ASIC
Australian Securities & Investments Commission

Market structures and market integrity: ASIC Update on Australian markets

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CFA Societies Australia 2017 Conference (Melbourne, Australia)
1 November 2017

CHECK AGAINST DELIVERY

Introduction

Good morning ladies and gentlemen.

Let me also begin by acknowledging the Traditional Owners ongoing connection to and custodianship of the lands on which we meet today, and to pay my respects to elders both past and present

I am delighted to be speaking at the CFA Australia Investment Conference this year.

On many levels, the objectives of the CFA and ASIC are aligned – in seeking to achieve better outcomes for investors:

- the CFA – through promoting the highest educational standards and high standards of ethical behaviour; and
- ASIC – through demanding fair and efficient markets and building investor trust and confidence.

While we regulate you, when we are regulating our markets we are regulating for you.

Today I will be talking about Australia's markets.

First, I will touch on the current state of our dynamic markets.

Then, I will outline ASIC's perspective on innovation and how it relates to financial markets.

Lastly, I will peer over the horizon at what is in store for our markets.

When we speak of 'markets' what exactly do we mean?

Of course we mean the securities and futures exchange markets that are readily accessible to all investors.

But these are not the only critical financial markets in our economy.

Those exchange markets only account for 34% of gross Australian turnover. The remaining 66% of turnover is done in our wholesale OTC markets – that is OTC derivatives, foreign exchange and other non-exchange traded products. And, when I am using the term 'markets' I am encompassing all of these critical Australian markets..

My message today is that innovation and technological advancement has the potential to deliver exceptional benefits in all of these markets – after all innovation driven by technological change is nothing new in these markets; though the pace of change is accelerating. We all know ASIC and the industry must embrace the changes innovation poses to realise these benefits for our economy.

But ASIC will not lose sight of the fundamental purpose of markets – for the traditional and most important users – those looking to raise capital to support their businesses in the real economy and those looking to invest and manage risk.

1. Current state of Australian markets

There is no question that major events in financial markets – like the global financial crisis – can rock the confidence of business owners and investors.

Strong market foundations

These events reinforce the importance of having strong foundations built on integrity and quality, and a market structure that is capable of adapting to change. While there is always room for improvement, **Australia's markets are robust**.

Resilience following the GFC

Following the GFC, the global economy experienced possibly the deepest recession since World War II. Australia performed better than most other major economies. This relatively strong performance has been attributed in large part to our sound banking and regulatory systems in Australia (and a touch of luck).

Since then, we have implemented a number of regulatory initiatives that further enhance transparency, governance, risk management and regulatory oversight in our markets. For example, the introduction of regulatory reporting of many OTC transactions. We are using this data to examine conduct in OTC markets and to assess trends within these markets and across related asset classes.

Market cleanliness

Our research last year into the cleanliness of Australia's listed equity market found there has been a sustained and statistically significant improvement in cleanliness (ie an absence of information symmetries) over the past decade. This is based on an assessment of possible insider trading and information leakage ahead of material, price sensitive announcements.

Preserving the integrity and good reputation of Australia's financial markets is a critical priority for ASIC, and a never ending task. This research set an important benchmark that we will continue to measure ourselves and our equity markets against over coming years.

Strong international reputation

We know that Australia's financial markets punch relatively above their weight. For example, in 2016, there were 133 initial public offerings on ASX. This is more than many major exchanges, including Singapore (16), New York (37), London (66), Nasdaq (91) and Hong Kong (115).

We also know that the Australian regulatory framework and market structure is highly regarded internationally. There have been numerous assessments by overseas regulators deeming the Australian regime sufficiently equivalent to their own and allowing Australian regulated entities to operate in those overseas jurisdictions under substituted compliance.

So our markets are built on strong foundations, but that doesn't mean we can be complacent.

Dynamic markets

Developments in technology have spurred market infrastructure to become increasingly integrated, competitive, global and complex. Having a *sound, adaptable market structure has been, and will continue to be, instrumental in accommodating change*.

Like elsewhere, competition and innovation in the Australian marketplace is intensifying at every level of our market infrastructure — from capital raising and secondary trading through to post-trade infrastructure, and across and between the exchange-traded and OTC markets. There has been enormous change across the entire spectrum and there is more change on the horizon.

