



## ***'INDUSTRY AS SELF-REGULATOR: DOES IT WORK?'***

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### **Summary of key points:**

- The topic is timely and relevant because it is part of the broader debate about whether business is over-regulated. Over-regulation is an issue because of its potential effect of impeding long-term economic growth, and ultimately undermining consumer confidence.
- The key is to strike the right balance between:
  - Using regulation to support and complement business activity; and
  - Not adding excessively to the cost of compliance by over-regulating and stifling innovation and entrepreneurial drive.
- Self-regulation by industry is one of the tools available to alleviate over-regulation by governments.
- The way ASX supervises the market is a solution not part of the problem. We are getting the regulatory balance right, and that in part explains the current confidence in our equity markets and the record levels of capital raising and trading activity.
- We have an inherent or inbuilt incentive to get the balance right. We need effective supervision to instil confidence in our markets. At the same time, we need to ensure that over-regulation does not add to the cost of capital and to transaction costs. Jeopardising either will reduce our attractiveness to customers and damage our business. The standing of Australia's capital markets would also suffer.
- The outcomes of our supervisory review, announced in December 2005, help us strike the right regulatory balance. They will reinvigorate ASX's market supervision including by creating a new structure for market supervision and by providing extra resources.

## Introduction

Thank you for the invitation to return today and speak at my second ASIC Summer School.

Twelve months ago, and only 5 months into taking up my role at ASX, I spoke on corporate governance and the ASX Corporate Governance Council.

I'm pleased to be back, this time addressing the topic "Industry as self regulator – Does it work?" as part of the Summer School's overarching theme: "Keeping consumers confident".

It's a timely and relevant topic for a number of reasons.

Not least because it allows me to take you through the outcomes of our supervisory review, which we announced just before Christmas, and which will reinvigorate ASX's market supervision including through providing extra resources.

The topic is also timely and relevant because it is part of the broader debate going on in Australia at present about whether business is over-regulated. Over-regulation is an issue because of its potential effect of impeding long-term economic growth, and ultimately undermining consumer confidence.

The debate is not a simplistic one about no-regulation versus black-letter law regulation. Rather, it's one about degree. Self-regulation by industry is one of the tools available to alleviate over-regulation by governments. As ever, the debate is about striking the right balance between:

- Using regulation to support and complement business activity. That is, to set proper standards for corporate activity in areas such as governance, employee safety, and the protection of consumers, investors and the environment;
- While at the same time, not over-regulating or using regulation to impede economic growth, by stifling innovation or entrepreneurial drive, reducing productivity, limiting competition or imposing an excessively costly burden of compliance. And, in turn, adding extra costs for consumers.

The debate is a real and legitimate one. And it throws up issues of long-term consequence that need to be addressed. Full credit to the Business Council of Australia (BCA) and other industry bodies who are leading and engaging in this debate. Those industry bodies are concerned, broadly, that the microeconomic reforms of the last 20 years which were deregulatory in nature could be undermined by re-regulation. As Australia's current prosperity is tied to those reforms, there is a concern that re-regulation or over-regulation could impede future economic growth. I should make a disclosure here: I am a BCA Board member.

The problem of over regulation adding to the costs of doing business is particularly well demonstrated in a number of studies (e.g. by the OECD, the Productivity Commission, the 1996 Small Business Deregulation Taskforce and the BCA). It's also worth considering Australia's recent experience with the Financial Services Reform legislation as a case in point.

The Federal Government recognises this and last October set up a Regulation Taskforce to examine and report on areas where regulatory reform can provide significant immediate gains to business. It has reported to Government and we await the release of its findings. It was also pleasing that the communique issued after the Council of Australian Government (COAG) meeting last Friday endorsed that effective regulation should not be offset by unduly high compliance and implementation costs. It identified immediate "hot spots" to focus on.

So that's the debate – getting the balance right between effective regulation and over-regulation.

A fair question to ask the CEO of the ASX is – is ASX adding to the problem in the way ASX supervises the market ...or is ASX part of the solution?

My very firm response is that we're part of the solution – we are getting the regulatory balance right, and that in part explains the current confidence in our equity markets.

Let me spend a few moments backing up that claim.

