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PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND
FINANCIAL SERVICES

Oversight of the Australian Securities and Investments Commission

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PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Wednesday, 15 June 2011

Members in attendance: Senator Boyce, Mr Ripoll, Mr Smith, Ms Smythand Ms Stephens

Terms of reference for the inquiry:

To inquire into and report on:
Oversight of the Australian Securities and Investments Commission.

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Committee met at 17:10

CHAIRMAN (Mr Ripoll): I declare open this public hearing of the Parliamentary Joint Committee on Corporations and Financial Services. This evening the committee is conducting a hearing into the Australian Securities and Investments Commission under section 243 of the Australian Securities and Investments Commission Act 2001. The corporations and financial services committee is required to oversee the functioning of ASIC. This hearing is part of that oversight. This evening the committee will hear from Mr Richard Gilbert and Mr Charles Suttie from the Rule of Law Institute of Australia, and Professor Carole Comerton-Forde from the Australian National University. Thank you for coming. The committee will hear from ASIC representatives on 24 June in Sydney.

I welcome you all here today and remind everyone that in giving evidence to the committee witnesses are protected by parliamentary privilege. This gives special rights and immunities to people who appear before the committees. People must be able to give evidence without prejudice to themselves. Any act that disadvantages a witness as a result of the evidence given a committee may be treated by the parliament as a contempt. It is also a contempt to give false or misleading evidence to a committee. If a witness objects to answering a question, the witness should state the grounds upon which the objection is to be taken and the committee will determine whether it will insist on an answer, having regard to the ground claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. A request to give a particular answer in camera may also be made at any other time. The committee may still publish confidential evidence at a later date, but we would consult the witness concerned before doing this.

I call our first witnesses: Mr Richard Gilbert, chief executive officer, and Mr Charles Suttie, adviser. Do you want to make any opening remarks?

Mr Gilbert: Thank you, Mr Chairman. First of all, I would like to thank the committee for inviting us here. We have never been to an ASIC oversight hearing of this type before and I congratulate the committee on taking the initiative of having non-ASIC witnesses. I think that is a very good move. I note that you have had two previous organisations come who were not ASIC officials and I think we are the third. In our opinion that is a very positive move. It will probably be a good thing for ASIC as well, in the long run.

Here is a little bit about our institute. It has four or five fundamental objectives: to promote the rule of law; to promote good governance in Australia by the rule of law; to encourage truth and transparency in the Australia federal and state governments; to reduce the complexity and arbitrariness and uncertainty of Australian laws; and to reduce the complexity and arbitrariness and uncertainty of the administrative application of Australian law.

We have made submissions to quite a number of committees on migration law, corporations law, tax law and privacy law. We have made major submissions on Senate scrutiny of bills submissions and have also made public statements about the need for journalist secrecy. So we will make statements on anything which has a relationship to the rule of law where we can. We are very much a fledgling and part-time organisation. Most of the work is done on a pro bono basis, so it took a lot of effort and resources to get here today, but we thought it was useful to come.

So we have taken an interest in the coercive powers of our federal regulators generally, including ASIC. I would like to make some general observations about them. The first thing is that we have conferred on our federal regulators quite intense and broad-ranging powers: for example, compulsory attendance and examination to answer questions, the need to produce books and documents, the need to provide assistance, search of premises—the ATO, for example, has departure prohibition orders which were recently in the public domain—and, of course, recent changes to the corporation law which gave ASIC enhanced wire-tapping and phone record access type powers. They are serious powers. It is very important that a committee such as this not only take the issue seriously, which I know you will, but also scrutinise what is being done by way of the use of those powers. Why is it significant to the rule of law? There are five or six reasons for that, one of which is the penalties for not complying or not cooperating with the regulators are harsh—up to two years imprisonment and fines, obviously. There are things such as the abrogated right against self-incrimination under ASIC. So the right of not incriminating yourself is a critical one in our system of justice and where you remove that will obviously need some checks and balances around it.

Coercive powers do diminish fundamental human rights and freedoms, one of which is the right of silence, which is a critical one. I will come to that in a minute. Normally, coercive powers would be issued or sanctioned only by an independent judiciary, but here we have got a regulator imposing on people a restriction on their rights. Again, another critical point is that, in most cases, the police do not have these powers that ASIC has or the ATO might have. Also, there are restrictions around legal professional privilege which regulators can also impose. With that in mind, I think the most critical debate we have had on coercive powers was when the previous Howard government brought in relation to the Australia Building and Construction Commission bill. Senator Wong correctly said that the ABCC has powers which the police do not have.

One of the interesting things about the debate on that bill is that that bill or that act for the ABCC has got model disclosure and regulation powers in it. That was because mainly the Senate did a very good job in making sure that fundamental rights of the individual were protected. We say, 'If it is good enough for the building construction industry, well, what about the other parts of the economy?' And so we should not lose sight of that.

Given the gravity of the powers which we give our regulators, including ASIC, we say we need to question first of all whether they are really needed. We need to question whether they have due process around them, whether there are checks and balances, whether there is transparency both in process and in outcome and, finally, where there is accountability on the regulator about how they use those powers.

In relation to ASIC's powers and how often they use them, there are five main powers which ASIC identified to the Senate. For the first time in their history they actually provided—I think it was last year—some statistics on how often they use those powers. The collection of statistics showed about 18,000 uses in three years. I will come to the size of that in minute. But that is not the whole story. There are other powers which they did not report on which we could advise you on if you want to go down that track. They just took the top five. That was their decision, but there are others and I do not know whether they would amount to thousands, but maybe to hundreds. Maybe ASIC will tell you that. But 18,000 is still a lot of use of coercive powers. It is probably second only to the Tax Office in their use of the powers. We do not know how often the Tax Office uses their powers, but we suspect it is probably more than ASIC.

