Submission to Financial System Inquiry
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My submission concerns how Australia can improve its regulation of the financial sector to enhance the funding of economic growth, provide higher superannuation returns to cater for an aging population and reduce systematic risk so as the reduce the likelihood of another GFC enveloping the Australian economy. I believe that if my proposed regulatory reforms are pursued then outcomes for the consumers of financial sector services will also improve.

In this submission, I propose two major regulatory reforms:

(1) for APRA to no longer require every APRA-regulated firm to adopt exceedingly counter-productive corporate governance requirements that the Australian Security Exchange (ASX) Corporate Governance Council (CGC) have had in place since 2003. In an attached working paper, I show that these requirements relating to just one of many regulations, the requirement to have a majority of "independent" board members, has already cost large Australian listed companies approximately $85 billion. All listed companies with the exception of APRA-regulated companies have the option to opt out. This opt-out provision takes the form of "if not, why not" such that only a public explanation is necessary as to why the firm does not meet the requirements.

(2) For the Australian Security Exchange (ASX) (and Chi-X) to replicate the transparency regime that was adopted by the Korea Stock Exchange in 1996, namely to display in real time to all participants the broker identities of the largest buying and selling brokers and their order imbalance in every stock on an *ex post* basis. An inferior version of the very successful Korean scheme which has made the Korean market one of the most liquid in the world was in place on the ASX market until November of 2005. The abandoned ASX scheme was confined to just brokers with only brokers able to see the broker identities of other brokers in the limit order book on a real-time basis. Hence, the ASX design was both *ex-ante* and *ex-post* transparent with transparency confined to just one class of participant. ASIC originally gave its approval for the removal of transparency based on partial and incomplete advice. ASIC can now assert itself and ask the ASX to trial a far better system than the ASX abandoned in 2005.

Corporate Governance Regulatory Structure

Commencing in 2003 the Australian Securities Exchange (ASX) Corporate Governance Council (CGC) has required that all listed firms either adopt a majority of "independent" board members without links either to management or to substantial shareholders (i.e., 5% or greater shareholding) or explain "if not, why not". While this close to a global standard, it is the opposite to US exchanges who also require "independence from management" but are explicit in stating that significant shareholding need be no barrier to independence from management. Within a framework of both fixed firm and year effects, we show that firm performance declines

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significantly as both Regular and Incentivized “Gray” directors depart the firm to make way for “Independents”. We estimate the cost of the performance decline to be AUS $85 billion (5.1%) over the period 2002-2012 in the form of destruction of shareholder value, with a $17.8 million (2.17%) rise in CEO pay and another $2.1 million (1%) rise in director fees.

According to the ASX CGC’s 2014 Exposure Draft, there has been a further tightening of the rules with (6) and (7) being added below:

“A director of a listed entity should be characterised and described as an independent director only if he or she is free of any interest, position, association or relationship that might influence, or reasonably be perceived to influence, his or her capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally.

Examples of interests, positions, associations and relationships that might cause doubts about the independence of a director include if the director:

(1) is, or has been, employed in an executive capacity by the entity or any of its related entities and there has not been a period of at least three years between ceasing such employment and serving on the board;
(2) is, or has within the last three years been, a partner, shareholder, director or senior employee of a professional adviser or consultant to the entity or any of its related entities;
(3) is, or has within the last three years been, a material supplier or customer of the entity or any of its related entities, or an officer of, or otherwise associated directly or indirectly with, such a supplier or customer;
(4) is a substantial shareholder of the entity or an officer of, or otherwise associated directly or indirectly with, a substantial shareholder of the entity;
(5) has a material contractual relationship with the entity or its related entities other than as a director;
(6) has close family ties with any person who falls within any of the categories described above; or
(7) has been a director of the entity for more than 9 years.

In each case, the materiality of the interest, position, association or relationship needs to be assessed to determine whether it might interfere, or might reasonably be seen to interfere, with the director’s capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally.”

Rules (1) to (3) and (5) seem designed to exclude so called “Gray” directors with some association with management that might actually make them more knowledgeable about the firm and industry than an “independent” director chosen in part for their lack of firm/industry experience while rule (4) is designed to exclude as directors a significant shareholder who have the strongest incentive to become informed and thus act as an effective monitor.

The Australian Government regulator, the Australian Prudential Regulatory Authority (APRA, 2012, Prudential Standard CPS510) has adopted the precise ASX rules on “independence” for banks and financial firms without leeway in terms of an “if not, why not” provision such that the requirements are in no way voluntary. This means that the weakened corporate governance due to firms adhering to these rules is likely to be worse for the financial sector than for any other sector. Replacement of knowledgeable and incentivized Gray directors by independents in order to achieve a majority is a more severe problem for the financial sector than any other sector as it is not voluntary.