I say that we are getting the regulatory balance right in five different ways:

- First, we have the right structure in place to manage our supervisory activities;
- Second, we promote principles-based self-regulation;
- Third, we consult widely when we make rules;
- Fourth, where there is complexity, we will seek to simplify; and
- Fifth, where regulatory intervention is necessary as a last resort, we will act.

I am going to expand on each of those in a moment but there is a further and more fundamental aspect about ASX that acts as a platform that supports and upholds our capacity to do each of those five things.

### **Getting the balance right – ASX's inherent incentive**

ASX gets the regulatory balance right not by accident or good luck but fundamentally because of what we are: a licensed market operator that is a listed company with obligations to a wide set of stakeholders – including, very importantly, our customers and our own shareholders.

This gives us an inherent incentive – an inbuilt incentive - to strike the right balance between effective regulation and over regulation.

Our markets are currently operating at record levels of capital raising and trading.

Our ability to retain our customers and attract new ones, is intrinsically tied to the confidence that they have in the integrity of our markets; which in turn depends on how well we operate and supervise our markets, and on the regulatory system in which we operate. Or to put it in simple terms, investors will not support or have confidence in markets that lack integrity.

At the same time, to keep our markets attractive for IPOs and other capital raisings, we need to keep our cost of capital low. To keep our markets attractive to the brokers and investors who bring their business to our markets, we need to keep our transaction costs low. If transactions costs rise relative to other markets, it can affect investment decisions.

In short, we have a twin imperative: the need to keep market integrity high, and the cost of capital and transaction costs low.

If we get it wrong – by having a poor regulatory system or making poor supervisory decisions that make our customers question our integrity, confidence in our markets will be weakened. We will lose our customers' business. ASX's business will suffer as will the standing of

Australia's equity markets. That will not be good for ASX's shareholders or for Australia's economy.

On the other hand, if we get the regulatory balance right, customers will be reassured and they will participate with us in greater volume, lowering the cost of capital and stimulating market growth. Brokers and investors will not seek alternate markets because of high transaction costs in Australia.

This inherent incentive - to get the regulatory balance right - is one of the strengths that a listed exchange such as ASX – working in cooperation with government regulators such as ASIC – brings to the equity markets.

The incentive to maintain this balance exists at government level. However, in the absence of focus and review, over-regulation can take over. Some measures of what seems to have been a shift to over-regulation come from the recent BCA study:

- In the period 2000 to 2003 the Federal Parliament passed the same volume of legislation as it passed in the previous 69 years.
- In 2003 Queensland added 8,700 pages of new legislation (the greatest volume) while South Australia added 1,001 pages (the lowest).

It is pleasing therefore - in addition to the creation of the Regulatory Task Force and the response of COAG - to hear the Parliamentary Secretary to the Treasurer, Chris Pearce, say in a recent speech that he and the Government were committed to a simpler regulatory system. He went on:

“I see a Simpler Regulatory System as a necessary component in securing that future productivity growth.

I believe that an effective framework regulating financial markets and corporations is a prerequisite for the market to function efficiently, for building market confidence and actually achieving future productivity growth.

Well-functioning markets essentially mean a “win-win” situation for business and consumers.”

That then is the key point: effective regulation that also achieves market efficiency, benefits both business and consumers. It builds the confidence of all participants.

With that background, let me detail each of those five ways in which we at ASX are actually operating to get this balance right.

## **1. We have the right supervisory structure in place**

First, I said that we had the right supervisory structure in place. This is an outcome from our review of market supervision that I mentioned earlier. The review has reinvigorated our supervisory activities and will enable us to keep a firm grip on our regulatory balance.

The supervision review was one of the first reviews we put in train when I became CEO of ASX in October 2004. It examined our supervisory role, structure and processes. We tested international models, spoke to other exchanges and consulted widely with stakeholders.

From 1 July this year, a new, separate, subsidiary company will manage all ASX's day-to-day supervisory functions. It will be called ASX Supervision, and it will have a board with a chairman and directors drawn equally from the ASX Board and elsewhere.

It will be headed by the Chief Supervision Officer (CSO), currently the Group Executive, Market Supervision. The CSO will not report to the CEO of ASX – as at present – but will report to the separate subsidiary board.

The CSO will make all operational supervisory decisions relating to our Operating Rules. This mirrors the existing practice where the GE, Market Supervision is responsible for such operational decision-making. The CSO will also chair the ASX Corporate Governance Council.

