AUSTRALIAN SHAREHOLDERS' ASSOCIATION

NATIONAL CONFERENCE

Sydney, 6 May 2013

ADDRESS BY ASX MANAGING DIRECTOR AND CEO – ELMER FUNKE KUPPER

Check against delivery

Thank you for the opportunity to speak at your national conference.

Let me start by thanking you for your business. It is true that you as retail shareholders do not trade directly on the ASX. You do this through your broker. Nevertheless, it is you who makes the decision to trade. Without your decision, and the decisions of fund managers and superannuation funds, very little activity would take place. So thank you.

Retail investors are critical to the health and success of our financial market.

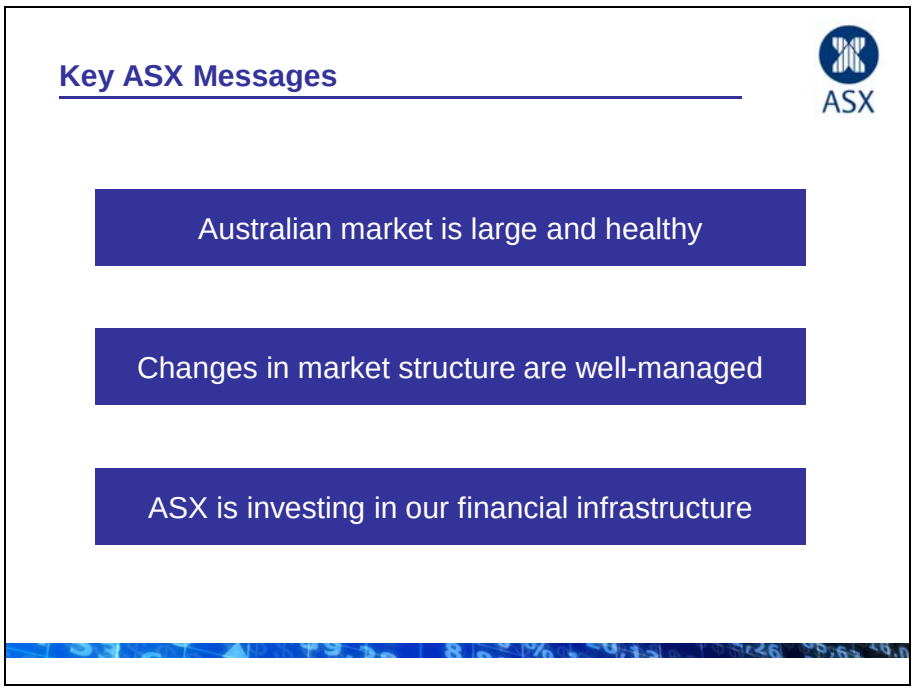
In the next few weeks ASX will release the results of the 2012 Australian Share Ownership study; the 13th study in a series that dates back to 1991. Preliminary results show that 38% of adult Australians own shares and other listed securities either directly or indirectly. This is down from 43% in 2010, which is understandable given the investment climate of the last few years. Australia still has on a per capita basis one of the highest levels of share ownership in the world.

As a result of your collective size, retail shareholders should have a voice in the way our markets operate. We know from other markets that this voice has been lost, often resulting in poor outcomes.

We have to acknowledge that it is not easy to be heard as individuals. You rely on organisations like the Australian Shareholders' Association to express a view, and on regulators such as ASIC to consider the interests of retail investors.

Exchanges also must play a central role in protecting the interests of retail investors, not a peripheral role. We are a neutral third party in every transaction. It is one of the most important reasons we exist.

Today, I would like to cover three topics.



First, I will share with you the strengths of our market and the role that ASX plays. This is the 'feel good' part of the story - our financial markets are healthy and are working well.