Now, one could say, 'So what?' about the numbers. We say, a low number of power uses could indicate a lazy regulator. It would be interesting to know how often they used their powers in the events leading up to the Storm situation. That would be interesting and useful for the committee, and perhaps the committee explored that when it did the Storm inquiry. But on the other hand, a rapidly increasing number of uses could show that the regulator is out of control and that they have few internal controls. We also say that dissected numbers on where they were used by state, by division, by function and by statute provision might also show systemic issues. On the one hand they could show systemic issues in ASIC in how they delegate and use their powers and on the other hand they could show that there are particular parts of the industry with problems which you need to know about and which the parliament needs to know about so as to work out whether ASIC is doing its job properly. These numbers are good indicators, we say, of how the regulator is working through the processes and procedures to find out where the wrong is.

We would also be interested to know what happens at the interview stage. What are the procedural rules around interview? When ASIC has an interview, is there typically the person that they are interviewing and the lawyer and eight ASIC officials in the room? Is there some sort of procedural equity around that? That is something I think ASIC could actually talk about, because ultimately the power of numbers is a critical thing. And I do not need to remind politicians about the power of numbers. We also say that the overuse of powers could impact on the cost of compliance and efficiency. It is not a core rule of law issue, but at the end of the day if a law becomes inefficient it will become a law which is not respected or adhered to. That is another critical issue around why the numbers are important.

We did an evaluation of the annual reports for the ACCC, the Australian Crime Commission, APRA, ATO, ASIC and the ABCC, and asked: 'What is in their annual report? What is disclosed?' We went through 12 to 13 particular components, a number of notices, notices by type, and they are all there for you. As I said before, the ABCC, because of the politics around that debate, is a savvy, new age, modern regulator in terms of its disclosure. You can see APRA does not appear to disclose anything. The ATO does not disclose a lot but has recently undertaken to do more, which is a good sign. The Australian Crime Commission, with recent legislation, had a fair bit of disclosure in the annual report. The same goes for the ACCC, but ASIC—I put this slide up at the ASIC conference summer school and they did not brook on it, so I think we are right—do not disclose a lot. They have indicated a willingness to disclose more and we say that is a very positive move. I think the job of the committee is to think about whether it is a positive move and how much disclosure you want as a supervisor.

The other interesting thing was the information disclosed about coercive powers between the regulators and where they disclose. We have noted whether various powers, information or no information is noted on the website, along with whether it is disclosed at Senate estimates hearings and general statistical use in the annual report. That is another point of comparison. Again, ASIC does not exactly come up as the model disclosure regulator.

We have also delved into how often people are examined. The only one we have not put up there is the ATO, because we do not know that. They have put some statistics before the parliament and have given an undertaking, as we understand it, to disclose the broadly based coercive powers in the next annual report. As you can see, ASIC is, by a long shot, compared to the other regulators, a very intense user of notices. Again, we do not want to say that in a pejorative way, but just that they are using them. Perhaps the committee needs to know why and how they use them and whether there are any issues.

It is our experience that a lot of other peak bodies remain silent on this because it is not in their interest to adversely criticise the regulator. But the Rule of Law Institute is perhaps a little bit more able to do that, and it is probably worth finding out whether others have concern. I think you probably would find that. We say there must have been a concern because, in 2008 the Australian Administrative Review Council—which has a whole lot of stakeholders on it, including the chair of the ALRC and the Secretary of the Attorney-General's Department—published a major report on coercive powers. From where that reference came I would not know, but I think it indicates that the Rule of Law Institute is not on their own in saying that there is an issue around how coercive powers are used. I do not want to go through the whole Administrative Review Council principles and report other than to say that the government has exercised its right not to respond to that report, and it is for the government to say why it would not respond. There are two critical points for us: the need for agencies to keep records and the need for transparency—these were recommendations 3 and 4.

The rest are about procedures, drafting notices, exercising the powers, contempt of court and authorisation delegation. Interestingly, the Taxation Office and others have a system of divided delegations, so that if you are a regulator and you see there is some malpractice happening in one sector of the economy and you want to question people, your SES person does not just sign off on that—they have to go to another division in the Taxation Office to have a sign off on that. I think that is a good practice because it injects some impartiality into the decision making, as well as some independence. We are not saying you should have to go to a court for the authorisation, but we are saying that there need to be internal controls and balance procedures. Again, that is something you could raise with ASIC. So the principles go on. I do not want to go through them at length, although I will come to the conflict of interest which is principle 12. We also think that all the regulators should publish statements of governance and codes of conduct and disclosure. If it is good enough for the parliamentarians to have such a set of requirements, then the independent regulators probably should draft them. We note that APRA has such a code, but I do not think actively reports on it. But we do not see a lot of evidence of the other regulators having that code. Now there were a couple of instances recently where the interests of some regulators were brought into question. We say that if they had had a code and some disclosure, perhaps there might not have been adverse media on that. This is something that perhaps this committee could look at in relation to ASIC as well.

There is a lot of principles there. This report is there and I think it needs reviving. It does not need to be a massive bureaucratic exercise. One of the options the committee could exercise is to have a similar procedure to what the ASX did when they first brought in corporate governance principles. They decided that corporates on the ASX could have an 'If not, why not?' policy—that is, if you do not subscribe to the policy ask, 'Why not?' Perhaps that is an option for the committee. We are not here to bind up ASIC forever in its own regulations. ASIC should be regulating others, not spending its life regulating itself. But equally, there should be some transparency and accountability around their operations.

Most of the talk I have given so far has been about ASIC seeking out wrongdoers and finding out what they are doing wrong and how they can make sure that they regulated and prosecuted, if that is the case. But ASIC also gathers information from the industry and it has information-gathering exercises. There was a recent case, I think it was February last year, which was recorded in a journal called *Money Management*, where ASIC issued a questionnaire to the top 20 financial planning firms and the questionnaire had 800 questions in it. Those were a lot of questions, and that was reported. I tried to get a copy of that survey but I was not able to because it is secret. If one of those institutions provided me with a copy, they would be in breach of the section 19 notice which they were delivered.