If the advice provided by the ASX CGC was soundly based on excellent quantitative research then is rather strange delegation of regulatory decisions from the regulator, APRA, to what is in reality little more an a lobby group might be acceptable. However, Alan Cameron, the chair of the CGC, describes the Council as a "grand consensus of 21 groups representing everyone from company directors to accountants, stockbrokers, industry funds and shareholder groups…that avoids government imposing detailed corporate governance rules." (Andrew White in *The Australian*, 28/03/2014). Delegates receive advice from their constituents but the Council does not carry out any research of its own and I am not aware of any of the constituent groups carrying out their own research. Nor is it correct to say that Council's recommendations avoids government imposed detailed corporate governance rules as APRA's enforcement of the ASX CGC rules means that wealth destroying and unjustified rules are imposed on a large portion of the Australian economy with no mechanism to opt out.

I present the full study,[†] which is currently being extended and updated, as an attachment. My recommendation is that the ASX CGC be effectively closed down and APRA cease to accept and enforce its rules that are damaging to the economic health and stability of the financial sector and acts as a huge and unjustified tax on the entire sector. I do not believe that either APRA or the ASX CGC knows enough about the individual history and governance mechanism appropriate for every firm within the financial sector to be able to justify a rigid set of rules representing black letter law. By all means, APRA can facilitate research and help to distribute and publish good research on the topic in conjunction with ASIC but providing recommendations or mandating rules as is the case in the USA is a step too far.

System of Ex-Post Transparent Stock Exchange with Public Display of Broker IDs

The working paper on which this second part of my submission is based is attached and is by Thu Phuong Pham, Peter L. Swan, and P. Joakim Westerholm, entitled, "Shining a Spotlight on Counterparty Identity in the World's Best-Lit Market".

In summary, the study finds: "We study the impact of post-trade broker identity disclosure on market efficiency, trading volume and bid ask spreads in a unique South Korean Korea Exchange experiment that created the World's best-lit market. Using a broad panel dataset of Korea Stock exchange listed stocks we find that simply revealing the ex-post order flow of the major brokers to the entire market improves market efficiency and increases trade volume both economically (24%) and statistically. Accounting for the variety of trade characteristics and stock liquidity levels in the sample, we measure liquidity providers' profits and information-effect component of spreads using trade-time benchmarked realized spreads and corresponding trade-time market impact. We find that both effective and realized spreads fall indicating greater competition between market makers and liquidity suppliers, and higher liquidity in the

[†] Peter L. Swan, 'Does Board "Independence" Destroy Corporate Value? Outcome of a Quasi-Natural Experiment', working paper, 28/03/2014, Australian School of Business, UNSW.

transparent period. These results suggest that transparency of counterparty identity post-trade is a viable policy for markets that wish to improve market efficiency and liquidity."

A second paper examining the performance of the ASX market over the period from one-year prior to the market going opaque to one-year post is almost complete and should be available soon. This study shows that when the market became opaque price discovery greatly worsened and stock liquidity declined. The first paper that examines the introduction of full ex-post transparency on the South Korean market finds in more detail as follows:

"Our study contributes to the literature with several novel findings. First, this is the first empirical paper to examine the impact of the post-trade broker identity disclosure on market efficiency. Employing the variance ratio test (Lo and MacKinlay, 1988) on two-day, ten-day, fifteen-day and twenty-day horizons returns over one-day returns, we document that previously negatively serially correlated returns at the daily level instead follow a random walk over the three longer horizons after post-trade transparent broker IDs. Our findings are supported by theoretical predictions made by Campbell, Grossman and Wang (1993) who predicted that informed trades do not result in serial correlation. Avramov, Chordia and Goyal (2006) also provide empirical support for these predictions. Thus simply revealing the ex-post order flow of the major brokers to the entire market, as in the Korean experiment, eliminates the mean reversion in daily price changes arising from noise trading. This result has important implication for exchanges indicating that any return predictability of future stock price based on today's prices is possibly simply due to an anonymous trading protocol. The transparency level is particularly important in a market dominated by uninformed noise traders as these rely on information from the order flow.

Second, we find that trading volume increases by 24% for all stocks when the public has access to the broker identities even after controlling for the determinants of trading volume and inclusion of a trend factor. The volume of the largest and least volatile stocks increase the most (50%), while there is no change in the trading volume of the smallest and most volatile stocks. Hollifield, Miller, Sandås and Slive (2006) establish that traded volume is a natural indicator of gains from trade. While some of the traded volume is liquidity driven (often classified as noise trading) and some of the volume is information driven, greater traded volume is generally likely to be associated with greater liquidity and faster price discovery. Although readily measurable and widely followed by market participants, most of current studies just include volume as a control variable in their analysis.

Third, we examine liquidity providers' profit using different intervals of trades, not calendar-time as in conventional measure to mitigate potential biases due to vastly differences in stock liquidity levels and trade rapidity since our data includes most of stocks in the KRX. We find that when broker IDs are public post-trade, the effective spread is significantly lower as a result of a large reduction in realized spreads. This is a strong indication that the higher competition between liquidity providers and a more informed order flow in transparent markets lead to lower costs of transacting per se. The effect is stronger in the low volatility stocks which are larger and where most trading interest manifests itself. By definition, the changes in effective and realized spreads must be offset by the change in market impact, see Boehmer (2005), Boehmer, Saar and Yu (2005) and Hendershott and Jones (2005)."

END OF SUBMISSION