users.

Globalisation

The third and final challenge facing securities regulators is globalisation. The importance of this challenge for ASIC is indicated by Chairman Medcraft recently becoming head of the International Organization of Securities Commissions (IOSCO).

Globalisation raises two issues.

Interoperability of markets

The first issue 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.

ASIC is involved in IOSCO's new 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 globalisation raises 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 securities regulators.

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

This means we 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.

Thank you.