In relation to the information giving in order for ASIC to work out what is happening in the market, which we do not oppose, I think there needs to be some sort of policy statement on that as well. So, we say, 'Consider being voluntary for a start.' We say, 'Seriously test the cost and benefits of what you are doing.' We say, 'Have simple

answers and not too complex an answer.' We say, 'Publish your data.' So if you go out and question 20 people times 800 and you get 16,000 answers, would it not be good to have the answers somewhere in the public domain? Because they will help competition and they will help inform consumers, and it might help inform this committee. If you go to the trouble of collecting the data, make sure you have the resources to somehow publish it if it is done and it is a non-wrongful-act type investigation.

We say, 'Publish composite data.' It could be that there are privacy issues around the firms you are collecting from. Well, publish it in a composite form. I have already said it, but I think when you collect that sort of data, you should avoid the secrecy provisions and confidentiality clauses. We should be an open and transparent market where possible. If there is no wrong being committed, why the secrecy?

In relation to this committee's next steps, we have very generously thought up three steps you could consider. The first is to require ASIC in its annual report to provide detailed statistics on its use of coercive powers, along with a discursive statement that notes their use and key trends. I do not think that would be too difficult a job for ASIC. The second is for ASIC to post on its website a policy statement on how it uses its coercive powers. It has an excellent policy statement on how it runs hearings when it gets people in for a licence dismissal, for example. If you want to take a licence away from a player, there is a full document on the website about how they do that. We say, 'What about a policy statement on your website which says, "This is how we go about exercising our coercive powers"?' Finally, we are suggesting to your committee that you adopt the ARC report of 2008 as a template for your future supervision of ASIC—not the only template, but the template for how you go about working out how ASIC is using its coercive powers. Mr Chairman, we are really grateful for being invited here today. I hope my statement did not go too long and that the slides were useful. I have with me a legal expert who advises the institute, and I would be very happy to take questions. Thank you.

CHAIRMAN: Thank you very much. I will give Mr Suttie an opportunity to add anything, if he would like, to your comments, Mr Gilbert.

Mr Suttie: I do not have anything to add.

CHAIRMAN: Not a problem. I do not have any specific questions—the questions I have are probably for ASIC rather than for you—but I am happy to open up the floor to the committee members if there are any specific questions, and then we will move on.

Senator BOYCE: I want to ask who else you have put these ideas to. Are there are other bodies that might be able to influence ASIC?

Mr Gilbert: We were invited to the ASIC summer school and made a similar presentation, and it was a very positive exchange. The informal feedback I have got is that ASIC will be interested in prosecuting this issue. But, generally speaking, we just do not have the resources to be advocating to a broad constituency, so the answer is that we have put submissions and put things on our public website, and we do get positive remarks from people in business and the financial services industry saying, 'What you are doing is a good thing.'

Senator BOYCE: I have a couple of queries; I want to make sure I have understood. You are saying that dissected numbers could show systemic issues. Are you suggesting that in terms of the state-by-state breakdown or in terms of prescriptions?

Mr Gilbert: Possibly there could be some rogue players in New South Wales or Queensland, for example, but it also might indicate an issue within ASIC. I am not sure how ASIC goes about making the decisions on its coercive power operations. It could be that one area of ASIC has a problem—I do not know. It could be within ASIC, it could be in the industry or it could be on a state-by-state basis. So the answer is that we need to explore that.

Senator BOYCE: Do you see any current issues with ASIC's use of its coercive powers? I suppose that is an extraordinarily broad question, but perhaps you—

Mr Gilbert: The only thing I would put to you is that we made a submission on the last set of changes to the ASIC powers about their search powers, which I think took place in November last year. ASIC got those powers, and I think the other night they admitted in estimates that they had not used them yet. So maybe they have powers they do not need—maybe. That is the only issue I would raise.

Mr TONY SMITH: I have a general question. Thanks for your presentation. Appreciating, Mr Gilbert, that you are a newly established, lean organisation with not many resources, you have done some great comparative work there.

Mr Gilbert: Thank you.

Mr TONY SMITH: Could you give us an appreciation, as best you can, on how ASIC would compare not so much with the other Australian regulators, but with—how can I put it?—cousin regulators in similar jurisdictions? Do you have an appreciation of that—assuming that you have not done any work in that regard? Perhaps the United States and the UK.

Mr Gilbert: I would like to go away and work on that if I could. If I were to say one thing or another now, it might mislead you, and I do not want to do that. But suffice it to say that in the UK—I am not suggesting another regulator—I do know that there is a regulator of the regulators, and they might have data. I am not suggesting that we have another bureaucracy.

Senator BOYCE: Good! Do you have coercive powers, Mr Gilbert?

CHAIRMAN: We will strike that one from the record, please!

Mr Gilbert: Maybe we will go and have a look at some of the data.

Mr TONY SMITH: If you are able to appreciate it—we would not have expected you to have done that work, but you have done a lot of work on the Australian scene—I think the committee members would just be interested to get an appreciation from you on some of the jurisdictions--not just the US and UK but also whether there is a similar trend, I suppose.

Mr Gilbert: One thing I will say is that New South Wales police have to give a very dissected approach to their use of coercive powers to the New South Wales parliament. It is very comprehensive. But we will go away and come back to the committee as quickly as we can to advise you.

Mr TONY SMITH: That would be helpful; thank you.

Ms SMYTH: Thank you very much to both of you for coming in. I certainly appreciate that it is a resourcing issue, often, to get here. I have a familiarity with the ATO's coercive powers and I am interested whether you think there should be greater differentiation between the ATO's powers and ASIC's powers in light of the different objectives that both organisations have and whether that factors into the nature and scope of the coercive powers of both organisations?

