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"Recession, Risk Aversion, Rules – Getting the supervisory balance right"

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Introduction

Good morning and thank you for inviting me to speak to you again at this important conference.

David Lawrence and I have been asked to speak on the Global Financial Crisis and Supervisory Challenges. Much has been written already about the global financial crisis. A year ago GFC stood for the Geelong Football Club! How quickly things change.

It would be quite easy for me to launch into a laundry list of supervisory challenges as there were no shortages of those over the last 18 months. Instead, what I propose to do is to step back and take a look at the impact of the crisis on risk aversion levels and the influence this has had on the threshold issue of supervisory balance.

I will spend about 15 minutes on this then David will cover off some of the specific challenges that the Australian Securities Exchange has identified in the supervision of our equity markets.

The global financial crisis and Australian equity markets

There is no doubt that the financial and economic turbulence we are experiencing is the worst in decades. With the benefit of hindsight, I can say that the financial firestorm hit the Australian equity markets relatively early with the funding problems of some highly leveraged listed entities, extraordinary levels of director margin loans and what we now know to be unconventional and risky margin lending models. Much of this I covered in my speech to this forum last year.

From an international perspective, "global financial crisis" and "global banking crisis" are almost synonymous. Thankfully, it looks like Australia has been spared the scale of pain experienced in many overseas markets by the relative resilience of our banks. Unlike the US, UK and Europe, there hasn't been the wave of near-nationalisation of Australian banks. In fact, the profitability of major Australian banks is a stark contrast to the billions in write-offs that many overseas banks have been forced into. A joke was circulating that only two banks would be left standing – the blood bank and the sperm bank.

I am telling you what you already know and have personally experienced. The most obvious impact of the crisis, at least to the Australian public, is the sharp decline of our equity markets (to March 2009 at least). Just using month-end values, the S&P/ASX 200 price index fell approximately 47% from December 2007 to February of this year. This fall was mirrored by declines of 50 per cent in the US market, 48 per cent in Europe and 51 per cent in the Japanese

market over approximately the same period[1]. While we were not alone, this comparison is of little consolation to the millions of Australian investors who have seen their superannuation balances decline dramatically.

What brought us to this point?

Up to the end of 2007, economic conditions were not only benign but with cheap credit, the markets favoured those willing to take on risk. Many financial institutions were extremely profitable and it is apparent that a run of double digit growth created a sense of complacency in the minds of many managers and investors that the good times would roll on. In the face of this good news, it appears that many did not rigorously question the apparent disconnect between risk and reward.

At the risk of oversimplification, this cocktail of unrestrained risk appetite coupled with complex business models and financial products created by sophisticated financial engineers, detonated the crisis that rocked our markets.

To be fair, much of the "innovation" and the excessive risk taking that we have seen were in unregulated OTC markets and products overseas.

But we saw some of that too in our equity markets. We now know that some of the very successful business models in the boom days weren't products of outstanding innovation but were about plain, old leverage that were sometimes dressed up in complex and opaque arrangements. Finance 101 tells us that leverage is a double-edged sword. As has come to pass, those entities that did not focus enough on downside risks have not survived.

It is not surprising, therefore, given the severe dislocations experienced by markets here and overseas, that there has been an enormous increase in risk aversion. We also know that investor confidence remains fragile and unfortunately, as a result of the actions of a minority of participants, trust in our markets has been compromised.

Risk aversion and regulation

This increase in risk aversion is not just at investor level. We now see that the thinking of supervisors and regulators the world over has changed, particularly in the US and the UK where the worst effects of the crisis have been felt. Remember too, that the US and UK were the two champions of the free market model. Both face enormous pressure to re-regulate from their governments, investors and the public, and much critical self-analysis is going on in those jurisdictions.

I recall that it was only in 2006 that here in Australia the Banks' Report argued for a reduction of the regulatory burden and for the cutting of red-tape. Not only for reasons of efficiency but that regulation stifled innovation and financial markets must innovate or be left behind. Implied in this thinking was that innovation was a necessary catalyst for future growth and that firms would, and could, manage their risks appropriately. We now know that this has not always been the case.

So too in Australia, the pendulum has swung the other way. There is a strong sense that domestic stakeholders expect regulators and market supervisors to be tougher. To a degree, the ASX is in an invidious position. Any time there is a difference in opinion about a matter, supervisory or otherwise, the usual "ASXMS is conflicted and has made the decision with an eye on the bottom-line" argument is raised.

I have two observations to make about this.

- We apply the same principles whether in good times or bad when making a supervisory decision.

[1] Source: RBA

- Our underlying philosophy of maintaining supervisory balance has not changed. That is not to say that there would not be changes to our Rules or how we enforce them as market conditions change. Indeed, we would be remiss in our duties as supervisors of the market if we failed to act to tighten the Rules where there are gaps or where current rules are plainly not effective.

In fact, we have seen rule changes in two main areas in the past year that relate to disclosure and short selling. I will deal with each briefly.

Disclosure

Regulators such as ASIC and market supervisors like ASXMS cannot remove completely the risk that comes with investing. What we can do, in appropriate cases, is to provide the mechanisms by which investors can inform themselves of the risks associated with securities that they are thinking of investing in or have invested in.

Partly paid securities have been a popular market feature for some time. Recently however, the liability attached to one such security was not (apparently) evident to many retail investors even though the company involved (I'm obviously talking about BrisConnections) had on numerous (to be precise, eight) occasions disclosed the information through various channels all of which were disseminated through ASX's company announcements platform.

