Creating growth through our markets: Using the right nudge

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Introduction

Good morning everyone. Once again, it's great to be speaking at the Annual Stockbrokers Conference. My topic today is how we can create growth through our markets by using the right nudge.

The key to creating growth is trust and confidence in markets. At their core, markets assist in funding the real economy and, in turn, economic growth. This contributes to improved standards of living for all Australians. For markets to do their job, investors need to have trust and confidence in them. Without it, you don't have a market.

As professionals in the stockbroking industry and gatekeepers for our markets, I know you appreciate the fundamental importance of trust and confidence in underpinning markets to do their job of funding the real economy.

Today, I'd like to talk about how ASIC helps provide trust and confidence. I will talk about three things:

- ASIC's role
- our challenges
- how we respond to these challenges.

ASIC's role

What is ASIC's role in creating trust and confidence in our markets?

ASIC’s fundamental objective is to allow markets to fund the real economy and, in turn, economic growth. This is dependent on Australians having trust and confidence in our markets, and is reflected in our twin regulatory strategic priorities of:

- investor and consumer trust and confidence
- fair, orderly and transparent markets.

Our first strategic priority has three areas of focus where we seek to apply the right nudge:

- *Education* – Investors taking responsibility for their own financial decisions remains core to our free enterprise system. We empower investors and consumers through our financial literacy work, conducted under our MoneySmart brand. For example, ASIC’s MoneySmart website (moneysmart.gov.au) was visited nearly 5 million times last year, a 30% increase on the year before.
- *Gatekeepers* – We hold gatekeepers (such as directors, advisers, auditors, product manufacturers, market participants and stock exchanges) to account. ASIC is a law enforcement agency, first and foremost; 70% of our regulatory resources are devoted to surveillance and enforcement.
- Lastly, *consumer behaviour* – We recognise how consumers really make decisions and look to apply insights from behavioural economics in our work.

Our areas of focus for our second strategic priority – fair, orderly and transparent markets – are:

- our role in market supervision
- surveillance of market conduct
- our corporate governance work.

Challenges to trust and confidence

For my second topic, I’d like to outline the five challenges we see to trust and confidence in our markets. At ASIC, our focus is on being proactive and forward looking to help manage these challenges, which are:

- getting the right balance between a free-market based system and investor and consumer trust and confidence
- digital disruption to existing business models and channels;
- structural change in our financial system through:
  - the movement of savings from the banking sector to the superannuation sector
  - the growth of capital markets, driven by the growth of superannuation
- financial innovation-driven complexity in products, markets and technology, largely driven by the digitisation of our economy

- globalisation, which also affects:
  - products
  - markets
  - technology.

Responding to our challenges by using the right nudge

My third topic is how ASIC responds to these challenges by using ‘the right nudge’. I’d like to focus on four things:

- how we influence conduct
- our new review of high-frequency trading and dark liquidity
- managing confidential information
- our new Market Entity Compliance System.

Influencing conduct

As a conduct regulator and law enforcement agency, ASIC keeps a close eye on what drives conduct, or human behaviour. I see three key drivers of behaviour:

- culture
- deterrence
- incentives.

Culture

The culture within a firm – its shared values and assumptions – has a positive influence on behaviour.

Poor culture – such as one that is focused only on short-term gains and profit – drives poor conduct. The benchmark manipulation scandals all over the world, and problems locally in the financial advice sector, demonstrate this.

Conversely, good culture drives good conduct. I see a good culture as one that puts the customer’s long-term interests first and has this embedded in a firm’s operations. The tone from the top is vital.

My colleague Greg Tanzer spoke about culture this week. I know from my IOSCO work that, at the international level, culture is on the minds of bank executives. And so it should. Because when culture is rotten and inappropriate investments become worthless, it is not the wealthy who are being fleeced.

When culture is rotten it often is ordinary Australians who lose their money.

And that is my point – markets might recover but often people do not.

So that is why we need to clean up culture because people suffer. And people are sick of it. They want to have trust and confidence in the institutions they are dealing with.

Deterrence

Penalties that are an effective deterrent against wrongdoing have a negative influence on conduct; they stop people from breaking the law. For penalties to be an effective deterrent, the disincentive to break the law must be greater than the potential gain – the fear must be greater than the greed.

ASIC's law enforcement targets the fear side of this equation in terms of, firstly, the fear of getting caught. As part of our 'detect, understand and respond' approach, we gather intelligence on potential and actual wrongdoing from:

- our proactive and reactive surveillance
- breach reporting
- reports from whistleblowers and the public
- data gathering, matching and analytics.