Mr Gilbert: There are a couple of distinct differences between the two. Perhaps Mr Suttie could firstly go through the distinct differences between the two.

Mr Suttie: One of the differences that stands out is the one that the ATO is reported on which is their section 263 access power. That is exercisable by ATO officers. They come into your office and present their identity cards and they can take copies of information that you have on your premises, and you are required to provide them with assistance in doing that. The recent power for search warrants that was given to ASIC still requires the Federal Police to execute the warrant. So there is a difference there in the sense that the ATO can go and do that of its own volition and there is no outside agency involved. You do tend to see more streamlining in general in the ATO powers. Section 263 allows them to take copies, a power that they have only used on 10 occasions on the figures we have. Section 264 is the examination power and also the provision of information documents power for the ATO. It is a general one and it is broad enough to cover the ground which you see in the division 3 powers that ASIC have. There are similar themes—production of documents, section 19 for the examinations and then in ASIC's case producing books. There is a narrowing down that goes on in division 3, as I read it, where the Corporations Act requires you to keep certain records and books, and the way the division reads is that those should be available to the regulator.

Mr Gilbert: To go back to the rightness or wrongness of the powers and the gravity, we are not opposed to the regulators having powers. That is very important. The tax office must have powers in order to collect the tax and so must ASIC have powers in order to ensure that there is corporate honesty in the securities market. Therefore, we are saying that we want the transparency and accountability issues to ensure that the powers are not abused.

Senator BOYCE: Are you suggesting that perhaps we should be looking at a use it or lose it policy around coercive powers? If, for instance, an authority has not used a power in 12 months, it should cease?

Mr Gilbert: We took a view when those previous changes were made to the ASIC powers that they were not needed and we still stand by that because they were there in essence and ASIC has been able to operate in the last seven months without them. There was a lot of fanfare about the introduction of those new powers and perhaps we should look at them more closely.

Mr Suttie: That is not to say that there are not situations where the regulator can come forward with a clear policy statement which will let you know why perhaps those powers are only reserved for certain cases. For example, the ATO might do an access without notice which is a very serious exercise of power and only happens

on a handful of occasions that they report on each year. The search warrant power might be another one where if they come out and give us a statement of when to use that power and when they are coming to do it, it might be self-evident as to why it is not being used that often.

Mr Gilbert: Senator Boyce, when the AIRC was doing its 2008 report, it found agencies that did not know they had a power—maybe they could have lost theirs. But I think ASIC knows its power.

Senator BOYCE: I think ASIC might, yes.

CHAIRMAN: Mr Gilbert, you talked about diminishing the human rights. I assume you are referring to the human rights of individuals.

Mr Gilbert: Yes.

CHAIRMAN: Is the difference here though that we are not talking about individuals with ASIC; we are talking about corporations. Do corporations have human rights?

Mr Gilbert: At the end of the day, to prosecute a corporation they need information from individuals.

CHAIRMAN: I just wanted to establish that for me there is a clear difference between the right of a human being and the right of a corporation, which is an entity, not a person.

Mr Suttie: That is right. There is a distinction drawn in some of the provisions. For example, the abrogation of self-incrimination privilege obviously only applies to individuals, and I think that section 19 is only ever going to apply to individuals where those people who are involved in the company's affairs have to come forward. To a certain extent you can have notices issued simply to a body corporate and they will have to respond through their officers or employees. But when people are required to attend or do other things it might be the natural persons who are involved.

CHAIRMAN: But if they are required to attend then they are required to attend in terms of their status or position in the organisation, not the fact of being a human being.

Mr Suttie: That is right.

CHAIRMAN: Fine. You said approximately 18,000 uses of coercive powers in three years. Let's round it all down: 9,000 a year, say, or even 10,000. Is this a big number or a small number? It is just a number. How do you see that number? What does that mean to you?

Mr Gilbert: It would worry me if it were escalating. We do not have a big sample, so that is the immediate problem. The second point is that it would be good to know what the outputs were. You have got the process and if, for example, they used those powers actively to prevent a Storm I do not think anyone would have worried about how often the powers were used. I think that is why in the statement that ASIC make, if a company gets coercive power use, it should say why they had to do it—there was a large number of bad cases. And that would be good for the committee to know.

CHAIRMAN: Absolutely. In terms of disclosure and data—and you have made a number of points about that—is it the case that ASIC's unique role in dealing with millions of corporations means that there is an issue of commercial-in-confidence not only in terms of what its activities are but the information it collects? Is there an issue with that?

Mr Gilbert: Absolutely; I agree with you. That is why, when I was presenting, I said the publication of materials should in no way prejudice their ability to prosecute wrongs. That is critical. But if you went out with a survey and you put it into composite, there should not be a breach of confidence. Similarly, there would be good reasons for not publishing something if you are in the middle of a major investigation which you would not want in the public domain. I think that would be acceptable.

Senator STEPHENS: Mr Gilbert, in relation to the dot point on slide 14 about the application of legal professional privilege to ASIC coercive powers, can you provide the committee with some detail of where we have evidence of that and perhaps some observations about the purpose of using that coercive power?

Mr Gilbert: Would you like an explanation now or in a written submission later?

Senator STEPHENS: Whichever suits you. It would be helpful for us to have it on the record.

Mr Gilbert: Is that slide 4 and the last dot point?

Senator STEPHENS: Significance for rule of law, on slide 14. Sorry, we are on the earlier version. It is slide 4, page 14 of your presentation.