This initiative will strengthen the already high degree of confidence that participants have about ASX's provision of fair, orderly and transparent markets. It will also, I believe, put the perception of conflict of interest between our supervisory and commercial roles firmly behind us and completely out of play.

We recognise very clearly that it is in ASX's long-term business interests to ensure that we manage potential conflicts so that confidence in the markets is never jeopardised.

That's why, in addition to this new structure, the existing tiers of oversight of ASX's activities will continue, including:

- An annual assessment by ASIC as to how well we comply with our licence obligations to operate markets that are fair, orderly and transparent; and
- The work of ASX Supervisory Review, internal Group Compliance, and Board Committees such as the Audit & Risk Committee and Market Rules Committee.

With the new structure has come an improved funding mechanism to meet the actual costs of market supervision in a transparent fashion.

ASX will continue to fund supervision and the subsidiary company. The CSO will operate under a three-year rolling budget and be subject to the normal disciplines on efficiency, productivity and requests for additional funding as are imposed on regulatory bodies like ASIC, ACCC and APRA. The need for additional investment in supervision will be passed on by ASX in increased listing fees.

It is important to emphasise that we took these measures ourselves – they were not imposed on us. Our supervisory system has been and is working well. We decided to go the extra step to put the potential conflict issue "out of play".

## **2. We promote principles-based self-regulation**

We promote outcomes based on principles not black-letter prescription, and implemented where possible through self-regulation

Underpinning our supervisory approach is a commitment by participants and listed entities to behaviour that is ethical, honest, cooperative and transparent.

The vast majority of our listed companies – some 1800 entities – do act ethically and honestly, and in the spirit of the rules. This is a point which is often missed in the rush to "blame and to legislate". We are fortunate in Australia to have a good corporate culture. Such a culture makes it easier to adopt principles-based regulation and self-regulation.

The ASX Corporate Governance Council is an example of principles-based self-regulation working well. And ASIC specifically commended ASX for our work in this area in its most recent assessment of us.

ASX established the Council in the wake of the Enron and other corporate collapses in the US. The US authorities were responding with a legislative crack down – the now well-known Sarbanes-Oxley legislation which prescribed black letter rules for corporate behaviour. Sarbanes-Oxley has increased compliance costs of US companies and as a result has lifted the cost of capital in the United States.

In establishing the Council, ASX was explicitly seeking to avoid that kind of penalty – or regulatory overload - being imposed in Australia. That the Council has succeeded in this role is now well accepted.

The Council is made up of 21 peak business, investor and finance industry bodies and is chaired by ASX. As I detailed in my speech to last year's ASIC Summer School, the Council's recommendations provide a flexible rather than mandatory framework for disclosing governance practices. The results of our monitoring of corporate governance are available on the ASX website.

This is a clear example of ASX using self-regulation in a way that achieves a good outcome for the marketplace as a whole.

### **3. We consult widely when we make rules**

A fundamental element in striking the right regulatory balance is ensuring that all relevant stakeholders are consulted. This enables alternative views to be considered, helps understand the impact of new rules or regulations, and avoids problems emerging when it's too late to deal with them.

When ASX makes rules we consult widely. This is evidenced, for example, by the broad membership of the Corporate Governance Council.

When we propose a change to the Listing Rules, we can't simply write it and issue it. Any change needs full exposure to the marketplace for comment, including extensive dialogue with ASIC and Treasury.

Consultation is a key element in our newly created Regulatory Policy Unit (RPU). The RPU began work in October last year and reports directly to the ASX CEO. It makes recommendations on ASX's policy positions to the ASX Board. It forms a key component of our new structure – in that we have separated development of regulatory policy from operational supervision and enforcement.

The RPU consults widely, obtaining input on policy matters from ASX Supervision, ASX's commercial and legal divisions, and industry, and it will keep Treasury and ASIC advised and work with them. It is also positioned close to the market to allow ASX to quickly respond to market dynamics that require a change to our Operating Rules.

Keeping policy development separate from supervisory operations at ASX is as desirable as it is at government level with the distinction between Treasury and ASIC. The Treasury provides financial markets policy advice to the Government and ASIC enforces the Corporations Act. Similarly, it is for the RPU to formulate policy for the consideration of the ASX CEO and Board, and for the new supervisory company to monitor and enforce ASX's rules (i.e. supervisory operations).