So, while some investors might claim, in truth, that they were unaware that there was a liability attached, it is quite a different thing to allege that no information about that liability was being available. In any event, ASX recognised that market conditions had changed and the arrangements already in place had to be reinforced. So, with the support of the regulator, we recently introduced a market rule that requires brokers to alert retail clients of the need to inform themselves of the rights and obligations associated with trading partly paid securities, except for securities in No Liability companies.

While some of you would see this as an increase in the regulatory burden, I trust that you will also see that rules only go so far and the danger that this becomes a tick-a-box exercise is real. Brokers and advisers can, and must, play their part to ensure that investors are properly informed of the risks – not just the possible rewards - they are about to undertake. This is a crucial element in restoring investor confidence in our markets.

Short selling

Short selling has long been recognised as a legitimate trading strategy – it deepens liquidity and aids price discovery. Needless to say, there was a pervasive view that the extreme market volatility experienced in the last quarter of 2008 was being exacerbated by short selling. Australia, like other major markets around the world, acted swiftly to temporarily ban short selling.

To complement the action of the Government and ASIC, ASX permanently banned naked short selling. In addition, to improve the management of settlement risk, we introduced a mandatory obligation to close-out a settlement shortfall after T+5, increased settlement fail fees and accelerated the process of referring lengthy settlement delays to the Disciplinary Tribunal.

Consequently, ASX has seen an improvement in settlement discipline. A record low initial fail rate of 0.049% was experienced on 23 April 2009 (i.e. a total of 21 settlements failed to settle on a T+3 basis out of 43,056 scheduled settlements that day). Admittedly, our equity settlement delivery fail rates are already low by global standards but, nevertheless, one could say that this is evidence that the tougher rules are working.

As you're all aware, ASX publishes a daily gross short sale report.

The disclosure and, hence, transparency in relation to short sales is an important regulatory outcome as it:

- Reduces the potential for rumour and speculation;
- Provides investors with information that assists them with understanding price movements and stock specific sentiment, and
- Improves price discovery and reduces the potential for market misconduct

All of these are vital to rebuilding investor confidence

Better understanding of the Rules

Getting the right balance in the Rules is one thing. Compliance with the Rules is another.

With compliance in mind, the ASXMS Education & Research Programme (funded by the proceeds of fines imposed by the Disciplinary Tribunal) is seeking to:

- Raise awareness of ASX supervisory requirements;
- Improve the ability of market participants to comply with ASX's supervisory requirements; and/or,
- Educate the market on trends and issues in supervision.

The on-going upgrade of industry practitioner skills is important even when times are good. Given the stresses in the industry and the inevitable loss of expertise through redundancies, educational programmes are even more critical. To this effect, the ASXMS Education and Research programme held compliance workshops late last year and in the coming months there are plans to run:

- Workshops on market manipulation (in conjunction with SDIA),
- Workshops on capital monitoring that would cover obligations and regulations in the capital monitoring regime of ASX participants; and,
- Compliance courses that would provide an overview of the Compliance and Risk framework, internal control systems and other techniques which mitigate, control and resolve risks under the ASX Operating Rules.

ASX on-going commitment to supervision

Cut-backs in the industry were inevitable as a result of the financial crisis. In line with ASX's unwavering commitment to market integrity, I am happy to report that is not the case with supervisory resources. ASXMS' budgeted headcount is set to increase again next year - from 111.2 FTE for June 2009 to 114.4 FTE in June 2010. In particular, we have increased staffing levels in our Participant Compliance and Capital Monitoring teams.

The expansion of supervisory human resources is complemented by an on-going technology programme to increase the effectiveness and efficiency of supervision. Most of you would be aware that in March this year, we rolled out the ASX Compliance Monitor system which streamlines and automates the management of Notifications and Assessments from participants.

There has been a significant upgrade to the SMARTS surveillance system just this month, with another upgrade scheduled in September/October. We are close to selecting a vendor to develop a new non-trading data analysis system that will facilitate better identification of potential insider trading suspects.

While not predicated by the financial crisis, the level of fines that can be imposed by the Disciplinary Tribunal was increased (up to $1 million for the most serious offences) and a streamlining of the disciplinary processes now allows for matters to be concluded in a more timely way.

In the current environment of fragile investor confidence, these changes will allow us to take quicker enforcement action and to send the message that serious breaches of the Rules – and threats to market integrity - will not be tolerated.

Conclusion

Despite the tumultuousness of recent events and the difficulties that have arisen, I believe any stock take should also include areas of our markets that have functioned well.

With this in mind, it is worth pointing out that while Australia has had a number of high profile corporate collapses we have also had the positive experience of many sound companies who managed to raise A$25.2 billion in capital in the secondary market in the first four months of this year alone, when access to debt was not available.

In my view, this indicates that we have the supervisory balance and rule framework about right and, therefore, have a good base to work from to start re-building investor confidence – vital to the success and resilience of any market.

While we have the necessary ingredients for this to occur, this alone is not enough. If I can leave one message today, it is this:

Market integrity is a vital element that engenders confidence. It is imperative, therefore, that directors and management recognise and embrace their responsibilities for setting the right tone from the very top. At every level in every organisation in our industry, we need integrity and an ethics-based culture - a corporate culture that looks beyond the question of "are we technically compliant?" to the broader question, "is this right?"

Thank you for your attention.