Mr Suttie: The reference there is to the fact that to a certain extent the ASIC Act is silent on legal professional privilege, but what has been looked into in December 2007 and following through to December 2008 is whether that means that legal professional privilege is imperilled by the way the statute is written. There was a case in the

Federal Court in December 2008 where there was confirmation that legal professional privilege did apply. It makes sense to me because the other provisions of the act tend to suggest that it does apply. For example, there is a provision where, if you go to somebody's solicitor and ask them what advice the solicitor gave them, then there is an ability to refuse to answer that question, and the basis is legal professional privilege. There is protection there, but it was not spelt out in the act which, I think, was the issue. The Australian Law Reform Commission did a report on legal professional privilege in federal investigations and I think it has sprung from that more recently. We think that that has been resolved to a certain extent by this Federal Court decision.

Senator STEPHENS: Would it be better if it was explicit in the legislation?

Mr Suttie: Personally, I think it would be because people would therefore know where they stand. I think it would be a good thing if it was spelt out.

CHAIR: As there are no more questions from the committee, I thank both of you very much for your very informative evidence. Can I take the slides and handouts that you gave us as evidence?

Mr Suttie: Yes.

CHAIR: Thank you for your time.

COMERTON-FORDE, Professor Carole Anne, Australian National University

[17:46]

CHAIR: Welcome and thanks for making the time to come and speak to us.

Prof. Comerton-Forde: By way of background, I do research in market structures and have been doing that for about 15 years. My research focuses mainly on the US and the Australian markets, but I am also pretty familiar with the European and Asian markets so I can give you a flavour of those also. I have recently been an economic consultant for ASIC, working with them on market structure issues and in the development of the market integrity rules for the launch of competition in the Australian equity markets. But I am speaking to you today in my capacity as a professor of finance and not representing ASIC. Obviously, the views I express are mine and not the views of ASIC.

Ian Holland heard me speak at the ASIC summer school earlier in the year and asked me to speak to you on similar topics to those I covered at the summer school. I think you have a copy of the slides that I used at the summer school, and probably those give you the flavour of the richness and complexity of the issues involved in market structure and competition. I am not going to speak to those slides because there is a lot of information there. Rather, I want to pick up on three key issues that I talked about. They are, firstly, giving you a big picture sense of what is happening globally in equity markets and how we might learn from that for what is going to happen in Australia and how we should regulate in Australia. Then I want to talk about two fairly hot and contentious issues—dark pools and high-frequency trading—because I think they are issues that are often poorly understood and it is useful to get further background on those.

At the outset I want to say that competition has had an extremely positive effect on equity markets around the world. I am going to talk mainly about some of the problematic areas. You may get a sense that it sounds very negative, but that is not the impression I want to convey; I think competition in equity markets is very good and very important for the development of the markets, but there are risks and issues that need to be managed. Those are the things I want to focus on today.

Firstly, the global trends. The Australian market has a long history of being an innovator in financial markets. Australia was one of the first markets to automate and one of the first markets in the world to demutualise. Despite that history of innovation, on the issues that I am talking about today the Australian market is lagging; we are probably three to five years behind the European and the US markets.

In some senses in this case that is a good situation to be in, because we can observe what has happened there, identify any issues and try to maximise the benefits and minimise the downsides. Equity markets are constantly evolving. We saw in the late 1990s, early 2000s exchanges go public and demutualise. That really had a significant effect on the way markets operate and the way exchanges do business. It has really set the scene for the changing landscape in markets around the world. Change in the US and Europe has been further accelerated by regulatory change, so the regulators in those two regions really pushed for competition between markets as a way of developing those markets, and that is coming much later here than it has in those markets. The approaches taken for those two different areas were quite different, and I do not want to go into the details of the differences, but they drove different outcomes. In a big picture sense the outcomes have been very similar across the US and Europe, and they are the things that I want to focus on.

Promoting competition means that there has been a proliferation of new trading venues in the US and Europe. In the US there are now over 50 different places where you can trade your stock and in Europe over 100 different places. That creates issues in terms of the fragmentation of the market and being able to access liquidity. New entrants have come into the market in both places and, typically, there have been one or two entrants who have been very, very successful. In the US that was BATS and Direct Edge—probably not names that you know, but together they represent 25 per cent of US equities trading, which is something not known even by a lot of investors in the US. Trix has been the most successful participant in Europe in some markets; they have been most successful in London, where they have captured close to 50 per cent of the market. They are very successful businesses.

What is the impact of that regulatory change and what impact has that had on the businesses in the incumbent markets? I draw your attention to the three figures I distributed today. One shows the changes in market share for exchange businesses in New York, France, Germany and Toronto. It is just a chart with a few lines on it. The zero on the horizontal axis is when competition commenced in those countries. You can see the incumbent businesses very quickly lost huge amounts of market share—within two years those markets had lost between 25 and 50 per cent of their business, which clearly changes the dynamic in the market. I think this picture gives us a strong

indication of what might happen in Australia when Trix launches later this year. I will talk a bit more about ASX and how they are prepared for that, so we may not expect such an extreme change, but I do think the impact will be very significant and I do not think everyone appreciates that yet.

So why have the new entrants in the various markets been very successful? There are probably a few dimensions on which they are competing that have driven this outcome, the most important of which are price, ownership and technology, all of which create issues that we need to think about. Trading venues have competed very aggressively on price, so we have seen very big reductions in the cost of trading in markets where there is competition, and that is clearly a very good thing for the participants in the market. Often these fee savings are not passed on to the end investor—it is the brokerage community that gets the benefit of that—but hopefully, with competition and brokerage, you will see that being passed on to the end client as well, through their commissions.

We have also seen innovation in the way in which exchanges charge for their services, so the development of what is known as maker-taker pricing, which has been contentious in Australia, at least, where you charge different fees for people who provide liquidity of the market versus those that take liquidity from the market. Those models have been put in place to incentivise people to move to the new markets and conduct their business there. Typically these new entrants have been owned by either investment banks or by very large trading firms, so they clearly have an incentive to drive down fees and to send order flow to the markets which they own.