#### **4. Where there is complexity we will seek to simplify**

One of the primary tasks of the new RPU is to manage the streamlining of ASX's Operating Rules.

Rewriting and simplifying our rules is an obvious way for ASX to reduce the red tape burden on participants and listed entities, and maintain the right regulatory balance. We announced this initiative as part of the supervisory review in December.

We will introduce more principles-based rules - without diminishing market integrity - that reduce complexity, unnecessary overlap with the Corporations Act and the costs of compliance.

We will also introduce sunset clauses and remove non-operating rules. We will develop new Guidance Notes to clarify the use of ASX's supervisory discretion and identify gaps in the existing rule framework.

These initiatives will ensure that our rules provide certainty for participants and remain relevant and up-to-date.

#### **5. Where regulatory intervention is necessary as a last resort, we will act**

Our supervisory approach relies on education and relationship building, and seeks to develop a culture beyond mere compliance that emphasises fair dealing, and promotes clear and timely disclosure. There is widespread acceptance of this approach by our participants and listed companies. This helps us get the regulatory balance right.

Of course, to bolster market confidence, we continuously monitor the market to detect behaviour that does not meet appropriate standards. ASX can employ methods of enforcement that prevent, manage or sanction inappropriate behaviour according to its severity. This could ultimately include referring participant matters to our Disciplinary Tribunal for possible fining. And we can suspend or de-list companies from our board. We also have a statutory obligation to refer matters to ASIC for further investigation and possible prosecution.

We will enforce when we need to:

- Last financial year we fined brokers \$533,500 for breaking our rules, applied 768 trading halts and 395 suspensions to listed companies, and notified ASIC of 107 suspected breaches of our rules or the Corporations Act.

We have committed significant additional resources to strengthen our monitoring and enforcement activities including via the:

- Creation of a specialist insider trading unit within ASX's Surveillance team, allowing us to be even more vigilant in detecting inappropriate trading behaviour; and the
- Upgrade of our technological and other systems, including our real-time electronic market monitoring and alert system, SMARTS.

## Have we got the balance right?

We believe we have the balance right between regulation and enforcement which is effective, and over-regulation which may add unnecessary cost or impede growth. You may say how do we judge if we have the balance right?

There are no specific measures which are applied to assess the performance of whether entities involved in regulatory and supervisory functions have the right balance.

Following our supervisory and other reviews, ASX will develop measures to place more emphasis on customer feedback through both quantitative and qualitative surveys. We will in these surveys better assess our performance in getting the balance right using more objective criteria.

While we may not have specific measures as yet, we can point to other things which support that we are getting the balance right:

- Confidence which exists in our markets at an international level from investors investing in our market;
- Our lower transaction costs compared to markets such as Hong Kong and Singapore; and
- Our lower costs of capital which encourage record levels of IPOs and other capital raisings.

Then there is the result of statutory oversight.

In ASIC's most recent report, the regulator found that ASX: "continues to function as an effective and reliable market"<sup>1</sup>. It concluded that ASX has adequate arrangements for supervising the markets we operate, including arrangements for handling conflicts between our commercial and supervisory responsibilities, for monitoring the conduct of participants in the market, and for enforcing compliance with our rules. At the same time ASIC flagged a number of areas for further improvement and ASX has accepted and actioned all of those.

We recognise, however, that there will be room to improve. Our most recent changes, announced last December, indicate willingness on ASX's part to improve and to do so in a proactive way, before the need to do so may be thrust upon us.

## Conclusion

Let me conclude by going back to the question which I posed as to whether ASX sees itself as part of the problem or the solution in the debate on over-regulation.

Our answer is that we see ourselves very much as part of the solution.

There is in the ASX structure an inherent incentive which drives us to seek to get the balance right. We need effective supervision to instil confidence in our markets. At the same time, we need to ensure that over-regulation does not add to the cost of capital and to transaction costs. In that way, we will continue, as an equity market, to punch above our weight in the region and internationally. After all, equity markets are global businesses with global competitors.

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<sup>1</sup> 'ASIC releases annual ASX assessment', ASIC media release, 19 July 2005