For example, our Market Analysis Intelligence (MAI) system allows us to gather, match and analyse data to detect suspected misconduct in real time. We also review the operation of the algorithms used by high-frequency traders.

Secondly, ASIC's law enforcement targets the consequences of getting caught. For these consequences to be an effective deterrent, we need penalties that inject so much fear it stops people from breaking the law. Tougher penalties for white collar crime will provide the right nudge so that fear can overcome greed.

Incentives

The third key influencing factor for conduct is incentives, such as remuneration and other rewards. Depending on how the incentive is structured, it can either influence:

- good conduct, which is reinforced by good culture, or
- bad conduct, which threatens investor and consumer trust and confidence.

How an entity influences conduct – particularly through its culture and incentives – is something ASIC focuses on in our surveillance work. I like to think of it in terms of three Cs:

- *Communication* – Communication of conduct expectations needs to be clear, concise and effective. This includes communication that is proactive and regularly and consistently repeated across the organisation.
- *Challenge* – Organisations:
  - should challenge existing practices to determine whether current conduct is appropriate
  - need to foster an environment where employees are encouraged to escalate concerns without fear of retribution

  - should consider rewarding staff for speaking up.
- *Complacency* – That is, don't be complacent. Conduct should be continually reviewed, enforced and validated.

If we find that the policies, procedures and practices in an entity don't influence good conduct, it raises a red flag with us. It tells us to look harder, as there are likely to be problems within that entity. And, we will look to apply the right nudge to change behaviour.

High-frequency trading and dark liquidity

The next topic I wanted to talk about is our upcoming review of high-frequency trading and dark liquidity. As part of ASIC's ongoing monitoring of our markets, we are reviewing high-frequency trading and dark liquidity following on from our earlier review in 2013.

While we don't have any specific concerns about high-frequency trading at present, and are satisfied that the regulatory framework is appropriate, we recognise that this is a dynamic area. In 2012, high-frequency traders were less than 1% of traders but 27% of turnover in the ASX 200. We are launching a new review to assess how high-frequency trading has changed in both the futures and equities markets.

On dark liquidity, our review will consider how dark liquidity – currently 28% of market turnover – and dark trading venues are evolving. It will also re-test whether the balance of lit and dark liquidity is impacting price formation, which is fundamental to trust and confidence in our markets.

Key findings from our reviews will be published towards the end of October 2015, and we will consider if there are any areas where we need to respond by applying the right nudge to change behaviour.

Confidential information

ASIC is also reviewing the handling of confidential, market-sensitive information. The fair, orderly and transparent operation of our financial markets depends on all investors having access to market-sensitive information about listed entities at the same time. Leakage of information before market announcements can lead to market abuse, such as insider trading, and undermine investor trust and confidence.

In 2013, ASIC conducted a review of listed entities and their advisers to consider practices regarding the handling of confidential, market-sensitive information. ASIC's review identified some areas of concern, including practices relating to soundings in capital raisings.

This has continued to be a focus for ASIC, and we are currently conducting a thematic review of market participants to:

- assess their policies and procedures for the handling of confidential, market-sensitive information, particularly in the context of research reports

- shape positive behavioural change to ensure that market participants and listed entities treat confidential information appropriately, including through non-selective disclosures.

ASIC can and will take action to apply the right nudge where misconduct occurs. For example, in July 2014, the Federal Court imposed a $1.2 million penalty on Newcrest Mining for contravening its continuous disclosure obligations. This followed proceedings issued by ASIC, alleging that there were a number of selective briefings to analysts where market-sensitive information was disclosed.

Market Entity Compliance System

My final topic for today is something I'm very excited about – our new Market Entity Compliance System (MECS). It is part of ASIC's industry-funded Flexible Advanced Surveillance Technologies (FAST) program.

MECS is ASIC's regulatory compliance portal that provides market entities with tools to help them comply with a number of regulatory obligations under the ASIC market integrity rules and the Corporations Act. I see MECS as an example of ASIC using technology as part of the right nudge to assist market entities in complying with the law.

MECS will maintain a record of interactions with ASIC, greatly simplifying document management and record-keeping practices. Entities can use MECS to:

- submit inquiries, applications and notifications
- respond to notices
- monitor the status of submissions.

The system is currently being piloted with a small group of entities. And, I'm pleased to announce that it will be rolled out to all market entities by the end of July 2015.