Technology has also been a very important dimension of the change in the markets. The new entrants have come into the market with superior and much faster technology and have innovated significantly in the way they offer trading services to the market. Generally this has been good, but there have been some risks along the way. There has been a massive change in the types of orders that are available to investors in the market: hidden orders, pegged orders, flash orders. They have generally been good, but there have been some instances, such as with the flash orders in the US, which have been problematic. It is important that the regulator is on top of those sorts of things and can step in and make changes quickly if needed.

Unlike the incumbent markets in other countries, ASX is much better prepared for these sorts of changes. Rather than waiting for competition, they have innovated with the threat of competition. In the last 18 months ASX have cut their fees and introduced new trading technology and new trading platforms, offering new services to the market. So they are probably better positioned than other markets.

The two other major trends that I wanted to talk about were dark pools and high-frequency trading. Before I do that, I think it is useful to get a sense of how markets operate traditionally and how that is changing, and what the characteristics of the market are that we should be looking for in regulating. Historically, equity market trading, as you know, took place on the floor. Trading now takes place on trading screens and the most common form of trading is an electronic limit order book, which is what the Australian Stock Exchange uses. That is a very transparent process in which orders get sent to the market, and people who observe that trading process can see the demand for and supply of stock. That process is very important in enabling people to identify liquidity and to know when is a good time to trade, and also for ensuring that there is an efficient price discovery process. That is also very important for ensuring investors get a good deal and ensuring that prices are set in a fair way when we are trying to price assets outside the financial markets. That was the way trading took place historically. Because it was all centralised in a single pool, everyone was coming to the same location, so participation in the markets involved lots of different types of traders. You had retail traders, you had institutional traders, you had speculators—all sorts of people participating in and ensuring that the market was operating well and that prices were efficient.

The two most important qualities that I think we need to keep in mind, as we look at how markets are evolving, are that liquidity and the price discovery process. You can get a sense from the picture where you see the decline in traditional markets and the proliferation in the number of venues—50 venues in the US, for example. It is now becoming much more difficult to find liquidity and trade across many markets. That problem can be solved through the consolidation of information. All information can be brought back together and reported to the market and people can still trade on that. But where things perhaps start to become a bit more difficult is when you have non-transparent trading—trading where you do not observe the trading process. That is what dark pools are essentially.

I guess 'dark pool' is an unfortunate term because it has sinister undertones, but really it is not. It is not a new concept; it is just a new term. Dark pools are essentially trading venues where there is no pretrade transparency. People place their orders to buy and sell stock in the market, but no-one sees those. The orders interact with one another electronically and when there is a match they get reported to the market. After the trading takes place it becomes transparent to everyone. Thinking about the price discovery process, you can see already there is a loss of information.

Dark pools, or non-transparent trading, have had considerable attention in the media, both here and overseas. Concerns have been raised about the potential negative impact of that. In the US, dark pool trading, or non-transparent trading, is now a very significant part of the market. It has grown from about 17 per cent in December 2008 to about 30 percent in December 2010. It is a substantial part of the market and it has raised concerns about both price discovery and liquidity.

When people talk about dark pools they often lump them into one category. I think it is useful to break down that category to get a better sense of what they offer to the market and think about how they should be regulated. You could categorise them in a range of different ways. Very basically, you can think of them as those that offer services to large block traders and those that do not. Those that offer services to large institutional traders have existed in some form for a long while and are a very important part of the market. The reason for that is that it provides opportunities for investors trading large amounts of stock to do so without having a price impact. If I am a large institution and I want to buy a very large amount of stock, I do not want to move the price simply because I am a large buyer or seller. The dark pool is an effective way for me to be able to do that.

This type of trading has always been an important part of the Australian market. For trades over \$1 million these dark facilities have always been available. Historically they have been over the phone, now there are automated systems where orders interact with one another anonymously and electronically. When a sufficiently large order is found, the two parties electronically negotiate the price at which they want to trade. Typically they will trade with reference to the price in the underlying market—in the Australian case, the ASX.

This is obviously a very important and useful part of the market. Where things become a bit more concerning is due to the fact that the development of technology now means that dark pools are available to everyone. This creates more risks, both because there is no longer a strong motivation for why that sort of trading is allowed and because there is no longer a lever for ensuring that sufficient transparency and liquidity are going to the main market. Potentially you get too much order flow going into dark pools and this is where the concerns arise in the US. In the US, 30 per cent of trading is done in the dark and 18 per cent is done in internalisation engines—these are engines that match small sized trades. In the US, the SEC reported that close to 100 per cent of retail orders are not sent to public markets; they are executed in internalisation engines, matched between the broker's own account or the broker matching orders with other clients and not sending them to the public market. The risk with that is that there is no longer liquidity being displayed to the markets and prices in the market are no longer efficient.

Should we be concerned about this sort of trading? I think the answer is clearly yes. The internalisers—the parties that are internalising the trades—argue that they are offering value to their clients by offering better price improvement. Let us think of a very simple example—say, you want to buy a stock and the stock is currently priced in the market at \$10 to buy and \$10.05 to sell. If you wanted to buy the stock in the market, you would need to pay \$10.05. An internalisation engine would give you the opportunity to trade within those prices, so rather than paying \$10.05 you would pay somewhere between \$10 and \$10.05. Potentially, that is very valuable. You could get a better price than what is available in the public market.

What happens in reality when there is no regulation around that process? In the US, a very large amount of that internalisation takes place at tiny price improvements—maybe one one-hundredth of a cent per share. If I am trading 100 shares, I might get a cent price improvement on my whole parcel of stock. You might say: 'Any price improvement is a good price improvement. I'm happy to have this cent rather than it being in someone else's pocket.' But what that does not capture is the cost to the market for the guy who was offering his order to sell at \$10.05 who is no longer able to trade. He no longer has any incentive to display his orders to the market. What is going to happen is that prices will become less efficient. Rather than that spread being \$10 and \$10.05, it might go out wider to \$9.90 and \$10.10, in an extreme case. If we take out a large amount of volume from the market in terms of internalisation, we disincentivise people from providing their liquidity to the market and potentially create significantly increased costs and lower liquidity in the market. It is important to think about and monitor that internalisation process and manage that.

