

# **The development of Australia's capital markets**

Discussion Paper

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Association of Superannuation Funds of Australia

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## The development of Australia's capital markets

The Association of Superannuation Funds of Australia welcomes the statement made on 20 November 2012 by Minister for Financial Services and Superannuation the Hon Bill Shorten MP outlining the Government's proposed reforms to high frequency trading and dark pools and the intention for Australian Treasury to conduct a review of Australia's financial market licensing regime.

The structure and conduct of Australia's equity market is of particular importance to the superannuation industry.

As at December 2011 Australian superannuation funds had \$435 billion invested in the ASX. According to Rainmaker Information, 95 per cent of superannuation fund investment in Australian equities is in ASX 200 companies. The five per cent of Australian equities funds invested outside of the ASX 200 equates to around \$21 billion or around 15 per cent of the total small cap market.

With compulsory superannuation contributions continuing to flow into the superannuation sector, it can be anticipated that over the coming decade superannuation funds will continue to make new allocations to Australian equities that will provide the capital for Australian businesses to grow. Australia's superannuation sector therefore has a material interest in the future composition and structure of Australia's capital markets.

ASFA has recently established a dialogue with the ASX around a number of areas of concern. ASFA wishes to ensure that the role of the superannuation and retirement system, as the largest collective investor in the ASX, is understood among regulators and policy makers.

ASFA will be providing a submission to the Government's review of Australia's financial market licensing regime. This discussion paper represents ASFA's initial thoughts in regards to the overall structure and conduct of Australia's equity markets. ASFA will be establishing a working group to discuss the development of Australia's capital markets. ASFA members who are interested in contributing to ASFA's work on developing Australia's capital market should contact:

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## Clearing and settlement

ASFA notes the significant debate around proposals to introduce competition into clearing and settlement in the Australian market. We welcome the Government's announcement that Treasury will conduct a review of Australia's financial market licensing regime as this will provide an opportunity for a transparent and open discussion on the benefits or risks of any change.

ASFA has yet to be convinced that there are any advantages of introducing competition in an economy and market the relative size of Australia. In particular we are concerned that the leakage of settlement to competitors may fragment the market and impact liquidity, which may have a negative impact on management of the super pool.

Our greater concern is around the issue of market liquidity. While the top end of the market consists of companies that are heavily traded, among the bottom end of the market there are significant issues around liquidity. ASFA has been in dialogue with the ASX around changes to capital raisings rules and broker research that aim to address liquidity at the bottom end of the market.

ASFA's interest in liquidity relates to the retirement system's specific regulatory structure. Under choice of fund legislation, superannuation provider members have the right to move their superannuation account balance to another fund within 30 days. Superannuation provider members can also enact investment choice within a fund.

The implication of choice of fund legislation is that superannuation providers must actively monitor and manage the liquidity of investments. The Government's legislation that has provided APRA with prudential standards making power will require superannuation providers to enhance their risk management practices, with a particular focus on stress testing portfolios for liquidity of investments at times of market stress.

The implication of parts of the market becoming illiquid, or less liquid, may be that superannuation providers would need to reduce the amount of investment that is allocated to these areas of the market. The reduction of superannuation capital could have a significant impact on the ability of parts of the ASX market to grow over time. ASFA recommends that the Government should consider any changes to clearing and settlement on the basis of the impact on future market liquidity.

## High frequency trading

ASFA welcomes proposed new rules provided for high frequency trading (HFT) that will include 'kill switches' to immediately stop an algorithm if required. ASFA has concerns that HFT is creating a market environment which is leading to increased market volatility. While circuit breakers have addressed the so called 'fat thumb' problem, we are aware of significant concerns around messaging and other market behaviour which have the potential to make investments more volatile. The volatility of investments is a core area of concern for the superannuation system, particularly impacting on the confidence of superannuation provider members.