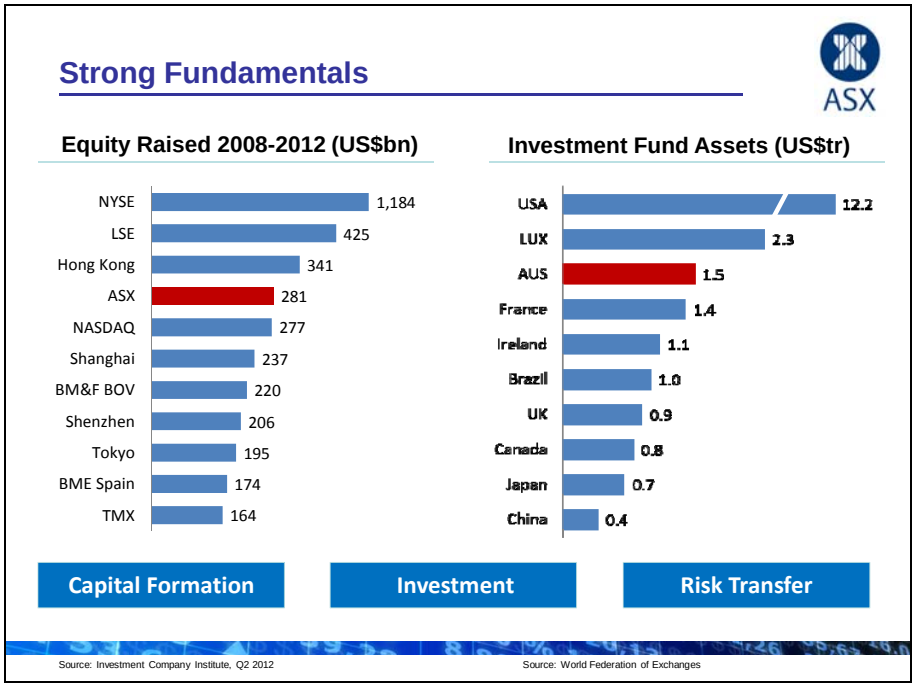
Second, I will highlight some of the changes that we see in the way the market works. Here we will venture into the topics of high frequency trading and dark pools, and discuss if you should be concerned about the issues they raise.

And third, I will summarise the investments ASX is making in the future of our financial markets. We are making good progress across a range of initiatives that we hope will help you as investors.

I will focus my speech on the equities market, given the broad interest in the trends in that market and the level of retail involvement.

Strength of our financial market

Australia's financial markets are large and healthy.



The chart on the screen illustrates this. On the right we show a ranking of the size of our market by looking at investment fund assets. It shows that Australia has one of the largest investment markets in the world.

We are also healthy. On the left we show the amount of new capital that was raised between 2008 and 2012, during the height of the Global Financial Crisis. Australian companies raised some US$280 billion, ranking us fourth in the world. In other words, when the market had to be there to support the real economy, it was there.

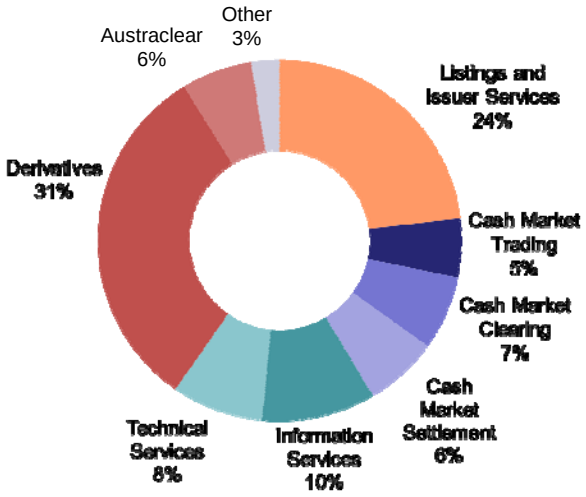
The chart goes to the heart of what financial markets are for. They are there for three primary reasons:

- Capital formation - funding companies that generate growth and employment.
- Investment - giving all of us the opportunity to invest for the long-term and share in the economic success of our country.
- Risk transfer - allowing investors to transfer the risk of an asset or investment to other investors who may have a different view of the risk or a different investment profile.

Everything that we do, everything that banks and brokers do, and everything that governments and regulators do has to add value to these three objectives.

The ASX plays a vital role in delivering on these objectives.

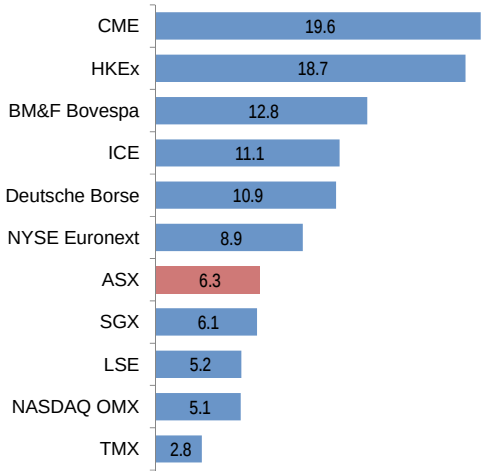
Revenue Mix 1H13



We are what is known as a multi-asset class and vertically integrated exchange. This means that we facilitate the trading of equities and derivatives, and that we support the end-to-end process of the market, from listing companies, to trading, clearing and settlement of trades. When you get a CHESS statement in the mail, it comes from ASX.