For example:

- There has been a proliferation of alternative markets, with many traditional voice brokers transitioning to automated 'market' models, while others are using social media or other technologies to create new forms of market-like platforms.

- Exchange markets (and some OTC markets such as FX) are now overwhelmingly electronic, and predominantly automated.
- Competition between equities exchange markets has delivered innovation in the services, products and access arrangements to these markets. It has also contributed to fragmentation of orders, which has necessitated the development of smart order routers to access liquidity between markets.
- We rely on algorithms – not only for trade execution – but also for analysis and advice – to navigate an environment where speed is measured in nanoseconds.
  - Technology has opened the door for high-frequency traders, which account for around 27% of equity market turnover and 14% of bond futures. Anecdotally, HFT is also active in the FX and other OTC markets.
  - We need to continue to monitor HFT and other developments to ensure they do not undermine the interests of companies and investors.

These are just a few examples.

With the ongoing shift in Australia towards greater reliance on market-based financing, these continuing changes have the potential to profoundly shape the future prosperity of businesses and investors in Australia.

2. ASIC's perspective on innovation

So how is ASIC responding to these changes and innovation more broadly?

We are outcomes focused. We are bringing a forward-looking mindset to our role and responsibilities.

We are partnering with industry to ensure that we keep abreast of developments and to consider how our role may need to change as a result of new developments. For example, we have partnered with CSIRO's Data61, Australia's leading data innovation group, to explore ways to improve ASIC's data analytics capability. The aim is to be smarter in our use of existing data within and across all corners of ASIC. We are also identifying additional sources of data that can enhance how we do our work.

Where we (or the industry) look to establish new systems or processes, we are open to considering entirely new technology or solutions. The same applies for solving existing problems – we and the industry need to be open to entirely new solutions and not just settling for incremental improvements on old approaches. We are operating in a global market environment and can't afford to fall behind.

It's about being outcomes focused. But we need to continue to test and validate that the outcomes do not undermine the purpose of markets – for companies, investors and others that use markets to raise capital and manage their risk.

Being proactive

In such a rapidly changing, global market environment, change is a given in the work we do. Part of our role is ensuring that the regulatory outcomes that support our robust markets are embedded in innovation so that their integrity is not undermined. We all know it is very difficult to turn back the clock once developments are embedded, so we must be forward looking, including looking to developments overseas.

We have had reasonable success at being proactive. Let me take you through some examples:

- Competition in clearing and settlement – together with the Reserve Bank and Treasury, we have developed a framework in preparation of addressing whatever competition in clearing models and also in settlement models may emerge;
- Market licensing – we have just consulted on a new framework for licensing markets. The old model was rigid and designed for exchange-type markets only. We have proposed a tiered licensing model that will provide the flexibility to accommodate the full range of emerging and specialised markets. It will also better support overseas markets seeking to operate in Australia, which provides Australians will better access to global liquidity.
- Technology – by providing clear guidance, we can make it easier for firms to develop and bring new services to market. For example:
  - We have released info sheets on distributed ledger ('blockchain') technology and initial coin offerings.
  - We have also worked intensively with the industry on cyber security – reviewing and reporting on the preparedness of market infrastructure providers, listed companies and participants for cyber threats. We have also released good practice principles and a series of questions boards should be considering about cyber risks in the context of their businesses.
- Market structure – observing potentially harmful developments overseas and responding early in Australia to ensure our markets remain fair, orderly and transparent, including:
  - Maker-taker pricing – this can involve markets paying traders for their orders, which has the potential to incentivise trading for rebates rather than a genuine interest in the relevant securities. We pre-empted the issue and prohibited the practice of offering more than a 100% rebate of trading fees. Other regulators are following our lead and starting to question the practice, albeit a challenge to unwind.
  - Payment for order flow – this is the practice of brokers buying and transacting against retail orders before they can reach public markets. It raises questions of conflicts of interest and best execution for clients. We prohibited the practice in Australia before it took off. In other jurisdictions, this practice has drained retail participation away from public markets – with almost no retail orders now reaching public exchange markets in the US and UK.