The other figure I provided is figure 2. This is a submission to the SEC by one of the US brokerage firms that explains this process. A retail order from an investor in the US goes to their broker dealer. Rather than sending it to the market, they will try to internalise that order themselves. They will obviously pick the best orders—the orders that they think are the least informed—and then if they decide they do not want to execute it, they send it on to another broker. You can see they have a number of layers where it takes a while for it to get to the public market. In terms of time it is a very short elapsed time—maybe only a second—but in terms of the orders that are getting to the public market, they are now very informed markets and the risk of trading on an exchange are much greater, discouraging people from displaying their liquidity to the market.

In Australia, brokers have always been able to internalise but there have been controls in place to minimise the level of internalisation. In recent times and as we move to a more competitive environment, brokers are building more sophisticated internalisation engines. We would expect in the absence of any regulation for more order flow in Australia to be internalised. That is something important to consider, watch and get right. In its consultation with the market at the end of last year, ASIC proposed a \$20,000 threshold. Orders could not be internalised unless the order was at least \$20,000. That was not welcomed by the market. So in subsequent feedback on the consultation process, ASIC indicated that it will consult further with the market to find an alternative mechanism to keep in check the rate of internalisation and ensure that price discovery and liquidity are protected in the displayed markets.

Finally, moving to high-frequency trading—again, another term which creates ill-feeling. High-frequency trading, or HFTs, have received significant media attention both here and overseas. Much of that attention has been negative and much of it unwarranted, in my view. High-frequency trading is not a single category of trading. We need to think about the differences in the way these types of traders participate in the market. They provide different functions and trade in different ways. The thing they have in common is that they all trade at very high speed and require managing their risks on very short time horizons. They will be sending lots and lots of orders to the market and increasing the technology requirements and capacity requirements for everyone in the market—participants, market operators and regulators. In the US and in Europe these have become very dominant players. In the US, they are estimated to represent about 50 to 60 per cent of the market. In the UK, they are estimated to be about 35 per cent. Early last year, the ASX estimated between three to four per cent of the Australian market was high-frequency trading. It is not possible to quantify with certainty but estimates these days are around the 15 to 20 per cent mark. The introduction of Chi-X and the introduction of ASX's PureMatch will increase the level of high-frequency trading in the market. We saw at the end of last month, Getco, one of the biggest high-frequency trading firms in the world, become a participant of the ASX. We would expect this trend to continue in Australia.

The academic evidence on high-frequency trading is predominantly very positive. They add a lot of value to the market in regard to their liquidity, tightening the spreads and reducing trading costs, and there is no evidence that they create an adverse market in terms of volatility. Despite those very clear benefits, there are risks. The main thing that needs to be thought about is the impact they have on the market in terms of the increased technology costs which need to be borne by everyone. Thought needs to be given about how to manage that and how to ensure that those costs are borne by those that create the costs rather than by the market as a whole.

The other thing that high-frequency trading does is to create a more complex environment for the surveillance. Again, the regulators need additional tools, technology and understanding of the market in order to monitor the market effectively. In general, the trends with high-frequency trading, dark pool trading and competition increase the need for better understanding of the markets and better access to data. It is important as we go forward that ASIC are able to obtain that information and that data to ensure they keep abreast of the market and abreast of developments in the market, and that they are able to be proactive and change quickly in response to the market dynamics.

That is all I have to say, but I am happy to take your questions on any market structure issues or concerns you might have.

CHAIRMAN: Thank you very much for that comprehensive and informative presentation. You raised the issue of electronic price discovery and liquidity, particularly in large trades, and that the price is electronically negotiated. Could you explain further how that works?

Prof. Comerton-Forde: Different trading venues will manage that in different ways, but a common mechanism are pools that are only open to institutional investors. They will send their orders to the market—a loose term, not in a legal sense but in the sense that there is a pool of liquidity—and where there are two parties that are wanting to trade a sufficiently large size, they both get a message saying, 'There is a party wanting to trade on the other side,' and then they negotiate. It is almost like sending an email anonymously to someone. Typically, these types of venues will trade somewhere between the two prices in the displayed market. These venues are not provide any price discovery to the market; they are about providing volume discovery—allowing large institutions to find one another without moving the price, which is very important.

CHAIRMAN: Do you have a regulatory view on how dark pools operate in different markets? Is there a particular course that seems to be the right course of regulation?

Prof. Comerton-Forde: One thing that is very important is that they are regulated in their own right. The current Australian regulatory environment does not provide for a dark pool class of markets. They are currently operating under the rules of the ASX. It is largely brokers operating a venue where they match orders and then they report them to the ASX.

Prof. Comerton-Forde: One thing that is very important is that they are regulated in their own right. So the current Australian regulatory environment does not provide for a dark-pool class of markets. They are operating currently under the rules of the ASX. So it is brokers, largely, operating a venue where they match orders and then report them to the ASX. In the US and Europe they have specific regulatory frameworks. In the US it is regulation ATS and in Europe it is multilateral trading facilities. It is a market designation where they operate under different rules from exchanges because they are only offering part of the services that an exchange offers. I think that is an important thing to have in place to ensure that you can appropriately regulate those entities.

Senator BOYCE: Is that almost a regulation that got left behind when the regulation of the ASX moved to ASIC?

Prof. Comerton-Forde: My understanding—and I am not an expert on this—is that to change this it requires Treasury to take action. It is not within ASIC's domain.

Senator BOYCE: I was just thinking that we probably should have put that in the bundle that was moved to ASIC's control.