The exchange model in Australia is an attractive model. It means that investors have access to a large, well-regulated, well-capitalised and efficient financial market place that can compete with the best in the world.

Market Capitalisation 31 March 2013 (A$bn)



Today, the ASX is a top-10 exchange in the world measured by market capitalisation. We rank ahead of exchanges such as the London Stock Exchange and NASDAQ. These exchanges operate in larger markets but have much narrower business models.

The ASX business model is similar to the business models of exchanges in Asia, including Singapore and Hong Kong. This matters given our ambition to be a financial centre and the opportunity that comes with the Asian Century. It also means that we should be careful and not simply copy market structures and regulations from Europe and the USA. Instead, we should keep an eye on what markets near us are doing.

Changes to our equity market

The way Australia's equity market operates changed fundamentally a few years ago. There are two significant drivers that created this.

- The first driver is technology. The progress of technology means that the speed with which information can be accessed and processed is ever increasing. New business models have arrived that leverage speed and technology; and they are challenging existing business models just like the internet is changing the way we all buy goods and services.

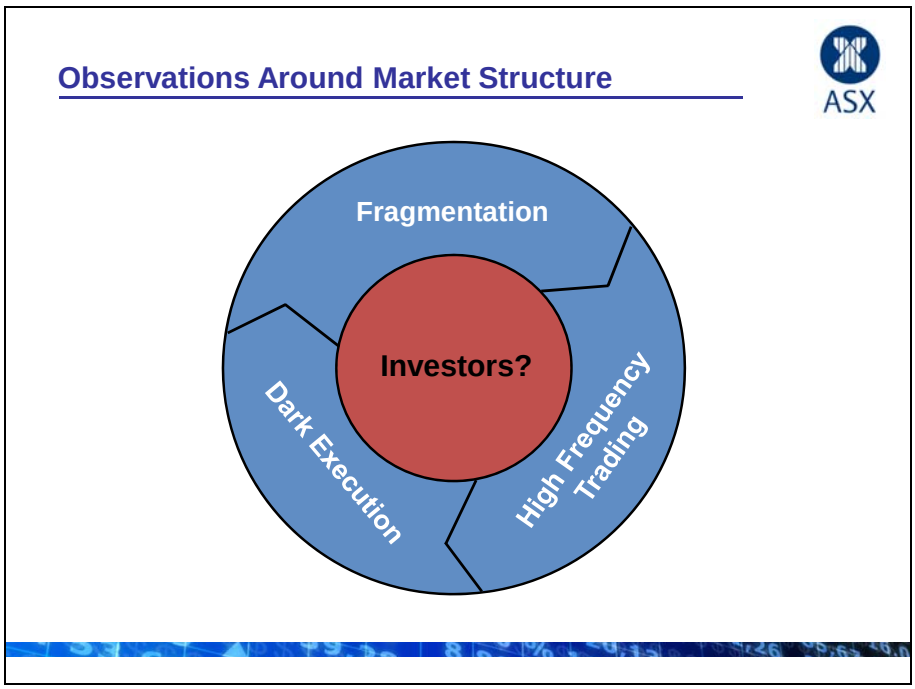
  An equity transaction that 25 years ago may have taken up to one minute to execute can now be executed in 150 micro seconds or less (a micro second is one millionth of a second). This is 400,000 times faster.

- The second driver is regulation. In many Western markets, governments and regulators have introduced competition in equities trading. Australia is no exception and around 18 months ago Chi-X opened for business. Australia now has two stock exchanges where brokers can send their orders for ASX-listed securities.

  The logic behind the change was simple: fees will come down, innovation will increase and new liquidity will arrive. It was a tempting proposition. Sadly, we now know that the outcomes are not quite as good as was anticipated at the time.

It is the combination of the two drivers - technology and changing regulations - that has created serious issues for some equity markets.

Here is what happened.



By introducing more than one exchange, regulators allowed markets to fragment. Liquidity that was previously concentrated in one place is now spread across multiple exchanges. There are two exchanges in Australia and as many as 14 exchanges in the USA.