- Automated trading – Australia led the way on analysing and responding to the impacts on direct market access and high-frequency trading. Many other developed markets are just catching up to our rule framework on automated order processing.
- Dark pools – again, we were one of the first major markets to assess the impacts of dark pools on market quality and integrity and to create rules designed to provide more transparency and accountability on their operation.

Being proactive in this way is enabling us to manage the fast pace of developments. Over the longer-term, we also see it as sustaining the attraction of the Australian market for investors and companies that want to invest and raise capital in markets that are fair and efficient.

3. Over the horizon

So what do we see coming over the horizon?

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As you know, January 3 will bring significant changes in Europe, which will have far-reaching impact on financial markets there and, potentially, a flow-on effect into our markets. For example, requirements about payments by investors for reasearch as well as best execution and transaction reporting requirements.

Centralisation of OTC market infrastructure

In the traditionally fragmented OTC markets, we are starting to see the centralisation of market infrastructure, such as the use of central clearing and other services like portfolio compression. In overseas markets, many OTC transactions are transitioning on to regulated and transparent trading venues, such as swap execution facilities in the US. Regulatory change has been the main driver.

New forms of market infrastructure

As I noted earlier, there are new forms of markets and market infrastructure in the pipeline. Many are not like traditional markets and instead use innovative technology to facilitate the transfer of title or the making of payments. Others will simplify things, by using the web to reach the crowd. For example, to access seed funding through crowd sourced equity funding or initial coin offers.

Benchmarks and FX reform

In response to a range of questionable conduct in the foreign exchange market and in the setting of key benchmarks here and abroad, the regulatory environment is changing. This is already leading to changes in behaviour, but it may also facilitate innovation, including in data capture, reporting and surveillance.

- FX Global Code – The spot FX market is a key global market and is of systemic importance to the Australian economy, with a daily average turnover of around $40 billion in Australia. The FX Global Code provides a global set of practice guidelines designed to promote the integrity and effective functioning of the wholesale FX market. ASIC has released a report (REP 525), which builds on the Code and encourages market participants to adhere to high standards of market practice.
- Benchmarks – The Government and ASIC have been consulting on a licensing regime for administrators of significant benchmarks. The intention is for ASIC to make rules designed to ensure the robustness and reliability of the benchmarks in line with the IOSCO Principles for Financial Benchmarks. ASX recently took on responsibility for administering the BBSW and there are changes in how the benchmark will be calculated. These changes are important so we have a contemporary regime, likely to meet requirements of European benchmark regulation that begin in January.

Providers of critical third party services

The industry is increasingly relying on third parties to deliver critical services, including networks, market data, collateral management, portfolio reconciliation and compression. While it is inherently more efficient to use providers that specialise in these services, it can introduce a range of risks – such as concentration, operational and compliance risk.

Technology is inherently disruptive and does not always fall neatly within the rule-books that govern traditional entities. The International Organisation of Securities Commissions is considering whether the regulatory expectations and supervisory tools currently applied (e.g. outsourcing principles for market infrastructure operators and participants) remain fit for purpose or whether new approaches or tools need to be developed.

Artificial intelligence

The power of data has opened the door to artificial intelligence in our financial markets. It will increasingly drive the algorithms that predict news, behaviour and market price movements. The algorithms that determine which products to trade in and when. And those that slice up orders, determine where to route them and how they are executed. They have the potential to redefine research and to enhance both front and back office functions.

The biggest managed funds and hedgefunds globally are using AI and you can bet the most sophisticated and fasters traders are too.

With this comes risk and moral hazard. Who is accountable for the trading decisions, including when the algorithms learn to behave immorally, to manipulate the markets. Whether intentionally or through complacency or ignorance of its users, the risks are real – to the fair and efficient operation of our markets and to investor confidence and trust.

Needless to say, this is an area we will continue to examine closely.

Conclusion

I hope I have given you a good sense of the dynamic nature of Australia's markets – as well as the enormous opportunities and challenges ahead.

In closing, I want to leave you with the same message I started with.

Innovation has, and will continue, to deliver exceptional benefits for financial markets. We will embrace this change so we can realise the benefits.

In our work, ASIC will continue to prioritise the interests of those raising capital to support and grow their businesses and those looking to invest and manage risk.

Thank you, I am very happy to take questions.