Prof. Comerton-Forde: Yes. ASIC regulates the brokers who are operating these venues, but they are not regulating the venue per se. So the brokers have an obligation to the market and to their clients and all that sort of stuff, but they are not regulated as a trading venue. And they probably should be.

CHAIRMAN: I made a note when you were talking about internalisation processes and the requirement to monitor those. Could you just explain how that might actually look and how you would monitor that process. Would you require that the markets themselves disclose that information that is done under regulation, or is it really a case of exploratory monitoring after the fact? How might that work?

Prof. Comerton-Forde: There are a couple of issues. One is regulating the conditions under which you allow internalisation. My view is that, in order to protect the displayed markets and ensure you have efficient price discovery, the internalisation needs to offer something extra. They cannot just be trading at the same price as the displayed market. So they need to offer something better, and not one one-hundredth of a cent better; they need to offer something meaningfully better. So that is one issue. The other issue, and I guess this is more what you are asking about, is: how do you manage and regulate that process of ensuring that the client's orders are being dealt with fairly? Is that your question?

CHAIRMAN: Yes.

Prof. Comerton-Forde: It would be part of the best execution obligation of the broker, and you would have to manage and monitor that after the fact.

CHAIRMAN: So it would use the same technology that is currently used to monitor the market? Is it as simple as that? Is it just a matter of applying the same technology, software and so forth as is there now?

Prof. Comerton-Forde: Yes and no. You are not seeing the orders in the public markets, so you cannot monitor the order flow. You can only monitor after the trade gets reported. ASIC have put in place monthly reporting from dark crossing engines in the Australian market. So they need to report aggregate statistics. But that is at quite an aggregate level, not at an individual order level. So it would have to be a more manual process to manage that.

CHAIRMAN: I think this will be a good question for ASIC!

Senator BOYCE: They do not do the work on dark pools, I know.

Senator STEPHENS: Thank you very much—that was a great presentation, and it really raised lots of issues for us. Can I go to the third key point that you were making about high-frequency trader participation and that point that you made about technology costs. What kind of advice would you have to the committee about how you can ensure that the costs are being borne by the people who are creating those cost pressures as opposed to the whole of the market?

Prof. Comerton-Forde: I think one of the differences between high-frequency traders and other traders is the rate with which they send orders to the market and also the rate with which they cancel their orders. So they might send a bunch of orders to the market and, when prices move, they need to adjust their orders, so they will send another set of cancellations and new orders to the market. So that is where the growth in message traffic comes from. I think one sensible proposal is to charge a fee when the ratio of orders being placed to cancelled orders becomes excessive. The only people that would be subject to that charge would be those using excessive message traffic and cancellation of orders. I know other markets have talked about the possibility of having a flat transaction tax or having minimum times in which orders need to be put in place in the market. I think both of

those are bad ideas and will have a negative impact on people's willingness to provide liquidity. Looking at the extremes, which is where the costs become worst, is a better place to try to start managing the issue.

Senator STEPHENS: What kind of a fee would you suggest would be appropriate?

Prof. Comerton-Forde: In terms of dollar value?

Senator STEPHENS: Yes.

Prof. Comerton-Forde: I do not think I could come up with anything off the top of my head.

Senator STEPHENS: Or a proportion?

Prof. Comerton-Forde: I think it would be a matter of looking at normal patterns of behaviour in terms of the ratio of order placement and order cancellation and finding where things become extreme. I have not done that analysis. I am not really in a position to answer. One thing to bear in mind is that in the US markets some of the individual exchanges would like to impose a fee like that but they cannot because if they do they lose business to their competitors. I think these types of issues need to be dealt with at a whole-of-market level not at an individual operational level. Clearly there are reasons for an individual operator not to try to address this, because it has an adverse effect on order flow coming to their markets

Senator STEPHENS: You talked about the surveillance challenge increasing. What exists now to monitor that significant change that has already happened and the potential for those cancellations—the huge transaction load that is happening in this space?

Prof. Comerton-Forde: As part of the transfer of supervision ASIC adopted SMARTS technology. That is a surveillance tool that essentially takes every individual message that comes into the market and they have the capacity to replay the market, analyse that data and investigate it. So they already have tools to do that. It becomes more complex though, as I said, as you have multiple markets. So when we have the introduction of Tri-X and the introduction of PureMatch there are technology issues in bringing those things together. Once those sources of data are brought together it is the same process, but obviously the volume of data becomes much larger.

Senator BOYCE: Professor, I think I may have misunderstood you at the beginning. You said the ASX had been quite innovative but that it was 3 to 5 years behind the US and Europe. Can you explain what you meant.

Prof. Comerton-Forde: I mean more in the sense that the US and Europe had major regulatory reform to drive competition. Australia has not had that.

Senator BOYCE: So it was about where we are in the competition spectrum.

Prof. Comerton-Forde: That is right. Because of the competition, markets have developed and the ASX has not had that pressure.

Senator STEPHENS: My question follows on very neatly from that. We have got the ASX and we are about to see Tri-X. Do you expect other players to come into the market in Australia?

Prof. Comerton-Forde: That is an interesting question and I do not know the answer. My expectation would be that the Australian market cannot sustain more than three or four markets. I guess it will be up to the brokerage community to decide whether or not they are going to support other new entrants. It is a small market, so you cannot have multiple competitors. Having said that, the Canadian market, which I guess is fairly similar in size and scope, has about seven or eight different trading venues—although three or four of them have most of the business. We could get to that sort of position as well.

CHAIRMAN: Professor, can I thank you very much for your presentation. The information you have provided, including the document you have given us, I will take as tabled evidence for the committee and incorporate that. Again, thank you very much for your very informative presentation.

That concludes this hearing. I thank everybody for their participation. The committee has resolved that questions taken on notice should be returned by Friday, 22 July.

Committee adjourned at 18:19