Once a market fragments, it becomes easier to use technology and speed to arbitrage different markets and be in front of the queue. More queues mean that each queue is shorter and being in front of them is easier. High frequency traders are very good at doing this, being in front – it is what they do for a living.

I should point out that not all high frequency trading is bad and that ASX does not advocate its banning. High frequency trading is an umbrella term that includes a range of different trading strategies, including arbitrage strategies, market making and momentum trading. Some of these strategies contribute genuine liquidity.

Moreover, the use of algorithms is quite common. Several brokers in Australia use algorithms to execute genuine investor orders.

So, the story starts with fragmentation. But it is just the start of the story. In some markets like the USA, other regulatory settings support high frequency trading even further. The most problematic of these settings is a pricing model called 'maker-taker' pricing. I will not go into the maker-taker pricing model other than to say that it financially benefits high frequency traders. It is one of the reasons that high frequency trading has been as much as 70% of daily trading activity in the USA. It dropped back to an estimated 50% in 2012.

The good news is that this pricing model does not exist in Australia. In fact, it is better than that. ASIC charges part of its supervisory fees to participants based on the orders they put in the market, not just trades they execute. This means that players who create a lot of orders, but do few trades, pay a price for their behaviour. They tend to be the high frequency traders.

I am a strong supporter of ASIC's approach. It better aligns high frequency traders with the interests of the wider market. And it ensures that the users who create the activity pay for the costs of the activity. It is also relatively simple, and we know it works.

As a result of the measured approach by ASIC, high frequently trading is estimated to be around 22% of the Australian market. This is manageable.

After the economics are aligned, we should let innovation happen. We cannot regulate away the advancement of technology, or outsmart those who are smarter, even if we wanted to. It is the reason we are not in favour of technology-based solutions, such as 'speed limits' or minimum resting times. They are likely to be ineffective, will create new opportunities for algorithmic trading, and may have unintended consequences.

Let's get back to the story. We have seen that fragmentation leads to more high frequency trading. And once high frequency trading starts to grow we see an increase in the use of dark pools. It starts with fund managers who prefer not to disclose their intentions in the open (or 'lit') market, and who want to avoid interacting with high frequency traders. The ASX supports the ability of fund managers to execute larger block trades away from the lit market. It makes sense.

More recently, however, we are seeing smaller trades being executed in the dark. We call this internalisation. Brokers, particularly large ones, will try to cross trades internally without sending them to an exchange. In other words, your trade may not even hit the ASX or any other exchange. It may be executed away from ASX in a 'private exchange' somewhere that is not a licensed market.

Should you be worried about this? The answer is 'not very' at the moment, provided the regulators limit the use of internalisation engines.

In Australia, ASIC is once more on the case. Today, dark execution represents around 25-30% of the market. This again is manageable. And ASIC has proposed new controls that should at least limit how much can be internalised in dark pools. We support these measures.

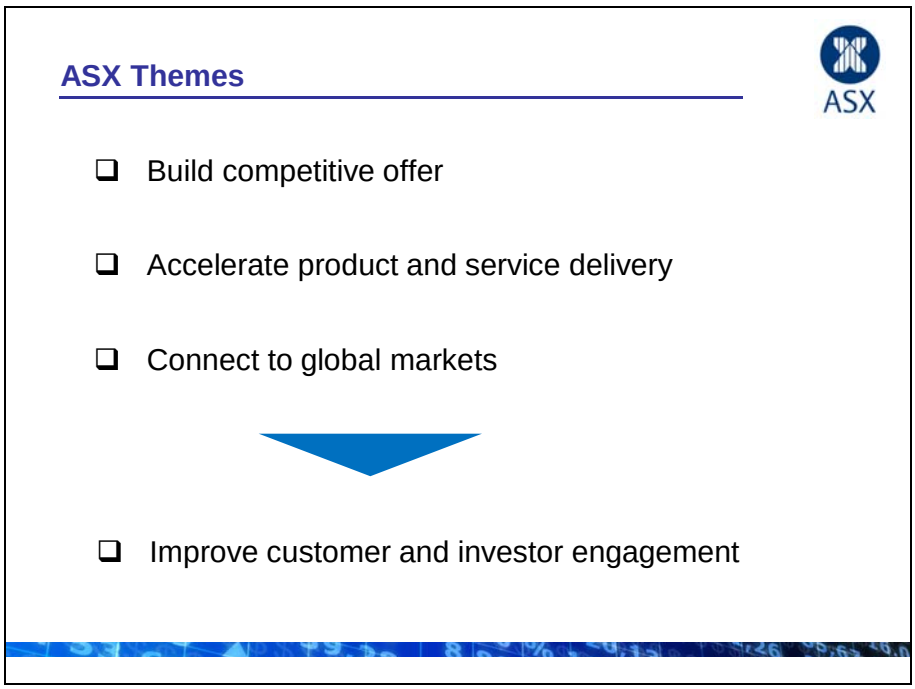
I am hopeful that by the end of this financial year we will have settled the various regulations and be able to enjoy a few years of peace. This will allow all of us to focus on growth and for ASX to get on with the investments we are making in the financial infrastructure of Australia.