## Dark pools

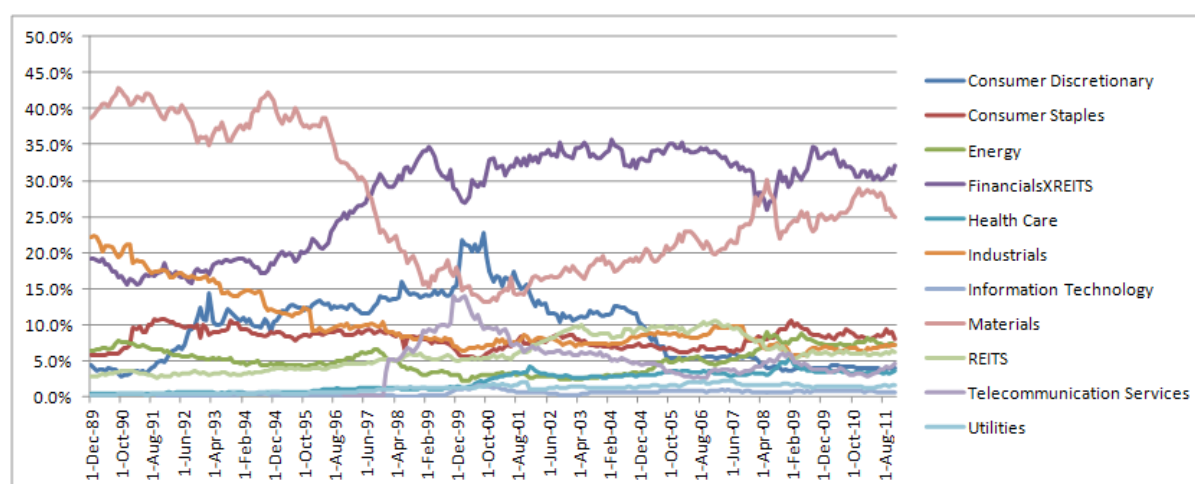
ASFA notes the Government's proposal to examine the licensing of dark pools. ASFA is concerned dark pools and dark execution have the potential to impact on the liquidity of the lit market. While we understand that in deep and liquid US capital markets dark pools can play a role in reducing transaction costs, we are concerned that in the Australian context dark pools could impact on the level of liquidity of ASX-listed companies. The need for the superannuation system to invest in liquid investments, which derives from the legislative and regulatory structure of superannuation, means that the Government should take particular notice of the emergence of dark pools. ASFA supports improved transparency around dark pools. In considering the overall benefits of dark pools it is important to take into account the impact that the growth in this form of trading would have on liquidity in the lit market.

## Market diversification

ASFA is of the view that it is in the long-term interest of superannuation fund members to encourage the diversification of the ASX. A diversified ASX provides superannuation funds with a broad range of investment opportunities which enables funds to invest according to their different risk and return objectives.

One of the issues that Australian superannuation vehicles face investing in the ASX is the ability to diversify across industry sectors. Table 1 tells the story of the resources sector in Australia and its influence on the ASX over the last 20 years. In the early 1990s the materials sector peaked at 45 per cent of market capitalisation of the ASX 200. Over the next decade this declined until it was below 15 per cent by the turn of the decade. Over the last 10 years the materials sector has steadily climbed, hitting over 30 per cent in 2010. Among the small and medium cap market concentration risk to the mining, resources and energy sectors is higher, accounting for over 50 per cent of the market.

**Table 1: Industry sector composition of ASX 200**



Source: State Street Global Advisors

Australian superannuation funds and advisers are conscious of the level of concentration risk in Australia's equity markets. This is an issue that providers manage day-to-day according to their investment views on commodities. ASFA believes that the superannuation system has a role to encourage the development of the ASX in a way that facilitates future investment as part of its role to deliver to the public good.

A recent focus of the ASX has been to target listings in the resources sector. An example of this is that the ASX now has 15 listed companies from Mongolia principally due to the on-the-ground engagement of the ASX in Mongolia. ASFA notes there are a significant number of ASX-listed resource companies that are active globally, with 186 companies actively exploring or producing in Africa alone.

The fact that Australian companies are active on a global basis provides investors with an ability to gain exposure to the global economy. However it also introduces risks that must be managed. The superannuation sector understands the importance that environmental, social and governance (ESG) factors can play in delivering long-term investment returns. Over the last five years a significant number of APRA-regulated superannuation funds have signed up to the United Nations Principles for Responsible Investment. A great deal of work is being done by these funds to build their capacity to understand and manage ESG risks across their portfolios.

ASFA is concerned that small and medium cap companies are particularly exposed to human rights risks when operating in developing and under-developed countries. In the US the Securities and Exchange Commission (SEC) has been required to issue new rules around disclosure practices for resources companies that operate in conflict zones. There is an international body of work around this focused on the Extractive Industries Transparency Initiative that requires countries to disclose revenues from resources in order to stop bribery and corruption in developing countries. The SEC move, which came from a Congress directive, will in the end set a new standard for disclosure of resources companies. Given the dominance of resources companies in the ASX, the SEC model could be considered in the Australian context.

ASFA is concerned that there has been insufficient attention paid at both a market, regulatory and policy level on the implications of encouraging a diversified capital market. The long-term impact of concentration risk is that in order to achieve portfolio diversification, superannuation funds will allocate new funds outside of the ASX. To the extent that concentration risk increases, this has the potential to have a long-term impact on the allocation by the superannuation sector to Australia's capital market. ASFA has been exploring ways in which market diversification can be encouraged and will be engaging stakeholders around policy options in 2013.