ASX business plan and investments

The best way to succeed in this much more complex and competitive world is to invest in areas that will benefit our customers.

Our customer base is large. We deal with more than 2,000 listed companies and issuers. We count as our trading clients 90 participants in the equity markets and 44 participants in the derivatives markets, plus a similar number in clearing and settlement. Seventy-one of our clients are now co-located in our new data centre. We have around 400 clients that use our data services and have three exchanges as customers in clearing and settlement.

And together with our immediate clients, we serve millions of investors.



The ASX plans evolve around three key themes:

- The first theme relates to the change in market structure in our equities business. We have responded well to the changes. We have cut our fees, introduced new products and built a new data centre. This is a good start, and it shows in our performance. We now need to be more nimble and continue to respond to our customers' needs and changing regulations. And we will continue to engage closely with investors and regulators to ensure that our markets continue to be well-regulated.

- The second theme relates to accelerating the delivery of new products and services.

  In the limited time we have left I will focus on some of the initiatives that are most visible to you.

  We have been working hard to support the functioning and growth of our equity market. Several of our initiatives target the small and mid-cap sector, which is an important segment when measured by the number of companies. Today, around 1,600 companies fall into the small and mid-cap sector.

Selected Equity Market Initiatives

- **Listings**
  - Capital raising flexibility
  - Liquidity in small and mid-cap sector
  - Timetable for rights issues
  - Equity Research Scheme pilot
  - Guidance Note 8 on Continuous Disclosure
  - Enhanced reporting for mining, oil and gas
- **Product expansion**
  - Australian Government Bonds

Last year, we made it easier for small and mid-cap companies to raise capital, while making sure that investors are protected. Companies can now raise up to 25% of their capital base without specific approval, provided they get general approval for the program at their AGM. In the first year, almost 600 companies received AGM approval.

Staying with the small and mid-cap sector, we have been trialling a new Equity Research Scheme. This Scheme provides funding to create fact sheets and broker research on small and mid-cap companies that are generally not well covered by research. We are hoping that improved information will help companies connect with investors. We will decide in the next few months if we will extend the pilot, or move to a full program.

We will also soon ask for market input on a number of ideas to improve liquidity in the small and mid-cap sector, and we are working on a reduction in the standard rights issue timetable. This timetable currently is 26 days and we hope to get it down to below 20.

In the general theme of investor confidence we have recently completed two important pieces of work. We have updated Guidance Note 8, one of the most important guidance notes in our tool kit, which deals with the rules around continuous disclosure. And we have finalised the new disclosure rules for reserves and resources in the mining and oil and gas industries.

And finally, we will soon quote Australian Government Bonds on the exchange, making them available to retail investors. We hope that this will stimulate the development of a corporate bond market, which should provide new investment options to retail investors.

- The third theme relates to our connection to other markets. I'm not talking here about exchange mergers – rather working together and sharing expertise with other exchanges in areas where we can each benefit.

  A good example of this is how we are extending our data network, called ASX Net, to a number of other markets. By connecting our network to locations such as Singapore, London and Chicago, traders in those markets can efficiently connect to our market. And, of course, the improved global connectivity opens up opportunities for our customers in Australia to access international markets.

All of the initiatives I mentioned are designed to support the fundamental roles of our market in funding corporate Australia and providing investment opportunities to you. We look forward to delivering them.

Conclusion

In conclusion – the Australian market is large, healthy and working well. Our regulators are on top of the issues our markets face and are responding well and early to the risks we face.

In the meantime, ASX is working hard to deliver new products and services for our many customers, including retail investors who continue to have a sizeable presence in the Australian share market. That presence gives you power – your voice should be heard in the debates about the future of our markets.

Thank you for listening to my voice today.